Source: Estate Planning/California Will Drafting/Contents

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Preface

When CEB published its first book on will drafting nearly 40 years ago, estate planning was a much different field of practice than it is today. In 1965, there was no durable power of attorney, and living trusts were just gaining popularity. Wills were the primary estate planning document. For many clients today, wills remain the primary vehicles for testamentary transfers. For all clients, wills are an integral part of a comprehensive estate plan.

Continuing the tradition established by its predecessors, California Will Drafting (Cal CEB 1965) and California Will Drafting Practice (2d ed Cal CEB 1982), this book is designed for the California attorney who, regardless of specialty, is called on to draft a will or prepare an estate plan. Updating and replacing the 1982 edition, the third edition reflects changes in the law since 1982 as well as current practical needs of estate planning attorneys and their clients. The organization of the book mirrors that of a typical will.

Because a will is usually part of an estate planning package, this book is intended to be used with other CEB estate planning publications. See California Powers of Attorney and Health Care Directives (Cal CEB 2008), Drafting California Revocable Trusts (4th ed Cal CEB 2003), and California Estate Planning (Cal CEB 2002).

CEB has paid special attention to the forms in this book. Illustrative forms follow each discussion of substantive law. The appendixes include sample wills, drawn from the forms in the text, which address situations that practitioners typically encounter.

The forms have been designed for use on word processing systems. Certain format decisions have been made to facilitate this use:

- The number of choices that must be made within each clause has been kept to a minimum. To the extent possible, each clause stands alone.
- The forms use gender neutral language. CEB has avoided the use of "he or she" by supplying functional descriptions (*e.g.,* executor, trustee, guardian) or by designating the use of a proper name.
- Brackets have been added before and after spaces to indicate places in the will where the attorney must supply some information. A search for an opening bracket, therefore, will take the user directly to a place where information must be added. A description of the information to be supplied has been included within each set of brackets.
- Each clause has a number and descriptive title.

CEB owes a special debt of gratitude to 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 Contents page and at the beginning of his or her chapter.

The CEB research attorney in charge of this project was Pamela J. Jester. She was assisted by CEB attorneys Carine M. Archer, Elizabeth W. Callaway, Robert N. Nakatani, Ruth Ratzlaff, Carol S. Sanders, and Richard B. Stevens.

Senior editor Maryann Aberg handled copyediting and production on this book. Legal research assistance was provided by Camille Bristow, Samuel R. Cacas, Elliot Cohen, Enrique De Anda, Duane de Joie, Elianne de la Vega, Maria Donohoe, Paula Hyman, Rachel Greenberg, Glenn Robert Hodge, Sue Homer, Rebecca Lackey, Bonnie J. Lamb, Kenneth Marr, Kenneth E. Scudder, Kate Sheppard, Mindy Spatt, Mujahidun Sumchai, Carolyn Valley, Martin Weis, Amy E. Wheat, and Tova L. Zeff.

The book was designed by Grier Thornburg. The index was prepared by CEB's Indexing staff. Composition was performed by CEB's Electronic Publishing staff.

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CEB Attorney Editor Robert Denham and Legal Editors Sally St. Lawrence and Kristin Schwaighart contributed to this update. Administrative support was provided by Kenya Denman and Nila Kanzaria. Paul Green handled copyediting and production. Kathryn Te Selle updated the index. Composition was performed by CEB's Electronic Publishing staff.

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Chapters 4, 11, 27, 31, and 37 were prepared by CEB staff attorneys.

Chapter 11 is based in part on California Will Drafting Practice, chap 10 (Cal CEB 1982), which was written by William A. Farrell (deceased) of San Francisco.

Chapter 27 is based in part on California Will Drafting Practice, chap 9 (Cal CEB 1982), written by Theodore E. Calleton of Los Angeles.

Chapter 31 is based on California Will Drafting Practice, chap 14 (Cal CEB 1982), written by Raymond G. Ellis of Orrick, Herrington & Sutcliffe, San Francisco. In preparing chap 31, CEB staff attorneys received generous assistance from Elizabeth Anne Bird of San Francisco. Ms. Bird is a Certified Specialist in Estate Planning, Trust, and Probate Law and is a co-author of Estate Planning for Special Assets (Cal CEB 2004).

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Source: Estate Planning/California Will Drafting/Selected Developments

Selected Developments

November 2009 Update

In *Chang v Lederman* (2009) 172 CA4th 67, 172 CR3d 67, the court held that a disappointed prospective heir could not sue an attorney who declined to draft estate plan amendments allegedly desired by the attorney's dying client. See §1.6.

In *Murphy v Murphy* (2008) 164 CA4th 376, 78 CR3d 784, the court held that a disinherited child was precluded from asserting that an estate plan executed in accordance with a substituted judgment order violated a will contract made by the conservatee and the conservatee's predeceased spouse. See §1.10B.

The IRS has issued final regulations providing that a practitioner may not sign a tax return as a preparer unless there is substantial authority for each position taken on the return or there is a reasonable basis for each position and each position is adequately disclosed to the IRS. See §1.20B.

In *Baker Manock & Jensen v Superior Court* (2009) 175 CA4th 1414, 96 CR3d 785, the court held that a law firm that drafted a decedent's estate plan could represent the personal representative of the decedent's estate, in either the representative's personal or fiduciary capacity, in litigation against another beneficiary of the estate. See §1.34.

In *Estate of Clementi* (2008) 166 CA4th 375, 82 CR3d 685, the court held that the disqualified person statute did not apply to a will drafted by an accountant that was executed and witnessed in Pennsylvania by a resident of that state who later moved to California. The court also held that a devise to fund "a charitable foundation or trust in my name" was valid even though there was no further description of the foundation or trust. See §§1.35B, 7.12.

In *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502, the court held that an agreement waiving the rights of an omitted spouse to share in the testator's estate need not meet the requirements for a valid premarital agreement. See §10.7.

In *Estate of Chambers* (2009) 175 CA4th 891, 96 CR3d 651, the court held that a preponderance of the evidence was not sufficient to establish a natural parent-child relationship. See §10.9A.

In *Marriage of Brooks & Robinson* (2008) 169 CA4th 176, 86 CR3d 624, the court held that requirements for a valid transmutation agreement do not apply to the initial purchase of separate property or joint tenancy property from a third person with community property funds. See §10.11.

In *Marriage of Lund* (2009) 174 CA4th 40, 94 CR3d 84, the court held that an agreement purporting to convert separate property to community property will not be interpreted as being effective only if parties are still married when one of them dies. See §10.11A.

In *Vernoff v Astrue* (9th Cir 2009) 568 F3d 1102, the court held that a posthumously conceived child was not a presumed natural child of the deceased father because the deceased father did not knowingly donate his sperm and did not consent to its use. See §12.29A.

In *Estate of Shellenbarger* (2008) 169 CA4th 894, 86 CR3d 862, the court held that the decedent's natural father was his heir even though he never saw the decedent during his lifetime. See §12.30.

The IRS has ruled that the protection accorded conservation easement grants from deemed disposition of special use property does not apply to sales or exchanges. See §13.17D.

The IRS has issued proposed regulations that would disregard trust document provisions specifying the sources of income to be used for payments to charity if the provisions have no economic effect independent of income tax consequences. See §14.82.

The update has an expanded discussion of gift taxes on the disposition of a QTIP income interest. See §§19.8-19.8B.

In *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 87 CR3d 413, the court held that a trust can be modified with the agreement of all current beneficiaries even if the trustee has the power to name additional beneficiaries. See §23.2.

The update has an expanded discussion of the risk of reduction of the marital or charitable deduction associated with boilerplate residuary tax payment clauses. See §26.24.

In *Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494, the appellate court held that a trial court may award fees for services rendered in connection with objections to the trustee's accounts even though the court has not yet ruled on the

objections. See §28.29B.

In *Estate of Bowles* (2008) 169 CA4th 684, 87 CR3d 122, the court held that a trust remainder beneficiary had standing to sue either the trustee or third parties or both for breach of trust, even after a successor trustee was appointed. See §28.51.

The legislature has amended Prob C §16361 regarding the allocation of deferred compensation and similar payments between principal and income. See §30.17.

In *Farb v Superior Court* (2009) 174 CA4th 678, 94 CR3d 586, the court held that the 1-year limitations period for filing an action based on a liability of a decedent was not tolled during the minority of the claimant. See §33.7.

In *Estate of Felder* (2008) 167 CA4th 518, 84 CR3d 220, the court held that an estate was entitled to retain the entire deposit of a defaulting purchaser of real property even though the estate owned only a one-half interest in the property. See §33.15A.

The update has an extensively revised discussion of no-contest clauses reflecting the new statute that takes effect January 1, 2010. The new statute generally provides for enforcement of no-contest clauses only with respect to direct contests brought without probable cause on specified grounds. The new statute eliminates widely used provisions for declaratory relief (safe harbor petitions) to determine whether a proposed action would violate a no-contest clause. The revised discussion includes a number of recent decisions under the old statute that might still apply to clauses in documents that became irrevocable before January 1, 2001. See §§35.9-35.9F.

In *Estate of Kelly* (2009) 172 CA4th 1367, 91 CR3d 674, the court held that a will may be admitted to probate at any time before distribution of the estate unless the proponent of the will has been served with a notice of petition to administer the estate. See §36.11.

Changes to Forms: The sample form of retention in trust for a young person until a specified age in §12.81 has been slightly revised ("pay to or apply for the benefit of") in paragraph 2.

An optional termination clause has been added to the mandatory charitable annuity trust proration clause in §14.60.

Sample forms providing for consideration of a beneficiary's other resources have been slightly revised to refer to resources "readily" available for specified purposes. See §§19.26, 21.16, 23.34.

The sample form of execution and attestation clauses in §36.16 has been revised to eliminate a reference to the witnesses' beliefs that the testator is of sound mind and is not being unduly influenced by another. Witnesses often may have no basis for such beliefs.

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Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of July 28, 2009, and monitored developments through August 15, 2009.

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Professional Responsibility

Thomas R. Bennett

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3. Attorney and Other Fiduciaries Disqualified as Beneficiaries §1.35
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    b. Exceptions to Disqualification §1.35B
4. Form: Certificate of Independent Review §1.36

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.1 I. WILL DRAFTER AS ESTATE PLANNER

§1.1 I. WILL DRAFTER AS ESTATE PLANNER

In practice, will drafting is just one aspect of estate planning. Estate planning is the process of:

- Gathering information about the client's personal and financial situation;
- Aiding the client to formulate his or her postmortem objectives; and
- Making recommendations and preparing documents to achieve these objectives in an efficient and cost-effective way.

Proper planning requires consideration of assets not subject to disposition by will or living trust as well as assets that are.

Estate planning often necessitates preparation of more than just a will. For example, life insurance, employee death benefits, and other assets not controlled by the will may require special attention. Clients with spouses or domestic partners holding title to assets as joint tenants may take advantage of a formal property agreement to affirm the community property character of all or some of their assets. Other clients who own assets with one or more persons may need advice on the best manner to hold title and may even need a formal agreement about the character, management, and sale or buy-out of the co-owned asset. See §§10.11-10.11C; California Real Property Sales Transactions, chap 4 (4th ed Cal CEB 2007). Living trusts, lifetime gifts, transfers for consideration, and other nontestamentary devices may be required to avoid probate and minimize federal and state tax burdens for clients with larger estates. See California Estate Planning (Cal CEB 2002); Drafting California Revocable Trusts (4th ed Cal CEB 2003); Gallo, *Advanced Estate Planning for the Larger Estate*, Estate Planning 2006, chap 10 (Cal CEB 2006).

PITFALL: Most attorneys have encountered clients who, believing that their affairs and intentions are simple, want only a "simple" will and not an estate plan. These clients assume that the attorney's job should be correspondingly simple. The attorney who habitually accedes to such a client's wishes and functions as a mere scrivener does so at his or her peril. If, for example, the client's estate later incurs significant probate costs and estate taxes, its beneficiaries may sue the attorney for malpractice, claiming that the attorney should have informed the client of the options available to minimize probate fees and death taxes, *i.e.,* that the attorney should have done estate planning for the client.

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II. AVOIDING MALPRACTICE

§1.2 A. Standard of Professional Skill and Care

An attorney must use the skill, prudence, and diligence that attorneys of ordinary skill and capacity possess and exercise under similar circumstances. 2 Mallen & Smith, Legal Malpractice §19.2 (5th ed 2000). An attorney who fails to meet that standard when drafting a will can be held liable for any resulting damage to the client's beneficiaries or heirs. 4 Mallen & Smith, Legal Malpractice §32.7.

EXAMPLE: In *Heyer v Flaig* (1969) 70 C2d 223, 74 CR 225, overruled on other grounds in *Laird v Blacker* (1992) 2 C4th 606, 617, 7 CR2d 550, the testator told her attorney that she wanted her entire estate to pass to her two daughters. She also told the attorney that she intended to marry in one month. Ten days before the marriage, she executed a will prepared by the attorney, leaving her entire estate to the daughters but failing to mention her intended husband except as executor. The testator died after marriage and her surviving husband successfully claimed an intestate share of her estate under former Prob C §70 (predecessor to Prob C §21610). The court had little difficulty in finding that the attorney was liable for malpractice for failing to expressly exclude any gift to the husband. See also *Garcia v Borelli* (1982) 129 CA3d 24, 180 CR 768 (devise failed because property held in joint tenancy). In *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, the attorney was held liable for malpractice when a devise failed because the intended transferee was a disqualified person. See §1.35B.

An attorney is not necessarily liable for every mistake he or she makes. No liability results if the error involves a question of law about which well-informed attorneys may have reasonable doubt. In *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821, the attorney drafted a will so that the testamentary trust would terminate 5 years after the probate court order distributing the assets to the trustee. Because of the remote possibility that the order would not be made before the perpetuities period had run, the trust was invalid. The attorney was held not liable, however, because the court concluded that any attorney of ordinary skill might have made the same mistake. 56 C2d at 593.

PITFALL: Because the question of law at issue must be one about which well-informed attorneys may have reasonable doubt, the protection of this holding may be more theoretical than real. Even if the question arises in an area of law that is "unsettled," the attorney may still be held liable for failing to do reasonable research. See §1.3. Furthermore, if the question arises in an area of law in which the attorney is not a specialist, the attorney may be held liable for not consulting or referring the client to a specialist. See §1.4.

An attorney's exposure to a malpractice claim involving will drafting may extend for many years because the statute of limitations for malpractice normally does not begin to run until the aggrieved party (1) discovers or should have discovered the facts that establish the cause of action and (2) sustains damages. CCP §340.6. See also *Jordache Enters., Inc. v Brobeck, Phleger & Harrison* (1998) 18 C4th 739, 76 CR2d 749; *Adams v Paul* (1995) 11 C4th 583, 46 CR2d 594. Because beneficiaries under a will normally do not discover the facts to establish a cause of action for negligent drafting and do not sustain damages until the testator dies (or arguably until entry of a decree of final distribution), the statute of limitations for malpractice on a will may not even begin to run until many years after the will is prepared. See *Heyer v Flaig, supra*.

In *Cavenisch v Superior Court* (1996) 44 CA4th 1689, 52 CR2d 450, the court held that the measure of an attorney's negligent estate planning work was the economic loss, and that the client's emotional distress damages were not recoverable.

NOTE: An attorney's failure to maintain professional competency may result in professional discipline as well as malpractice liability. See Cal Rules of Prof Cond 3-110. For example, in *Lewis v State Bar* (1981) 28 C3d 683, 170 CR 634, the court disciplined an attorney for undertaking an estate administration despite his complete unfamiliarity with probate laws and procedures. Discipline was imposed even though there was no showing that the attorney had acted in bad faith or with a desire to benefit himself at his client's expense.

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§1.3 1. Duty to Do Research

An attorney must not only understand the basic principles of law known by well-informed attorneys but also discover rules of law that are not commonly known but may be found by standard research techniques. If the attorney does not do such research when required, he or she can be liable for any resulting damage.

EXAMPLE: In *Smith v Lewis* (1975) 13 C3d 349, 118 CR 621, overruled on other grounds in *Marriage of Brown* (1976) 15 C3d 838, 851, 126 CR 633, an attorney representing the wife in a dissolution proceeding failed to assert her community property interest in her husband's retirement benefits. The court noted that community property rights of the nonparticipant spouse in the participant spouse's retirement benefits was an unsettled area of the law. However, the court held the attorney liable for malpractice because he failed "to undertake reasonable research." 13 C3d at 359.

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§1.4 2. Duty to Consult or Refer Client to Specialist

If an attorney undertakes a task in a specialized area of the law, he or she must exercise the degree of skill and knowledge possessed by attorneys who practice in that specialty. 2 Mallen & Smith, Legal Malpractice §19.4 (5th ed 2000). Consequently, an attorney who is confronted with a task in a specialized area of law should either consult a specialist or refer the client to a specialist. On the division of attorney fees with a specialist, see §1.4A.

EXAMPLE: In *Horne v Peckham* (1979) 97 CA3d 404, 158 CR 714, disapproved on other grounds in *ITT Small Bus. Fin. Corp. v Niles* (1994) 9 C4th 245, 255, 36 CR2d 552, a general practitioner drafted a trust and had it funded with royalties from a license agreement on patents that the client continued to own. The Internal Revenue Service refused to permit the royalty income to be taxed to the trust. The court held the attorney liable for the resulting deficiency because he had neither referred the client to a tax specialist nor consulted a tax specialist.

An attorney who gives advice or prepares documents designed to minimize estate and gift tax liability must adhere to the higher standard of specialized professional skill. See, *e.g., Bucquet v Livingston* (1976) 57 CA3d 914, 129 CR 514. The general practitioner should refer the client to a specialist when the client's net taxable estate is large enough to incur estate and gift taxes (*i.e.,* larger than the "applicable exclusion amount," as discussed in §20.2). The cautious practitioner does so even when the client's net taxable estate is not large enough to incur taxes if:

- The client owns assets (*e.g.,* real property) that may appreciate greatly during the client's lifetime; or
- The client is one party in a couple whose combined net taxable estates exceed the applicable exclusion amount.

PITFALL: An attorney who refers a client to a specialist should exercise caution in the selection of the specialist to avoid malpractice exposure for a negligent referral.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.4A 3. Division of Attorney Fees With Specialist

§1.4A 3. Division of Attorney Fees With Specialist

If the referring attorney and the specialist (as discussed in §1.4) agree to divide the estate planning fees, they must comply with Cal Rules of Prof Cond 2-200(A). This rule prohibits any such division of fees unless:

- Written disclosure is made to the client that fees will be divided and the terms of the fee division;
- The client consents in writing after full disclosure; and
- The total fee charged by all attorneys is not increased by the fee division.

See also Cal Rules of Prof Cond 2-200(B), which prohibits referral fees in the absence of compliance with Cal Rules of Prof Cond 2-200(A).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.5 B. Preparing for Inevitable Threat of Malpractice

§1.5 B. Preparing for Inevitable Threat of Malpractice

Even attorneys of the highest professional competence who conscientiously meet their responsibilities to their clients may face the threat of malpractice. A will that carries out the client's wishes to the letter can appear to a disappointed heir to be contrary to the testator's intent. An estate plan that reflects the client's informed decision to gamble for a particular tax advantage may appear to be malpractice to a beneficiary who suffers adverse tax consequences.

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§1.6 1. File Memoranda and Letters to Clients

An attorney may avoid being placed in a difficult position after the client's death by preparing for an accusation of negligence.

As a minimum precaution, the attorney should have the client sign a representation agreement that includes a provision setting forth the scope of the services to be provided and any applicable limitations. See §2.33. If specialists will be consulted, this should be stated. The attorney should also prepare a detailed memorandum of the client's financial and personal circumstances, the client's dispositive wishes, the legal issues involved, the attorney's advice, and the client's ultimate decisions. See §§2.1-2.5. Even though the memorandum is self-serving, it may be admissible evidence in future proceedings as a business record (Evid C §1271), and it will at least be useful for refreshing recollection (see Evid C §§771, 1237).

NOTE: One precautionary measure that cannot be taken is an agreement with a client limiting the attorney's liability. California Rules of Professional Conduct 3-400 prohibits an attorney from prospectively contracting with a client to limit the attorney's liability for professional malpractice.

In addition, the cautious practitioner may send the client a letter that reiterates the client's wishes and decisions and explains the estate plan and how the will helps accomplish it. As an added precaution, the client may be asked to sign and return a copy of the letter as an acknowledgment of receipt and acceptance of the plan. If the letter or the office memorandum is signed or initialed by the client, it becomes admissible evidence under the adoptive admission exception to the hearsay rule. Evid C §1221. See 1 Witkin, California Evidence, *Hearsay* §102 (4th ed 2000).

A letter should also be sent to a client who thwarts the completion of his or her estate plan by neglecting to provide the attorney with necessary information or feedback. The letter should inquire whether the client wishes assistance in completing the estate plan, and should inform the client that, if the matter is not completed within a reasonable time, the attorney will close the file. The letter should explain the reasons for doing so and urge the client to complete the estate plan eventually. However, the attorney should not withdraw from representation until he or she has taken the necessary steps to avoid reasonably foreseeable prejudice to the rights of the client. Cal Rules of Prof Cond 3-700(A)(2).

In *Radovich v Locke-Paddon* (1995) 35 CA4th 946, 41 CR2d 573, the court considered whether an attorney owed a duty to a potential beneficiary named in a will that the attorney had drafted and provided to the decedent, but which the decedent had never signed. The court found that the attorney owed no such duty because there was insufficient evidence of commitment on the part of the decedent to actually execute the will. Nevertheless, the court acknowledged that it would have been appropriate for the attorney to at least inquire of the decedent whether she wished further assistance in completing the change of testamentary disposition. 35 CA4th at 965. See also *Chang v Lederman* (2009) 172 CA4th 67, 172 CR3d 67, in which the court held that a disappointed prospective heir could not sue an attorney who declined to draft estate plan amendments allegedly desired by the attorney's dying client. The court held 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. The decision in *Chang v Lederman* includes a moderately lengthy discussion of the history of California law with respect to suits by estate beneficiaries against attorneys involved in pre-death drafting. At common law, such beneficiaries could not sue such attorneys because there was no privity between the drafting attorney and the beneficiary. The former strict requirement of privity was abandoned by the California Supreme Court in *Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16, but the privity defense is still recognized in some other jurisdictions, notably including New York. See *Schneider v Finmann* (App Div 2009) 876 NYS2d 121.

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§1.7 2. Colleague Review of Finished Will

In some firms the will drafter routinely submits the finished will to a partner or associate for review. This is an excellent practice. A careful reading by a colleague may uncover omissions, ambiguities, and dispositional gaps that eluded the attorney who drafted the will. The author of a complex document often fails to detect flaws that are obvious to another person.

An attorney's obligation to protect confidences does not preclude disclosing the client's affairs to firm members, unless the client directs otherwise. See ABA Model Rules Prof Cond 1.6(a). See also Evid C §952.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.8 C. Will Contracts

§1.8 C. Will Contracts

The author believes that use of a will contract is seldom desirable. An attorney who wishes to steer clear of malpractice pitfalls is advised to encourage clients desiring will contracts to employ other alternatives to achieve their objectives. For discussion of common types of will contracts, see §1.9. For discussion of reasons that will contracts should be discouraged, see §§1.10-1.15. On alternatives to will contracts, see §1.16.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.9 1. Types of Will Contracts

§1.9 1. Types of Will Contracts

Will contracts generally take one of two forms:
(1) A contract between parties not to revoke their existing wills; or
(2) A contract between parties to dispose of their property in a certain manner by will.

Will contracts are governed by the law of contracts and not by the law of wills.

An attorney most frequently considers the following types of will contract:

- *Third party disposition contract.* A third party disposition contract is created when one party agrees to leave property to the other, provided the survivor agrees to leave that property or part or all of the survivor's property to a particular person or persons. For example, one spouse agrees to leave his or her property to the other only if the survivor leaves any portion remaining at the survivor's death to the children of the first spouse.
- *Simple survivorship contract.* A simple survivorship contract is created when two persons agree to devise their property to each other. This contract differs from a third party disposition contract in that no obligations are imposed on the survivor with respect to the subsequent disposition of the property. In practice, an attorney is rarely requested to draft this type of will contract.
- *Personal service contract.* A personal service contract is created when one party agrees to devise part or all of his or her property to the other in exchange for the other party's performing services for the first party or another. In practice, an attorney is not often called on to draft such a contract. The attorney is more likely to encounter such a contract in the context of a probate administration when the service provider makes a claim against the estate based on an oral personal service contract with the decedent.

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2. Reasons to Discourage Will Contracts

§1.10 a. Enforcement Problems With Will Contracts

Because most will contracts do not clearly define each party's rights to use the property subject to the contract, problems in enforcing will contracts commonly arise. California courts have held that the obligation of good faith and fair dealing inherent in every contract includes an implied covenant not to make unreasonable use of the property subject to the contract. See *Crail v Blakely* (1973) 8 C3d 744, 106 CR 187; *Brewer v Simpson* (1960) 53 C2d 567, 2 CR 609; *Brown v Superior Court* (1949) 34 C2d 559, 212 P2d 878. Unfortunately, this general principle is not very helpful in attempting to avoid or resolve the many enforcement disputes that arise. On survivorship and personal service contracts, see §1.10A. On third party disposition contracts, see §1.10B.

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§1.10A (1) Survivorship and Personal Service Contracts

For simple survivorship and personal service contracts, the parties' obligations and restrictions only exist before the death of one party. No California court has considered whether a party can fully consume his or her property during his or her lifetime and thereby defeat the obligation to leave property to the survivor or to one who performs services. This power was presumed, however, in *Estate of Turner* (1959) 171 CA2d 591, 341 P2d 376, in which the court held that an unlimited power to consume one's property did not render the will contract illusory when the other party had fully performed the promised services. Thus, even extravagant or wasteful personal consumption is probably permissible. Gifts may not be permissible, however, depending on the scope of the promise. See generally *Chase v Leiter* (1950) 96 CA2d 439, 215 P2d 756. What is permissible may also depend on (1) the materiality of the gifts in relation to the person's total property, (2) the person's patterns of giving before that time, and (3) the other party's knowledge of those patterns.

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§1.10B (2) Third Party Disposition Contracts

A third party disposition contract presents additional enforcement problems between the deaths of the first party to die and the survivor. Typically, the parties have agreed that one party will leave his or her entire estate to the other, provided the survivor will leave the first decedent's property or their entire combined estates to designated beneficiaries at the survivor's death. In such situations, the courts are faced with the difficult problem of defining the survivor's rights, duties, and obligations.

In *Brewer v Simpson* (1960) 53 C2d 567, 589, 2 CR 609, 620, the court implied a covenant "not to make unreasonable use of the property, as by conveying it all away" arising out of the general obligation of good faith and fair dealing. The court held that the surviving spouse's transfer of property received from her deceased husband's estate under an oral will contract into joint tenancy with her new husband violated this covenant. However, the court approved the lower court's ruling that the survivor could use, sell, and otherwise deal with the property to serve the needs and general well-being of both the survivor and her new spouse in any reasonable manner. Courts in other jurisdictions have held that the survivor can even make gifts, but only in reasonable amounts that do not violate the purpose of the agreement. See, *e.g.*, *Draper v Bank of America* (Kan 2009) 205 P3d 698 (surviving spouse violated duty of good faith when she transferred all but $10,000 of property received from her husband's estate to irrevocable trusts that did not benefit third party designated beneficiaries).

In contrast, the court in *Redke v Silvertrust* (1971) 6 C3d 94, 98 CR 293, determined that the oral will contract required that the first decedent's property be passed intact by the survivor to the third party beneficiary. Consequently, the surviving spouse's estate was held liable for interest on the proceeds of sale of property received from the predeceased wife from the date of the sale. Litigation also may arise if the survivor's estate plan directs the decedent's intact property to a different third party beneficiary. In *Murphy v Murphy* (2008) 164 CA4th 376, 78 CR3d 784, the court held that a disinherited child was precluded by the doctrine of collateral estoppel not only from advancing "undue influence" and similar claims in a post-death action with respect to an estate plan executed for a conservatee in accordance with a substituted judgment order, but also from asserting that the estate plan violated a will contract made by the conservatee and the conservatee's predeceased spouse.

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b. Tax Problems With Will Contracts

§1.11 (1) Estate Tax Consequences

Will contracts frequently have unforeseen tax consequences and raise thorny tax issues. For example, if the survivor had an unrestricted power to consume the property received from the decedent, that property is includable in the gross estate of the survivor at the survivor's death for federal estate tax purposes and is in effect taxed twice. IRC §2041(a)-(b)(1); Rev & T C §13696. If the survivor's interest in the decedent's property qualified for the marital deduction under the IRC §2056(b)(7) qualified terminable interest property (QTIP) rules, the value of the property generally will be included in the survivor's estate. IRC §2044. An exception applies if the survivor disposes of this property in a transaction to which IRC §2519 applies, in which case the survivor is subject to gift tax on the value of the property. See §1.12.

For complete discussion of estate tax consequences, see Hess, *The Federal Transfer Tax Consequences of Joint and Mutual Wills*, 24 Real Prop, Prob, & Tr J 469, 495 (Winter 1990).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.12 (2) Gift Tax Consequences

§1.12 (2) Gift Tax Consequences

A will contract may also have unforeseen gift tax consequences. Consider the third party disposition contract in which the survivor agrees to dispose of his or her own property as well as the decedent's property in a particular manner. If the survivor is free to consume the property during his or her lifetime, there are no gift tax implications because the transfer is considered incomplete for gift tax purposes. See Treas Reg §25.2511-2(c); *Sallie B. Hambleton* (1973) 60 TC 558, acq in result only 1974-1 Cum Bull 2; *S. E. Brown* (1969) 52 TC 50, acq in result only 1969-2 Cum Bull xxiv.

This result might be different, however, if the will contract limited the survivor's right to enjoy his or her property to some ascertainable standard. In *Pyle v U.S.* (7th Cir 1985) 766 F2d 1141, the court held that the survivor had made a completed gift of a remainder interest because, by will contract, she had limited her power to invade both her property and the decedent's property to a standard that was measurable under state law.

If a third party disposition contract qualifies for the marital deduction under the IRC §2056(b)(7) qualified terminable interest property (QTIP) rules, the survivor's disposition of part or all of the life income interest will be treated as a taxable gift. IRC §2519.

For complete discussion of gift tax consequences, see Hess, *The Federal Transfer Tax Consequences of Joint and Mutual Wills*, 24 Real Prop, Prob, & Tr J 469, 472 (Winter 1990).

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§1.13 (3) Income Tax Consequences

A personal service will contract can have severe income tax consequences. Under such a contract, the amount received as payment or awarded in an action for damages or in quantum meruit is taxable as ordinary income to the recipient even though the party performing the services is a natural object of the decedent's bounty. *Joseph M. Mariani* (1970) 54 TC 135; *Ethel West Cotnam* (1957) 28 TC 947, aff'd in part and rev'd in part on other grounds (5th Cir 1959) 263 F2d 119; *John Davies* (1954) 23 TC 524. But see *Bath v U.S.* (5th Cir 1973) 480 F2d 289, in which a person claiming benefits from an estate for personal services was not required to treat the payment as income. See also IRS Letter Ruling 200137031 (settlement payments for breach of contract to devise property not income under IRC §102). A cash-basis taxpayer must report the entire amount received under a personal service contract as income in the year of receipt. The income tax consequences of a personal service contract are more complex if payment for the services is received over a period of years (*e.g.,* if a service provider receives a life estate in the decedent's home).

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§1.14 (4) Generation-Skipping Transfer (GST) Tax Consequences

A third party disposition contract may have generation-skipping transfer (GST) tax implications. See IRC §§2601-2664. This may arise if the surviving party is in a generation younger than the first party to die and the third party for whose benefit the property is to be held is assigned to a second younger generation. The GST tax is discussed in more detail in chap 15.

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§1.15 c. Drafting Problems With Will Contracts

Will contracts are time-consuming and expensive to prepare because they require considerable research and careful drafting. Even if the attorney can anticipate the enforcement and tax problems described in §§1.10-1.14, he or she still must shape the contract to deal with those issues in a manner consistent with the clients' objectives.

Will contracts must be drafted with painstaking precision. In drafting the final contract, the attorney must:

- Describe the exact nature of the property interests subject to the contract.
- Anticipate tracing difficulties.
- Delineate carefully the parties' rights to use or dispose of the properties and any income or proceeds from them.
- Assist the parties in formulating remedies if either party breaches the contract. Remedies for breach of contract are particularly important to consider when the nonbreaching party has performed the contract in whole or in part.

Third party disposition contracts are particularly problematic because they can never be drafted to handle all changes in circumstances during the survivor's lifetime. When such an unanticipated circumstance arises, litigation frequently results.

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§1.16 3. Alternatives to Will Contracts

The attorney should suggest an alternative to a will contract such as reciprocal wills (see §1.16A) or funded revocable trusts (see §1.16B) that may accomplish the clients' objectives with more certain tax and other legal consequences, may be less expensive to prepare, and may be less likely to result in litigation.

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§1.16A a. Reciprocal Wills

Parties contemplating a third party disposition contract usually want to give the surviving party the economic benefit of the deceased party's property and to pass the property remaining at the survivor's death to designated beneficiaries. This objective can be better accomplished by reciprocal wills creating a testamentary trust at the first party's death.

A testamentary trust minimizes the risk of expensive and protracted litigation to clarify the beneficiaries' rights. Drafting trust documents is usually routine for most attorneys and involves fewer hidden traps because the status of the trust property and the rights and duties of the trustee and beneficiaries are clearly delineated by case and statutory law. A testamentary trust preserves flexibility to deal with changes in circumstances that frequently occur after the death of the first party. Furthermore, property passing to the testamentary trust at the first party's death can easily avoid taxation in the survivor's estate. For married persons, the use of a qualified terminable interest property trust should also be considered. See chap 19. On reciprocal funded revocable trusts, see §1.16B.

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§1.16B b. Funded Revocable Trusts

Another alternative to a third party disposition contract or a simple survivorship contract (see §1.9) is the use of reciprocal funded revocable trusts. The parties could act as cotrustees of both trusts. Although each party would be free to revoke his or her trust, the other party would be aware of this action. An irrevocable lifetime trust also may be used as an alternative. On reciprocal wills, see §1.16A.

A revocable trust with both the promisor and the service provider as cotrustees is a good alternative to the personal service will contract. This structure gives the service provider greater assurance that he or she will receive the benefit of the bargain.

On preparation and uses of revocable and irrevocable trusts, see Drafting California Revocable Trusts (4th ed Cal CEB 2003); Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

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D. Avoiding Joint Wills

§1.17 1. Definition and Use of Joint Will

"A joint will is a single testamentary instrument constituting or containing the wills of two or more persons, and jointly executed by them as their respective wills." *Daniels v Bridges* (1954) 123 CA2d 585, 588, 267 P2d 343.

When one of the testators to a joint will dies, the will is admitted to probate as the separate will of that person. When the other testator to the joint will dies, the same instrument is again admitted to probate in a separate proceeding. See *Estate of Lee* (1964) 225 CA2d 578, 37 CR 572.

The joint will offers no discernible advantage over separate wills and creates additional problems. See §1.18.

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§1.18 2. Reasons Not to Create Joint Will

Because a joint will strongly suggests the existence of a will contract, the attorney should avoid creating joint wills for the same reasons that will contracts should be avoided. See §§1.10-1.15.

Even if the drafter negates the existence of a will contract, a joint will can still result in unexpected consequences. For example, a joint will executed by both spouses or registered domestic partners may constitute an agreement transmuting joint tenancy property into community property whether or not it includes or is executed according to a will contract. See *Estate of Watkins* (1940) 16 C2d 793, 108 P2d 417; *Thompson v Boyd* (1963) 217 CA2d 365, 32 CR 513; Fam C §297.5. This type of agreement is based on the doctrine of estoppel by contract. See also *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385, in which the husband expressly transmuted a large amount of separate property into community property and the wife became obligated to allow specified property to pass under terms of a trust at her death. In subsequent dissolution proceedings, the court held that the agreement accomplished the transmutation but did not affect the husband's right to seek reimbursement under Fam C §2640(b). The court noted that a statement in a will concerning the character of property is not admissible as evidence of a transmutation in a proceeding commenced before the testator's death. Fam C §853(a). However, this statute literally applies only to wills, and the court noted that wills are not intended to convey a present interest in property.

Even if the attorney can avoid the drafting pitfalls of a joint will, this device is still not recommended for the following reasons:

- The additional drafting care and resulting expense to the client seldom justify any perceived advantage.
- The process of submitting the same document for probate in both parties' estates can be cumbersome. For example, additional time and expense might be necessary to locate and obtain suitable copies of the will for use in the second estate, particularly if the parties died in different jurisdictions.
- The joint will becomes a matter of public record at the first party's death.
- A joint will can never qualify as an international will under the Uniform International Wills Act (Prob C §§6380-6390). Prob C §6381(c).

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§1.19 E. Duty to Notify Client of Defective Will

In two cases the California Supreme Court concluded that an attorney has a duty to notify his or her client of a defect in a will prepared by the attorney. In *Heyer v Flaig* (1969) 70 C2d 223, 74 CR 225, overruled on other grounds in *Laird v Blacker* (1992) 2 C4th 606, 617, 7 CR2d 550, the beneficiaries of a will sued the attorney who drafted it, alleging that he (1) knew that the testator intended to marry after execution of her will, (2) negligently drafted the will so that it lacked adequate provisions to avoid omitted spouse protections under former Prob C §70 (see Prob C §21610), and (3) negligently failed to advise the testator after her marriage that she should change her will. The attorney demurred to the complaint on the ground that the statute of limitations had run. The court held that the statute of limitations had not run because of the attorney's continuing negligence in failing to notify the testator of the need to change her will.

In *Codiga v State Bar* (1978) 20 C3d 788, 144 CR 404, an attorney was charged with five separate counts of misconduct, including the failure to notify clients that their wills were defective. The record showed that the attorney had written a number of wills that contained the same defect. The attorney was aware of the problem but for 3 years did nothing to correct it. The court concluded that the attorney's inaction constituted misconduct.

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§1.20 F. Possible Duty to Notify Former Client of New Law

The decisions in *Heyer v Flaig* (1969) 70 C2d 223, 74 CR 225, overruled on other grounds in *Laird v Blacker* (1992) 2 C4th 606, 617, 7 CR2d 550, and *Codiga v State Bar* (1978) 20 C3d 788, 144 CR 404 (see §1.19), suggest that attorneys do not have a duty to notify past clients of a change in the law affecting their wills. In these cases the California Supreme Court held that the attorney-client relationship and the duties mandated by this relationship do not end with the execution of a *defective* will. From this it can be argued that the attorney-client relationship and the duties of this relationship should be considered terminated if the attorney drafts a will *competently* and the client accepts the attorney's services as completed.

The decision in *Brandlin v Belcher* (1977) 67 CA3d 997, 134 CR 1, lends support to this view. In *Brandlin,* the attorney prepared a will for a client and approved a trust that had been prepared for the client by a bank. Several years later the client discussed amending the trust with the bank. Although the bank told her to contact her attorney concerning the amendment, she did not. After her death, the beneficiaries who would have benefited by the amendment sued the attorney. The court held that no attorney-client relationship existed with respect to the amendment of the trust and, without that relationship, the attorney had no duty to act.

To protect themselves, some attorneys send form letters to their past estate planning clients, informing them of the possible impact of a new tax reform act on their estate plans and recommending that clients review their wills and seek legal advice if they have questions. Other attorneys explain changes in the law in letters of notification, adding questionnaires to assist the clients' review of their wills. These communications do not violate advertising and solicitation prohibitions. Cal Rules of Prof Cond 1-400(C). In giving advice on the effect of tax changes, the attorney also must consider the effect of Circular 230 (31 CFR pt 10). See §1.20B.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.20A G. No Duty to Determine Client Competence

§1.20A G. No Duty to Determine Client Competence

Fortunately, courts have held that the attorney does not owe a duty to takers under an earlier will or trust to ascertain and document the client's competence when the client makes a new will or amendments to an existing will or trust. In *Moore v Anderson Zeigler Disharoon Gallagher & Gray* (2003) 109 CA4th 1287, 135 CR2d 888, the provisions of the amended trust reduced the shares of some of the decedent's children, who then sued the attorney alleging that the attorney had acted negligently in failing to "investigate, confirm and document" that the decedent had capacity. The court held that imposing such a duty might unjustifiably deny many persons the opportunity to make or amend their wills. In *Boranian v Clark* (2004) 123 CA4th 1012, 20 CR3d 405, the court held that an attorney who drafted a will for a dying testator did not owe a duty of care to individuals who were to receive the testator's estate under a prior will. For discussion of testamentary capacity, see §§2.9-2.15.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.20B H. Effect of Circular 230

§1.20B H. Effect of Circular 230

In preparing an estate plan that is intended to have tax advantages, the attorney must consider the effect of Circular 230 (31 CFR pt 10). Circular 230 imposes practice standards on attorneys, accountants, and enrolled agents who represent taxpayers before the Internal Revenue Service. The definition of "practice before the IRS" covered by Circular 230 includes "rendering written advice with respect to any entity, transaction plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion." 31 CFR §10.2(a)(4).

Under 31 CFR §10.34(b), applicable to documents that are not tax returns, practitioners may not advise a client to take a position on a document submitted to the IRS unless the position is not frivolous. Under 31 CFR §10.34(c), practitioners are required to inform clients of penalties that are likely to apply on a position taken on tax returns and other documents submitted to the IRS. With respect to tax returns, the final return preparer penalty regulations under IRC §6694(d)(2) provide that a practitioner may not sign a return as a preparer (which may include preparation of a document used in connection with the preparation of a return under IRC §7701(a)(36) and Treas Reg §301.7701-15(b)) unless there is substantial authority for each position taken on the return, or there is a reasonable basis for each position and each position is adequately disclosed to the IRS as provided in Treas Reg §1.6694-2(d). See Notice 2009-5, 2009-3 Int Rev Bull 309; TD 9436, 2009-3 Int Rev Bull 268, discussed in 30 CEB Est Plan Rep 91-92 (Feb. 2009). See also discussion of the regulations as proposed in *Tax Return Preparer Penalties: New Proposed Regulations and a Possible Statutory Change*, 30 CEB Est Plan Rep 5 (Aug. 2008).

Circular 230 also imposes standards in connection with written opinions on tax matters. Under 31 CFR §10.35(b)(2), a "covered opinion" includes written advice (including e-mail) concerning federal tax issues arising from any plan or arrangement if the advice concludes that it is more likely than not that the taxpayer will prevail on the issue (reliance opinion) and a significant purpose of the transaction is the avoidance or evasion of any tax. Under 31 CFR §10.35(c), advice in the form of a covered opinion must comply with detailed requirements relating to the use of reasonable factual assumptions and the need to provide a conclusion with respect to each significant issue considered in the opinion.

Cautious practitioners should avoid writing opinions that directly or indirectly state that it is "more likely than not (a greater than 50-percent likelihood)" that one or more tax issues will be resolved in a client's favor. However, this may be difficult to avoid in cases where the client is advised to take a return position subject to the more-likely-than-not standard discussed previously, in view of the obligation to inform the client of penalties that are likely to apply. In the context of tax shelters, the taxpayer may not have protection from accuracy-related tax penalties in the absence of an opinion containing such a "more likely than not" assessment, but in other than tax-shelter cases, the opinion will normally provide such protection even without a likelihood estimate, provided it states that there is "substantial authority" for the specified tax treatment as discussed above. IRC §6662(d)(2)(B)(i), (d)(2)(C); Treas Reg §1.6664-4(f).

Alternatively, the practitioner may include a prominent disclosure that the opinion was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. For example, the disclosure may state: "The tax advice, if any, contained in this communication does not meet Treasury Department standards for legal opinions that can be relied upon by a taxpayer for the purpose of avoiding tax penalties." If such a disclosure is used, the advice is not a reliance opinion and therefore it will not be a covered opinion unless the plan or arrangement is a listed transaction under Treas Reg §1.6011-4(b)(2) or the transaction has the "principal purpose" of tax avoidance or evasion as defined in Treas Reg §1.6662-4(g)(2)(ii). Under that definition, a plan or arrangement does not have the principal purpose of tax avoidance or evasion if it has as its purpose the claiming of exclusions from income or other tax benefits in a manner consistent with the statute and congressional purpose. Even in the absence of a prominently disclosed penalty disclaimer, an opinion is not a reliance opinion unless the IRS has a "reasonable basis" for a successful challenge to the proposed transaction. 31 CFR §10.35(b)(3). For further discussion, see Dennis-Strathmeyer, *The New Circular 230 Regulations: Keeping the Tempest in the Teapot*, 26 CEB Est Plan Rep 97 (Feb. 2005); Dennis-Strathmeyer, *"Revised Revised" Final Regulations and Continuing Debate—The Ongoing Circular 230 Controversy*, 26 CEB Est Plan Rep 157 (June 2005); *Proposed Amendments to Circular 230 Concerning Practice Before the IRS*, 27 CEB Est Plan Rep 98 (Feb. 2006).

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III. CONFLICTS OF INTEREST

§1.21 A. Conflicts of Interest in Will Drafting

Conflicts of interest frequently occur in will drafting. Whenever two persons jointly consult an attorney about wills and related estate planning, the issue of conflict of interest emerges. The issue also emerges when an attorney provides estate planning services for an individual that affect a former client. For a detailed analysis of conflicts of interest in estate planning situations, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel (2d ed 2008).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.22 B. Conflicts of Interest in Representing Couples

§1.22 B. Conflicts of Interest in Representing Couples

Couples often have their wills prepared by the same attorney at the same time. In this situation, the attorney should address two conflict-of-interest issues: duty of confidentiality (see §1.22A) and conflict between clients (see §1.22B).

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§1.22A 1. Duty of Confidentiality

An attorney has a duty not to disclose confidential communications or secrets of a client, except in rare circumstances. Bus & P C §6068(e). When the attorney jointly represents two clients, this duty may conflict with the attorney's duty to represent each client's interests fully. This can happen, for example, when two spouses or domestic partners jointly retain an attorney to draft wills and perform related estate planning, and one spouse or partner subsequently tells the attorney confidentially about substantial property acquired before entry into marriage or domestic partnership about which the other is unaware. The attorney cannot fully carry out his or her duty to represent the interests of the unaware spouse or partner fully without disclosing this relevant information. Disclosure, however, would violate the attorney's duty not to disclose confidential communications. In this situation, without the clients' informed written consent to joint representation despite the conflict, the attorney must withdraw from representing one or both clients. Cal Rules of Prof Cond 3-310(C)(2).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.22B 2. Conflict Between Clients

§1.22B 2. Conflict Between Clients

California Rules of Professional Conduct 3-310(C)(1) mandates that an attorney shall not accept representation of more than one client in a matter in which the interests of the clients potentially conflict, without the informed written consent of each client. Moreover, an attorney may not concurrently represent clients whose interests are in actual conflict without their informed written consent. Cal Rules of Prof Cond 3-310(C)(2). This requirement is strictly construed. In *Cal West Nurseries, Inc. v Superior Court* (2005) 129 CA4th 1170, 29 CR3d 170, the court held that a firm did not cure concurrent representation issues by withdrawing from the representation of aspects of litigation relating to two clients but not from the entire litigation. In *People v Baylis* (2006) 139 CA4th 1054, 43 CR3d 559, the court held that a conflict waiver in a criminal case did not meet the strict test of informed consent with respect to knowledge of the dangers and drawbacks of joint representation.

Rule 3-310(C) is intended to apply to the representation of multiple parties in a single transaction or other common enterprise or legal relationship, including the preparation of joint or reciprocal wills for couples. Comment to Cal Rules of Prof Cond 3-310. The Comment to Rule 3-310 makes clear that the attorney must obtain the clients' *further* consent under Rule 3-310(C)(2) to continue the joint representation if the potential conflict under Rule 3-310(C)(1) becomes actual.

PITFALL: Many conflict situations cannot be resolved by consent. If the clients' relationship is such that consent by one may be seen as unduly influenced by the other, or the situation is so complex that any consent might not be informed, the attorney should simply tell the clients to retain separate counsel.

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C. Examples of Conflicts of Interest

§1.23 1. Spouses or Domestic Partners as Clients

An attorney who drafts wills for spouses or registered domestic partners (see Fam C §297.5) might face potential or actual conflicts of interest in the following circumstances:

- The spouses or partners differ over the characterization of property as separate or community.
- Each spouse or partner prefers a different person for the guardian of their children.
- The spouses or partners differ in their views of their own and each other's abilities to invest funds and manage a trust.
- One spouse or partner has children by a prior marriage or domestic partnership.
- One spouse or partner has a substantially larger estate than the other.
- One or both spouses or partners have substantial amounts of separate property or substantial estates that each wishes to give to persons other than the survivor.
- Spouses differ over the use of the estate tax marital deduction or over the choice between an IRC §2056(b)(7) qualified terminable interest property (QTIP) trust and an IRC §2056(b)(5) general-power-of-appointment marital deduction trust.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.24 2. Other Couples as Clients

§1.24 2. Other Couples as Clients

Many of the same conflict of interest situations that an attorney faces when representing spouses or registered domestic partners emerge when representing other couples. See §1.23. In addition, the attorney representing other couples may face potential or actual conflicts of interest in the following situations:

- The couple is considering placing an asset purchased by one party into some form of common ownership.
- The couple has taken title to property in joint tenancy without understanding the legal implications of this action.
- The clients are members of a partnership or own substantial shares of stock of a close corporation. A conflict of interest may arise in matters involving, *e.g.,* buy-out agreements, ownership and operation of the partnership or corporation after one party's death, and retirement benefits.
- One party wishes a durable power of attorney for property management or health care and wants to name the other as agent.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.25 3. Conflicts Involving Individual Clients

§1.25 3. Conflicts Involving Individual Clients

The potential for a conflict of interest even exists in estate planning for individual clients. Conflicts of interest commonly arise in the following situations:

- An attorney who wrote a will for a parent disinheriting a child is retained to prepare the child's will. The attorney's duty to the child requires disclosure of the disinheritance to the child, but the attorney's duty to the parent prohibits this disclosure.
- An attorney names a bank as the executor of a client's will, and the bank has a policy of employing the attorney who drafted the will to represent the bank in the probate of the client's estate.
- An attorney drafts an instrument in which one of several beneficiaries is also a fiduciary.
- An attorney who represents a business with several owners is asked to do estate planning (including advising on stock dispositions, retirement plans, and buy-outs) for one of them.

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§1.26 D. Future Conflict Caused by Joint Estate Planning

California Rules of Professional Conduct 3-310(E) mandates that an attorney

> shall not accept employment adverse to a client or former client where, by reason of the representation of the client or former client, [the attorney] has obtained confidential information material to the employment except with the informed written consent of the client or former client.

This means that the attorney who represents multiple clients in will drafting may face serious future conflict of interest problems. See *Industrial Indem. Co. v Great Am. Ins. Co.* (1977) 73 CA3d 529, 140 CR 806 (counsel may not continue representation when conflict becomes apparent).

For example, an attorney who performs will drafting and related estate planning for spouses or registered domestic partners faces a serious conflict of interest if, at a later date, he or she represents one spouse or partner in a dissolution proceeding. See LA Bar Ass'n Informal Ethical Opinion No. 1958-5; Fam C §297.5. See also LA Bar Ass'n Formal Ethical Opinion No. 448 (Dec. 21, 1987), in which the Committee on Legal Ethics concluded that an attorney who had drafted wills and living trusts for a husband and wife could not later represent the husband in drafting a *Marvin* agreement with his paramour without his wife's consent. See *Marvin v Marvin* (1976) 18 C3d 660, 134 CR 815.

Similarly, the attorney may not be able to represent one of two clients who later wishes, without the knowledge of the other client, to alter the estate plan to the other's detriment. See Wilcox, *Ethical Concerns in Estate Planning*, 2 Prob Prac Rep 1, 4 (May 1990).

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§1.27 E. Taking Conflicts of Interest Seriously

The attorney who represents conflicting interests may (1) be liable for malpractice by causing harm to the client or a beneficiary (*e.g.,* when the estate plan is not implemented because of the conflict), (2) lose fees, and (3) be subject to professional discipline. See generally 4 Mallen & Smith, Legal Malpractice §32.5 (5th ed 2000). See also *Galbraith v State Bar* (1933) 218 C 329, 23 P2d 291 (professional discipline); *Anderson v Eaton* (1930) 211 C 113, 293 P 788 (nonconsensual, conflicting representation by attorney may constitute defense to nonpayment of legal fees); *Jeffry v Pounds* (1977) 67 CA3d 6, 136 CR 373 (defense to claim for fees); *Ishmael v Millington* (1966) 241 CA2d 520, 50 CR 592 (malpractice liability).

Many attorneys dislike discussing the advisability of separate representation because of the additional expense involved and because they do not like to raise the possibility of discord between clients in an intimate relationship. These attorneys frequently justify joint representation by rationalizing that they represent "the couple," "the family," or "the situation." This rationalization does little to reduce the risk of malpractice liability or professional discipline.

Because of the obligation that an attorney should avoid even the appearance of professional impropriety, courts have often resolved doubts against the attorney when an issue of conflict of interest arises. See *Hull v Celanese Corp.* (2d Cir 1975) 513 F2d 568; *General Elec. Co. v Valeron Corp.* (ED Mich 1977) 428 F Supp 68. But see *Neal v Health Net, Inc.* (2002) 100 CA4th 831, 123 CR2d 202 (appearance of impropriety standard does not apply in California).

NOTE: When accused by a client of not fully representing the client's interest because of a conflict of interest, an attorney cannot rely on "honesty of purpose, intention and motive" to defend his or her actions. *Hammett v McIntyre* (1952) 114 CA2d 148, 155, 249 P2d 885.

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F. Dealing With Conflicts of Interest

§1.28 1. Identifying Conflicts

A routine check for conflicts of interest should be part of every will drafter's initial office procedures. Many law office management computer programs now automate these procedures.

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§1.29 2. Obtaining Informed Written Consent

An attorney who foresees a possible conflict of interest in representing one or more clients must obtain each affected client's informed written consent to the representation before providing any services. See §1.31. This can be done by letter or as part of the fee agreement for legal services. For a sample dual representation letter, see California Estate Planning §1.62 (Cal CEB 2002). For provisions intended to be used as part of a fee agreement, see Fee Agreement Forms Manual §§1.34-1.35 (2d ed Cal CEB 2007).

Before obtaining the clients' consent to representation, the attorney should discuss with them the provisions of Evid C §962. This statute makes clear that in a civil proceeding between two former joint clients of an attorney, any communication made from one client to the attorney during the representation is not privileged. See §1.30.

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§1.30 a. Obtaining Consents When Issue Is Confidentiality

To address the issue of confidentiality (see §1.22) when representing spouses or unmarried partners, some attorneys ask their clients to consent to the following provisions:

- The attorney may disclose all communications from both clients to each client except any communication that one client tells the attorney to keep confidential.
- If a client tells the attorney not to share a particular communication with the other client, the attorney will tell the other client that such a request has been made, without divulging the subject matter.
- If a client protests the attorney's nondisclosure of a confidential communication from the other client, the attorney may withdraw from representing one or both clients. See Fee Agreement Forms Manual §1.34 (2d ed Cal CEB 2007).

Other attorneys ask both clients to consent to complete disclosure to each client of all communications between the attorney and each client, even if the information is obtained in private conferences with one client. See Wilcox, *Ethical Concerns in Estate Planning*, 2 Prob Prac Rep 1, 4 (May 1990) (guideline proposed by American College of Trust and Estate Counsel suggests that attorney not represent couple when confidences are not intended to be shared). See also the discussion of this topic in House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel (2d ed 2008).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.31 b. Obtaining Consents When Issue Is Representation of Potentially Adverse Interests

§1.31 b. Obtaining Consents When Issue Is Representation of Potentially Adverse Interests

When representing couples as estate planning clients, the attorney should obtain the clients' consents under Cal Rules of Prof Cond 3-310(C). The attorney is being asked to represent each of them, but each of them is interested in the attorney's representation of the other. See §1.22.

In obtaining these consents, the attorney's hardest task is ensuring that the consents are "informed." According to Cal Rules of Prof Cond 3-310(A),

> "informed" means full disclosure to the client of the circumstances and advice to the client of any actual or reasonably foreseeable adverse effects of these circumstances upon the representation.

To meet this standard, the attorney should explain the potential for conflicts in at least these areas:

- Ownership and characterization of property;
- How property should be held;
- How property should be disposed of; and
- Who should serve in fiduciary capacities (*e.g.,* executor, trustee, guardian).

See Fee Agreement Forms Manual §8.2 (2d ed Cal CEB 2007). See also California Estate Planning §1.62 (Cal CEB 2002).

PITFALL: Full disclosure by the attorney includes informing clients that he or she may have to withdraw from representing either client if an actual conflict arises, resulting in wasted time and fees. Full disclosure probably also means informing clients of their right to obtain independent counsel.

Informing clients of the risks of joint representation is not easy. Because clients often deny the existence of conflicts, the attorney's delicate task is to make them aware of conflicts without exacerbating existing friction or alienating them. A useful tactic may be to describe hypothetical conflict of interest situations, recent newspaper articles recounting actual problems between jointly represented clients, or cases from the attorney's own practice.

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§1.32 3. Treating Each Party as Client

The attorney should treat each party in a joint representation as a client. Although many couples prefer to have one person deal with the attorney, with the other person meeting with the attorney only to execute documents, this practice is extremely unwise. The attorney should meet with both parties at all stages in the estate planning process; meeting with each party individually may also be necessary at some point. The attorney should be particularly wary when one client appears to dominate the other. For an illustration of how an estate plan can be voided when one client dominates the other, see *Estate of Madu* (1970) 11 CA3d 409, 89 CR 787.

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G. Attorney as Interested Party

§1.33 1. Attorney as Executor

An attorney should not routinely name himself or herself executor in wills that the attorney drafts. See *State v Gulbankian* (Wis 1972) 196 NW2d 733. The attorney should inform the client that the executor does not need to be an attorney and that an attorney's appointment as executor will probably not save the estate the cost of attorney fees, because it is normally advisable for an executor to have separate counsel in handling the estate. If the client then selects the attorney, it will be an informed choice.

An attorney must conform to the professional standards of an attorney in whatever capacity he or she is acting. *Libarian v State Bar* (1943) 21 C2d 862, 865, 136 P2d 321. Therefore, an attorney serving as executor will be held to an attorney standard of conduct while performing the duties of executor. See *Layton v State Bar* (1990) 50 C3d 889, 904, 268 CR 845. Further, it is questionable at best whether the attorney's professional liability insurer will cover claims made against the attorney in the capacity of executor.

When requested to serve as executor, the attorney should consider the standards articulated in ABA Informal Ethical Opinion No. 602 (1963), adopted by the Committee on Professional Ethics under former ABA Canons of Prof Ethics 11. Under this opinion, the attorney may name himself or herself executor if:

- The testator is unquestionably competent;
- The relationship between the testator and attorney is long-standing; and
- The testator initiated the idea.

Despite the fact that the ABA Canons of Professional Ethics have evolved into the Model Rules of Professional Conduct, the author believes that cautious attorneys should continue to follow the guidelines in Informal Opinion No. 602. Before agreeing to serve as executor, the attorney must ensure that this decision is the testator's alone and has been made under circumstances that avoid even the appearance of impropriety.

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§1.34 2. Attorney as Attorney for Estate

The same ethical issues that arise when the attorney is named executor (see §1.33) are also present when the drafting attorney is designated the attorney for the estate. This conflict is eased somewhat by the fact that the executor is not bound by the will and may select his or her own attorney. *Highfield v Bozio* (1922) 188 C 727, 207 P 242.

A conflict of interest also can arise when the executor selects the drafting attorney to represent the estate of a deceased spouse. In *Baker Manock & Jensen v Superior Court* (2009) 175 CA4th 1414, 96 CR3d 785, for example, the personal representative of the deceased husband's estate, who claimed that all of the community property had passed to the husband on the wife's death, attempted to disqualify the law firm that drafted the wife's estate plan from representing the personal representative of the wife's estate, who claimed that the wife's community property had passed to the residuary beneficiaries of her estate. The beneficiaries of the wife's estate did not have an interest in the husband's estate. The court held that the law firm could represent the personal representative of the wife's estate, in either the representative's personal or fiduciary capacity. According to the court, the law firm did not owe a duty of loyalty to the beneficiaries of the husband's estate, even though the law firm might be liable to the beneficiaries for negligence in drafting the wife's will, citing *Estate of Goulet* (1995) 10 C4th 1074, 1081, 43 CR2d 111 (executor may advocate for interpretation of will that preserves and implements the testator's intent even when a contrary interpretation is asserted by a beneficiary). Nevertheless, the attorney could have avoided the appearance of a conflict of interest in *Jensen* by declining to represent the personal representative in the probate proceedings.

If an attorney serves as executor and elects to act as his or her own counsel, the attorney cannot receive both executor's commissions and attorney fees unless approved in advance by the court, notwithstanding any provision in the will. Prob C §10804. See also *Estate of Lankershim* (1936) 6 C2d 568, 58 P2d 1282; *Estate of Parker* (1926) 200 C 132, 251 P 907; *Estate of Miller* (1968) 259 CA2d 536, 66 CR 756. If the attorney named executor retains a partner as attorney for the estate, the estate must pay both executor's commissions and attorney fees only if the executor does not share in the fees paid to the partner. *Estate of Parker* (1926) 200 C 132, 137, 251 P 907. This prohibition against double compensation applies even when the attorney's secretary is named as executor. LA County Bar Ass'n Formal Opinion No. 382 (Dec. 11, 1979).

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§1.35 3. Attorney and Other Fiduciaries Disqualified as Beneficiaries

With certain exceptions (see §1.35B), no provision of an instrument is valid to make a donative transfer to the person who drafted the instrument and related persons (see §1.35A) or a person who has a fiduciary relationship with the transferor, including but not limited to a conservator or trustee, who transcribes the instrument or causes it to be transcribed. Prob C §21350(a)(1), (4). In *Estate of Swettman* (2000) 85 CA4th 807, 102 CR2d 457, however, the court held that a conservator who arranged the conservatee's meetings with an estate planning agent and paid for the drafting of the conservatee's revocable trust instrument was not a person who caused the instrument to be transcribed for purposes of the statute. In *Rice v Clark* (2002) 28 C4th 89, 120 CR2d 522, the court held that beneficiaries who provided information needed to prepare will and trust instruments and encouraged the decedent to execute the instruments also were not persons who caused the instruments to be transcribed. See also *David v Hermann* (2005) 129 CA4th 672, 28 CR3d 622 (contestant proved undue influence by preponderance of evidence even if she failed to prove that defendant beneficiary procured trust documents).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.35A a. Additional Disqualified Persons

§1.35A a. Additional Disqualified Persons

Also disqualified from receiving donative transfers under the instrument are the drafter's or fiduciary's relatives by blood or marriage, registered domestic partner, cohabitants, employees, specified business associates of the drafter, and the care custodian (as defined in Welf & I C §15610.17) of a dependent adult (as defined in Welf & I C §15610.23) or the relatives, registered domestic partner, cohabitants, or employees of the care custodian, regardless of whether the care custodian drafted the instrument or caused the instrument to be transcribed. Prob C §21350(a)(2)-(3), (5)-(7). In *Estate of Shinkle* (2002) 97 CA4th 990, 119 CR2d 42, the court held that a long-term care ombudsman remained a disqualified person even after a skilled nursing facility patient returned home. In *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248, the California Supreme Court held that there is no preexisting personal friendship exception to the definition of "care custodian" in Welf & I C §15610.17. In *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390, the court held that a paid live-in caregiver clearly provided social services within the meaning of Welf & I C §15610.17 and was therefore a care custodian. The court held that the caregiver and her son were disqualified from receiving donative transfers because she failed to prove that the transfers were not the result of undue influence.

NOTE: Proposed legislation recommended by the California Law Revision Commission (CLRC) would replace the disqualified person statute with a new statute that would exclude from the definition of "care custodian" persons who provide care without remuneration. The proposed statute would reduce the standard of proof required to rebut the statutory presumption of undue influence and in most cases would permit the drafting attorney to execute a certificate of independent review, as discussed in §1.35B. Prop Prob C §§21360-21392; SB 103 (2009). See 38 Cal L Revision Comm'n Reports 107 (2009).

"Related by blood or marriage" for purposes of Prob C §21350(a) is defined to include a spouse and relatives within the third degree of the person or person's spouse, and spouses of such relatives. Prob C §21350(b). While the statute specifically lists domestic partners of the drafter or fiduciary as disqualified persons, it appears that domestic partners and their relatives (and the spouses or domestic partners of those relatives) also should be considered related by blood or marriage under Fam C §297.5(a).

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.35B b. Exceptions to Disqualification

§1.35B b. Exceptions to Disqualification

Disqualification under Prob C §21350 does not apply under any of the following circumstances (Prob C §§21350.5, 21351):

- The transferor is related by blood or marriage to, or is cohabitant with, or is the California-registered domestic partner of the transferee or the person who drafted the instrument (Prob C §21351(a));

NOTE: For purposes of Prob C §21351(a), "related by blood or marriage" includes persons within the seventh degree. Prob C §21351(g).

- An independent attorney counsels the transferor and delivers to the transferor a certificate of independent review, in substantially the form specified in Prob C §21351(b);
- After full disclosure of the relationships involved, the instrument is approved by a substituted judgment order in a conservatorship proceeding (Prob C §21351(c));
- The court determines, on clear and convincing evidence, excluding the testimony of any disqualified person described in Prob C §21350(a), that the transfer was not the product of fraud, menace, duress or undue influence (Prob C §21351(d), (e));
- The transferee is a governmental entity or a tax-exempt charitable entity or a trust holding an interest for this entity (but only to the extent of this entity's interest), or the trustee of this trust (Prob C §21351(f));
- The transfer does not exceed $3000 and the total value of the transferor's estate does not exceed $100,000, excluding specified property described in Prob C §13050 (Prob C §21351(h)); or
- The transfer is made by a document executed by a nonresident of California, who was not a resident when the document was executed, and the document was not signed within California (Prob C §21351(i)). See *Estate of Clementi* (2008) 166 CA4th 375, 82 CR3d 685 (will drafted by accountant executed and witnessed in Pennsylvania by resident of that state who later moved to California).

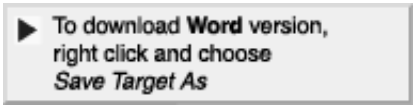
In *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, the court held that a drafting attorney who failed to advise the testator that a devise to a care custodian would likely fail unless the testator obtained a certificate of independent review breached a duty of care owed to both the testator and the care custodian. For an argument that the drafting attorney should not be liable to the intended transferee in these circumstances, see Streisand, *To Tell the Truth (T & E Lawyer's Version): Will My Real Client Please Stand Up?,* Estate Planning 2006, chap 9 (Cal CEB 2006).

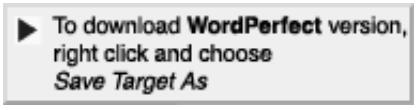
For a discussion of removal of a disqualified person who is a sole trustee, see §28.4. For a form of certificate of independent review under Prob C §21351(b), see §1.36.

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Source: Estate Planning/California Will Drafting/1 Professional Responsibility/§1.36 4. Form: Certificate of Independent Review

§1.36 4. Form: Certificate of Independent Review





1.36-1 Certificate of independent review

Certificate of Independent Review

I, _ _[*name of attorney*]_ _, have reviewed _ _[*name of instrument*]_ _ and counseled my client, _ _[*name of client*]_ _, on the nature and consequences of the transfer, or transfers, of property to _ _[*name of potentially disqualified person*]_ _ contained in the instrument. I am so disassociated from the interest of the transferee as to be in a position to advise my client independently, impartially, and confidentially as to the consequences of the transfer. On the basis of this counsel, I conclude that the transfer, or transfers, in the instrument that otherwise might be invalid under Section 21350 of the Probate Code are valid because the transfer, or transfers, are not the product of fraud, menace, duress, or undue influence.

Comment: When Prob C §21351(b) was originally enacted, it was assumed that the drafting attorney would never be independent and could never execute the certificate inasmuch as disqualified persons were all persons connected to the drafter. When Prob C §21350 was amended to include care custodians of dependent adults, the amendment created the possibility that the drafting attorney might indeed be completely independent and therefore able to execute the certificate. Whether a drafting attorney can execute a certificate of independent review in a case involving an unrelated caregiver is uncertain. Unless and until legislation is enacted that would either amend the statute to expressly permit the drafter to execute the certificate or eliminate the requirement of a certificate in these cases, it is recommended that the certificate be executed by an attorney other than the drafter and independent of the drafter in all cases.

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2

Initial Client Conference

Thomas R. Bennett

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I. PREPARATION FOR INITIAL CLIENT CONFERENCE

A. Preparation by Attorney

§2.1 1. Checklist for Client Conference

Even a highly skilled attorney can fail to meet his or her professional responsibility by overlooking a significant detail in the drafting of a will. An attorney can avoid oversights by using a client interview checklist. A sample checklist is presented in §2.2. The attorney should also review any client files. See §2.3.

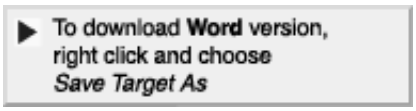
To save time, some attorneys prefer to send their estate planning clients questionnaires to fill out before the initial client conference. See §§2.4-2.5. Some clients, however, are unwilling to take the time to fill out questionnaires. Others simply do not have sufficient understanding of their affairs or of the importance of the information requested to complete a questionnaire accurately. The client interview checklist is especially useful for those kinds of clients because it provides a format for the attorney to conduct a detailed interview. Other attorneys dislike sending their clients lengthy initial questionnaires because of concerns that the client may become overwhelmed or fearful of the estate planning process before it begins.

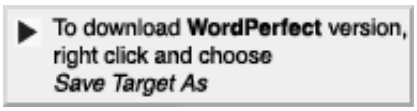
The attorney uses a client interview checklist to gather from the client the information needed to plan and draft the client's will or revocable trust and other estate planning documents. The interview checklist is a list of topics that the attorney should cover with the client at the initial conference. A checklist is most effective when used by one who understands its purpose, is familiar with its organization and content, and recognizes its limitations.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.2 2. Checklist: Client Interview

§2.2 2. Checklist: Client Interview





File No.:

Date:

A. Personal Profile

1. Client
   a. Full name
   b. Other names used
   c. Address, telephone number, fax number (residence and business)
   d. Business or occupation
   e. Employer
   f. Social security number
   g. Birthdate
   h. Place of birth and citizenship
   i. Period of residence in California
   j. State of health
   k. Veteran?
      (1) I.D. number
      (2) Branch of service
      (3) Discharge date
2. Spouse (if any)
   a. Full name
   b. Other names used
   c. Address, telephone number (residence and business)
   d. Business or occupation
   e. Employer
   f. Social security number
   g. Birthdate
   h. Place of birth and citizenship
   i. State of health
   j. Veteran?
      (1) I.D. number
      (2) Branch of service
      (3) Discharge date
3. Domestic partner (if any)
   a. Name
   b. Other names used

c. Address, telephone number (residence and business)
d. Business or occupation
e. Employer
f. Social security number
g. Birthdate
h. Place of birth and citizenship
i. State of health
j. Adult adoption?

4. Marital relationships
   a. Current
      (1) Date and place of marriage
      (2) Periods of out-of-state domicile
      (a) Dates
      (b) Places
      (3) Premarital or postmarital agreement (obtain copy)
      (4) Separated and/or in process of getting a divorce? If so, obtain date of separation
   b. Prior marriages of client or current spouse
      (1) Name of former spouse
      (2) Approximate dates of marriage
      (3) Marriage terminated by divorce or death?
      (4) Existing right or obligation from prior marriage?
   c. Future marriage contemplated? If so, to whom?
5. Nonmarital relationship
   a. Duration of relationship
   b. Periods of out-of-state domicile
      (1) Dates
      (2) Places
   c. Property agreement(s) with domestic partner or certificate of domestic partnership filed? If so, obtain copy
   d. Existing right or obligation from prior relationship?
6. Children
   a. Names of living children
      (1) Of current marriage or relationship
      (2) Of any prior marriage or relationship
      (3) Of spouse or domestic partner by prior marriage or relationship
      (4) Adopted
   b. Each living child
      (1) Address
      (2) Birthdate
      (3) Place of birth and citizenship
      (4) Marital status and/or name of spouse
      (5) Occupation
      (6) Special needs

(7) Existing right from or obligation to former spouse or partner re child?

c. Deceased children

(1) Names

(2) Dates of birth

7. Grandchildren (names, addresses, approximate ages, parents' names)

8. Living parents of client and of spouse or domestic partner

a. Names

b. Addresses

c. Approximate ages

d. Health

e. Financial status

9. Siblings of client and of spouse or domestic partner

a. Names

b. Living or deceased?

c. Addresses

d. Approximate ages

e. Children

10. If there are no close relatives, obtain family tree (to ease probate tasks)

B. Financial Profile

1. Assets

a. Real property

(1) Address of property

(2) Co-owners?

(3) Form of title (obtain copy of deed)

(4) Actual ownership interests, including whether interests are separate or community property (obtain facts and documents establishing characterizations)

(5) Buy-out agreement? If so, obtain copy

(6) Type of property (*e.g.,* residential, income)

(7) Acquisition date and purchase price

(8) Approximate fair market value

(9) Encumbrances

b. Cash (*e.g.,* checking accounts, savings accounts, CDs, money market funds)

(1) Names and addresses of financial institutions

(2) Amounts on deposit

(3) How accounts are held (*e.g.,* sole ownership, joint, in trust for)

(4) Actual ownership interests, including whether interests are separate or community property (obtain facts and documents establishing characterizations)

c. Securities (*e.g.,* common stock, preferred stock, corporate bonds, commodities, municipal bonds, government savings bonds, treasury bills, limited partnership interests, mutual funds)

(1) Name and holdings of each security

(2) Value of holdings of each security; basis information if relevant

(3) How securities are held (*e.g.,* sole ownership, joint tenancy)

(4) Actual ownership interests, including whether interests are separate or community property (obtain facts and documents establishing characterizations)

(5) Section 1244 stock

(6) "Restricted" or "qualified" stock option or stock acquired by exercise of this type of option

(7) Stock in "professional corporation"

(8) Stock in close corporation

(9) ESOP stock

(10) Subchapter S corporation stock

(11) Shareholders' agreements? If so, obtain copy

d. Business interests

(1) Name of business

(2) Type of business (*e.g.,* sole proprietorship, partnership, corporation)

(3) Startup date; basis information if relevant

(4) Nature of business and location

(5) Other owners' names and percentage of ownership

(6) Separate property or community property?

(7) Buy-sell agreement, partnership agreement, employment agreement, key executive insurance agreement, pension or profit-sharing plan? If so, obtain copies

(8) Present and projected profitability

(9) Fair market value

e. Retirement and other employee benefits

(1) Benefits related to present and/or former employment, including stock purchase plans, stock options, bonus plans

(2) Retirement assets, including IRA accounts, Keogh plans, pension plans, profit-sharing plans, annuities, deferred compensation plans, social security benefits

(3) Date-of-death value of each benefit, assuming current date of death

(4) Death beneficiary of each benefit, if any

(5) Separate property or community property?

f. Life insurance

(1) Policies in which client, spouse, or domestic partner is the insured (obtain name of company and type of policy)

(2) Face value of each policy less borrowed amount

(3) Surrender value of each policy

(4) Beneficiary and/or contingent beneficiary of each policy

(5) Owner of each policy

(6) Separate property or community property?

g. Promissory notes

(1) Payer

(2) To whom note is payable

(3) Actual ownership interests in note

(4) Terms of note, including amount, due date, interest, security (obtain copy of note and security instrument)

h. Copyrights, patents, mineral rights

(1) Description of asset

(2) Form of title (obtain copy of title documents)

(3) Actual ownership interests

(4) Separate property or community property?

(5) Current value

i. Expected inheritances or gifts (obtain general description including expected amount, source, date expected)

j. Beneficial interest in trust (obtain copy of trust document and amendments)

(1) Name of trust and trustee

(2) Description of client's interest

(3) Value of trust principal and income

(4) Other beneficiaries

(5) Power of appointment

k. Automobiles, trucks, trailers, recreational vehicles, boats, airplanes

(1) Model and year

(2) Current value

(3) Encumbrances

(4) Title shown on ownership document

(5) Actual ownership interest

l. Tangible personal property of significant value (*e.g.,* artworks, jewelry, antiques, coins, rare books, stamps, silver, furs)

(1) Description of item

(2) Approximate value/basis information

(3) Actual ownership interests, including whether separate or community property

m. Other assets (*e.g.,* interest in lawsuit)

2. Annual income

a. Present and projected salary or other personal service income of client, spouse, domestic partner

b. Other present and projected income sources of client, spouse, domestic partner (*e.g.,* annuities)

3. Liabilities

a. Secured obligations

(1) Creditor's name and address

(2) Amount of outstanding debt

(3) Security for obligation

(4) Other persons obligated

(5) Community or separate obligation

(6) Other material terms (obtain copy of note and security instrument)

b. Unsecured obligations

(1) Creditor's name and address

(2) Amount of outstanding debt

(3) Other persons obligated

(4) Community or separate obligation?

c. Pending lawsuits or claims

d. Other liabilities

4. Safe-deposit box

a. Number and location

b. Signatories and client's intentions about whether contents are held in joint tenancy

5. Existing estate plan documents (obtain copies)
    a. Will of client, spouse, domestic partner, including codicils and informal memoranda or letters of instructions
    b. Trust of client, spouse, domestic partner
    c. Powers of attorney of client, spouse, domestic partner
6. Past gifts by client
    a. Outright or in trust
    b. Property given and value at time of gift
    c. Donee
    d. Date of gift
    e. Gift tax returns? If so, obtain copy

C. Testamentary Wishes

1. Disposition of assets after death
    a. Specific gifts of specific items of property
    b. Gift of remaining personal belongings
    c. General gifts, particularly monetary gifts and interest on such gifts
    d. Residuary gifts
    e. Terms of gifts in trust, including, *e.g.,* names of trustee and beneficiaries, distribution terms, invasion powers, investment powers
    f. Names and addresses of contingent beneficiaries
2. Executor and alternate executor/bond or no bond
3. Guardian and alternate guardian of the person of minor child(ren) (obtain names for guardian and alternate guardian of estate if needed)
4. Custodian for minor beneficiary under California Uniform Transfers to Minors Act
5. Wishes regarding organ donation
6. Funeral or burial instructions
    a. Person in charge
    b. Special wishes regarding funeral or burial
    c. Obtain copies of documents already describing or making funeral or burial arrangements
    d. If not prepaid, source of funds to be used for funeral or burial goods and services
7. Manner of payment
    a. Unsecured debts
    b. Encumbrances and whether or not they should be exonerated
    c. Expenses of administration
    d. Packing and shipping costs
    e. Death taxes
8. Survivorship period
9. Ademption
10. No-contest clause
11. Other will provisions (*e.g.,* creation or exercise of power of appointment, gift of insurance owned on life of spouse)

D. Other Will Drafting Concerns

1. Probate avoidance devices available
2. Ways to reduce death tax burdens (*e.g.,* annual gifts, charitable gifts)

3. Changes in form of holding title to property (*e.g.,* joint tenancy to community property)
4. Changes in form or structure of business (*e.g.,* sole proprietorship to corporation)
5. Preparation and execution of buy-out agreements for co-owned assets
6. Planning for management of financial and personal affairs during incapacity (see chap 3)

Comment: This checklist is designed for the attorney to use during the initial client conference. See §2.1. Its purpose is to remind the attorney of the information that should be obtained about the client's family, property, and testamentary wishes. Because the checklist is fairly comprehensive, many items will not apply to a particular client's situation. The attorney may wish to create a condensed version of this checklist for clients with simple and small estates.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.3 3. Client File Review

§2.3 3. Client File Review

If the attorney has done work for the client in the past, the attorney should review the files, especially if the previous services were in the area of estate planning. This review will familiarize the attorney with the client's situation and save time during the initial client conference.

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B. Preparation by Client

§2.4 1. Preconference Questionnaires

Some attorneys prefer to gather information from the client by preconference questionnaire. The questionnaire should be short and easy to complete. If it is not, the attorney should explain to the client, either when arranging the appointment for the initial conference or by letter accompanying the questionnaire, why the information is necessary and how the client can save expense by filling out the questionnaire thoroughly and accurately. Alternatively, the attorney can ask the client to meet with the attorney's legal assistant before the initial conference to fill out the questionnaire. A sample questionnaire is presented in §2.5.

Although questionnaires cover most of the same topics as checklists, they should not contain questions that require some legal understanding to answer. For example, it is probably preferable for the attorney to explore with the client at the initial conference whether a particular asset is community or separate property instead of to ask the client to characterize the asset on a preconference questionnaire. The attorney should discuss topics not covered by the questionnaire at the initial conference. See §2.2 for a list of topics to cover at the conference.

A questionnaire has two advantages over a checklist. First, the client saves money because the attorney does not have to take time at the initial conference to obtain information that the client can easily provide in a preconference questionnaire. Second, the completed questionnaire becomes a permanent record of client data, arranged in a standard format for easy reference by anyone in the office.

The chief disadvantage of a questionnaire is that many clients do not like to fill them out, which sometimes slows down or abruptly terminates the estate planning process. Furthermore, because many clients complete the questionnaire hastily, the attorney may still have to go over the questionnaire with the client at the initial conference. Some attorneys resolve this problem by having a legal assistant help the client complete the questionnaire before the initial conference.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.5 2. Form: Client Questionnaire

§2.5 2. Form: Client Questionnaire

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

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

A. Personal Profile

1. Client

Full name:_____

Other names used _____

Home address:_____

Home telephone number:_____

Business occupation: _____

Employer: _____

Work address: _____

Work telephone number: _____

Work fax number: _____

Social security number: _____

Birthdate: _____

Birthplace: _____

Citizenship: _____

Period of residence in California: _____

State of health: _____

If veteran, supply I.D. number, branch of service, and discharge date: _____

2. Spouse (if any)

Full name: _____

Other names used: _____

Home address: _____

Home telephone number: _____

Business or occupation: _____

Employer: _____

Work address: _____

Work telephone number: _____

Social security number: _____

Birthdate: _____

Birthplace: _____

Citizenship: _____

Period of residence in California: _____

State of health: _____

If veteran, supply I.D. number, branch of service, and discharge date: _____

3. Domestic partner (if any)

Full name: _____

Other names used: _____

Home address: _____

Home telephone number: _____

Business or occupation: _____

Employer: _____

Work address: _____

Work telephone number: _____

Social security number: _____

Birthdate: _____

Birthplace: _____

Citizenship: _____

Period of residence in California: _____

State of health: _____

Have you adopted your partner or has your partner adopted you? _____ If yes, attach copy of decree of adoption.

4. Marital relationships

a. Current

(1) If you are currently married, please give the date and place of marriage:
_____

(2) Since your marriage, have you and your spouse resided outside California? _____ If yes, please list the dates and place(s) of your out-of-state residence(s): _____
_____
_____

(3) Have you and your spouse executed a prenuptial agreement or postmarital agreement? _____ If yes, please attach a copy of the agreement.

(4) Are you in the process of getting a divorce? _____
Are you and your spouse separated? _____
If separated, please give the date of separation:
_____

b. Prior marriages of client

(1) Have you ever been married before?_____

(2) If yes, give the following information for each former marriage (please attach sheets, if necessary):

(a) Name of former spouse:_____

(b) Dates of marriage: _____

(c) Was the marriage ended by death or divorce? _____

(d) If the marriage ended in divorce, please attach copies of the following:

(i) Interlocutory judgment if entered before July 1, 1984, or judgment if entered on or after that date;

(ii) Any order modifying the interlocutory judgment or judgment;

(iii) Marital termination agreement if not expressly set out in, or physically attached to, the interlocutory judgment or judgment; and

(iv) Any agreements modifying the terms of the marital termination agreement

c. If you are unmarried, do you plan to marry in the near future? _____ If yes, please give the name of your intended spouse:
_____

5. Nonmarital relationships

a. _ If you currently have a domestic partner, please indicate how long you have been in this relationship:

b. During your relationship, have you and your domestic partner resided outside California? _____ If yes, please list the dates and place(s) of your out-of-state residence(s):_____
_____

c. Have you and your domestic partner signed any agreement describing rights and obligations with respect to each other? _____ If yes, please attach a copy of the agreement.

d. Have you and your domestic partner (or former domestic partner) filed a declaration of domestic partnership with the Secretary of State? _____ If yes, please attach a copy of the filed document(s).

e. Do you have any financial obligation to any former domestic partner from a domestic partnership for which no declaration of domestic partnership was filed with the Secretary of State or does any former domestic partner have any financial obligation to you? _____

If yes, please describe:_____
_____
_____
_____
_____

f. Prior domestic partnerships of client

(1) Have you ever been in a domestic partnership before for which a declaration of domestic partnership was filed with the Secretary of State at any time? _____

(2) If yes, give the following information for each former domestic partner (please attach sheets, if necessary):

(a) Name of former domestic partner:_____

(b) Dates of domestic partnership: _____

(c) Was the partnership ended by death or dissolution? _____

(d) If the partnership ended in dissolution or termination, please attach copies of the following:

(i) Judgment of dissolution or notice of termination;

(ii) Any order modifying the judgment;

(iii) Partnership termination agreement if not expressly set out in, or physically attached to, the judgment; and

(iv) Any agreements modifying the terms of the partnership termination agreement

g. If you do not have a registered domestic partner, do you plan to register as a domestic partner in the near future? _____

If yes, please give the name of your intended domestic partner:
_____

6. Children

a. Living children of current marriage or relationship (please attach additional sheets for additional children)

(1) Child 1

(a) Name: _____

(b) Address: _____
_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status and/or name of spouse:
_____

(g) Occupation: _____

(2) Child 2

(a) Name: _____

(b) Address: _____

_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status and/or name of spouse:

_____

(g) Occupation: _____

b. Living children of prior marriage or relationship (please attach additional sheets for additional children)

(1) Child 1

(a) Name: _____

(b) Address: _____

_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status and/or name of spouse:

_____

(g) Occupation: _____

(h) Name of parent other than client:

_____

(2) Child 2

(a) Name: _____

(b) Address: _____

_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status and/or name of spouse:

_____

(g) Occupation: _____

(h) Name of parent other than client:

_____

c. Living children of spouse or domestic partner by prior marriage or relationship (please attach additional sheets for additional children)

(1) Child 1

(a) Name: _____

(b) Address: _____

_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status or name of spouse or domestic partner: _____

_____

(g) Occupation: _____

(h) Name of natural parent other than spouse or domestic partner:

_____

(i) Have you legally adopted this child? _____
_____

(2) Child 2

(a) Name: _____

(b) Address: _____
_____

(c) Birthdate: _____

(d) Place of birth: _____

(e) Citizenship: _____

(f) Marital status or name of spouse or domestic partner: _____
_____

(g) Occupation: _____

(h) Name of natural parent other than spouse or domestic partner:
_____

(i) Have you legally adopted this child? _____
_____

d. Deceased children of client and spouse or domestic partner (please attach additional sheets for additional children)

(1) Child 1

(a) Name: _____

(b) Birthdate: _____

(c) Parents' names: _____
_____

(d) Did this child have any children? _____ If yes, please list their names and ages:
_____
_____
_____
_____

(2) Child 2

(a) Name: _____

(b) Birthdate: _____

(c) Parents' names: _____
_____

(d) Did this child have any children? _____ If yes, please list their names and ages:
_____
_____
_____
_____

e. Do any of the living children listed above have any special needs (*e.g.,* caused by a physical or mental disability)? _____ If yes, list the name of the child and describe the problem: _____
_____
_____

f. Do you or your spouse or domestic partner have any child support obligations to a former spouse or domestic partner? _____ If yes, please list the name of the child involved, the person who is obligated, and the person to whom he or she is obligated. Describe the nature and extent of the obligation: _____
_____
_____

7. Grandchildren

Please list the names of your grandchildren. For each living grandchild, provide the address, approximate age, and parents' names. For each deceased grandchild, provide the parents' names:
_____

_____
_____

8. Parents

a. Living parents of client

(1) Names: _____
_____

(2) Addresses: _____
_____

(3) Ages: _____

b. Living parents of spouse or domestic partner

(1) Names: _____
_____

(2) Addresses: _____
_____

(3) Ages: _____

c. Do any of the parents listed above have special needs? _____ If yes, please indicate which parent and describe the needs: _____
_____
_____

9. Siblings (brothers and sisters)

a. Siblings of client (please attach additional sheets for additional siblings)

(1) Sibling 1

(a) Name: _____

(b) Living or deceased? _____

(c) Address: _____

(d) Age: _____

(e) Names and ages of children: _____
_____
_____

(2) Sibling 2

(a) Name: _____

(b) Living or deceased? _____

(c) Address: _____

(d) Age: _____

(e) Names and ages of children: _____
_____
_____

b. Siblings of spouse or domestic partner (please attach additional sheets for additional siblings)

(1) Sibling 1

(a) Name: _____

(b) Living or deceased? _____

(c) Address: _____

(d) Age: _____

(e) Names and ages of children: _____
_____
_____

(2) Sibling 2

(a) Name: _____

(b) Living or deceased? _____

(c) Address: _____

(d) Age: _____

(e) Names and ages of children: _____
_____
_____

B. Financial Profile

1. Assets

a. Real property (please attach copies of all deeds for, and buy-out agreements affecting, parcels of real property listed below)

(1) Parcel 1

(a) Address: _____
_____

(b) Do you believe that your actual ownership interest in this parcel is not accurately reflected by the deed? _____ If yes, please explain: _____
_____
_____

(c) Type of property (*e.g.,* your residence, rental property, vacation property):
_____
_____

(d) Date of acquisition and purchase price: _____
_____

(e) Approximate fair market value: _____

(2) Parcel 2

(a) Address: _____
_____

(b) Do you believe that your actual ownership interest in this parcel is not accurately reflected by the deed? _____ If yes, please explain: _____
_____
_____

(c) Type of property (*e.g.,* your residence, rental property, vacation property):
_____
_____

(d) Date of acquisition and purchase price: _____
_____

(e) Approximate fair market value: _____

(3) Parcel 3

(a) Address: _____
_____

(b) Do you believe that your actual ownership interest in this parcel is not accurately reflected by the deed? _____ If yes, please explain: _____
_____
_____

(c) Type of property (*e.g.,* your residence, rental property, vacation property):
_____
_____

(d) Date of acquisition and purchase price: _____
_____

(e) Approximate fair market value: _____

b. Cash (*e.g.,* checking accounts, savings accounts, CDs, money market accounts; please attach additional sheets for additional accounts)

(1) Account 1

(a) Name of financial institution: _____
_____

(b) Location of financial institution: _____
_____

(c) Type of account (*e.g.,* checking, savings): _____
_____

(d) Approximate balance: $ _____

(e) How is title to this account held? _____
_____

(2) Account 2

(a) Name of financial institution: _____
_____

(b) Location of financial institution: _____
_____

(c) Type of account (*e.g.,* checking, savings): _____
_____

(d) Approximate balance: $ _____

(e) How is title to this account held? _____
_____

(3) Account 3

(a) Name of financial institution: _____
_____

(b) Location of financial institution: _____
_____

(c) Type of account (*e.g.,* checking, savings): _____
_____

(d) Approximate balance: $ _____

(e) How is title to this account held? _____
_____

(4) Account 4

(a) Name of financial institution: _____
_____

(b) Location of financial institution: _____
_____

(c) Type of account (*e.g.,* checking, savings): _____
_____

(d) Approximate balance: $ _____

(e) How is title to this account held? _____
_____

(5) Account 5

(a) Name of financial institution: _____
_____

(b) Location of financial institution: _____
_____

(c) Type of account (*e.g.,* checking, savings): _____
_____

(d) Approximate balance: $ _____

(e) How is title to this account held? _____
_____

c. Securities (*e.g.,* common stock, preferred stock, corporate bonds, commodities, municipal bonds, government savings bonds, treasury bills, limited partnership interests, mutual funds)

(1) Please list each security that you own. Indicate how many you own, the current value of your holdings, and how title to the security is held (*e.g.,* 200 shares of International Paper common stock; $10,000; John Smith and Kevin Daniels as joint tenants):

_____
_____
_____
_____

(2) Do you own any stock in a professional corporation? _____ If yes, give the name of the corporation

(3) Do you own stock in a close corporation? _____ If yes, list the name of the corporation:
_____

(4) Do you own ESOP stock? _____

(5) Have you entered into any shareholders' agreements affecting your stocks? _____ If yes, please attach a copy of the agreement

d. Client-owned business

(1) Name of business: _____

(2) Type of business (*e.g.,* sole proprietorship, partnership, corporation):
_____

(3) Nature of business and location: _____
_____

(4) Co-owners and ownership interest of each: _____
_____
_____

(5) Fair market value of business: _____

(6) Have you entered into a buy-sell agreement, partnership agreement, employment agreement, key executive insurance agreement, or pension or profit-sharing plan? _____ If yes, please attach a copy of each agreement and plan

e. Retirement and other employee benefits (please attach a copy of employee benefits statement; for benefits provided by your employer, the benefits, human resources, or personnel department may be able to provide the requested information)

(1) Please list all retirement assets, including IRA accounts, Keogh plans, pension plans, profit-sharing plans, annuities, deferred compensation plans, and social security benefits. In your description of each asset, include its value (assuming a current date of death). If you have designated a death beneficiary for the asset, indicate who the beneficiary is:

_____
_____
_____
_____

(2) Please list all currently owned benefits (other than retirement assets) relating to your present and/or former employment, including stock purchase plans, stock options, and bonus plans. Include the value of each benefit and the name of its death beneficiary, if one has been designated: _____

_____
_____
_____
_____

f. Life insurance (policies in which client, spouse, or domestic partner is the insured party; please attach copies of all beneficiary designation statements)

(1) Policy 1

(a) Insurance company: _____

(b) Life insured: _____

(c) Owner of policy: _____

(d) Type of policy (*e.g.,* whole life, term): _____

(e) Face value of each policy less borrowed amounts: _____

(f) Surrender value: _____

(g) Beneficiary: _____

(2) Policy 2

(a) Insurance company: _____

(b) Life insured: _____

(c) Owner of policy: _____

(d) Type of policy (*e.g.,* whole life, term): _____

(e) Face value of each policy less borrowed amounts: _____

(f) Surrender value: _____

(g) Beneficiary: _____

(3) Policy 3

(a) Insurance company: _____

(b) Life insured: _____

(c) Owner of policy: _____

(d) Type of policy (*e.g.,* whole life, term): _____

(e) Face value of each policy less borrowed amounts: _____

(f) Surrender value: _____

(g) Beneficiary: _____

(4) Policy 4

(a) Insurance company: _____

(b) Life insured: _____

(c) Owner of policy: _____

(d) Type of policy (*e.g.,* whole life, term): _____

(e) Face value of each policy less borrowed amounts: _____

(f) Surrender value: _____

(g) Beneficiary: _____

g. Promissory notes

For each promissory note in which you have an ownership interest, list the name of the payer, the name(s) of the payee(s), and the current outstanding balance on the note. Please attach a copy of each note and security agreement or deed of trust, if any: _____

_____

_____

_____

_____

h. Beneficial interest in trust

(1) Are you a beneficiary of a trust?

(2) If yes, please provide a copy of the trust document and all amendments to it and complete the following:

(a) Name of trust: _____

(b) Name of trustee:

(c) Value of trust principal and income: _____

_____

_____

i. For each automobile, truck, trailer, recreational vehicle, boat, and airplane that you own, please list the model and year, the current value, and the title as shown on the ownership document: _

_____
_____

_____
_____

j. Tangible personal property

Please list all tangible personal property of significant value that you own, including, *e.g.,* artworks, jewelry, antiques, coins, rare books, stamps, silver, and furs. Indicate the approximate fair market value of each item. If the item is not entirely owned by you, list the co-owners and their ownership interests in the item: _____

_____
_____
_____
_____

k. Other assets (*e.g.,* interest in lawsuit, copyrights, patents, mineral rights)

Please list any asset you own that has not been listed above, except for tangible personal property of an ordinary nature. Describe each asset and state its current value: _____

_____
_____
_____
_____

l. Do you believe that your actual ownership interest in any asset listed above is *not* accurately reflected by the title document for the asset? _____ If yes, list all assets whose title documents do not conform to actual ownership interests and describe the actual interests:

_____
_____
_____
_____
_____

2. Liabilities

Please list all your liabilities and provide the name of the creditor, the amount owed, the names of any co-debtors, and the property that secures the debt, if any, for each (you need not list a revolving or charge account unless the outstanding balance exceeds $5000): _____

_____
_____
_____
_____

3. Do you have a safe-deposit box? _____ If yes, please give the box number and the name and address of the financial institution where the box is located:

_____

Provide the name of any person who has direct access to your safe-deposit box: _____

Do you intend this person to receive the contents of the safe-deposit box at your death? _____ Where do you keep the keys to the safe-deposit box? _____

_____

4. Do you expect to inherit some property in the near future? _____ If yes, please describe what you expect to inherit and from whom: _____

_____
_____

5. What is the approximate net worth of your spouse or domestic partner?
$_____

6. Have you made gifts to anyone of over $10,000? _____ If yes, please provide the name of the person to whom you made the gift, a description of what was given, the value of the gift when the gift was made, and the year in which the gift was made. If you filed gift tax returns, please attach a copy: _____

_____
_____
_____

7. If you currently have a will (including any codicils and letters of instructions) and/or a revocable living trust, please attach copies. If you have executed a durable power of attorney of any sort, attach a copy of it

8. If you wish to be an organ and tissue donor, have you executed an organ donor card or indicated your donative intent in a durable power of attorney for health care or on your driver's license? _____ Have you informed your family of your donative intent? (Many physicians will not carry through on organ removal, even if the decedent expressed donative intent in writing, unless authorization is obtained from the decedent's next of kin at the time of death.)_____

9. Please indicate any burial or funeral instructions you wish to be followed. If you have already prepared such instructions, please attach. _____
_____
_____
_____

Comment: This sample questionnaire only contains questions that most clients are able to answer without an attorney's assistance. Topics listed in the client interview checklist, but not in the questionnaire, should be covered in the first conference. See §2.2. Some attorneys delete the financial profile portion of the questionnaire and either ask the client to complete that portion after the initial conference or obtain the information from the client directly at the conference. See discussion in §2.4.

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II. INITIAL CLIENT CONFERENCE

§2.6 A. Conducting Client Conference

The first conference between the client and the attorney should be a productive exchange of information. Usually, the client discloses relevant details of his or her personal and financial situation, and the attorney begins to educate the client on the law controlling the desired dispositions. The attorney should use a client interview checklist (see §2.2) to obtain all pertinent information. If the client has filled out a preconference questionnaire (see §2.5), the attorney should review it to ensure that it has been thoroughly and accurately completed.

PITFALL: As a general rule, the attorney should not assume that information provided by the client is entirely accurate. This is particularly applicable to information about the nature of the client's property. Will clients tend to underestimate the value of their assets and frequently are unaware of legally significant distinctions in title, *e.g.,* joint tenancy versus community property, tenancy in common versus partnership. The attorney should verify the client's responses, when possible, by examining supporting documents such as deeds and tax returns.

In addition to asking questions about the client's probate assets, the attorney should use the initial conference to learn about the nature and extent of the client's nonprobate assets. Part of this review should include an examination of beneficiary designation documents for life insurance, retirement plans, and other employee benefits. Outdated beneficiary designations can seriously distort estate plans and lead to litigation. The attorney should also examine title documents for jointly owned property, particularly deeds and documents relating to multifaceted brokerage accounts. If a client needs to make a change in a nonprobate asset to make it consistent with his or her estate planning objectives, the attorney should follow through with the client to ensure that the change is made.

If the client is married or has a registered domestic partner, the attorney should obtain a detailed financial history of the marriage or domestic partnership. This information, which may be needed by the surviving spouse or registered domestic partner to complete the Spousal or Domestic Partner Property Petition (Form DE-221) under Prob C §13650, can be obtained more easily from both spouses or partners during the initial conference than from one spouse or partner after the other has died. The financial history will assist the attorney in determining which of the client's assets are community property and which are separate property. Because the client's ability to devise a community property asset is limited, this is not an academic distinction. See *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153, discussed in §10.11.

The attorney should make an effort to put the client at ease, especially one who has not dealt with attorneys before. If the client is not comfortable with the attorney or feels that the attorney may be judgmental, the client may withhold information vital to the development of a satisfactory estate plan. See §2.7.

The attorney should listen closely to the concerns of the client, resisting any impulse to assume what the client wants or needs. The role of the attorney is to present the client with options tailored to his or her situation and to assist the client in making informed decisions. The attorney should not attempt to manipulate the client into making decisions that will make the attorney's job of drafting documents simple.

The attorney should set aside enough time for a relaxed and comprehensive conference. The initial conference is often the most enjoyable part of the estate planning process for the attorney, providing the attorney an opportunity to meet people and discover their personal histories and values. From a practical standpoint, a successful initial conference can be the basis for a continuing professional relationship that may carry into other areas of law and beyond the lifetime of the client.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.7 B. Eliciting Testamentary Wishes

§2.7 B. Eliciting Testamentary Wishes

Eliciting and understanding the client's testamentary wishes is just as important as becoming familiar with the client's personal and financial background. Some clients, particularly those without spouses, domestic partners, or children, come to the initial conference with only vague notions of how they wish their estates to be distributed at their death. These clients require direction from the attorney. The attorney should elicit which persons and organizations are important to the client and suggest possible disposition alternatives. The attorney may also explain how others in a similar situation have handled disposition of assets. See §2.6.

The attorney should not assume that the first priority of every client is to minimize estate taxes. For example, a married couple in their middle years with a moderate estate may be more concerned with the security of the surviving spouse than with saving taxes. It is not unreasonable for them to wish their entire estate to pass outright to the surviving spouse or to a trust providing maximum benefits to the spouse even though using less than the unlimited marital deduction might be advantageous from a tax standpoint when both estates are considered. For another example, a client may be unwilling to accept a complex estate plan just to lower the beneficiaries' estate taxes and probate expenses after the client's death.

The attorney cannot substitute his or her judgment for the client's. The client must make the basic decisions about his or her will. The attorney's responsibility is to see that the client's decisions are informed and to implement the decisions by drafting the appropriate will or revocable trust and other estate planning documents.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.8 C. Anticipating Issues of Incapacity, Fraud, and Undue Influence

§2.8 C. Anticipating Issues of Incapacity, Fraud, and Undue Influence

The attorney should use the initial client conference (see §§2.6-2.7) to satisfy himself or herself that the client is competent to make a will and is not acting as a result of fraud or undue influence. To make this determination, the attorney should be familiar with the laws concerning testamentary capacity (see §§2.9-2.15), undue influence (see §§2.16-2.21), and fraud (see §§2.22-2.23).

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1. Testamentary Capacity

§2.9 a. The Due Process in Competence Determinations Act and Other Legal Standards of Capacity

The Due Process in Competence Determinations Act (Prob C §§810-813) codifies standards for a court to use in determining if a person has the capacity to perform particular acts, including executing a will. The testator is presumed to have testamentary capacity, and the burden of rebutting this presumption by a preponderance of the evidence is on the will contestant. See *Estate of Russell* (1947) 80 CA2d 711, 182 P2d 318.

A determination that a person lacks the capacity to do a certain act must be supported by evidence of a deficit in at least one of the following mental functions and evidence of a correlation between the deficit and the decision or act in question: alertness and attention; information processing; thought processes; and the ability to modulate mood and affect. (Each function is further broken down into specific manifestations of the function.) Prob C §811(a).

A deficit in any of the specified mental functions is relevant only if, by itself or in combination with other mental function deficits, it significantly impairs the person's ability to understand and appreciate the consequences of his or her actions with regard to the type of act or decision in question. Prob C §811(b). The mere diagnosis of a mental or physical disorder is not sufficient by itself to support a determination that a person is of unsound mind or lacks the capacity to do a certain act. Prob C §811(d).

NOTE: The capacity required to execute a will under many tests is less than the capacity required to execute a contract. See Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008).

In addition, specific criteria apply to the determination of testamentary capacity (see §2.9A) and the testator must have a specified ability to communicate (see §2.9B).

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.9A (1) Criteria of Testamentary Capacity

§2.9A (1) Criteria of Testamentary Capacity

Every adult (including an emancipated minor) of sound mind can make a will. Prob C §6100; Fam C §7050(e)(6). Under Prob C §6100.5(a), a person is not mentally competent to make a will—even if the person satisfies the standards discussed in §2.9—if, at the time the will is executed, either of the following is true:

- The testator does not have sufficient mental capacity to:
- Understand the nature of the testamentary act;
- Understand and recollect the nature and situation of his or her property; or
- Remember and understand his or her relations to his or her living descendants, spouse, parents, and those whose interests are affected by the will. Prob C §6100.5(a)(1).
- The testator suffers from a mental disorder involving delusions or hallucinations that cause the testator to choose a disposition for his or her property that he or she would not have chosen but for the delusions or hallucinations. Prob C §6100.5(a)(2).

Probate Code §6100.5 was not intended to change the common law on testamentary capacity. Furthermore, Prob C §6100.5(a) does not affect existing law on the admissibility of evidence to prove mental incompetence or mental disorders. Prob C §6100.5(b).

Under Prob C §6100(b), a conservator may make a will for the conservatee if the conservator has been so authorized by a substituted-judgment order under Prob C §2580. However, the conservatee who is mentally competent to make a will may revoke or amend a will made by the conservator, or may make a new and inconsistent will.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.9B (2) Ability to Communicate

§2.9B (2) Ability to Communicate

Probate Code §812 provides that a person lacks capacity to make a decision (presumably including testamentary decisions)—even if the person satisfies the standards discussed in §2.9—unless the person can communicate, verbally or by other means, all of the following:

(a) The rights, duties, and responsibilities created by or affected by the decision;

(b) The probable consequences for the decisionmaker and, when appropriate, the persons affected by the decision; and

(c) The significant risks, benefits, and reasonable alternatives involved in the decision.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.10 b. 'Natural' Objects of Testator's Bounty

§2.10 b. "Natural" Objects of Testator's Bounty

The common law required that the testator be able to remember and understand his or her relations to the persons "who are the natural objects of his [or her] bounty." *Estate of Glass* (1958) 165 CA2d 380, 383, 331 P2d 1045. This requirement was often involved in suits challenging a testator's mental capacity brought by family members disappointed by the will being offered for probate. The disappointed heir's claim in such suits was that the testator's failure to provide for the heir was evidence of the testator's inability to recognize the heir, a "natural" object of his or her bounty.

Probate Code §6100.5(a)(1)(C) eliminated the ambiguity of the term "natural objects of bounty" by requiring that the testator have the mental ability to know his or her children, spouse, and parents and any other persons affected by the will. See §2.9A.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.11 c. Delusions Affecting Devises

§2.11 c. Delusions Affecting Devises

Delusions or hallucinations that have no bearing on testamentary dispositions are not sufficient to overcome the presumption of testamentary capacity.

In *Estate of Lingenfelter* (1952) 38 C2d 571, 241 P2d 990, the evidence showed that the testator held strange and emotional beliefs about many subjects, *e.g.,* politics, Franco, Stalin, the stability of the economic system of the world, and her own relatives. The testator also believed, on occasion, that her husband was unfaithful to her. Although her suspicions about her husband were unwarranted, on one of those occasions she procured a gun. The court found this evidence inadequate to prove that the testator was mentally unfit to make a will, because none of her beliefs or prejudices affected her testamentary disposition.

In *Estate of Martin* (1969) 270 CA2d 506, 75 CR 911, the decedent left a will giving his estate to the attorney who had probated his wife's will and a bank officer acquainted with the decedent in that business capacity only. The decedent's nephew, his sole heir at law, contested the will. In affirming the judgment for the contestant, the court found substantial evidence to conclude that the decedent had lacked testamentary capacity when he had executed the will. The evidence also showed that the decedent had really cared for his nephew before the onset of his mental difficulties. This evidence showed that the will was the result of these delusions held by the decedent:

- The nephew was planning to commit him to a mental institution;
- The beneficiaries of his will were the only persons who would prevent this from happening and who would attend to him any time he called; and
- The nephew had killed the decedent's mother (the nephew had not yet been born at the time of her death).

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§2.12 d. Testator's Incapacity Must Be Shown at Time of Execution of Will

Testamentary incapacity must be shown to have existed at the time the will was executed to invalidate the instrument on this ground. *Estate of Lockwood* (1967) 254 CA2d 309, 313, 62 CR 230.

Evidence of physical infirmity, chronic alcoholism, senility, judicially declared mental incompetency, or insanity does not by itself establish a lack of testamentary capacity. However, evidence that the testator suffered from these conditions, or evidence of the testator's general mental status, is admissible in will contests if relevant to the issue of the testator's capacity at the time the will was executed. See *Estate of Locknane* (1962) 208 CA2d 505, 25 CR 292. See also *Estate of Alexander* (1931) 111 CA 1, 11, 295 P 53 (proof of existence of permanent mental disorder shortly before or after execution of will may warrant inference that disease existed at time of execution).

In *Estate of Ross* (1962) 204 CA2d 82, 22 CR 135, a will contest, the record included evidence that the testator had attempted suicide on many occasions and eventually succeeded, was addicted to barbiturates, had epileptic fits, had undergone extensive psychiatric treatment, might have suffered brain damage from an overdose of barbiturates, was despondent and erratic, and lacked good judgment. Because this evidence did not specifically address the issue of the testator's capacity on the day the will was executed, the court affirmed summary judgment for the defendants.

In *Estate of Bullock* (1956) 140 CA2d 944, 295 P2d 954, the evidence showed that the testator, a judicially declared incompetent, suffered from arteriosclerosis, a softening of the brain, high blood pressure, loss of bladder control, partial deafness, and malnutrition, combining to cause a progressive, incurable brain degeneration. The evidence also showed that she was in a state of advanced senility when she died. The appellate court held that this evidence was insufficient to support the trial court's findings of testamentary incapacity, noting that no witness offered evidence of the testator's condition when she wrote the will that would support such findings.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.13 e. Admissibility of Opinion Evidence

§2.13 e. Admissibility of Opinion Evidence

Physicians, psychiatrists, subscribing witnesses, and "intimate acquaintance[s]" of the testator are qualified to give opinion evidence on the issue of testamentary capacity. Evid C §870. See generally 14 Witkin, Summary of California Law, *Wills and Probate* §122 (10th ed 2005). If the subscribing witness was not an intimate acquaintance of the testator, the witness may only render an opinion about the testator's capacity at the time the writing was signed. Evid C §870. See also Jefferson's California Evidence Benchbook §§30.1-30.15 (4th ed CJA-CEB 2009).

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§2.14 f. Unnatural Will as Evidence of Incapacity

A will cannot be set aside only because it is unnatural. "'[I]t is well to remember that one has the right to make an unjust will, an unreasonable will, or even a cruel will.'" *Estate of White* (1954) 128 CA2d 659, 667, 276 P2d 11, quoting *In re McDevitt* (1892) 95 C 17, 33, 30 P 101. A will is admissible as evidence in a will contest, however, if its provisions tend to show some delusion (see §2.11) or lack of capacity (see §2.12) at the time of execution. Generally speaking, a natural, just, or reasonable will tends to show capacity; an unnatural, unjust, or unreasonable will casts doubt on capacity.

Occasionally a court suggests that a "natural" will can be identified without regard to the testator's specific experiences and views, *e.g.*, with regard to the "natural" objects of the testator's bounty. See §2.10. In practice, however, a will is usually considered "unnatural" (and therefore evidence of incapacity) only if it is significantly at odds with the testator's lifetime loyalties and beliefs. Most courts examine a will for evidence of testamentary incapacity in light of the testator's unique experiences.

In *Estate of Powell* (1931) 113 CA 670, 299 P 108, the decedent left the bulk of her estate to a close personal friend and did not provide for her mother or siblings. The contestant, mother of the decedent, argued that the "unnatural" disposition of the will proved that there was something wrong with the testator. Both the trial and appellate courts summarily rejected this argument. The appellate court noted that the testator's family had "broken up" about 30 years before her death, its members rarely saw her, and they had very little in common with her. In contrast, the beneficiary had been a close friend of the testator for nearly 20 years, even taking the testator into her home to care for her after her husband's death. The court found nothing unnatural, unjust, or unreasonable about the decedent's will. See also *Estate of Bullock* (1956) 140 CA2d 944, 950, 295 P2d 954 (not unnatural for testator to leave estate to her most intimate friend rather than relatives whom she seldom saw).

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§2.15 g. Protecting Against Claim of Incapacity

The drafting attorney must be alert for any situation that could invite a claim that the client lacked testamentary capacity. If the attorney does not believe that the client has the requisite capacity to sign a will, the attorney should not prepare the will. On the other hand, the attorney should not decline to prepare the will merely because there is some uncertainty about competence. If the desired document is not drafted and the client is in fact competent, the failure to draft amounts to a unilateral decision by the attorney that the client is incompetent, despite the attorney's actual uncertainty. Often, however, even though the attorney is convinced of the client's testamentary capacity, some claim of incapacity is foreseeable. In these cases, the attorney should take all reasonably practical steps to diminish the chances of such a claim being made or being successful.

If a claim of incapacity is foreseeable because the client is leaving the bulk of the estate to someone the client's immediate family dislikes, the attorney should advise the client that he or she can minimize the risks of a will contest by explaining to the family the nature of his or her relationship to the beneficiary and, if appropriate, how the client intends to provide for the beneficiary in his or her will.

EXAMPLE: An attorney has a gay client who wishes to leave most of his estate to his domestic partner. The client's family, ignorant of his homosexuality, believes his domestic partner to be just his roommate. If the client does not inform his family about the nature of his relationship to his partner, the family will be forced to deal at his death with its grief while trying to reconcile the person they thought they knew and loved with the person whose will provided primarily for his domestic partner. The family members are likely to conclude that, because the client never told them he was gay, he must not have been and that his will must have been the result of a lack of testamentary capacity or undue influence. If the client had revealed to his family the nature of his relationship to the beneficiary of the will, his family would not have come to these conclusions even if they could not accept the relationship.

For court decisions holding that the attorney does not have a duty to third persons to determine client competence, see §1.20A. For other steps that the attorney may take in anticipation of a will contest asserting a lack of testamentary capacity, see §36.13.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/ 2. Undue Influence/§2.16 a. Definition of 'Duress' and Undue Influence

2. Undue Influence

§2.16 a. Definition of "Duress" and Undue Influence

Probate Code §6104 provides that the "execution or revocation of a will or a part of a will is ineffective to the extent the execution or revocation was procured by duress, menace, fraud, or undue influence." Use of the words "duress," "menace," and "undue influence" seems redundant. Most modern cases treat these terms as synonymous and refer only to undue influence. See §§2.17-2.21. See also Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008). But because "fraud," as used in Prob C §6104, has a different connotation from undue influence, it is separately discussed in §§2.22-2.23.

Undue influence is conduct that subjugates the testator's will to the will of another and causes the testator to choose a disposition of property that he or she would not have chosen in following his or her own inclination or judgment. *Estate of Franco* (1975) 50 CA3d 374, 382, 122 CR 661. The pressure on the testator (1) must have been so overpowering that he or she was not a free agent when the will was made (*Estate of Franco, supra*) and (2) must have directly affected the testamentary act (*Estate of Gleason* (1913) 164 C 756, 765, 130 P 872; *Estate of Wright* (1963) 219 CA2d 164, 169, 33 CR 5).

A beneficiary's influence on the testator does not invalidate the will if the influence was not "undue." Influence gained by kindness and affection is not undue influence if there was no imposition or fraud, even though the influence affected the testator in making the will. *Estate of Bould* (1955) 135 CA2d 260, 270, 287 P2d 8.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.17 b. Elements of Presumption of Undue Influence

§2.17 b. Elements of Presumption of Undue Influence

A presumption of undue influence is raised if the evidence shows one of two sets of facts. The first set of facts, described in *Estate of Lingenfelter* (1952) 38 C2d 571, 585, 241 P2d 990, includes the following:

- A confidential relationship existed between the chief beneficiary and the testator;
- The provisions of the will are inconsistent with the testator's intentions expressed before and after the will's execution;
- The chief beneficiary's relationship with the testator gave the former the opportunity to control the testamentary act;
- The testator's mental or physical condition permitted a subversion of his or her free will; and
- The chief beneficiary under the will was active in procuring it.

Commonly cited by courts and commentators (see, *e.g., Estate of Baker* (1982) 131 CA3d 471, 480, 182 CR 550; *Estate of Goetz* (1967) 253 CA2d 107, 115, 61 CR 181), the second set of facts sufficient to raise a presumption of undue influence includes:

- The beneficiary's active participation in procuring the will;
- A confidential relationship between the testator and beneficiary; and
- Undue benefit to the beneficiary under the will.

Because this second set of facts is more concise and somewhat less burdensome to the party challenging the validity of the will, it is more frequently used to raise the presumption of undue influence than the set of facts described in *Estate of Lingenfelter, supra*.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.18 c. Active Participation in Procurement of Will

§2.18 c. Active Participation in Procurement of Will

Active procurement of a will is a beneficiary's involvement in the preparation and execution of the will that brings pressure to bear directly on the testamentary act. It is often difficult for will contestants to prove this necessary element of the prima facie case for undue influence. 14 Witkin, Summary of California Law, *Wills and Probate* §135 (10th ed 2005).

Active procurement of a will is usually proved by a combination of factors. It often is demonstrated by circumstantial evidence. The beneficiary's presence (see §2.18A) or absence (see §2.18B) at the execution of the will is not determinative. Evidence of circumstances before and after the will execution may be considered if it tends to show undue influence at the time of will execution. *Estate of Baker* (1982) 131 CA3d 471, 481, 182 CR 550.

When the testator's attorney participated in the preparation of the will and benefited thereunder, proof that the benefit to the attorney was "undue" (as discussed in §2.20) is not required to trigger a presumption of undue influence. *Estate of Auen* (1994) 30 CA4th 300, 35 CR2d 557.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.18A (1) Presence of Beneficiary

§2.18A (1) Presence of Beneficiary

The beneficiary's presence at the execution of the will is not enough to prove active procurement of the will. There must be some evidence that the beneficiary influenced the actual dispositive provisions of the will. *Estate of Arnold* (1940) 16 C2d 573, 577, 107 P2d 25; *Estate of Bould* (1955) 135 CA2d 260, 275, 287 P2d 8.

EXAMPLE: In *Estate of Mann* (1986) 184 CA3d 593, 229 CR 225, the beneficiary encouraged the testator to make a will, arranged for her to consult an attorney who was a friend of his, and was present during the execution of the will. The court found that this activity did not amount to active procurement of the will, because there was no evidence that the beneficiary had sought to influence the content of the will. In *Estate of Goetz* (1967) 253 CA2d 107, 61 CR 181, the beneficiary was present both at the initial conference and at the execution of the will. During the initial conference, the testator asked the beneficiary, "How do you want the Will made out?" The court declined to find undue influence, noting that it is not uncommon for people to ask their beneficiaries for advice in estate planning matters.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.18B (2) Absence of Beneficiary

§2.18B (2) Absence of Beneficiary

The beneficiary's absence at the execution of the will does not necessarily mean that he or she did not actively procure the will.

EXAMPLE: In *Estate of Baker* (1982) 131 CA3d 471, 182 CR 550, the beneficiary was a psychic who convinced the testator that she was in communication with the testator's deceased relatives. Although the psychic was not present at the will execution, the court found that she had so completely subverted the testator's will that it was not unreasonable to conclude that she had actively procured the will. See also *Estate of Pohlmann* (1949) 89 CA2d 563, 201 P2d 446, in which the court found that even though the beneficiary was not present at the will execution, he had actively procured the will by refusing to help the testator escape from Nazi Germany unless she made him her sole heir.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.19 d. Confidential Relationship

§2.19 d. Confidential Relationship

A confidential relationship exists when one person places trust and confidence in the integrity and fidelity of another. *Estate of Cover* (1922) 188 C 133, 143, 204 P 583; *Estate of Rugani* (1952) 108 CA2d 624, 630, 239 P2d 500. A confidential relationship always exists between husband and wife, registered domestic partners (see Fam C §297.5), attorney and client, guardian and ward, and doctor and patient. Although a confidential relationship may exist between relatives, intimate friends, or business associates, these relationships do not necessarily contain the level of confidence and fidelity indicative of confidential relationships.

In *Estate of Llewellyn* (1948) 83 CA2d 534, 189 P2d 822, the testator's brother-beneficiary was found not to have been in a confidential relationship with the testator, because they had not been close and the testator had not entrusted his brother with any of his affairs. In *Estate of Spaulding* (1947) 83 CA2d 15, 187 P2d 889, the court found that there was no confidential relationship between the testator and his gay lover, because there was no "proof of confidence or reliance actually reposed by decedent in proponent." 83 CA2d at 19. See also *Estate of Baker* (1982) 131 CA3d 471, 182 CR 550, in which the court found a confidential relationship between the testator and her psychic advisor.

NOTE: It is possible for undue influence to be found without proving a confidential relationship. In *Estate of Franco* (1975) 50 CA3d 374, 122 CR 661, the court declared that a confidential relationship between testator and beneficiary is not an essential factor in determining undue influence. The facts of this case, however, do not unequivocably support this statement. In *Franco,* the testator executed a will at his brother's request, leaving nearly everything to his brother's two sons. The court found that the confidential relationship between the testator and his brother could be imputed to the brother's sons. Cases that demonstrate undue influence in the absence of a confidential relationship emphasize the need to show the testator in a susceptible mental state. See 14 Witkin, Summary of California Law, *Wills and Probate* §§130-135 (10th ed 2005).

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.20 e. Unnatural Will; Undue Benefit

§2.20 e. Unnatural Will; Undue Benefit

Whether a will is "unnatural" and whether a beneficiary has unduly profited from a will are questions of fact to be determined in light of the testator's lifetime experiences and values. See discussion in §2.14. See also *Estate of Sarabia* (1990) 221 CA3d 599, 270 CR 560.

In *Estate of Mann* (1986) 184 CA3d 593, 229 CR 225, the court was faced with a will contestant and proponent who were equally related by blood to the decedent. The court found that the will benefiting the proponent was not unnatural, because the decedent had helped rear the proponent and the proponent had lived close to and had taken care of the decedent for most of her life. See also *Estate of Bullock* (1956) 140 CA2d 944, 295 P2d 954 (estate willed to intimate friend rather than relatives); *Estate of Jacobs* (1938) 24 CA2d 649, 76 P2d 128 (estate willed to friends rather than nephew).

If someone other than the beneficiary of the will put pressure on the testator, the courts will examine the relationship between that person and the beneficiary. If the relationship is close, the courts will consider the benefits as having been made to the person charged with undue influence. See *Estate of Franco* (1975) 50 CA3d 374, 122 CR 661; *Estate of Trefren* (1948) 86 CA2d 139, 194 P2d 574. See also *Cabral v Soares* (2007) 157 CA4th 1234, 69 CR3d 242 (when daughter induced mother to devise property to daughter by promising to hold property for benefit of brother, who owed substantial child and spousal support arrearages, daughter holds devised property in constructive trust for brother and brother's former spouse).

NOTE: To prove undue influence, a will contestant need not show that the person charged with undue influence profited from the will. A lack of personal profit does not negate undue influence but only is evidence refuting the allegation. Without a showing of personal gain from a will, however, the contestant must prove a stronger combination of other factors to make a prima facie case of undue influence. *Estate of Ventura* (1963) 217 CA2d 50, 31 CR 490; *Estate of Muller* (1936) 14 CA2d 129, 57 P2d 994.

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§2.21 f. Discovering Undue Influence

During the initial will client conference, the attorney should look for signs that the client might be under the undue influence of another person. An attorney who determines that his or her client is acting under undue influence should refuse to prepare the will.

When someone in a confidential relationship with the client is active in the preparation of the will or when the client is particularly susceptible to persuasion because of his or her physical or mental condition, the attorney must proceed with utmost caution. If the will contains unusual provisions, the attorney should carefully question the client about his or her reasons for the provisions. Because the purpose of this interrogation may be jeopardized by the presence of someone other than the client, the attorney should not allow others to be present while interviewing the client.

It is usually neither feasible nor desirable to deal with the client and his or her spouse or domestic partner separately; they generally come to the attorney's office together and participate in the planning and execution of each other's wills. If either one will not speak freely in the presence of the other, however, the attorney should arrange to speak separately with each spouse or partner to determine whether he or she is being coerced by the other. If coercion exists, the attorney should insist that each spouse or partner seek separate representation. On other circumstances in which separate representation may be appropriate, see §§1.22-1.25.

For discussion of undue influence by the will drafter, see §§1.33-1.35. For practical measures that might be taken if a contest asserting undue influence is foreseeable, see §36.13.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/ 3. Fraud/§2.22 a. What Constitutes Fraud

3. Fraud

§2.22 a. What Constitutes Fraud

Will contestants frequently lump fraud and undue influence together as grounds for a contest because misrepresentations are often part of the pressure brought to bear on the testator. Fraud, however, is a separate and distinct ground of contest. When fraud alone is alleged, the contestant must show that the testator, even though acting of his or her own free will, was deceived into doing what he or she would not have done without fraudulent representations. *Estate of Newhall* (1923) 190 C 709, 214 P 231.

The will contestant must prove that the false representations were made with the intent to deceive the testator and for the purpose of affecting his or her testamentary disposition. The fraud need not be perpetrated at the time the will is executed, however. Even when the false representations were made long before the will was executed, the fraud vitiates the will if the testator's belief in the representations persisted until the time of execution of the will and affected its terms. *Newhall*, 190 C at 722.

If fraud is demonstrated, only the will provision procured by the fraud is invalidated. 14 Witkin, Summary of California Law, *Wills and Probate* §129 (10th ed 2005). The entire will is invalidated, however, if (*Estate of Carson* (1920) 184 C 437, 194 P 5):

- The fraud affects the entire testamentary disposition;
- The invalidated portions of the will are not severable from the rest of the will; or
- All the beneficiaries participated in the fraud.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.23 b. Discovering Fraud

§2.23 b. Discovering Fraud

An attorney is unlikely to discover that fraud has been perpetrated on a client, because the client usually is completely unaware of it. If, however, the client's will is entirely or partially based on "facts" derived from the representations of a beneficiary or others, the attorney should attempt to confirm or dispute this information. Even if the client is willing to rely on someone's statement that an heir is dead or is "very well off and doesn't need anything," the attorney should try to confirm the veracity of the statement.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.24 D. Explaining Other Types of Wills

§2.24 D. Explaining Other Types of Wills

California recognizes four types of wills:

- The witnessed will (Prob C §6110);
- The holographic will (Prob C §6111; see §2.25);
- The statutory will (Prob C §§6200-6248; see §§2.26-2.29); and
- The international will (Prob C §§6380-6390; see §2.30).

Because an attorney is almost invariably called on to draft a witnessed will, this book primarily discusses this type of will. See chap 36 for the execution requirements of a witnessed will. For these purposes, a "will" includes a codicil. Prob C §88. See chap 6.

Because clients sometimes ask about these other types of wills, the attorney should be familiar enough with them to explain why they may or may not be suitable for the client's estate planning purposes.

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§2.25 1. Holographic Will

A holographic will is a will signed by the testator, with its material provisions appearing in the testator's handwriting. Prob C §6111(a). This type of will need not be witnessed or dated. The testator may sign the will anywhere on the document as long as the signature is made with the intent to authenticate the will. The document must be clearly intended to be a will and not, *e.g.,* mere instructions to an attorney regarding the drafting of a proposed witnessed will.

Any statement of testamentary intent contained in a holographic will may be part of a commercially printed form will. See Prob C §6111(c). The prudent attorney, however, advises a client to write a holographic will entirely in his or her own handwriting. This eliminates the possibility of a later dispute over what is "material" and what is not. See *Estate of Sola* (1990) 225 CA3d 241, 275 CR 98.

In *Estate of Brenner* (1999) 76 CA4th 1298, 91 CR2d 149, the court held that a will was valid as a holographic will even though most of the dispositive provisions were in the form of a photocopy of a document that was in the testator's own handwriting. Nevertheless, the attorney should advise a client to actually write the provisions.

Although a holographic will need not be dated, the attorney should always advise a client to date it. If the holographic will is not dated and an inconsistent will exists, the courts will deem the holographic will invalid to the extent of the inconsistency unless it is shown that the holographic will was executed after the other will. Prob C §6111(b)(1). Further, Prob C §6111(b)(2) provides that if the testator lacked testamentary capacity at any time when the holographic will might have been executed, the courts will consider the will invalid unless it is shown that the testator had capacity when the will was executed.

The attorney normally is not concerned with holographic wills except to review one created by a client who is now interested in obtaining a witnessed will. Nevertheless, an attorney may be asked to draft or dictate by telephone a holographic will in certain circumstances, *e.g.,* when a client is taking an unexpected trip or has to undergo surgery. The attorney should advise the client to copy, date, and sign the will provisions on blank paper in his or her own handwriting.

A detailed discussion of holographic wills is beyond the scope of this book. For a complete discussion, see 14 Witkin, Summary of California Law, *Wills and Probate* §§148-158 (10th ed 2005).

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.26 2. Statutory Will

§2.26 2. Statutory Will

Probate Code §§6200-6243 establish the California statutory will. Printed forms of the statutory will are available from the State Bar of California. Any person may use a statutory will. See §2.27. However, the form cannot be used to create a testamentary trust. See §2.28. Like other wills, a statutory will may be revoked by dissolution of a marriage or domestic partnership. See §2.29.

The requirements for executing a statutory will differ slightly from those for executing other witnessed wills. Compare Prob C §6221 with Prob C §6110. See §2.29A.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.27 a. Persons Entitled to Use Statutory Will

§2.27 a. Persons Entitled to Use Statutory Will

Under Prob C §6220, any person "of sound mind and over the age of 18" may execute a California statutory will. Probate Code §6100(a), however, states that a person "18 or more years of age" may make a will. Although the age requirements under these statutes appear to differ, the author believes they are identical. The Cal L Rev'n Comm'n Comment to Prob C §6220 makes clear that an emancipated minor may make a will, including a statutory will. If Prob C §6220 excludes 18-year-olds from executing statutory wills, emancipated minors may make statutory wills but 18-year-olds may not—a result clearly not intended by the legislature. There appears to be no sound reason for statutory wills to have different age requirements from other types of wills.

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§2.28 b. Limitations of Statutory Will

The statutory will should not be used by any client who needs professional estate planning advice (particularly about avoiding probate or limiting estate taxes) or any client whose distributive goals are not reflected in the statutory will form. There is no longer a form for a statutory will with trust. The informational introduction in the statutory will form explains that trusts are too complicated to be used in the statutory will and advises the testator who wants a trust to see an attorney. Prob C §6240.

A person dissatisfied with the limitations of the statutory will form may not change, delete, or add words to the form. Any change, deletion, or addition will "be given effect only where clear and convincing evidence shows that they would effectuate the clear intent of the testator." Prob C §6226(b). A statutory will may be amended, however, by codicil in the same manner as other wills. Prob C §6226(a).

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.29 c. Effect of Dissolution on Statutory Will

§2.29 c. Effect of Dissolution on Statutory Will

If the testator's marriage or registered domestic partnership is dissolved or annulled after a California statutory will has been executed, any disposition of property made by the will to the former spouse or registered domestic partner and any nomination of the former spouse or registered domestic partner as an executor, trustee, or guardian under the will is revoked. Prob C §6227(a); Fam C §297.5(b). If the disposition or nomination was revoked solely because of the dissolution or annulment, the disposition or nomination will be revived by the testator's remarriage to the former spouse or reestablishment of domestic partnership with the former domestic partner. Prob C §6227(a). If the testator's marriage or domestic partnership is dissolved after the testator executes a statutory will and if the testator remarries or enters into a domestic partnership with a person other than his or her former spouse or domestic partner, a new will should be executed if the new spouse or partner is the intended beneficiary of the statutory will's spousal provisions. Similar provisions relating to the effect of dissolution and remarriage or reestablishment of domestic partnerships on wills generally are contained in Prob C §§6122 and 6122.1, respectively. See §10.7.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.29A d. Execution of Statutory Will

§2.29A d. Execution of Statutory Will

The testator must complete all the appropriate blanks in the statutory will form and then sign the will in the space provided. Prob C §6221(a). The testator's execution of the will must be witnessed by two or more persons, who must each observe the testator's signing and then sign his or her name in the presence of the testator. Prob C §6221(b). See Prob C §6226(c).

NOTE: If the testator is too infirm to physically sign the will or is incompetent, a statutory will cannot be used. The nonstatutory formal will may be signed in the testator's name by some other person in the testator's presence and by the testator's direction (Prob C §6110(b)(2)), or by a conservator under a court order under Prob C §2580 (Prob C §6110(b)(3)). See §36.3.

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§2.30 3. Uniform International Will

California has adopted the Uniform International Wills Act. Prob C §§6380-6390. Under these provisions, a will made in the form of an international will is valid in California, regardless of the place where the will was prepared, the location of the assets, or the testator's domicile, residence, or nationality. Prob C §6381(a). The requirements for the execution of an international will are substantially different from those for an ordinary witnessed will. See §§37.16-37.17.

The validity of a will executed in conformity with the Uniform International Wills Act is recognized by other states or countries that have adopted the Act. Use of this type of will may benefit a client who is likely to move to another jurisdiction or who anticipates admission of the will in multiple jurisdictions.

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§2.31 E. Discovering Delinquent Gift Tax Returns

The client's past gift-giving should not be overlooked during the initial client conference. Federal law generally requires donors to file a gift tax return unless the gift qualifies for the annual exclusion under IRC §2503(b), or under IRC §2523(i) for gifts to a noncitizen spouse. No tax may be due because of available deductions and credits under the uniform rate and credit structure. See §20.2. See also California Estate Planning, chap 10 (Cal CEB 2002).

The penalty for failure to file a gift tax return is a percentage of the unpaid tax. See IRC §§6651, 6653. Consequently, if no tax was due, no penalty will be charged. But see IRC §7203 (criminal penalties for failure to file). Interest is also charged on the amount of the tax due plus the penalties at a rate equal to the federal short-term rate plus 3 percentage points. IRC §6621. One advantage of filing a return when no tax is due is that it starts the running of the statute of limitations on the valuation of gifts that are adequately disclosed on the return. IRC §6501. See discussion in §17.57.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.32 F. Dealing with Conflicts of Interest

§2.32 F. Dealing with Conflicts of Interest

During the initial client conference, the attorney should be alert for any possibility of a conflict of interest. See chap 1 for a complete discussion of conflicts of interest. If an actual or potential conflict of interest exists, the attorney should discuss it with the involved parties, making a record of all discussions and how the conflicts were resolved or left unresolved.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/ G. Discussing and Executing Fee Agreements/§2.33 1. Requirement of Written Contract

G. Discussing and Executing Fee Agreements

§2.33 1. Requirement of Written Contract

During the initial client conference, the attorney should discuss his or her fee arrangement with the client. Under Bus & P C §6148(a), a written contract for attorney fees is required in any case in which it is reasonably foreseeable that the total expense to the client will exceed $1000. At the time the contract is entered into, the attorney must provide to the client or to the client's guardian or representative a duplicate copy of the contract, signed by both the attorney and the client or by the client's guardian or representative. The contract must state:

- Any basis of compensation, including, but not limited to, hourly rates, statutory fees or flat fees, and other standard rates, fees, and charges applicable to the case;
- The general nature of the services to be provided;
- The respective responsibilities of the attorney and the client; and
- That the attorney does not meet any of the following criteria:
- Maintains errors and omissions insurance coverage;
- Has filed with the State Bar an executed copy of a written agreement guaranteeing payment of all claims established against the attorney by his or her clients for errors or omissions arising out of the practice of law in the amount specified in Rule IV(B)(1)(c) of the Law Corporation Rules of the State Bar;
- If a law corporation, has filed with the State Bar an executed copy of the written agreement required under Rule IV(B)(1)(a), (b), or (c) of the Law Corporation Rules of the State Bar.

See Fee Agreement Forms Manual §8.2 (2d ed Cal CEB 2007) for a sample fee agreement for estate planning services. Business and Professions Code §6148(b) sets forth the information that must appear on the attorney's bill.

The attorney's failure to comply with the provisions of Bus & P C §6148 renders the fee agreement voidable at the client's option. If the client chooses to void the agreement, the attorney is entitled to collect "a reasonable fee." Bus & P C §6148(c).

Section 6148 does not apply to the following:

- Situations in which a writing is impractical, *e.g.,* an emergency;
- A fee arrangement implied by the fact that the attorney's services are similar to those previously rendered to and paid for by the client;
- A client who waives the requirement of a written contract; or
- Corporate clients.

Even when fees are not expected to exceed $1000, the attorney should discuss them with the client at the initial conference. Any fee agreement reached should be put into writing. This minimizes the risk that the client will be rudely surprised by the bill and react by refusing to pay it.

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§2.34 2. Deductibility of Attorney Fees

A client may take an income tax deduction for an estate planning fee only if the attorney can establish that it is a reasonable fee for work relating to the production of income (IRC §212(1)), the management of income property (IRC §212(2)), or the determination, collection, or refund of tax (IRC §212(3)). See *Sidney Merians* (1973) 60 TC 187, acq 1973-2 Cum Bull 2. To accomplish this, the attorney must keep detailed records of the work done, the time spent, and the difficulty of the problems involved. *Arthur K. Wong,* TC Memo 1989-683. See Horn, *Setting and Deducting Fees in an Estates Practice*, 24 U Miami Inst Est Plan, chap 3 (1990).

NOTE: A deduction under IRC §212 is a miscellaneous itemized deduction for purposes of IRC §67. Miscellaneous itemized deductions are allowable only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income. This limitation does not apply to expenses incurred in connection with the administration of an estate or trust. IRC §67(e). For further discussion, see §33.15.

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§2.35 3. Time Records and Billing

The client may take an income tax deduction only for estate planning fees that qualify under IRC §212. The attorney must be able to substantiate the claim of deductibility with detailed and accurate records. When providing estate planning services, the attorney should keep track of the time spent on a time sheet designed to support a claim of deductibility. A carefully completed time sheet provides both the basis for support of the claim for deductibility and a source for itemized billing with a minimum of effort.

The attorney should use the time sheet on the following page as a guide to preparing his or her own estate planning time sheets. Fifteen categories of services have been assigned code numbers to make the form easy to complete and to promote uniformity in description of services on estate planning client's bills. This format should accommodate billing by hand or by computer.

The bill for estate planning services should explain the services for which the client is being billed and what portion of the charge is deductible under IRC §212. See the sample estate planning bill in §2.37. To prevent the client's confusion on receiving the bill, the attorney should discuss with the client at the initial conference his or her billing procedures and the format of a typical estate planning bill.

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.36 a. Form: Sample Estate Planning Time Sheet

§2.36 a. Form: Sample Estate Planning Time Sheet

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

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

Estate Planning Time Sheet

Client: _____ File No.: _____

Attorney: _____ Assistant: _____

SERVICE CODES

Office conference..... 01	Estate tax computation..... 06	Correspondence.... 10
		Drafting will..... 11
Telephone conference..... 02	Gift tax computation..... 07	Drafting trust..... 12
Document review..... 03	Income tax computation..... 08	Drafting property agreement..... 13
Legal research..... 04	Consultation..... 09	Pension plan..... 14
Tax research..... 05		Life insurance..... 15

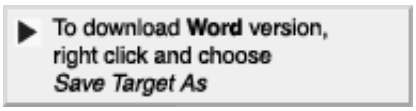
Date	*Time from/to*	*Service code*	*IRC §212* (1)	(2)	(3)	*Problem*
/ /	/					
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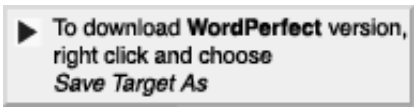
EXPLANATION FOR DEDUCTIBILITY:

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Source: Estate Planning/California Will Drafting/2 Initial Client Conference/§2.37 b. Form: Sample Estate Planning Bill

§2.37 b. Form: Sample Estate Planning Bill





_ _[*Attorney letterhead*]_ _

_ _[*Date*]_ _

_ _[*Name(s) of client(s)*]_ _

San Francisco, California 94123

AGREED FEE FOR PROFESSIONAL SERVICES in connection with estate plan, including office conference; telephone discussions; preparation of revocable trust, asset schedule, wills, community property agreement, general assignment, certification of trust, instructions to stock broker for titling securities, deeds transferring real property to trustees, preliminary change of ownership reports, transfer tax affidavit, durable powers of attorney for asset management and for health care, and explanatory letter; revision of asset schedule; office conference to review and sign documents; recording deeds
$_____

Costs expended:

San Francisco County Recorder	**$_____**	
Marin County Recorder	**_____**	**_____**
TOTAL DUE		**$_____**

Of the amount billed, $1000 relates to tax consequences of the estate plan and is for "tax counsel"; $1000 is an expense of managing income-producing property. Expenses of these kinds are deductible for income tax purposes under Internal Revenue Code §212. A deduction under that section is a miscellaneous itemized deduction under Internal Revenue Code §67. Miscellaneous itemized deductions are allowable only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

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III. SPECIAL PROBLEMS

§2.38 A. Deathbed Wills

The attorney drafting a will for a client who is near death must be prepared to act quickly and resourcefully. Neither the attorney nor the client has the luxury of time for a complete initial conference, careful tailoring of estate planning documents, and a methodical execution at the attorney's office. The attorney must do what is essential in the shortest amount of time.

If the client is able to speak only with difficulty, the attorney should arrange to ask the client's friends or family for as much personal and financial information as possible before going to see the client at home or in the hospital. Because such persons are likely to be beneficiaries of the client's will, the attorney should verify the information with the client. The attorney should consult the client's medical attendants to determine the best time to visit. Discussing a will with a client who is under heavy sedation invites a challenge to the will on the ground of the testator's lack of testamentary capacity.

In medical emergencies, the attorney frequently does not have time to draft a will at the office after first seeing the client. Because the attorney must meet with the client, prepare the will, and have it executed all in the same visit, the attorney should take a skeletal will containing the standard provisions, *e.g.,* revocation of past wills, executor's powers, lapse and no-contract provisions, severability clause, and execution and attestation provisions. The attorney can print or type into the document provisions that cannot be drafted until after speaking with the client.

The attorney should anticipate difficulties that may arise in executing the will of a terminally ill client outside the attorney's office. If the client is too ill to sit up and write, the attorney should have a clipboard ready for the client to use. Because the client may be unable to sign his or her name in full, the attorney should be familiar with the procedure for signing a will with an "X" and with the procedure permitting someone else to sign for the client at the client's direction. See §36.3. The attorney should bring to the will execution persons who can witness it. Many hospitals and nursing homes prohibit their employees and volunteers from serving as witnesses, and the persons available to witness the will for a dying client are usually beneficiaries under the will.

Assisting a dying person to do a will can take a tremendous emotional toll on the attorney, particularly if the attorney and client have had a long professional relationship. To make matters worse, a dying client may view the arrival of the attorney as the arrival of the "angel of death." The attorney should set aside time after the will execution to process the emotional stress it has produced. Talking with the client's gathered friends and family is one way to do this.

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§2.39 B. Wills for Non-English-Speaking or Illiterate Clients

A will does not have to be in English to be valid. Wills written in foreign languages have been admitted to probate. See, *e.g., Estate of Jepson* (1918) 178 C 257, 172 P 1107 (German); *Estate of Guerrero* (1986) 183 CA3d 723, 228 CR 408 (Spanish). See also Prob C §8002(b)(2) (English language translation must be attached to petition for probate of will in foreign language). Thus, if a client cannot read or write English but is literate in another language, the attorney may interview the client and prepare the will in the other language if the attorney is comfortable doing so.

If the attorney is conversant only in English, the will may be prepared and executed in English as long as the testator thoroughly understands the contents of the will. The client interview should be conducted with the assistance of a competent interpreter. During the interview, the attorney should determine the extent of the client's familiarity with English. Evidence of even a limited understanding of English is admissible in a will contest to show that the testator knew the contents of his or her will. See *Camperi v Chiechi* (1955) 134 CA2d 485, 500, 286 P2d 399.

That the client is illiterate and cannot read his or her will in any language does not affect its validity if the client understands its contents. See *Estate of Shay* (1925) 196 C 355, 237 P 1079. During the initial client conference, the attorney should attempt to determine the extent of the client's literacy. Evidence of some ability to read English might be helpful if a will contest develops.

For advice on how to modify the will execution procedure for a non-English-speaking or illiterate client, see §36.12.

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3

Other Documents Prepared in Connection With Wills

Thomas R. Bennett

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§3.1 I. ROLE OF WILLS AND OTHER LEGAL DEVICES IN PLANNING FOR INCAPACITY

Many clients who seek an attorney's services to plan the disposition of their assets at death also desire professional assistance to prepare for possible later incapacity. An elderly or terminally ill client may be concerned about how his or her financial affairs will be handled and about how decisions involving health care and personal matters will be made once he or she is incapacitated. This chapter provides an overview of the legal devices and documents available to deal with these concerns.

These legal devices and concerns are generally unaffected by the client's decision to use a will rather than a funded revocable trust as the primary mechanism to transfer the client's wealth at death. In most cases, clients with real property will prefer to use a funded revocable trust to avoid probate administration. These clients generally use a pourover will and include most of their dispositive provisions in the revocable trust. Other clients with real property may prefer to use a joint tenancy in conjunction with a will (or an unfunded revocable trust with a pourover will) to dispose of personal property. Clients with only intangible property and tangible personal property eligible for collection or transfer by affidavit may prefer the simplicity of using a will in conjunction with other nonprobate transfers.

Clients with a funded revocable trust must take care to coordinate trustee powers and the incapacity trustee provisions of the trust with the powers granted to the agent and the naming of the agent in a durable power of attorney (DPOA). For these clients, an agent who is also the successor trustee of a funded revocable trust may have less need to use those powers. Clients without a funded trust may need to provide more expansive powers and more detailed instructions in the DPOA. Both types of clients generally have the same need for advance health care directives and other devices for management of personal affairs. For both types of clients, the primary goal is to avoid the need for a conservatorship.

NOTE: Because planning for incapacity is a rapidly changing legal field, the practitioner who counsels clients in these matters must continually reexamine traditional methods of providing for possible incapacity and consider using newer, more flexible devices.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.2 II. PLANNING FOR MANAGEMENT OF FINANCIAL AFFAIRS ON INCAPACITY

§3.2 II. PLANNING FOR MANAGEMENT OF FINANCIAL AFFAIRS ON INCAPACITY

There are a variety of estate planning tools for handling the financial affairs of incapacitated persons. The will drafting attorney should be familiar with all of them so that he or she can discuss them intelligently with his or her clients. See §§3.3-3.44.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.3 A. Conservatorships

§3.3 A. Conservatorships

A conservatorship is a court proceeding to appoint a manager for the personal care or financial affairs of another. A conservator of the person may be appointed for one who is unable to provide properly for his or her personal needs; a conservator of the estate may be appointed for a person who is substantially unable to manage his or her own financial resources or to resist fraud or undue influence. See Prob C §1801. The person whose affairs will be managed is called the conservatee.

For the nature of evidence of incapacity, see Prob C §811.

Sections 3.4-3.14 and 3.38-3.44 focus on the conservator of the estate, whose primary responsibility is to conserve, manage, and use the conservatee's property for the benefit of both the conservatee and those whom he or she is obligated to support.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.4 1. Role of Conservator

§3.4 1. Role of Conservator

For almost all financial matters, the conservator of the estate steps into the shoes of the conservatee. The conservator enters into contracts, sells or buys property, and incurs and pays debts for the conservatee. The conservatee retains the ability to contract to provide the necessaries of life to the conservatee and his or her spouse or minor children and to provide the basic living expenses of a registered domestic partner. Prob C §1871(d). The conservatee also retains the capacity to control an allowance, wages, or salary (Prob C §1871(a)-(b)). He or she may also make a will (Prob C §1871(c)). However, a conservator may only make a will for the conservatee if the conservator has been so authorized by a substituted-judgment order under Prob C §2580. The conservatee who is mentally competent to make a will may revoke or amend a will made by the conservator, or may make a new and inconsistent will. Prob C §6100(b). The powers that a conservator assumes and the powers that a conservatee retains may be modified by court order. Prob C §§1873-1874, 1880, 1901, 1910.

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§3.5 2. Appointment of Conservator

Probate Code §1812 guides the court in deciding whom to appoint as conservator of the estate. Making clear that this decision is solely in the court's discretion, the statute states that the court is "to be guided by what appears to be for the best interests of the proposed conservatee." Prob C §1812(a).

When choosing between "persons equally qualified in the opinion of the court to appointment as conservator," the court must make its selection in the following order: (a) spouse or domestic partner, (b) nominee of the spouse or domestic partner, (c) an adult child, (d) nominee of an adult child, (e) parent, (f) nominee of a parent, (g) a sibling, (h) nominee of a sibling, and (i) any qualified person or corporation. Prob C §1812.

Limits on the court's discretion to choose a conservator are found in Prob C §1810, which requires the court to appoint the nominee of a proposed conservatee who had sufficient capacity at the time of nomination to form an intelligent preference, unless the court finds that the appointment is not in the conservatee's best interests. See *Conservatorship of Ramirez* (2001) 90 CA4th 390, 108 CR2d 581. Because of this statutory limitation on the court's discretion to select a conservator, a client whose preferences for conservator do not mirror the order of preference defined in Prob C §1812(b) should execute a nomination of conservator (see §§3.6-3.7). In this nomination, the client should (1) name the person the client would like to serve as his or her conservator of the estate and (2) state why this person has been selected. Executing a nomination of conservator is particularly important for a client who prefers a close friend or lover to serve as conservator instead of a relative.

Additionally, CC §2432 places limitations on a conservator designated as the attorney in fact to make health care decisions under a durable power of attorney for health care.

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3. Nomination of Conservator

§3.6 a. Formal Requirements for Nomination

The only formal requirements for a nomination of conservator of the estate are that it be in writing and signed. Prob C §1810. Additional formalities (*e.g.,* execution in the same manner as a will) may help persuade a court that the nomination reflects the proposed conservatee's true intentions and that he or she was competent when signing the nomination, but they are not necessary. See California Conservatorship Practice §1.36 (Cal CEB 2005).

A nomination in a will may pose problems in some circumstances because:

- The nomination may cause the will to become public during the testator's lifetime, creating potentially unpleasant consequences if the terms are such that some family members will be upset.
- The nomination may not come to light until after the nominator's death. Although the apparent nominee may file a petition for the depositary to produce the incompetent's will, the court cannot be depended on to make such an order. See *Vigne v Superior Court* (1940) 37 CA2d 346, 99 P2d 589.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.7 b. Other Possible Provisions of Nomination

§3.7 b. Other Possible Provisions of Nomination

The chief purpose of a nomination of conservator is to give a person as much control as possible over the later appointment of a conservator of his or her estate. The nomination also provides a suitable format for the nominator to indicate how matters should be handled in the conservatorship.

The attorney should explore with the nominator whether and to what extent he or she would like to control the prospective conservator's conduct. For instance, the nominator may want to keep a significant block of shares of stock in the family, may have an emotional attachment to a piece of property, may wish to make annual gifts to several persons, or may have particular desires concerning joint tenancy property. These wishes may be expressed in the nomination of conservator.

Because circumstances often change between the time the nomination is executed and when the conservatorship is needed, the client's desires are not binding on the court. The client should understand this. There is no reason, however, for the client to refrain from attempting to direct his or her conservator's future conduct. It is likely that both the conservator and the court will welcome the guidance of requests made in writing by the client before incapacity.

The nomination of conservator may include a clause requesting that a particular person not be appointed as conservator. The attorney should decide whether it is wise to explain why the nominator makes this request. An explanation may add force to the request, but if the explanation suggests that the nominator's fears are imaginary, it may actually detract from the persuasiveness of the request. In addition, the nomination may include a provision nominating a second person if the first choice declines or is unable to serve.

NOTE: The client should understand that the more provisions placed in the nomination of conservator, the more frequently the document should be reviewed.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/ 4. Selection of Nominee/§3.8 a. Spouse or Domestic Partner

4. Selection of Nominee

§3.8 a. Spouse or Domestic Partner

The spouse or domestic partner is often the logical choice for conservator of the estate. Another person should be selected, however, if the spouse or domestic partner is too sick, disabled, or inexperienced to manage a complex estate or is unwilling to do so.

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§3.8A b. Adult Child

An adult child familiar with his or her parent's affairs may be the appropriate choice for conservator of the estate. Lack of experience should not necessarily preclude an adult child from serving as conservator if he or she is willing to act as conservator and is inclined to seek good advice. A child who is uninterested in serving, who is deeply engrossed in his or her own career or family, or who lives too far away to do an effective job should not be nominated as conservator.

An important consideration in nominating an adult child as conservator of the estate is the reaction of siblings to the nomination. If the nomination is likely to produce jealousy and suspicion, the nominator may wish to select a third party or corporate conservator.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.8B c. Friend as Conservator

§3.8B c. Friend as Conservator

Some attorneys believe that the nominee should not be a spouse, adult child, or domestic partner of the nominator. They feel that, for example, an intelligent and longtime friend is a better choice because such an individual can be more objective than someone who is emotionally intimate with the nominator. Further, such an individual is disinterested; he or she has nothing personally to gain from any decision made for the conservatee.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.9 d. Attorney as Conservator

§3.9 d. Attorney as Conservator

An attorney who has represented the nominator for many years may be an appropriate person to act as conservator of the estate. Before accepting the nomination, the attorney should seriously consider whether he or she has the qualifications and time to manage the estate properly and whether he or she can afford to take the job. (An attorney cannot be compensated on the usual hourly basis for acting as conservator.) The attorney should also determine whether his or her professional liability insurance policy covers his or her actions as conservator. Recognizing these problems, many law firms forbid their members from acting as conservators except in unusual cases. Some attorneys believe that the conservator-conservatee relationship is potentially conflictual and that, if the attorney is to play a role at all, it should be as the conservatee's attorney rather than as conservator.

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§3.10 e. Other Individuals

A client who has no close friend or relative appropriate for nomination as conservator should consider individuals with whom he or she has had a professional relationship. A stockbroker, investment counselor, or accountant who has handled the client's investments over a period of years might be a logical choice. A business associate who is acutely aware of the client's estate problems and who does not have an adverse interest may be a good choice.

The client should always ask the possible nominee whether he or she would agree to serve as conservator.

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§3.11 f. Trust Company

Any corporation or association authorized to conduct trust business in California may be appointed to act as a conservator of the estate. Prob C §§83, 300, 1812. A corporate conservator offers the advantages of technical skill, continuity of management, experience, and impartiality. The latter can be important if the family situation is disharmonious. A corporate conservator is less affected by the pull of self-interest than an individual conservator who is likely to inherit what remains of the conservatee's estate. In addition, a corporate conservator may have a common trust fund, which may be an excellent investment for the estate. Finally, the relatively substantial assets of a corporate conservator provide protection for the conservatee from the effects of the conservator's negligent acts.

Using a corporate conservator involves some disadvantages. A corporate conservator is unlikely to give personal attention to the conservatee's affairs or to want to act as conservator unless the estate is substantial or the corporation has other business dealings with the future conservatee.

On factors to consider in selecting a conservator of the estate, see California Conservatorship Practice §§1.31-1.45 (Cal CEB 2005).

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.11A g. Private Professional Conservators

§3.11A g. Private Professional Conservators

In most larger counties there are persons who serve as conservators on a professional basis. Many of these persons are highly qualified and efficient. In some counties the court investigator or other court staff will be willing to provide names of suitable professionals on an informal basis. The practitioner should also seek recommendations from local attorneys who regularly engage in conservatorship practice. Professional conservators are required to register with the county clerk under Prob C §§2340-2342 and with the Statewide Registry in the Department of Justice under Prob C §§2850-2856. The registry information is available to the court, but is otherwise confidential. The county clerk is required to make background checks. Prob C §2342(c). Although these statutes add a modicum of public protection, they are not a substitute for due diligence on the part of a practitioner making a recommendation.

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§3.12 h. Co-Conservators

The client's nomination of two or more persons as co-conservators should be made only after careful consideration. If there are two conservators, they must concur to exercise a power; if there are more than two, a majority must agree to exercise a power. Prob C §2105(c).

Although the need to secure the consent of two or more people greatly increases the administrative problems of a conservatorship, family considerations and the protection of checks and balances may make co-conservators the wisest decision. Further, nominating a corporate fiduciary as co-conservator with a friend or relative will provide for the conservatee both the professional skills of a trust company and the personal attention of an individual close to the conservatee. See California Conservatorship Practice §§1.34, 1.41 (Cal CEB 2005).

NOTE: The disadvantages of multiple conservators do not suggest that different persons should serve as conservators of the estate and the person. Because the duties of each office are different, different nominees may be entirely appropriate.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.13 5. Conservator Need Not Be California Resident

§3.13 5. Conservator Need Not Be California Resident

A conservator of the estate or the person need not be a California resident, although this usually is desirable if the conservatee remains in the state. It is virtually certain that the court will not waive the requirement for posting bond if the conservator is not a resident, but many courts will not waive the requirement in any event.

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§3.14 6. Need to Keep Nomination Current

The client should be aware that a change of circumstances may be sufficient grounds for the court to refuse to honor a nomination of conservator. For example, if the client nominates a person who resides in the same state and the nominee moves to another state, the court may consider the change of residence as a factor in deciding not to appoint the nominee as conservator. Therefore, whenever there is a significant and material change of circumstances, the client should execute a new nomination, either renominating the previous nominee or selecting a more appropriate person to serve.

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B. Durable Power of Attorney (DPOA)

§3.15 1. Definition of DPOA

A power of attorney is a written instrument in which one person, the principal, appoints another person, the agent, to act on behalf of the principal to take actions with respect to property. A *durable* power of attorney (DPOA) is a power of attorney in which the agency relationship continues despite the principal's later loss of capacity. The provisions controlling DPOAs in California are found in the comprehensive Power of Attorney Law (Prob C §§4000-4545). For complete discussion of durable powers of attorney, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/ 2. Types of DPOA/§3.16 a. General Versus Limited Powers of Attorney

2. Types of DPOA

§3.16 a. General Versus Limited Powers of Attorney

A durable power of attorney can be general, *i.e.,* giving the agent authority to enter into all types of property or business transactions for the principal. It can also be limited (or special). A limited power of attorney grants the agent only certain restrictive authority to manage the principal's property. Authority can be limited to a specific period of time, to specific assets, or to specific actions.

The agent may be authorized to perform any acts that the principal might perform, except those requiring the principal's personal attention, *e.g.,* assuming the principal's fiduciary responsibilities or painting a portrait that the principal had contracted to paint. CC §2304.

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b. Immediately Effective Versus Springing DPOA

§3.17 (1) Immediately Effective DPOA

The immediately effective DPOA, on execution, confers authority on the agent to manage the principal's property, regardless of the principal's ability to continue to do so. This type of DPOA is easy for the agent to use because the agent is not required to prove that the principal is unable to handle his or her own affairs as required for a springing DPOA. See §3.18.

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§3.18 (2) Springing DPOA

A springing DPOA becomes effective only after the principal has been determined to be incapacitated. A springing DPOA is authorized by Prob C §4124, which provides that such a power must contain the words, "This power of attorney shall become effective upon the incapacity of the principal," or similar words showing the intent of the principal.

Probate Code §4129 provides a mechanism for avoiding the risk that third parties will be reluctant to honor a springing DPOA. This statute provides:

- In a springing power of attorney, the principal may give one or more persons the power to determine conclusively that the principal is incapacitated (Prob C §4129(a));
- The springing power of attorney becomes effective when the designated persons execute a written declaration under penalty of perjury that the principal has become incapacitated (Prob C §4129(b)); and
- Any persons may act in reliance on such a written declaration without liability to anyone, regardless of whether the principal is actually incapacitated or not (Prob C §4129(b)).

This statute applies to a power of attorney whenever executed if the power of attorney contains the designation described in Prob C §4129(a). Prob C §4129(c). The statute should not be construed to provide the exclusive method of creating a springing power of attorney. Prob C §4129(d).

The instrument creating the springing DPOA should define incapacity and describe the determination mechanism. If it does not, the agent will have considerable difficulty convincing third parties that they should honor it. If the DPOA terminates on restoration of capacity, the instrument should define and describe the meaning and determination of restoration. On possible determination mechanisms, see §3.18A. On alternatives to springing powers, see §3.18B.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.18A (3) Incapacity Determination Mechanisms for Springing DPOA

§3.18A (3) Incapacity Determination Mechanisms for Springing DPOA

The attorney should discuss possible incapacity determination mechanisms for a springing DPOA with the client. These are some of the more common ones:

- The written opinion of any licensed physician that the principal is incapacitated;
- The written opinion of the principal's treating physician that the principal is incapacitated;
- Written opinions of two licensed physicians, one of whom is the principal's treating physician, that the principal is incapacitated; and
- Written opinions of two parties, one a trusted friend and the other a licensed physician, that the principal is incapacitated.

Springing powers create a number of practical problems. First, in cases in which the principal's descent into incapacity is gradual, it may be unclear, even to a physician, when the principal is incapacitated. Second, parties such as title companies may be unwilling to accept a springing DPOA no matter how clearly the instrument is drafted or how carefully the principal's incapacity is documented. Third, a springing DPOA is not expressly authorized in all states. This can cause problems for the agent who must do business in a state that does not explicitly sanction springing DPOAs. For alternatives to a springing DPOA, see §3.18B.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.18B (4) Alternatives to Springing DPOA

§3.18B (4) Alternatives to Springing DPOA

Because of problems with springing powers, many clients choose one of the following alternatives to a springing DPOA:

- *Creating an immediately effective DPOA but instructing the agent to use it only when incapacity occurs.* The agent should be aware that the principal can revoke the power at any time and will do so if the agent uses it prematurely. This alternative works well if the agent is completely trustworthy and clearly understands the circumstances under which the principal wishes him or her to use the DPOA.
- *Creating an immediately effective DPOA but retaining possession of the document.* The agent can be told how to find the document when it must be used. If the DPOA will be kept in the principal's safe-deposit box, the agent must be given express authority to enter the box. This option assumes that the agent can be trusted to obtain the DPOA only when it is appropriate to do so.
- *Creating an immediately effective DPOA and delivering it to a trusted third party, e.g., the principal's attorney.* The principal should also deliver to the third party written instructions to deliver the instrument to the agent only on the occurrence of a specific event. To protect the third party, the client should choose an event whose occurrence is easy to determine, *e.g.,* the receipt of a request for delivery signed by a majority of the principal's then-surviving adult children or the receipt of a physician's certificate of incapacity.

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§3.19 3. Selection of Agent for DPOA

The agent should be someone the principal trusts, who has common sense, and who is willing and able to act. The same factors that a client should consider in nominating a conservator of the estate are appropriate to consider in selecting an agent for the DPOA. See §§3.8-3.10. As with a conservator of the estate, there is no requirement that an agent be a California resident.

The DPOA can provide for multiple agents. If it does, the instrument should clearly state whether joint decisions are required or whether each agent can act alone. The client should be aware that:

- Agents who have the power to act alone may make conflicting decisions or act in ignorance of each other; and
- Agents who have the power only to act together may encounter logistical problems and difficulties in taking action when the agents cannot agree.

The client who insists on multiple agents should consider how such problems can be prevented or resolved. See California Powers of Attorney and Health Care Directives (Cal CEB 2008) for some ideas. One solution to the multiple agent problem is to authorize different agents to perform different tasks.

If there are joint agents, the client should consider what happens when one agent is unable to serve. The DPOA may authorize the remaining agent to serve alone or may name a successor to serve as co-agent with the remaining agent.

Many banks and trust companies are unwilling to serve as agents under a DPOA. The attorney should check with the particular bank or trust company suggested by the client before appointing it as agent.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.20 4. Successor Agents for DPOA

§3.20 4. Successor Agents for DPOA

Successor agents can be named in the instrument to serve as agent when the primary agent is unable to do so. A physician's certificate or other proof of the primary agent's incapacity can be required. In a harmonious situation, the instrument can provide that a written declaration by the successor agent that the primary agent is unable to serve will be sufficient proof of succession and may be relied on by third parties. The DPOA can authorize the agent to appoint his or her own successor, perhaps from a class of persons named by the principal in the instrument, or can even authorize a third party to appoint a successor.

PITFALL: In theory, the inclusion of provisions for the selection of successor agents is a sound idea. In practice, any complicated scheme for appointment of a successor may be thwarted by a third party's unwillingness to accept the DPOA under these circumstances. A principal who is competent when a successor is needed should immediately execute a new DPOA and revoke the prior instrument.

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§3.21 5. Special Drafting Concerns for DPOA

The attorney should discuss the proposed terms of the DPOA with the client to tailor it to the client's needs. This is particularly important for limited or springing DPOAs. Even a general DPOA may require some tailoring; if the agent is likely to confront unusual matters, the DPOA should specify whether the principal intends to give the agent authority to deal with them.

Probate Code §§4400-4465 provide a statutory form for a durable power of attorney (but see §3.31). Many attorneys prefer to draft their own DPOA to tailor it to the individual client, thus limiting the potential for abuse that comes with the broad statutory DPOA form.

A DPOA that affects real property should be notarized so that it can be recorded. The requirements of the certificate of acknowledgment of notary public for the DPOA have been revised to make notarization requirements uniform in California. CC §1189(d). On timely recording of a DPOA, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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§3.22 a. Tax-Related Issues

Under a properly drawn DPOA, an agent can make almost any income, gift, or estate tax planning decision that the principal can make. The agent's actions can save the principal or the principal's heirs a considerable amount of taxes. Premortem tax planning measures should be discussed with the client, and provisions authorizing them should be made part of the DPOA instrument. Some of the more common premortem tax planning measures are the following:

- Establishing and funding an inter vivos trust for the principal.
- Making cash gifts to take advantage of the annual gift tax exclusion. The DPOA must expressly grant the power to make gifts. Gifts made by an agent without the power to make gifts may be included in the principal's estate under IRC §2038. Under California law, a DPOA that does not expressly confer the power to make gifts cannot be construed to grant that power. Prob C §4264; *Estate of Huston* (1997) 51 CA4th 1721, 60 CR2d 217.
- Executing disclaimers.
- Consenting to split gifts with spouse.
- Paying tuition and medical expenses for family members.
- Qualifying for special use valuation under IRC §2032A.
- Qualifying for the family-owned business exclusion under IRC §2057 (repealed in 2004).
- Qualifying for installment payment of federal estate taxes under IRC §6166.

For further discussion of premortem tax planning measures and how they relate to a DPOA, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

PITFALL: The attorney should be aware that a carelessly drafted DPOA can have adverse tax effects on the agent. In particular, the attorney should ensure that tax problems are not created by giving the agent too much power over principal or income of the property subject to the power.

NOTE: To deal with tax returns and give the agent the power to represent the principal before the Internal Revenue Service, it may be advisable for the principal to execute the IRS's own power of attorney form. An agent may sign a tax return on behalf of a taxpayer only if the authority is both permitted under the Internal Revenue Code and regulations (see Treas Reg §1.6012-1(a)(5)) and specifically granted in the power of attorney. See Treas Reg §601.504(a)(6). Using that form is not mandatory, but it is more convenient than tailoring an attorney-drawn form to the IRS's specifications.

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§3.23 b. Qualification for Public Medical Benefits

Medi-Cal eligibility is dependent on a financial means test. To qualify, an individual's nonexempt assets and income must not exceed specific stated levels.

The DPOA should be drafted to give the agent the authority that he or she needs to implement strategies designed to permit the principal to qualify for Medi-Cal without impoverishing the principal's spouse. For example, an agent who is authorized to repair or improve the principal's home, pay off the mortgage, or purchase a new home for the principal has the ability to change nonexempt assets into exempt assets if the change in the character of the assets occurs before Medi-Cal eligibility is sought. For additional planning strategies, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003).

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§3.24 c. Business Affairs

If the principal is a sole proprietor of a business, the DPOA should give the agent the authority to continue the business during the principal's incapacity. Under appropriate circumstances, a limited DPOA granting a trusted employee the authority to keep the business running can prove extremely useful. The attorney should discuss with the principal the employee-agent's conflict of interest and any opportunities for abuse of authority.

If the principal is a member of a partnership, the DPOA should authorize the agent to represent the partner-principal vis-à-vis other partners or on behalf of the partnership with respect to third parties. Before drafting the DPOA, the attorney should always review partnership documents for any limitations on delegation of authority. The client should be aware that delegating all the partner-principal's powers to the agent could cause problems with respect to a general partnership, because any general partner can act on behalf of all other partners. The agency could thus lead to friction between the agent and other partners.

For further discussion, see California Powers of Attorney and Health Care Directives, chap 5 (Cal CEB 2008).

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§3.25 d. Multistate Considerations

The attorney should ask the client whether the DPOA may have to be used in another state. Although a DPOA executed in California should be accepted in other states under the well-established legal principle that the form of jurisdictional acts is governed by the law of the place of execution, there may be practical difficulties interfering with its implementation elsewhere.

The attorney should avoid drafting a DPOA for use in another state. If this is impossible, the attorney should ensure that the instrument complies with that state's laws governing powers of attorney. Depending on the transaction and the assets involved, that state's laws or California law on general agency relationships will control.

For further discussion, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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§3.26 e. Principal as Fiduciary

The attorney should ask the client whether he or she is serving in a fiduciary capacity. A fiduciary includes a director of a corporation, an executor, a trustee, a guardian, a conservator, or a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925).

The principal should not give the agent the power to handle matters for the principal as fiduciary unless the instrument creating the fiduciary relationship and the law governing the relationship specifically grant the principal the authority to do so. Even with such authority, the agent's powers to act for the principal as fiduciary should be limited to procedural matters that require no judgmental input or to emergency situations. As a practical matter, third parties will frequently not accept a DPOA executed by a fiduciary. For further discussion, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.27 f. Dealing With Troublesome Family Members and Others

§3.27 f. Dealing With Troublesome Family Members and Others

Under Prob C §4541, a petition may be filed for any of the following purposes:

- To determine whether the power of attorney is in effect or has terminated;
- To review the agent's acts or proposed acts, including approval of authority for the agent to disobey the principal's instructions;
- To compel the agent to account;
- To terminate the authority of the agent, upon a determination that (1) the agent has violated or is unfit to perform the fiduciary duties under the DPOA, (2) the principal lacks capacity to give or revoke a power of attorney, and (3) the revocation of the agent's authority is in the best interest of the principal or the principal's estate;
- To approve the resignation of the agent; and
- To compel a third person to honor the authority of the agent.

Such a petition may be filed by any of the following persons (Prob C §4540):

- The agent;
- The principal;
- The principal's spouse or any other relative of the principal;
- The conservator of the person or estate of the principal;
- The court investigator or public guardian;
- The personal representative or trustee of the principal's estate;
- The principal's successor in interest;
- Third persons who are requested by the agent to honor the power of attorney; or
- Any other interested person or friend of the principal.

Probate Code §4503(a) describes the procedures that the attorney should follow in drafting the DPOA to eliminate any of these persons' authority to petition the court for any of these purposes. However, the authority to so petition may not be eliminated as to the attorney in fact, the principal, the conservator of the person or estate of the principal, or the public guardian. Prob C §4503(b).

If a family member or a class of family members is likely to interfere with the agent's attempts to carry out his or her duties, the principal should consider eliminating the ability of this person or these persons to petition the court. This should not be done, however, without serious thought. Probate Code §§4540-4541 protect the principal from abuse by his or her agent.

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§3.28 g. Agent's Duty and Standard of Care

California law imposes a number of affirmative duties on the agent. For example, the agent has a duty of loyalty to the principal and must exercise reasonable and ordinary diligence in carrying out the principal's wishes. See California Powers of Attorney and Health Care Directives (Cal CEB 2008). California law also sets out a number of specific prohibitions for agents. For example, the agent must not deal with the principal's property for his or her personal profit or take part in any transaction in which the agent's interest is adverse to the principal's.

Because the principal's attorney drafts the DPOA, the agent often acquires these responsibilities without instructions. It may be useful for the attorney, the principal, and the agent to meet to discuss the DPOA, the principal's wishes, and the agent's responsibilities. The attorney can answer the agent's questions at this meeting. Both the principal and the agent should understand, however, that the DPOA was drafted for the principal's benefit and that the attorney represents the principal and not the agent.

Because an agent may be held even to a fiduciary standard, the principal may wish to protect the agent by modifying the standard of care in some of the following ways:

- *Limitation of liability.* The DPOA may provide that the agent will not be liable to the principal or the agent's successors when the agent acts in good faith; the agent should be liable only for willful misconduct or gross negligence. When discussing this limitation with the principal, the attorney should remember that his or her duty is to represent the principal and not the agent.
- *Authorization to accept predecessor's accounts.* If successor agents are named, the principal should consider authorizing a successor agent to assume control of the principal's assets without investigating the acts of a predecessor agent and without the need for an accounting. A successor agent who does not have this authority may be reluctant to act.
- *Authorization to self-deal.* The agent should be permitted to self-deal in certain circumstances. Self-dealing may be necessary or advisable, *e.g.,* in the following situations:
- A child of the principal is acting as agent and also managing the family business in which the principal holds an ownership interest;
- The principal wants the family member-agent to have a right of first refusal at fair market value to buy the principal's vacation home if it must be sold to pay the principal's medical bills; or
- The principal does not want his or her long-standing practice of making gifts to his or her children and grandchildren terminated simply because a child is serving as agent.

In these instances, the DPOA should expressly permit the agent to self-deal in the limited ways desired by the principal.

- *Authorization to commingle assets.* If the principal and agent (*e.g.,* spouses or domestic partners) have commingled funds for a long time, the principal may wish to authorize commingling either in general or in a particular situation.
- *Authorization to disclose confidential information.* When confronted by requests for information by family members or others, the agent may be placed in an awkward situation. The principal can prevent this dilemma by authorizing the agent to release information when appropriate.
- *Accounting.* The DPOA should state the type and frequency of accounting required and to whom accounting should be made.

Because the laws governing an agent's duties and latitude to act are general in nature, the DPOA should expressly state the principal's wishes on matters about which he or she feels strongly, *e.g.,* staying in the residence with in-home care instead of being placed in a nursing home.

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§3.29 h. Compensation of Agent

The attorney should discuss with the client whether the agent should be compensated. Unless the DPOA authorizes compensation, the agent's use of the principal's assets to pay himself or herself might be considered self-dealing. See California Powers of Attorney and Health Care Directives (Cal CEB 2008) for forms authorizing compensation of an agent.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.30 i. Aids to Acceptance by Third Parties

§3.30 i. Aids to Acceptance by Third Parties

Certain statutory provisions are intended to promote the acceptance of durable powers by third parties. For example, a third person may be liable for attorney fees in judicial proceedings that were necessary to confirm the agent's authority, after the agent gave an affidavit to that person. See Prob C §§4300, 4304-4306. If, however, the third person acts in good faith and relies on the representations of the agent, he or she will be protected from liability. See, *e.g.,* Prob C §§4301, 4303. Nevertheless, it can be anticipated that some third parties will continue to be reluctant to take instructions from anyone other than the principal directly. The following steps can be taken to increase the probability that third parties will accept the instrument:

- Have the DPOA notarized.
- Advise the client to keep the DPOA current. Third parties look more favorably on recently executed DPOAs.
- Keep the DPOA as simple as possible. If only a limited DPOA is needed, avoid a general one.
- Include a clause that exonerates third parties from liability for accepting the DPOA.
- Anticipate language that third parties will want to see in the instrument by (1) asking the client which third parties are likely to be requested to accept the DPOA and (2) asking the third parties what language the DPOA should include. Instruct the client to present the DPOA to the third parties to determine whether they will accept it. Clearing up difficulties before the onset of the client's incapacity is highly advisable.
- Include a clause authorizing the agent to institute and prosecute any civil action or proceeding against any person who fails or refuses to honor the agent's instructions (see Prob C §§4304-4306 discussed in §3.41).

For discussion of these and other measures the attorney can take to help convince third parties to accept the DPOA, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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§3.31 6. Forms of DPOA

Probate Code §4401 contains the statutory form power of attorney, which is an immediately effective DPOA. Even a defective statutory form power of attorney may be sufficient to appoint an attorney-in-fact if the document meets the more general document requirements for powers of attorney. *Torres v Torres* (2006) 135 CA4th 870, 37 CR3d 754 (statutory form was defective because principal indicated desired powers using an "X" rather than her initials). For nonstatutory forms of DPOAs, including a general, immediately effective power, a springing power, and a limited power for management and disposition of specific real property, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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C. Other Estate Planning Tools for Management of Financial Affairs on Incapacity

1. Revocable Trust

§3.32 a. Definition of Revocable Trust

In this book, the term "revocable trust" means a trust created by a written instrument that the settlor may revoke during the settlor's lifetime. On revocation, the trust assets are returned to the settlor. In California, all trusts are revocable by the settlor unless expressly made irrevocable by the trust instrument. Prob C §15400.

A revocable trust is usually created to transmit property to designated beneficiaries at the settlor's death without probate or to manage property after the settlor's death. However, because the trust is established during the settlor's lifetime, it can also be used to manage property during the settlor's lifetime, particularly on his or her incapacity.

WARNING: An existing revocable trust is not revoked by a later will. Therefore, unless the trust is revoked by the settlor, or by operation of law on dissolution of marriage or domestic partnership (see §10.7), trust property will not pass under a later will that provides for a different disposition, even though the will revokes the settlor's previous pourover will. See, *e.g.*, *In re Will of Tamplin* (Alaska 2002) 48 P3d 471. Generally, a trust that is revocable may be revoked by any method provided in the instrument creating the trust (Prob C §15401(a)(1)) or by a writing to that effect (other than a will), signed by a settlor and delivered to the trustee during the settlor's lifetime (Prob C §15401(a)(2)). In *Gardenhire v Gardenhire* (2005) 127 CA4th 882, 26 CR3d 143, the court held that a revocable trust that authorized revocation by giving written notice to the trustee could be revoked by execution of a will that manifested an intention to revoke. See also *Masry v Masry* (2008) 166 CA4th 738, 82 CR3d 915 (joint revocable trust that authorized revocation by either settlor by written direction delivered to the other settlor could be revoked by settlor delivering notice to himself as trustee because the trust's revocation method was not explicitly exclusive). However, it may not be necessary to revoke the trust to change the disposition if the trust document gives each spouse a general power of appointment over that spouse's share of the trust property, as discussed in §4.5.

For complete discussion of revocable trusts, see Drafting California Revocable Trusts (4th ed Cal CEB 2003).

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§3.33 b. Selection of Trustee

Many of the factors that a client should consider in selecting a conservator of the estate or an agent under a DPOA should also be considered in selecting a trustee. See §§3.8-3.10, 3.19. At a minimum, the client should be confident of the proposed trustee's honesty and integrity, sound judgment, experience in investment, and ability to deal with people.

Because a revocable trust is not established primarily for financial management of the client's property during his or her incapacity, the factors a client should consider in selecting a trustee are considerably broader and more complex than those to consider in selecting a conservator or agent. See Drafting California Revocable Trusts, chap 16 (4th ed Cal CEB 2003). See also §§28.3-28.8 on selecting the trustee of a testamentary trust.

When creating trusts, people sometimes choose corporate trustees, *e.g.,* banks or trust companies. The advantages of a corporate trustee are permanence, continuity of administration, and professional management of the trust assets. The disadvantages are substantially greater administration costs, the tendency of some institutions to assign more inexperienced personnel to the administration of trusts, a conservative investment philosophy, and occasional delays in making decisions. Before selecting a corporate trustee, the client should find out whether the institution is willing to serve. Most banks and trust companies will not agree to act as trustee for a small trust or one with primarily nonproductive assets.

Many settlors prefer the personal relationship between trustee, settlor, and beneficiary that exists when a family member or close friend acts as trustee. These settlors believe that a family member or friend can provide personal attention, speed and flexibility in making decisions, and the ability to deal effectively with beneficiaries who have conflicting interests. Further, if the trust includes an interest in a closely held business, a corporate trustee may lack the sensitivity needed to manage the trust. The settlor should realize, however, that naming a friend or relative as trustee puts that person in a difficult position because his or her decisions may offend a beneficiary, destroy a friendship, or expose him or her to liability.

Because a settlor can also serve as trustee, the client's choice in establishing a revocable trust is similar to the choice between an immediately effective DPOA and a springing DPOA. See §§3.17-3.18. If the settlor names himself or herself as trustee, management of his or her assets by another person begins only on incapacity. The trust instrument, in that case, would have to define incapacity and the determination mechanism in addition to naming a successor trustee. If the settlor names another person as trustee, management of assets begins when the trust is funded.

The advantages of having the settlor act as trustee include lower administration costs and greater flexibility in investment and other trust decisions. Allowing the settlor to act as trustee also encourages clients who would otherwise not establish a revocable trust for fear of losing control of their property to take advantage of the somewhat lower after-death administrative costs of a revocable trust. The main disadvantage of the settlor's serving as trustee is that he or she may not be scrupulous about keeping proper trust records or segregating trust assets from his or her own. Ignoring the administrative steps essential to prove the validity of the trust may subject it to later attack, thereby frustrating the settlor's estate plan.

For a discussion of special considerations that apply when the attorney who drafted the will is named trustee, see §28.4.

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2. Joint Ownership

§3.34 a. Features of Joint Ownership

California statutes provide various ways for multiple parties to hold title to property. Generally, multiple owners may own property as joint tenants or tenants in common. Married persons and registered domestic partners also may own property as community property or community property with right of survivorship. Fam C §§297.5, 750; CC §§682, 682.1. Ownership arrangements may also provide for the transfer of property on death. When property is owned in joint tenancy or community property with right of survivorship, the interest of a deceased owner will pass to the surviving owner(s) on the decedent's death without the property being administered in a probate proceeding. CC §683. This will occur even if there is a contrary provision in the decedent's will. Further, Division 5 of the California Probate Code authorizes a wide variety of methods for passing assets at death without administration. See particularly Prob C §§5100-5407, concerning multiple-party accounts with financial institutions, and the Uniform TOD Security Registration Act (Prob C §§5500-5512).

These arrangements all have varying consequences in terms of management rights and creditor rights. Sometimes the same form of ownership will have different consequences depending on the nature of the asset. For example, a joint tenant of a bank account usually can withdraw amounts on deposit without obtaining the signatures of other joint tenants. In contrast, most stock transfer agents will not transfer a security held in joint tenancy without the signatures of all owners. A joint tenant owner of real property can sell his or her own fractional interest in the property, but cannot sell or encumber the interest of another owner. CC §683.2.

When co-owners are married, there is a significant postdeath income tax difference between joint tenancy property and community property with right of survivorship. If the property is held as joint tenants, the surviving spouse will receive a new "value at death" basis (or the decedent's aggregate basis increase may be allocated in 2010) only for the decedent's one-half interest in the property. If the property is held as community property with right of survivorship, the surviving spouse will receive a new basis (or basis increase may be allocated) for both halves. IRC §§1014, 1022.

These provisions of federal law do not apply to same-sex domestic partners treated as spouses under California law. Although the IRS generally relies on state law for its definitions of spouse and community property, the federal Defense of Marriage Act (Pub L 104-199, 110 Stat 2419) prohibits the IRS from relying on state law for its definition of surviving spouse when that definition would treat same-sex spouses or domestic partners as surviving spouses. The Act provides the following (1 USC §7):

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

Therefore, both joint-tenancy property of domestic partners and same-sex spouses and property held as community property with right of survivorship by domestic partners and same-sex spouses will be included in the estate of the deceased spouse or domestic partner and receive a new basis under IRC §1014 except to the extent of any contribution to the property by the surviving spouse or domestic partner, and the portion of the property excluded from the decedent's estate will not receive a new basis. See IRC §2040. Nevertheless, same-sex surviving spouses and domestic partners may be entitled to a step-up in basis for both halves of community property for California income tax purposes. Although IRC §1014 is incorporated by reference in Rev & T C §18031, the rationale of *In re Marriage Cases* would appear to require equal treatment of opposite-sex and same-sex surviving spouses for these purposes and state law provides that registered domestic partners are "treated by California law as if federal law recognized a domestic partnership in the same manner as California law." Fam C §297.5(e).

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§3.35 b. Transfer to Joint Tenancy Solely for Property Management Purposes

Clients sometimes establish joint tenancy arrangements for property management reasons—often without the advice of counsel. This can produce problems for several reasons.

First, all apparent joint tenants are generally presumed to be true owners of the property. If the client puts an asset into joint tenancy, he or she cannot have title to the property changed back to his or her name alone at a later time without the joint tenant's consent. If, for example, the client puts his or her spouse or domestic partner on title as a joint tenant and the relationship later deteriorates or dissolves, the client may be faced with a property claim by the estranged partner.

Second, the principal's intended estate plan at death, as declared by his or her will or revocable trust, can be completely destroyed regarding those assets in joint tenancy.

Third, transfers to joint tenancy can have significant income tax, gift tax, property tax, and estate tax consequences because of the ownership interest in joint tenancy property. IRC §§1014, 2040. See California Estate Planning, chap 10 (Cal CEB 2002). See also California Conservatorship Practice §1.30 (Cal CEB 2005).

Fourth, a joint tenant is not a fiduciary per se. Either joint tenant can legally use joint tenancy assets for his or her own purposes. The contributing joint tenant thus has limited legal recourse for recovery of misappropriated assets. The risk is especially acute for joint bank accounts, which can be severely depleted or even closed by one joint tenant. In *Lee v Yang* (2003) 111 CA4th 481, 3 CR3d 819, the court held that an account owner who withdraws more than that owner's share of account contributions has no duty to account to the other owner.

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3. Community Property Management by Spouse or Domestic Partner

§3.36 a. Features of Community Property Management

In California, both spouses or registered domestic partners have equal control and management of community property. A spouse or domestic partner who is competent may generally manage community property on behalf of an incapacitated spouse or partner. Fam C §§297.5(a), 1100(a), 1102(a); Prob C §3051(a). This is true even if a third party has been appointed conservator of the incompetent spouse or partner's estate. Prob C §3051(b)(1). The conservatorship proceeding will not include the community property unless the competent spouse or partner consents. Prob C §3051(b)(2)-(c).

The competent spouse or partner has broad management authority over community property but may not enter into certain transactions on behalf of the community without obtaining prior court approval. Prob C §3071. These transactions include sales, encumbrances, long-term leases, and gifts of community property. Fam C §§1100(a), 1102(a).

The availability of community property management powers may render any formal provisions for incapacity unnecessary until after the first spouse or partner's death. This method should not be exclusively relied on, however, because (1) spouses or partners of similar age often slip into incapacity about the same time, and (2) these management powers cover only community property and do not extend to certain possibly significant transactions. For a spouse or partner with significant separate property, this method of asset management is of extremely limited use.

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§3.37 b. Transmuting Separate Property to Community Property Solely for Property Management Purposes

Transmuting separate property to community property has far-reaching implications. Transmutation affects how property is divided on dissolution and how it is distributed at death. It even affects how property can be transferred to a third party and how one spouse can qualify for government benefits such as Medi-Cal or perhaps how one domestic partner can qualify for government benefits such as Medi-Cal to the extent that eligibility for such benefits is determined under state law. Discussion of all the implications is beyond the scope of this book, but the attorney should not advise a client to transmute separate property to community property solely to gain the rather limited management advantages of such a change.

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4. Nonownership Transfer Vehicles

§3.37A a. Totten Trusts and Pay-on-Death (POD) Accounts

In California, some financial institutions permit establishment of accounts in the form "X, Trustee for Y." These accounts, called "Totten trusts," permit a testator to retain exclusive rights to the account during his or her lifetime. On a testator's death, the account is payable to the named beneficiary. See *Estate of Allen* (1993) 12 CA4th 1762, 16 CR2d 352. See generally Prob C §§80, 5404, 5406.

Pay-on-death (POD) accounts stand in the name of one or more persons and, on the death of such persons, become the property of one or more designated payees. See Prob C §5140. When the account holder dies, funds can be transferred to the designated payees without probate. Both Totten trusts and POD accounts are regulated by the California Multiple-Party Accounts Law (Prob C §§5100-5407). Unlike a joint account (see §3.35), a beneficiary of a Totten trust or POD account has no access to the funds in the account during the account holder's lifetime. Prob C §5401(b)-(c).

PRACTICE TIP: A Totten trust or a POD account can be useful as a simple means of making small cash gifts that the client does not want to appear as part of his or her will or revocable trust. Funds in these accounts can be paid to the designated beneficiary immediately after death without waiting for probate administration or distribution from a trustee. The 40-day waiting period for collecting a small estate under Prob C §13100 does not apply.

Most spouses use a joint account rather than a Totten trust or POD account to hold cash or securities (see §3.37B), although this may not be true of domestic partners. If a Totten trust or POD account is funded with community property, the surviving spouse or domestic partner is entitled to set aside the transfer of one-half of the funds under Prob C §5021 if the attempted transfer was made to someone other than the survivor without the survivor's consent, notwithstanding the general rule that the account is payable to the named beneficiary. See §17.11.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.37B b. Transfer on Death (TOD) Security Registration

§3.37B b. Transfer on Death (TOD) Security Registration

The Uniform TOD Security Registration Act (Prob C §§5500-5512) permits registration of securities and security accounts in a manner that will result in the property passing to a named beneficiary on death. As with a pay-on-death (POD) or Totten trust bank account, the beneficiary has no interest in the property before death. Securities can be registered in a manner that results in property passing to the beneficiary on the death of multiple original owners, but this generally creates a situation in which all multiple owners must sign documents in order to transfer the securities during lifetime. Spouses and registered domestic partners can hold community property in a TOD account and also provide that the property is to pass to a named beneficiary on the death of the survivor of them. Some clients hold substantially all of their assets in stock brokerage accounts that hold cash as well as stocks and bonds. If the client does not own real estate, a TOD registration can be used to transfer a significant portion of the client's assets. In other respects, the benefits and burdens of TOD accounts are similar to POD accounts. See §3.37A.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.37C c. Revocable TOD Deed (Proposed)

§3.37C c. Revocable TOD Deed (Proposed)

A revocable transfer-on-death (TOD) deed is an alternative to joint tenancy as a method of transferring real property at death without probate. Proposed legislation (AB 250) would provide a revocable TOD deed for the California real property of decedents dying on or after the effective date of the statute. Prop Prob C §§5600-5696. Unlike joint tenancy, a revocable TOD deed would have no effect on ownership rights or control of the property during the transferor's lifetime. Prop Prob C §5650. Therefore, it could not be used for property management, and it would not alter the status of the property as described in §3.35. However, a revocable TOD deed is included in this outline because, unless the deed were revoked before death as provided in Prop Prob C §5644, it could destroy the principal's intended estate plan with respect to the property as declared by his or her will or revocable trust. As of this writing, it appears that the proposed legislation will not be enacted in 2008.

Revocable TOD deeds could have important implications for will drafting. Joint tenancy is usually disfavored as a testamentary device because it gives the joint tenant an interest in the property. Most estate planners advise their clients to create a revocable trust and transfer any real property to the trust. Because the trust instrument provides for the disposition of the property, most wills for clients with real property are pourover wills directing the transfer of the decedent's remaining personal property to the trust.

Probate Code §§13000-13210 provide for disposition without administration of estates containing less than $100,000 in real and personal property, excluding property passing by nonprobate transfers. Property also passes without administration to a surviving spouse under Prob C §§13500-13660, but most spouses use a revocable trust because the trust is intended to provide for disposition of the property on the survivor's death. In many cases, the bulk of the decedent's personal property passes by nonprobate transfers such as pay-on-death (POD) accounts (see §3.37A) or TOD securities accounts (see §3.37B) and retirement plan beneficiary designations. Thus, if the decedent's real property could pass by revocable TOD deed, it might be unnecessary to use a revocable trust to avoid probate. In some cases, estate planners might advise their clients to use a revocable TOD deed for real property and use a will rather than a trust to dispose of the decedent's remaining personal property. However, there are other reasons to use a revocable trust, such as to provide for property management during the settlor's lifetime, if the settlor becomes incapacitated, and many estate planners might prefer to continue current practice. See §3.32.

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D. Selecting Appropriate Legal Device for Property Management on Incapacity

§3.38 1. Factors to Consider About Client

The attorney should carefully explore the client's personal and financial background before recommending how to plan for incapacity. The client's current and anticipated physical and mental condition, age, family situation, assets and liabilities, relationships, and attitudes all play a part in selecting the most appropriate legal device for handling the client's financial affairs on incapacity.

EXAMPLE: If the client has several children but no spouse or domestic partner, the selection of one child to manage the parent's property may make the other children suspicious and jealous. Because the siblings may be less suspicious if services are performed under court supervision, a conservatorship of the estate may be appropriate in this case.

Careful scrutiny of a client's personal and financial situation may lead the attorney to advise that nothing be done to plan for incapacity. No additional planning may be necessary, for example, if the client (a) owns relatively few assets that are either community property or held in joint tenancy, and (b) trusts his or her spouse or domestic partner or the joint tenant to manage the assets wisely. See §§3.34, 3.36. As noted in §§3.34-3.37, however, there are important limitations on the powers of a spouse or joint tenant to manage co-owned assets. For community property, the burden of these limitations is eased somewhat by a special procedure to obtain court authorization for a transaction involving community property, and, for good cause, separate property, when one spouse or registered domestic partner lacks legal capacity and does not have a conservator. See Fam C §297.5(a); Prob C §§3100-3154. These special procedures can also be utilized if the incapacitated spouse or partner has a separate property interest in the assets subject to the transaction. Prob C §3100(b).

Even a client who has no community property or assets held in joint tenancy may not need complex legal arrangements to handle incapacity. If managing just one or two bank accounts during incapacity is the client's only concern, giving a trusted friend or family member the power to sign on those accounts may be all that is necessary. See Prob C §5204, which creates a simple statutory durable power of attorney for bank accounts, or contracts concerning safe deposit services.

If the client's sole concern is management of his or her income from a government program such as veterans' or social security benefits, the attorney may advise having a trustworthy friend or relative appointed as a substitute payee. See, *e.g.,* 38 USC §5502 (veterans' benefits); 42 USC §405(j) (social security benefits). Many government programs and private or public pension plans allow recipients to designate a payee to receive the income on their behalf. For discussion of substitute payee alternatives, see California Conservatorship Practice §1.16 (Cal CEB 2005).

In most cases, however, the attorney will advise more formal devices for dealing with incapacity, matching the client's needs and desires with the device most suited to meet them.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.39 2. Primary Legal Devices: Characteristics and Comparisons

§3.39 2. Primary Legal Devices: Characteristics and Comparisons

The primary options for a client planning for incapacity are a nomination of conservator of the estate, a durable power of attorney (DPOA), and a revocable trust. The attorney and client should carefully consider the unique features of each device before choosing the one most suited to the client's situation.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.40 a. Features of Conservator of Estate

§3.40 a. Features of Conservator of Estate

The most prominent feature of a conservatorship of the estate is court supervision, which provides the best protection of the conservatee's interests. A number of devices are built into the conservatorship proceeding to protect the conservatee, including automatic appointment of an independent court investigator, discretionary court appointment of independent counsel for the conservatee, requirements for periodic court reports and accountings by the conservator, bond requirements, and requirements for prior court approval for certain significant transactions. If the conservator dies or becomes incapacitated, the conservatorship proceeding provides an established forum for supervised transfer of management to a successor conservator.

Court supervision also benefits the conservator by providing a means to have the court approve in advance the conservator's actions on sensitive issues. This protection may prove invaluable when the conservator expects a third party to challenge his or her acts.

Court supervision has its drawbacks. First, it is public. The proposed conservatee is required to attend the court hearing to appoint a conservator unless he or she specifically elects not to attend or is declared medically unable to attend by a licensed physician. See Prob C §1825(a). At the hearing, the conservatee is publicly adjudged to be unable to manage his or her affairs. Thus, the proceeding can be humiliating and psychologically harmful to the conservatee. In addition, the conservatee's financial affairs become a matter of public record through the inventory and accounting requirements of a conservatorship.

Second, court supervision means delays. It may take weeks for the court to appoint a nominee as conservator. Further, asset management is delayed because sales, leases, loans, and many other transactions require court approval. See Prob C §§2540-2574.

Third, court supervision means substantial costs. In conservatorships, the costs include initial and periodic legal fees, court filing fees, court investigator's fees, bond fees, and possibly conservator's fees, particularly if a trust company is appointed. Although the cost of a nomination of conservator is minimal, the costs of a conservatorship usually exceed the routine costs of revocable trusts or powers of attorney.

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§3.41 b. Features of DPOA

The salient characteristic of a DPOA is its ease of preparation and implementation. The instrument establishing the DPOA can be easily prepared and executed. Implementation is quick; no formal transfer of assets is required, and no court supervision is needed.

The DPOA is also quite flexible. The powers granted to the agent may be as wide or as narrow as the principal wishes. Because the powers granted can be extensive, the DPOA can eliminate the need for a conservatorship.

The DPOA involves no court supervision, thus ensuring the principal's privacy and avoiding unnecessary delays in asset management. If court supervision is desired, a relatively simple procedure to obtain court review is available. See Prob C §§4500-4545.

Because the DPOA is simple to prepare and involves no formal transfer of assets or court supervision, it is an economical device for handling financial affairs and property transactions on incapacity. Attorney fees for the preparation and execution of a DPOA are usually substantially less than those for setting up a revocable trust or establishing and administering a conservatorship.

A problem with the DPOA has been the reluctance of some third parties to honor it. Despite CC §2356(b) (protecting third parties to a transaction who are ignorant of the agency's termination) and CC §1216 (requiring recordation of certain revocation instruments), some third parties, particularly title companies, have been less willing to transact business with an agent under a DPOA than with a conservator or even a trustee. Banks and other financial institutions are often reluctant to recognize a power of attorney not executed on their own forms. For a discussion of statutory and drafting solutions for these problems, see §3.30.

The ease with which a DPOA can be executed and implemented has its drawbacks. Because the DPOA is so easily prepared and executed, principals sometimes sign them without fully understanding their terms and implications, and agents sometimes implement them with little understanding of their duties and responsibilities. Because the DPOA can be implemented without the formalities of a court proceeding or a transfer of title to assets, agents tend to take their responsibilities and the terms of the DPOA lightly, growing careless about record keeping, accounting, and the principal's affairs in general. Further, the ease of implementation may tempt unscrupulous agents to obtain a DPOA prematurely and put it into effect without the principal's knowledge and to the principal's detriment. Without court supervision, few safeguards exist to ensure that an agent is serving the principal's best interests and wishes. An agent's negligent or improper acts can go undetected for a long time.

If the principal executes an immediately effective DPOA, permitting the agent to handle property matters while the principal has legal capacity, transitional problems may be eliminated. The principal can monitor the agent's performance and work out any unforeseen problems. When the principal becomes incapacitated, the agent simply continues to manage the principal's affairs. Serious transitional problems can arise, however, if the agent becomes incapacitated or is unable to serve for any reason. If no successor agent is able and willing to step in, the agency terminates and a conservatorship may have to be established. Transitional problems also arise at the principal's death because an agent has no power to continue managing assets after the principal's death. CC §2356(a)(2). Such management must await the appointment of an executor for the principal's estate.

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§3.42 c. Features of Revocable Trust

A revocable trust is a more comprehensive estate planning tool than a conservatorship of the estate or a durable power of attorney (DPOA). Although a revocable trust can be used to manage the settlor's assets during incapacity, it is primarily a very useful and popular device to distribute the settlor's assets to his or her beneficiaries at death without the expense and delays of probate administration. The revocable trust can also be designed to continue for years beyond the settlor's death, making it an attractive estate planning tool for those who want a trusted friend or relative to manage assets for the beneficiaries' benefit. Because the trustee's powers continue after the settlor's death, a smooth transition is possible from lifetime to postmortem management.

In deciding whether to recommend a revocable trust to a client, the attorney should examine its advantages and disadvantages not only as a device to manage property during incapacity but also as a tool to advance postmortem goals. The revocable trust's postdeath features include probate avoidance, unified management and distribution, reduction of risk of attack, tax consequences, and absence of creditors' claims cutoff (but see CCP §366.2 and Prob C §§19000-19403). See California Estate Planning, chap 6 (Cal CEB 2002). See also Drafting California Revocable Trusts, chap 1 (4th ed Cal CEB 2003) for complete discussion of the advantages and disadvantages of a revocable trust after the settlor's death.

A revocable trust can provide greater flexibility and specificity in property management than a conservator of the estate or a power of attorney. A trustee can be given broader powers to manage assets than the statutory powers available to conservators. A settlor can prescribe investment guidelines and accounting requirements not usually included in a power of attorney and not commonly available to conservators.

No matter how extensive the powers of a trustee, they can be used only to manage assets that have been formally assigned to the trust. Because a trustee has no control over assets that remain outside the trust, a conservatorship must be established if those assets are substantial. Further, a trustee cannot execute disclaimers, consent to split gifts with a settlor's spouse, sign and file the settlor's personal income tax returns, or make any number of other decisions involving the settlor individually but not the trust per se.

Although a revocable trust is established without a court proceeding and is administered without court supervision, trust formalities must be observed for the trust to be valid and to ensure a smooth transition when the settlor dies or becomes incapacitated. The trustee should not commingle trust assets with the settlor's personal assets and should maintain adequate records. If the settlor is not the trustee, a taxpayer identification number should be obtained and trust tax returns prepared and filed. Finding a responsible successor trustee will be difficult if the formalities are not observed.

Clients are likely to grow impatient with trust formalities. A trustee's responsibilities can be particularly burdensome when many types of assets must be monitored, traded, or reinvested frequently. If the settlor is unwilling to handle these responsibilities, he or she should transfer them to a trusted friend or relative as trustee, select a professional trustee, or create an unfunded trust and execute a DPOA to fund it when necessary. See California Powers of Attorney and Health Care Directives §2.17 (Cal CEB 2008); Revocable Trusts, chap 22.

Unlike a conservatorship, a revocable trust permits a trial run of the trust while the settlor is able to oversee it and make any necessary adjustments. A settlor who is not fully satisfied with the trust's operations or with the trustee's performance can change the administrative provisions, substitute trustees, or make other changes. This feature may be particularly attractive to the client who wishes to turn over management of his or her assets to someone else before incapacity because, *e.g.*, he or she changes residences frequently or just wants relief from the responsibility of managing his or her financial affairs.

A revocable trust eliminates difficult problems of transition. If the settlor is not serving as trustee at incapacity or death, there will be no interruption in the management of trust assets at either time. If the trustee is no longer able to serve or is removed, the trust does not terminate. If no successor has been named, the court can be petitioned to appoint a successor. Prob C §15660.

Because there is no mandatory court supervision, a revocable trust protects the settlor's privacy. There is no need

for public disclosure of assets and transactions, and there is no public adjudication of incapacity. Court supervision of the trust, if needed, is available through petition. See Prob C §17200.

Trustees rarely face the problems encountered by agents in gaining third party acceptance of powers of attorney. Because trust assets are vested in the trustee's name, a third party is typically more willing to deal with a trustee than with an agent. Compared to a revocable trust, the durable power of attorney is a recent device without an established body of law interpreting it and the agent's duties and powers. This also helps explain the preference of banks, title companies, and other financial institutions to deal with trustees over agents.

If the settlor has contacts with or owns property in other states, the revocable trust affords further advantages. The trust instrument may be drafted to provide more administrative and taxation certainty than under any other option. A revocable trust may also be used to avoid ancillary administration. See Prob C §§12500-12591.

NOTE: Currently, foreign state personal representatives can use the same procedures available to heirs to collect California personal property by affidavit if the aggregate value of such property is less than $100,000. Prob C §§12570, 13100-13116. Proposed legislation would establish a similar procedure that could be used to collect larger estates by affidavit if the decedent did not own California real property at the time of death. Prop Prob C §§12577-12590; AB 355 (2009).

A revocable trust is not an inexpensive legal device. The legal fees involved in preparing the trust instrument and transferring the settlor's assets to the trust can be large. Brokerage charges, recording fees, and other charges to transfer assets such as limited partnership interests may be incurred. Trustee fees can be costly, too, but they can be minimized if the settlor acts as trustee and is later succeeded by a family member or friend. The client should realize that the start-up legal fees are small in comparison to the substantial legal fees that could be incurred if a conservatorship (and, for that matter, a probate) were required.

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3. Legal Devices for Property Management Not Mutually Exclusive

§3.43 a. Potential Conflicts to Anticipate

Unless the DPOA provides otherwise, an agent's powers under a DPOA do not terminate with the appointment of a conservator of the estate. If a conservator is appointed, the agent is accountable to him or her as well as to the principal. Subject to advance court approval, the conservator also has the power to amend or revoke the DPOA. Prob C §4206. Because of the potential for conflict this poses, it may be advisable to nominate as conservator the same person appointed agent under the DPOA.

Under the California "substituted judgment" statute, a conservator of the estate may be allowed to execute the conservatee's power to revoke or modify a revocable trust. Prob C §2580(b)(11). The instrument can prevent this, but such a trust provision would adversely deprive the conservatee and the persons interested in the conservatee's estate of the very benefits that the substituted judgment is intended to confer, including the ability to modify an estate plan in a manner that will reduce taxes. Prob C §2580(b)(11). To avoid any unnecessary disputes, a client should usually nominate as conservator the same person appointed as trustee.

An agent under a DPOA may revoke or modify a principal's revocable trust, but only if both the DPOA and the trust instrument expressly authorize him or her to exercise these powers. Prob C §§15401(c), 15402. Consequently, if the attorney and client determine that both a DPOA and a revocable trust are appropriate, they should decide whether to give the agent the power to modify or revoke the trust. Frequently, the holder of a DPOA is authorized to partially revoke a revocable trust for the purpose of obtaining funds to be used to make IRC §2503 annual gift tax exclusion gifts. In *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285, however, the court held that the agent's authority to create, modify, or revoke a trust under Prob C §4264(a) does not confer the power to change the persons entitled to the principal's property on the principal's death, unless the power of attorney contains express authority to designate or change the designation of beneficiaries under Prob C §4264(f).

Coordination efforts can become extremely complex if the client has both community property and an agent under a DPOA. If there is no conservatorship, either the agent or the competent spouse can manage the community property—the spouse only to the degree that the transaction is not listed in Fam C §§1100 and 1102, and the agent only to the degree that the DPOA allows. If a conservatorship has been established, Prob C §3051 gives management and control exclusively to the competent spouse; the agent appears to have no authority. See also Prob C §3071. A court order can be obtained under Prob C §3054 to exclude property from a conservatorship, which returns the parties to the situation in which either the competent spouse or the agent can act. With court approval, however, the conservator can revoke a DPOA. See Prob C §4206. Thus, the situation can become extremely complicated if the competent spouse, the conservator, and the agent are not the same person or cannot work together.

If community property is involved and an agent is desired for property management, one obvious solution is the execution of a general DPOA by each spouse, granting immediately effective powers to the other. This eliminates a court petition when Fam C §§1100 and 1102 actions are anticipated. If the spouses wish a third party to manage affairs, however, each spouse should execute a DPOA that refers to Fam C §§1100(a) and 1102 and Prob C §3051(a), selects the same person as agent, and nominates the same person as conservator of each spouse.

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§3.44 b. More Than One Legal Device May Be Desirable

Because the wisest course for property management on incapacity may involve more than one of the legal devices previously discussed, the attorney should consider tailoring two or more of these devices to the client's situation. For example, the careful practitioner usually recommends both a revocable trust and a DPOA. The DPOA can allow the agent to manage the assets not normally held in trust and to handle financial affairs involving the settlor individually. The DPOA can also permit the agent to transfer additional assets to the trust at his or her discretion. This power is extremely important when the settlor's incapacity is imminent, when the incapacitated settlor receives assets unexpectedly, or when the settlor has failed to transfer assets to the trust before becoming incapacitated.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.45 III. PLANNING FOR MANAGEMENT OF PERSONAL MATTERS ON INCAPACITY

§3.45 III. PLANNING FOR MANAGEMENT OF PERSONAL MATTERS ON INCAPACITY

For the client who is concerned about how personal matters will be handled when he or she is unable to care for himself or herself, there are fewer legal devices to choose from and fewer decisions to make. The primary legal options are a conservatorship of the person and advance health care directives (including, under Prob C §4605, both powers of attorney for health care (PAHCs) and individual health care instructions that provide directions for health care decisions without appointing a decision maker). For complete review of the law on conservatorships of the person, see California Conservatorship Practice (Cal CEB 2005). For complete discussion of the law on the PAHC option, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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A. Conservatorship of Person

§3.46 1. What Is Conservatorship of Person?

A conservatorship of the person is much like a conservatorship of the estate except that the former deals with the personal affairs of the conservatee and the latter with the conservatee's property. A conservator of the person is an individual appointed by the court to take responsibility for the physical health, food, clothing, and shelter of a person who is unable to provide properly for these needs. Prob C §1801(a). On selection, nomination, and appointment of a conservator, see §3.47.

In general, the conservator of the person must ensure that the conservatee is properly cared for. This general duty includes a variety of significant personal decisions. For example, the conservator may be required to decide:

- Whether the conservatee should live at home or in an institution;
- Where within California the conservatee's residence should be fixed (see Prob C §2352); or
- Whether the conservatee should undergo surgery.

See Prob C §§2350-2359 for the duties of the conservator of the person.

On appointment, the conservator of the person assumes many but not all of the personal powers of the conservatee. The establishment of a conservatorship does not automatically terminate the conservatee's ability to make a will, to marry, to enter into a registered domestic partnership, or to vote. Prob C §§1871(c), 1900, 1910. Most important, the conservatee retains the ability to give informed consent for medical treatment. Prob C §1880. The court has the authority, however, to determine that the conservatee is unable to exercise these powers competently and to transfer them, in some cases, to the conservator of the person. See Prob C §1881 for the nature of evidence of inability to give informed consent to medical treatment.

If the conservatee has been adjudicated to lack the capacity to give informed consent for medical treatment, the conservator gains the exclusive authority to give consent for medical treatment that he or she, on medical advice, considers necessary. Prob C §2355(a). If, before the conservatorship, the conservatee followed a religion with tenets and practices that called for reliance on prayer alone for healing, the conservator must use an accredited practitioner of that religion for the treatment required. Prob C §2355(b). The conservator also gains the power to consent to the removal of life support, including nutrition and hydration, from the conservatee without the conservatee's prior written consent. California Conservatorship Practice §13.21 (Cal CEB 2005).

There are limits on the conservator's authority to make medical decisions. For example, a conservator may not place a conservatee in a mental health facility or allow the use of an experimental drug or convulsive treatment on the conservatee. Prob C §2356. See Conserv Prac §§13.23, 13.26. The conservator's powers are also subject to the effect of an advance health care directive. Prob C §2356(e). See also Prob C §4685.

See §3.48 for procedures to designate a person to make health care decisions when a patient without a conservator lacks capacity to make health care decisions.

Under Prob C §2356.5, a conservator may be granted special powers by a court to place a conservatee with dementia in secured long-term care facilities, or to authorize administration of medication appropriate for the care and treatment of dementia. See Conserv Prac §13.24. For further discussion, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 4 (Cal CEB 2003).

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§3.47 2. Selection, Nomination, and Appointment of Conservator of Person

The discussion of the selection, nomination, and appointment of a conservator of the estate in §§3.5-3.10 also applies to the conservator of the person.

The client's choice for conservator of the person should be the person who can best furnish the care, affection, and personal attention that the client will need when incapacitated. Usually this person is the client's spouse or domestic partner, adult child, or close relative. If none of these persons is available, a close friend or neighbor may be an appropriate choice. Often, such an individual is only willing to help in an informal capacity because of fears that others will think that he or she is meddling in the conservatee's financial affairs. If this is the case, the individual should be reassured that he or she will not be responsible for the conservatee's financial affairs. The client should be encouraged to select someone who lives near him or her. Regardless of the particular choice, the attorney should insist that the client find out whether the selected person is willing to serve before nominating him or her.

Trust companies and other financial entities that often serve as conservators of the estate will not serve, and cannot be appointed, as conservators of the person. Many such companies will not consent to serve as conservator of the estate if a conservator of the person has not been appointed.

See California Conservatorship Practice §§1.42-1.44 (Cal CEB 2005) for discussion of professional conservators, the public guardian, and nonprofit charitable organizations as potential conservators of the person.

Because many decisions affecting the conservatee are best made by the conservator of the estate and that of the person, having the same person serve as both conservators eliminates a potential source of conflict. For example, deciding how the conservatee should live is best done by both conservators. The decision should be based on the conservatee's needs (about which the conservator of the person knows best) and on the conservatee's ability to pay (about which the conservator of the estate knows most). If one individual is not the best choice to perform the duties of both conservators, two individuals should be selected to serve, but only if they are able to work together for the conservatee's benefit.

If a court is not likely to honor a client's preference for conservator of the person because of the order of preference defined in Prob C §1812(b), the client should execute a nomination of conservator. See §3.6. However, the attorney should not necessarily discourage a client whose preferences follow the statutory order of preference from executing a nomination of conservator. A nomination expresses the client's confidence in the nominee and may later reduce concerns about the nominee's acting against the conservatee's wishes. A nomination of conservator can also be used to express the nominator's specific desires about, *e.g.,* in-home care versus nursing home care. See §3.7.

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§3.48 3. Is Conservatorship Necessary?

A client who has family and friends willing and able to provide for his or her food, clothing, shelter, and other personal needs and who is willing to accept the decisions of these persons about personal matters may not require a conservator of the person regardless of his or her physical or mental condition. If the client is unable to make health care decisions, a full conservatorship may still not be necessary. Probate Code §3201 provides a court procedure to petition for a determination that the patient lacks the capacity to make health care decisions concerning specified treatment for an existing or continuing condition, and for an order authorizing a designated person to make a health care decision on behalf of the patient. A properly executed power of attorney for health care can also take care of this problem.

Even if the client has no present need for a conservatorship of the person, this does not mean that the need will never arise. For example, disputes may develop among family members and friends about the manner in which the incapacitated individual's personal affairs are being handled. The appointment of a conservator may be the only way to end the disputes. In view of the ease with which a nomination of conservator can be prepared and executed, it is usually advisable for a client to have one done even if he or she feels that appointment of a conservator will never be needed.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/ B. Advance Health Care Directives/§3.49 1. Power of Attorney for Health Care (PAHC) and Individual Heath Care Instructions

B. Advance Health Care Directives

§3.49 1. Power of Attorney for Health Care (PAHC) and Individual Heath Care Instructions

Under the Health Care Decisions Law (HCDL) (Prob C §§4600-4805), an individual may execute advance health care directives. These may appoint an agent to make health care decisions if the principal is unable to do so, in which case the document is a power of attorney for health care. If no agent is appointed, but the document declares wishes concerning health care decisions, the document is an individual health care instruction. Prob C §§4605, 4623, 4629.

Probate Code §4615 defines "health care" to mean "any care, treatment, service, or procedure to maintain, diagnose, or otherwise affect an individual's physical or mental condition." Probate Code §4617 defines "health care decision" as "a decision made by the patient or the patient's agent, conservator, or surrogate, regarding the patient's health care."

A power of attorney for health care (PAHC) has no effect until the principal is unable to make health care decisions. At that point, the agent is vested with the authority to make health care decisions. Prob C §4682. The agent has a duty to act consistently with the principal's desires as expressed in the PAHC or otherwise made known to the agent. If the desires are unknown, the agent must act in the principal's best interests. Prob C §4684.

The PAHC does not give the agent the power to commit the principal to a mental health facility or to authorize convulsive treatment, psychosurgery, sterilization, or abortion. Prob C §4652. It may give the agent some postdeath powers not normally considered within the scope of health care, including the power to authorize an autopsy; to donate the principal's body or body parts for transplant, therapeutic, educational, or scientific purposes; and to direct the disposition of remains. Prob C §4683.

The effect of an arbitration agreement signed by an agent when the principal is admitted to a residential care or nursing home facility is unclear at this point. In *Garrison v Superior Court* (2005) 132 CA4th 253, 33 CR3d 350, the court held that an agent under a PAHC had authority to execute an agreement requiring arbitration of a dispute with a residential care facility. See also *Hogan v Country Villa Health Servs.* (2007) 148 CA4th 259, 55 CR3d 450 (agent under a statutory advance health care directive had authority to execute arbitration agreement). Compare *Flores v Evergreen at San Diego, LLC* (2007) 148 CA4th 581, 55 CR3d 823 (arbitration agreement signed by spouse who was not authorized to act on behalf of the patient was unenforceable). See also *Warfield v Summerville Senior Living, Inc.* (2007) 158 CA4th 443, 69 CR3d 783 (agreement signed by husband who was not authorized to act on behalf of wife). However, all of these decisions are in doubt under *Fitzhugh v Granada Healthcare & Rehabilitation Ctr., LLC* (2007) 150 CA4th 469, 58 CR3d 585, in which the court held that a nursing home cannot compel arbitration of elder abuse claims. Note that the *Fitzhugh* court reached this conclusion without addressing plaintiff's role as decedent's purported agent. 150 CA4th at 473.

The principal may revoke the PAHC, orally or in writing, at any time while the principal has the capacity to give a durable power for health care. It is presumed that the principal has such capacity. Prob C §4657.

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§3.50 2. Selection of Agent for PAHC

The agent should be a responsible, trustworthy, and willing individual close enough to the principal to know his or her wishes about health care. A spouse, domestic partner, or adult child may be a logical first choice.

A PAHC may be particularly important for the client who wishes to appoint an agent other than a spouse or child. Physicians often consult with family members about medical treatment for an incapacitated person without asking for a PAHC. See *Barber v Superior Court* (1983) 147 CA3d 1006, 195 CR 484 (court agreed with physicians' recognition of family members as surrogate for incapacitated patient despite lack of PAHC or court order). A PAHC, however, is advisable even for clients who intend to appoint a family member as agent. It gives the client's physician one person to rely on if a difference of opinion arises among family members. It also gives the client the opportunity to express his or her wishes about health care, although this can be done in an individual health care instruction that does not appoint an agent.

The principal should be aware that if the spouse is designated as agent, a subsequent divorce revokes the designation. If the principal remarries the former spouse, the designation is revived. Prob C §4697.

Probate Code §4659(a) prohibits the following persons from serving as agent: a treating health care provider or an employee of the health care institution where the principal is receiving care, and an operator or employee of a community care facility or a residential care facility for the elderly. An employee of the health care institution or these facilities may, however, serve as agent if the employee is related to the principal or is a registered domestic partner of the principal, or if the principal is employed by the same health care institution or facility. Prob C §4659(b).

There is no statutory prohibition against designating a nonresident individual as agent. Although the appointment of co-agents appears to be permissible, this raises the possibility of conflict. Further, most health care providers prefer dealing with just one individual. On the other hand, the client may desire that major decisions not be made without consensus or may wish to avoid conveying the impression that the client trusts one family member more than another. If co-agents will be designated, the PAHC should clearly specify whether the agents must act unanimously and should normally confirm that the available co-agents can act if other co-agents are not available. The PAHC may also designate one of the agents to be the sole contact with health care providers and can designate a primary physician.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.50A 3. Alternative Agents for PAHC

§3.50A 3. Alternative Agents for PAHC

The principal should name alternative agents to allow for succession in case an agent becomes incapacitated, dies, or resigns. As with successor agents for a DPOA (see §3.20), practical problems with third party acceptance may arise if an alternative agent must act. A principal who is competent when a primary agent becomes unable to serve should execute a new PAHC and revoke the old one.

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4. Special Drafting Concerns for PAHC

§3.51 a. Defining Client's Wishes Concerning Health Care Issues

The attorney must determine which of the client's desires concerning personal health care needs should be mentioned in the PAHC. Eliciting the client's wishes and drafting the appropriate documents require the attorney to become conversant with medical issues and terminology. For discussion of the medical issues that may arise under a PAHC, see California Powers of Attorney and Health Care Directives, chap 9 (Cal CEB 2008).

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§3.52 b. Specifying Client's Wishes Concerning Life-Sustaining Treatment

A PAHC can authorize the agent (1) to select and discharge health care providers and institutions; (2) to approve or disapprove diagnostic tests, surgical procedures, and programs of medication; and (3) to give directions to provide, withhold, or withdraw artificial nutrition and hydration and all other forms of health care, including cardiopulmonary resuscitation. Prob C §4617. Some clients may wish to have their lives prolonged to the greatest possible extent; others may wish to die naturally when continued medical treatment would be futile. The attorney must be prepared to discuss the various life-prolonging procedures with the client to determine the nature and extent of the powers to be granted and the circumstances permitting their exercise.

The attorney must probe into vague or general feelings to determine the client's concerns. For a client without a specific illness, a general statement expressing his or her philosophy regarding life-sustaining treatment should be set forth in the PAHC or a separate individual health care instruction. The desires of a client with a terminal illness should be discussed and memorialized in more specific terms.

NOTE: If a provision authorizing withholding or withdrawal of life-sustaining treatment is intended to include nutrition (food) and hydration (water), the PAHC or individual health care instruction should expressly say so and limit this authority to situations in which the nutrition or hydration are medically (*i.e.,* artificially) provided. Withholding or withdrawal of nutrition and hydration can be an emotional issue for some families, and requiring an agent to make these decisions without guidance can place an unfair burden on the agent.

For further discussion of withholding or withdrawal of life-sustaining treatment as it relates to a PAHC, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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§3.53 c. Limiting Power to Petition

Under Prob C §4766, a petition may be filed for any of the following purposes:

- To determine whether the patient has capacity to make health care decisions;
- To determine whether an advance health care directive is in effect or has terminated;
- To determine whether the acts or proposed acts of the agent are consistent with the principal's desires or, if unknown or unclear, are in the best interests of the principal;
- To declare that an agent's authority is terminated, on a determination that (1) the agent has violated, has failed to perform, or is unfit to perform the duty to act consistently with the patient's desires or, if the patient's desires are unknown or unclear, is acting in a manner that is clearly contrary to the best interests of the patient, and (2) the patient lacks the capacity to execute or revoke an advance health care directive; or
- To compel a third person to honor individual health care instructions or the authority of an agent.

Under Prob C §4765, such a petition may be filed by any of the following persons:

- The patient;
- The patient's spouse, unless legally separated;
- A relative of the patient;
- The patient's agent or surrogate;
- The conservator of the person of the patient;
- The court investigator or public guardian;
- The treating health care provider; or
- Any other interested person or friend of the patient.

In the PAHC, the principal may eliminate the authority of any of these persons to so petition, except for the authority of the conservator to petition to determine whether the PAHC is in effect or has terminated or to declare that the agent's authority is terminated. Prob C §4753. Similarly, the principal may not eliminate the authority of the agent to petition to determine whether the PAHC is in effect or has terminated, or whether the acts or proposed acts of the agent are consistent with the principal's desires or, if unknown or unclear, the best interests of the principal. Prob C §4753(b). Special execution requirements must be followed to eliminate the authority of the other enumerated persons to petition. Prob C §4753(a).

If the agent is likely to encounter hostility and harassment from any of these persons while attempting to carry out his or her responsibilities, their power to seek court review probably should be eliminated. For example, if one partner of a gay couple wishes to appoint the other as agent and both of them are on bad terms with the principal's parents, the principal may wish to eliminate the parents' ability to challenge in court the actions of the partner under the PAHC. Clients must be advised, however, that limiting court access for review or enforcement purposes requires absolute faith and trust in the agent, because this is a limitation on those who can question the acts of the agent. A client who wishes to impose some limits should be encouraged to leave the authority to petition at least in the court investigator, public guardian, and treating health care provider. For further discussion, see California Powers of Attorney and Health Care Directives (Cal CEB 2008). In considering whether to eliminate the power of certain persons to bring petitions, consideration should be given to the risk that this will simply increase the animosity among the various interested persons. Further, the excluded person may be able to effectively circumvent the restriction by having another friend or family member bring the petition.

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§3.54 d. Hospital Visitation Rights

When warranted by a patient's condition, a hospital may impose restrictions on the patient's visitors. In such cases, most hospital policies limit visitors to members of the immediate family. This may lead to a tense and difficult situation if others emotionally closer to the patient than immediate family members are not allowed to visit and the patient is unable to make his or her wishes clear. One of these other persons may even be the agent under the PAHC.

Although a hospital is unlikely to refuse to allow the agent to visit the principal (particularly an agent with the power to select the health care provider), the safest course is for the principal to address hospital visitation rights in the PAHC. The instrument should explicitly state that the principal wishes the hospital to give preference to the agent and those designated by the agent if restrictions are placed on visitors. This type of provision is particularly important for clients in nontraditional families.

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§3.55 e. Funeral Arrangements

A will often contains the client's desires about burial and funeral arrangements. See Health & S C §§7100, 7100.1. See §10.16 for further discussion. If the client's will contains such provisions, the attorney preparing the PAHC should ensure that it does not conflict with the will. Because an agent under a PAHC has the power to direct the disposition of the principal's remains in the absence of a contrary provision in the PAHC (Prob C §4683(b)(3)), the attorney should particularly note whether the will appoints someone to direct the disposition of remains and resolve the inconsistency if that person is not the agent.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.56 f. Anatomical Gifts

§3.56 f. Anatomical Gifts

Under the California Uniform Anatomical Gift Act (Health & S C §§7150-7156.5), an individual may donate all or part of his or her body to an eligible institution or individual for transplant, education, or research purposes. The agent under a PAHC has the power to make (or not to make) anatomical gifts unless the PAHC contains other provisions. Prob C §4683(b)(1). There are other ways to make anatomical gifts. See Health & S C §7150.20. One of the best ways is for the donor to execute the small preprinted anatomical gift form distributed by the Department of Motor Vehicles for attachment to the donor's driver's license. In any event, the PAHC should reflect the principal's wishes.

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§3.57 5. Forms of PAHC

A statutory form of PAHC is provided in Prob C §4701. See §3.65. The California Medical Association (CMA) also provides printed forms. Providers are accustomed to using the CMA forms. Under the transition provisions for the Health Care Decisions Law (HCDL) (Prob C §§4600-4805), effective July 1, 2000, PAHC forms executed before that date remain valid, and any PAHC executed on a printed form is valid regardless of whether it was enacted before or after that date. Prob C §4665. Further, because the HCDL did not change the basic requirements for a valid PAHC, older forms are usually valid even if they are not printed.

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§3.58 6. Coordination With Agent for PAHC

The attorney should encourage the principal to discuss his or her wishes concerning health care with the agent and to caution the agent of the need to be an active participant in the principal's health care. The agent should be prepared to initiate discussions with the principal's physicians and to insist on being consulted about each major health care decision.

The PAHC should be kept in a safe place accessible to the agent. It is unwise to keep the document in a safe-deposit box because problems may arise if health care decisions need to be made when the safe-deposit box is not accessible. The client should give a copy of the PAHC to his or her primary physician, discussing its terms with the physician to determine whether he or she will be able to comply with it.

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C. Selecting Appropriate Legal Device for Management of Personal Affairs on Incapacity

§3.59 1. Features of Conservatorship of Person

Like a conservatorship of the estate, the most prominent feature of a conservatorship of the person is court supervision, which means some judicial protection of the conservatee's interests and some judicial guidance for the conservator in making personal decisions.

Court supervision has serious drawbacks. It means a public proceeding and significant costs. Most important, it means delays. Health care decisions often must be made quickly, and legal requirements imposed on the conservator of the person may limit his or her ability to act expeditiously.

See §3.40 for further discussion of the features of a conservatorship.

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§3.60 2. Features of PAHC

An advance health care directive can take the form of a power of attorney for health care (PAHC) or an individual health care instruction that does not appoint an agent. Prob C §4605. Using a PAHC provides a mechanism for making health care decisions without creating a document that addresses the great variety of medical decisions that might be required. The PAHC shares many of the features of the durable power of attorney (DPOA). See §3.41. The PAHC can be easily prepared and implemented. Because no court supervision is required, the client's privacy is ensured, legal expenses are minimized, and unnecessary delays are avoided. Court supervision is available, however, when the need arises.

Like the DPOA, third parties are sometimes reluctant to honor the PAHC. This problem has been greatly eased, however, by Prob C §4740, which provides that health care providers are not subject to civil or criminal liability or professional discipline for complying with the health care decisions of an agent if the provider believes in good faith that the agent has the authority to make health care decisions, including a decision to withhold or withdraw health care. Prob C §4740(c).

If the client creates a PAHC using either the statutory form in Prob C §4701 (see §3.65) or a current California Medical Association (CMA) form, the agent is unlikely to experience any difficulty convincing a health care provider to recognize his or her authority. Most hospitals and physicians are familiar with the CMA form and readily accept it (along with the protections it provides to the health care provider). Regardless of which form is used, the principal should give a copy of the PAHC to his or her treating physician before its use is needed. If the physician has problems with the form, the client can make changes in it while still having the capacity to do so.

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§3.61 3. Coordination of Conservatorship With PAHC

Often it is advisable for the client to execute both a nomination of conservator of the person and a PAHC. The attorney should strongly recommend that the same individual be selected as conservator of the person and agent under the PAHC. If different individuals are chosen, a conflict between them may arise that would be detrimental to the principal. Probate Code §§4765 and 4766 give the conservator of the person the power to petition the court (a) to determine whether the principal has capacity to make health care decisions or lacks capacity to execute or revoke an advance health care directive; and (b) to determine whether the PAHC is in effect or has terminated; or (c) to determine whether the acts or proposed acts of the agent are consistent with the principal's desires or in the principal's best interests; or (d) to terminate the authority of the agent on a determination that the agent has made a health care decision that authorized anything illegal, or that the agent has violated, has failed to perform, or is unfit to perform the duty to act consistent with the principal's desires or best interests. The principal in the PAHC cannot eliminate the conservator's authority to petition the court. Prob C §4753(b)(1). Consequently, if the conservator of the person is not the same individual as the agent and the two individuals differ about what is best for the principal, the authority to petition can lead to judicial disputes about the principal's health care. In the PAHC, however, the principal can strip the conservator of the person of the power to petition for this particular purpose. Prob C §4753(a). See §3.53.

Another reason why the conservator of the person should be the same individual as the agent under the PAHC lies in the vague boundaries of authority available under the PAHC. Attorneys differ over where the authority of one ends and the other's begins. See §3.60. If the same individual serves in both capacities, there is no need for clear delineation of, or constant coordination between, the two roles.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.61A 4. Coordination of PAHC With DPOA

§3.61A 4. Coordination of PAHC With DPOA

If the client will need both a PAHC and a DPOA, a coordination problem may arise if the same individual is not named as agent under both documents. The two documents should be drafted to avoid contradictory provisions and to provide complementary powers. Consider the following questions:

- If the agent under the PAHC has broad powers to authorize expensive elective medical treatment, does the agent under the DPOA have the authority to pay for such treatment?
- Which agent has authority to select convalescent hospitals or execute contracts for personal nursing care?

The attorney should discuss the interaction between the PAHC and DPOA with the client. It is usually advisable to give the agent under the PAHC priority in all potentially conflicting situations.

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D. Declaration for Attending Physician Under Former Health & S C §7186.5(b)

§3.62 1. California Natural Death Act [Repealed]

The former California Natural Death Act (former Health & S C §§7185-7194.5) was repealed effective July 1, 2000, because the statute was no longer needed in light of the much broader provisions of the Health Care Decisions Law (HCDL) (Prob C §§4600-4805) that took effect on that date. However, former California Natural Death Act declarations executed before July 1, 2000, remain valid, as do later executed declarations that are executed on printed forms. Prob C §4665. Other declarations executed after July 1, 2000, probably can be relied on by an agent in making health care decisions under Prob C §4684.

The former California Natural Death Act expressly recognized the right of adults to direct the withholding or withdrawal of life-sustaining procedures in instances of a terminal or permanent unconscious condition. Former Health & S C §7185.5. Former Health & S C §7186.5(b) provided a declaration form for this purpose. See §3.65. The declaration instructs the attending physician that if the declarant is unable to make health care decisions and has an incurable condition diagnosed by two physicians, which will shortly result in death or has produced an irreversible coma, life-sustaining procedures should be withheld or withdrawn and the declarant permitted to die naturally. The declaration, however, does not relieve the attending physician of the responsibility to provide for the declarant's comfort or to alleviate his or her pain. Former Health & S C §7189.5(b).

The declaration has no force or effect while the declarant is pregnant. Former Health & S C §7189.5(c). The declarant can revoke the declaration at any time and in any manner, without regard to the declarant's physical or mental condition. Former Health & S C §7188(a). Presumably the declarations can now be revoked under the provisions applicable to advance health care directives in Prob C §§4695-4698.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.63 2. Legal Effect of Declaration for Attending Physician

§3.63 2. Legal Effect of Declaration for Attending Physician

A declaration for attending physician becomes operative when (former Health & S C §7187.5):

- It is communicated to the attending physician; and
- The declarant is diagnosed and certified by the attending physician and a second physician to be in a terminal or permanent unconscious condition and no longer able to make decisions about administration of life-sustaining treatment.

"Terminal condition" is defined in former Health & S C §7186(j) as

> an incurable and irreversible condition that, without the administration of life-sustaining treatment, will, within reasonable medical judgment, result in death within a relatively short time.

Former Health & S C §7186(e) defines "permanent unconscious condition" as

> an incurable and irreversible condition that, within reasonable medical judgment, renders the patient in an irreversible coma or persistent vegetative state.

When the declaration becomes operative, the attending physician must either comply with its terms or, if unwilling to do so, take all reasonable steps to transfer care of the declarant to a physician who is willing to do so. Former Health & S C §§7187.5, 7190. An unwilling physician or health care provider who willfully fails to transfer care of the declarant is guilty of a misdemeanor. Former Health & S C §7191(a).

No action taken within the scope of the former California Natural Death Act (former Health & S C §§7185-7194.5) will affect the terms of any existing life insurance policies. A death resulting from compliance with the Act may not be adjudged a suicide or homicide for any purpose. Former Health & S C §7191.5.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.64 3. Coordination Between Declaration for Attending Physician and PAHC

§3.64 3. Coordination Between Declaration for Attending Physician and PAHC

If a client has an existing declaration for attending physician under the former California Natural Death Act (former Health & S C §§7185-7194.5), which was repealed effective July 1, 2000, the declaration remains valid under Prob C §4665. Assuming the client's wishes have not changed, any new PAHC should be consistent with the declaration and expressly confirm that it continues to state the principal's wishes. Evidence that a principal's wishes have remained constant over a period of time may minimize the risk of controversy.

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Source: Estate Planning/California Will Drafting/3 Other Documents Prepared in Connection With Wills/§3.65 E. Form: Statutory Form Advance Health Care Directive (Prob C §4701)

§3.65 E. Form: Statutory Form Advance Health Care Directive (Prob C §4701)

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ADVANCE HEALTH CARE DIRECTIVE

(California Probate Code Section 4701)

Explanation

You have the right to give instructions about your own health care. You also have the right to name someone else to make health care decisions for you. This form lets you do either or both of these things. It also lets you express your wishes regarding donation of organs and the designation of your primary physician. If you use this form, you may complete or modify all or any part of it. You are free to use a different form.

Part 1 of this form is a power of attorney for health care. Part 1 lets you name another individual as agent to make health care decisions for you if you become incapable of making your own decisions or if you want someone else to make those decisions for you now even though you are still capable. You may also name an alternate agent to act for you if your first choice is not willing, able, or reasonably available to make decisions for you. (Your agent may not be an operator or employee of a community care facility or a residential care facility where you are receiving care, or your supervising health care provider or employee of the health care institution where you are receiving care, unless your agent is related to you or is a coworker.)

Unless the form you sign limits the authority of your agent, your agent may make all health care decisions for you. This form has a place for you to limit the authority of your agent. You need not limit the authority of your agent if you wish to rely on your agent for all health care decisions that may have to be made. If you choose not to limit the authority of your agent, your agent will have the right to:

(a) Consent or refuse consent to any care, treatment, service, or procedure to maintain, diagnose, or otherwise affect a physical or mental condition.

(b) Select or discharge health care providers and institutions.

(c) Approve or disapprove diagnostic tests, surgical procedures, and programs of medication.

(d) Direct the provision, withholding, or withdrawal of artificial nutrition and hydration and all other forms of health care, including cardiopulmonary resuscitation.

(e) Make anatomical gifts, authorize an autopsy, and direct disposition of remains.

Part 2 of this form lets you give specific instructions about any aspect of your health care, whether or not you appoint an agent. Choices are provided for you to express your wishes regarding the provision, withholding, or withdrawal of treatment to keep you alive, as well as the provision of pain relief. Space is also provided for you to add to the choices you have made or for you to write out any additional wishes. If you are satisfied to allow your agent to determine what is best for you in making end-of-life decisions, you need not fill out Part 2 of this form.

Part 3 of this form lets you express an intention to donate your bodily organs and tissues following your death.

Part 4 of this form lets you designate a physician to have primary responsibility for your health care.

After completing this form, sign and date the form at the end. The form must be signed by two qualified witnesses or acknowledged before a notary public. Give a copy of the signed and completed form to your physician, to any other health care providers you may have, to any health care institution at which you are receiving care, and to any health care agents you have named. You should talk to the person you have named as agent to make sure that he or she understands your wishes and is willing to take the responsibility.

You have the right to revoke this advance health care directive or replace this form at any time.

PART 1: POWER OF ATTORNEY FOR HEALTH CARE

(1.1) DESIGNATION OF AGENT: I designate the following individual as my agent to make health care decisions for me:

_____

(name of individual you choose as agent)

_____

(address) (city) (state) (ZIP Code)

_____

(home phone) (work phone)

OPTIONAL: If I revoke my agent's authority or if my agent is not willing, able, or reasonably available to make a health care decision for me, I designate as my first alternate agent:

_____

(name of individual you choose as first alternate agent)

_____

(address) (city) (state) (ZIP Code)

_____

(home phone) (work phone)

OPTIONAL: If I revoke the authority of my agent and first alternate agent or if neither is willing, able, or reasonably available to make a health care decision for me, I designate as my second alternate agent:

_____

(name of individual you choose as second alternate agent)

_____

(address) (city) (state) (ZIP Code)

_____

(home phone) (work phone)

(1.2) AGENT'S AUTHORITY: My agent is authorized to make all health care decisions for me, including decisions to provide, withhold, or withdraw artificial nutrition and hydration and all other forms of health care to keep me alive, except as I state here:

_____

_____

_____

(Add additional sheets if needed.)

(1.3) WHEN AGENT'S AUTHORITY BECOMES EFFECTIVE: My agent's authority becomes effective when my primary physician determines that I am unable to make my own health care decisions unless I mark the following box.

If I mark this box , my agent's authority to make health care decisions for me takes effect immediately.

(1.4) AGENT'S OBLIGATION: My agent shall make health care decisions for me in accordance with this power of attorney for health care,

any instructions I give in Part 2 of this form, and my other wishes to the extent known to my agent. To the extent my wishes are unknown, my agent shall make health care decisions for me in accordance with what my agent determines to be in my best interest. In determining my best interest, my agent shall consider my personal values to the extent known to my agent.

(1.5) AGENT'S POSTDEATH AUTHORITY: My agent is authorized to make anatomical gifts, authorize an autopsy, and direct disposition of my remains, except as I state here or in Part 3 of this form:

_____

_____

_____

(Add additional sheets if needed.)

(1.6) NOMINATION OF CONSERVATOR: If a conservator of my person needs to be appointed for me by a court, I nominate the agent designated in this form. If that agent is not willing, able, or reasonably available to act as conservator, I nominate the alternate agents whom I have named, in the order designated.

PART 2: INSTRUCTIONS FOR HEALTH CARE

If you fill out this part of the form, you may strike any wording you do not want.

(2.1) END-OF-LIFE DECISIONS: I direct that my health care providers and others involved in my care provide, withhold, or withdraw treatment in accordance with the choice I have marked below:

(a) Choice Not To Prolong Life

I do not want my life to be prolonged if (1) I have an incurable and irreversible condition that will result in my death within a relatively short time, (2) I become unconscious and, to a reasonable degree of medical certainty, I will not regain consciousness, or (3) the likely risks and burdens of treatment would outweigh the expected benefits, OR

(b) Choice To Prolong Life

I want my life to be prolonged as long as possible within the limits of generally accepted health care standards.

(2.2) RELIEF FROM PAIN: Except as I state in the following space, I direct that treatment for alleviation of pain or discomfort be provided at all times, even if it hastens my death:

_____

_____

_____

(Add additional sheets if needed.)

(2.3) OTHER WISHES: (If you do not agree with any of the optional choices above and wish to write your own, or if you wish to add to the instructions you have given above, you may do so here.) I direct that:

_____

_____

_____

(Add additional sheets if needed.)

PART 3: DONATION OF ORGANS AT DEATH (OPTIONAL)

(3.1) Upon my death (mark applicable box):

(a) I give any needed organs, tissues, or parts, OR

(b) I give the following organs, tissues, or parts only.

_____

(c) My gift is for the following purposes (strike any of the following you do not want):

(1) Transplant

(2) Therapy

(3) Research

(4) Education

PART 4: PRIMARY PHYSICIAN (OPTIONAL)

(4.1) I designate the following physician as my primary physician:

_____

(name of physician)

_____

(address) (city) (state) (ZIP Code)

_____

(phone)

OPTIONAL: If the physician I have designated above is not willing, able, or reasonably available to act as my primary physician, I designate the following physician as my primary physician:

_____

(name of physician)

_____

(address) (city) (state) (ZIP Code)

_____

(phone)

PART 5

(5.1) EFFECT OF COPY: A copy of this form has the same effect as the original.

(5.2) SIGNATURE: Sign and date the form here:

_____ _____

(date) (sign your name)

_____ _____

(address) (print your name)

_____

(city) (state)

(5.3) STATEMENT OF WITNESSES: I declare under penalty of perjury under the laws of California (1) that the individual who signed or acknowledged this advance health care directive is personally known to me, or that the individual's identity was proven to me by convincing evidence, (2) that the individual signed or acknowledged this advance directive in my presence, (3) that the individual appears to be of sound mind and under no duress, fraud, or undue influence, (4) that I am not a person appointed as agent by this advance directive, and (5) that I am not the individual's health care provider, an employee of the individual's health care provider, the operator of a community care facility, an employee of an operator of a community care facility, the operator of a residential care facility for the elderly, nor an employee of an operator of a residential care facility for the elderly.

First witness	Second witness
_____	_____
(print name)	(print name)
_____	_____
(address)	(address)
_____	_____
(city) (state)	(city) (state)
_____	
	_____
(signature of witness)	(signature of witness)
_____	_____
(date)	(date)

(5.4) ADDITIONAL STATEMENT OF WITNESSES: At least one of the above witnesses must also sign the following declaration:

I further declare under penalty of perjury under the laws of California that I am not related to the individual executing this advance health care directive by blood, marriage, or adoption, and to the best of my knowledge, I am not entitled to any part of the individual's estate upon his or her death under a will now existing or by operation of law.

_____	_____
(signature of witness)	(signature of witness)

PART 6: SPECIAL WITNESS REQUIREMENT

(6.1) The following statement is required only if you are a patient in a skilled nursing facility—a health care facility that provides the following basic services: skilled nursing care and supportive care to patients whose primary need is for availability of skilled nursing care on an extended basis. The patient advocate or ombudsman must sign the following statement:

STATEMENT OF PATIENT ADVOCATE OR OMBUDSMAN

I declare under penalty of perjury under the laws of California that I am a patient advocate or ombudsman as designated by the State Department of Aging and that I am serving as a witness as required by Section 4675 of the Probate Code.

_____

_____

(date) (sign your name)

_____ _____

(address) (print your name)

_____

(city) (state)

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§3.66 IV. ETHICAL CONSIDERATIONS IN PLANNING FOR INCAPACITY

Ethical issues can arise in numerous ways in connection with the preparation or use of any of the documents discussed in this chapter.

EXAMPLE: *Identification of client.* The son of a seriously ill parent contacts the attorney to request a DPOA for the parent which names the son as agent. If the attorney agrees to undertake this task, he or she should make clear to the son that the parent is the client. The attorney should then act accordingly. At a minimum, the attorney should interview the parent to determine whether he or she has the requisite legal capacity to hire an attorney and to understand and execute a DPOA. If the parent does, the attorney should confirm that the parent wishes to retain him or her and to execute a DPOA in favor of the son. An attorney who is uncertain about the parent's capacity should obtain a written statement from the parent's physician attesting to the parent's capacity. The attorney should not rely on the son's opinion to make the determination about the parent's capacity. As much as possible, the attorney should consult with the parent out of the presence of the son or anyone else and should insist on being paid by the parent directly.

EXAMPLE: *Conflict of interest.* The attorney in the above example has had a long-standing professional relationship with the son. What advice should the attorney give the principal about including in the DPOA authorization for the agent to make gifts, including gifts to the son? Should the son-agent be permitted to self-deal? If the attorney is aware of facts about the son that may affect his ability to serve as a trustworthy agent, should he or she volunteer that information to the principal? What kind of disclosure should the attorney make to the principal and to the son to avoid liability for conflict of interest? Even though there are no easy answers to ethical questions in this area, recognition of ethical problems is a vital first step to their solution.

For further discussion of ethical issues, see §§1.21-1.35. See also California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 2 (Cal CEB 2003); California Powers of Attorney and Health Care Directives, chap 3 (Cal CEB 2008); California Conservatorship Practice §§1.4-1.6 (Cal CEB 2005); California Estate Planning, chap 28 (Cal CEB 2002); Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008); Streisand & Spa, *A Lawyer's Guide to Diminished Capacity and Effective Use of Experts,* Estate Planning 2008, chap 4 (Cal CEB 2008); Streisand, *To Tell the Truth: (T & E Lawyer's Version): Will My Real Client Please Stand Up?,* Estate Planning 2006, chap 9 (Cal CEB 2006).

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4

Review of Existing Wills

CEB Staff

I. REVIEWING WILLS PREPARED BY ANOTHER
A. Importance of Being Thorough §4.1
B. Checklist: Will Review §4.2
C. Review of Foreign Wills §4.3

II. ADVISING CLIENTS TO HAVE WILLS REVIEWED
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I. REVIEWING WILLS PREPARED BY ANOTHER

§4.1 A. Importance of Being Thorough

An attorney is frequently asked to review a will prepared by another attorney or one prepared by the client with the assistance of a self-help book. It is important for the attorney to spend as much time gathering information about the client's personal background and financial status as the attorney would spend on a first will. See chap 2 on matters to cover in an initial client conference. An existing will may no longer adequately address the wishes of the client either because those wishes have changed or because the client's personal or financial picture has changed since the will was executed. An attorney who is not adequately apprised of the client's current circumstances may overlook a problem with the will.

When reviewing a will, the attorney should bear in mind that it is relatively simple to spot instances of improper drafting. What is more difficult is determining whether provisions that should have been included were omitted.

Because of the need to be thorough, a review of a will prepared by another attorney or by the client is not likely to cost much less than the preparation and execution of a first will. When first meeting the client, the attorney should explain this so that the client is not surprised by the final bill. See discussion in §§2.33-2.37.

For a checklist of items that the attorney should look for when reviewing a will, see §4.2. Although the checklist does not cover every issue that the attorney must confront, it can steer him or her toward portions of a will that are most likely to contain errors or to need revision. On review of foreign wills, see §4.3. On advising clients to have wills reviewed, see §§4.4-4.6. On organizing will files for easy retrieval, see §4.7.

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Source: Estate Planning/California Will Drafting/4 Review of Existing Wills/§4.2 B. Checklist: Will Review

§4.2 B. Checklist: Will Review

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Checklist for Will Review

A. Introductory Clauses

1. Has the client's name changed?
2. Is the client's domicile correct? For tax or other planning purposes, would it make sense to begin to document a different domicile? See §§37.29-37.31.
3. Are the declarations concerning the client's family current? See §§10.7-10.10.
4. Has there been a change in the nature and value of the client's assets? Has there been a change in the characterization of significant assets? See §10.11.
5. Is the will prone to attack for breach of a contract to make wills or not to revoke wills? See §§10.12-10.13.
6. Does the will or some other document name someone to handle funeral arrangements and the disposition of remains? See §§10.16-10.18.

B. Debts and Taxes

1. How are debts and estate taxes to be paid? Does the burden of liabilities fall on the intended parties? Are the marital deduction gift and other specific gifts affected? If the residue is to pay debts and taxes, are there sufficient residuary assets to do so? Are the statutory abatement rules satisfactory to the client? See §§12.3-12.6, chap 26.
2. Are any secured debts to be exonerated? See §§12.41, 12.52-12.53.
3. Does the will provide for payment of packing and shipping expenses? See §§12.42, 33.36-33.37.
4. If the client has a revocable trust, are the instruments coordinated in terms of payment of liabilities, especially taxes? See §26.33.
5. Have generation-skipping transfer (GST) tax consequences of the will been reviewed? What provisions have been made for payment of GST taxes? See chap 15.
6. Has the client considered ways to minimize probate fees? See §12.1.
7. When the will was prepared, did the client consider methods to minimize estate tax liability? Is it appropriate to do so now?

C. Devises

1. Does the client no longer own any items that have been specifically devised? Does the client want to say what should be done if an item specifically devised is not part of the estate at the time of the client's death? See §§12.7-12.13 on ademption.
2. Have there been any advances not reflected in the will? See §§12.14-12.15.
3. Are the primary beneficiaries current?
4. Are alternate beneficiaries named for primary beneficiaries who fail to survive the client or who disclaim devises made to them? See §§12.19-12.24. Are the alternate beneficiaries still appropriate?
5. Are any gifts made to a class? Are the identities of the members of the class clear? See §§12.27-12.34.

6. Are the items or groups of items being devised clearly identified? See §12.38.
7. Is there any reliance on "informal" means of testamentary disposition, *e.g.,* a letter to the executor? If so, is the document current? See §12.43.
8. Are there any general pecuniary devises? Has the matter of interest been addressed? See §§12.70-12.72.
9. Are any devises made to charitable organizations? Has the organization been correctly named? Are there any conditions on the gift that might affect deductibility? See §§13.2-13.4. Has provision been made for an alternate charitable beneficiary if the primary beneficiary goes out of existence, loses its exempt status, or declines the gift? See §13.5.
10. Are any beneficiaries minors? If so, have provisions been made for the fact that a minor cannot directly receive a devise? See §§33.33-33.35.
11. Does the client possess items belonging to someone else? Should the will confirm that the client does not own such items? See §12.37.
12. Does the existing will contain any demonstrative devises? Is the fund out of which the devise is to be made still sufficient to make the devise? See §§12.75-12.76.
13. Are any tangible items of a personal nature going to a trust? If so, are they appropriate assets for the trust corpus?
14. Does the client have a power of appointment? If so, does the will carry out the client's wishes concerning the power? See chap 11.
15. If there is a pourover provision, does the will specify what is to happen if the trust into which the residue was to have poured is revoked? See chap 8.

D. Nomination and Powers of Fiduciaries

1. Does the client still wish to nominate the persons named as executor and backup executor (and trustee and backup trustee, if applicable)? Do the nominees still live close enough to the client to be effective fiduciaries? Do the nominees still wish to serve? See chaps 28, 32.
2. Should bond be waived for the executor and any testamentary trustee? See §§28.22-28.23, 32.17-32.18.
3. Are guardians needed for minor children? If guardians have been named, are they still desirable appointees? See chaps 24-25.
4. Has the client considered the application of the Independent Administration of Estates Act (Prob C §§10400-10600)? See §§33.10-33.13.
5. If the estate or trust is likely to contain unusual assets, does the fiduciary have the powers necessary to administer those assets?
6. Are there any "tax-sensitive" powers? For example, is a beneficiary the holder of a fiduciary power that would result in adverse tax consequences? See chap 16, §§28.7-28.9.
7. If necessary, does the executor explicitly have the power to make the qualified terminable interest property (QTIP) election? See §33.49.
8. Will the powers granted have an adverse effect on the marital deduction? See §§17.30-17.38.
9. Might any of the powers granted result in a conflict of interest? If so, should specific language be added to permit the conflict? See §§28.42-28.45, 33.44-33.45.
10. Does the executor explicitly have a power of sale? See §§33.15-33.16.
11. In general, are the powers given to the fiduciary as broad or as narrow as the client desires? See chaps 29-31.

E. Execution

1. Has the will been properly executed? Are any of the witnesses beneficiaries under the will? See chap 36.
2. Is the will "self-proving"? See §36.5.
3. Do any duplicate wills exist? See §36.7.
4. Should special precautions be taken because of a possible will contest? See §§35.13-35.15.

F. Additional Considerations

1. Is there a need to disinherit someone specifically? If so, does the will adequately do so? See chap 35.
2. Does the client own real property located outside California, or does the client plan to move to another state in the near future? See chap 37.
3. Is a testamentary special needs trust appropriate? See chap 23.
4. If coordination is appropriate with the will of the client's spouse, have the wills been coordinated?
5. Has a QTIP trust as a postmortem planning tool been considered? See chap 19.
6. Is there a need for a perpetuities saving clause? See §§34.35-34.41.
7. Are the client's "nonprobate" dispositions (*e.g.,* life insurance and retirement plan beneficiary designations) current and consistent with the estate plan as reflected in the will?
8. Has the client made satisfactory arrangements for management of his or her personal and financial affairs on incapacity? See chap 3.

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Source: Estate Planning/California Will Drafting/4 Review of Existing Wills/§4.3 C. Review of Foreign Wills

§4.3 C. Review of Foreign Wills

An attorney is sometimes asked to review a will executed by the client while he or she was a resident of another state or country. The attorney should know that a foreign will is validly executed under Prob C §6113 if it is executed in accordance with the laws of:

- California;
- The place of execution at the time of execution; or
- "[T]he place where at the time of execution or at the time of death the testator is domiciled, has a place of abode, or is a national."

The attorney should particularly note whether the will was executed in compliance with the Uniform International Wills Act (Prob C §§6380-6390). See §§37.15-37.17.

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II. ADVISING CLIENTS TO HAVE WILLS REVIEWED

§4.4 A. Need for Periodic Review

The client must understand the importance of having his or her will and estate plan reviewed by an attorney periodically. Many attorneys are all too familiar with the anguish and disappointment caused when a client dies with an outdated will. Every will client should be encouraged to review annually his or her personal and financial situation to determine whether his or her will and other estate plan documents still adequately carry out his or her testamentary wishes. On giving clients a list of changes that necessitate review, see §4.5.

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§4.5 B. Changes That Necessitate Review

Some attorneys provide their clients with a list of changes in circumstances that frequently necessitate revisions to a will or estate plan. See §4.6. On the effect of changes in the law, see §4.7.

Among the most common and significant changes is separation from a spouse and dissolution of marriage. However, a typical revocable trust estate plan with a pourover will can be drafted to minimize the need to revoke the trust and prepare a new will immediately on separation by providing in the trust document that each spouse has a lifetime general power of appointment over that spouse's share of the trust property. The trust distribution provisions are designed to take effect only if the power is not exercised. In this arrangement, a married settlor contemplating separation or dissolution can execute an instrument, as provided in the trust document, exercising the power and making an alternate disposition of the settlor's interest in the trust property. Assuming that the trust is valid and adequately funded, it may not be necessary for the settlor to revoke the trust or the pourover will to avoid the disposition contemplated in the trust document if the settlor then dies before dissolution and division of the trust property. For further discussion and a form of survivor's trust adopting this approach, see Drafting California Revocable Trusts, chap 12 (4th ed Cal CEB 2003).

Attorneys who give their clients such a list should point out that the list is not exhaustive. The attorney should also caution clients against attempting to make their own modifications to their wills and other estate planning documents.

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Source: Estate Planning/California Will Drafting/4 Review of Existing Wills/§4.6 C. Checklist: Changes That Necessitate Review of Will and Estate Plan

§4.6 C. Checklist: Changes That Necessitate Review of Will and Estate Plan

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Changes Requiring Review of Will and Estate Plan

If any of the following changes occurs, you should have an attorney review its potential effect on your will and estate plan to determine whether they should be revised. (This is not an all-inclusive list.)

A. Changes Affecting Family and Personal Matters

1. Marriage of client
2. Separation from, divorce from, or death of spouse
3. Development of long-term, committed unmarried relationship
4. Dissolution of long-term relationship or death of domestic partner
5. Birth, adoption, maturity, marriage, divorce, or death of a child or grandchild
6. Death of a beneficiary
7. Serious illness or incapacity of spouse, domestic partner, child, or any other significant beneficiary
8. Significant change in economic status of spouse, domestic partner, child, or any other significant beneficiary
9. Significant change in relationship between client and any beneficiary
10. Significant change in client's health
11. Client's change of residence to another state or country
12. Change in relationship between client and person named as executor, trustee, or guardian; incapacity, unavailability, or death of same

B. Changes in Client's Financial Status

1. Significant change in income, net worth, or nature of assets
2. Disposal of specific assets mentioned in will
3. Change in employment
4. Change in business interests: new partnerships or corporations; dissolution of partnerships or corporations
5. Acquisition or disposal of property in a different state or country
6. Retirement

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§4.7 III. ORGANIZING WILL FILES FOR EASY RETRIEVAL

Any major change in the California Probate Code or in federal or state tax laws necessitates review of a client's will and estate plan. The attorney should tell clients to be on the alert for changes in these laws and to contact him or her when they notice such changes. However, because clients are not likely to notice changes in the law and because it is still unclear whether an attorney has a duty to notify old clients of changes in the law affecting their estate plans, many attorneys inform clients in writing of changes that may affect their wills and estate plans. See §1.20.

To avoid the task of contacting all clients about a change in any probate or tax law, the attorney should develop a system of indexing wills by type. With such a system, retrieving the names and addresses of clients who have the type of will affected by a change in the law becomes a simple task. A system of indexing wills by type is also invaluable if the attorney discovers a drafting error common to one particular type of will. Notifying only the affected clients of the defect does not then present an onerous task.

In developing a system of indexing wills by type, the attorney should take into account other possible reasons for retrieving certain types of will files. For example, the attorney may wish to retrieve the files of all older clients to notify them that their wills may need updating. The system of indexing wills selected should be able to accomplish all retrieval needs of the attorney.

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Source: Estate Planning/California Will Drafting/5 Reference to Matters Outside Will/Chapter Outline

5

Reference to Matters Outside Will

Susan York Janin

I. EXTRINSIC FACTS AND OTHER DOCUMENTS §5.1

II. DOCTRINE OF FACTS OF INDEPENDENT SIGNIFICANCE §5.2

III. DOCTRINE OF INCORPORATION BY REFERENCE §5.3
A. Letters of Instruction §5.4
B. Form: Reference to Letter of Instruction §5.5

IV. DISPOSITION OF TANGIBLE PERSONAL PROPERTY BY WRITING §5.6

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Source: Estate Planning/California Will Drafting/5 Reference to Matters Outside Will/§5.1 I. EXTRINSIC FACTS AND OTHER DOCUMENTS

§5.1 I. EXTRINSIC FACTS AND OTHER DOCUMENTS

This chapter covers issues that the attorney should address when drafting a will in which particular dispositions cannot be ascertained without reference to extrinsic facts (see §5.2) or in which reference must be made to another document (see §§5.3-5.6).

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§5.2 II. DOCTRINE OF FACTS OF INDEPENDENT SIGNIFICANCE

Under the doctrine of facts of independent significance, an attorney may draft a will that disposes of property by reference to a particular act or event if the act or event has significance apart from its effect on the disposition made by the will. See Prob C §6131. It is immaterial whether the act or event occurred before or occurs after the will execution or the testator's death. See generally 1 Scott & Ascher on Trusts §7.1.2 (5th ed 2006).

The doctrine of facts of independent significance is often used to ascertain beneficiaries whose identities cannot be satisfactorily determined by reference to the will. Thus, devises to "children," "heirs," "next of kin," or "such person or institution as may care for me during my old age or last illness" are not invalid for vagueness, because the beneficiaries' identities can be ascertained from extrinsic facts of independent significance. See, *e.g., Estate of Hollingsworth* (1940) 37 CA2d 432, 99 P2d 599 (devise to persons "in my employ"). However, it is preferable to name particular beneficiaries whenever possible. The doctrine may also be used to determine particular items of property to be given to identified beneficiaries. Thus, devises of funds in a particular bank account, securities in the testator's safe-deposit box, or furniture in a designated room or house are usually held valid despite the fact that the property can be ascertained only by reference to extrinsic facts. 1 Scott on Trusts §7.1.2.

NOTE: The doctrine of facts of independent significance should not be confused with the doctrine of incorporation by reference. See §5.3. For example, unlike the doctrine of incorporation by reference, the doctrine of facts of independent significance permits reference to events occurring after the date of the will.

A disposition is invalid when the facts from which it can be ascertained have no significance apart from the disposition in the will. Accordingly, devises to persons named in an unattested memorandum not incorporated in the will by reference are invalid on the ground that the memorandum has no significance apart from the will. 1 Scott on Trusts §7.1.2. For this reason, a devise of personal property to "those persons designated in a memorandum which I shall prepare and leave in my safe-deposit box" would not be valid. See discussion in §5.6.

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§5.3 III. DOCTRINE OF INCORPORATION BY REFERENCE

The doctrine of incorporation by reference in Prob C §6130 states:

> A writing in existence when a will is executed may be incorporated by reference if the language of the will manifests this intent and describes the writing sufficiently to permit its identification.

A testator may incorporate by reference into his or her own will a will made by another person. A testator may also incorporate nontestamentary papers written by the testator or any third party. On letters of instruction, see §5.4. On incorporation by reference in wills generally, see 14 Witkin, Summary of California Law, *Wills and Probate* §§165-168 (10th ed 2005).

The following are examples of nontestamentary documents commonly incorporated by reference into wills:

- A contract relating to the disposition of the testator's body or parts of the body (e.g., eyes) for medical research (see §3.56);
- A contract providing arrangements for the testator's funeral and burial;
- A letter directing the executor about the testator's funeral or burial;
- A deed to real property devised by the will (to avoid lengthy legal descriptions of the property in the will);
- An option or buy-sell agreement that may define or limit the testator's right to acquire or dispose of corporate stocks or other property (see §§12.61, 12.64);
- A letter to a beneficiary of the will containing suggestions for the distribution of certain property (see §§5.4, 12.43);
- A property agreement entered into by the testator; and
- A letter to an executor, trustee, or guardian nominated in the will detailing the testator's wishes about sales of property or other matters concerning estate administration or the welfare of beneficiaries.

A California statutory will (discussed in §§2.26-2.29) incorporates by reference material in the Probate Code. See Prob C §6223.

Any attempt to incorporate a document that does not exist when the will is executed is ineffective. Nevertheless, a document that does not exist when the will is executed, but exists later when a codicil is executed, may be validly incorporated by reference into the will by the codicil. *Simon v Grayson* (1940) 15 C2d 531, 533, 102 P2d 1081.

PITFALL: If the will incorporates by reference a document that may be altered or amended after the will is executed, the will drafter should impress on the testator the need to reexecute or republish the will by codicil after each change. See chap 6. The reexecuted will or the codicil should refer specifically to the change and express the testator's intent to incorporate the document in its altered or amended form. If this is not done, the document will be incorporated as it existed on the date of execution of the will.

The will drafter must recognize that mere reference to an existing document is not sufficient. The will must clearly show the testator's intent to incorporate the extrinsic document into his or her will. The safest course is for the will to state explicitly that the testator intends to incorporate the particular document by reference.

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§5.4 A. Letters of Instruction

A client may wish to write a letter to a friend, relative, beneficiary, executor, or his or her attorney, with suggestions or requests for handling a matter after the client's death. Although letters of instruction can be useful, the attorney should warn the client that they should be written only with the attorney's advice. If the client has already written such a letter, the attorney should review it for possible problems and consider whether it should be incorporated by reference into the will.

The chief question raised by a letter of instruction is whether it expresses testamentary intent. If the letter expresses testamentary intent, it must be treated as a holographic will or codicil (Prob C §6111) even if the client refers to it as a letter rather than as a will (see *Estate of Gutierrez* (1961) 189 CA2d 165, 11 CR 51; §2.25). Litigation may be required to settle the question of testamentary intent. See generally 14 Witkin, Summary of California Law, *Wills and Probate* §§153-158 (10th ed 2005).

EXAMPLE: The dangers of letters of instruction are illustrated by *Estate of Darms* (1966) 247 CA2d 254, 55 CR 463, in which the decedent executed a formal will leaving $3000 to a particular beneficiary. Several years later, the decedent wrote a letter to a trust officer at the bank where the will was on file, stating in part, "Wish you would change [the will] to read $15,000.00 instead of $3000. Thanking you in advance." The appellate court affirmed the trial court's finding that the letter constituted a holographic codicil.

The safest course for a client who insists on writing a letter of instruction is to use language that is clearly precatory. See §7.4. For example, in the letter the client might suggest, recommend, or indicate his or her desire (but not require or direct) that the provisions of the letter be carried out. This should ensure that, even if the court deems the letter to be a codicil, the instructions will still be nonbinding.

A will that refers to the letter of instruction should also emphasize that the letter is nonbinding. If the testator wishes to make testamentary directions binding, he or she should execute a new will or a codicil to the will.

NOTE: Letters of instruction are particularly useful for funeral and burial directions, because by specific statutory authorization these directions may be given without the formality of a will. Health & S C §§7100, 7100.1. See §10.16.

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Source: Estate Planning/California Will Drafting/5 Reference to Matters Outside Will/§5.5 B. Form: Reference to Letter of Instruction

§5.5 B. Form: Reference to Letter of Instruction

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5.5-1 Reference to letter of instruction

If I leave notes or a letter of instruction indicating my preferences for distribution of my tangible personal property, I request that the recipient of this property under my will honor these wishes. I recognize that this request and such notes or letter are not legally binding.

Comment: This clause, which refers to notes or a letter requesting that the testator's tangible personal property be distributed in a certain way (see §12.43), may be adapted to refer to a letter of any sort of instruction.

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§5.6 IV. DISPOSITION OF TANGIBLE PERSONAL PROPERTY BY WRITING

Probate Code §6132 provides that a will may refer to a writing that directs disposition of tangible personal property not otherwise disposed of by the will, except for money that is common coin or currency (*i.e.*, not collectables) and property used primarily in a trade or business. The writing must be dated and either be in the testator's handwriting or be signed by the testator. Prob C §6132(a). The writing may be written or signed by the testator before or after the execution of the will and need not have significance apart from its effect on the dispositions of property made by the will. Prob C §6132(c). The testator may make subsequent handwritten or signed changes to the writing, and the most recent writing controls the disposition. Prob C §6132(d). If there are inconsistent dispositions, a dated writing will control over an undated writing unless it can be established that the undated writing was created later than the dated writing. Prob C §6132(e). The value of any single item of tangible personal property disposed of by the writing may not exceed $5000 and the total value of tangible personal property identified and disposed of by the writing may not exceed $25,000. Prob C §6132(g).

Inclusion of a provision in a will allowing creation by the testator of a "writing" under Prob C §6132 may be problematic, and may result in litigation or a disposition of personal property that is at odds with the intentions of the testator. The writing is subject to very flexible requirements. Although §6132(a)(2) requires the writing to be dated and either handwritten or signed by the testator, §6132(b) provides that the failure of the writing to conform to these requirements does not preclude the introduction of evidence regarding the testator's intent regarding the disposition of personal property.

Attorneys who wish to include a provision in a will that allows creation of writings that will control disposition of personal property should proceed with caution. One commentator has suggested that the will should require the writing to be subject to the same requirements for disposing of personal property as are applied to all holographic instruments. See Prob C §6111. For further discussion, see Schenone, *New Probate Code Section 6132: An Improvement or Just a Stimulus for Litigation?,* 13 Cal Tr & Est Q 18 (Spring 2007).

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Source: Estate Planning/California Will Drafting/6 Codicils/Chapter Outline

6

Codicils

Susan York Janin

I. NATURE OF CODICIL §6.1

II. USE AND PREPARATION OF CODICIL §6.2

III. FORM: CODICIL §6.3

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§6.1 I. NATURE OF CODICIL

A codicil is a testamentary document that supplements, amends, qualifies, or republishes a prior testamentary document. *Estate of Benson* (1944) 62 CA2d 866, 145 P2d 668. A codicil must be executed with the same formalities as a will and must be made with testamentary intent. A writing that refers to a will, but shows no intent to change it, lacks testamentary intent and is not a codicil. *Estate of Loud* (1945) 70 CA2d 399, 161 P2d 49. A valid codicil is part of the will to which it refers, and both instruments are construed together as one.

The word "will" is defined by the Probate Code to include codicils "and any testamentary instrument which merely appoints an executor or revokes or revises another will." Prob C §88. Thus, provisions in the Probate Code that apply to "wills" also apply to codicils.

NOTE: A codicil need not be executed in the same way as the will it modifies. Thus, a holographic codicil can be made to a witnessed will and vice versa. However, the codicil must satisfy the execution formalities for one of the recognized types of testamentary disposition. Thus, a witnessed codicil must satisfy the requirements for a witnessed will (see §36.1), and a holographic codicil must satisfy the requirements for a holographic will (see §2.25).

A codicil should clearly state the client's intent to republish the previous will if republication is desired. Such a provision may be undesirable unless there is a thorough review of the will. Wills are generally construed based on the law in effect at the time they are originally drafted. If a relevant law has changed, republication may have the effect of changing the meaning of a provision the testator wants left unchanged.

Republication is not necessary to pass property acquired after the date of execution of the will. Probate Code §21105 provides that a will, whether or not modified or republished by a codicil, passes all property owned by the testator at death, including property acquired after the will execution.

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§6.2 II. USE AND PREPARATION OF CODICIL

A codicil is chiefly used to add new or supplementary provisions to a will, to revoke part of a will, or to revoke a prior codicil totally or partially. Other uses include revival of a revoked will, validation of an invalid will (*i.e.,* incorporating by reference an improperly executed will into a properly executed codicil), and republication or redating of a valid will (*e.g.,* updating the incorporation-by-reference clause in a pourover will when the inter vivos trust has been amended after execution of the will; see §8.6).

In deciding whether the testator's wishes can best be carried out by a codicil or by a new will, the attorney should consider a number of factors. A codicil may be appropriate if the contemplated change is simple (*e.g.,* altering the amount of a general pecuniary devise or appointing a different executor), the time to make the change is short, or the limiting of costs is important. A codicil may also be desirable if the testator's testamentary capacity is currently questionable; if the codicil is held invalid, the will still survives.

If the codicil provisions will complicate interpretation of the will, the attorney should advise the drafting of a new will instead of a codicil. This is also sound advice if the testator has already executed several codicils. In this case, the attorney should prepare a new will consolidating all the testamentary provisions into one instrument.

In deciding between a new will and a codicil, the attorney should also consider probate requirements. If the will and the codicil will have different sets of witnesses, the attorney should consider the possible inconvenience of proving the two instruments for admission to probate. But see the discussion of "self-proving" wills in §36.5. If the change to be made by codicil will eliminate a particular devise, the impact of local probate rules governing notice should be checked. If the rules require notice of probate proceedings to any beneficiary of the will, including one whose devise has been revoked in a subsequent codicil, the testator may prefer a new will in order to eliminate the need to give notice to the former beneficiary. See San Francisco Ct R 14.32(A), 14.31(D)(1) (also requiring that notice be given to all heirs of the decedent, even though the decedent died testate). Notice to a disappointed former beneficiary may lead to more than just hurt feelings; a contest over the probate of the codicil may result. For the same reason, a new will may be desirable when a devise is reduced.

NOTE: A codicil is a separate instrument for purposes of provisions that limit the enforcement of a no-contest clause to pleadings that allege the invalidity of the instrument that contains the clause or an instrument in existence on the date the instrument is executed that is expressly identified in the clause. Prob C §21310(e). Therefore, a codicil must include a no-contest clause if the testator wishes to penalize a beneficiary who files a pleading that alleges the invalidity of the codicil. See §35.9.

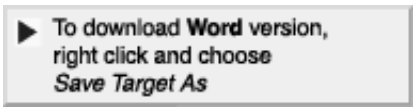
An attorney preparing a codicil should investigate the possible consequences of republication of the will on the will's meaning and effect. If a will is republished on the date of execution of a codicil, some of the will's original provisions may become ambiguous because of intervening events or changes in law.

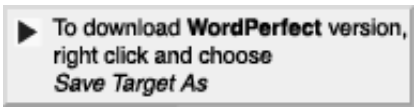
PITFALL: When drafting a codicil, the attorney should avoid ambiguous provisions. See, *e.g., Estate of Lund* (1973) 34 CA3d 668, 110 CR 183, in which the court had to construe a codicil that did not specify whether a $20,000 bequest was in addition to, or instead of, a $10,000 bequest to the same person in the will. The attorney should take particular care in preparing a codicil to a will drafted by someone else. If the codicil confirms and republishes the will, the drafter of the codicil could be held responsible for any errors in the will. In addition, it is easier to create ambiguities or inconsistencies when amending a will drafted by another person. The additional time the attorney must take to ensure accuracy and consistency may make preparation of a codicil more expensive than preparation of a new will.

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Source: Estate Planning/California Will Drafting/6 Codicils/§6.3 III. FORM: CODICIL

§6.3 III. FORM: CODICIL





6.3-1 Codicil

I, _ _[*name of testator*]**_ _, a resident of _ _**[*name of county*]**_ _, California, declare that this is the first codicil to my will of _ _**[*date*]**_ _.**

I revoke the following paragraphs of my will: Paragraphs _ _[*numbers of revoked paragraphs*]**_ _**.

I add the following provisions to my will: _ _[*New provisions*]**_ _**.

In all other respects, my will remains unchanged.

Comment: This clause should be used for the testator who wishes to revoke parts of his or her will and to add provisions to it. If a previous codicil has been executed, the first and last paragraphs of the clause should be modified to reflect that fact. Multiple codicils are not recommended, however. See §6.2.

For signature and attestation clauses, see §36.16.

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7

Overview of Testamentary Trusts

Susan York Janin

I. WILLS CREATING TRUSTS

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B. Uses of Testamentary Trusts §7.2

C. California Trust Law §7.3

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I. WILLS CREATING TRUSTS

§7.1 A. Essential Elements of Testamentary Trusts

This chapter presents a detailed discussion of each of the following essential elements of a trust that may be created by a will:

- The intention to create a trust (Prob C §15201) (see §§7.4-7.6);
- Trust property (Prob C §15202) (see §§7.7-7.9);
- A trust beneficiary (Prob C §15205) (see §§7.10-7.12);
- A trust purpose that is not illegal or against public policy (Prob C §15203) (see §7.13); and
- A trust purpose that is ascertainable with reasonable certainty (Prob C §15204) (see §§7.14-7.17).

The will may create multiple trusts (see §7.18) and the trust may provide for distributions of principal and income (see §§7.19-7.22). On uses of trusts, see §7.2. On sources of trust law, see §7.3.

A testamentary trust is by definition an integral part of the will that establishes it. Unless the will purporting to create the testamentary trust is valid, no testamentary trust will be created. This chapter does not dwell on the requirements for a valid will; attention is paid only to formal requirements peculiar to trusts. These requirements also apply to trusts created by an inter vivos trust document. This discussion assumes that the trust is created by will, but the more common practice is to create a funded or partly funded revocable trust that is supplemented by a pourover will. See chap 8.

It is not essential that an instrument establishing a trust appoint a trustee. If a trust has no trustee, the court having jurisdiction over the trust may appoint a trustee. Prob C §15660. Nevertheless, given the importance of the trustee to the achievement of the purposes of the trust, the testator or settlor should carefully select the individual or entity to act as trustee and appoint that individual or entity in the will or trust instrument. See chap 28.

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§7.2 B. Uses of Testamentary Trusts

The decision to use a testamentary trust may be made for any number of reasons. See, *e.g.,* §§1.16 (trusts as alternatives to will contracts), 22.4-22.12 (comparison of trusts and guardianships). See also chap 16 on achieving trust objectives through powers of appointment.

Frequently, the decision to create a testamentary trust is made to accomplish nontax objectives. For example, if the testator wishes to keep property management away from a spouse, a domestic partner, or children, a trust is the most efficient and flexible means to do so. Often these same objectives are achieved by a using a funded or partly funded revocable trust. A trust may also be appropriate for the testator who wishes to provide for a loved one in a manner that will not jeopardize his or her eligibility for public benefits. See chap 23 on special needs trusts.

Testamentary trusts are also often used for tax-motivated reasons. For example, through the use of a credit shelter trust at the death of the first spouse or domestic partner to die, a couple can pass more wealth to their children or other beneficiaries free of estate tax on the second death than they could by leaving their property outright to the other spouse or partner. See §§17.6-17.7. Testamentary trusts may also be used to take full advantage of the exemptions available from the generation-skipping transfer (GST) tax. See chap 15.

In general, this chapter assumes that the decision to use a testamentary trust has already been made and that the reader is primarily concerned with the legal requirements for a valid trust.

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§7.3 C. California Trust Law

California has a comprehensive statute concerning trusts. See the Trust Law (Prob C §§15000-19403). The common law of trusts remains California law except as modified by statute. Prob C §15001.

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II. TRUST INTENT

§7.4 A. Testator's Intent Should Be Unambiguous

A testamentary trust cannot be established if the testator did not intend to create a trust through his or her will. Prob C §15201. Although no particular words or phrases must be used to manifest an intention to create a trust, this intent must be clearly stated in the will. *Estate of Mallon* (1939) 34 CA2d 147, 93 P2d 245. To avoid any ambiguity, the will should explicitly state "in trust" when a trust is intended. See Restatement (Third) of Trusts §17 (2003).

If a trust is intended, the drafter should particularly avoid precatory words unless a precatory devise is intended, *i.e.,* expressions of hope, wish, desire, recommendation, or request. See *Estate of Sloan* (1935) 7 CA2d 319, 341, 46 P2d 1007.

EXAMPLE: In *Estate of Collias* (1951) 37 C2d 587, 233 P2d 554, the decedent had devised the residue of his estate to his nephew. The will also contained the following provision (37 C2d at 588):

It is my desire and wish that my nephew … will give half of my estate to my nearest relative heir in Greece instructing him or her to distribute said half of my estate in equal shares to all my close relatives in Greece.

The trial and appellate courts disagreed with some of the decedent's relatives, who contended that the proper construction of this provision is that half of the nephew's bequest is left to him in trust for the use and benefit of the decedent's nearest relatives in Greece. The courts agreed with the nephew that the decedent's precatory words demonstrated that the provision was a "mere request" and did not amount to a testamentary imperative. In short, the courts concluded that if the decedent had intended a trust, he should not have used the precatory words "desire" and "wish."

The drafter should also use careful, precise language when the testator intends a precatory provision. Such words as "direct," "command," or "instruct," which are frequently interpreted as mandatory, should not be used. Even when only precatory words are used, it is advisable for the will to expressly negate an intent to create a trust. On intentionally precatory devises, see §7.5.

NOTE: The drafter should be aware that certain language tends to be construed as mandatory when addressed to an executor, but precatory when addressed to a beneficiary. If the person addressed is both executor and beneficiary and the language being interpreted pertains to the disposition of his or her devise, the language is usually treated as precatory and the devise an absolute one. *Estate of Collias, supra*; *Estate of Moore* (1967) 253 CA2d 945, 61 CR 722.

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§7.5 B. Intentionally Precatory Devises

The drafter should explain to the client the disadvantages of a testamentary gift with a precatory request and discuss other ways in which the testator's basic objective can be achieved. In some cases, a trust may be the appropriate answer.

Not only is making a gift with a precatory provision in a will or revocable trust often inadvisable, it is almost always inappropriate when property of substantial value is involved, even if the wording of the request is unambiguously precatory. The danger that the request will be held mandatory always exists (see §7.4), and precatory language is often an invitation to litigation. In addition, the testator's intent may be wholly defeated by the death of the beneficiary of the gift before the request has been carried out.

Precatory language may result in adverse tax consequences. The inclusion of precatory language in a trust intended to qualify for an estate tax marital deduction could result in loss of the deduction. Only certain types of trusts qualify for the marital deduction, and precise technical requirements must be met. IRC §2056(b)(7). See discussion in §§17.19-17.26.

If the precatory language involves a gift to a charity, such language may put the charitable deduction at risk. Because the Internal Revenue Code imposes strict requirements on gifts to charities to obtain an estate tax charitable deduction when other interests in the same property may be used for noncharitable purposes, the deduction may be lost if precatory, rather than clear and definite, language is used to establish the charitable gift. IRC §2055(e)(2). See chap 14.

Precatory words may also have income tax ramifications. For example, a trustee who has paid income to a beneficiary may be liable for tax on the income if the language in the will establishing the trust is so ambiguous that the trustee is considered to be the substantial owner of the trust. IRC §671; Treas Reg §1.671-1. See §7.20.

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§7.6 C. Secret Trusts

Sometimes a client proposes to leave property outright to someone who has agreed to hold the property in trust for some purpose. This arrangement is called a secret trust. Because secret trusts often create legal problems, they should generally be avoided. See 1 Scott & Ascher on Trusts §7.2 (5th ed 2006).

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§7.7 III. TRUST PROPERTY

"Corpus" or property is an essential element of a trust. Prob C §15202. Property intended to go into a trust should be described with certainty. See Restatement (Third) of Trusts §40 (2003); Restatement (Second) of Trusts §76 (1959). "The residue of my estate" is a sufficient designation.

The corpus of a testamentary trust is usually derived from the residue of the testator's estate although, if desired, it may come from a nonresiduary gift. Other assets may be substituted for those that come to a trust from the decedent's estate as a result of the exercise of the power, given to most trustees, to sell trust property and invest the proceeds. See §29.23.

A testamentary trust may receive property from sources other than the decedent's estate. Probate Code §16221 authorizes the trustee to accept such property. See §31.27. One source other than the decedent's estate may be the surviving spouse who is permitted to contribute his or her portion of the community or quasi-community property to a trust created by the deceased spouse's will. See Prob C §13502. Another source may be an inter vivos trust set up by the testator that "pours over" into the testamentary trust. For discussion of this and other variants of the pourover device, see chap 8.

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§7.8 A. Interests That Can Be Held in Trust

Generally, either any real or personal interest or any legal or equitable interest can be held in trust if it constitutes a property interest and can be voluntarily transferred by its owner. See Restatement (Third) of Trusts §§40-41 (2003); Restatement (Second) of Trusts §§74-86 (1959). For example, the corpus of a trust may include an interest in an insurance policy (*Shaw v Johnson* (1936) 15 CA2d 599, 59 P2d 876) or in a limited partnership (*Walberg v Smyth* (ND Cal 1956) 142 F Supp 293). See also CC §982 (products of the mind); *Placerville Fruit Growers' Ass'n v Irving* (1955) 135 CA2d 731, 737, 287 P2d 793 (trust may hold transferable interest of creditor in debt or contract right); Restatement (Second) of Trusts §82 (corpus may include patent, copyright, goodwill, trademark, trade secret, uncopyrighted literary production, or unpatented invention).

Because an interest must be property and must be transferable to be held in trust, a bare expectancy cannot be held in trust. CC §§700, 1045. See *Gonsalves v Hodgson* (1951) 38 C2d 91, 237 P2d 656.

NOTE: For each interest intended to be in the trust, the attorney should ensure that there is no impediment to the testator's right or ability to transfer the interest to the trust. For example, property held in joint tenancy passes to the surviving joint tenant and is not subject to disposition by either joint tenant's will. See California Estate Planning, chap 7 (Cal CEB 2002). Also, if the interest is that of the beneficiary of a trust, spendthrift provisions may prevent any transfer. See Restatement (Second) of Trusts §79, Comment f. If the testator is incompetent or is acting under some other disability (*e.g.,* fraud or undue influence), the attempted transfer may likewise be ineffective.

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§7.9 B. Inadvisability of Putting Particular Assets in Trust

Although certain assets may legally be placed in a testamentary trust, it may be inadvisable for the testator to do so. For example, if property unlikely to be income-producing is held in a marital deduction trust, the marital deduction may be lost unless the spouse has the power to compel the trustee to make the property productive. See §17.30. Some attorneys advise against putting tangible personal property or family residences into a trust. As a result of recent marked increases in the value of a personal residence in the average estate, however, the will drafter should carefully consider the tax effects of placing the residence in a trust as opposed to leaving it outright to the surviving spouse. See §12.48. Further, oil and gas interests may be unsuitable for transfer to a trust because they may be depreciating assets. See also §34.27, which points out the danger, under the rule against perpetuities, of permitting "aged" appointive assets to pass under a power of appointment into a testamentary trust.

This section does not contain a comprehensive list of pitfalls to avoid when deciding which assets to include in a trust. It is intended only to illustrate the need for care in determining what to include.

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IV. TRUST BENEFICIARY

§7.10 A. Trust Must Have Definite Beneficiary

A trust fails unless there is a beneficiary whose identity is ascertainable with reasonable certainty. Prob C §15205(b)(1). See also *Reagh v Kelley* (1970) 10 CA3d 1082, 1092, 89 CR 425, 432. If there is no definite beneficiary, the trust cannot be enforced, because there is no one to enforce it. See 2 Scott & Ascher on Trusts §12.10 (5th ed 2006). The requirement of a definite, ascertainable beneficiary is easily met in the ordinary testamentary trust which, for example, is directed to hold the residue of the estate in trust for the benefit of the spouse and children. This requirement does not apply to a charitable trust. Prob C §15205(a); 2 Scott on Trusts §12.1.

The will drafter should be careful whenever beneficiaries are designated by description rather than by name (as in the designation of any class gift). The description must be sufficiently precise and complete to permit the beneficiaries to be identified with certainty. See, *e.g.,* §§12.27-12.34 on drafting class gifts.

Sometimes a testamentary trust gives the trustee or another person discretion to determine which member or members of the class of beneficiaries will take and in what proportions they will take. This provision does not violate the requirement of definite beneficiaries as long as the class is sufficiently identified and its membership is definite. 2 Scott on Trusts §12.7. When such discretion is given, the will drafter should specify the disposition to be made if the trustee or designated person fails to exercise his or her discretion.

A person (*e.g.,* an attorney who is designated to serve as attorney for the trustee) may incidentally benefit from the creation of a trust, but he or she is not thereby made a beneficiary and may not enforce the trust. A person is not a beneficiary if the settlor has not expressed an intention to give him or her a beneficial interest. See Restatement (Third) of Trusts §48 (2003).

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§7.11 B. Permissible Beneficiaries

Probate Code §6102 lists the persons and entities capable of taking by will. Within the limits of that section, any person or entity that has the capacity to take and hold legal title to property may be a beneficiary of a testamentary trust. See Restatement (Third) of Trusts §43 (2003). This includes a state, the United States, an infant, or an insane person. (Although an infant or insane person lacks the capacity to transfer property or to make contracts, he or she has the capacity to be the beneficiary of a trust. Restatement §43, Comment a.)

A corporation may be the beneficiary of a trust of property if it has the capacity to take and hold legal title to the property. Restatement §43, Comment c. Courts have not uniformly enforced this capacity requirement, particularly when unincorporated associations are involved. See *Ruddick v Albertson* (1908) 154 C 640, 98 P 1045 (grant of land may be made to trustees of unincorporated association of Yokayo Indians). See also Restatement §43, Comment d (unincorporated association has capacity to be beneficiary of a trust whether or not it has capacity to take or hold legal title to property). Note, however, that Prob C §15211 provides that a trust for a noncharitable corporation or unincorporated society may be performed by the trustee for only 21 years, whether or not there is a beneficiary who can enforce the trust.

If there are several trustees, one of them may be the sole beneficiary of the trust. If there is a sole trustee, that person may be one of several beneficiaries but must not be the sole beneficiary of the trust. When one person holds both legal and equitable title to property, he or she holds it free of trust because the legal and equitable interests merge. Restatement §32, Comment b. No merger occurs when the settlor is the sole trustee and sole beneficiary during the settlor's lifetime as long as the trust provides for one or more successor beneficiaries after the settlor's death. Prob C §15209.

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§7.12 C. Charitable Beneficiaries

Charitable beneficiaries generally include churches, cultural organizations, schools, government institutions, hospitals, orphanages, soup kitchens, and other institutions that serve the general social interests of the community at large. See *Estate of Henderson* (1941) 17 C2d 853, 112 P2d 605; 6 Scott & Ascher on Trusts §38.1 (5th ed 2009); 13 Witkin, Summary of California Law, *Trusts* §§295-299 (10th ed 2005). See also definitions of charities for tax purposes in IRC §§2055(a) (estate tax), 2522(a) (gift tax), and 170(c) (income tax). A charitable trust is one that has been established for charitable purposes and beneficiaries.

The requirement of definite beneficiaries (see §7.10) does not apply to charitable trusts. *Fay v Howe* (1902) 136 C 599, 69 P 423. See 11 Witkin, Summary, *Trusts* §286.

EXAMPLE: In *Estate of Bunn* (1949) 33 C2d 897, 206 P2d 635, the testator's will provided that at her spouse's death all her possessions should be "sold and given to a worthy charity, selected by [the testator's] executors." The court upheld the trust, noting that although the beneficiary designation was indefinite, that did not render the trust invalid because it was clear that the testator had charitable intentions. In *Estate of Clementi* (2008) 166 CA4th 375, 82 CR3d 685, the court held that a devise directing the estate administrator to fund "a charitable foundation or trust in my name" was valid even though there was no further description of the purpose of the foundation or trust.

In any event, even if indefiniteness is not fatal legally, it should be avoided as an invitation to litigation. If the testator desires a charitable trust, the cautious will drafter should designate the beneficiaries and the charitable purposes as specifically and unambiguously as the testator's desires will permit. The fact that the beneficiaries are definite will not alter the character of the trust as charitable as long as the trust serves a public interest. 11 Witkin, Summary, *Trusts* §277.

Because many charities have similar names, the will drafter should be careful in naming the charity designated by the testator. To determine the charity's proper name, the will drafter can:

- Refer to the testator's membership card or receipt for past contributions;
- Call the charity to verify the correct designation;
- Refer to a copy of the charity's federal tax exemption letter; or
- Consult IRS Pub 78, Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986.

If the charity preferred by the testator has local as well as state and national chapters, the will drafter should ask the testator which chapter to designate as beneficiary.

See §7.17 on application of the cy pres doctrine when charitable beneficiaries cannot be clearly identified.

PITFALL: Great care must be exercised in drafting any trust that has both charitable and noncharitable beneficiaries if the testator wants any part of the trust to qualify for a charitable deduction for federal estate tax purposes under IRC §2055. For discussion of charitable split interest trusts, see chap 14.

The rule against perpetuities does not apply to wholly charitable trusts. *Estate of O'Connor* (1958) 158 CA2d 187, 322 P2d 616. See §34.9. But see 2 Scott & Ascher on Trusts §9.3.9 (5th ed 2006).

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V. TRUST PURPOSES

§7.13 A. Purpose Cannot Be Illegal or Against Public Policy

When the purpose of a trust is illegal or against public policy, the trust will not be enforced. Prob C §15203. Trusts that, *e.g.,* encourage divorce or separation (see 2 Scott & Ascher on Trusts §9.3.3 (5th ed 2006)), encourage neglect of parental duties (see 2 Scott on Trusts §9.3.4), restrain marriage (see 2 Scott on Trusts §9.3.5), defraud creditors (see 2 Scott on Trusts §9.4), or are created for illegal consideration (see 2 Scott on Trusts §9.5) are invalid and should be avoided.

For complete discussion of purposes for which trusts should not be created, see 2 Scott on Trusts §§9.2-9.6.3. See also 13 Witkin, Summary of California Law, *Trusts* §36 (10th ed 2005). If the testator insists on a provision that may be void, the attorney should urge the testator to include an alternative provision to take effect if the first provision is invalidated.

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§7.14 B. Purpose Cannot Be Too Indefinite or General

If the purpose for which a trust is created is so indefinite that the trust cannot be enforced, the intended trust fails. 2 Scott & Ascher on Trusts §9.8 (5th ed 2006). In *Estate of Ralston* (1934) 1 C2d 724, 37 P2d 76, for example, the court held that a devise to a person "in trust" to distribute "as he may see fit" did not establish a valid trust.

There is a line of cases, however, that downplays the need for a definite trust purpose. In *Estate of Berges* (1977) 76 CA3d 106, 142 CR 635, the will gave $600 to an individual "as trustee … for each of her children surviving at the time of my death." No trust purposes were stated and no guidance was given the trustee for her discretionary control of the trust property. The court held that the trust was valid. Lending its considerable weight to this line of authority, Prob C §15204 states that a valid trust can have an indefinite or general purpose "if it can be determined with reasonable certainty that a particular use of the trust property comes within that purpose."

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C. Erection of Tombstones, Care of Graves, Support of Pets

§7.15 1. Trend Toward Honorary Trusts

Courts have had difficulty with certain intended noncharitable trusts that have no definite beneficiary but seek to effectuate a specific legitimate purpose. Examples are trusts for the erection or maintenance of tombstones or monuments, the care of graves, or the support of the testator's pet. See Health & S C §§8775-8776, which explicitly permit certain devises in trust for perpetual cemetery care. See §7.15B on pet trusts. Because the purposes are not charitable, a definite beneficiary is normally required who could enforce the trust. See §7.10. Clearly in these cases there is no one to enforce the trust.

Although some courts over the years have rejected these bequests as invalid trusts (see, *e.g., Estate of Pfund* (1949) 93 CA2d 444, 209 P2d 52), the trend has been to give effect to these dispositions. See, *e.g., Estate of Hamilton* (1919) 181 C 758, 186 P 587 (masses); *Estate of Henderson* (1936) 13 CA2d 449, 57 P2d 212 (erection of mausoleum); *Estate of Koppikus* (1905) 1 CA 84, 81 P 732 (gravestone). See also 2 Scott & Ascher on Trusts §12.11 (5th ed 2006); Restatement (Third) of Trusts §43 (2003); Restatement (Second) of Trusts §124 (1959).

Courts that have given effect to these dispositions usually have referred to them as honorary trusts. The honorary trustee is held to have the power to devote the property to the designated purpose although he or she cannot be compelled to do so. If the trustee does not act to carry out the stated purpose, he or she holds the property in a resulting trust for the residuary beneficiary or the testator's heirs. 2 Scott on Trusts §12.11. However, except as provided above with respect to perpetual cemetery care, the performance of a trust for a lawful noncharitable purpose is subject to statutory limitations on the duration of the trust. Prob C §§15211-15212. See §7.15A.

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§7.15A 2. Trust for Lawful Noncharitable Purpose

Probate Code §§15211-15212 are the legislature's response to the murkiness of the law concerning honorary trusts. Under Prob C §15211, a trust for a lawful noncharitable purpose may be performed by the trustee for only 21 years, whether or not there is a beneficiary who can seek enforcement or termination of the trust and whether or not the terms of the trust contemplate a longer duration. Special rules apply to pet trusts under Prob C §15212. See §7.15B.

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§7.15B 3. Pet Trusts

Probate Code §15212(a) specifically authorizes performance of a trust for the care of domestic animals or pets as a lawful noncharitable purpose for the lifetime of the animal. The testator should specify how the remaining trust corpus should be disposed of at the pet's death; otherwise, the unexpended trust property will be distributed as provided in the residuary clause of the will or distributed to the settlor's heirs. Prob C §15212(b)(2). It is not clear whether a single trust may be created for the care of all the testator's pets or whether a separate trust for each pet is required. On alternative arrangements for care of pets, see §7.16.

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§7.16 4. Alternative Arrangements for Care of Pets

Attorneys frequently are faced with a request for assistance in making arrangements for the care of a pet after the testator's death. Because a testator may not want to establish a trust under Prob C §15212, practitioners should be aware of alternatives that may accomplish the testator's objectives.

One alternative is simply to devise the pet to a trusted friend or relative along with a gift of some cash. The testator should speak with the person before the will is drafted to see whether he or she is willing to care for the pet with the funds devised. The advantage of this alternative is that it is simple. Its disadvantage is that the beneficiary of the pet and funds may decide not to use the funds for the care of the pet.

Another alternative is a program called the "Sido Service," established by The San Francisco Society for the Prevention of Cruelty to Animals (SF/SPCA) (http://www.sfspca.org). If a testator's will entrusts the care of a pet to this organization, or if the executor is directed to seek its assistance, the organization will make every effort to ensure that the animal is placed in the best possible home. In addition, the SF/SPCA will provide for all the pet's medical needs at no charge to the new owner, and a representative will make periodic visits to the animal's new home to ensure that the animal is well cared for. Although there is no fee for the Sido Service, a $25 donation is requested to the SF/SPCA. (The Peninsula Humane Society, also located in the San Francisco Bay Area, has implemented a program similar to the Sido Service.)

The Sido Service was inspired by Sido, a dog whose owner, believing that no one could care for her pet as well as she, provided in her will that at her death Sido should be humanely euthanized. The SF/SPCA successfully challenged this provision of the will. *Estate of Murphy* (SF Super Ct, June 1, 1980, Probate Case No. 225-698). Practitioners should be aware that a will provision directing euthanasia of a pet may not be enforceable and may be challenged by a local humane society.

Care of a pet after one's death can be a difficult problem for many testators. Attorneys can provide an important service to their clients by informing them of programs for the care of pets, which may serve as alternatives to trusts. For further discussion, see Estate Planning for Special Assets, chap 6 (Cal CEB 2004).

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§7.17 D. Reforming Charitable Trusts

Sometimes the specific purpose of a charitable trust cannot be carried out. If the testator manifested a general intention that the trust property be devoted to charitable purposes, however, the court may reform the trust by directing that the property be used for some related charitable purpose. Reformation of a charitable trust is done to give effect to the testator's intentions as much as possible. The doctrine providing the legal basis for such reformation is called cy pres. See 13 Witkin, Summary of California Law, *Trusts* §302 (10th ed 2005). See also §§13.3, 13.5.

EXAMPLE: In *Estate of Faulkner* (1954) 128 CA2d 575, 275 P2d 818, the testatrix made a devise to Alcoholics Anonymous. Because of AA's policy of not accepting donations from nonmembers, the devise was refused. The court refused to invalidate the devise and instead, using the doctrine of cy pres, held that a trustee should be appointed to ensure that the devised funds were used to carry out the testatrix's general purpose of rehabilitating alcoholics.

Because cy pres cannot be used when the testator has not expressed a general charitable intent (see, *e.g.*, *Estate of Klinkner* (1978) 85 CA3d 942, 151 CR 20), the will drafter should discuss the possibility of court reformation of a charitable gift or trust with the client. When the client wants a court to apply the doctrine of cy pres if his or her specific charitable purpose cannot be achieved, the attorney should draft the charitable gift or trust to make clear both that the testator has a general charitable intent and specifically what that intent is. See Comment, *Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres,* 74 Va L Rev 635 (1988); Note, *Phantom Selves: The Search for a General Charitable Intent in the Application of the Cy Pres Doctrine,* 40 Stan L Rev 973 (1988).

NOTE: Application of the doctrine of cy pres is not a complete substitute for the testator's naming a successor charitable beneficiary for a gift to a charity that fails. Naming a successor charity increases the likelihood that the testator's intentions will be carried out. Cy pres should only be relied on to provide alternative beneficiaries when a charitable gift to primary and successor beneficiaries fails.

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§7.18 VI. SINGLE VERSUS MULTIPLE TRUSTS

A will or revocable trust may create a single testamentary trust or multiple trusts. Alternatively, the will or revocable trust may provide for a single trust to be created at death, to be divided into two or more trusts at a later time.

A trustee who holds property under separate trusts must keep separate the property of the several trusts and property not subject to the trusts. Prob C §16009; 13 Witkin, Summary of California Law, *Trusts* §70 (10th ed 2005). However, there need not be any physical segregation of trust assets if the will or revocable trust authorizes the trustee to hold the trust assets without segregation except as necessary for distribution. See §§30.5-30.6.

A court, on petition of a trustee or beneficiary, may combine two or more substantially similar trusts into a single trust (Prob C §15411) or divide a single trust into multiple trusts (Prob C §15412) as long as the accomplishment of trust purposes and the interests of all beneficiaries are not impaired. Instead of relying on these court powers, however, a testator should decide between single or multiple trusts and clearly express this decision in the will. See §§30.5, 30.7.

Whether a single trust or multiple trusts are used depends on the size and nature of the trust assets, the nature and interests of the beneficiaries, and the manner in which the testator desires to provide for them. If an estate is small, a single trust for the benefit of several children may be the wisest course because the entire estate will then be available for the special needs of one child if necessary. On the advantages of a single family "pot" trust for several children, see §22.19. Widely scattered trust assets or the need for specialized and dissimilar kinds of managerial experience might call for separate trusts, separate trustees, or both. In large estates with children as trust beneficiaries, it may be preferable to create a separate trust for each child. For discussion of separate trusts for children, see §22.20.

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VII. PRINCIPAL AND INCOME

§7.19 A. Principal and Income Defined

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) defines the term "income" and provides general rules for apportioning receipts and expenses between principal and income. Under Prob C §16324, "income" is defined as "money or property that a fiduciary receives as current return from a principal asset." Whether property is principal or income is typically important in any situation in which a will or trust distributes income in a manner that differs from the disposition of principal. It is frequently difficult to determine whether a receipt or expense should be classified as principal or income. For example, it may appear at first glance that receipts from the rental of property should be classified as income, but such a classification may favor the income beneficiary over later recipients of principal if the leased property is depreciating. The UPAIA addresses many common issues of this type. These rules only apply to the extent that the will or trust does not provide allocation rules and does not give the fiduciary discretionary power to determine principal and income. Prob C §16335(a)(3).

Generally, because the income interest is mandatory for marital deduction trusts under IRC §2056(b), (c), drafters should avoid custom provisions and instead rely on the UPAIA when drafting marital deduction trusts. In some cases, a unitrust interest may satisfy the income requirement. See §19.7. Alternatively, the drafter can provide custom provisions, but further provide that in no event will the amount of income be less than it would be under the UPAIA.

In situations not involving marital deduction issues, drafters have greater flexibility. Because a strong argument can be made that the UPAIA results in excessive allocations to principal, drafters may wish to include provisions allocating additional amounts to income, particularly if a substantial portion of trust assets will consist of annuities, copyrights, royalties, and oil, gas, and mineral rights. The UPAIA bias in favor of principal is based on the assumption that the trustee can reallocate some of the principal to income using the trustee adjustment power in Prob C §16336. However, the adjustment power often cannot be exercised without a reformation that confers the adjustment power on an independent special trustee because the statute prohibits exercise of this power by a trustee who is also a beneficiary. See Prob C §16336(b)(7). Another problem is that even appropriate attempts by income beneficiaries to compel the trustee to exercise the adjustment power have been held to violate a trust's no-contest clause. See *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129, discussed in §35.9E. For further discussion of the UPAIA and the trustee adjustment power, see chap 30. See also California Trust Administration, chap 8 (2d ed Cal CEB 2001).

Many drafters are now seeking ways to draft distribution provisions that do not require distinguishing between principal and income. A primary reason for this is the belief that a trustee should invest trust property in whatever manner produces the best "total return" regardless of whether that total return results from income (*e.g.,* interest and dividends) or principal (*e.g.,* capital gains). Accordingly, it is undesirable to restrict investment flexibility by creating a situation in which the trustee is forced to take into account whether the investment portfolio is producing a sufficient level of income. An alternative to providing a beneficiary with a right to income is to provide the beneficiary with the right to receive a certain percentage of the value of the trust assets. For further discussion of this "unitrust" approach, see California Estate Planning, chap 24A (Cal CEB 2002).

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§7.20 B. Income Taxation of Trusts

Trusts are taxed in the same manner as individuals (see IRC §641(b)), with certain exceptions designed to limit taxation of the trust as a separate entity and to tax the trust's income to its current or ultimate recipients or persons exercising certain powers treated as substantial owners of the trust. See, *e.g.,* IRC §§642, 651-652, 671.

Basic to taxation of trusts is the concept of distributable net income (DNI). See IRC §643(a); Treas Reg §1.643(a)-1. Stated simply, DNI is the taxable income of the trust before taking into account the deductions allowed for distributions to beneficiaries, the trust's deduction for its personal exemption, and the exclusion allowed for a portion of dividends or interest received. Also generally excluded are capital gains and losses, certain extraordinary dividends, and taxable stock dividends allocated to principal. Tax-exempt income is included. IRC §643(a); Treas Reg §1.643(a)-1.

NOTE: Trust accounting income usually differs from DNI. In some instances, distributions of trust accounting income do not consist entirely of DNI; in other instances, distributions of principal are entirely DNI. Accordingly, when structuring a testamentary trust, the attorney should carefully consider the income tax consequences of the type of distribution clauses selected.

How a trust is taxed depends on whether it is "simple" or "complex." A trust that is required to distribute all its income currently is a "simple" trust. IRC §§651-652; Treas Reg §1.651(a)-1. "Required" means that the trustee must have a duty to distribute the fiduciary accounting income under the terms of the governing instrument. Treas Reg §1.651(a)-2(a). A discretionary power to select among beneficiaries to receive the trust income does not prevent the trust from being a simple trust. Treas Reg §1.651(a)-2(b).

"Currently" means a present right to income. The definition allows for a modest deferral, such as waiting until the close of the taxable year. Treas Reg §1.652(a)-1.

A trust may be simple in 1 year and complex in the next. Treas Reg §1.651(a)-2(c). Stated otherwise, a trust will not be simple as to any year in which it distributes principal, such as the year of termination or a year in which the trustee makes a discretionary distribution of principal. Treas Reg §1.651(a)-3. Nor will it be a simple trust if it "provides" that any amounts may be paid to charity. IRC §651(a)(2); Treas Reg §1.651(a)-4.

If a trust permits its income to be accumulated or its corpus to be distributed, it is a "complex" trust governed by a different set of rules for income tax purposes. IRC §§661-664; Treas Reg §1.661(a)-1, (a)-2(c). A thorough discussion of the differences between simple and complex trusts is beyond the scope of this chapter. See chap 23A. For a more detailed discussion of the income taxation of trusts, see California Trust Administration, chap 11 (2d ed Cal CEB 2001). For a general discussion, see California Estate Planning, chap 13 (Cal CEB 2002).

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§7.21 C. Accumulations of Income

Whenever a trustee is not required to distribute all the net income of the trust currently, the trust instrument should state what should be done with any undistributed net income. Ordinarily, the testator will want the excess income to be accumulated and added to principal. This direction to accumulate income should be expressed in the trust document. CC §724. See §§21.22-21.23. The trust may provide for addition of all income to principal with no mandatory distributions of income nor discretionary distributions of principal. On accumulation of income and the rule against perpetuities, see §34.15.

Income due but not yet received at the income beneficiary's death is added to principal. Undistributed net income remaining in the trust at the income beneficiary's death, which is received by the trustee before the beneficiary dies, generally belongs to the income beneficiary or his or her personal representative. Prob C §§16345-16347. However, the trust instrument may provide that part or all of the undistributed income be paid to the next successive beneficiary. This may save estate taxes in the deceased beneficiary's estate.

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§7.22 D. Distributions of Principal

Distributions of principal may be necessary if the income available is insufficient to carry out the testator's purposes. See, *e.g.*, §§21.28, 21.30. Resorting to principal to provide for an income beneficiary is not permitted without express authority in the trust instrument. *Estate of Van Deusen* (1947) 30 C2d 285, 293, 182 P2d 565. Distributions of principal are always permitted if the trust provides for accumulation of income and discretionary distributions. See §7.21.

Whenever the trustee is authorized to invade principal for the benefit of an income beneficiary, there is a risk of conflict either between the income and remainder beneficiaries or between the trustee and some of the beneficiaries. For these purposes, an income beneficiary may include a current beneficiary with an annuity or unitrust interest. The potential for conflict arises because invasion of principal reduces the remainder interest. The will drafter should explore this problem with the testator and define clearly when and to what extent invasion will be permitted. If invasion is subject to some discretion by the trustee, the will or trust should also indicate whether the testator's primary concern is the income or remainder beneficiary and direct the trustee to exercise his or her discretion in accordance with this preference. See §21.32.

The testator should seriously consider income tax factors when deciding on the nature and extent of distributions of principal. See chap 23A. See also California Trust Administration, chap 11 (2d ed Cal CEB 2001). In addition, the testator should understand the estate tax implications of clauses permitting principal distributions. For example, if the testator gives a beneficiary the right to demand principal payments of any amount and for any purpose, this right may be construed as a general power of appointment for estate tax purposes. If so construed, all trust assets subject to that right will be included in the beneficiary's taxable estate at death even if the demand is never made. IRC §2041(a)(2). If the testator does not wish to risk such adverse tax consequences, he or she should consider giving the beneficiary more limited powers of invasion over principal, such as a special power of appointment or a five or five power. See chap 16.

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Source: Estate Planning/California Will Drafting/8 Pourover Wills/Chapter Outline

8

Pourover Wills

Susan York Janin

I. DEFINITION OF POUROVER WILL §8.1

II. PURPOSES OF POUROVER WILL §8.2

III. UNIFORM TESTAMENTARY ADDITIONS TO TRUSTS ACT §8.3

IV. AUTHORIZING ACCEPTANCE OF ADDITIONS TO TRUST §8.4

V. GENERATION-SKIPPING TRANSFER (GST) TAX CONSEQUENCES OF ADDITIONS TO TRUST §8.5

VI. POUROVER DEFAULT TRUST PROVISIONS §8.6

VII. FORM: POUROVER AND DEFAULT PROVISIONS §8.7

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§8.1 I. DEFINITION OF POUROVER WILL

The term "pourover" is commonly used to describe a testamentary transfer to the trustee of a revocable trust that becomes irrevocable on the death of the settlor. The assets transferred are added to and administered as part of the trust along with its existing assets. In this way, the will "pours over" into the trust. See §8.2.

"Pourover" is also used to describe the following procedures:

- A transfer of the assets of an existing trust to a newly created testamentary trust, with the living trust terminating in whole or in part (sometimes referred to as "pouring uphill"); and
- A transfer of the assets of one trust to another trust when the reason for separate trusts has ended.

These procedures may be appropriate for particular estate plans, but they are less commonly used than the standard pourover from a will to a revocable trust.

"Pourover" is also used to describe the incorporation by reference or duplication of the terms of an existing trust instrument in a will, resulting in the creation of a separate testamentary trust with the same terms as the existing trust. Because the will incorporates or duplicates only the terms of the existing trust and does not include a devise to the trust itself, a "pouring over" of assets does not actually occur. This type of "reverse pourover" can be used to provide for a trust to administer the decedent's assets if the trust that is the receptacle for testamentary assets is held to be invalid or has been revoked. See §8.6.

This chapter focuses on the most common type of pourover: a pourover from a will to an existing revocable trust. A comprehensive treatment of this subject, however, is beyond the scope of this book. For further discussion, see Drafting California Revocable Trusts §§22.3-22.6 (4th ed Cal CEB 2003); Drafting California Irrevocable Trusts §§20.45-20.46 (3d ed Cal CEB 1997); 2 Scott & Ascher on Trusts §7.1.3 (5th ed 2006).

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§8.2 II. PURPOSES OF POUROVER WILL

Pourover wills are most commonly used for two purposes. When a revocable trust is "funded" during lifetime by a transfer of assets to the trustee, the primary purpose of the pourover will is to protect against a possible failure to transfer later-acquired assets to the trust. If the value of the assets not transferred to the trust does not exceed $100,000, the trustee may be able to collect the assets without probate under Prob C §13100. On the validity of the pourover will, see §8.3. On the trustee's acceptance of additions to the trust, see §8.4.

Pourover wills also may be used when a revocable trust has only nominal assets during lifetime. In such instances, a pourover will permits the property to be probated on death (which may be desirable if there is a risk of significant creditor problems), but avoids the public record disclosure of the final disposition of the property.

For whichever purpose the pourover will is used, it is important to coordinate the tax payment clause in the will (if any) with the tax payment clause in the trust. See chap 26.

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§8.3 III. UNIFORM TESTAMENTARY ADDITIONS TO TRUSTS ACT

The Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303) provides that a pourover will is valid if the trust is identified in the will and its terms exist either in a nontestamentary written instrument executed before or at the same time as the will or in the will of a person who has predeceased the testator. Prob C §6300. Unless the testator's will provides otherwise, assets are administered under the terms of the trust to which the pourover was made, including all amendments to that trust, regardless of when the amendments were made. Prob C §6300.

Probate Code §6300 also validates pourovers by will to an unfunded life insurance trust. Many attorneys still advise their clients to fund the trust minimally with $100 if there is a reasonable possibility that another jurisdiction's laws may govern the pourover will and the trust. See Drafting California Revocable Trusts §5.3 (4th ed Cal CEB 2003).

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§8.4 IV. AUTHORIZING ACCEPTANCE OF ADDITIONS TO TRUST

Probate Code §16221 authorizes trustees to accept additions to trusts from any source, without the need for court approval. This provision allows the trustee of a revocable trust to administer property transferred by the settlor's pourover will. Although it is not necessary to include a provision expressly authorizing additions to the trust, careful attorneys usually do so. On possible tax consequences of additions to an existing irrevocable trust, see §8.5.

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§8.5 V. GENERATION-SKIPPING TRANSFER (GST) TAX CONSEQUENCES OF ADDITIONS TO TRUST

The attorney must consider the generation-skipping transfer (GST) tax consequences of pourovers to existing irrevocable trusts. Assets of an existing trust may be exempt from GST tax, either because the trust was created before the effective date of the tax or because of an allocation of the grantor's IRC §2631 GST exemption.

For a trust that would otherwise be exempt under these rules, only the additions to it will be subject to the GST tax. In most cases, however, it is preferable to create a new trust to avoid tainting an exempt trust. For a complete description of the GST tax, see chap 15.

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§8.6 VI. POUROVER DEFAULT TRUST PROVISIONS

Although there is no doubt about the validity of the pourover device (see §8.3), adding a default provision in the will is still advisable. Under Prob C §6300, revocation or termination of the trust before the testator's death causes the pourover gift to fail, unless otherwise provided in the will. The default provision should provide that if the pourover fails for any reason, the assets slated for pouring over into the trust should be distributed to a testamentary trust. For sample default trust provisions, see §8.7.

The will can establish the terms of this testamentary trust in one of two ways:

- *By fully stating the terms of the trust in the will.* The terms should be identical to those of the revocable trust, with modifications necessary to adapt to the testamentary situation (*e.g.,* elimination of terms in the revocable trust applicable only to the period before the settlor's death). Each time the revocable trust is amended, a codicil or a new will should be prepared with corresponding changes to the terms of the trust.
- *By incorporating the terms of the revocable trust by reference.* If the terms of the revocable trust are modified after the date of execution of the will, a codicil should be executed to incorporate these amendments by reference. See discussion of incorporation by reference in §5.3.

Either alternative "backstops" the pourover with a substitute arrangement approximating the intended result of the pourover. Because the default clause provisions are similar to those of the revocable trust, they remove the incentive to contest the validity of the pourover. The default clause may not take effect, however, if the trust was intended to benefit the testator's former spouse. See §10.7.

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Source: Estate Planning/California Will Drafting/8 Pourover Wills/§8.7 VII. FORM: POUROVER AND DEFAULT PROVISIONS

§8.7 VII. FORM: POUROVER AND DEFAULT PROVISIONS

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8.7-1 Disposition of estate residue to trust

***Gift of Residue*. I give the residue of my estate to the trustee then in office of the trust identified below, to be held and administered by the trustee according to the terms and conditions of that trust including, without limitation, any amendment made to it before my death:**

Trust: _ _[*Name of trust*]_ _, established on _ _[*date*]_ _

[*Add one of the following alternatives*]

[*Alternative 1: Mirror-image trust provisions*]

If at the time of my death the residue of my estate is not permitted by law to be distributed to the trustee, or if the trust is not then in existence, is revoked after the date of my will, or fails for any reason, I give the residue of my estate to _ _[*name*]_ _, as trustee, to be held, administered, and distributed as follows: _ _[*Provisions of "backstop" testamentary trust*]_ _.

[*Alternative 2: Incorporation of trust terms by reference*]

If at the time of my death the residue of my estate is not permitted by law to be distributed to the trustee, or if the trust is not then in existence, is revoked after the date of my will, or fails for any reason, I incorporate here by reference the terms of the trust existing on the date I signed my will, and I give the residue of my estate to the trustee named in the trust as trustee, to be held, administered, and distributed according to the trust terms incorporated in my will.

Comment: If Alternative 2 is used, the drafter should note that a few of the provisions of the revocable trust being incorporated by reference into the will may be inapplicable to a testamentary trust. There is no need to specifically exclude them from incorporation, however. These provisions, by their own terms, are usually clearly inapplicable; the likelihood of ambiguity is remote at best. There is danger in attempting to incorporate by reference some, but not all, provisions of a revocable trust. If the drafter inadvertently excludes or includes some provisions and neglects to modify certain provisions that should be modified, the ambiguity that the drafter was hoping to avoid may result.

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9

Revocation

Susan York Janin

I. METHODS OF TOTAL REVOCATION
- A. Statutory Revocation Provisions §9.1
- B. Revocation by Subsequent Instrument §9.2
- C. Form: Revocation of Prior Will §9.3
- D. Revocation by Mutilation or Destruction
  - 1. Requirement of Both Intent and Act §9.4
  - 2. Presumption of Revocation by Destruction §9.5

II. METHODS OF PARTIAL REVOCATION §9.6

III. DEPENDENT RELATIVE REVOCATION §9.7

IV. PREFERENCE FOR EXPRESS REVOCATION §9.8

V. RETENTION OF REVOKED WILLS §9.9

VI. REVIVAL OF REVOKED WILLS §9.10

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I. METHODS OF TOTAL REVOCATION

§9.1 A. Statutory Revocation Provisions

California provides two methods of total revocation of a will: revocation by subsequent written instrument (see §§9.2-9.3) and revocation by mutilation or destruction of the will (see §§9.4-9.5). Prob C §6120.

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§9.2 B. Revocation by Subsequent Instrument

A subsequent valid will can totally revoke a prior will if:

- A clause in the subsequent will expressly revokes the prior will (Prob C §6120(a)); or
- The provisions of the subsequent will are entirely inconsistent with the terms of the prior will (Prob C §6120(a)).

Thus, a subsequent will that disposes of the testator's property in a manner different from that provided in an earlier will constitutes a total revocation of the prior will. *Estate of Mallon* (1938) 28 CA2d 106, 81 P2d 992. See also *Estate of Benson* (1944) 62 CA2d 866, 145 P2d 668; 14 Witkin, Summary of California Law, *Wills and Probate* §176 (10th ed 2005).

A competent attorney does not rely on the second method of revoking a will, because it operates by implication only and may necessitate court interpretation of the document. Revocation of prior testamentary instruments should always be accomplished by an express clause in the new will. For such a clause, see §9.3.

A prior will can be revoked by express provision in a subsequent will even if the subsequent will cannot be given testamentary effect.

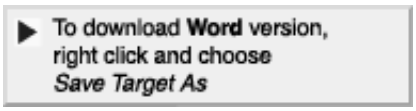
EXAMPLE: In *Estate of Lopes* (1984) 152 CA3d 302, 199 CR 425, the decedent executed a will in 1977 and a new will with an express revocation clause in 1979. The original version of the 1979 will, which could not be found when the decedent died, could not be admitted to probate as a lost or destroyed will under former Prob C §350. Despite this, the court gave effect to the revocation clause in the 1979 will, resulting in distribution of the decedent's estate by intestate succession.

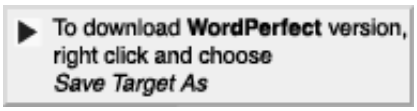
If a will is revoked, any codicil to it is usually considered to be revoked. The codicil is not revoked by revocation of the underlying will, however, if the codicil is complete enough to stand on its own and if the testator revoked the underlying will intending the codicil to be the final expression of his or her testamentary desires. *Estate of Cuneo* (1963) 60 C2d 196, 32 CR 409.

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Source: Estate Planning/California Will Drafting/9 Revocation/§9.3 C. Form: Revocation of Prior Will

§9.3 C. Form: Revocation of Prior Will





9.3-1 Revocation of prior will

I revoke all wills and codicils that I have previously made.

Comment: Many attorneys add this provision to the introductory clause of the will. See §10.6.

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D. Revocation by Mutilation or Destruction

§9.4 1. Requirement of Both Intent and Act

Under Prob C §6120(b), a will can be revoked by being

> burned, torn, canceled, obliterated, or destroyed, with the intent and for the purpose of revoking it, by either (1) the testator or (2) another person in the testator's presence and by the testator's direction.

A will executed in duplicate is revoked if the testator (or another person in the testator's presence and by the testator's direction) destroys one of the duplicates with the requisite intent. Prob C §6121.

For destruction of a will to effect its revocation, there must be a union of intent and act. Intent alone and destruction alone are insufficient. See Prob C §6120(b). Therefore, a will is not revoked by destruction when:

- The destruction is accidental or caused by undue influence, mistake, or fraud; or
- The testator is incompetent and thus not legally able to form an intent to revoke.

See also 14 Witkin, Summary of California Law, *Wills and Probate* §174 (10th ed 2005). A will destroyed without the requisite intent may be admitted to probate under Prob C §8223. However, a lost will may be presumed destroyed by the testator with intent to revoke the will under Prob C §6124. See §9.5.

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§9.5 2. Presumption of Revocation by Destruction

Probate Code §6124 provides that the testator will be presumed to have destroyed the will with the intent to revoke it if the following requirements are met:

- The will was last in the testator's possession;
- The testator was competent until death; and
- Neither the will nor a duplicate original of the will can be found after the testator's death.

A photocopy of a will is not a "duplicate original" for purposes of the presumption of revocation and therefore cannot be probated if the will cannot be found after death. *Lauermann v Superior Court* (2005) 127 CA4th 1327, 26 CR3d 258. The court noted that the phrase "duplicate original" in Prob C §6124 has the same meaning as the phrase "executed in duplicate" in Prob C §6121. See §9.4.

The easiest and most effective way to avoid the operation of this presumption of revocation by destruction is to take proper precautions to prevent loss of the will. See §36.10.

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§9.6 II. METHODS OF PARTIAL REVOCATION

Under Prob C §6120, a will can be partially revoked in four ways:
(1) By express provision in a subsequent testamentary instrument;
(2) By the will's partial inconsistency with a subsequent testamentary instrument;
(3) By cancellation (*i.e.,* crossing out) of part of the will; and
(4) By interlineation (*i.e.,* writing) on the face of the will.

See 14 Witkin, Summary of California Law, *Wills and Probate* §174 (10th ed 2005). Partial revocation of a will may also occur as a result of statutory provisions concerning omitted spouses or domestic partners and children (Prob C §§21600-21630; Fam C §297.5) or former spouses or domestic partners (Prob C §§6122, 6122.1) of the testator, but these are not methods of revocation within the meaning of the present discussion. As a practical matter, the only aspect of partial revocation that concerns the will drafter is the partial revocation of a will by a subsequent codicil. See chap 6.

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§9.7 III. DEPENDENT RELATIVE REVOCATION

A testator may make the revocation of an earlier will expressly conditional on the validity of the revoking will. This concept of an expressly conditional revocation has been extended considerably by the doctrine of dependent relative revocation. Under this doctrine, the testator is presumed to have intended to revoke an earlier will on the condition that a later will was valid (even if the later will does not expressly state this condition) if the testator's revocation of the earlier will was based on the mistaken belief that the later will was valid. 14 Witkin, Summary of California Law, *Wills and Probate* §179 (10th ed 2005). The doctrine may apply even if the testator first executes a new will and then revokes or destroys the earlier will. See *Estate of Oliva* (Ind App 2008) 880 NE2d 1223. When this doctrine applies, the earlier will is not considered to have been revived; instead, its revocation is merely considered to have been ineffectual. See *Estate of Cuneo* (1963) 60 C2d 196, 32 CR 409. For additional illustrations of this doctrine, see 14 Witkin, Summary, *Wills* §§180-181.

The doctrine of dependent relative revocation also applies to partial revocations. For example, if a testator by codicil has revoked a particular gift on the mistaken belief that the beneficiary has died, the doctrine may be applied to nullify the revocation. 14 Witkin, Summary, *Wills* §179. There has been some controversy over whether the doctrine applies only if the mistaken belief appears in the revoking instrument. In *Estate of Anderson* (1997) 56 CA4th 235, 65 CR2d 307, the court held that extrinsic evidence may be considered in determining whether the decedent intended to revoke a certain portion of the prior will.

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§9.8 IV. PREFERENCE FOR EXPRESS REVOCATION

Although several methods of revocation exist, the attorney should use only express revocation by subsequent instrument unless unusual circumstances require adopting one of the other methods. Express revocation by subsequent instrument is the only method that clearly shows the relation between a subsequent testamentary instrument and any preceding instrument.

Similarly, the will drafter should never rely on the doctrine of dependent relative revocation (see §9.7) and the notions of intent and factual circumstances on which application of that doctrine depends. Because California law recognizes conditional wills (see Prob C §6105), the attorney should expressly provide in the subsequent will that revocation of the earlier will is dependent on the later will's validity or on the occurrence or absence of an act or event if such a condition is desired by the testator.

EXAMPLE: If the testator wishes to revoke all prior testamentary instruments, a specific revocation clause (*i.e.,* a clause enumerating specific prior testamentary instruments to be revoked) is not recommended, because one or more instruments may be overlooked. A general revocation clause (*i.e.,* one revoking all prior wills without specific enumeration) accomplishes the same result more efficiently. For such a clause, see §9.3.

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§9.9 V. RETENTION OF REVOKED WILLS

Obviously, the attorney or testator must retain a will that is only partially revoked. Whether either should retain a will that has been totally revoked depends on the circumstances.

If the attorney or testator retains an earlier will revoked by a subsequent will that omits or reduces some devises, the beneficiaries of these devises may learn of the earlier provisions. To avoid the litigation that may result from their disappointment, the attorney or testator may wish to destroy the earlier revoked will.

If the testator expects a will contest, however, retention of one or more earlier wills may be advisable. A revoked will may help defend against a contest by providing evidence of a pattern of testamentary giving. Further, if a contest is expected from an intestate heir, retention of earlier wills may discourage him or her from filing the contest. A disappointed heir is less likely to expend the time and expense of such a contest if several wills in which he or she was not provided for may have to be set aside.

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§9.10 VI. REVIVAL OF REVOKED WILLS

Probate Code §6123 establishes a presumption against revival of a previously revoked will. When a will is revoked by a subsequent will that is later revoked by mutilation or destruction, the original will is not thereby revived unless it is clear from the circumstances of the revocation or from the testator's contemporaneous or later declarations that the testator intended to revive the original will. Prob C §6123(a). When a will is revoked by a subsequent will that is revoked by a third will, the original will is not thereby revived unless it is clear from the terms of the third will that the testator intended to revive the first will. Prob C §6123(b).

Except in rare circumstances, it is better to prepare an entirely new will than to attempt to revive a former will.

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10

Getting Started: Introductory Clauses

Clare H. Springs

I. WILL DRAFTING SYSTEMS §10.1

II. HEADING TO THE WILL §10.2

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- A. Testator's Name §10.3
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- A. Written Instructions Strongly Recommended §10.16
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- C. Devises for Care of Monument or Burial Plot §10.18

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§10.1 I. WILL DRAFTING SYSTEMS

Except for dispositive provisions, most wills can be drafted without much original writing, using provisions from prior wills or from practice manuals such as this book. Because of this, will drafting can be done much more quickly and efficiently if the attorney develops a system featuring standard will provisions that can easily be inserted into any type of will.

When using a will drafting system, the practitioner must always remember to pay careful attention to the individual case. For example, a married client who has children from a prior marriage usually has different and more complex testamentary needs than the typical married client. Too much reliance on a will drafting system may lead the practitioner to overlook these needs.

NOTE: When creating a will drafting system, the attorney should keep in mind the system of indexing wills by type that he or she would like to have. See §4.7. The attorney may wish to include in each will certain information that facilitates the development of such a system. For example, if the attorney wants this system to identify all older clients, he or she should include the testator's birthdate in all wills. If the attorney wants the system to retrieve the files of testators who have children by a prior marriage, the attorney should include that biographical fact in all applicable wills.

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§10.2 II. HEADING TO THE WILL

In the heading to a will, many practitioners use the designation "Last Will and Testament." This expression dates from a time when "testament" described an instrument that disposed of personal property and "will" described an instrument that disposed of real property. Today, the word "will" is the equivalent of both. Although the heading to a will customarily reflects the old expression, the drafter need not follow this tradition.

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III. NAME, RESIDENCE, AND TESTAMENTARY INTENT

§10.3 A. Testator's Name

The will should state the testator's most commonly used name (*e.g.,* William B. Smith) and all other names by which the testator has been known (*e.g.,* Bennett Smith). Because women increasingly retain or reclaim their maiden or former married name, it is particularly important to list all names by which a female testator has been known. Including all names used by the testator may help to differentiate between assets belonging to the testator and those belonging to someone with the same or a similar name (such as a child). It may also assist the executor in locating assets held in a name other than the one the testator is currently using.

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§10.4 B. Testator's Residence

Although there is no legal requirement to do so, the will should state the residence of the testator. The residence may be indicated by street address, but it is more commonly described by county and state of residence. The will should state the testator's legal residence, not the place where the testator may be living temporarily at the time of execution of the will. Because Prob C §7051 provides that the will of a California resident must be proved and the administration must be conducted in the county in which the decedent resided, stating the county of legal residence may be useful in determining the appropriate jurisdiction for probating the will.

A statement of residence takes on greater significance if the testator maintains multiple residences, but such a statement is not determinative of legal residence, particularly if the testator has moved since execution of the will.

See *Estate of Guerrero* (1986) 183 CA3d 723, 228 CR 408, for an example of the confusion that may arise when a California resident executes a will in a foreign jurisdiction.

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§10.5 C. Testamentary Intent

Declaring the document to be a will indicates the testator's testamentary intent.

Older wills often contain declarations of the testator's mental capacity, *e.g.,* that the testator is "of sound mind and body." These declarations are unnecessary because the courts have long held that the presumption of capacity to make a will exists regardless of such declarations. See *Estate of Sanderson* (1959) 171 CA2d 651, 341 P2d 358. Obviously, if the testator is later proved to have been mentally incapacitated on the date of execution, the will recital will not be of much value.

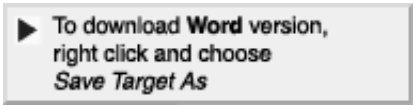
Another phrase often used in older wills is that the testator is "not acting under menace, undue influence, or fraud." This recital is also unnecessary because, if the testator is under anyone's undue influence or is being defrauded, he or she is unlikely to be aware of it at the time of execution. This recital will be of little use if the will is later contested on the ground that the testator was acting under undue influence or fraud.

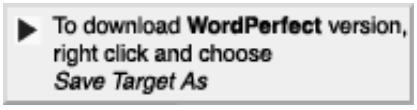
For discussion of steps to be taken in anticipation of a challenge based on the ground of lack of capacity or undue influence, see §§2.15, 36.13-36.15.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.6 D. Form: Introductory Clause

§10.6 D. Form: Introductory Clause





10.6-1 Introduction

I, _ _[*name of testator*]**_ _, a resident of _ _**[*name of county*]**_ _, California, declare this to be my will.**

[*If applicable, add the following option*]

[*Option: Testator's other name*]

I have also been known as _ _[*other name*]**_ _.**

Comment: Many attorneys add a revocation provision to this introductory clause. See §9.3. For discussion of the optional addition, see §10.3.

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IV. DECLARATIONS CONCERNING FAMILY

§10.7 A. Marital or Partnership Status

There is no legal requirement for a valid will to include a declaration of marital or California-registered domestic partnership status. Nevertheless, will drafters generally find it useful to make such a declaration in the will's introductory provisions, to preface the will's dispositive provisions. The declaration may help the executor identify relatives or partners and locate assets, and it may tend to refute any putative spouse or domestic partner claims. See §10.7A. In cases where the client has provided incorrect information, such a declaration also helps to protect the drafter by effectively memorializing the representations made to the drafter by the client.

Usually, a declaration regarding marital or partnership status is simply a statement that the testator is currently married or in a domestic partnership or that the testator has never been married nor been in a domestic partnership. Many practitioners prefer to avoid mentioning former spouses and partners, believing that the benefit is modest and that most clients are not eager to have such persons mentioned in their wills. This assumes that the testator has obtained a final judgment of dissolution. See §10.7B. When the testator is a surviving spouse or partner, the declaration may include the date of death of the deceased spouse or partner. See §10.7C.

PRACTICE TIP: If the testator has had a marriage or domestic partnership dissolved, it may be useful to identify the court proceeding in the declaration so that, if necessary, the court documents can be easily retrieved and reviewed. Obligations and rights under marital settlement agreements often become the subject of dispute in probate proceedings.

An attorney drafting a will should know not only whether the client has ever been a party to a marital or partnership settlement agreement but also whether the client has ever entered into a premarital or postmarital agreement. An attorney drafting a will for domestic partners should assume that any property agreement entered into after registration will be treated as a postmarital agreement, unless the partnership was registered before January 1, 2005, and the agreement was fully executed and in force as of June 30, 2005. Such agreements are enforceable as provided in the Uniform Premarital Agreement Act (Fam C §§1600-1620). Fam C §297.5(k)(2).

If the client has been a party to any of these agreements, the attorney should review the terms of the agreement to ascertain whether the parties have waived any of the rights enumerated in Prob C §141. These rights include the right to inherit under a will that was executed before the waiver and the right to be appointed personal representative of the spouse or partner's estate. Prob C §141(a)(2), (9). The validity of such waivers is governed by Prob C §§140-147. The most important of these sections is Prob C §143, which provides that the waiver is enforceable unless, at the time of the waiver, (1) the deceased spouse or domestic partner did not give the survivor a fair and reasonable disclosure of his or her property or financial obligations or (2) the survivor was not represented by independent legal counsel.

PITFALL: If the client may be contemplating marriage or domestic partnership, the attorney should discuss the provisions of Prob C §§21610-21611. Under these statutes, if the testator marries or enters into a registered domestic partnership after making his or her last will and the will fails to provide for the surviving spouse or partner, the omitted spouse or partner is entitled to one-half of the testator's community and quasi-community property and the share of testator's separate property (up to one-half) to which the spouse or partner would have been entitled had the testator died intestate. Prob C §21610; Fam C §297.5(k)(1). The omitted spouse or partner is not so entitled if (1) the will reveals that the testator's failure to provide for the spouse or partner was intentional, (2) the testator provided for the spouse or partner outside the will and intended those provisions to be in lieu of provision in the will, or (3) the spouse or partner executed a valid written agreement waiving all rights to share in the testator's estate. Prob C §§21610-21611. The waiver agreement need not meet the requirements for a valid premarital agreement. See *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502.

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§10.7A 1. Omitted Spouse or Partner

Family Code §2251 provides that a court can declare parties to have putative spouse status if it finds that either or both parties believed in good faith that a void or voidable marriage was valid. Putative spouse status is a critical determination because a surviving spouse may be entitled to an intestate share of a testator's estate as an omitted spouse if the will fails to provide for that person. See *Estate of Leslie* (1984) 37 C3d 186, 207 CR 561. See also *In re Domestic Partnership of Ellis & Arriaga* (2008) 162 CA4th 1000, 76 CR3d 401 (putative registered domestic partner). For further discussion of putative spouses, see California Decedent Estate Practice §28.36 (2d ed Cal CEB 2009).

Note that the rules for setting aside the provisions of the will to give an intestate share of the testator's estate to an omitted spouse are less inclusive than the rules for automatic revocation of provisions in favor of a former spouse, discussed in §10.7B. A spouse who has obtained a judgment of legal separation is not a surviving spouse for intestate succession purposes even if the spouse is still married to the testator. *Estate of Lahey* (1999) 76 CA4th 1056, 91 CR2d 30. See also *Estate of McDaniel* (2008) 161 CA4th 458, 73 CR3d 907 (person who "was a party to a valid proceeding concluded by an order purporting to terminate all marital property rights" was not a surviving spouse for intestate succession purposes). But see *Estate of Garrett* (2008) 159 CA4th 831, 71 CR3d 864 (nominee of decedent's spouse was entitled to letters of administration even though decedent and spouse permanently separated and spouse filed action for divorce that was dismissed for lack of prosecution). To avoid confusion, the drafter should take care to either disinherit or specifically provide for persons who might be considered spouses or partners of the testator whenever there is any question about the testator's marital or partnership status. For disinheritance clauses that address the problem of an omitted spouse or domestic partner, see §35.8.

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§10.7B 2. Former Spouse or Partner

If the client's marriage or domestic partnership is in trouble but the client still wishes to provide for the spouse or partner, the attorney should discuss the provisions of Prob C §6122 or §6122.1 with the client. These statutes generally provide that, on dissolution or annulment of a marriage or dissolution or termination of a domestic partnership, all provisions in the will in favor of the former spouse or partner are revoked and the will is interpreted as though the former spouse or partner had predeceased the testator. Similar provisions apply to revocable trust provisions in favor of a former spouse or domestic partner. Prob C §§5600-5604; Fam C §297.5(b).

If the testator (1) wishes to provide for the former spouse or partner, (2) wishes to confer a power of appointment on the former spouse or partner, or (3) wishes the former spouse or partner to serve as executor of the will or trustee of trusts for their children or other beneficiaries, then prudence dictates that the testator do so by a codicil or new will executed after the annulment or dissolution of the marriage or dissolution or termination of the partnership even in the rare case that this is not literally required because the will or trust expressly provided that termination of the marriage or partnership will not result in revocation of the relevant provision. If nothing else, this precaution can eliminate the relevance of the kinds of conflict-of-law issues that can arise when a testator dies domiciled in another state or owning real property in another state.

NOTE: If a devise to a revocable trust fails because the trust was revoked, a backup devise incorporating the trust document by reference creates a testamentary trust that is subject to statutory rules regarding revocation of wills, including the Prob C §6124 presumption that a missing will is revoked under specified circumstances and the Prob C §6122 provision revoking transfers to former spouses. See *Estate of Coleman* (2005) 129 CA4th 380, 28 CR3d 282 (former spouse surviving settlor may not take under will or testamentary trust of deceased settlor even if unexecuted copy of pourover will is admitted to probate).

A decree of legal separation that does not terminate the status of husband and wife is not a dissolution of the marriage for purposes of Prob C §6122. Prob C §6122(d). Similarly, a domestic partnership is not terminated for purposes of Prob C §6122.1 until a notice of termination is filed with the California Secretary of State or a judgment of dissolution of domestic partnership is filed, if required. Prob C §37(b); Fam C §299. If a will provision is revoked solely as a result of the dissolution or annulment of the marriage or domestic partnership, the provision is revived if the testator remarries the former spouse or establishes another domestic partnership with the former domestic partner. Prob C §§6122(b), 6122.1(b).

If the client is separated from his or her spouse or domestic partner or if a dissolution action has been filed, it is important for both the testator and attorney to understand that the marriage or domestic partnership is still in effect. A marriage is not terminated until the marital status termination date specified in the dissolution judgment is reached. See *Estate of Gibson* (1990) 219 CA3d 1486, 269 CR 48, for an example of the confusion that may arise if a spouse dies after the judgment of dissolution but before the marital status termination date. Similarly, a domestic partnership is not terminated until the date specified in the dissolution judgment under Fam C §299.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.7C 3. Deceased Spouse or Partner

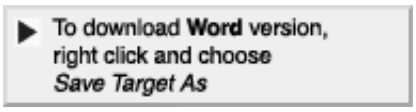
§10.7C 3. Deceased Spouse or Partner

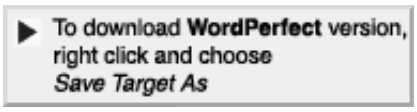
When the client is a surviving spouse or registered domestic partner, the declaration of marital or partnership status should include the deceased spouse or partner's date of death. This may help the executor determine both whether the prior transfer property (PTP) credit will apply and the percentage applicable to the credit. See IRC §2013. It will also facilitate retrieval of documents from the predeceased spouse or partner's estate. The executor may need to review these documents not only to compute the PTP credit but also to help identify the assets owned by the testator and to determine the prior estate tax consequences of certain assets or interests that passed to the testator. Specifying the date of death is also useful when determining whether the deceased spouse or partner's trusts are grandfathered for generation-skipping transfer (GST) tax or other tax-related purposes.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.8 B. Form: Declaration of Marital or Partnership Status

§10.8 B. Form: Declaration of Marital or Partnership Status





10.8-1 Declaration of marital or partnership status

[*Add one of the following alternatives*]

[*Alternative 1: Currently married*]

I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

[*If applicable, add the following option*]

[*Option: Married to former domestic partner*]

I was previously registered with the California Secretary of State as the domestic partner of my spouse.

[*Alternative 2: Never married*]

I have never been married.

[*Alternative 3: No spouse or domestic partner*]

I am not married and I do not have a domestic partner.

[*Alternative 4: Marriage dissolved*]

I am not married. I was formerly married to _ _[*name of former spouse*]_ _. That marriage was dissolved on _ _[*date*]_ _ by order of the following Court: _ _[*Name of court; case number*]_ _.

[*Alternative 5: Deceased spouse*]

I am not now married. I was formerly married to _ _[*name of deceased spouse*]_ _. My spouse died on _ _[*date*]_ _.

[*Alternative 6: Currently in a domestic partnership*]

I am currently registered with the California Secretary of State as the domestic partner of _ _[*name of partner*]_ _, who is hereafter referred to as "my partner."

[*Alternative 7: Domestic partnership terminated or dissolved*]

I am not currently registered with the California Secretary of State as a domestic partner.

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

[*Option: Domestic partnership terminated*]

I was formerly registered as the domestic partner of _ _[*name of former partner*]_ _. That domestic partnership registration was terminated on _ _[*date*]_ _ by notice of termination filed with the California Secretary of State: _ _[*file number*]_ _.

[*Option: Domestic partnership dissolved*]

I was formerly registered as the domestic partner of _ _[*name of former partner*]_ _. That domestic partnership was dissolved on _ _[*date*]_ _ by order of the following Court: _ _[*Name of court; case number*]_ _.

[*Alternative 8: Deceased domestic partner*]

I am not currently registered with the California Secretary of State as a domestic partner. I was formerly

registered as the domestic partner of _ _[*name of deceased partner*]_ _. My partner died on _ _[*date*]_ _.

Comment: These clauses cover the most common and significant marital and partnership statuses. Testators who were previously registered and may be currently registered as the domestic partner of the testator's current spouse may wish to include this information, as provided in the optional addition to Alternative 1. (The California Secretary of State has given informal advice that dissolution of a domestic partnership is not required for same-sex domestic partners to marry each other.) For same-sex spouses, the date of registration may be treated for state law purposes as the date of marriage. The declaration of marital or partnership status is often followed immediately in the same paragraph by a declaration concerning children. See §10.10.

Note that using "spouse" instead of "husband" and "wife" reduces the number of changes that must be made in "mirror-image" wills for spouses and allows for same-sex spouses. For disinheritance clauses, particularly those dealing with the problem of an omitted spouse or domestic partner, see §35.8.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.9 C. Declaration Concerning Children

§10.9 C. Declaration Concerning Children

The will should list the names and birthdates of all the testator's living children. The names of deceased children should also be listed. If the children are minors and the other parent is not the testator's current spouse, the other parent should be identified by name.

The need to list children in the will is particularly compelling if the testator does not intend to provide for a child. Probate Code §21622 states that if a will fails to provide for a child living at the time of execution of the will and if that failure to provide is the result of either the testator's belief that the child is dead or the testator's ignorance of the child's birth, the child is entitled to his or her intestate share of the testator's estate. The child has the burden of proving that the testator believed the child was dead. *Estate of Della Sala* (1999) 73 CA4th 463, 86 CR2d 569. Thus, a statement in the will that the disinherited child is living, along with his or her date of birth, should be sufficient to prevent the provisions of Prob C §21622 from coming into play. The careful will drafter, however, should go further and include a statement in the will that the testator's failure to provide for the child is intentional. See §§35.4-35.8.

PRACTICE TIP: Because of Prob C §21622, the attorney should urge the client to reveal the names of each one of his or her children. Some clients are understandably embarrassed about the existence of certain children, especially those who have not been a part of the client's life for many years.

If the testator is likely to have children after the execution of his or her will, the attorney should advise the client of the provisions of Prob C §§21620-21621. Probate Code §21620 states that if a will fails to provide for a child born or adopted after its execution, the omitted child must receive his or her intestate share of the testator's estate. However, Prob C §21621 states that the omitted child may not receive this share if the testator:

- Expresses an intention not to provide for the child in the will;
- Had other children when the will was executed and left the bulk of the estate to the other parent of the omitted child; or
- Provided for the omitted child outside the will in lieu of a testamentary provision.

The testator should not rely on Prob C §21620 to provide for a child born or adopted after the date of the will. The testator also should not rely on Prob C §21621 to exclude children born or adopted before the date of the will. Instead, the will should specifically state the testator's intent regarding such children. If the testator is related to an individual who might be deemed a "child" under Prob C §26, the safest course of action is to treat that individual as a child for purposes of the will. Thus, if the testator does not wish to provide for that individual, the will must conform to the provisions of Prob C §21621 to avoid the provisions of Prob C §21620.

PITFALL: Probate Code §26 defines "child" to mean any individual entitled to take as a child under the laws of intestate succession from the parent whose relationship is involved. This definition not only includes both natural and adopted children but also may include stepchildren and foster children. See Prob C §§6450-6455. On natural children, see §10.9A.

A recital in the will of the names of children, as well as the name of a spouse, may be useful if there is any question of the testator's capacity. The recital may help to establish that the testator knew the natural objects of his or her bounty. This may be important if the will is attacked on the ground that the testator lacked testamentary capacity. See §§2.9-2.10, 2.14.

A recital in the will of the birthdates of children serves a variety of purposes. It may be important in determining the necessity for a family allowance and for guardianship proceedings. If there is a testamentary trust, the trustee will need the birthdates to determine the timing of various types of distributions under the trust provisions.

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§10.9A 1. Effect of Uniform Parentage Act

The existence of a natural parent-child relationship is generally determined under the Uniform Parentage Act (UPA) (Fam C §§7600-7730). See Prob C §6453. The natural children of a deceased beneficiary may include posthumously conceived children conceived within 2 years after the decedent's death if the decedent specified in writing that his or her genetic material shall be used for posthumous conception. Fam C §7611(f); Prob C §§249.5-249.8. Natural children also may include children who have no genetic connection to presumed parents who received the children into their homes and openly held them out as their natural children under Fam C §7611(d). See *In re Nicholas H.* (2002) 28 C4th 56, 120 CR2d 146 (presumed father provided home for mother and child). Such presumed parents may include a second parent of the same sex. See *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46 (presumed mother lived with and supported biological mother and child). See also *Kristine H. v Lisa R.* (2005) 37 C4th 156, 33 CR3d 81 (biological mother estopped from challenging validity of stipulated judgment declaring that her female partner was parent of child). In some cases, the determination may depend on presumptions concerning the paternity of a child born during a marriage. Fam C §§7540-7547. See §10.9B.

In *Estate of Chambers* (2009) 175 CA4th 891, 96 CR3d 651, the court held that a preponderance of the evidence was not sufficient to establish a natural parent-child relationship under Prob C §6453(a) on the basis that the decedent received the child into his home and held him out as his own as provided in Fam C §7611(d). Instead, the court concluded that clear and convincing evidence was required to establish paternity on the basis that decedent held the child out as his own under Prob C §6453(b)(2) in cases falling under Fam C §7630(c), which applies to proceedings in which the presumed father is deceased. However, the decision to apply Prob C §6453(b)(2) in this case may be open to criticism. A reasonable construction of Prob C §6453(b)(2) would appear to require clear and convincing evidence to establish paternity under that section only in cases in which paternity cannot be established under Prob C §6453(a) because the child cannot also prove reception into decedent's home.

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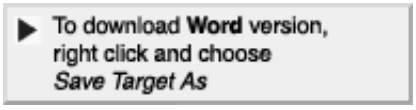
§10.9B 2. Conclusive Marital Presumption

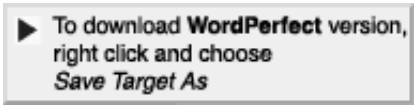
The child of a woman cohabiting with a registered domestic partner is conclusively presumed to be a child of the domestic partnership under Fam C §7540, obviating application of parentage presumptions under the UPA. See Fam C §297.5(d). (Despite language in Fam C §§7540-7541 limiting the application of the presumption that the child of a wife cohabiting with her husband is the child of the husband when there is evidence demonstrating the biological impossibility of the husband's paternity, the California Supreme Court has stated that "the conclusive marital presumption in section 7540 is not really a presumption at all but is instead 'a rule of substantive law.'" *In re Jesusa V.* (2004) 32 C4th 588, 614, 10 CR3d 205, quoting *Kusior v Silver* (1960) 54 C2d 603, 619, 7 CR 129.) Such a child of a domestic partnership also would be considered the natural child of the partner for purposes of intestate succession under Prob C §6453, because a presumed parent under Fam C §7540 is considered a natural parent under the UPA. Fam C §7611. The same principle should apply to the child of a man cohabiting with a registered domestic partner.

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§10.10 D. Form: Declaration Concerning Children





10.10-1 Declaration concerning children

[*Add one of the following alternatives*]

[*Alternative 1: No children*]

No Children or Issue. **I have no living or deceased children or other issue.**

[*Alternative 2: Living children only*]

Children and Issue**. The names and birthdates of my children are: _ _**[*Names of children and birthdates*]**_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others _ _**[*except that the term shall also include any child or children hereafter born to or adopted by me*]**_ _. All references in this will to my "issue" are to my children as so defined and their issue.**

[*Alternative 3: Deceased children only*]

No Living Children. **I have no living children. The names of my deceased children are as follows: _ _**[*Names of deceased children*]**_ _. _ _**[*All references in this will to my "issue" are to the issue of the deceased children just named and no others.*]**_ _**

[*Alternative 4: Living and deceased children*]

Children and Issue**. The names and birthdates of my children are as follows: _ _**[*Names of children and birthdates*]**_ _ The term "my children" in my will refers only to my children named above. I also have deceased children, whose names are as follows: _ _**[*Names of deceased children*]**_ _. All references in this will to my "issue" are to the issue of both my children as so defined and my deceased children.**

[*Alternative 5: Children from prior marriage*]

Children and Issue**. My spouse and I have the following children, whose names and birthdates are: _ _**[*Names of children and birthdates*]**_ _ I also have the following children from a prior marriage to _ _**[*name of former spouse*]**_ _, whose names and dates of birth are: _ _**[*Names of children and birthdates*]**_ _.**

I have no deceased children. The term "my children" in my will refers only to my children of my current or previous marriage named above. The above birthdates are conclusive for all purposes under my will. All references in this will to my "issue" are to my children as so defined and their issue.

[*Alternative 6: Children from prior domestic partnership*]

Children and Issue**. My partner and I have the following children, whose names and birthdates are: _ _**[*Names of children and birthdates*]**_ _ I also have the following children from a prior domestic partnership with _ _**[*name of former partner*]**_ _, whose names and dates of birth are: _ _**[*Names of children and birthdates*]**_ _.**

I have no deceased children. The term "my children" in my will refers only to my children of my current or previous domestic partnership named above. The above birthdates are conclusive for all purposes under my will. All references in this will to my "issue" are to my children as so defined and their issue.

Comment: Always use the complete formal name of a child. If the testator wishes the term "my children" also to refer to individuals other than those named as children in the declaration, the drafter should modify the clause accordingly. See §10.9 on later-born or adopted children. See also §§12.29, 12.33 for discussion of issues to consider when defining "children" for purposes of a class gift.

The declaration concerning children often follows the declaration of marital or partnership status in the same

paragraph. See §10.8.

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§10.11 V. PROPERTY CHARACTERIZATION

If a client has a current or former spouse or registered domestic partner or owns property with anyone other than a spouse or domestic partner, one of the will drafter's most important responsibilities is to determine the character of the client's property. This usually requires that the attorney review the title document for each major asset and the circumstances surrounding its acquisition. If the document of title is incorrect, it should be corrected.

PRACTICE TIP: Whether or not a characterization issue exists, the attorney should always check title documents to verify the manner in which title to the testator's property is being held. In one situation with which the author is personally familiar, an attorney wrote a will but never checked whether the testator's assets were held in joint tenancy. The attorney later represented the executor in a probate administration. The court denied the attorney's request for fees for services that were required because the attorney had failed to inquire about title. In another instance, an attorney had his terminally ill client gift his partnership interest in real property to the client's close friend so that the estate could avoid probate administration. After the testator died, the attorney learned that the partnership interest in real property was actually a tenancy-in-common interest. A probate had to be opened just to clear title.

The most common characterization problem involves a community property residence that is being held under a joint tenancy deed. The attorney should carefully consider whether the joint tenancy arrangement is in the best interests of the client, the client's spouse or domestic partner, and the entire family. In most cases, the attorney and client will decide that the residence should be held as community property because, at the death of a spouse, the entire residence may receive a stepped-up basis equal to the property's fair market value as of the date of death for both federal and California income tax purposes. In the case of same-sex registered domestic partners, the residence may receive a stepped-up basis for California income tax purposes. IRC §1014(a); Rev & T C §18031; Fam C §297.5. See §3.34. If the residence is held in joint tenancy, only the portion of the residence included in the deceased spouse or partner's estate will receive a stepped-up basis (or may be allocated basis increase) for federal income tax purposes. IRC §§1014(b)(9), 2040. Further, joint tenancy allows much less flexibility in estate planning than does community property. See California Estate Planning, chap 7 (Cal CEB 2002).

WARNING: In considering the choice of title for a residence owned by registered domestic partners that may have been acquired with unequal amounts of separate property or with unequal earnings treated as community property for purposes of California law, the attorney must remember that any net gift resulting from equal ownership of the acquired property may be a taxable gift because same-sex spouses and domestic partners are not treated as spouses for purposes of the IRC §2523 gift tax marital deduction. The attorney also should remember that same-sex spouses and domestic partners are not eligible for nonrecognition of gain on transfers between spouses under IRC §1041(a) if a residence previously acquired by one partner is transferred to both partners as community property or joint tenancy property and the gain is not fully excluded by the IRC §121 exclusion for gain from the sale of a personal residence.

The principal advantage of joint tenancy ownership is probate avoidance. This advantage has been reduced for property passing to a surviving spouse or domestic partner, however, by the abbreviated confirmation proceedings of Prob C §§13650-13660.

Another advantage of joint tenancy ownership is creditor protection for the surviving spouse. Under California law, full title to joint tenancy property passes to the surviving joint tenant and the estate of the deceased joint tenant has no interest in the property. *Dieden v Schmidt* (2002) 104 CA4th 645, 653, 128 CR 365; *Zeigler v Bonnell* (1942) 52 CA2d 217, 220, 126 P2d 118 (judgment lien against joint tenant extinguished by death; holding limited to cases where judgment lien was created after right of survivorship had already arisen). Accordingly, the death of a judgment debtor will generally terminate the liens of that debtor's judgment creditors unless the debtor created the joint tenancy by conveyance made after creation of the judgment lien. In this context, actions of the judgment creditor do not sever the

joint tenancy until there is an execution sale. *Grothe v Cortlandt Corp.* (1992) 11 CA4th 1313, 15 CR2d 38. Under *U.S. v Craft* (2002) 535 US 274, 152 L Ed 2d 437, 122 S Ct 1414, a federal tax lien attaches to the joint tenancy interest of the spouse liable for the tax. However, the IRS has issued guidance suggesting that federal tax liens on joint tenancy property are generally extinguished on death and so are not enforceable against the survivorship interest of the non-liable spouse. See Notice 2003-60, 2003-2 Cum Bull 643. But see *Paternoster v U.S.* (SD Ohio 2009) 2009-2 USTC ¶50520, 104 AFTR2d 5530, (reaching a contrary result under Ohio law).

If a decision is made to change the joint tenancy residence to community property, the attorney should have the spouses or partners execute a deed to the residence that makes that change. See Fam C §852(a). To assure that the deed satisfies the requirements for making a transmutation of property, the deed should contain a recital that the purpose of the deed is to transmute the parties' interests in the property into community property. *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153; *Marriage of Barneson* (1999) 69 CA4th 583, 81 CR2d 726. The testator should not solely rely on a declaration in the will that the residence is community property. See §10.11A.

The supreme court has further held that the writing requirement is not subject to the "part performance" exception that may apply under the more general CC §1624 statute of frauds, which would allow specific performance of a contract when assertion of the statute would cause unconscionable injury. *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471. The husband in *Benson* had claimed that the transfer of a residence to a trust was in exchange for the wife's promise to relinquish her interest in his retirement plan. See also *Marriage of Starkman* (2005) 129 CA4th 659, 28 CR3d 639 (separate property residence transferred to a joint revocable trust was not transmuted by clause providing that property transferred to the trust was community property unless identified as separate property). On the other hand, courts have held that Fam C §852(a) does not apply to the initial purchase of separate property or joint tenancy property from a third person with community property funds. *Marriage of Brooks & Robinson* (2008) 169 CA4th 176, 86 CR3d 624; *Hanf v Summers (In re Summers)* (9th Cir 2003) 332 F3d 1240. For further discussion, see California Estate Planning §§4.39-4.39E (Cal CEB 2002).

CAUTION: Even a valid transmutation agreement does not operate as a waiver of the right to reimbursement for a contribution of separate property to community property on dissolution of marriage under Fam C §2640(b) unless expressly stated in the agreement. See *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385.

Recording the new deed will not trigger a reappraisal of the residence for property tax purposes and will not result in a loss of the exemption from reassessment at death for either spouses or registered domestic partners. See Rev & T C §§62(a), 62(p), 63. See also *Strong v State Bd. of Equalization* (2007) 155 CA4th 1182, 66 CR3d 657 (legislature had authority to create exclusion for transfers between registered domestic partners in Rev & T C §62(p)). If they acquired the property together and took title in joint tenancy, it remains the case that both are considered original transferors and there will be no reassessment of the property if a new deed is not recorded and one of them dies. Rev & T C §65(c); 18 Cal Code Regs §462.040.

NOTE: Joint tenancy title creates a rebuttable presumption that the property is owned as equal shares of separate property. *Machado v Machado* (1962) 58 C2d 501, 25 CR 87. Under Fam C §2581, joint tenancy property acquired during a marriage or domestic partnership is presumed to be community property, but this presumption does not apply if there is no dissolution proceeding. This presumption and the Evid C §662 presumption in favor of record title may be overcome in a dissolution proceeding by the presumption of undue influence that arises under Fam C §721 when one spouse or partner acquires a joint tenancy interest in the other's separate property residence. *Marriage of Delaney* (2003) 111 CA4th 991, 4 CR3d 378.

Another common characterization problem involves real property that is being held by two or more owners who are not spouses or domestic partners. The attorney must assess whether the client holds the property with the other owner or owners as a tenant in common, as a joint tenant, or in partnership. The legal nature of the ownership interests affects not only whether there will be a probate at death but also who receives the ownership interest. If there might be any question concerning the character of the property, the client and the other owners should execute a written agreement spelling out the nature and extent of each owner's interest. The testator should not rely only on a declaration in the will to clear up any questions about the character of the property.

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§10.11A A. Effect of Testamentary Declaration

A declaration in the will about the character of the testator's property may be unwise. Such a declaration may cause the testator some embarrassment if property rights must be decided in a later proceeding such as a partition action. But see Fam C §853 (statement in will about character of property inadmissible as evidence of transmutation in any proceeding commenced before testator's death). Further, a change in circumstances after execution of the will (*e.g.,* later gifts or inheritances) may make the declaration inaccurate.

NOTE: Family Code §853 literally applies only to wills and does not apply to a transmutation agreement executed in connection with a transfer of property to a revocable trust. See *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385, in which the court held that an agreement purporting to transmute separate property to community property accomplished that transmutation even though the transmutation was conditioned on a specified revocable trust disposition on the death of the survivor. See also *Marriage of Lund* (2009) 174 CA4th 40, 94 CR3d 84 (agreement purporting to convert separate property to community property will not be interpreted as being effective only if parties are still married when one of them dies).

A testamentary declaration may not only be unwise but may be ineffective as well. For example, a unilateral testamentary declaration that property held in joint tenancy is in reality community property does not empower the testator to pass the property by will. In *Estate of Kennedy* (1982) 135 CA3d 676, 185 CR 540, the testator's detailed and unequivocal declaration of intent to pass her joint tenancy interest to her daughter instead of to her cotenant husband did not defeat the husband's survivorship interest. See also *Aguilar v Aguilar* (2008) 168 CA4th 35, 85 CR3d 193, invalidating a purported lifetime transfer of a community property interest in a residence by the surviving settlor of a jointly settled trust that expressly provided that the trust became irrevocable on the death of the first spouse to die.

If there is a dispute after the testator's death between the estate and an individual who owned a piece of property with the testator, a unilateral declaration by the testator in the will would not be nearly as effective in clearing up the dispute as a written ownership agreement signed by the testator and the co-owner. Now that the summary procedures for passage of property to a surviving spouse or registered domestic partner are available regardless of the character of the property (see Prob C §§13500-13502; Fam C §297.5), a declaration in the will about the character of marital or partnership property makes even less sense.

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§10.11B B. Using Property Ownership Agreement

Rather than relying on a unilateral testamentary declaration, the testator may enter into a written property ownership agreement with the other party whenever there is any potential issue about the proper characterization of property. If the testator's estate includes substantial separate or quasi-community property, it is helpful if facts establishing the characterization are included, *e.g.,* "In 1951, I inherited from my aunt who died in Oklahoma 6 shares of *ABC* and 100 shares of *XYZ,*" or "In 1954, when we became California residents, we owned 100 shares of *ABC* and 200 shares of *XYZ,* which we acquired with our earnings while we were residents of Vermont." This will increase the probability that the characterization in the agreement will be later accepted by all interested parties, including the Internal Revenue Service. The necessity of such an agreement will depend on circumstances and the relevance of the characterization to the intended dispositive scheme. A property ownership agreement may be particularly important in situations when there are children from a previous marriage or domestic partnership and the testator has a second spouse or domestic partner.

Some practitioners believe that because of conflict issues that may be inherent in characterization of property between spouses or domestic partners, the attorney should participate in this process only if conflict of interest disclosures are made and written consent of the clients is provided under Cal Rules of Prof Cond 3-310 (avoiding representation of adverse interests). See §§1.21-1.32. Some practitioners also believe that characterization of property is often unnecessary in situations when the characterization of the property will have no effect on distributions. If property characterization will be particularly complex (as may be the case if there has been commingling, community property improvements to separate property, or community services provided in the conduct of a business that was originally separate property) the effort to characterize property interests may be divisive and expensive. It may also expose the practitioner to a malpractice suit if the settlors later dissolve the marriage or domestic partnership and the family lawyers believe the characterizations were erroneous.

There are no required formalities for such an agreement, although the signatures should be notarized if the agreement will be recorded. The agreement may be in the form of a letter, or it may be drawn as a formal agreement. If the testator's attorney drafts the agreement, the other affected parties should be advised to have the agreement reviewed by their own independent counsel before execution. A property agreement between spouses or domestic partners that does not provide for equal ownership may be subject to strict scrutiny in the event of dissolution. See Fam C §§721, 1500-1620. See also *Marriage of Bonds* (2000) 24 C4th 1, 27, 99 CR2d 252.

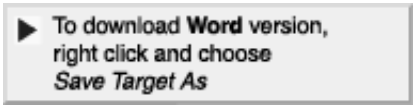
NOTE: For registered domestic partners, the standards relating to marital agreements generally apply to the enforcement of any agreement entered into after the partners filed a declaration of domestic partnership with the Secretary of State. See Fam C §297.5(k)(1). The attorney must remember that any net gift resulting from the application of a partnership agreement providing for equal ownership of assets acquired with unequal amounts of separate property may be a taxable gift, because domestic partners are not treated as spouses for purposes of the IRC §2056 estate tax marital deduction or IRC §2523 gift tax marital deduction. However, it is unclear whether the acquisition of partnership assets with community property earnings will be treated as a transfer by the earning partner for federal estate and gift tax purposes.

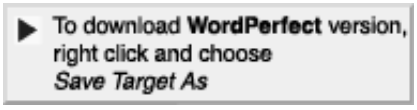
For a form of property agreement providing that all property is separate property except as provided in the agreement, see §10.11C. For further discussion of this approach and other provisions of a complete form of property agreement, see California Marital Settlement and Other Family Law Agreements, chap 18 (3d ed Cal CEB 2005).

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.11C C. Form: Marital or Domestic Partnership Property Agreement

§10.11C C. Form: Marital or Domestic Partnership Property Agreement





10.11C-1 Purpose of property agreement

The purpose of this agreement between _ _[*name of testator*]_ _ **(**_ _[*Husband/Wife/First Spouse/First Partner*]_ _**) and** _ _[*name of testator's spouse or domestic partner*]_ _ **(**_ _[*Wife/Husband/Second Spouse/Second Partner*]_ _**) is to define the parties' respective property rights. Specifically, it precludes the creation of any community property, except as it expressly provides. The parties intend by this agreement to change the characterization (as community or separate property) or ownership of property they own.**

10.11C-2 Disclosures of property and financial obligations

Exhibit _ _[*e.g., A*]_ _ **is a list of the property in which** _ _[*Husband/Wife/First Spouse/First Partner*]_ _ **has an interest with a value exceeding** _ _[*e.g., $500*]_ _**, along with the extent and value of each such interest, and of** _ _[*his/her*]_ _ **financial obligations that exceed** _ _[*e.g., $500*]_ _**, along with the amount of each such financial obligation.**

Exhibit _ _[*e.g., B*]_ _ **is a list of the property in which** _ _[*Wife/Husband/Second Spouse/Second Partner*]_ _ **has an interest with a value exceeding** _ _[*e.g., $500*]_ _**, along with the extent and value of each such interest, and of** _ _[*his/her*]_ _ **financial obligations that exceed** _ _[*e.g., $500*]_ _**, along with the amount of each such financial obligation.**

10.11C-3 All property to be separate property

All property of either party will be entirely _ _[*his/her/his or her*]_ _ **separate property except as provided in paragraph(s)** _ _[*numbers(s)*]_ _**. The parties acknowledge that, as a result of this agreement, certain assets and interests that would otherwise have been the parties' community property, belonging equally to each of them, will be one party's separate property. These include, but are not limited to,** _ _[*e.g., earnings resulting from the efforts of either party during marriage and before separation; assets acquired with such earnings; increased values in separate property resulting from the application of such earnings, or from the efforts of either party, during marriage and before separation; certain assets or interests acquired by loan or extension of credit during marriage and before separation; and certain commingled funds*]_ _**.**

10.11C-4 Waivers of joint and survivor annuities and survivor benefits

Each party understands that he or she may become entitled, under federal law or the terms of the other's retirement plan, to receive a joint and survivor annuity or survivor benefits under that plan on the other's death. Each party hereby waives all of his or her rights to such benefits; consents to the designation by the other party of any beneficiaries and to any subsequent change of beneficiaries without the waiving party's further waiver or consent; acknowledges his or her awareness that this waiver may result in his or her loss of joint and survivor annuity or survivor benefits; and agrees to execute before a plan representative or notary public all necessary waivers and consents requested by the other party within the time periods specified by law for these waivers to be effective.

10.11C-5 Joint accounts and other community property

The parties will maintain at least one joint account in both their names, from which joint living expenses will be paid. "Joint living expenses" include, but are not limited to _ _[*e.g., food at home, household supplies, utilities, telephone, laundry and cleaning, joint entertainment, and joint gifts to third parties*]_ _**. The parties will contribute to such accounts the amounts needed for their joint expenses. Contributions will be** _ _[*equal/in proportion to the parties' respective gross incomes. The parties will fully disclose their incomes to each other in order to carry out the apportionment of contributions to joint expenses*]_ _**.**

Despite any other provision of this agreement, the following will be the parties' community property:

(a) All amounts deposited into the joint accounts, including any increases in those amounts; and

(b) Any property acquired with amounts withdrawn from the joint accounts, including, but not limited to, any income produced by the property, increases in its value, and proceeds from its sale.

[(c) Personal residence at _ _[*address*]_ _]

[(d) _ _[*Specify other property*]_ _]

10.11C-6 Gifts made to parties jointly

Despite any other provision of this agreement, gifts made to the parties jointly will be their community property.

10.11C-7 Gifts and other transfers between parties

Any gift between the parties of clothing, wearing apparel, jewelry, or other tangible articles of a personal nature that is used solely or principally by the party to whom the gift is made and that has a value, at the time of the gift, of less than _ _[*dollar amount*]_ _ will be valid without the requirement of a writing and will be the separate property of the recipient. Other gifts and transfers between the parties will be valid only if accompanied by an express declaration in writing that is made, joined in, consented to, or accepted by the party whose interest in the property is adversely affected.

10.11C-8 Transmutation of one spouse's separate property to community property

The assets listed in Exhibit _ _[*e.g., C*]_ _ are separate property assets of _ _[*Husband/Wife/First Spouse/First Partner*]_ _ that are hereby transmuted by this agreement to community property assets of the parties.

10.11C-9 Transmutation of community property to one spouse's separate property

The assets listed in Exhibit _ _[*e.g., D*]_ _ are community property assets of the parties that are hereby transmuted by this agreement to separate property assets of _ _[*Wife/Husband/Second Spouse/Second Partner*]_ _.

10.11C-10 Transmutation of one spouse's separate property to separate property of the other spouse

The assets listed in Exhibit _ _[*e.g., E*]_ _ are separate property assets of _ _[*Husband/Wife/First Spouse/First Partner*]_ _ that are hereby transmuted by this agreement to separate property assets of _ _[*Wife/Husband/Second Spouse/Second Partner*]_ _.

10.11C-11 Debts

Each debt existing as of the effective date of this agreement will be the separate debt of the party who incurred it. Each debt incurred on or after the effective date of this agreement, including credit cards, charge accounts, and other loans or extensions of credit, will be the separate debt of the party who incurred it unless the parties acquire the debt in their joint names.

Comment: To meet the requirements of Fam C §852, the agreement must contain language expressly stating that the characterization or ownership of property is being changed. See form 10.11C-1.

In property agreements between spouses or domestic partners, the parties are under a duty of the highest good faith and fair dealing, requiring that neither take any unfair advantage of the other. Fam C §721(b). A fair and reasonable disclosure of property and financial obligations will be a significant step in fulfilling this duty. See form 10.11C-2.

The waiver in form 10.11C-4 will be effective only if certain requirements, including the execution of specified forms available from the plan administrator, are met. The waiver may not be necessary for same-sex spouses or registered domestic partners, because same-sex spouses and domestic partners treated as spouses under California law are not

considered spouses entitled to a qualified joint and survivor annuity interest in qualified retirement plan benefits for purposes of federal law. See 1 USC §7 (discussed in §3.34).

The provision in form 10.11C-3 is the essence of any property agreement designed to preclude the unintended creation of community property by operation of law. Such a provision can change earnings during a marriage or domestic partnership and before separation, and assets acquired with such earnings, from community to separate property. Any exceptions to the preclusion of community property should be set out in separate provisions. This provision should include a cross-reference to those provisions. See, *e.g.,* forms 10.11C-5 (joint accounts and other community property), 10.11C-6 (gifts made to parties jointly). Forms 10.11C-8, 10.11C-9, and 10.11C-10 specify the various transmutations of community and separate property involved in the agreement.

Under California law, spouses and domestic partners may transmute community property to separate property of either spouse, separate property of either spouse to community property, or separate property of one spouse to separate property of the other spouse. Fam C §297.5, 850. To be valid, such a transmutation generally requires a writing. Fam C §852(a). See *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153; *Estate of Bibb* (2001) 87 CA4th 461, 104 CR2d 415. The writing requirement is not subject to the "part performance" exception that may apply under the more general CC §1624 statute of frauds. *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471. In *Benson*, the husband claimed that the transfer of a separate property residence to a trust benefiting the wife was in exchange for the wife's promise to relinquish her interest in his retirement plan. The writing requirement does not apply, however, to a gift between spouses of clothing, wearing apparel, jewelry, or other tangible articles of a personal nature used solely or principally by the recipient and not substantial in value, taking into account the circumstances of the marriage. Fam C §852(c).

Including a provision like form 10.11C-7 in the agreement may clarify the law for the parties. Further, substituting a maximum dollar amount for the requirement that an item not be substantial in value, taking into account the circumstances of the marriage, may simplify understanding and implementation of the provision. Selecting a relatively low dollar amount may serve to avoid litigation over whether a gift was intended by requiring a writing in most instances.

Under Fam C §910, the community estate is normally liable for debts incurred by either spouse or partner, either before or during the marriage or domestic partnership, regardless of whether one or both spouses or partners are parties to the debt. Form 10.11C-11 is designed to ensure that the only debts for which the property of both parties might be liable will be those incurred jointly. If the parties wish to make any exceptions, they should specify them.

For discussion of the pros and cons of characterizing property during estate planning, see §10.11B.

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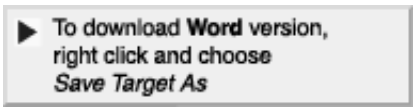
§10.11D D. Statement of Intention Concerning Forced Election

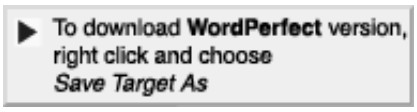
In some cases the provisions of a will may appear to force a surviving spouse or registered domestic partner to elect between the survivor's rights in community and quasi-community property under Prob C §§100-101 and the benefits of the will. This is particularly a concern if the will purports to dispose of a particular item of property that is community or quasi-community property. To avoid ambiguity and also to remind the drafter and client of the potential issues, many drafters routinely include a clause clarifying the testator's intentions. In most cases the testator will not intend to force an election with respect to community property, although forced elections are sometimes used to deter a claim that the survivor has a community property interest in a farm or other business that has separate property origins. Problems more frequently occur with quasi-community property, because it is the separate property of the testator until the testator dies domiciled in California and the testator may be unaware of the consequences of California domicile. Accordingly, the owner of the quasi-community property may indeed want to force an election. A forced election may also be desired in cases in which the testator wants to be sure that the spouse or partner will not be able to set aside an inter vivos gift under Fam C §1101 or Prob C §102 or a nonprobate transfer under Prob C §5021. More rarely a forced election provision is used to deter applications for such things as family allowance and probate homesteads under Prob C §§6500-6545. The forms in §§10.11E (spouse) and 10.11F (registered domestic partner) are suitable for denying an intention to force an election. The clause is often unnecessary if substantially all of the estate will pass to the testator's spouse or registered domestic partner. When the drafter intends to force an election, it is necessary to draft a custom provision that expressly states what rights the spouse or partner must surrender to receive the benefits of the will.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.11E E. Form: Confirmation of Marital Property Rights

§10.11E E. Form: Confirmation of Marital Property Rights





10.11E-1 Confirmation of marital property rights

***Confirmation of Marital Property Rights*. No provision of this will is intended to force my spouse to make an election between the benefits of this will and any rights my spouse may have to shares of community and quasi-community property under California Probate Code §§101(a) and 102(a).**

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.11F F. Form: Confirmation of Domestic Partnership Property Rights

§10.11F F. Form: Confirmation of Domestic Partnership Property Rights

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

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

10.11F-1 Confirmation of domestic partnership property rights

***Confirmation of Domestic Partnership Property Rights*. No provision of this will is intended to force my domestic partner to make an election between the benefits of this will and any rights my domestic partner may have to shares of community and quasi-community property under California Probate Code §§101(a) and 102(a).**

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VI. "NO-CONTRACT" CLAUSE

§10.12 A. Will Contracts

Will contracts generally take one of two forms:

(1) A contract between parties not to revoke their existing wills; or

(2) A contract between parties to dispose of their property in a certain manner by will.

Probate Code §21700 is the primary statutory basis for will contracts. The use of a will contract is seldom desirable. See §§1.8-1.15. A surviving spouse or domestic partner should be able to change his or her will without fear of a will contest or protracted litigation.

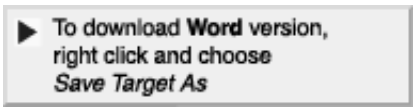
Often, spouses or domestic partners execute "mirror-image" wills but do not intend any contract to arise preventing the survivor from changing his or her will. Form 10.13-1 makes this intent clear. If inserted in a will, the clause may prevent problems with beneficiaries who have been deleted by a later change in either will. Although Prob C §21700(b) provides that a joint will (one will executed by both spouses or domestic partners) or mutual wills (separate wills with similar or reciprocal provisions) do not create a presumption of a contract not to revoke the will or wills, it is still advisable for the testators to make their intent explicit in this regard. At least one court has held that a will contract need not be in writing despite the requirement of "a writing signed by the decedent evidencing the contract" in Prob C §21700(c). *Estate of Murphy* (Dec. 21, 2001, H022492) 2001 Cal App Unpub Lexis 477, 2001 WL 1640734 (opinion not certified for publication).

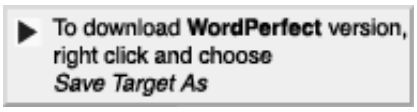
Even if the clients are not spouses or domestic partners, the will drafter should include a clause negating the testators' intent to make contractual wills if (1) they have expressed a desire for a will contract but eventually decide against it and (2) there are significant reciprocal provisions in their wills. Form 10.13-1 can be modified for this purpose.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.13 B. Form: No Contract to Make Wills

§10.13 B. Form: No Contract to Make Wills





10.13-1 No contract to make wills

***No Contract to Make Wills*. I have not entered into any contract to make this will and any similarity of the provisions of this will to the provisions of a will of my _ _**[*spouse/domestic partner*]**_ _ shall not be construed as evidence of such a contract.**

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VII. RULE OF CONSTRUCTION FAVORING TESTATOR'S RELATIVES

§10.14 A. Dealing With Possible Impact of Rule Favoring Relatives

In interpreting a will, the paramount rule of construction is that effect must be given to the testator's intent if it can be ascertained. Prob C §21102(a); *Estate of Hartson* (1933) 218 C 536, 24 P2d 171. In *Estate of Goyette* (2004) 123 CA4th 67, 19 CR3d 760, for example, the court held that the term "my money" in a holographic will devising property to the testator's friends and neighbors included bank accounts, treasury bills, and other financial assets. If the testator's intent is uncertain, however, and a will provision is capable of two interpretations one that favors the testator's relatives and the other that favors someone unrelated to the testator, then the interpretation favoring the relatives will be adopted. 14 Witkin, Summary of California Law, *Wills and Probate* §205 (10th ed 2005).

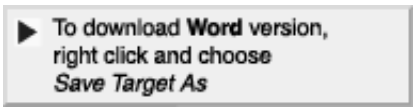
EXAMPLE: In *Estate of Garner* (1964) 228 CA2d 506, 39 CR 577, a dispute arose over the correct interpretation of this provision in the will: "I give and bequeath the sum of Five thousand ($5000) Dollars to the following nieces." The nieces contended that this paragraph meant that $5000 was bequeathed to each of them. The residuary beneficiary contended that $5000 was to be shared among the nieces. Reversing the trial court's judgment in favor of the residuary beneficiary, the court found that the testator's intentions were ambiguous and applied the rule of construction favoring an interpretation preferring relatives.

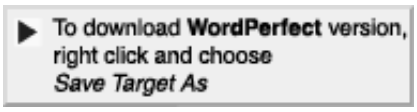
Although this rule of construction approximates the actual intentions of most testators, it is not always appropriate. If a dispute arises concerning conflicting interpretations of a will, some testators may not wish their relatives to be preferred over unrelated beneficiaries. If that is the case, the attorney should discuss with the testator whether the will should express the testator's intent that the rule of construction preferring relatives must never be applied to the will. If the testator decides to include such a provision, form 10.15-1 may be used.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.15 B. Form: Rule Preferring Relatives Inapplicable

§10.15 B. Form: Rule Preferring Relatives Inapplicable





10.15-1 Rule of construction favoring relatives inapplicable

***Special Rule of Construction*. If (1) any provision of my will or of any codicil to it can be interpreted in at least two ways, (2) at least one of the interpretations favors a person related to me and another interpretation favors a nonrelative, and (3) my intentions concerning the provision are unclear, the rule of construction giving preference to the interpretation favoring my relative shall play no part in determining the correct interpretation of the provision.**

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/ VIII. FUNERAL AND BURIAL INSTRUCTIONS/§10.16 A. Written Instructions Strongly Recommended

VIII. FUNERAL AND BURIAL INSTRUCTIONS

§10.16 A. Written Instructions Strongly Recommended

If a client has strong preferences about the manner in which his or her remains should be disposed or about the nature of funeral services, the attorney should advise him or her to investigate and take advantage of pre-need plans offered by many funeral establishments and cemeteries. By contracting for such a plan, the client can personally design and pay for funeral and burial arrangements. This not only relieves the executor, family, and friends of the burden of making these arrangements, but it eliminates the possibility that the client's wishes will be ignored.

A client who contracts for such a plan should give a copy of the contract to the individual who has the right to control the disposition of the client's remains. To make doubly sure that duplication of arrangements and payments will not occur, the client's will or durable power of attorney for health care (see §3.55) should mention that he or she has made funeral and burial arrangements. See form 10.17-1.

If a client has preferences about funeral and burial matters but does not wish to take advantage of a pre-need plan or cannot find a satisfactory one, the client should at least express those preferences in the form of written directions. Unless there is a statement to the contrary that is signed and dated by the decedent, such written directions may not be altered in any material way, except as required by law, if the directions are complete and unambiguous and the costs of the disposition and funeral goods and services to be provided are properly set aside. See Health & S C §7100.1(a).

If the decedent has not given directions under Health & S C §7100.1, the following persons, listed by order of priority, have the right to control the disposition of the decedent's remains and to arrange for funeral goods and services to be provided (Health & S C §7100):

(1) An agent under a power of attorney for health care (PAHC) (see §§3.49-3.58);

(2) The competent surviving spouse or registered domestic partner;

(3) The sole surviving competent adult child, or a majority of the surviving competent adult children. A minority may be vested with the right if they have used reasonable efforts to notify all other surviving competent adult children of their instructions and are not aware of any opposition to those instructions on the part of one-half or more of all surviving competent adult children;

(4) The surviving competent parent or parents. If one of the surviving parents is absent, the remaining parent may be vested with the right after reasonable efforts to locate the absent surviving parent have been unsuccessful;

(5) The surviving competent adult person or persons in the next degrees of kindred; and

(6) The public administrator when the deceased has sufficient assets.

If the client does not have a PAHC and this order is unacceptable to the client or there is a substantial risk that the client's children might not be able to agree on funeral arrangements, written instructions about who should have the right to control the disposition of remains are essential. This point cannot be made strongly enough for a client in a same-sex relationship that is not a marriage or registered domestic partnership.

EXAMPLE: A gay man is in a long-term partnership, which his out-of-state parents find completely unacceptable. The partners have not filed a declaration of domestic partnership with the California Secretary of State. The man dies, leaving his partner everything, but does not leave instructions about disposition of his remains. Under Health & S C §7100, his parents have the right to control disposition of the remains. They arrange for the remains to be flown to their hometown, where services and burial take place, and exclude the partner from participation. An advance health care directive or a set of written instructions giving the partner the right to control the disposition of remains would have protected him from the emotional distress inflicted by the parents. See form 10.17-1.

Some will drafters place funeral and burial instructions in the will because nontestamentary instructions are easily misplaced and because, for survivors, the will is a natural place to look for postdeath instructions. If funeral and burial instructions are left in a will, they must be carried out immediately, regardless of the will's validity in other respects or of

the fact that the will may not yet have been admitted to probate. Health & S C §7100.1(c). Additionally, if funeral or burial instructions are left in the will, and the will is kept in a safe-deposit box, counsel should advise survivors regarding compliance with Prob C §331, which covers the requirements of obtaining the contents of a safe-deposit box. Other attorneys prefer funeral and burial instructions to be in a document that is independent of the will. If the will includes such instructions and is kept in a safe-deposit box, the instructions may not be immediately available for survivors to consult. Further, the testator may wish to share the funeral and burial instructions with family or friends but may not wish the other contents of the will to be revealed until after his or her death.

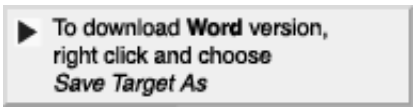
Regardless of where the written instructions are placed, the attorney should be careful that they do not conflict with any instructions that have been included in the client's durable power of attorney for health care. See CC §2434(b); §3.55. The client should ensure that the person he or she wishes to be in charge of the funeral and burial arrangements knows where the instructions are kept and has access to them.

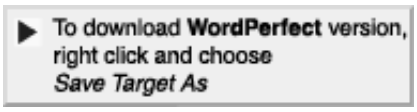
NOTE: If the testator wishes to dispose of all or parts of his or her body for research, transplantation, or educational purposes, he or she should follow the provisions of the Uniform Anatomical Gift Act (Health & S C §§7150-7156.5). Because an anatomical gift requires immediate action by all concerned at the donor's death, it is not wise to make the gift in a will that may not be accessible when the donor dies. Instead, the durable power of attorney for health care (see §3.56) or the small preprinted form distributed by the Department of Motor Vehicles may be used. The testator should inform his or her family regarding donative intentions, since many physicians will not remove organs or make other anatomical dispositions, even if the testator has left written instructions regarding donative intent, unless the next of kin authorizes the physician to do so.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.17 B. Form: Funeral and Burial Instructions

§10.17 B. Form: Funeral and Burial Instructions





10.17-1 Funeral and burial instructions

[*Add one of the following alternatives*]

[*Alternative 1: Prepaid funeral and burial arrangements*]

I have made and paid for funeral and burial arrangements with _ _[*name of company*]**_ _ I direct my executor to take all steps necessary to carry out these arrangements.**

[*Alternative 2: Funeral and burial directions*]

I direct that _ _[*e.g., my remains be cremated and my ashes scattered at _ _*[*name of location*]*_ _. I desire that any services held in my memory be simple*]**_ _. I authorize _ _**[*name*]**_ _ to carry out all these directions and wishes, particularly those for disposition of my remains.**

Comment: Burial instructions may be included in a separate clause of a will, although some attorneys consider them more appropriate for inclusion in another document. See §10.16 on requirements for funeral directions under Health & S C §7100.1.

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Source: Estate Planning/California Will Drafting/10 Getting Started: Introductory Clauses/§10.18 C. Devises for Care of Monument or Burial Plot

§10.18 C. Devises for Care of Monument or Burial Plot

Unless a devise for the upkeep and maintenance of a burial plot or monument is properly structured, it will violate the rule against perpetuities. *Estate of Pfund* (1949) 93 CA2d 444, 209 P2d 52. At best, the recipient of the devise will be able to carry out the testator's purposes for only 21 years. Prob C §15211. See §7.15.

There are three possible means for the testator to get around the rule against perpetuities:

(1) The devise may be properly limited in duration so that it meets the requirements of Prob C §21205. See §§34.6-34.8.

(2) The devise may be made in trust to an "endowment care fund" of a cemetery for the care, improvement, repair, or ornamentation of a plot or monument. Such devises are deemed for charitable purposes under Health & S C §8776 and do not violate the rule against perpetuities.

(3) The testator may give the devise to a charitable organization for use as its governing board determines, but he or she may condition the devise on the organization's agreement to maintain and care for the testator's burial plot or monument.

If there is no requirement that any of the devise be used for maintenance of the plot or monument and the organization does not use any of the devise for such maintenance, the devise is exempted from the prohibition of the rule against perpetuities as a charitable gift. See *Estate of Campbell* (1971) 20 CA3d 474, 97 CR 726.

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§10.19 IX. DIRECTIONS FOR PAYMENT OF DEBTS

Probate Code §§11400-11446 provide a statutory framework for paying the debts of a decedent. Accordingly, a general provision in a will directing that all debts be paid is superfluous. An executor is under a duty to use the testator's property to pay the testator's debts regardless of the presence or absence of a provision in the will directing payment of debts. Moreover, such a provision may revive a debt that was somehow previously barred, *e.g.,* by a statute of limitations.

A will provision directing payment of debts, expenses, and taxes may have unforeseen effects on the apportionment of estate taxes.

EXAMPLE: In *Estate of Warren J. Shannon,* TC Memo 1990-614, the decedent's will gave a piece of farmland to his wife for life with the remainder to their children. The residue was left to the spouse. The will also provided:

> I direct that my representative … pay all my just debts, funeral expenses, expenses of last illness, expenses of administration, inheritance and estate taxes as soon after my death as may be convenient.

The estate, applying the Minnesota apportionment law, claimed a marital deduction for the residuary gift.

On audit, the Internal Revenue Service assessed a deficiency, claiming that the provision overrode the state's tax apportionment statute and caused the residue to be charged with the estate tax attributable to the life estate property, thereby reducing the marital deduction. Although the tax court ultimately ruled in the estate's favor, this litigation could have been avoided if the attorney had not put in the will the superfluous boilerplate directive to pay debts and taxes.

For extensive discussion of abatement concerns, see §§12.3-12.6. On death tax clauses, see chap 26.

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11

Exercising Powers of Appointment

CEB Staff

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§11.1 I. POWERS NOT CREATED BY TESTATOR

A power of appointment, which can be created in a variety of ways, is a power to dispose of specific property. This chapter discusses only a testator's exercise of a power of appointment created by someone else. The testator's creation of a power of appointment is discussed in detail in chap 16.

NOTE: In this chapter, the testator is the donee of a power; in chap 16, the testator is the donor of a power.

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II. WHEN POWER MAY BE EXERCISED

§11.2 A. Instrument Creating Power Controls Its Exercise

If the instrument creating a power of appointment specifies the manner, time, and condition for exercise of the power, any exercise not complying with those requirements is usually invalid. Prob C §630(a). Under Prob C §631, a court can sometimes excuse full compliance if the manner of appointment approximates the manner prescribed and the failure to satisfy the formal requirements does not defeat the accomplishment of a significant purpose of the donor. See *Catch v Phillips* (1999) 73 CA4th 648, 86 CR2d 584. However, the court cannot excuse compliance with a requirement of specific reference to the power. Prob C §632. See §11.3. Thus, the attorney should carefully review and follow the requirements for exercise set forth in the creating instrument.

Unless the creating instrument expressly prohibits it, a power of appointment created to be exercised inter vivos can also be exercised by a written will. Prob C §630(b); *Rosenauer v Title Ins. & Trust Co.* (1973) 30 CA3d 300, 106 CR 321.

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§11.3 B. Exercise by Specific Reference to Power

The clearest way to exercise a power of appointment is to execute a writing that specifically refers to the document creating the power, its date of execution, and the type of power being exercised. The document exercising the power should also identify the proposed disposition, any contingencies affecting the exercise, and takers in default of appointment. In *Estate of Eddy* (1982) 134 CA3d 292, 184 CR 521, the court held that the general language in a donee's will was insufficient to exercise a power of appointment because the creating instrument required specific reference to the power in the donee's will or codicil. The attempted exercise referred only to "any property over which I have a power of appointment."

A general residuary clause in a will, or a will making a general disposition of all the testator's property, does not exercise a power of appointment held by the testator unless specific reference is made to the power or the donee's intent to exercise the power. Prob C §641(a). See §11.4 for discussion of Prob C §640(a) and manifestation of intent to exercise a power.

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§11.4 C. Manifestation of Donee's Intent to Exercise Power

The instrument of exercise of a power of appointment should clearly and explicitly state whether or not the donee will exercise a power of appointment. When the donee does not specifically reveal his or her intent, the court must determine under Prob C §640 whether the donee intended exercise of the power of appointment. Probate Code §640(b) lists three nonexclusive examples of indications of intent:

(1) The donee declares, in substance, that he or she exercises the specific power or all powers that he or she has. Prob C §640(b)(1). See Restatement (Second) of Property, Donative Transfers §17.2 (1977).

(2) The donee purports to transfer an interest in the appointive property to which the donee would not otherwise have a right of disposition. Prob C §640(b)(2). See Restatement §17.4.

(3) The donee makes a disposition that, in light of surrounding facts and circumstances, manifests the understanding that he or she is appointing the property subject to the power. Prob C §640(b)(3); *Childs v Gross* (1940) 41 CA2d 680, 107 P2d 424; *Reed v Hollister* (1919) 44 CA 533, 186 P 819. See Restatement §17.5.

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III. TYPES OF APPOINTMENT

§11.5 A. Exercise of General Power

Under Prob C §650(a), the donee of a general power of appointment may either appoint all the property at one time or make several partial appointments at different times if the power is exercisable inter vivos. In exercising a general power by an inter vivos instrument or by a will, the donee may (1) create present or future interests, or both, subject to conditions, charges, or otherwise lawful restraints on alienation; and (2) make appointments outright, in trust, or by creating new powers of appointment. Note that the description in Prob C §650(a) of how the donee may appoint is illustrative, not exclusive. Prob C §650(b).

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Source: Estate Planning/California Will Drafting/11 Exercising Powers of Appointment/§11.6 B. Exercise of Limited or Special Power

§11.6 B. Exercise of Limited or Special Power

Unless the donor puts limits on the power, the donee of a special power of appointment (see §16.27) may make any of the types of appointment that a donee of a general power may make under Prob C §650. Prob C §651. See §11.5. All powers, however, are subject to the rule against perpetuities. See §11.17.

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IV. INCORRECT OR INCOMPLETE EXERCISE OF POWER

§11.7 A. Exercise Beyond Scope of Power

The exercise of a power of appointment that extends beyond the scope of the power outlined in the will is given effect to the extent that the exercise is permissible under the terms of the power. Prob C §670. The excess is mere surplusage. The disposition of the property should be determined by common law principles. Section 670 does not cover a fraud on a special power, which occurs when the exercise is for an unauthorized purpose, the potential beneficiaries of the power are not permissible appointees, or the donee directly or indirectly attempts to benefit personally from the power. See generally Restatement (Second) of Property, Donative Transfers §20.2 (1977). See also *Horn v Title Ins. & Trust Co.* (SD Cal 1948) 79 F Supp 91.

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§11.8 1. Imperative Power

An imperative power of appointment (see definition in §16.4) must be exercised, and the donee must comply with all the donor's commands. Unless contrary to the creating instrument or the donee's written intent, the rules in Prob C §671(a) apply, as described below:

- If the donee dies without having exercised an imperative power, the permissible appointees share the property not already appointed equally.
- If a minimum distribution is required, the appointees must receive the specified property. If they do not, all appointees who have received a partial appointment must return a prorata portion of that property in an amount sufficient to meet the minimum distribution requirement.

For example, if Appointee 1 of five permissible appointees must receive 40 percent of the property and the donee makes no appointment, each of the five appointees would receive 20 percent of the property but for the specific provision for Appointee 1. Thus, Appointees 2-5 must each relinquish 5 percent of their property to Appointee 1 to make 40 percent (20 percent received as an equal share and 20 percent from the remaining permissible appointees).

Probate Code §635 authorizes a court of competent jurisdiction to remedy a defective exercise of an imperative power of appointment. See also Prob C §671(b).

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§11.9 2. Discretionary Power

If the donee of a discretionary power (see definition in §16.4) fails to appoint the property, makes an ineffective appointment in whole or in part, or releases the entire power, the property not effectively appointed goes to the takers in default or reverts to the donor if there are no takers. Prob C §672(a). An exception to this general rule appears in Prob C §672(b), which provides that when the donee of a general power of appointment makes an ineffective appointment, an implied alternative appointment to the donee's estate may be found if the donee intended the appointive property to be disposed of as the donee's property rather than as property in default of appointment. The Restatement views the donee's assumption of control over appointive property or a "blending" of the donee's property with property subject to the power as a manifestation of the donee's intent to dispose of appointive property as his or her own. See Restatement (Second) of Property, Donative Transfers §23.2 (1977).

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§11.10 3. Antilapse of Appointment

A doctrine similar to the antilapse statutes (see §§12.16-12.18) is applied to general and special powers of appointment made by will or by an instrument effective only at the donee's death. If the appointee dies before the appointment becomes effective and leaves issue surviving the donee, then the issue (whether or not related to donor or donee) is permitted to take the appointed property. Prob C §673(a). This rule applies only when the donor or donee has not shown a contrary intent. Prob C §673(b). Eligible persons are restricted to "permissible appointees."

PITFALL: If the donor or donee does not want the antilapse provisions of Prob C §673 to apply, the instrument creating or exercising the power should make this clear, and some other disposition of the appointive property should be made.

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Source: Estate Planning/California Will Drafting/11 Exercising Powers of Appointment/§11.11 4. Appointment to Issue of Permissible Appointee

§11.11 4. Appointment to Issue of Permissible Appointee

Probate Code §674 empowers a donee to appoint a special power (see §16.27) to the issue of a deceased permissible appointee who either was alive when the creating instrument was executed or was born afterwards. This section applies whether the power is exercisable by lifetime instrument, by will, or otherwise. It does not apply if the creating instrument contains an express contrary provision.

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§11.12 B. Inadvertent Exercise of Power

Regardless of which type of power of appointment the testator holds, its inadvertent and unplanned exercise can cause serious tax consequences and defeat the testator's intended testamentary plan. For example, inadvertent exercise of the power may pass property to residuary beneficiaries rather than to takers in default whom the testator intended to receive the property.

Inadvertent exercise of a power of appointment may also violate the rule against perpetuities. See §34.26. Inadvertent exercise is less likely in California since the enactment of Prob C §641(a), which provides that a clause in a will that purports to dispose of all the testator's property does not exercise a power of appointment unless specific reference is made to the power or some other indication is shown of intent to exercise the power. See §§11.3-11.4. It may be a problem, however, for the mobile client.

The possibility that a donee will inadvertently exercise a power can be minimized by requiring specific reference to the power in the instrument creating the power of appointment. The drafter of a will for the donor of a power should consider including this requirement in the will. For forms creating a power of appointment, see chap 16.

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V. CAPACITY OF DONEE TO EXERCISE POWER; LIMITATIONS ON EXERCISE

§11.13 A. When Donee Has Capacity to Exercise Power

Not every person holding a general power of appointment has the capacity to exercise it. The capacity required to exercise a general power is the same as that required to transfer the property subject to the power. Prob C §625(a). Thus, a minor generally cannot exercise a power of appointment unless the creating instrument specifically authorizes the minor's exercise under Prob C §625(b). If the creating instrument authorizes lifetime exercise of the power during the donee's minority, however, the donee can make a lifetime exercise of the power and postpone the effective date of the exercise until his or her death, thus eliminating the problem of the minor's lack of capacity to make a valid will.

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§11.14 B. When Consent to Exercise Power Required

Although practitioners generally do not recommend this practice, a donor can require the donee to obtain the consent of the donor or another person to exercise the power. To be effective, the instrument of exercise or a separate written instrument must contain the statement of consent, which must be signed by the person or persons whose consent is required. Prob C §633(a).

If a person whose consent is required dies, the consent requirement is excused unless the donor expressly provides otherwise in the creating instrument. Prob C §633(b)(1). Incompetency of the person whose consent is required does not excuse the donee from obtaining the required consent. The guardian or conservator may consent on that person's behalf unless the creating instrument expressly prohibits this action. Prob C §633(b)(2).

The required consent may be given before or after exercise of the power. Prob C §633(b)(3). To be "recorded," the consent must be acknowledged and certain formalities must be complied with. See Govt C §27287. See California Real Property Sales Transactions, chap 10 (4th ed Cal CEB 2007) for requirements of a valid deed.

It is difficult to understand why the donor would give the donee a power of appointment and then insert a provision in the creating instrument requiring another person's consent.

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§11.15 C. Exercise of Power by Donee's Will Executed Before Creation of Power

Under Prob C §642, a donee can exercise a power of appointment by a will executed before creation of the power, if the power exists at the date of the donee's death. (Probate Code §642 states the rule contained in Restatement (Second) of Property, Donative Transfers §17.4 (1977). Under this rule, a power created and exercisable by a will is not considered to exist at the donee's death if the donee predeceased the donor.) This rule applies unless (1) the creating instrument shows an intent that a previously executed will may not exercise the power or (2) the will shows an intent not to exercise a power acquired later. *Estate of Cox* (1970) 8 CA3d 168, 87 CR 55.

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Source: Estate Planning/California Will Drafting/11 Exercising Powers of Appointment/§11.16 D. Contracts to Appoint Property

§11.16 D. Contracts to Appoint Property

The donee of a presently exercisable power of appointment can contract to appoint the property subject to the power to the same extent that the donee can make an effective appointment. Prob C §660(a). When the power is not presently exercisable, however, the donee cannot contract to appoint the property. Prob C §660(b). If a promise to make an appointment under a power that is not presently exercisable is not performed, the promisee under such a contract cannot obtain either specific performance or damages. The promisee is not prevented, however, from obtaining restitution of the consideration given for the promise.

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§11.17 E. Exercise of Power Cannot Violate Rule Against Perpetuities

The permissible period under the rule against perpetuities for interests to be created by exercise of a power of appointment is measured from the date of creation of the power. Prob C §§21206-21207. See *United Cal. Bank v Bottler* (1971) 16 CA3d 610, 94 CR 227. (An exception applies when the donee, acting alone, has a presently exercisable general power of appointment. Under these circumstances, the permissible period begins when the appointment becomes effective. Prob C §21211.) Thus, the general rule applies to a special power of appointment and to a testamentary general power of appointment whether exercisable alone, jointly with one or more other persons, or with the consent of any other person. The rule against perpetuities is discussed in chap 34. See §34.22 on operation of the general rule.

The rule against perpetuities will not be applied on a theoretical basis. Although the rule might have been violated, if the facts and circumstances existing when the power is exercised lead to the conclusion that the rule has not been violated, the rule will not invalidate the appointment. This "second-look doctrine" is discussed in §34.23.

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VI. RELEASE OF DISCRETIONARY POWER

§11.18 A. When Power May Be Released

Unless the creating instrument provides otherwise, a general or special discretionary power of appointment generally can be released, in whole or in part, either with or without consideration. Prob C §661(a)-(b). A release of a power of appointment usually favors the takers in default. On tax consequences of release of a power of appointment, see §§11.23-11.26.

The release may apply to all or part of the property, and the permissible appointees may be reduced or limited. If the power was not originally imperative, a partial release will not make the remaining power imperative unless this is expressly provided in the instrument of release. A power that is not presently exercisable (see definition in §16.4) may not be released if the donor designated takers in default (see §11.3) who are not all benefited by the release. Prob C §661(b). The statute ensures that release of a power not presently exercisable does not defeat the donor's intent by benefiting some but not all takers in default.

See Prob C §661(c)-(d) for rules on delivery, recordation, and certification of releases.

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§11.19 B. Release and Lapse of Power Compared

For estate and gift tax purposes, release of a post-1942 general power is treated in the same manner as a lifetime exercise of such a power. A lapse is treated as a release except to the extent that the five or five exception applies. IRC §2041(a)(2); Treas Reg §§20.2041-1(d), 25.2514-3(c)(4). See §16.17 for rules on five or five powers. For further discussion of tax consequences, see §§11.23-11.26.

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§11.20 C. Release of Power by Guardian of Estate

The court in which the guardianship of the estate proceeding is pending may authorize or require the guardian of a minor's estate to release, on behalf of the minor, the ward's powers as donee of any general or special power of appointment that is permitted under Prob C §661. Prob C §662. The court may hand down such an order if it determines "that the ward as a prudent person would make the release of the power of appointment if the ward had the capacity to do so." Section 662 also specifies who may petition for a court order and to whom and in what manner notice of the hearing on the petition must be given.

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VII. REVOCATION OF POWER OF APPOINTMENT

§11.21 A. Exercise of Power of Appointment Revocable Unless Expressly Made Irrevocable

Unless the creating instrument or the instrument of exercise provides otherwise, exercise of the power of appointment is revocable if the power to revoke exists under Prob C §15400 or if the interest in the appointive property has not been transferred or has not become distributable under the appointment. Prob C §695(b). See *Estate of Wood* (1973) 32 CA3d 862, 108 CR 522. This rule is generally contrary to the rule on creation of the power, which is that unless the power to revoke is reserved in the creating instrument or is included in a revocable trust, the creation of a power of appointment is irrevocable. Prob C §695(a). Because the donee can create a trust by exercising the power, Prob C §695(b) applies Prob C §15400 (living trust revocable unless expressly declared irrevocable) to this section if the trust is created by the donee during his or her lifetime. Thus, if the donee creates such a trust, it is revocable unless expressly declared irrevocable.

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Source: Estate Planning/California Will Drafting/11 Exercising Powers of Appointment/§11.22 B. Release of Power of Appointment Irrevocable Unless Revocation Reserved

§11.22 B. Release of Power of Appointment Irrevocable Unless Revocation Reserved

The release of a power of appointment is irrevocable unless the power to revoke is reserved in the instrument of release. Prob C §695(c). For procedure on release of a power, see Prob C §661, discussed in §11.18.

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VIII. ESTATE AND GIFT TAX EFFECTS OF EXERCISE OR RELEASE OF POWER

§11.23 A. Lifetime Exercise or Release of General Power

If a general power of appointment created after October 21, 1942, is exercised during the donee's lifetime, the transfer is taxable for gift tax purposes measured by the property's value on the date of transfer. (Value is determined under the same rules as for transfer of property owned. IRC §2031.) An outright appointment to a third person and an appointment in trust by which property rights are transferred to one or more third persons are gift-taxable transfers. IRC §2514(b); Treas Reg §25.2514-3(a). However, a transfer in trust under which the donee retains either a power to revoke the trust or a further power of appointment does not invoke a gift tax.

If a transfer is made to which IRC §2035(a) applies or that creates or reserves interests under IRC §§2036-2038, the value of the property will be included in the gross estate of the donee at the date of death, but the transfer may also constitute a taxable gift. For example, if the donee makes a transfer (whether or not in trust) in which he or she reserves the income for life from the transferred property, but creates a vested remainder in a son or daughter, then transfer of the remainder interest constitutes a taxable gift (IRC §2514(b); Treas Reg §25.2514-3(c)) and the full value of the property at the donee's death will be included in his or her gross estate under IRC §2036 (with credit for the gift tax paid). The partial release of a general power of appointment is a transfer of the property that could be appointed, minus the value of interest retained by the donee that is subject to gift tax. IRC §2511(a); Treas Reg §25.2514-3(c).

When a general power is released or lapses, however, and the trust requires undistributed income to be accumulated and added to principal, the release or lapse of the general power is not a taxable gift if the donee of the power has a special testamentary power of appointment over the trust corpus, because the donee continues to retain dominion and control over the accumulated income. Treas Reg §25.2514-3(c). For discussion of gift taxes on the exercise of special powers, see §11.24. Before creating such a trust, the attorney should consider the income tax consequences. See §16.16.

Also treated as general powers are certain special powers ("first powers") by which the donee by will or specified lifetime disposition creates another power under which vesting of property can be deferred, or its absolute ownership or power of alienation suspended, for a period that can be determined without reference to the date on which the first power was created. IRC §2041(a)(3); Treas Reg §20.2041-3(e). These so-called successive powers, which are apparently invalid under California law, are discussed in §16.30.

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§11.24 B. Exercise or Release of Special Power

The exercise of a special power of appointment over trust income in favor of a person other than the donee of the power is a transfer of the property that could be appointed, minus the value of interest retained by the donee that is subject to gift tax. IRC §2511(a); Treas Reg §§25.2514-1(b)(2), 25.2514-3(c).

However, if a special power is exercised during the donee's lifetime to transfer property in a manner that terminates his or her life estate in the property transferred, then the transfer is subject to gift tax, based on the value of the life estate in the property at the date of transfer. Treas Reg §25.2514-1(b)(2); Rev Rul 79-327, 1979-2 Cum Bull 342. In *Estate of Ruth B. Regester* (1984) 83 TC 1, the court found that the holder of an unrestricted life estate who had a special power of appointment over the trust property made a taxable transfer when she appointed a portion of the trust property. The value of the transfer was the actuarially computed value of the life estate in the property transferred at the date of the transfer. But see *Self v U.S.* (Ct Cl 1956) 142 F Supp 939, in which the court held that a transfer did not result in a taxable gift. In *Robinson v Commissioner* (5th Cir 1982) 675 F2d 774, the court held that the release of a retained special power of appointment constituted a taxable gift of the remainder interest in the property subject to the power.

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§11.25 C. Existence of Power at Donee's Death Controls Inclusion in Donee's Estate

The existence of a general power of appointment at the donee's death controls whether the property is included in the donee's estate for estate tax purposes. The value of property subject to a special power of appointment is not included in the donee's gross estate.

A general power of appointment does not exist at the date of the donee's death if the power can be exercised only if a certain contingency occurs during the donee's lifetime (*e.g.,* attaining age 30) and this contingency does not occur during his or her lifetime. However, if an event must occur that is within the donee's control (*e.g.,* giving 30 days' notice before exercise of the power), the property subject to the power is included in the decedent's gross estate whether or not such notice is given. See Treas Reg §20.2041-3(b).

Lack of mental capacity to exercise the power does not generally nullify the power for purposes of the federal estate tax. *Boeving v U.S.* (8th Cir 1981) 650 F2d 493; *Fish v U.S.* (9th Cir 1970) 432 F2d 1278; Rev Rul 75-351, 1975-2 Cum Bull 368. The rule is that taxation of a general power of appointment depends on the existence of the power rather than the capacity to exercise the power. *Williams v U.S.* (5th Cir 1981) 634 F2d 894; *Estate of Gilchrist* (5th Cir 1980) 630 F2d 340; *Alperstein v Commissioner* (2d Cir 1979) 613 F2d 1213.

A minor's incapacity to exercise a power of appointment does not preclude imposition of the estate tax. *Estate of Rosenblatt v Commissioner* (10th Cir 1980) 633 F2d 176; Rev Rul 75-351.

As a result of nonexercise of a testamentary power of appointment, the appointive assets will pass to the takers in default if the creating instrument contains a provision covering default of appointment. See §16.40. In effect, the nonexercise constitutes an exercise in favor of the takers in default. If the power in question is a general power, the appointive assets are included in the donee's gross estate. Treas Reg §20.2041-1(d). Thus, a tax apportionment clause in the donee's will should clearly state whether recipients of assets that are not part of the probate estate must pay their share of the death taxes. See IRC §2207; see also chap 26.

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§11.26 D. Generation-Skipping Transfer (GST) Tax Consequences

If the decedent holds a general power of appointment at death and exercises it by will, the property is included in the donee's gross estate under IRC §§2001-2210. If the donee appoints the property to a grandchild, it is unclear whether the appointment is taxable as a direct skip to the grandchild. If this were the case, the donee of the power would be considered the "decedent" with respect to generation-skipping transfers of property included in his or her gross estate.

The generation-skipping transfer (GST) tax provisions (IRC §§2601-2664) contain no special rules applicable to powers of appointment. See IRC §2652(c). No GST tax should accrue if a decedent grants a general power of appointment to a child and designates a grandchild as the taker in default, because the result for tax purposes would be the same as if the property were devised to the child, who in turn devised it to his or her child. A release or lifetime lapse of a general power of appointment results in a gift-taxable transfer under IRC §§2501-2524. Again, the donee of the power becomes the transferor under the GST tax.

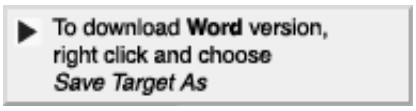
It appears that the appointee of the donee of a special power of appointment, and not the donee, should be the taxable recipient in a taxable termination. IRC §2652(c). This result is consistent with the general concept that the "transfer" is from the donor and not from the donee.

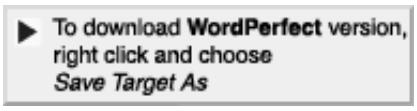
If a person creates a trust to pay the income for life to a grandchild and grants the grandchild a presently exercisable general power of appointment with a gift over in default of appointment to the donee's issue, it is arguable that the transfer is a direct skip under IRC §§2612(c) and 2613(a), because the donee has the power immediately to appoint the property to himself or herself. The GST tax would be due at the time the gift tax or estate tax return is filed. IRC §2662. Thus, all transfers involving grandchildren and a presently exercisable power of appointment should be carefully reviewed. The transferor could incur penalties and interest if a tax is not timely filed and paid.

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IX. POWER EXERCISE FORMS

§11.27 A. Form: Exercise of Testamentary Special Power of Appointment





11.27-1 Testamentary special power of appointment exercised

Under the instrument identified below, I have a testamentary special power of appointment. I exercise this power of appointment by appointing all assets subject to it to the issue of the person identified below who survive me, by right of representation. If no issue of this person survive me, I appoint all assets subject to this power to my issue who survive me, by right of representation.

Instrument creating power of appointment: _ _[*Instrument*]_ _ **Designated person:** _ _[*Name*]_ _

Comment: The drafter should always examine the terms of the power being exercised to determine any limits on the power and the manner of its exercise. This clause refers specifically to the power being exercised. Specific reference to the power is recommended (see §11.3) whether or not the creating instrument requires it (see forms in §§16.37-16.38).

NOTE: Instead of providing that the appointive assets will pass under the residuary clause of the will, this clause provides for a gift over to the testator's issue in case of failure of the designated person's issue. The assumption is that the residue under the testator's will goes into trust. If the assets subject to the power were to become part of the testamentary trust, the interest created might violate the rule against perpetuities because the period of the rule applicable to powers of appointment differs from that applicable to the decedent's estate. See chap 34.

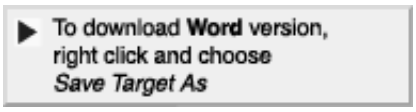
If the testator is survived by neither the designated person's issue nor his or her own issue and the power of appointment is not exercised, the appointive assets will be distributed as provided by the instrument creating the power. This assumes that the creating instrument contains a provision covering default of appointment.

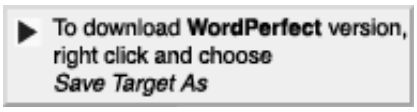
See §11.3 for an example of the potential problems caused by failure to use a clause such as form 11.27-1. On use of the words "by right of representation," see §12.32.

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Source: Estate Planning/California Will Drafting/11 Exercising Powers of Appointment/§11.28 B. Form: Nonexercise of Testamentary Power of Appointment

§11.28 B. Form: Nonexercise of Testamentary Power of Appointment





11.28-1 Testamentary power of appointment not exercised

I decline to exercise the testamentary power of appointment given to me by the instrument identified below.

Instrument creating power of appointment: _ _[*Instrument*]_ _.

Comment: Depending on the circumstances, it may be wise to refer specifically to each power deliberately not exercised, particularly when the residuary beneficiaries and the takers in default are not the same persons. When the testator has children by different spouses, the will provides for the children of only one spouse, and the children of the other spouse are takers in default under other family documents, problems may arise if the drafter and donee do not carefully consider the exercise or nonexercise of the power of appointment. A similar situation may occur when a second spouse has a power of appointment under a marital deduction trust that, if not exercised, gives the property to issue of the predeceased spouse's prior marriage. The use of a qualified terminable interest property trust may be advisable in the latter situation. See chap 19.

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12

Outright Noncharitable Gifts

Martin A. Neumann
Sussan A. Shore

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I. PLANNING OUTRIGHT GIFTS

§12.1 A. Role of Outright Gifts in Will Drafting

Outright gifts are made in almost every will or revocable trust prepared by an attorney. Even when most of the testator's estate is left to a "credit shelter" or "exemption equivalent" trust (see chap 17), at least the testator's personal belongings are given outright under the will or cases under the testator's revocable trust if the will is a pourover will. Outright gifts are frequently used to dispose of entire estates when no death tax problem is anticipated and no beneficiary needs assistance in managing a gift.

Outright gifts are especially appropriate when the testator is concerned that particular assets reach particular beneficiaries, *e.g.,* a gift of the family business to a child active in the business, a gift of the grandmother's wedding ring to the eldest daughter. Outright gifts can also achieve more sophisticated estate planning objectives. For example, the testator can minimize the estate tax payable in both spouses' estates by making a formula marital deduction gift outright or in trust to the testator's surviving spouse in the will or in the testator's revocable trust. (Planning for the unlimited marital deduction is beyond the scope of this chapter, but this issue is covered in chaps 17-20.) Properly drafted outright gifts (direct skips) to younger generation beneficiaries (*e.g.,* grandchildren) may minimize the impact of the generation-skipping transfer (GST) tax. See chap 15.

Disposing of an estate by outright testamentary gifts does not result in probate avoidance. Although under Prob C §§13500-13660 outright gifts to a surviving spouse or registered domestic partner avoid probate administration unless the survivor elects otherwise (see generally California Decedent Estate Practice §§4.40-4.78 (2d ed Cal CEB 2009)), outright testamentary gifts to anyone other than the testator's spouse or domestic partner do not avoid probate unless the requirements of the small estate provisions of Prob C §§13000-13208 are met. The value of a small estate may not exceed $100,000. Prob C §13100. Furthermore, those provisions cannot be used for real property with a gross value of more than $20,000. Prob C §13200. Dispositions of tangible personal property in a writing incorporated by reference under Prob C §6132 also do not avoid probate. See §5.6. The will drafter should discuss with the client alternatives that dispose of assets outside probate, including:

- Lifetime gifts (see California Estate Planning, chap 8 (Cal CEB 2002)) including gifts in trust (see Estate Plan, chap 6A);
- Trustee bank accounts (Totten trusts) or pay-on-death (POD) accounts and transfer on death (TOD) security accounts (see Drafting California Revocable Trusts §§1.35-1.36 (4th ed Cal CEB 2003));
- Joint tenancies (see Estate Plan, chap 7; Revocable Trusts §1.34; see also §§3.34-3.35);
- Revocable trusts (see Estate Plan, chap 6; see also §§3.32-3.33, 3.38-3.44); and
- Pay-on-death beneficiary designations (see Prob C §5000; see also 14 Witkin, Summary of California Law, *Wills and Probate* §108 (10th ed 2005).

Complete discussion of probate avoidance alternatives is outside the scope of this book. However, for many clients with no real property, POD and TOD accounts can eliminate the need to use a revocable trust for probate avoidance. These clients can use a will to make modest outright gifts of money or personal property to anyone. For additional discussion of property not subject to probate administration, see Decedent Estate Prac, chap 2.

NOTE: Outright testamentary gifts cannot be made directly to a minor beneficiary. For alternatives available to a testator who wishes to provide for a minor, see chaps 21, 24.

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§12.2 B. Definitions and Classifications of Gifts

Traditionally, a testamentary gift of an interest in real property is termed a "devise," and gifts of personal property are called "bequests" or "legacies." These terms, which have been used interchangeably by the courts, have had little if any legal significance. See, *e.g., Estate of Gracey* (1927) 200 C 482, 491, 253 P 921. The Probate Code now recognizes the interchangeability of these terms. When used as a noun, "devise" means "a disposition of real or personal property by will"; when used as a verb, "devise" means "to dispose of real or personal property by will." Prob C §32. In this chapter, the authors use the words "gift" and "devise" interchangeably. Because "devise" is now defined by the Probate Code, the will drafter should exercise caution when using that word in a will.

Probate Code §21117 recognizes six categories of gifts: specific, general, demonstrative, general pecuniary, annuity, and residuary. It is important for the will drafter to recognize into which classification a particular gift falls, primarily for the purpose of determining which gifts will be subject to abatement. See §12.4.

The six categories of gifts delineated in Prob C §21117 are briefly summarized as follows:

(1) *Specific gift*. A specific gift is a gift of a particular thing, specified and distinguished from all other items of the same kind, *e.g.,* "I give my wedding ring to *A.*" See §§12.7-12.13 on ademption of specific gifts; §§12.35-12.69 on drafting specific gifts.

(2) *General gift*. A general gift is a gift from the general estate that does not give specific property. For example, a gift of "300 shares of common stock of General Motors Corporation" is a general gift, particularly if the will instructs the executor to buy GMC stock on the open market for the beneficiary if the estate stock is insufficient at the testator's death. See §§12.70-12.74. In contrast, a gift of "*my* 300 shares of General Motors Corporation stock" is a specific gift.

(3) *Demonstrative gift*. A demonstrative gift designates a particular fund or asset from which the gift is to be made, *e.g.,* "I give the sum of $5000 to *B* to be paid from my credit union savings account." See §§12.75-12.76.

(4) *General pecuniary gift*. A general pecuniary gift is a gift that is expressly stated either as a fixed dollar amount or as a dollar amount determinable by the provisions of the will. For example, "I give the sum of $25,000 to *C*" and a gift to a surviving spouse of an amount determined by a pecuniary amount marital deduction formula clause are general pecuniary gifts. See §§12.70-12.72.

(5) *Annuity gift*. An annuity gift is a general pecuniary gift that is payable periodically, *e.g.,* "I give the sum of $500 per month to *D* for the rest of her life." See §§12.77-12.78.

(6) *Residuary gift*. A residuary gift is a gift of all that remains after all specific and general gifts are discharged, *e.g.,* "I give the residue of my estate to *E.*" See §§12.79-12.80.

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II. PROBLEMS AFFECTING DISPOSITIONS

A. Abatement of Gifts

§12.3 1. The Abatement Problem

"Abatement" means a reduction or diminution of testamentary gifts. Abatement occurs in the administration of any decedent's will. In the usual case, residuary gifts are abated because residuary assets are used to discharge the decedent's debts and expenses of administration or to satisfy gifts. Abatement becomes a problem when the residue is insufficient to pay all debts, expenses, and gifts in full.

Abatement problems are commonly seen in administration of these types of wills:

- A will in which the testator has attempted to devise specifically most or all of the assets that he or she owns;
- A will with large, fixed general pecuniary gifts; and
- A will directing that death taxes attributable to nonprobate assets be paid out of the probate estate.

These wills result in abatement problems either because the testator overestimated the size of the estate or because the nature and value of the estate changed after execution of the will. The result of the overestimation or the changes is an estate in which residuary assets cannot satisfy both liabilities and gifts.

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§12.4 2. Statutory Abatement Solution

Probate Code §§21400-21406 contain the California abatement rules. Among other things, these rules set forth the order in which testamentary gifts abate. The statutory abatement rules apply for all purposes, including payment of debts, expenses, and other charges and satisfaction of gifts. Prob C §21401. They do not apply, however, to payment and apportionment of death taxes. See chap 26.

Under Prob C §21402(a), testamentary gifts abate in the following order:

(1) Property disposed of by the laws of intestate succession;

(2) Residuary gifts;

(3) General gifts to persons other than the testator's relatives;

(4) General gifts to the testator's relatives;

(5) Specific gifts to persons other than the testator's relatives;

(6) Specific gifts to the testator's relatives.

Annuities and demonstrative gifts are considered to be specific gifts to the extent they are satisfied out of the fund or asset specified in the will for satisfaction, and general gifts to the extent they are satisfied out of other property. Prob C §21403(b). All gifts within a particular class described in Prob C §21402 abate pro rata. Prob C §21403(a).

The term "relative" is specifically defined as a person who would be an intestate heir of the testator if the testator died intestate and no other person had priority. Prob C §21402(b).

An important exception to the abatement rules concerns encumbered property. If the testator directs that liens on specifically devised property be exonerated, a specific devise of other property will not abate for the purpose of exonerating the encumbered property. Prob C §21404.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/ 3. Personalized Abatement Solution/ §12.5 a. When Preferable to Statutory Solution

3. Personalized Abatement Solution

§12.5 a. When Preferable to Statutory Solution

The attorney should discuss with the will client how the statutory rules of abatement apply to the client's dispositive scheme. If the client does not wish the statutory rules to apply to his or her will, the attorney should draft abatement provisions in the will to effectuate the client's preferences. Probate Code §21400 makes clear that provisions in a will that provide for abatement supersede the provisions of Prob C §§21400-21406.

PITFALL: Probate Code §21400 provides that if application of the statutory abatement rules would thwart the testator's "plan" or "purpose," "the shares of beneficiaries abate as is necessary to effectuate the instrument, plan, or purpose." Because this language gives the court a significant degree of discretion to modify a testator's dispositive plan, the cautious drafter either provides for a system of abatement in the will or clearly states that the statutory abatement scheme will control when abatement becomes necessary. See clauses in §12.6.

The will drafter should pay particular attention to abatement problems when:

- The client is in a nontraditional family. The statutory abatement rules create a preference for relatives that may be completely inappropriate for this type of client. For example, if the client is in a long-term relationship with a same-sex partner, but the client and partner have not filed a declaration of domestic partnership with the California Secretary of State, then the partner and children of the partner (unless adopted by the client) will not be considered relatives of the client. The attorney should not rely on the good graces of the court, exercising its powers under Prob C §21400, to establish a more appropriate abatement scheme for the client. For a clause eliminating the statutory preference for gifts to relatives, see Alternative 2 in form 12.6-1.
- The client makes outright gifts to a spouse or registered domestic partner. Because any property left to a surviving spouse or registered domestic partner will not be subject to estate administration, the property will not be charged with probate expenses. However, debts payable by the estate that are also payable in whole or in part by the surviving spouse or registered domestic partner are subject to allocation under Prob C §§11440-11446; Fam C §297.5(c). In the absence of an agreement, the debts will be allocated in a procedure comparable to that used for the allocation of debts between spouses in a divorce proceeding. Under the procedure, the court will first characterize the debts as separate or community and then allocate them to assets similarly characterized, which will then be primarily liable for the debts. Prob C §11444(b).

However, funeral expenses and expenses of last illness are charged only against the estate of the decedent. Prob C §11446. See California Decedent Estate Practice §§4.22-4.25, chap 14 (2d ed Cal CEB 2009) for complete analysis of debt allocation.

- The client makes a residuary gift to the spouse intended to qualify for the marital deduction. The will drafter must consider both how liabilities will be charged and the source of funds for payment of debts and expenses of administration. If specific devises to beneficiaries other than the surviving spouse are exempted from payment of debts and expenses and payment is made from the residuary estate, the gift to the surviving spouse will be reduced, resulting in a smaller marital deduction. See *Estate of John W. Dawson* (1974) 62 TC 315. To avoid this problem, the will can provide for debts and expenses chargeable against the probate estate to be charged only against nonmarital gifts or to be charged against the estate as a whole. On directions for payment of death taxes, see chap 26.

Because there is no right or wrong manner of abatement, abatement provisions in a will should reflect the testator's preferences. The testator might specify the order of abatement or direct that certain named beneficiaries be given preference in abatement. Another option is to provide that certain gifts, especially cash or securities, be limited to a fixed percentage of the estate. See Alternative 4 in form 12.6-1. If the latter option is used, the adjustments to the gifts should not be based on a value (*e.g.,* the testator's "net estate") not determinable on the date of death. If they are, the

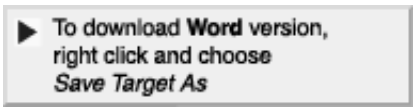
gifts may be disqualified from the provisions of IRC §663, which state that recipients of specific gifts of property or cash are not taxed on any estate income. See Treas Reg §1.663(a)-1(b). Disqualification may cause the recipients of the adjusted gifts to be taxed on estate income under IRC §662. See generally California Estate Planning, chap 13 (Cal CEB 2002). This is why Alternative 4 bases adjustments on the date-of-death value of the estate.

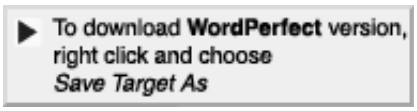
If the will provides for payment of death taxes in a particular manner, this clause should be coordinated with abatement clauses to eliminate inconsistencies. See chap 26 for death tax clauses.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.6 b. Form: Abatement of Gifts

§12.6 b. Form: Abatement of Gifts





12.6-1 Abatement of Gifts

[*Add one of the following alternatives*]

[*Alternative 1: Statutory abatement*]

***Abatement of Gifts*. I direct that abatement for any purpose shall be in the manner prescribed by Probate Code §§21400-21406 or by California law on abatement in effect at my death.**

[*Alternative 2: Statutory abatement with no preference for relatives*]

***Abatement of Gifts*. I direct that abatement for any purpose shall be in the manner prescribed by California law in effect at my death. At the time of execution of my will, California law on abatement is found in Probate Code §§21400-21406. However, the portions of any law that give preference in order of abatement to gifts to my relatives shall not apply to my will. If abatement is necessary, the shares of all beneficiaries (including relatives) shall abate pro rata within each class of gifts (*e.g.,* the class of general gifts, the class of specific gifts).**

[*Alternative 3: Order of abatement*]

***Abatement of Gifts*. Except as provided in paragraph _ _**[*number of paragraph dealing with proration of death taxes*]**_ _, the order of abatement for all purposes shall be as follows: _ _**[*Order*]**_ _.**

[*Alternative 4: Gifts restricted to fixed percentage of estate*]

***Abatement of Gifts*. If the total gifts made in paragraphs _ _**[*numbers*]**_ _ exceed _ _**[*number*]**_ _ percent of the value of my property disposed of by my will, these gifts shall be reduced on a prorata basis so that their total value shall not exceed that percentage of the value of my property. The value of my property disposed of by my will is the value as reported on the estate's inventory and appraisement.**

Comment: These clauses provide alternative methods of dealing with the issue of abatement. Alternative 1 should be used by testators who prefer the statutory abatement rules and Alternative 2 should be used by testators who wish to follow the statutory abatement rules except for the preference established for gifts to relatives. See §12.4.

Alternative 3 should be used by testators who prefer to specify the order of abatement. No particular order of abatement is suggested here, because abatement is a highly individual matter. The testator may specify which gifts abate first (*e.g.,* "the cash gift to my brother under paragraph _ _[*number*]_ _ will abate first; next …") or which gifts abate last (*e.g.,* a small cash gift to a grandchild).

Alternative 4 takes a different approach to abatement by limiting the total amount of specified gifts to a fixed percentage of the total value of the estate passing under the will. See §12.5.

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B. Ademption of Gifts

§12.7 1. General Rule: Testator's Intent Controls

If the testator makes a specific gift of property that does not exist or is not in the testator's estate at the time of the testator's death, the gift may be considered adeemed (extinguished). This may occur when property has been exchanged, sold, lost, destroyed, or given away during the testator's lifetime. When ademption occurs, the personal representative may not substitute other assets in place of the specific devise.

Whether ademption occurs depends primarily on what can be inferred about the testator's intent. There is no ademption without sufficient proof that the testator intended the gift to fail. *Estate of Austin* (1980) 113 CA3d 167, 173, 169 CR 648.

EXAMPLE: In *Austin,* the testator specifically bequeathed an oil portrait and a promissory note secured by a deed of trust to a friend, Betty. Four months after the will was executed, the security for the note was sold, the note was paid off, and the proceeds were placed in an existing savings account. Shortly afterwards, the testator loaned the bulk of the account to other friends, receiving a secured note in return. The testator then died without having changed her will. The note was paid off in full soon thereafter. Finding that there was no proof of intent by the testator to adeem, the court ruled that there should be no ademption. In discerning the testator's intent, the court noted the following:

- The will contained a large number of legacies and bequests, which strongly implied the testator's intent to particularize the disposition of assets;
- The testator had done nothing to initiate the payoff of the first note;
- There was no proof that the testator had changed her mind about Betty's appropriateness as a beneficiary; and
- The testator left the proceeds of the note in an easily traceable form.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.8 2. Statutory Provisions Concerning Ademption

§12.8 2. Statutory Provisions Concerning Ademption

The Probate Code provisions relating to ademption, Prob C §§21132-21135, address only issues frequently faced by courts and practitioners. Following the growing judicial trend against finding ademption, Prob C §21139 provides that these ademption rules should not be construed to increase the incidence of ademption under California law. Probate Code §21102(b) makes clear that these ademption rules apply only "where the intention of the testator is not indicated by the instrument."

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.9 a. Gift of Securities

§12.9 a. Gift of Securities

The issue of ademption of a gift of securities often turns on a determination of whether the testator intended a specific gift of certain securities or a general gift of the equivalent value of the securities. Under Prob C §21132, when the testator intended a specific gift of securities, some or all of which are not part of the estate at the testator's death, the specific devisee still is entitled to receive any of the devised securities remaining in the estate and the following:

- Securities of the same organization owned by the testator because of actions initiated by the organization or any successor, related, or acquiring organization;
- Securities of another organization owned by the testator because of a merger, consolidation, reorganization, or other similar action initiated by the organization or any successor, related, or acquiring organization; and
- Securities of the same organization acquired as a result of a plan of reinvestment.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.10 b. Devisee's Right to Other Specifically Devised Property

§12.10 b. Devisee's Right to Other Specifically Devised Property

Unless the testator intends otherwise, a devisee of specifically devised property, some or all of which is not in the testator's estate at the time of death, is entitled to the remainder of the specifically devised property and the following (Prob C §21133):

- If the testator sold the property, the balance of the purchase price (and the security interest) owed to the testator by the buyer at the time of the testator's death;
- If the property was destroyed, any insurance proceeds owed and unpaid at the time of death;
- If the testator lost the property because of eminent domain, the amount of the award unpaid at the time of death; and
- Any property owned by the testator as a result of foreclosure, or obtained in lieu of foreclosure, of the security for a specifically devised obligation.

The devisee of specifically devised property may be entitled to even more than that provided under Prob C §21133 if the property was sold by a conservator or if eminent domain or insurance proceeds were paid to a conservator. Prob C §21134.

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§12.11 c. Effect of Certain Actions by Testator on Specifically Devised Property After Execution of Will

In *Estate of Worthy* (1988) 205 CA3d 760, 252 CR 462, the owner-testator entered into a contract of sale of real property that her will left specifically to two beneficiaries. Escrow closed three days after the owner-testator's death. In ruling that the specific beneficiaries were entitled to the property but subject to the buyer's right to complete the sale, the court held in effect that the devisees were entitled to the sale proceeds. See §12.10.

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§12.12 3. Effect of Testator's Lack of Capacity on Ademption

Because the testator's intent controls the issue of ademption, disposition of property subject to specific testamentary gifts by the conservator of an incompetent testator does not cause an ademption. See Prob C §21134. The incompetent testator lacks both the intent to adeem and the opportunity to avoid the effect of an ademption by making a new will. *Estate of Mason* (1965) 62 C2d 213, 42 CR 13, superseded by statute on other grounds as stated in *Estate of Worthy* (1988) 205 CA3d 760, 252 CR 462. Similarly, if the testator sells property while under another person's influence, no ademption occurs. *Estate of Holmes* (1965) 233 CA2d 464, 43 CR 693, superseded by statute on other grounds as stated in *Estate of Worthy* (1988) 205 CA3d 760, 252 CR 462. The intent to adeem or revoke a specific testamentary gift is lacking if the testator has been deprived of free will. If, after execution of the instrument, specifically devised property is sold or mortgaged by a conservator or agent under a durable power of attorney for an incapacitated principal, the devisee is entitled to a general pecuniary gift equal to the net sale price of, or the amount of the unpaid loan on, the specifically devised property. Prob C §21134.

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§12.13 4. Handling Potential Ademption Problems

The attorney should assist a will client who anticipates an ademption problem to decide what should be done if such a problem arises. To avoid litigation over the client's intent, the will should clearly state what should be done if property subject to a specific testamentary gift is not in the estate at the time of the client's death.

A testator who wishes to avoid ademption may make general or demonstrative gifts instead of specific gifts. For example, when a testator wishes to give a certain number of shares of publicly traded stock to a beneficiary, the will may provide for a general gift of the shares ("I give 100 shares of XYZ common stock to *B,*" instead of "I give *my* 100 shares of XYZ common stock to *B*"). If XYZ stock is not in the testator's estate at death, the executor is required to purchase these shares for *B* in accordance with the terms of the general gift. See §§12.70-12.73.

Gifts of assets such as automobiles that are likely to be disposed of and replaced during the testator's lifetime should be drafted to allow for exchanges ("the automobiles I own at the time of my death" instead of "my 1995 Ford Taurus"). When more substantial assets such as real property may be sold during the testator's lifetime, the testator should consider whether the specific devisee should be entitled to the economic equivalent of the property. For a suggested clause, see form 12.56-1. See also Alternative 2 in form 12.45-1 for a clause providing for a substitutional gift if the tangible personal property specifically devised is not part of the testator's estate at the time of death.

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C. Ademption by Satisfaction

§12.14 1. When Devise Satisfied by Lifetime Gift

Under some circumstances, a testator's lifetime gift to a devisee is treated as a partial or total satisfaction of the provision by will. The gift in the will is considered partially or wholly adeemed. A testator's lifetime gift will be treated as a satisfaction of a devise in whole or in part if (Prob C §21135(a)):

- The property given is the same property that is the subject of a specific gift to that person;
- The will provides for deduction of the lifetime gift from the devise;
- The testator states in a contemporaneous writing that the gift should be deducted from or satisfies the devise; or
- The devisee acknowledges satisfaction in writing.

A testator who has made a significant lifetime gift that is intended to be a satisfaction of a devise should compensate for this gift in the dispositive provisions of the will instead of relying on satisfaction and equalization provisions in the will. For example, if the testator's children will share the residue equally and one child has received a lifetime gift, the testator should equalize the shares by giving offsetting general or specific gifts to the others before equally dividing the residue. This may prevent complicated distribution computations at the testator's death. Further, provisions in a will that acknowledge a satisfaction and direct the executor to adjust distributions to compensate for it may have unintended income tax consequences. For example, if the testator made a lifetime gift to one beneficiary, the estate may realize gain for federal income tax purposes if a distribution of the estate assets, other than cash, is made to the other beneficiaries under provisions in the will directing the executor to equalize matters taking the gift into consideration as a satisfaction. See Rev Rul 82-4, 1982-1 Cum Bull 99.

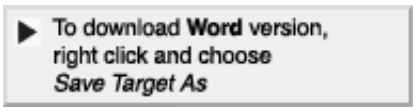
NOTE: Ademption by satisfaction usually becomes a disputed issue when a testator makes significant lifetime gifts after execution of the will. See, *e.g., Estate of Lackey* (1971) 17 CA3d 247, 94 CR 524. After explaining this concern to the client, the attorney should advise him or her to consult an attorney if, in the future, the client wishes to make a significant lifetime gift to a beneficiary.

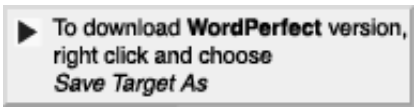
If a testator intends a lifetime gift to be in partial satisfaction of a devise, he or she should be aware of how the gift will be valued at the time of death for the purpose of division and distribution of his or her estate. The value of the gift will be the value expressed in a contemporaneous writing of the testator or in an acknowledgment of the devisee made contemporaneously with the gift. Prob C §21135(c). If there is no such writing or the writing does not express the value of the gift, then the lifetime gift will be valued at the time the devisee came into possession or enjoyment of the property or at the time of the testator's death, whichever is first. Prob C §21135(b). If the devisee fails to survive the testator, the gift is treated as a full or partial satisfaction of the gift in applying the anti-lapse statute unless the testator's contemporaneous writing provides otherwise. Prob C §21135(d). See §§12.16-12.18.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.15 2. Form: Ademption by Satisfaction

§12.15 2. Form: Ademption by Satisfaction





12.15-1 No satisfaction of devise by lifetime gift

***Gift Not Treated as Satisfaction of Devise*. Any gift I have made or will make during my lifetime shall not be treated as a satisfaction, in whole or in part, of any devise in my will.**

Comment: If the testator has made or intends to make any significant lifetime gifts and does not want any of them to be treated as a satisfaction of a devise, the will should contain this clause.

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D. Lapse and Antilapse

§12.16 1. Disposition of Devise if Initial Beneficiary Predeceases Testator

When a beneficiary fails to survive the testator, or fails to survive until a future time required by the will, the devise to that beneficiary fails (Prob C §21109) and passes in the following order:

- To the designated substitute beneficiary, if any (Prob C §21110(b));
- If the antilapse statute applies (see §12.17), to the beneficiary's issue under the laws of intestacy (Prob C §21110(a); see Prob C §240);
- If (1) the failed gift is a share of the residue (a transfer of "all of my estate" is considered a residue under Prob C §21111(c)) or of a future interest, (2) the residue or future interest is devised to two or more persons, (3) the antilapse statute does not apply, and (4) the will does not express a contrary intention, to the other beneficiaries in proportion to their other interest in the residue or future interest (Prob C §21111(b));
- If the failed gift is a future interest and the failure results in an intestacy, then under the laws of intestate succession in effect on the date the interest was to take effect in enjoyment as provided in Prob C §21114 (Prob C §21111(d)) (see *Estate of Stoddart* (2004) 115 CA4th 1118, 1131, 9 CR3d 770);
- If none of the above apply, then as provided in the will (Prob C §21111(a)(1)) or to the residuary beneficiaries of the will if the will does not provide for an alternative disposition (Prob C §21111(a)(2); *Estate of Walker* (1925) 196 C 323, 237 P 1070); and
- If there is no residuary clause or if a residuary gift fails and none of the above apply, to the testator's estate passing to the heirs at law under intestate succession (Prob C §21111(a)(3)).

The careful will drafter does not rely on the statutory lapse rules. Instead, the will should be drafted to provide for substitute takers in place of beneficiaries who do not survive the testator.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.17 2. Antilapse Statute

§12.17 2. Antilapse Statute

The antilapse statute (Prob C §21110; Fam C §297.5) determines what happens to a gift when:

- The beneficiary fails to survive the testator;
- The beneficiary is kindred either of the testator or of the testator's surviving, deceased, or former spouse or registered domestic partner; and
- The will does not express an intention contrary to the provisions of the antilapse statute.

The statute provides that such a gift should be distributed to the issue of the deceased beneficiary in the manner provided in Prob C §240. Prob C §21110(a). For example, unless the will provides otherwise, a gift to a deceased child of the testator who leaves children who survive the testator will pass to those children (the testator's grandchildren). The antilapse statute is designed to reflect most testator's intentions when the testator's intentions are not expressed in the will. See *Estate of Sowash* (1923) 62 CA 512, 515, 217 P 123.

The term "issue" is generally equivalent to "lineal descendants." Prob C §50. "Issue" includes adopted children and probably children "legitimated" under the Uniform Parentage Act (Fam C §§7600-7730). Fam C §§7601-7604, 7610-7613. Note, however, that under certain circumstances an adopted child may be considered kindred of the child's natural parent. See Prob C §6451.

PITFALL: "Kindred" means relationship by blood and not by affinity. Thus, spouses or domestic partners are not kindred under the statute (*Estate of Dye* (2001) 92 CA4th 966, 112 CR2d 362), but parents (*Estate of Monticelli* (1951) 107 CA2d 90, 236 P2d 661) and children are. This results in an anomaly: The antilapse statute does not cover gifts to the testator's spouse or partner but does cover gifts to kindred of, *e.g.,* the testator's former spouse or partner.

Adopted children are generally kindred of the adopting parent and not of the natural parents. See Prob C §6451; *Estate of Goulart* (1963) 222 CA2d 808, 35 CR 465. Parents and children whose relationship is established under the Uniform Parentage Act also are kindred for purposes of the antilapse statute. For further discussion of adoption and the parent-child relationship, see §12.29.

When there are multiple deceased beneficiaries, the issue of deceased beneficiaries do not take equally; rather, the issue of each beneficiary take the gift that would have been received by that beneficiary by right of representation. See *Estate of Mooney* (2008) 169 CA4th 654, 87 CR3d 115 (four children of one predeceased sister each receive one-eighth share and three children of another predeceased sister each receive one-sixth share). However, the class of "issue" of a beneficiary is smaller than the class of intestate heirs. Thus, a gift to a beneficiary who dies without issue will lapse even if the deceased beneficiary has living "heirs" or relatives. See §12.30.

When the antilapse statute applies, the issue take by its provisions and may not claim as pretermitted heirs under Prob C §§21620-21622. *Estate of Childs* (1937) 21 CA2d 103, 68 P2d 306.

Although the antilapse statute applies to class gifts, the statute does not apply if the kindred beneficiary died before execution of the will and the testator knew that fact at the time of execution. Prob C §21110(a). See, *e.g., Estate of Steidl* (1948) 89 CA2d 488, 201 P2d 58.

The best way for a testator to avoid application of the antilapse statute is to express this intent in the will. See §12.16. Under Prob C §21110(b), a requirement in the will that the initial beneficiary survive for a specified period of time after the testator's death will circumvent application of the antilapse provisions. Alternatively, a requirement in the will that the initial beneficiary survive until a future time related to the probate of the will or the administration of the testator's estate is sufficient to avoid application of the statute.

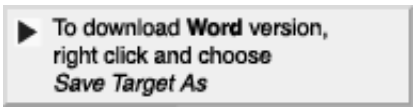
The mere presence of a residuary clause in the will does not circumvent operation of the antilapse statute (*Estate of Casey* (1982) 128 CA3d 867, 180 CR 582); however, a clause in the will disposing of the residue, "including all failed and lapsed gifts," may be sufficient to express the necessary intent (*Estate of Salisbury* (1978) 76 CA3d 635, 143 CR 81).

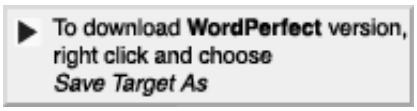
NOTE: To avoid litigation over this issue, the will drafter should focus on clarity. A drafter who relies on a phrase such

as the one at issue in *Salisbury* may thwart application of the antilapse statute but may not prevent litigation over its interpretation. See also *Larrabee v Tracy* (1940) 39 CA2d 593, 104 P2d 61, in which the court found that a disinheritance clause did not prevent operation of the antilapse statute.

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§12.18 3. Form: Gifts Lapse





12.18-1 No application of antilapse statute

***Antilapse Statute Not to Apply*. I do not want the provisions of any antilapse statute to apply to my will. At the time of execution of my will, the California antilapse statute is found in Probate Code §21110(a)-(c).**

Comment: This clause is designed to prevent unintentional applications of the antilapse statute. See §12.17.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/ E. Disclaimers/§12.19 1. Tax Planning for Qualified Disclaimers

E. Disclaimers

§12.19 1. Tax Planning for Qualified Disclaimers

A beneficiary of any type of gift (including a power of appointment) may disclaim, in whole or in part, his or her interest in the gift. For example, if the testator's will leaves *B* a general gift of $5000, *B* can disclaim any part or all of *B*'s right to the $5000. Under the Internal Revenue Code, the refusal to accept a gift is considered a gratuitous transfer by the disclaiming individual to the person ultimately receiving the interest. IRC §2511(a); Treas Reg §25.2511-1(c)(1). This transfer constitutes a taxable gift, unless the individual refuses the gift in the form of a "qualified disclaimer." See IRC §2518; Treas Reg §25.2518-1(b). If the refusal is a "qualified disclaimer," the property interest being devised is treated as if it had never been transferred to the disclaimant. The disclaimant must not have "accepted" the transfer. Merely taking delivery of an instrument of title, without more, does not constitute acceptance. Treas Reg §25.2518-2(d)(1). See IRS Letter Ruling 200030011.

A qualified disclaimer permits the intended beneficiary to refuse assets in order to prevent an increase in the size of his or her gross estate. The careful use of a qualified disclaimer permits the beneficiary and the final recipients of the disclaimed property to do some postmortem estate tax planning.

Particularly when the attorney anticipates the possibility of a qualified disclaimer, the will should provide for the disposition of disclaimed interests. For clauses providing alternate takers in the event of disclaimer, see forms 12.20-1, 12.23-1. If there is more than one beneficiary for the disclaimed interest, the will should specify the proportion that each takes. If the testator has not directed this disposition in the will, a disclaimed testamentary gift is distributed as if the disclaiming beneficiary had predeceased the testator. Prob C §282(a). On disposition of gifts when the initial beneficiary predeceases the testator, see §§12.16-12.17. A disclaimed future interest is distributed as if the disclaiming beneficiary had died before the event determining that the taker of the interest had become finally ascertained and the taker's interest vested. Prob C §282(a).

A qualified disclaimer must be made within 9 months of the date of the transfer or within 9 months after attaining age 21, whichever is later. IRC §2518(b). Disclaimers of transfers made before the January 1, 1977, effective date of IRC §2518 must be made within a reasonable time after the disclaimant acquires knowledge of the existence of the disclaimed interest. Treas Reg §25.2511-1(c)(2). However, the IRS is apparently willing to issue letter rulings concerning disclaimers of trust interests created before 1977 on the basis of current regulations. See IRS Letter Ruling 200838026 (minor beneficiary of trust may disclaim trust interests within 9 months after attaining age 18, the age of majority, despite acceptance of benefits). Under Prob C §279, a disclaimer must be filed within a "reasonable time after the person able to disclaim acquires knowledge of the interest," and a disclaimer made within 9 months of the transfer is conclusively presumed reasonable. Whether a transfer made 9 months after attaining age 21 would meet the reasonable time standard could be highly debatable if the disclaimant had actual knowledge for a prolonged period or accepted any benefits. State law precludes a disclaimer after acceptance. Prob C §285. In contrast, Treas Reg §25.2518-2(d)(3), Example (11), allows a disclaimer of stock notwithstanding the disclaimant's acceptance of dividends before age 21. It would appear, however, that Prob C §295—providing, in effect, that a disclaimer that is valid under federal transfer tax law is valid for state law purposes—is sufficient to validate a disclaimer for state law purposes even if the disclaimant accepts dividends or interest before age 21.

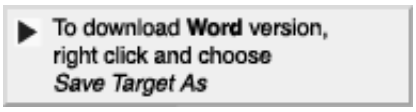
As a general rule for qualified disclaimers, the disclaimant cannot have the power, either alone or in conjunction with another, to direct the redistribution of the disclaimed property unless that power is subject to an ascertainable standard. Treas Reg §25.2518-2(e). Further, the entire disclaimed interest must pass to a person other than the disclaimant. IRC §2518(b)(4)(B). An exception is made for the testator's spouse, however. The testator's surviving spouse is permitted to make a qualified disclaimer of a devise and still accept certain benefits in the disclaimed property. IRC §2518(b)(4)(A); Treas Reg §25.2518-2(e)(2).

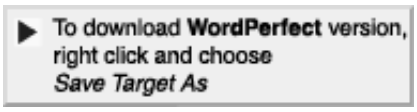
A complete discussion of qualified disclaimers and their place in postmortem estate planning is beyond the scope of this book. For further discussion of disclaimer planning, see California Estate Planning, chap 28 (Cal CEB 2002).

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.20 2. Form: Disposition of Any Disclaimed Gift

§12.20 2. Form: Disposition of Any Disclaimed Gift





12.20-1 Disposition of any disclaimed gift

***Disposition of Disclaimed Gift*. If any beneficiary named in my will disclaims all or part of a gift, the portion of the gift disclaimed shall be distributed as if the disclaimant had not survived me as provided in my will.**

Comment: See §12.19. See also §§12.22-12.23 for discussion of gifts conditioned on survivorship and related clauses.

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§12.21 III. CONDITIONAL GIFTS

Although testamentary gifts are presumed to vest at the time of the testator's death, the testator may make a disposition conditioned on the occurrence or nonoccurrence of some act or event. Under the California system of free testation, gifts may be conditional if the condition does not violate the law or public policy. Prob C §6105. For example, a gift conditioned on the beneficiary's freedom from drugs and alcohol is probably valid, but a gift conditioned on the dissolution of the beneficiary's marriage or domestic partnership is probably invalid as against public policy.

If the testator desires to make a conditional gift, the will should describe the condition so clearly that it will be easy to determine whether the condition has been met. For gifts of this kind, the testator may even wish to give a specific person (*e.g.,* the executor) absolute discretion to determine whether the condition has been met. This arrangement can be advantageous as long as it does not bestow a general power of appointment on the person.

Further, the attorney should anticipate circumstances that may affect whether the condition can be satisfied and discuss them with the client.

EXAMPLE: In *Estate of Quinn* (SD 1990) 450 NW2d 432, the decedent devised 8 percent of his estate to his housekeeper on the condition that she must be working for him at the time of his death. When the decedent's health worsened, he was moved to a nursing home. His brother subsequently moved the decedent's belongings out of his home and terminated the lease. Noting that the decedent never actually dismissed the housekeeper, the court liberally interpreted the will and upheld the gift.

The attorney should not only anticipate events that may affect fulfillment of a condition but should specify exactly what should happen to the gift if the condition is not met.

NOTE: The attorney should discuss with the testator alternatives to conditional gifts that might more easily meet the testator's goals. For example, a trust may be a particularly appropriate alternative if the testator knows someone who would be suitable as trustee.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.22 A. Gifts Conditioned on Survivorship

§12.22 A. Gifts Conditioned on Survivorship

An outright gift need not be explicitly conditioned on the beneficiary's surviving the testator because Prob C §21109(a) provides that a beneficiary who fails to survive the testator does not take under the will. Provisions for a substitute taker if the beneficiary does not survive, however, should be included in the will so that the testator can control the disposition of the property left to that beneficiary. See §12.16. In *Ruotolo v Tietjen* (Conn 2007) 916 A2d 1, the court held that a gift conditioned on survivorship passed to the heir of a deceased beneficiary because the will did not provide for an alternative disposition, even though the effect of the decision was to render the survivorship language superfluous. The court held that the testator did not unequivocally express an intention to override the antilapse statute. See §12.17. In connection with survivorship provisions, the will drafter should consider the ramifications of a beneficiary's disclaiming a gift. See §12.19. Disclaimed property generally will pass as if the disclaimant predeceased the testator unless the will provides otherwise. Prob C §282.

In many cases drafters include provisions that require the transferee to survive a specified period of time—particularly in the case of transferees who might die near in time to the decedent as a consequence of a common accident. A 30-day survival period is usually sufficient to cover that contingency. Longer periods are generally not recommended. Lengthy survival periods can complicate probate proceedings because uncertainty about the takers of the estate property may result in the necessity of giving court proceeding notices and notices of proposed action to large groups of persons—most of whom will not be receiving anything. Survival clauses can also delay the ability of devisees to collect estates using small estate and spousal property set-aside procedures. Prob C §§13000-13210, 13500-13660.

Further, a survival period of more than six months will result in the loss of the federal estate tax marital deduction for a gift to a spouse or marital deduction trust. IRC §2056(b)(3). See chap 17. For clauses, see form 12.23-1.

There is one circumstance when it is inappropriate to impose a survival requirement on a transfer qualifying for the marital deduction. This occurs when federal estate taxes are a concern, and one spouse has relatively little wealth. If the spouses die near in time, it might be highly desirable to create a marital deduction-qualifying QTIP trust for the benefit of the less wealthy spouse even if he or she dies at the same time as the wealthy spouse. A QTIP election can then be made in an amount that reduces the wealthy spouse's estate, while increasing the less wealthy spouse's estate up to the maximum amount that will not result in any estate tax liability. To preserve the ability to use this strategy in the event of simultaneous death, there should be no survival contingency with respect to the creation of the QTIP trust, and the trust should expressly name the less wealthy spouse as the one who will be deemed to survive for marital deduction purposes. The IRS will honor such a clause. See Treas Reg §20.2056(c)-2(e).

Generally, the attorney should also recommend a short period of survivorship for a gift of tangible personal property. A testator frequently wants the beneficiary of tangible personal property (usually the surviving spouse, domestic partner, or children) to have immediate use and possession of that property. A long survivorship period may interfere with an early preliminary distribution of the property.

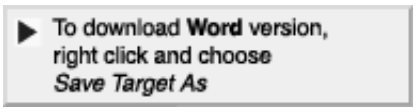
PITFALL: The will drafter must exercise extreme caution if a testator desires to impose a survivorship requirement conditioned on the probate of the testator's will or the administration of the testator's estate. Such a provision may cause difficulties during estate administration. For example, in *Estate of Justesen* (1999) 77 CA4th 352, 91 CR2d 574, a devise was contingent on the survival of the devisee until the estate was distributed. Final distribution was incomplete when the devisee died nearly 2 years later. The court held that the devise was to be construed as requiring survival only until the date the estate reasonably ought to have been distributed. There is a presumption of unreasonable delay when the personal representative fails to distribute the estate within the Prob C §12200 time limits (one year if no estate tax return is needed and otherwise 18 months). Therefore, a time limit should be placed on any survivorship condition relating to the probate of the testator's will or the administration of the testator's estate. Additionally, when the testator wishes a gift to his or her spouse to qualify for the marital deduction, the survivorship period should not exceed six months. Internal Revenue Code §2056(b)(3) provides an exception to the terminable interest rule under which gifts may be conditioned on the spouse's survival for a

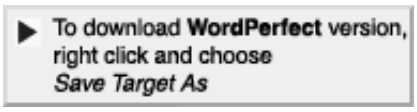
period not to exceed six months without loss of the marital deduction. See §17.39.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.23 B. Form: Survivorship Conditions

§12.23 B. Form: Survivorship Conditions





12.23-1 Survivorship conditions

[*Add one of the following alternatives*]

[*Alternative 1: Survivorship condition for particular gifts*]

I give _ _[*gift*]_ _ **to** _ _[*name of beneficiary*]_ _ **if** _ _[*he/she*]_ _ **survives me by 30 days. If** _ _[*name of beneficiary*]_ _ **fails to so survive me, I give this gift to** _ _[*name of alternate beneficiary*]_ _ **if** _ _[*he/she*]_ _ **survives me by 30 days. If** _ _[*name of beneficiary*]_ _ **also fails to so survive me this gift shall lapse.**

[*Alternative 2: Survivorship condition for all gifts*]

Except when my will specifically provides otherwise, a beneficiary must survive me for 30 days before entitlement to his or her gift.

Comment: See §12.22. If different survivorship periods are desired for most gifts, Alternative 1 should be used. Survivorship requirements should be integrated into each clause making a disposition. If the same survivorship period is acceptable for all gifts, Alternative 2 should be followed. If the same survivorship period is appropriate for most, but not all gifts, both clauses may be used.

Note that Alternative 1 provides for the same alternate beneficiary to take the gift if the primary beneficiary fails to meet the survivorship condition or disclaims the gift. Alternatively, different beneficiaries can be named to succeed on the occurrence of each contingency.

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§12.24 C. Simultaneous Death

California has adopted the Uniform Simultaneous Death Act (Prob C §§220-234). When it is impossible to prove that one person survived another (*i.e.,* that they died other than simultaneously), the Act regulates the devolution of property to or from these persons. Probate Code §220 provides that if the priority of death of persons who have died simultaneously determines the title or devolution of property, the property of each person will be disposed of as if he or she had survived the other. The will or other dispositive instrument, however, may contain different provisions. Prob C §221.

The will drafter should consider tax consequences when providing for the distribution of property in connection with simultaneous deaths. See §17.45 on marital deduction planning and simultaneous deaths. See also California Decedent Estate Practice, chap 8 (2d ed Cal CEB 2009). The drafter should also explore with the client the devolution of the client's nonprobate property (*e.g.,* joint tenancy property, life insurance) in case of simultaneous deaths. This devolution may affect survivorship and simultaneous death provisions in the client's will.

PITFALL: The Uniform Simultaneous Death Act may have an unintended effect when a couple's wills both include a general pecuniary gift intended to be paid only once, on the survivor's death. For discussion of this problem and a suggested clause for drafting around it, see §§12.70, 12.72.

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§12.25 D. Gifts Conditioned on Employment

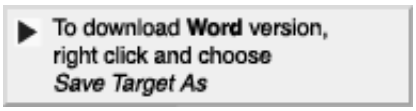
Sometimes a testator wishes to leave a portion of his or her estate to a faithful employee. If the gift is conditioned on the beneficiary's employment with the testator at the time of the testator's death, form 12.26-1 is recommended. See §12.21 for additional advice on drafting a conditional gift.

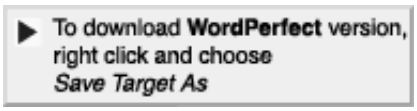
NOTE: When the terms of a testamentary gift to an employee suggest that the gift is compensation for services rendered, the employee may be required to include the gift in his or her gross income for federal and state income tax purposes. See *Mildred E. McDonald* (1943) 2 TC 840.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.26 E. Form: Gift to Employee

§12.26 E. Form: Gift to Employee





12.26-1 Gift conditioned on employment

***General Pecuniary Gift*. I give the sum of _ _[*amount*]_ _ to my valued employee, _ _[*name of employee*]_ _, if _ _[*name of employee*]_ _ is in my employ on the date immediately preceding my death.**

Comment: If appropriate, this clause could be adjusted to include a survivorship condition as well. See §12.23. This clause should be modified if the client wants to ensure that the gift is not included in the employee's income for tax purposes.

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IV. CLASS GIFTS

§12.27 A. Drafting Considerations for Class Gifts

A will that makes a gift to the testator's "children," "nephews and nieces," or some other specified class raises several thorny issues that the will drafter should consider when drafting class gifts:

- *Identity of class.* Is the gift made to a class or to designated members of a particular group? Who will be included in class gifts to "children," "descendants," "issue," or "heirs"? See §§12.28-12.30.
- *Time for ascertaining class membership.* Should only members be included who were living when the will was executed and who survive the testator? How might the antilapse statute apply to the disposition? See §§12.16-12.17, 12.31.
- *Proportions to be taken by members.* Will class members always share equally (per capita) or should distribution be made to the class members "by right of representation"? Should proportions be clearly defined in the will? See §12.32.

The will drafter should also consider the rule against perpetuities when drafting class gifts. See §34.19.

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B. Need to Specify Identity of Class

§12.28 1. Class Gift Versus Gift to Named Individuals

A will should always specify whether the testator intends to make a class gift or a gift only to named members of a class. The former is a gift to all individuals fitting the description of the class; the latter is a gift to only the individuals named. If a class gift is intended, the individual members should not be named because this implies that the gift is not intended to be made to a class. A similar inference will be drawn when the number of persons in the class is specifically mentioned in the will (*e.g.,* "to my three grandchildren").

EXAMPLE: In *Estate of Murphy* (1909) 157 C 63, 64, 106 P 230, 231, the testator made a gift in the residuary clause of the will of "all the rest of my property … to … the four children of my late sister … that is to say … to Timothy J. Flynn, William D. Flynn, Mary Jane Logan, and Kate I. Prendergast." The court had no difficulty characterizing this as a gift to particular individuals and not as a gift to the class of the late sister's children. See also *Estate of Moore* (1955) 135 CA2d 122, 286 P2d 939 (gift to "Carrie D. Griffin and her sister, Anna M. Davis, equally divided" not found to be class gift).

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§12.29 2. Gifts to Children and Issue

Testators frequently desire to make gifts to "children" or "issue." Because the ambiguity of these terms often leads to litigation after the testator's death, a will making such a class gift should clearly state what the testator means by the terms. See clauses in §§12.33-12.34B. Although the statutes discussed in this section can be applied to construe these terms, they do not apply if the will indicates the testator's intentions. Prob C §21102. To avoid confusion, the terms "child" or "children" are often defined by the will to refer to named individuals. For form clauses, see §10.10. On posthumously conceived children, see §12.29A. On foster children and stepchildren, see §12.29B. On adopted children, see §12.29C.

Probate Code §21115 is the primary statute used to construe ambiguous class gifts to children or issue. Under Prob C §21115(a), unless otherwise provided in the will, and except as to a transferor who is not the natural or adoptive parent,

> halfbloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of all such persons when appropriate to the class, are included in terms of class gift … in accordance with the rules for determining relationship and inheritance rights for purposes of intestate succession.

The rules for determining relationship and inheritance rights for purposes of intestate succession are found in Prob C §§6406, 6450-6455. Under these rules, a gift to "children" generally includes children born out of wedlock. Prob C §6450(a). In *Estate of Griswold* (2001) 25 C4th 904, 108 CR2d 165, the court held that a father's admission of paternity in a court proceeding was sufficient acknowledgement of a child under Prob C §6452 to permit the father's later-born children to inherit a portion of the first child's estate.

The term "issue" is generally equivalent to "lineal descendants," with the relationship of parent and child at each generation being determined by the definitions of "parent" and "child." Prob C §50. The terms "parent" (Prob C §54) and "child" (Prob C §26) are defined in terms of individuals who are entitled to take as a parent or child by intestate succession under Prob C §§6450-6455. See §10.9.

The supreme court has held that the testator's intent is presumed to be reflected by the laws in effect at the time the will was executed and may not fairly be deemed to be reflected by a legislative change in public policy that is enacted after the testator's death. *Newman v Wells Fargo Bank* (1996) 14 C4th 126, 140, 59 CR2d 2 (refusing to apply 1985 change, interpreting 1972 testamentary trust; disapproving a contrary conclusion in *Estate of Joslyn* (1995) 38 CA4th 1428, 45 CR2d 616). See also *Estate of Dye* (2001) 92 CA4th 966, 112 CR2d 362 (applying 1985 change, interpreting 1989 will). But see Prob C §21140(a) (rules for interpretation of instruments under Prob C §§21101-21140 apply regardless of when the instrument was drafted). The best way to prevent litigation in this area is for the testator to make his or her intentions clear in the will.

Occasionally, it may be unclear whether a class gift to "children" includes grandchildren. Unless the will provides otherwise, a gift to "children" is generally limited to issue of the first generation. See *Estate of Craig* (1944) 64 CA2d 132, 148 P2d 100, in which the court acknowledged this rule but found that the will at issue, when read as a whole and in light of extrinsic evidence, led inexorably to the conclusion that the deceased had intended the word "children" to include grandchildren.

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§12.29A a. Posthumously Conceived Children

The gift to children or issue may include posthumously conceived children. Prob C §6453(c). See discussion in §10.9. The Ninth Circuit has held that posthumously conceived children may be entitled to Social Security survivor benefits—even if they could not inherit from the father by intestate succession—if they can prove that the father affirmatively consented to posthumous conception and to the support of any resulting children. See *Gillett-Netting v Barnhart* (9th Cir 2004) 371 F3d 593 (Arizona law). See also *Woodward v Commissioner of Social Security* (Mass 2002) 760 NE2d 257 (posthumously conceived child entitled to Social Security benefits because child was intestate heir of decedent under state law). But see *Eng Khabbaz v Commissioner of Social Security Admin.* (NH 2007) 930 A2d 1180 (posthumously conceived child not entitled to Social Security benefits because child was not surviving issue of decedent under state law). In *Vernoff v Astrue* (9th Cir 2009) 568 F3d 1102, the court held that a posthumously conceived child was not entitled to Social Security survivor benefits as a presumed natural child of the deceased father under Fam C §7611(f) because the deceased father, who died of accidental causes, did not knowingly donate his sperm and did not consent to its use as required by Prob C §249.5. See also *Estate of Kievernagel* (2008) 166 CA4th 1024, 83 CR3d 311, in which the appellate court held that the trial court properly denied a surviving spouse's petition for distribution of the decedent's sperm. The trial court based its decision on a determination that the decedent intended that the sperm be destroyed in the event of his death.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.29B b. Foster Children and Stepchildren

§12.29B b. Foster Children and Stepchildren

Foster or stepchildren are treated as "children" if (Prob C §6454):

- The relationship began during the child's minority and continued throughout the parties' joint lifetimes; and
- Clear and convincing evidence establishes that the foster parent or stepparent would have adopted the person but for a legal barrier.

In the case of intestacy claims by adult foster children or stepchildren, it must be shown that the legal barrier to adoption continued from the child's majority until the death of the foster parent or stepparent. *Estate of Joseph* (1998) 17 C4th 203, 70 CR2d 619.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.29C c. Adopted Children

§12.29C c. Adopted Children

Adopted children are generally included in class gifts to "children." Prob C §6450(b). The right to the intestate share of an adopted child also can be based on the doctrine of equitable adoption. Prob C §6455. See *Estate of Ford* (2004) 32 C4th 160, 8 CR3d 541 (equitable adoption claimant must demonstrate some direct expression of intent by decedent to adopt claimant or that decedent held out claimant as adopted, and must establish these facts by clear and convincing evidence); *Estate of Furia* (2002) 103 CA4th 1, 126 CR2d 834 (doctrine of equitable adoption is based on contract and does not permit a child to receive a distribution of property from the estate of a person who did not promise to adopt the child); *Estate of Wilson* (1980) 111 CA3d 242, 168 CR 533. Probate Code §§21115(b) and 6451(a), however, list the somewhat unusual circumstances under which an adopted child might not be included. Litigation about "children" or "issue" has frequently concerned adoptees. In particular, such litigation has usually concerned whether a testator intended to include in class gifts:

- Adoptees who were adopted as adults. See *Estate of DeLoreto* (2004) 118 CA4th 1048, 13 CR3d 513 (adult adoptees were not grandchildren of the settlor for trust distribution purposes because they did not live in the household of the adopting parent while they were minors). See also *Abramovic v Brunken* (1971) 16 CA3d 719, 94 CR 303, and *Williams v Ward* (1971) 15 CA3d 381, 93 CR 107, in which the courts found that the testator did not intend to include adult adoptees. But see *Estate of Stanford* (1957) 49 C2d 120, 315 P2d 681; *Estate of Moulton* (1976) 63 CA3d 1, 133 CR 500.
- Adoptees who were adopted after the testator's will was executed. See *Estate of Huntington* (1976) 58 CA3d 197, 129 CR 787; *Wells Fargo Bank v Huse* (1976) 57 CA3d 927, 129 CR 522.

Adoptees also may continue to be "children" of a natural parent if (Prob C §6451; Fam C §297.5):

- The natural parent and the adoptee lived together at any time as parent and child; and
- The adoption was by the spouse or registered domestic partner of either of the natural parents or after the death of either of the natural parents.

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§12.30 3. Gifts to Heirs

Unless the will states otherwise, a gift made to "heirs," "relatives," "family," "next of kin," or persons described by similar words is considered to be made to those who would take under the laws of intestate succession. Prob C §21114. See Prob C §§6400-6455. For these purposes, "heirs" or "relatives" may include natural parents of the designated person even in the absence of a normal parent-child relationship. See *Estate of Shellenbarger* (2008) 169 CA4th 894, 86 CR3d 862 (decedent's natural father takes by intestate succession even though he never saw decedent during decedent's 42-year lifetime and allegedly did not pay child support). Probate Code §21114 provides that if the designated person's surviving spouse is living but remarried when the devise takes effect in enjoyment, then the surviving spouse is not an heir of the designated person. A person also may be married to the designated person at the time of death but may not be the decedent's "surviving spouse" for intestate succession purposes under Prob C §78. See §10.7A.

These takers are determined on the date the gift to them will take effect in enjoyment and according to the California statutes of intestate succession of property not acquired from a predeceased spouse in effect at that time. Probate Code §21114 also applies to surviving registered domestic partners who have formed another domestic partnership. Fam C §297.5(c). Because California's succession laws are fairly complex and may change after execution of the will, these words should be defined in the will. See Alternative 4 in form 12.80-1 for a definition of "heirs" in a residuary clause.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.31 C. Time for Ascertaining Class Membership

§12.31 C. Time for Ascertaining Class Membership

The time for ascertaining the membership of a class is determined by the intent of the testator as expressed in the instrument. Prob C §21102(a). See clauses in §§12.33-12.34B.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.32 D. Proportions to Be Taken by Class Members

§12.32 D. Proportions to Be Taken by Class Members

When a gift is made to a class, it may be unclear in what proportions the gift should be distributed to each member of the class.

The general rule is that the testator's intent determines the manner of distribution. *Lombardi v Blois* (1964) 230 CA2d 191, 40 CR 899. If the testator's intent is unknown, the members of the class take per capita (equally), even when a gift is made to an individual and a group of persons ("*A* and the children of *B*") or when a gift is made to several groups constituting the class ("to the children of *A, B,* and *C*"). 14 Witkin, Summary of California Law, *Wills and Probate* §223 (10th ed 2005).

Probate Code §245 modifies the above common law rule when the class involved consists of issue or descendants. When the will does not specify the manner in which issue or descendants are to take, the distribution pattern described in Prob C §240 will be employed. Prob C §245.

The attorney should familiarize himself or herself with Prob C §§240-247 if the testator wishes to make a class gift to issue, descendants, or the like. These statutes present three alternative schemes for distribution, which the attorney should discuss with the client:

(1) Under Prob C §240, invoked by Prob C §245, the property is divided

> into as many equal shares as there are living members of the nearest generation of issue then living and deceased members of that generation who leave issue then living, each living member of the nearest generation of issue then living receiving one share and the share of each deceased member of that generation who leaves issue then living being divided in the same manner among his or her then living issue.

(2) Under Prob C §246, the property subject to the class gift is divided

> into as many equal shares as there are living children of the designated ancestor, if any, and deceased children who leave issue then living. Each living child of the designated ancestor is allocated one share, and the share of each deceased child who leaves issue then living is divided in the same manner.

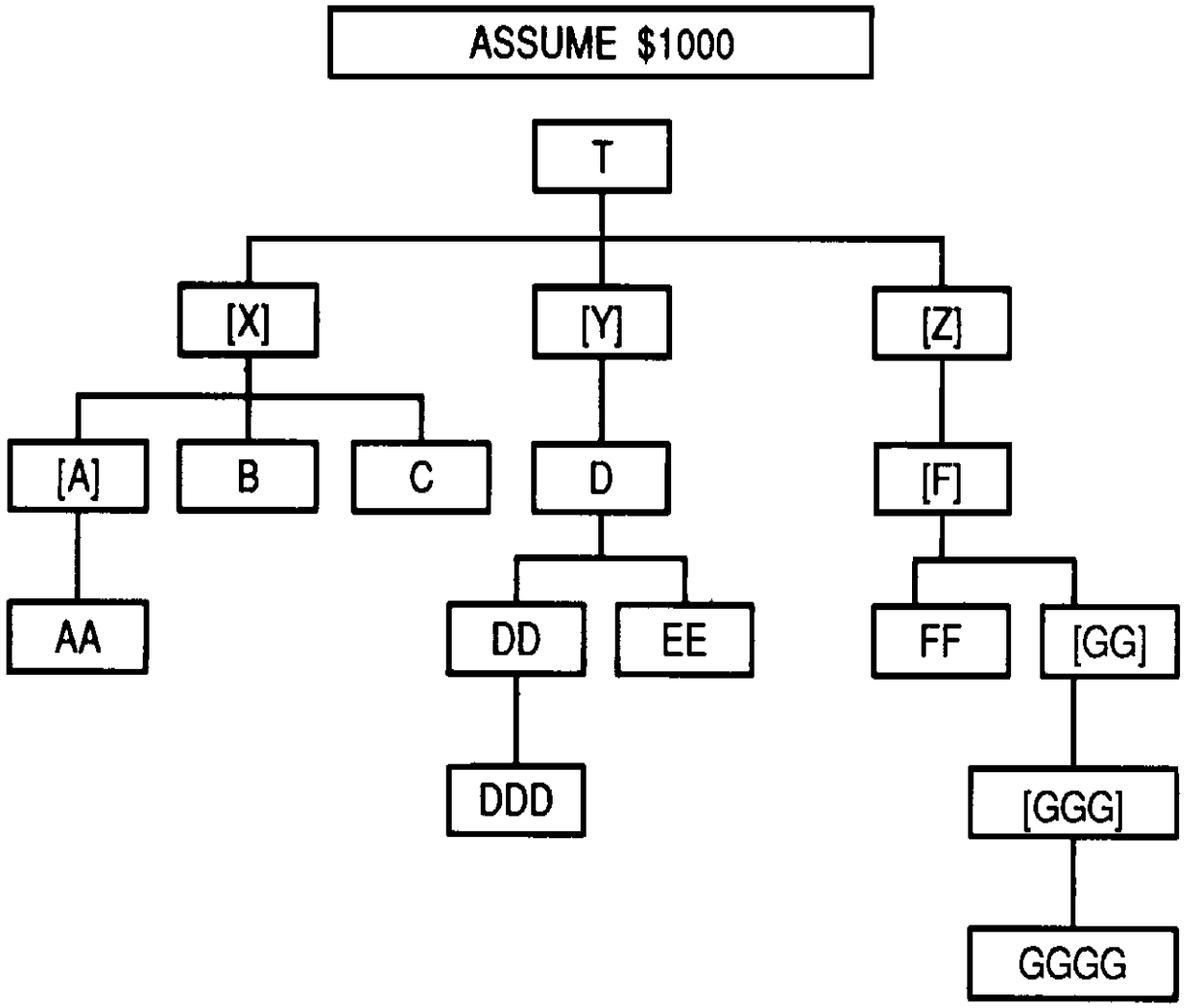
(3) Under Prob C §247, the property is divided in a "per capita at each generation" disposition scheme

> into as many equal shares as there are living members of the nearest generation of issue then living and deceased members of that generation who leave issue then living. Each living member of the nearest generation of issue then living is allocated one share, and the remaining shares, if any, are combined and then divided and allocated in the same manner among the remaining issue as if the issue already allocated a share and their descendants were then deceased.

The following chart illustrates the different results achieved by using the statutory schemes of Prob C §§240-247 to distribute a $1000 gift to the testator's issue:



Distribution Under Probate Code §§240–247



By Representation (§246)	*§240*	*"Per Capita" at Each Generation (§247(a))*
B–1/9 = $111.11	B–1/5 = $200	B–1/5 = $200
C–1/9 = $111.11	C–1/5 = $200	C–1/5 = $200
AA–1/9 = $111.11	D–1/5 = $200	D–1/5 = $200
D–1/3 = $333.33	AA–1/5 = $200	AA–2/15 = $133.33
FF–1/6 = $166.67	FF–1/10 = $100	FF–2/15 = $133.33
GGGG–1/6 = $166.67	GGGG–1/10 = $100	GGGG–2/15 = $133.33

If the testator prefers the distribution scheme set forth in Prob C §240, the will should call for the gift to be distributed "in the manner provided in Section 240 of the Probate Code." Prob C §245(a). Although Prob C §240

distribution may also be invoked simply by providing for issue or descendants without specifying the manner of distribution (Prob C §245(a)), there seems to be no reason for a testator to choose that method of invoking the provisions.

If the testator prefers the distribution scheme outlined in Prob C §246, the will should call for the gift to be (1) distributed "in the manner provided in Section 246 of the Probate Code" (Prob C §246(a)) or (2) distributed or taken "per stirpes," "by representation," or "by right of representation" (Prob C §246(b)).

If the testator prefers the distribution scheme described in Prob C §247, the will should call for the property to be (1) distributed or taken "in the manner provided in Section 247 of the Probate Code" (Prob C §247(a)) or (2) distributed "per capita at each generation" (Prob C §247(b)).

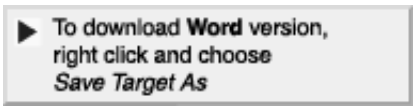
For clauses, see forms 12.34-1, 12.34A-1, 12.34B-1.

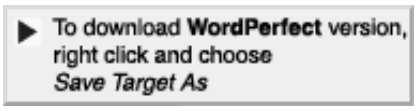
NOTE: The statutory distribution schemes do not limit the testator, who is free to specify how he or she wishes the distribution to be made.

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E. Class Gifts and Residuary Gifts to Named Class Members

§12.33 1. Form: Lapsing Class Gift to Children





12.33-1 Gift in equal shares to children who survive testator

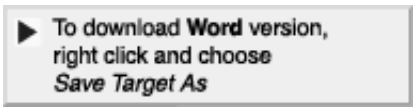
***Gift of Property*. I give _ _[*gift*]_ _ in equal shares to my children who survive me by 30 days. If none of my children so survive this gift shall lapse. Issue of a child not so surviving are not entitled to take in the place of the deceased child.**

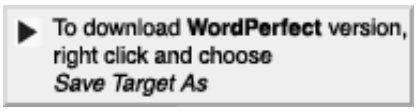
Comment: In some cases, particularly when making dispositions of tangible personal property, a testator will want to avoid the possible application of the Prob C §21111 antilapse statute. See §§12.16-12.17 on the effect of the antilapse statute on class gifts. This clause limits class membership to children who are living at the testator's death. This clause assumes that the "children" have already been identified in the will. If not, it may be necessary to further define the term "children." See §12.29. The clause may be modified to refer to the children of another person. The attorney and testator should consider naming alternate beneficiaries if none of the children survives. See §§12.22-12.23.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.34 2. Form: Class Gift of Residue to Issue

§12.34 2. Form: Class Gift of Residue to Issue





12.34-1 Class gift to issue

[*Add one of the following alternatives*]

[*Alternative 1: By right of representation*]

***Gift of Residue*. I give the residue of my estate, including any lapsed gifts not otherwise disposed of, to my issue who survive me by 30 days, by right of representation. "Issue" means all of my lineal descendants of all generations at the time of my death, with the relationship of parent and child at each generation being determined according to the California statutes for determining relationship and inheritance rights for purposes of intestate succession in effect at that time. The term "issue," however, does not include the following:** _ _[*Excluded groups*]_ _.

[*Alternative 2: Per capita*]

***Gift of Residue*. I give the residue of my estate, including any lapsed gifts not otherwise disposed of, to my issue who survive me by 30 days, per capita at each generation as described in California Probate Code §247.**

Comment: Alternative 1 distributes a gift to the testator's issue by right of representation. This triggers the application of Prob C §246(a). Alternative 2 triggers the application of Prob C §247. Because this clause does not involve the disposition of a future interest, both clauses will usually produce the same distribution unless at least two children predecease the testator and leave surviving issue. For discussion of these methods of distribution, see §12.32. For additional clauses, see §§12.34A-12.34B.

Note that both clauses limit class membership to issue who survive the testator by 30 days. On the time for ascertaining membership in a class, see §12.31.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.34A 3. Form: Class Gift to Named Persons and Their Issue--Equal Shares

§12.34A 3. Form: Class Gift to Named Persons and Their Issue—Equal Shares

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12.34A-1 Class gift to named persons and their issue—equal shares

Gift of Residue. **The residue of my estate, including any lapsed gifts not otherwise disposed of, shall be divided into as many equal shares as there are persons named in the following list who survive me by 30 days and persons named in that list who do not so survive me but who leave issue who so survive me. Each so surviving listed person shall receive one share and the so surviving issue of each listed person who did not so survive me shall take by representation the share created on account of the ancestor who did not so survive me. The named persons are: _ _[*names*]_ _.**

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.34B 4. Form: Class Gift to Named Persons and Their Issue--Unequal Shares

§12.34B 4. Form: Class Gift to Named Persons and Their Issue—Unequal Shares

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12.34B-1 Class gift to named persons and their issue—unequal shares

Gift of Residue. **The residue of my estate shall be divided into the number of equal shares that equals the total number of shares shown opposite the names below, except that shares shall be created only for those listed persons who survive me or leave issue who survive me. I give each listed person who survives me the number of shares of the residue created for that person, with the issue who survive me of any deceased listed person receiving by representation the shares the deceased listed person would have received had that person survived. For purposes of this paragraph a person is deemed to survive me only if they survive me by 30 days.**

Name	**Number of Shares**
_ _[*names*]_ _	_ _[*numbers of shares*]_ _

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V. SPECIFIC GIFTS

§12.35 A. Definition and Usage of Specific Gift

"A specific gift is a transfer of specifically identifiable property." Prob C §21117(a). For example, a gift of "my diamond wedding ring" is a specific gift.

Whether a gift is legally categorized as "specific" is of more than just theoretical interest. For example, the categorization of a gift affects abatement priorities (see §§12.3-12.4) and determines whether ademption rules apply (see §§12.7-12.13) and how income from the devised property and expenses attributable to it should be treated (see Prob C §12002; §12.53).

The attorney should encourage the testator to limit the number of specific gifts. In addition to the problems of ademption raised when specifically devised assets are sold, exchanged, or otherwise disposed of, the impact of unpredictable future changes in the testator's financial situation on a will with numerous specific gifts should not be underestimated. Either ademption or significant changes in the value of the estate or of particular estate assets can seriously distort the testator's dispositive goals. A will with numerous specific gifts requires frequent review and revision at considerable expense to the testator. For discussion of similar problems with excessive general gifts, see §12.70.

The attorney should particularly scrutinize a proposed specific gift of the testator's residence. In the past, a testator customarily made an outright gift of his or her residence to his or her spouse or domestic partner. This custom should be reconsidered in today's inflationary economy. If death tax liability is possible at the death of the surviving spouse or domestic partner, the testator should be encouraged to consider disposition of the residence through a trust. See chap 17. See also California Estate Planning, chap 17 (Cal CEB 2002).

It may not be easy to convince a client to use specific gifts sparingly. Many clients erroneously believe that they must dispose of their estate on an asset-by-asset basis. Some spend a good deal of time and effort compiling a list of specific gifts. A client who is adamant that valuable items of property be specifically devised should be advised of all the disadvantages of such a disposition plan.

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B. Specific Gifts of Tangible Personal Property

§12.36 1. Factors to Consider When Deciding on Specific Gifts of Tangible Personal Property

Although specific gifts are generally not advisable, they are sometimes appropriate for disposition of the testator's tangible personal property, *e.g.,* furniture, personal effects. When tangible personal property is disposed of as part of the residue of the estate, administration problems may arise if minors share in the residue or the residue goes into trust. Distribution problems may also arise if more than one beneficiary is entitled to the residue. Further, a specific gift of tangible personal property is likely to facilitate prompt preliminary distribution of the property to beneficiaries, saving considerable storage and maintenance costs.

This does not mean that there are no drawbacks to disposition of tangible personal property by specific gifts. Many of these drawbacks are discussed in §12.35. Additional problems may arise from the following:

- Probate notice requirements. Notice must be given to all beneficiaries named in the will at the commencement of probate proceedings and at various points during probate. See Prob C §1206. If the tangible personal property is given to many specific beneficiaries, notice will be a burdensome task. Further, the testator or his or her primary beneficiary may not wish the beneficiaries of relatively small gifts to know all that transpires during probate administration.
- Probate appraisal requirements. Courts usually require that personal items specifically given in a will be separately appraised, which can present an irritating task for the executor.

If the testator insists on giving specific personal articles to many beneficiaries, the attorney should explore with him or her the possibility of making these gifts outside probate, *e.g.,* from a revocable living trust or by informal means. See §12.43.

NOTE: The will drafter should be aware that personal items left to the surviving spouse or registered domestic partner will not form part of the probate estate and will pass free of administration. Prob C §13500; Fam C §297.5(c).

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§12.37 2. Problems of Ownership of Personal Articles

If the testator has jointly purchased many household furnishings and other personal items with someone, the attorney should encourage him or her to devise all tangible personal property to that person. If the testator devises the property to someone else, disputes over the nature and extent of the testator's interest in each item may arise during probate administration unless the testator has kept careful records.

If, at the date of death, the testator is likely to be in possession of valuable items belonging to someone else, the will should confirm that the items do not belong to the testator. This provision should eliminate postmortem arguments over ownership.

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§12.38 3. Specific Gift Drafting Considerations

When all tangible personal property is not meant to pass to the same beneficiary or group of beneficiaries, the will drafter must exercise care when including or excluding certain items from particular gifts to avoid any conflict or ambiguity. For example, the testator may desire to leave tangible personal property used in connection with improved real property or a business venture with those interests. These personal property items should be expressly excluded from the gift of general personal property so that they will remain intact and pass with the real property or business interest, either as part of another specific gift or as part of the residue (if the real property or business is part of the residue). See §§12.58, 12.68.

Instead of "tangible personal property" or "tangible articles of a personal nature," some attorneys prefer to use "personal effects," "belongings," or even "personal property."

For discussion of court interpretations of such phrases, see 14 Witkin, Summary of California Law, *Wills and Probate* §§193-196 (10th ed 2005).

When drafting a gift of a particular item, the attorney should carefully describe and identify the item being given. After doing so, the attorney should ask the testator whether the description is precise enough to avoid disputes over which item the testator intended to devise by this language. The attorney should avoid describing an item by reference to where it can be found in the testator's residence, because the testator's rearrangement of a room may effectively rewrite the will. Dickinson, *Avoiding Conflicts Among Beneficiaries Over Bequests of Personal Property*, 17 Est Plan 216, 220 (July/Aug. 1990).

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§12.39 4. Gifts of Tangible Personal Property to Children and Other Groups of Beneficiaries

When tangible personal property is left to the testator's children as a class (either as primary or alternate beneficiaries), disputes may arise over how the property should be divided. Because children attach a great deal of sentiment to a parent's personal effects, animosity can arise over their disposition in even the most harmonious families.

To reduce the risk of hostility among the testator's children, the testator can provide for the children to receive equal shares of the tangible personal property. A harmonious distribution still depends, however, on the children's willingness to agree about who should receive each item and about the value of each item on the date the property is distributed. To prevent disagreements from delaying distribution, the testator may want to give the executor the power to determine the distribution of personal property in the event the children cannot agree. See Alternative 1 in form 12.47-1. Another solution might be to allow the children to make alternate selections of equal groups of items, under the executor's supervision, until the personal property is depleted. See Alternative 2 in form 12.47-1. Finally, the will could provide for the executor to sell the personal property and distribute the proceeds if the children are unable to agree on division and distribution. For further options, see Dickinson, *Avoiding Conflicts Among Beneficiaries Over Bequests of Personal Property*, 17 Est Plan 216 (July/Aug. 1990).

If any of the children are minors, other problems may arise. See §12.1. If the tangible personal property might be of substantial value, the testator should consider giving the executor power to transfer it to a trust for the benefit of the minor children or to a custodianship under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). See §33.33.

If the children are to participate in the selection and division of the testator's tangible personal property, the testator should be encouraged to authorize the executor to represent the minor children in this process. See Alternative 2 in form 12.47-1.

NOTE: Concerns about disputes over distribution of personal property to a group of beneficiaries are not limited to gifts to children. Whenever personal property is given to a group of beneficiaries, the problems raised in this section and the suggested solutions should be carefully considered.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.40 5. Intangible Rights Related to Tangible Personal Property

§12.40 5. Intangible Rights Related to Tangible Personal Property

Casualty insurance carried on tangible personal property should pass to the beneficiary of the insured property. The will must specify whether the testator wishes other intangible property (*e.g.,* ownership of a copyright or reproduction rights in a painting) to pass with the gift of tangible personal property. Dickinson, *Avoiding Conflicts Among Beneficiaries Over Bequests of Personal Property*, 17 Est Plan 216, 218 (July/Aug. 1990).

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§12.41 6. Gifts of Property Subject to Encumbrances

Probate Code §21131 provides that a "specific gift passes the property transferred subject to any mortgage, deed of trust, or other lien existing at the date of death, without right of exoneration, regardless of a general directive to pay debts contained in the instrument." If the testator owns encumbered tangible personal property (*e.g.,* automobiles, trailers, boats), the drafter should specify in the will the testator's desires regarding payment of the encumbrances from other estate assets. See §12.51.

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§12.42 7. Administrative Expenses Related to Tangible Personal Property

If the testator expects unusual expenses to safeguard and maintain items of tangible personal property, the will should indicate whether the estate or the beneficiary of the item should pay for those expenses. For example, a caretaker may have to be hired to look after the testator's stable of thoroughbred horses. The testator must decide whether the estate or the beneficiary of the horses should pay for the caretaker's services. See Dickinson, *Avoiding Conflicts Among Beneficiaries Over Bequests of Personal Property*, 17 Est Plan 216, 219 (July/Aug. 1990).

The testator may not wish to burden the beneficiary of tangible personal property with the expense of transporting the property. Accordingly, if the beneficiary lives more than a short distance from the testator's home, the will should include a clause requiring the estate to bear packing and shipping expenses. If the testator wishes, the clause may be modified to require payment of only "reasonable" charges or to leave payment by the estate to the executor's discretion. If the testator wants each beneficiary to bear these charges, the will should say so. See §§33.36-33.37.

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§12.43 8. Disposition of Tangible Personal Property Informally or by Holographic Codicil

It is relatively common for a testator to provide for distribution of his or her tangible personal property outside the will by instructing a trusted relative or friend to handle its disposition. The will leaves the property to that person, and the testator relies on the person's honesty and good faith to carry out his or her wishes. The testator may provide the trusted person with a letter of instructions, which the will may or may not mention. Of course, the beneficiary is not bound by the testator's letter unless it is validly incorporated by reference in the will. See §§5.3-5.5. This method of disposition is most often used by testators who want the freedom to add or alter the disposition with a minimum of fuss and expense. The attorney should advise the testator to type any instructions to the trusted relative or friend, to prevent a court from deeming the document a holographic codicil to the will.

When a testator wants his or her wishes about the disposition of tangible personal property to be legally enforceable and not dependent on another person's good faith, the attorney should instruct him or her on the preparation of a holographic codicil if those wishes may change several times before death. In such instances, the will can omit any provisions for disposition of tangible personal property or state that this disposition will be by later codicil. Immediately after execution of the will, the testator should execute the holographic codicil. Other codicils can be prepared as the need arises in the future. The testator should be instructed to send a copy of any holographic codicil to the attorney, who can review it for conflicts with the remaining provisions of the will.

PITFALL: Disposition by holographic codicil should only be used by the most sophisticated clients. Even carefully written codicils may have unintended effects on prior wills or codicils or may contain ambiguous descriptions of items evident only to an attorney familiar with the probate process. In the long run, it may be less expensive for the attorney to prepare the codicil than for the attorney to review and redraft a codicil written by the client.

The client should realize that many counties require notice of probate proceedings to be given to beneficiaries whose gifts were revoked by codicil. The client may not wish such persons to learn of revoked gifts. A new will may be a more suitable alternative. See §6.2.

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§12.44 9. Specific Gift Planning Problems

The attorney should ask the client whether he or she owns any sensitive or potentially embarrassing items, papers, or letters. If so, the client may want to make sure that they are distributed to persons who will appreciate their delicacy and take measures to respect the client's privacy.

On specific gifts of fine art, see Fraiman, *You Can't Take It with You: Testamentary Disposition of Fine Art*, 5 Prob & Prop 12 (Jan./Feb. 1991). On charitable gifts of artwork, see Estate Planning for Special Assets, chap 7 (Cal CEB 2004).

If a specifically devised piece of property is likely to earn income or incur expenses during administration of the estate, the will should indicate what should happen to the income and how the expenses should be paid. If the will does not, the provisions of Prob C §12002 will apply. See §12.53 for discussion of these provisions in the context of specifically devised real property. See also §§12.41-12.42.

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10. Forms of Specific Gifts

§12.45 a. Form: Specific Gifts of Items of Personal Property

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12.45-1 Specific gifts of items of personal property

***Gift of Specific Items of Personal Property*. I give** _ _[*item of tangible personal property*]_ _**, together with any insurance on it, to** _ _[*name of beneficiary*]_ _.

[*If applicable, add the following option*]

[*Option: Substitute gift if primary gift adeemed*]

If for any reason the _ _[*item*]_ _ **is not a part of my gross estate (as defined for federal estate tax purposes) at the time of my death, I give** _ _[*amount*]_ _ **to** _ _[*name of beneficiary*]_ _.

Comment: See §§12.36, 12.38, 12.40-12.41, 12.44.

The optional addition is one way to handle the issue of ademption. See §§12.7-12.13. The attorney should be cautious in using this clause, however, because the substitutional gift of cash may set the asset's value at an unrealistically high level both for estate tax purposes and for computing executor commissions and attorney fees for the probate of the testator's estate. Of course, the substitutional gift need not be a cash amount.

See forms 12.20-1, 12.23-1 (survivorship and disclaimer conditions).

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.46 b. Form: Gift of Tangible Personal Property to Individual

§12.46 b. Form: Gift of Tangible Personal Property to Individual

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12.46-1 Gift of tangible personal property to individual

***Gift of Tangible Personal Property*. I give all my jewelry, clothing, household furniture and furnishings, personal automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in my will or in any other manner, together with any insurance on the property, to _ _[*name of beneficiary*]_ _.**

Comment: See §§12.36-12.38, 12.40-12.41, 12.44.

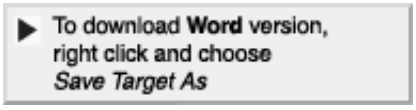
The will drafter should review with the testator the personal property that he or she owns to confirm that items of substantial value (*e.g.,* boats, airplanes, trailers) are intended to pass under the provisions of this clause. If the items are intended to pass but the clause may be construed to exclude them, the drafter should modify the clause to list those items specifically. If they are not intended to pass but the clause may be construed to include them, the drafter should modify it to make the exclusion clear. See *Prince v Higgins* (Ala 1990) 572 So2d 1217 (litigation over whether gold coins are "tangible personal property").

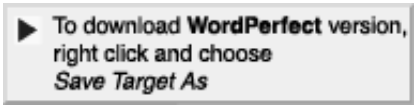
If form 12.45-1 is used to make gifts of specific items of personal property, the last phrase in form 12.46-1 becomes particularly important.

See forms 12.20-1, 12.23-1 (survivorship and disclaimer conditions).

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§12.47 c. Form: Gift of Tangible Personal Property to Children





12.47-1 Gift of tangible personal property to children

***Gift of Tangible Personal Property*. I give all my jewelry, clothing, household furniture and furnishings, personal automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in my will or in any other manner, together with any insurance on the property, to my children who survive me, in substantially equal shares as selected by them on the basis of valuation.**

[*Add one of the following alternatives*]

[*Alternative 1: Executor divides if children cannot agree*]

If my children cannot agree on a division of the tangible personal property, my executor shall divide it among them in any manner considered appropriate by my executor as long as my children receive substantially equal shares on the basis of valuation.

[*Alternative 2: Executor controls selection of shares if children cannot agree*]

If my children cannot agree on a division of the tangible personal property, my executor shall divide the property, in my executor's absolute discretion, into as many shares of substantially equal value as there are children who survive me. My executor shall allow each child to select one of these shares in an order designated by my executor until distribution is complete.

[*Continue*]

My executor shall represent any minor child in matters relating to the distribution of tangible personal property, including selecting the assets that will constitute that child's share. In my executor's absolute discretion, my executor may (1) sell all or part of the minor child's share considered by my executor to be unsuitable for the child's use, and (2) deliver the proceeds and unsold property without bond to the child if sufficiently mature or to any suitable person with whom the child resides or who has control or care of the child.

Comment: Either of the alternative clauses may be used by the testator who wishes to give tangible personal property to his or her children and to provide a procedure for resolving disputes if the children cannot agree on how the property should be divided. Either clause can be modified for gifts of tangible personal property to a group of beneficiaries other than the testator's children. See §§12.36, 12.38-12.41, 12.44.

For discussion of class gifts to children, see §§12.27-12.29, 12.31, 12.33. See forms 12.20-1, 12.23-1 (survivorship and disclaimer conditions).

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C. Specific Gifts of Real Property

§12.48 1. Testator's Residence

If the testator wishes his or her spouse or registered domestic partner to have the family home, an outright gift may not be the best method. In an inflationary economy, an outright gift of the family residence to the surviving spouse or partner may be poor estate planning. See §12.35. Even if estate taxes are not a consideration, it may be wiser for the testator to use a trust for disposition of the residence, *e.g.,* when the testator has children of a former marriage and the home is separate property. A trust can give the spouse or partner use of the home for life, with the residence passing to the testator's children at the spouse or partner's death. Of course, a legal life estate may be used, but because of its inflexibility and the problems created by conflicts between the life beneficiary and the remainderpersons, it is not recommended.

If the residence is left outright to the surviving spouse or partner, it will pass free of probate administration unless the spouse or partner elects otherwise. Prob C §§13500, 13502-13503; Fam C §297.5(c). If the residence is devised to others, administration will be required unless the property's value is so minimal that the summary procedures available under Prob C §§13000-13208 can be used.

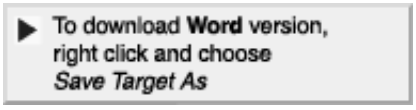
Insurance carried on the residence should be given to its beneficiary. See form 12.49-1.

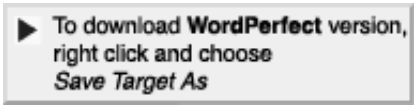
NOTE: If the testator intends to leave the family residence to a beneficiary other than the surviving spouse or domestic partner or minor children, the attorney must consider the effect of the probate homestead rules: Prob C §§6520-6528. A clear statement of intent under Prob C §6523 is recommended to increase the likelihood that the testator's estate planning goals will not be thwarted by a probate judge's application of these rules. See, *e.g.,* form 12.50-1.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.49 a. Form: Gift of Residence to Spouse or Domestic Partner

§12.49 a. Form: Gift of Residence to Spouse or Domestic Partner





12.49-1 Gift of residence to spouse or domestic partner

***Gift of Residence*. I give to my _ _[*spouse/partner*]_ _ any interest I own in the property that was our principal residence at the time of my death, together with any insurance on the property.**

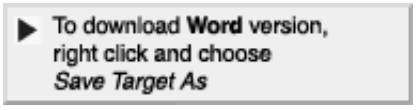
Comment: This clause should be adequate to dispose of the testator's interest in the family residence, regardless of its character (community, quasi-community, or separate property) or nature (single-family residence, condominium unit, cooperative apartment). In addition, because the property is not identified by a common or legal description, the will need not be updated if the spouses move to a new residence. If a dispute is likely to arise over the meaning of "principal residence," this clause should not be used. In such cases, the will drafter should describe the property by its street address. Of course, the clause can easily be adapted for use by the testator in a nontraditional personal relationship.

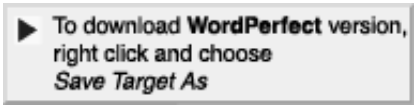
See forms 12.20-1, 12.23-1 (survivorship and disclaimer conditions).

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.50 b. Form: Gift of Residence to Other Beneficiary With No Probate Homestead

§12.50 b. Form: Gift of Residence to Other Beneficiary With No Probate Homestead





12.50-1 Gift of residence with no probate homestead

***Gift of Residence*. I give all my interest in the residence located at _ _[*address*]_ _ to _ _[*name of beneficiary*]_ _, together with any insurance on the property. I direct that no probate homestead be set apart for my _ _[*spouse/domestic partner*]_ _ or for any one or more of my minor children.**

Comment: See §12.48.

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2. Exoneration of Encumbrances

§12.51 a. Expression of Testator's Wishes

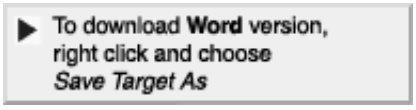
Unless the will provides otherwise, a specific gift of encumbered real property passes the property to the beneficiary subject to the encumbrance, without right of exoneration. Prob C §§21102, 21131.

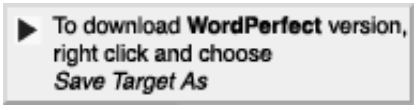
Because a testator is free to determine whether encumbrances on devised property should be exonerated, it is important for the will drafter to specify in the will the testator's desires regarding payment of encumbrances from other estate assets. See form 12.52-1. If the testator desires exoneration of encumbered specific gifts, he or she must further decide whether specific gifts of other property should abate for the purpose of exonerating the encumbered property. A testator who does not provide for such abatement will be presumed to have not desired it. Prob C §21404.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.52 b. Form: Exoneration of Encumbrances on Real Property

§12.52 b. Form: Exoneration of Encumbrances on Real Property





12.52-1 Exoneration of encumbrances on real property

[*Add one of the following alternatives*]

[*Alternative 1: Executor to pay encumbrances*]

I direct my executor to pay any encumbrances on the property at the time of my death, including mortgages, deeds of trust, and real property taxes and assessments. Such payments shall be made from the residue of my estate.

[*Alternative 2: No exoneration of encumbrances*]

I give the property subject to any encumbrances on it on the date of my death, including mortgages, deeds of trust, and real property taxes and assessments.

Comment: One of these alternative clauses should be adapted for use with any specific gift of real property. See §12.51. See also §12.4. If Alternative 1 is chosen by a testator who wishes exoneration from assets other than those in the residue, the drafter should modify the clause accordingly.

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3. Income and Expenses Attributable to Specifically Devised Real Property

§12.53 a. General Rules

The beneficiary of specifically devised real property receives the income on the devised property less the expenses attributable to the property during the administration of the estate. Prob C §12002(b). Mortgage payments, repairs, property taxes, and taxes on income from the property are examples of expenses attributable to specifically devised real property, but that portion of the death taxes attributable to the property is not considered such an expense. Prob C §12002(b).

If the income on the specifically devised property is not sufficient to pay the expenses attributable to it, the estate pays the deficiency until the property is distributed or until the beneficiary takes possession of or occupies the property, whichever occurs first. Prob C §12002(c). Any deficiency payments made by the estate after a year from the testator's death become a charge against the beneficiary's share. The executor is given a statutory lien against the specifically devised property equal to the amount paid after the anniversary of the testator's death. Prob C §12002(c).

The rules described above apply only when the testator's intention is not indicated in the will. Prob C §12000. The attorney should assist the client to make an informed decision about the treatment of income and expenses of specifically devised property. The income tax ramifications of the available options to both the estate and the specific beneficiary should be considered. See generally California Decedent Estate Practice, chap 33 (2d ed Cal CEB 2009) on income taxation of estates and beneficiaries. The attorney should also examine whether a provision directing the executor to pay these expenses will be considered a taxable transfer to the beneficiary for estate tax purposes and discuss his or her conclusions with the client. Finally, the attorney should ensure that the client's decision about income and expenses of specifically devised property is clearly expressed in the will.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.54 b. Form: Payment of Expenses Relating to Real Property

§12.54 b. Form: Payment of Expenses Relating to Real Property

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12.54-1 Payment of real property expenses

[*Add one of the following alternatives*]

[*Alternative 1: Payment of expenses out of residue*]

I direct that, during the period of probate administration, my executor pay all note payments, income and real property taxes, insurance premiums, and maintenance expenses attributable to the property first from income from the property during administration and then from the residue of my estate. My executor shall not charge these sums to the beneficiary of the property.

[*Alternative 2: Payment of expenses by beneficiary*]

I direct that, during the period of probate administration, my executor pay all note payments, income and real property taxes, insurance premiums, and maintenance expenses attributable to the property from income from the property during administration. If the income is insufficient to meet all these expenses, the beneficiary of the property shall pay the remaining expenses. If the beneficiary does not, my executor may pay these sums and charge them to any of the beneficiary's gifts under my will.

Comment: These alternative clauses are designed to be inserted after the clause making the specific gift of the real property. See §§12.49-12.50. If the testator prefers Alternative 1 but wishes to discourage litigation over whether administration has been unduly prolonged, a clause may be added limiting the time during which the residue of the estate will bear the expenses. See §12.53.

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4. Substitutional Gifts

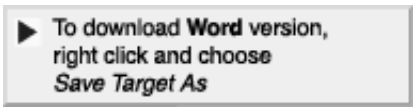
§12.55 a. Providing for Beneficiary of Real Property That Has Been Sold

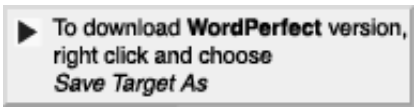
If the testator decides to make a specific gift of real property, he or she should consider whether to provide for its beneficiary if the property is sold before the testator's death. Some testators prefer to provide a substitutional gift of cash equal to the proceeds received from the sale of the specifically devised property. See form 12.56-1. Others prefer to give the beneficiary "replacement" property, especially if the expectation is that the testator will exchange the devised property for another or will not retain sale proceeds in a liquid form. Providing a substitutional gift in the event of a sale or exchange would certainly assuage the disappointment of the beneficiary faced with an ademption of his or her gift. See §§12.7-12.13 for discussion of ademption problems. If the testator consumes the sale proceeds, however, a substitutional gift, particularly of cash, may unintentionally have serious adverse effects on other gifts under the will.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.56 b. Form: Substitution for Gift of Real Property That Has Been Sold

§12.56 b. Form: Substitution for Gift of Real Property That Has Been Sold





12.56-1 Substitution for gift of real property that has been sold

If I have sold the property, I give the beneficiary cash equal in value to the net proceeds of the sale unless at my death I hold a note secured by a deed of trust or mortgage on the property received as part of the sales price, in which case the note shall be distributed to the beneficiary in partial satisfaction of this gift to the extent of the balance remaining due on the note. For purposes of this paragraph, "net proceeds" means the gross proceeds of the sale, reduced by the amount of all encumbrances, commissions, and expenses of sale paid by me, including the amount of any income taxes arising from the sale.

"Net proceeds" does not include interest from the date of the sale.

Comment: This clause provides for a substitutional gift of cash equal to the proceeds received from the sale of the specifically devised property, if the testator sells the property before the testator's death. See §12.55. The clause is intended to be used in conjunction with other clauses related to the giving of a specific piece of real property. See §§12.49, 12.50, 12.52, 12.54.

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§12.57 5. Form: Gift of Condominium Unit or Cooperative Apartment

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12.57-1 Gift of condominium unit or cooperative apartment

[*Add one of the following alternatives*]

[*Alternative 1: Condominium unit*]

***Gift of Condominium Interest*. I give all my interest in the condominium unit located at _ _**[*address*]**_ _ to _ _**[*name of beneficiary*]**_ _, together with any insurance on the property.**

[*Alternative 2: Cooperative apartment*]

***Gift of Cooperative Apartment*. I give all my interest in the cooperative apartment located at _ _**[*address*]**_ _ to _ _**[*name of beneficiary*]**_ _, together with any insurance on the property. This gift includes the related stock and lease, subject to any encumbrances against the stock at my death.**

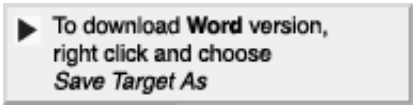
Comment: Condominiums are rapidly replacing single-family dwellings as the first home of many younger individuals and the final home of many retirees. Alternative 1 is sufficient to pass the entire interest in the condominium owned by the testator, including the unit itself and the testator's undivided interest in common in the land on which the condominium is located. If the property is encumbered, the attorney should add a clause stating whether the encumbrance is to be exonerated. See form 12.52-1. If the testator wishes to pass the contents of the condominium or apartment to the same beneficiary, the appropriate clause should be modified to make that clear. For related clauses that might be useful, see forms 12.20-1, 12.23-1 (survivorship and disclaimers); 12.54-1 (income and expenses); 12.56-1 (substitutional gifts).

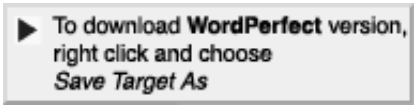
Instead of either of these clauses, the drafter may use form 12.49-1 for a gift of the testator's residence.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.58 6. Form: Gift of Income-Producing Property

§12.58 6. Form: Gift of Income-Producing Property





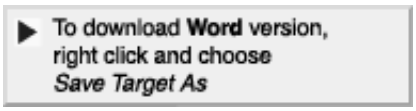
12.58-1 Gift of income-producing property

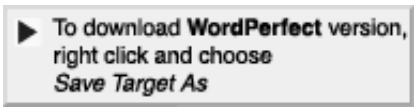
***Specific Gift of Property*. I give my interest in the real property located at _ _[*address*]_ _, together with the tangible personal property used in connection with the real property and any insurance on the real and personal property, to _ _[*name of beneficiary*]_ _.**

Comment: This clause is designed to pass not only the testator's income-producing real property but also the tangible personal property used in connection with the real property. See §12.38. For related clauses, see forms 12.20-1, 12.23-1 (survivorship and disclaimers); 12.52-1 (encumbrances); 12.54-1 (income and expenses); 12.56-1 (substitutional gifts).

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§12.59 7. Form: Gift of Farm or Ranch





12.59-1 Gift of farm or ranch

***Specific Gift of Property*. I give to _ _[*name of beneficiary*]_ _ the real property located at _ _[*address*]_ _, commonly known as _ _[*name of farm or ranch*]_ _, together with all livestock, machinery, and other tangible property used in connection with the real property and any insurance on the real and personal property.**

Comment: This clause is intended to pass the farm or ranch as an entity to the beneficiary. If disputes are likely to arise over which property is intended, the will drafter should be more specific. See §12.38. For related clauses, see forms 12.20-1, 12.23-1 (survivorship and disclaimers); 12.52-1 (encumbrances); 12.54-1 (income and expenses); 12.56-1 (substitutional gifts).

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§12.60 8. Option to Purchase Real Property

If the testator desires to give someone the option to buy a piece of real property, the will should carefully describe the material terms and conditions of the sale. The purchase price or the procedure by which the purchase price must be determined should be stated. The will should also specify a time limit for exercise of the option. If none is specified, the time limit is one year from the date of death. Prob C §9980(b).

A problem related to exoneration arises from a gift of an option to purchase real property at a stipulated price when the property is subject to an encumbrance at the time of the testator's death. The will should state whether the beneficiary is entitled to buy the option property at the stipulated price, free and clear of any encumbrance.

Other terms and conditions of the option that the testator and drafter may wish to include in the will are:

- Whether the purchase must be an all-cash transaction;
- Whether the sale must be on an "as is" basis;
- How sale expenses (*e.g.,* title insurance, transfer taxes) will be apportioned;
- Whether the sale must be completed within a certain period of time; and
- Whether the beneficiary may assign the option.

See California Real Property Sales Transactions, chaps 4-8 (4th ed Cal CEB 2007) for complete discussion of options and purchase and sale agreements.

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D. Specific Gifts of Corporate Stock

§12.61 1. Drafting Considerations

It is usually prudent to avoid specific gifts of publicly traded stock because the testator's stock holdings will almost certainly be altered in some manner or sold after execution of the will. The testator should consider providing for the beneficiary of the proposed specific gift of stock by making a general pecuniary gift or a percentage gift of the residue of the estate.

If the testator insists on making a specific gift of publicly traded stock, the will should specify whether and how the gift should be adjusted for changes in the capital structure of the corporation made after execution of the will. If the will does not, Prob C §21132 will control. See §12.9. See also 14 Witkin, Summary of California Law, *Wills and Probate* §257 (10th ed 2005). The testator may also wish to specify what is to happen if the specifically devised stock is sold by the testator before his or her death. See §§12.7-12.13 for discussion of ademption issues. See also form 12.45-1 (substitutional gift if gift of personal property is adeemed); §§12.55-12.56 on substitutional gift if real property is sold.

In the case of closely held stock, the attorney should be careful to avoid inadvertently drafting a specific gift when a general gift is actually intended. Courts may view the nonpublic character of the shares as evidence of an intent to make a specific gift. See *Estate of Buck* (1948) 32 C2d 372, 374, 196 P2d 769, 770.

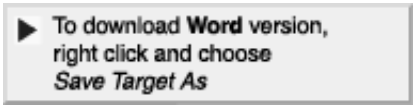
Because closely held stock is often subject to buy-out agreements (*e.g.,* a stock redemption agreement), the will drafter should determine whether the disposition of the stock is consistent with such an agreement. See generally California Estate Planning, chap 18 (Cal CEB 2002). If there is no buy-out agreement, the attorney should consider recommending to the client that one be drafted. See generally Business Buy-Sell Agreements (Cal CEB 1991).

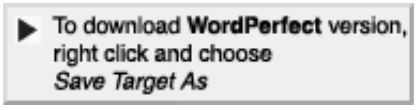
On giving securities to minors under the California Uniform Transfers to Minors Act (Prob C §§3900-3925), see chap 21.

For suggested clauses for making specific gifts of stock, see forms 12.62-1, 12.63-1.

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§12.62 2. Form: Specific Gift of Publicly Traded Stock





12.62-1 Specific gift of publicly traded stock

***Specific Gift of Property*. I give to _ _[*name of beneficiary*]_ _ my _ _[*number of shares*]_ _ of _ _[*type of stock*]_ _ stock of _ _[*name of corporation*]_ _ If, between the date of execution of my will and the date of my death, an adjustment is made in the capital structure of the corporation whose stock I am giving under this paragraph, resulting from stock dividends, stock splits, mergers, consolidations, reorganizations, or exchanges of shares, this gift shall consist of the number of shares of stock of the corporations or successors that represent, on the date of my death, the number of shares of stock given in my will. If the total number of shares of the class of stock given in my will (adjusted for changes in capital structure) exceeds the number of shares owned by me at the time of my death, this gift of stock shall be reduced so that the total number of shares of stock given will be the number of shares owned by me at the date of my death.**

Comment: This clause is designed to give the beneficiary of a specific gift of publicly traded stock the equivalent shares if the capital structure of the corporation is changed. See §12.61.

When the testator's shares of stock in one corporation have been specifically given to two or more beneficiaries, the last sentence of the clause should be modified to provide that, if the total number of shares given exceeds the number owned, all gifts of the particular stock should be ratably reduced so that the total number of shares of stock given will equal the number of shares owned on the date of death.

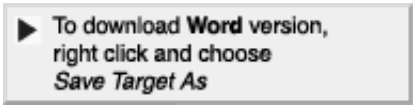
If the testator intends the beneficiary to receive the gift whether or not the shares are owned in sufficient number on the date of death, a general gift should be utilized. See §12.73.

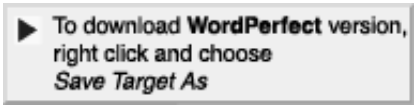
See §§12.19-12.23 on survivorship and disclaimers; §12.44 on income and expenses attributable to specifically devised assets.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.63 3. Form: Specific Gift of Closely Held Stock

§12.63 3. Form: Specific Gift of Closely Held Stock





12.63-1 Specific gift of closely held stock

***Specific Gift of Property*. I give to _ _[*name of beneficiary*]_ _ all my capital stock in _ _[*name of corporation*]_ _ or its successors held by me on the date of my death, subject to the terms of the shareholders' agreement dated _ _[*date*]_ _, which provides an option for surviving stockholders to purchase a deceased stockholder's interest. If the option is exercised, I give the net proceeds of the sale of this stock to _ _[*name of beneficiary set forth above*]_ _.**

Comment: See §12.61. See also §§12.19-12.23 on survivorship and disclaimers; §12.44 on income and expenses attributable to specifically devised assets. This clause should be modified if there is no shareholders' agreement. If a disagreement over what is meant by "net proceeds" is likely, the drafter should add a sentence defining it in the manner desired by the testator.

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E. Specific Gift of Partnership Interest

§12.64 1. Drafting Considerations

When the testator wishes to specifically give his or her interest in a partnership, the will drafter should review the terms of the partnership agreement to determine its impact on the testator's estate plan. See §33.42; California Estate Planning, chap 18 (Cal CEB 2002). See also §12.61 on buy-out agreements and closely held stock. The drafter should also discuss with the testator what he or she wants done with income attributable to the partnership interest and debts associated with it. See §12.44. Even with a limited partnership interest, there may be sizable obligations. On debts and income attributable to specifically devised real property, see §§12.53-12.54.

There are myriad tax ramifications involving a decedent's partnership interests. See generally California Decedent Estate Practice §§33.31-33.36, 33.65-33.68 (2d ed Cal CEB 2009) on the income tax consequences of a partner's death.

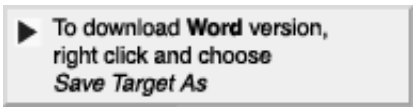
When the testator's spouse or domestic partner is engaged in a professional partnership, an outright gift of the testator's interest in the partnership should be made to the spouse or domestic partner to prevent many potential postdeath administration problems.

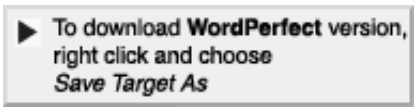
For suggested clauses for making a specific gift of a partnership interest, see §§12.65-12.66.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.65 2. Form: Specific Gift of General Partnership Interest

§12.65 2. Form: Specific Gift of General Partnership Interest





12.65-1 Specific gift of general partnership interest

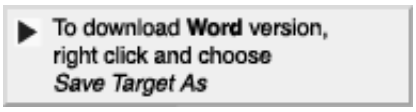
***Specific Gift of Property*. I give to _ _**[*name of beneficiary*]**_ _ my entire interest in the partnership doing business under the name of _ _**[*name of business*]**_ _, or any successor to it, subject to the option given to my surviving partners under our partnership agreement either to purchase my partnership interest or to liquidate the partnership. If the option is exercised, I give the net proceeds of the sale or liquidation to _ _**[*name of beneficiary set forth above*]**_ _.**

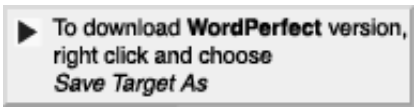
Comment: See §12.64. The drafter should modify this clause to accommodate the specific partnership agreement. See also §§12.19-12.23 on survivorship and disclaimers. If a disagreement over what is meant by "net proceeds" is likely, the drafter should add a sentence defining it in the manner desired by the testator.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.66 3. Form: Specific Gift of Limited Partnership Interests

§12.66 3. Form: Specific Gift of Limited Partnership Interests





12.66-1 Specific gift of limited partnership interests

***Specific Gift of Property*. I give all my limited partnership interests to _ _**[*name of beneficiary*]**_ _ If a dispute arises over whether a particular estate asset is a limited partnership interest, my executor has absolute discretion to decide the issue.**

Comment: See §12.64. The drafter should not use the second sentence of the clause if the executor is an interested beneficiary. See also §§12.19-12.23 on survivorship and disclaimers; §§12.7-12.13 on ademption.

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F. Specific Gift of Sole Proprietorship

§12.67 1. Drafting Considerations

Because most sole proprietorships are personal service businesses with little "going concern" value, they are frequently not worth giving to anyone as a specific gift. If, however, the testator wishes to specifically devise a sole proprietorship with significant "going concern" value (*e.g.,* a manufacturing business), the drafter should attempt to ensure the continuous operation of the business and the integrity of its assets. One way to do this is to direct the executor to deliver possession of the business to the beneficiary as soon as possible if the executor is an individual who is unable or unwilling to operate the business during estate administration. See form 12.68-1. For discussion of continuing a business after the owner's death, see §33.42; California Decedent Estate Practice, chap 23 (2d ed Cal CEB 2009). For business interest estate planning, see California Estate Planning, chap 18 (Cal CEB 2002).

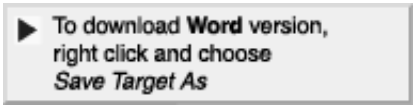
The drafter should also attempt to shield the estate from business creditors. If the testator desires, the will may even give the executor discretion to require the beneficiary, as a condition of delivery of the business, to deposit security to protect the estate from business liabilities. See form 12.68-1.

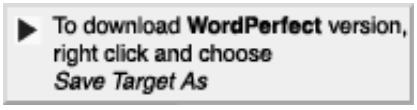
If appropriate, the attorney may add a clause indicating the testator's wishes concerning income and expenses attributable to the business during estate administration. See Prob C §12002; §12.44. See also §§12.53-12.54 for discussion of this issue in the context of specifically devised real property.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.68 2. Form: Specific Gift of Sole Proprietorship

§12.68 2. Form: Specific Gift of Sole Proprietorship





12.68-1 Specific gift of sole proprietorship

***Specific Gift of Property*. I give to _ _[*name of beneficiary*]_ _ my business known as _ _[*name of business*]_ _, which I have conducted as a sole proprietor at _ _[*address*]_ _, together with all my tangible personal property used in connection with the business. I make this gift subject to the payment by _ _[*name of beneficiary*]_ _ from the assets of this business of all debts, claims, and other liabilities arising from the operations of the business and outstanding at my death, except liabilities for federal and state income taxes. I direct my executor to deliver possession of the business and all its assets to _ _[*name of beneficiary*]_ _ as soon after my death as possible, to minimize interruption in its operation.**

My executor has absolute discretion to require _ _[*name of beneficiary*]_ _ to deposit security as a condition of delivery of the business, in form and amount that my executor considers necessary to protect my estate from incurring liability for debts, claims, and other liabilities incurred in operation of the business.

Comment: See §12.67.

If there is likely to be a dispute over whether a particular valuable asset is "tangible personal property used in connection with the business," the clause should be modified to make the testator's intent clear. See §12.38.

The clause calls for treating income taxes differently from other liabilities arising from the operations of the business. If the testator does not desire to treat taxes differently, the word "except" can be changed to "including."

The last paragraph concerning security may be deleted if the testator desires.

See §§12.19-12.23 on survivorship and disclaimers.

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§12.69 G. Specific Gift of Cemetery Property

If the testator's estate includes a cemetery plot, the will drafter should familiarize himself or herself with the provisions of Health & S C §§8600-8680. If no remains are interred in the testator's cemetery plot, the property passes at the testator's death to the intestate heirs unless the testator has given the property to someone else either by specific gift in the will or by written instructions to the cemetery authority. Health & S C §8603. Transfer is accomplished outside probate. If the cemetery plot contains the remains of the owner or a family member, it becomes inalienable at the owner's death unless the owner has made a disposition of it either by specific gift in the will or by written instructions to the cemetery authority. Health & S C §8650.

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VI. GENERAL, DEMONSTRATIVE, ANNUITY, AND RESIDUARY GIFTS

§12.70 A. General Gifts

A general gift is a gift from the general estate that does not give specific property. Prob C §21117(b). General gifts usually are made in the form of specific amounts of cash. Not surprisingly, the Probate Code defines general gifts of cash as "pecuniary gifts." See Prob C §§21117(d), 21118(b). Other property, however, may be the subject of general gifts, *e.g.,* publicly traded stock. See discussion of general versus specific gifts of stock in *Estate of Buck* (1948) 32 C2d 372, 196 P2d 769. See also §12.73.

Because general gifts can distort the testator's dispositive plan as much as specific gifts (see §12.35), the will drafter should counsel sparing use of them. On the one hand, cash gifts that were generous when the will was executed may seem wholly inadequate a few years later. On the other hand, cash gifts may turn out to be too large in relation to the total estate, dissipating the residue typically left to the testator's principal beneficiaries. Even when the estate has not diminished in value after execution of the will, general pecuniary gifts may deplete the available cash, forcing the executor to sell other assets to pay taxes, claims, and expenses. On abatement problems when general gifts are involved, see §§12.3-12.6.

NOTE: The testator may wish to provide for an adjustment of general pecuniary gifts based on an appropriate cost-of-living index, such as the All Urban Consumer Price Index published by the Department of Labor's Bureau of Labor Statistics. Such indexing protects the beneficiary of the cash gift but at the residuary beneficiaries' expense.

The beneficiary of a general pecuniary gift is entitled to interest on the gift beginning on the first anniversary of the testator's death. Prob C §12003. Probate Code §12001 provides that the interest rate will be three percentage points less than the legal rate on judgments in effect one year after the date of the testator's death. The interest rate will not be recomputed if the rate changes in the future.

The Probate Code does not provide for interest or income on nonpecuniary general gifts. The testator may direct that interest on general pecuniary gifts not be paid. See §§33.38-33.39.

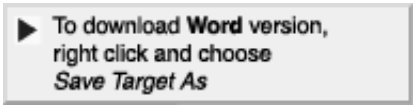
Sometimes a couple wishes to give a specific sum to an individual once both of them are dead. Form 12.72-1 should be used to prevent a "double gift" under certain circumstances.

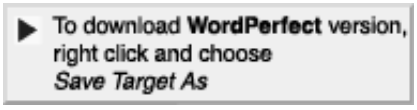
EXAMPLE: A couple wishes to give $100,000 to the wife's mother if both spouses die before the mother's death. The husband's will provides that his wife will receive his entire estate at his death unless she does not survive him, in which case $100,000 will go to his mother-in-law. The wife's will provides that her husband will receive her entire estate at her death unless he does not survive her, in which case $100,000 will go to her mother. These provisions will result in the mother's receiving $200,000 if the husband and wife die simultaneously (see §12.24) or within the survivorship period set forth in their wills. If the couple does not intend this result, the drafter should use form 12.72-1.

Note that the problem of a "double gift" is not limited to cash gifts by spouses or domestic partners. The drafter should adapt form 12.72-1 for use when two or more testators' wills include a cash gift intended to be paid only once, at the last survivor's death.

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§12.71 1. Form: General Pecuniary Gifts





12.71-1 General pecuniary gifts

Monetary Gifts. **I give to each of the following persons the sum of money shown opposite their name. Any estate or inheritance tax imposed with respect to any of these gifts shall be paid from the residue of my estate. If any listed person fails to survive me by 30 days, the gift to that person shall lapse.**

_ _[*names of recipients and amounts, e.g., John Doe—Five Thousand Dollars.*]_ _

[*If applicable, add the following option*]

[*Option: Limitation on total value of gifts of money and property*]

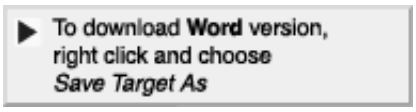
The total value of the foregoing gifts of money, excluding any payments of estate or inheritance taxes, is not to exceed _ _[*number*]_ _ percent of the combined value of the gifts of money and the net value of the property that will be distributed as part of the residue of my estate. In the event that percentage would otherwise be exceeded the value of the monetary gifts shall be reduced on a prorata basis so that their total value does not exceed that percentage.

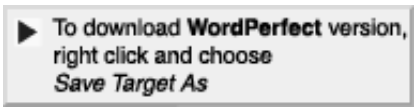
Comment: If the testator does not want interest on these gifts to be paid, see form 33.39-1. For survivorship and disclaimer conditions, see §§12.19-12.23. On making gifts to minors, see chaps 22, 25. If a couple's wills include a general pecuniary gift intended to be paid only once, at the survivor's death, see form 12.72-1. Attempts to determine values of assets distributed under a residuary clause can be troublesome, particularly if the values are changing. If the optional addition reducing the values of gifts is used, the percentage should be set high enough to make it unlikely that a reduction in the gifts will be necessary.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.72 2. Form: General Pecuniary Gift From Couple

§12.72 2. Form: General Pecuniary Gift From Couple





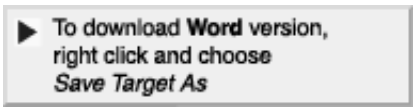
12.72-1 General pecuniary gift from couple

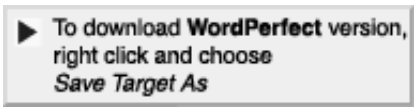
***Monetary Gift*. If my _ _**[*spouse/partner*]**_ _ does not survive me by 30 days, I give the sum of _ _**[*dollar amount*]**_ _ to _ _**[*name of beneficiary*]**_ _ This gift shall be reduced by half, however, if I have failed to survive my spouse by 30 days and as a consequence the distributee is receiving an identical gift from the estate of my _ _**[*spouse/partner*]**_ _.**

Comment: When both spouses die within the survival period specified in the will, neither of them will have a surviving spouse or partner for distribution purposes. This creates the risk that the recipient of a pecuniary gift will receive twice the amount of money intended.

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§12.73 3. Form: General Gift of Stock





12.73-1 General gift of stock

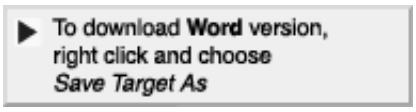
***General Gift of Property*. I give to _ _[*name of beneficiary*]_ _ _ _[*number*]_ _ shares of _ _[*type of stock*]_ _ in _ _[*name of corporation*]_ _ If I do not own sufficient shares of this stock at my death, I direct my executor to purchase additional shares to satisfy this gift.**

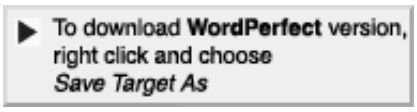
Comment: This clause clearly states the testator's intent that the executor purchase shares on the open market for the beneficiary if the estate does not have sufficient stock to cover the gift at the testator's death. See §12.13. See forms 12.62-1, 12.63-1 for clauses relating to specific gifts of stock. See also §§12.19-12.23 on survivorship and disclaimer conditions; chaps 22, 25 on gifts to minors. Because of the uncertainties concerning future stock values, these types of gifts are not recommended.

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.74 4. Form: Forgiveness of Indebtedness

§12.74 4. Form: Forgiveness of Indebtedness





12.74-1 Forgiveness of indebtedness

***Forgiveness of Indebtedness*. I forgive all indebtedness owed to me at my death by _ _[*name of debtor*]_ _ I direct my executor to cancel any written instrument of this indebtedness and return it to _ _[*name of debtor*]_ _.**

Comment: Forgiveness of indebtedness may be considered a gift to the debtor for estate tax purposes. If the testator wishes this gift not to bear its share of estate tax liability, the testator should modify this clause to make that intent clear. See generally chap 26.

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B. Demonstrative Gifts

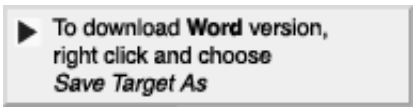
§12.75 1. Satisfaction of Demonstrative Gifts

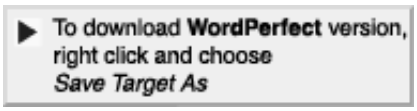
A devise is demonstrative if the testator specifies the fund or property out of which the devise should be made. Prob C §21117(c). When drafting a demonstrative gift, the attorney should clearly describe the property or fund out of which the gift should be made. It is also important to specify whether the gift should be satisfied from the general estate if the property or fund is insufficient to cover the gift. Even though existing law provides that a demonstrative gift should be satisfied from the general estate if the particular property or fund is insufficient (see Cal L Rev'n Comm'n Comment to former Prob C §6154, now Prob C §21117), the testator should specify this in the will to prevent disputes about his or her wishes. Interest is not payable on demonstrative gifts. See Prob C §12002(a).

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.76 2. Form: Demonstrative Gift

§12.76 2. Form: Demonstrative Gift





12.76-1 Demonstrative gift

***Demonstrative Gift*. I give to _ _[*name of beneficiary*]_ _ the sum of _ _[*amount*]_ _, to be paid from my savings account at _ _[*name of institution*]_ _. If that account is insufficient to satisfy this gift in full, the balance shall be paid from the residue of my estate.**

Comment: This clause should be modified if the testator wishes to limit the gift to the funds in the account at his or her death. See §12.75. See also §§12.19-12.23 on survivorship and disclaimer conditions; chaps 22, 25 on gifts to minors; §§12.7-12.13 on ademption issues.

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C. Annuity Gifts

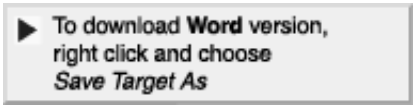
§12.77 1. Definition of Annuity; Drafting Considerations

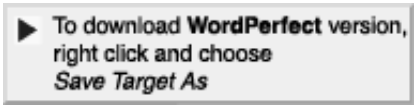
An annuity is a general pecuniary gift that is payable periodically. Prob C §21117(e). It is not recommended that annuities be the subject of outright testamentary gifts; annuities can be seriously affected by inflation, are a charge against the assets of the general estate regardless of the estate income, and may unduly prolong administration. If the testator desires to establish an annuity for a particular beneficiary, the annuity should be made payable from a trust or the testator should provide that a commercial annuity be purchased for the beneficiary (annuitant).

Testamentary annuities are considered to begin on the date of the testator's death. Prob C §12004(a). If the testator does not otherwise provide, the annuitant is entitled to interest on unpaid accumulations only after the first anniversary of the testator's death. Prob C §12004(b). The rate of interest on unpaid accumulations is described in Prob C §12001, discussed in §12.70.

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§12.78 2. Form: Gift of Commercial Annuity





12.78-1 Gift of commercial annuity

***Gift of Annuity*. I direct my executor to purchase a commercial annuity for _ _[*name of beneficiary*]_ _ under the following terms:**

(1) The principal amount of the annuity should be _ _[*amount*]_ _, and its monthly benefit should be _ _[*amount*]_ _;

(2) The annuity should be for _ _[*duration*]_ _, beginning on _ _[*date*]_ _ ;

(3) The annuity should be on a nonguaranteed, nonrefundable, nonassignable basis; and

(4) The issuing annuity company should have an "A" financial rating in Class XIII or higher from the A.M. Best Company and should belong to an industry or government group that guarantees the annuity obligation (*e.g.,* the New York Guaranty Fund).

My executor will have absolute discretion to purchase a performance bond.

Comment: See §12.77. The annuity described in this clause is nonrefundable and nonassignable, which will prevent the annuitant from selling or cashing in the policy. See generally California Estate Planning, chap 20 (Cal CEB 2002) on commercial annuities. See also chaps 22, 25 on gifts to minors.

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D. Residuary Gifts

§12.79 1. Definition of Residue; Drafting Considerations

A residuary gift passes the estate of the testator remaining after all other types of gifts have been satisfied. Prob C §21117(f). Gifts that fail because they are void (see *Estate of Stauffer* (1956) 142 CA2d 35, 297 P2d 1029) or lapse (see *Estate of Walker* (1925) 196 C 323, 237 P 1070) usually pass with the residuary devise. See §12.16. The residue also contains the net income earned by the estate during administration, other than income from specific gifts, unless the will provides otherwise. See Prob C §§12002(b), 12006. Because a clause distributing the residue may be considered an exercise of a general testamentary power of appointment held by the testator, the will should clearly convey the testator's intent in this regard. See chap 11. Every will should contain a residuary clause.

If there is a total or partial failure of the residuary gift, the affected portion of the residue will pass under the laws of intestate succession. *Estate of Russell* (1968) 69 C2d 200, 70 CR 561. Thus, the residuary clause should be drafted with care to avoid any possible gaps. See §§12.19-12.23 on survivorship and disclaimer provisions; §§12.16-12.18 on lapse rules. Even when the testator is content to allow the residue to pass under the laws of intestate succession when all the designated beneficiaries fail to survive, it might be appropriate to define the testator's heirs at law. See §12.30.

NOTE: If the testator leaves the residue of the estate to two or more persons, and the share of one of them fails for any reason, that share will pass to the other residuary beneficiaries in proportion to their remaining interest in the residue, except as otherwise provided in the will. Prob C §21111(b). Probate Code §21111 does not apply if any provision of Prob C §21110 (the antilapse statute) applies to the gift. See §§12.16-12.18.

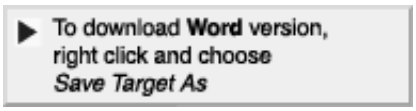
As previously mentioned in §§12.35 and 12.70, the residue may be drastically depleted by specific and general gifts. In addition, the residue often is burdened with the payment not only of all the testator's debts and expenses but also of all death taxes attributable to the testator's estate. See §§12.3-12.4, chap 26. These concerns should be reviewed with the testator, especially when the residuary beneficiaries are the testator's principal beneficiaries. Substantial specific or general gifts could be restructured into proportional gifts of the residue, and the testator might decide to charge debts, expenses, and death taxes in a more equitable fashion.

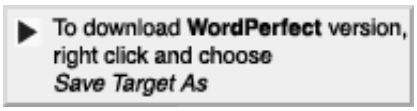
For income tax purposes, it should be noted that distributions of residuary gifts, unlike specific gifts of cash or property, carry out the estate's distributable net income to the beneficiaries. For discussion of income tax consequences of nonprorata distributions of a residuary gift, see §31.3. See also California Decedent Estate Practice §§4.14-4.17 (2d ed Cal CEB 2009).

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Source: Estate Planning/California Will Drafting/12 Outright Noncharitable Gifts/§12.80 2. Form: Residuary Gifts

§12.80 2. Form: Residuary Gifts





12.80-1 Gift of residue

[*Add one of the following alternatives*]

[*Alternative 1: Equal shares*]

***Gift of Residue*. I give the residue of my estate in equal shares to those who survive me of the following _ _[*number*]_ _ persons: _ _[*Names of beneficiaries*]_ _.**

[*Alternative 2: Unequal shares*]

***Gift of Residue*. I give the residue of my estate as follows:**

(1) _ _[*Number*]_ _ percent of the residue to _ _[*name of beneficiary*]_ _;

(2) _ _[*Number*]_ _ percent of the residue to _ _[*name of beneficiary*]_ _; and

(3) _ _[*Number*]_ _ percent of the residue to _ _[*name of beneficiary*]_ _.

If any of these residuary beneficiaries fails to survive me or disclaims part or all of this gift to him or her, the gift or any portion of it that does not pass to the beneficiary shall be added on a prorata basis to the gifts to the remaining residuary beneficiaries.

[*Alternative 3: Gift of residue to spouse with gift over to issue, then to families of both spouses*]

***Gift of Residue*. I give the residue of my estate to my spouse if my spouse survives me by 30 days. If my spouse does not so survive me, I give the residue to my issue who so survive me, by right of representation. If no issue so survive me, I give the residue as follows:**

(1) Half equally to my parents, if they survive me, or to the one of them who survives me. If neither parent survives me, this half to their issue who survive me, by right of representation. If none of their issue survive me, this half to be added to the share described in (2).

(2) Half equally to my spouse's parents, if they survive me, or to the one of them who survives me. If neither parent survives me, this half to their issue who survive me, by right of representation. If none of their issue survive me, this half to be added to the share described in (1).

[*Alternative 4: Gift of residue to spouse with gift over to issue, then to heirs*]

***Gift of Residue*. I give the residue of my estate to my spouse if my spouse survives me by 30 days. If my spouse does not so survive me, I give the residue to my issue who so survive me, by right of representation. If no issue so survive me, I give the residue to my heirs, their identities and shares to be determined under California law in effect on the date of my death relating to the succession of separate property not acquired from a previously deceased spouse.**

[*Alternative 5: Gift of residue to domestic partner with gift over to issue, then to families of both partners*]

***Gift of Residue*. I give the residue of my estate to my partner if my partner survives me by 30 days. If my partner does not so survive me, I give the residue to my issue who so survive me, by right of representation. If no issue so survive me, I give the residue as follows:**

(1) Half equally to my parents, if they survive me by 30 days, or to the one of them who so survives me. If neither parent so survives me, this half to their issue who so survive me, by right of representation. If none of their issue so survive me, this half to be added to the share described in (2).

(2) Half equally to my partner's parents, if they survive me by 30 days, or to the one of them who so survives me. If neither parent so survives me, this half to their issue who so survive me, by right of representation. If none of their issue so survive me, this half to be added to the share described in (1).

[*Alternative 6: Gift of residue to domestic partner with gift over to issue, then to heirs*]

***Gift of Residue*. I give the residue of my estate to my partner identified above. If my partner does not survive me by 30 days, I give the residue to my issue who so survive me, by right of representation. If no issue so survive me, I give the residue to my heirs, their identities and shares to be determined under California law in effect on the date of my death relating to the succession of separate property.**

Comment: See discussion in §12.79. These alternative clauses make residuary gifts commonly encountered by practitioners. Some attorneys prefer more expanded descriptions in the residuary clause, *e.g.,* "all the rest, residue, and remainder of my estate," "the residue of the property over which I have the power of testamentary disposition." Such preferences are a matter of style, not substance. See generally 14 Witkin, Summary of California Law, *Wills and Probate* §243 (10th ed 2005).

A clause naming contingent beneficiaries to receive the residuary estate after issue is more commonly used in trusts than in outright gifts of the residue. Because trusts are typically designed to continue for a period of years beyond the trustor's death, the trust document must provide for such a contingency. It may be wise, however, for the testator to provide for the possibility of his or her entire immediate family's death in a common disaster or in other circumstances preventing the testator's execution of a new will. See §12.24.

If the contingent beneficiaries include minors, as is often the case with a gift of the residue to a spouse or partner with gift over to issue, the will may provide for gifts to custodians (see §§33.33-33.35) or retention of gifts in trust (see §12.81).

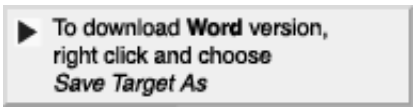
If the testator's intent regarding the exercise of any power of appointment has not been set forth in the will, the residuary clause should state that intent. Otherwise, there may be an inadvertent exercise of the power. See §11.12.

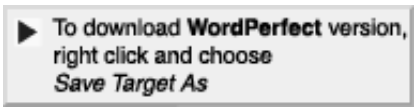
See §§12.27-12.34B on class gifts, issue, and heirs; §§12.19-12.23 on disclaimers and survivorship conditions; chaps 22, 25 on gifts to minors. See also §§10.12-10.13 on contracts to make or not to revoke wills.

The gifts to "my spouse" and "my partner" in the above forms assume that the person answering the description has already been identified. See §10.8.

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§12.81 3. Form: Retention of Gift in Trust





12.81-1 Retention in further trust until specified age

***Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall instead be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The separate trust shall be administered as follows:**

1. *Unproductive Property.* The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions.* The trustee shall pay to or apply for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee in its discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal.* When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

[*Add if appropriate*]

4. *Power to Delay Distributions.* Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

[*Continue*]

[5.] *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then-living siblings of the Beneficiary, with the then-living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

[6.] *Trustee.* The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority. The provisions of this document concerning trustees shall continue to apply to this trust to the extent not inconsistent with exercises of the powers of the trustee granted in this subparagraph.

Comment: This form applies only if a beneficiary is otherwise entitled to outright distribution. It is particularly useful for plans in which outright distributions to young persons will not occur unless an unexpected death occurs, such as a plan providing for distribution of the residue to the testator's spouse with gift over to issue. See §12.80. If the will does not contain a spendthrift clause, the drafter should consider adding one. See chap 27. The drafter should also consider adding a provision for trustee powers. See chap 29.

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13

Outright Gifts to Charity

Donald J. McCubbin
Mary Pilibos White

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I. PLANNING CHARITABLE GIFTS

§13.1 A. Limited Scope of Chapter

Chapters 13 and 14 focus exclusively on testamentary gifts. This chapter covers only outright gifts to charity made by will; gifts to charity in trust are covered in chap 14.

This chapter discusses lifetime charitable gifts, with their important income and gift tax ramifications, only in passing. The emphasis is on (1) explaining the basic requirements of qualifying an outright testamentary gift to an organization described in IRC §2055(a) for an estate tax charitable deduction and (2) drafting the gift provisions in the will to meet those requirements.

For discussion of basic estate planning considerations for charitable gift giving, see California Estate Planning, chap 23 (Cal CEB 2002). On the statutory framework for and forms of inter vivos charitable remainder trusts, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

Under most circumstances, the best source of information on drafting a charitable gift is the charitable beneficiary. On request, a charity will provide a copy of its California and federal tax exemption letters. The letters allow the drafter not only to verify the tax-exempt status of the charity but also to confirm the charity's correct and full name.

Most major charities also have material, including printed forms, that they will send to the drafter on request. Often they have preferred wording for particular kinds of gifts and appreciate being consulted before the will is executed.

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§13.2 B. Statutory Framework for Charitable Deductions

To qualify for an estate tax charitable deduction, an outright testamentary gift to charity must meet the IRC §2055 requirements. Generally, that section restricts the deduction to gifts passing only to certain organizations (see §13.3) and severely limits the form of any gift that is not for the charity's exclusive use, *i.e.,* outright split-interest gifts (see §§13.15-13.24) and split-interest gifts in testamentary trusts (see chap 14).

California gift and inheritance taxes were repealed for deaths and transfers occurring after June 7, 1982. The drafter need consider only federal law for tax compliance issues.

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§13.3 C. Organizations Qualifying for Charitable Deduction

Under IRC §2055(a), five categories of organization qualify for an estate tax charitable deduction:

(1) If the gift is exclusively for public purposes, the United States, any state, any political subdivision of a state, or the District of Columbia;

(2) Any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, whose net earnings do not benefit any private stockholder or individual, and which is not disqualified for tax exemption under IRC §501(c)(3) for attempting to influence legislation and does not participate in or intervene in any political campaign of any candidate for public office;

(3) If the gift is exclusively for religious, charitable, scientific, literary, or educational purposes, any trust, fraternal society, order, or association operating under the lodge system, which is not disqualified for tax exemption under IRC §501(c)(3) for attempting to influence legislation and does not participate in or intervene in any political campaign of any candidate for public office;

(4) Any veterans' organization incorporated by act of Congress, no part of whose net earnings benefits any private shareholder or individual; and

(5) If the gift consists of qualified employer securities and the requirements of IRC §664(g) are satisfied, any ESOP.

Organizations customarily obtain a ruling or determination letter from the Internal Revenue Service confirming that contributions are deductible. The IRS periodically publishes a list of charities that have obtained a determination letter. See IRS Pub 78, Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986. Even charities listed in this publication can become disqualified. Generally, the IRS allows a deduction if the gift was made on or before the publication date of the Internal Revenue Bulletin announcing revocation of the charity's qualified status. For the IRS's position on when organizations may rely on IRS Pub 78, see Rev Proc 82-39, 1982-2 Cum Bull 759.

In addition to losing its tax-exempt status, a charity may cease to exist or alter its operation in some essential way after the will is executed. If the testator intended the gift primarily to accomplish a charitable purpose rather than to benefit that particular organization, the court can apply the rule of cy pres to accomplish the testator's purpose by permitting distribution of the gift to an alternative charity. *Estate of Klinkner* (1978) 85 CA3d 942, 151 CR 20; *Estate of Gatlin* (1971) 16 CA3d 644, 94 CR 295. An express provision in the will directing an alternative distribution, however, can eliminate the need for cy pres. Application of cy pres is unnecessary if the charity is a California corporation that ceases to exist because of a merger or a bankruptcy reorganization. By operation of law, the gift inures to the benefit of the surviving corporation. Corp C §§6022, 8022. On cy pres generally, see §7.17.

An indirect transfer to charity made through a fiduciary (*e.g.,* the testator's executor, a trustee) with discretion to choose the charitable, religious, or educational organizations to receive the property may qualify for an estate tax charitable deduction if distribution must clearly be made only to the charities described in IRC §2055(a). See, *e.g., U.S. v Leonhardt* (MD Fla 1976) 76-1 USTC ¶13,138, 37 AFTR2d 1589; Rev Rul 69-285, 1969-1 Cum Bull 222. Similarly, an estate tax charitable deduction may be allowable for a gift to an organization (*e.g.,* a fraternal society) not described in IRC §2055(a) if the deduction must be used exclusively for charitable purposes. IRC §2055(a)(3); Rev Rul 74-523, 1974-1 Cum Bull 304. To carry on their charitable activities, organizations not described in IRC §2055(a) sometimes maintain a foundation that is described in that section. If the testator wishes to make a gift to such an organization, the gift should be made to the foundation.

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II. GIFTS EXCLUSIVELY FOR PUBLIC CHARITY

§13.4 A. Split-Interest Gifts Distinguished

A testamentary gift intended for the use of a noncharitable person or entity as well as a qualified charity is sometimes referred to as a split-interest gift. The portion of a split-interest gift passing to charity does not qualify for an estate tax charitable deduction unless it is in a form specifically authorized by IRC §2055(a). On specific types of outright testamentary gifts of split interests, see §§13.15-13.26.

Split-interest gifts are often made in trust. If the charity's partial interest is an income interest, known as a charitable lead trust, that interest must be in the form of a guaranteed annuity interest (a right to receive a specified amount) or a unitrust interest (a right to receive a fixed percentage of the annually determined fair market value of transferred property). See §14.81. If the charity's partial interest is a remainder interest, however, that interest must be created in the form of a charitable remainder annuity trust, charitable remainder unitrust, or pooled income fund. See §§14.4-14.80.

A testamentary transfer exclusively for the use of a public charity described in IRC §2055(a) qualifies for an estate tax deduction. In providing for such a transfer, the attorney's concern with deductibility is to ascertain that the gift is exclusively for the charity and that the charity is qualified and accurately named in the will. Problems may arise if the gift is for a limited purpose, as in an endowment. The attorney can avoid some of these problems by consulting the charity before the will is executed.

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B. Specific Gifts to Charity

§13.5 1. For General Use

The simplest form of an outright testamentary gift to charity is a specific gift for the charity's general use.

In drafting a specific gift to charity, the attorney may need to protect a residuary beneficiary's share from depletion if the residue decreases significantly before the client's death. That is not usually a concern unless the charitable gift is a substantial portion of the estate.

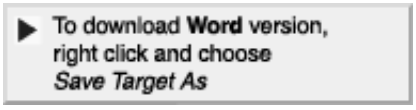
The drafter should also allow flexibility for income tax planning during estate administration. Adding language making the gift dependent on the value of the residue may prevent the gift from being considered a gift of a "specific sum" of money within the meaning of IRC §663(a)(1). See Treas Reg §1.663(a)-1(b)(1). A preliminary distribution to satisfy a gift that is not a gift of a "specific sum" of money carries out the estate's distributable net income (DNI), which is then taxed to the distributee, not to the estate as income. Distributing the DNI to a tax-exempt charity should remove it from taxation entirely.

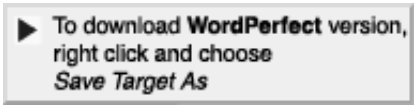
A charity that meets the requirements of IRC §2055(a) when the will is drafted can cease to exist, or it can lose its exempt status before the testator's death. Therefore, naming an alternative charity or giving the personal representative the discretion to apply the cy pres doctrine (see §13.3) in selecting some charity then qualified for the deduction will carry out the testator's general charitable intent. When the testator wishes the charity to receive the gift even if it does not qualify for a deduction under IRC §2055, or wishes a noncharitable beneficiary to receive the gift under those circumstances, the drafter should express that intent in the will instead of naming an alternative charity.

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.6 2. Form: Specific Gift to Charity for General Use

§13.6 2. Form: Specific Gift to Charity for General Use





13.6-1 Specific gift to charity for general use

[*Add one of the following alternatives*]

[*Alternative 1: Specific sum to charity for general use*]

I give the sum of _ _[*amount*]_ _ **to** _ _[*exact name of qualified charity*]_ _ **to be used for its general charitable purposes. If on the date of my death** _ _[*exact name of qualified charity*]_ _ **is not an organization described in Internal Revenue Code §2055(a), this gift shall** _ _[*alternative disposition*]_ _.

[*Alternative 2: Lesser of specific sum or percentage of residue to charity for general use*]

I give the sum of _ _[*amount*]_ _ **or a sum equal in value to** _ _[*number*]_ _ **percent of the residue of my estate** _ _[*after reduction for all debts, liabilities, taxes, costs, and expenses of administration payable out of the residue*]_ _**, whichever is less, to** _ _[*exact name of qualified charity*]_ _ **to be used for its general charitable purposes. If on the date of my death** _ _[*exact name of qualified charity*]_ _ **is not an organization described in Internal Revenue Code §2055(a), this gift shall** _ _[*alternative disposition*]_ _.

Comment: Alternative 1 creates a charitable gift of a specific sum of money without restricting the charity's use of it. This clause may be included in the provision for general pecuniary gifts. See §12.71.

Alternative 2 includes an additional limitation on the gift to avoid depleting the residue. This clause must be coordinated with the main provision for gift of the residue. See §12.80. The IRC §2055(a) condition may be deleted if the testator is unconcerned about the charitable deduction.

If the gift is to a fraternal order for exclusively charitable purposes (see §13.3), the drafter should limit the use of this gift to uses described in IRC §2055(a)(3).

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§13.7 3. For Specific Purpose

When the client wishes to make a gift to charity for a specific purpose, it is preferable to consult representatives of the charity before drafting the gift provisions. Most charities welcome the opportunity to assist attorneys in setting up gifts that will accomplish the client's goals without causing any administrative problems for the charity. Clients frequently prefer that the attorney withhold the client's identity from the charity.

If the client is interested in making a charitable gift to be used for ongoing purposes, the institution should be consulted about establishment of an endowment fund with the charitable gift.

The gift provision should specify whether the institution may use appreciation or principal of the endowment fund for its stated purposes. Without an express provision in the will, the issue is controlled by the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510). Under UPMIFA, the institution may appropriate so much of the endowment fund as the institution deems is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Prob C §18504(a). But see Prob C §18504(d) (appropriation of more than 7 percent per year creates presumption of imprudence).

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.8 4. Form: Specific Gift to Establish Endowment

§13.8 4. Form: Specific Gift to Establish Endowment

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13.8-1 Specific gift to establish endowment

I give the sum of _ _[*amount*]_ _ **or a sum equal to** _ _[*number*]_ _ **percent of the residue of my estate** _ _[*after reduction for all debts, liabilities, taxes, costs, and expenses of administration payable out of the residue*]_ _**, whichever is less, to** _ _[*exact name of qualified charity*]_ _ **(institution), to be held and administered as the** _ _[*name*]_ _ **Endowment Fund (fund). For investment purposes, institution may merge assets of fund with any of its investment assets. If on the date of my death institution is not an organization described in Internal Revenue Code §2055(a), this gift shall** _ _[*alternative disposition*]_ _.

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

[*Option 1: Use of principal and appreciation prohibited*]

Institution may use fund income, but not fund principal or appreciation on principal, for the following purposes: _ _[*Permissible purposes*]_ _.

[*Option 2: Use of principal prohibited*]

Institution may use fund income and as much of the appreciation on fund principal as the governing board considers appropriate, but not the historic dollar value of fund principal, for the following purposes: _ _[*Permissible purposes*]_ _.

[*Option 3: Use of principal and appreciation allowed*]

Institution may use fund income and as much of the principal and appreciation on principal as the governing board considers appropriate for the following purposes: _ _[*Permissible purposes*]_ _.

Comment: This clause must be coordinated with the main provision for gift of the residue. See §12.80.

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C. Lifetime Pledge to Charity

§13.9 1. Direction for Payment to Charity

Before including any provision under the will for payment of a lifetime pledge, the attorney should review the pledge to determine whether it is legally binding and whether it is revocable or irrevocable.

Rather than being repeated in the will, the specific terms of the pledge should merely be incorporated by reference to prevent any discrepancy between the pledge agreement and the will.

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.10 2. Form: Direction for Payment of Lifetime Pledge to Charity

§13.10 2. Form: Direction for Payment of Lifetime Pledge to Charity

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13.10-1 Payment of lifetime pledge to charity

***Payment of Pledge to Charity*. I give to _ _[*exact name of qualified charity*]_ _ any balance remaining unpaid on the date of my death on the pledge executed by me on _ _[*date*]_ _, which provides for a contribution of _ _[*dollar amount*]_ _ in satisfaction of the pledge.**

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D. Reduction of Gifts by Taxes

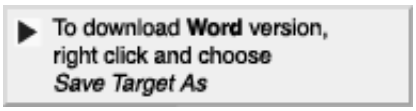
§13.11 1. Computation Problems When Residual Charitable Gift Is Subject to Taxes

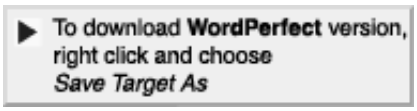
When a residuary gift to charity is burdened with estate taxes, a special tax computation problem arises because the amount of the charitable deduction is reduced by the amount of the tax, which depends on the amount of the deduction. This requires an interrelated computation, either by the trial-and-substitution method or by the algebraic method, both of which are long and complex. A number of computer programs that perform these calculations are now available as well. An alternative to paying the taxes from the residue is to require each beneficiary to pay the tax attributable to his or her gift. The will drafter may wish to consider increasing each beneficiary's gift by the amount of the anticipated tax.

Ordinarily, when the will does not provide for how estate taxes will be paid, they will be apportioned under Prob C §§20100-20225 and no portion of them will be charged against a deductible gift to charity. Prob C §20112. For discussion of tax payment clauses, see chap 26. Care must be exercised in using tax apportionment clauses. In *Estate of Marion P. Bradford*, TC Memo 2002-238, for example, the court held that tax apportionment clauses in a pourover will and revocable trust had the effect of reducing the trust's residuary gift to charity despite a similar apportionment statute. It is not unusual, however, to include an express provision making the gift to the charity tax free.

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§13.12 2. Form: Gift Not Reduced by Taxes





13.12-1 Gift not reduced by taxes

No tax that becomes payable because of my death, nor any cost or expense of administration, shall be charged against the gift to _ _[*exact name of qualified charity*]**_ _.**

Comment: Tax payment clauses should be used with caution. See chap 26 for detailed discussion.

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E. Gift of Residue to Charity

§13.13 1. Gift to Charity as Alternative Disposition

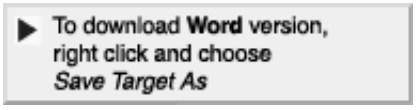
A gift of the residue to charity may be an alternative disposition if the primary residuary beneficiary does not survive. Care must be taken when a charitable gift is subject to a condition. A charitable deduction is permitted under IRC §2055 only if, at the decedent's death, the possibility of the occurrence of the event that would defeat the gift to charity was so remote as to be negligible. Treas Reg §20.2055-2(b)(1). Because of that requirement, no survival period has been specified in form 13.14-1. If the gift to charity is not subject to a condition, the drafter should omit the first phrase, "If _ _[*name of primary residuary beneficiary*]_ _ does not survive me," in form 13.14-1.

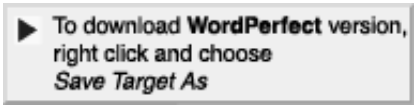
Only charities described in IRC §2055(a) qualify for a charitable deduction for federal estate tax purposes. Form 13.14-1 names a contingent beneficiary because charities that qualify when the will is written can cease to exist or become disqualified (see §13.3). Typical contingent beneficiaries are major charities organized in California that are unlikely to be dissolved in the foreseeable future, *e.g.,* a long-established university. If such a charity is named in the first instance, the contingent beneficiary may be omitted. The testator's estate also may receive an income tax deduction for items of income in respect of a decedent (IRD) allocated to the residue. In IRS Letter Ruling 200336020, for example, the IRS ruled that an estate could deduct IRA distributions and interest elements of series HH savings bonds received after distribution of all noncharitable bequests, because all residuary amounts were permanently set aside for charitable purposes under Treas Reg §1.642(c)-2(d).

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.14 2. Form: Residue to Charity if Primary Beneficiary Does Not Survive

§13.14 2. Form: Residue to Charity if Primary Beneficiary Does Not Survive





13.14-1 Residue to one charity if primary beneficiary does not survive

[*Add one of the following alternatives*]

[*Alternative 1: Entire residue to one charity*]

If _ _[*name of primary residuary beneficiary*]_ _ **does not survive me, I give the residue of my estate** _ _[*after payment of taxes and costs and expenses of administration, as provided in paragraph* _ _[*number*]_ _,]_ _ **to** _ _[*exact name of qualified charity*]_ _ **if on the date of my death it is an organization described in Internal Revenue Code §2055(a). If it is not such an organization, I give the residue to** _ _[*alternative disposition*]_ _.

[*Alternative 2: Residue to more than one charity*]

If _ _[*name of primary residuary beneficiary*]_ _ **does not survive me, I give the residue of my estate** _ _[*after payment of taxes and costs and expenses of administration, as provided in paragraph* _ _[*number*]_ _,]_ _ **as follows:**

Notwithstanding the foregoing provisions of this paragraph, any portion of the residue otherwise distributable to an organization not described in Internal Revenue Code §2055(a) on the date of my death instead shall be distributed to the organizations listed in subparagraphs _ _[*numbers*]_ _ **that are then so described, in the proportion that their respective percentage shares bear to the total of the percentage shares given to the described organizations. If none of the organizations listed is then so described, I give the residue to** _ _[*alternative disposition*]_ _.

Comment: This clause may be added to the main provision for gift of the residue. See §12.80. In both alternative clauses, the gift to the charity is conditioned on the death of a primary beneficiary. The first phrase, "If _ _[*name of primary residuary beneficiary*]_ _ does not survive me," can be deleted to make an outright residual gift.

See Comment to form 13.6-1 for additional limitations on a gift to a fraternal order.

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.15 III. GIFTS NOT EXCLUSIVELY FOR PUBLIC CHARITY

§13.15 III. GIFTS NOT EXCLUSIVELY FOR PUBLIC CHARITY

A split-interest charitable gift is a gift of an interest in property that passes to both a qualified charity and a noncharitable beneficiary. Because the latter is usually an individual, the noncharitable beneficiary is referred to in this chapter as the individual beneficiary. The general rule is that split-interest gifts to charity are not deductible unless they qualify under one of the statutory exceptions. Besides the charitable remainder and charitable lead trusts (see chap 14), there are several other ways to create deductible split-interest gifts to charity. These are described in Treas Reg §20.2055-2(e)(2)(i)-(v) and discussed in §§13.16-13.26, with clauses suggested by the regulations.

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§13.16 A. Undivided Portion of Entire Interest

If the decedent gives an undivided portion of the entire interest in property to a qualified charity, not in trust, the value of the interest passing to charity is deductible. Treas Reg §20.2055-2(e)(2)(i). The clearest example of this is a gift of property to a charity and an individual, as tenants in common. The charity receives an undivided half interest of the fee.

The deduction is not limited to gifts of fee interests. For example, if the decedent has a life estate in the property for the life of his wife and no other interest in the property during his lifetime, his gift of a half interest in the life estate to charity is a transfer of a deductible interest. Treas Reg §20.2055-2(e)(2)(i).

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§13.17 B. Qualified Conservation Contribution

A deduction for a gift of a partial interest in property is allowed for a "qualified conservation contribution," as defined in IRC §170(h). See §13.17B. An estate tax exclusion also may result. See §13.17C. In some cases, a conservation easement can be created after the decedent's death. See §13.17D.

The gift must be of a qualified property interest to a qualified charity to be used exclusively for conservation purposes. IRC §170(h). The conservation purpose must be protected in perpetuity. IRC §170(h)(5)(A). See §13.17A.

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§13.17A 1. Definition of Conservation Purpose

The term "conservation purpose" is defined in IRC §170(h)(4)(A) as:

- The preservation of land areas for outdoor recreation by, or for the education of, the general public;
- The protection of a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem;
- The preservation of open space (including farmland and forestland) that is intended for the general public's scenic enjoyment or that is based on a clearly delineated federal, state, or local governmental policy and will yield a significant public benefit; or
- The preservation of an historically important land area or a certified historic structure.

Qualifying purposes are clarified at some length in Treas Reg §1.170A-14(d). In *Glass v Commissioner* (6th Cir 2006) 471 F3d 698, the court held that easements limiting development of portions of lakefront property were qualified because they protected a "relatively natural habitat" for bald eagles and two endangered plants under Treas Reg §1.170A-14(d)(3). For a critical analysis of the *Glass* decision, see Schingler & Hurwitz, *Common Ground … Conservation Easements: Matching Conservation Values to the Public With Tax Benefits to the Donor,* 17 Cal Tax Law 42 (Spring 2008). In *James D. Turner* (2006) 126 TC 299, the court held that a deed that limited the number of residential units that could be built on a tract did not create a qualified conservation easement because of failure to prove that the limitation would preserve a nearby historic site.

Under IRC §170(h)(4)(B), conservation easements intended to preserve the exteriors of buildings in registered historic districts must apply to the entire exterior of the building and prohibit any change that is inconsistent with the historical character of the building. Contributions for open space are particularly restricted, with the regulations requiring substantial public benefit and furtherance of a "clearly delineated federal, state, or local government conservation policy." Treas Reg §1.170A-14(d)(4)(A). In some situations, preservation of a historically important land area will qualify. See Treas Reg §1.170A-14(d)(5).

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§13.17B 2. Allowable Deduction for Qualified Conservation Contributions

The deduction is allowed to the extent that the donor's total qualified conservation contributions do not exceed 50 percent (100 percent for a qualified farmer or rancher) of adjusted gross income for donations before January 1, 2010. IRC §170(b)(1)(E). The generally applicable limitation for contributions of capital gain property is 30 percent of adjusted gross income. IRC §170(b)(1)(B).

In Rev Rul 2003-123, 2003-2 Cum Bull 1200, however, the IRS ruled that a trust was not allowed an income tax deduction for a contribution of a qualified conservation easement because the contribution was not made from trust income under IRC §642(c). In *Thomas B. Goldsby, Jr.,* TC Memo 2006-274, the court held that the income beneficiary of a trust also could not claim the deduction, even though he was the owner of the income portion of the trust under IRC §678, because he failed to show that the easement was contributed from the income portion of the trust.

This problem does not arise for partnerships or other pass-through entities. In *Kiva Dunes Conservation, LLC*, TC Memo 2009-145, the court held that a limited liability company (LLC) taxed as a partnership was entitled to a $28.7 million deduction for a contribution of a qualified conservation easement in a golf course that reduced the value of the property from $32 million to $3 million and increased the value of adjacent property by $300,000. Assuming the individual owner who transferred the property to the LLC remains a substantial owner of the LLC at death, a $500,000 estate tax exclusion also may be allowed for the value of the easement, as discussed in §13.17C.

Contributions to a charitable organization of "qualified real property interests" (as defined in IRC §170(h)(2)(C)) that are not deductible for federal income tax purposes but meet the requirements of IRC §170(h), except for the "conservation purpose" requirement of IRC §170(h)(4)(A), may nonetheless be allowed as deductions for federal estate and gift tax purposes. See IRC §§2055(f), 2522(d).

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§13.17C 3. Estate Tax Exclusion for Property Subject to Conservation Easement

Further, contributions that are deductible for income tax purposes may result in an exclusion from a testator's gross estate of a fraction of the value of the property subject to a qualified conservation easement under IRC §2031(c), in addition to reducing the value of the affected property for estate tax purposes. The fraction that may be excluded is 40 percent (reduced, if applicable, by 2 percent for each percentage point or fraction thereof by which the value of the conservation easement is less than 30 percent of the value of the land without the easement determined as of the date of the easement), but the total value of the property that may be excluded cannot exceed $500,000. IRC §2031(c)(2)-(3). The value of any retained development rights that are not subordinate to and directly supportive of the use of land for farming purposes may not be reduced under these provisions. IRC §2031(c)(5), (7). The exclusion also must be reduced to the extent that the donor's adjacent property increases in value as a result of the easement. IRS Letter Ruling 200002020. The exclusion applies to an interest in a partnership, corporation, or trust if at least 30 percent of the entity is owned (directly or indirectly) by the decedent. IRC §2031(c)(10).

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§13.17D 4. Postmortem Conservation Easement

The easement may be granted after the decedent's death by the decedent's estate or heirs, but in that case no income tax deduction is allowed. IRC §2031(c)(8)(A)(iii), (c)(8)(C), (c)(9). In IRS Letter Ruling 200418005, for example, an estate tax exclusion was allowed for a postdeath contribution of a scenic easement by the decedent's revocable trust on the condition that no person claim an income tax deduction for the donation. Because of the loss of the income tax deduction, a postdeath grant is most useful for the purpose of augmenting a previous grant when this is necessary to qualify an existing easement. Similarly, a defective grant that does not prohibit commercial recreational activity or reserves the right to subdivide the property may be corrected by postmortem agreement. IRS Letter Ruling 200014013. The grant of a qualified conservation easement in qualified special use property is not treated as a disposition resulting in additional estate tax. However, the IRS has ruled that the protection accorded conservation easement grants does not apply to sales or exchanges, notwithstanding statutory language excluding qualified conservation contributions "by gift or otherwise." IRC §2032A(c)(8); IRS Letter Ruling 200840018. See §17.88.

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C. Gift to Charity's Qualified Pooled Income Fund

§13.18 1. Alternative to Establishing Charitable Remainder Trust

A pooled income fund is a trust created by a qualified charity in accordance with IRC §642(c)(5) to invest commingled donations from a number of individual donors. A gift to such a fund is an attractive alternative to drafting a testamentary charitable remainder annuity trust or unitrust, particularly when the assets involved are of moderate value. See California Estate Planning, chap 24 (Cal CEB 2002). The income attributable to the donation can be paid to the donor's beneficiary for life and, if all requirements have been met for creating and managing the fund, the value of the remainder interest that passes to the charity when the income interest ends will qualify for a charitable deduction. IRC §2055(e)(2)(A).

The requirements for qualification of a pooled income fund include the following (Treas Reg §1.642(c)-5(b); Rev Rul 90-103, 1990-2 Cum Bull 159, as modified by Rev Rul 92-81, 1992-2 Cum Bull 119):

- The remainder interest of the fund must be irrevocably transferred to, or for the use of, a public charity.
- The income interest must be for the life of one or more specified beneficiaries who are living at the time of transfer, and the share of income distributable to each person must also be specified. Unlike charitable remainder and charitable annuity trusts, the income interest cannot be for a term of years. The public charity named as the remainder beneficiary of the trust may be designated to receive an income interest, but no charitable deduction is allowed for the value of this income interest.
- The property transferred to the fund by each donor must be commingled with, and invested and reinvested with, other property transferred to the fund by other donors.
- Tax-exempt securities may not be transferred to the fund, which may not invest in such securities.
- The fund must be maintained by the same public charity that will receive the remainder interest. This maintenance is satisfied if the charity exercises direct or indirect control over the fund (e.g., with the power to remove the trustee and designate a new trustee).
- The trustee of the fund must not be an income beneficiary (other than the public charity) or the testator.
- Each income beneficiary must receive fund income in an amount determined with reference to the rate of return earned by the fund.
- On termination of an income interest, the charity must receive from the fund an amount equal to the value of the remainder interest in the property on which the income interest is based.
- The trustee either must be prohibited from accepting or investing in depreciable property or must establish a depreciation reserve.

Many major charitable organizations have at least one pooled income fund. By contacting a representative of the charity, the drafter should be able to obtain a copy of the trust instrument creating the fund and a history of its income payment record.

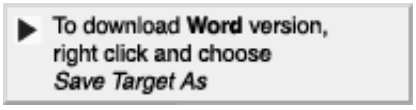
On request, the charity should also be able to provide a copy of the letter ruling from the Internal Revenue Service showing the charity's tax-exempt status. Although a separate ruling is not required under IRC §642(c)(5), charities usually have a separate ruling that the fund qualifies.

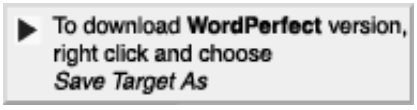
In the new marital deduction regulations, the IRS has included an example in which a decedent makes a testamentary gift to a pooled income fund, naming the spouse as income beneficiary for life. The regulations recognize that the executor may elect to treat the gift as qualified terminable interest property, eligible for the marital deduction. Treas Reg §20.2056(b)-7(h), Example (13).

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.19 2. Form: Residue to Pooled Income Fund

§13.19 2. Form: Residue to Pooled Income Fund





13.19-1 Residue to pooled income fund

I give _ _[*number*]_ _ **percent of the residue of my estate** _ _[*after payment of taxes and costs and expenses of administration, as provided in paragraph* _ _[*number*]_ _**,**]_ _ **to** _ _[*exact name of qualified charity*]_ _ **(charity), to hold in its pooled income fund, commonly called** _ _[*exact name of qualified pooled income fund*]_ _ **(fund), to be managed and invested under the terms of the governing plan of fund as set forth in the declaration of trust executed by charity on** _ _[*date*]_ _**, and later amended. Charity shall pay the net income of fund attributable to my gift under this paragraph to** _ _[*name of beneficiary*]_ _ **during** _ _[*name of beneficiary*]_ _**'s lifetime. The amount and time of the payments shall be determined according to the terms of the governing plan in the controlling declaration of trust. At the death of** _ _[*name of income beneficiary*]_ _**, the property represented by fund units attributable to the gift under this paragraph shall be the absolute property of charity. If at my death fund is not a qualified pooled income fund as then defined under Internal Revenue Code §642(c)(5),** _ _[*alternative distribution*]_ _**.**

Comment: This clause may be added to the main provision for gift of the residue. See §12.80. The wording of this clause is little more than a residuary gift to the charity's pooled income fund. Whether the value of the remainder interest qualifies for a charitable deduction largely depends on the provisions of the trust instrument creating the pooled income fund.

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D. Gift of Remainder Interest in Residence or Farm

§13.20 1. Charitable Deduction Allowed

Generally, a gift of a remainder interest to a qualified charity will not qualify for a charitable deduction under IRC §2055 unless it is in a charitable remainder unitrust (see IRC §664(d)(2)), a charitable remainder annuity trust (see IRC §664(d)(1)), or a pooled income fund (see IRC §642(c)(5)). IRC §2055(e)(2). An exception is a gift, not in trust, of a remainder interest in a personal residence or farm passing to a qualified charity. Treas Reg §20.2055-2(e)(2)(ii) (residence), (iii) (farm). For example, the testator can give the surviving spouse a life estate in the family home and, at the spouse's death, the remainder interest to a qualified charity.

The deduction is available for the remainder interest even if the personal residence was not the decedent's principal residence. Thus, a vacation home can qualify as a personal residence within the meaning of the statute. Treas Reg §20.2055-2(e)(2)(ii). A personal residence includes a condominium or stock in a cooperative housing corporation. Reg §1.170A-7(b)(3). The interest, however, must be in the property itself, not in the proceeds of sale of the private residence (compare Rev Rul 83-158, 1983-2 Cum Bull 159, with Rev Rul 76-543, 1976-2 Cum Bull 287, amplified by Rev Rul 77-169, 1977-1 Cum Bull 286), and it must be a legal life estate and remainder, not in trust (see Rev Rul 76-357, 1976-2 Cum Bull 285). The individual beneficiary may be given an interest for a term of years and, unlike the term of a charitable remainder unitrust or annuity trust (see §14.7), the term is not limited to 20 or fewer years. See Reg §1.170A-7(b)(3)-(4). The Secretary of the Treasury is directed to prescribe rules permitting the reformation of charitable transfers in personal residences or farms. See IRC §2055(e)(3)(I).

A spouse's exclusive and unrestricted right to use a personal residence for life (including the right to occupy the residence or to receive rental income from it) satisfies the qualified terminable property interest "income" requirement. See Treas Reg §20.2056(b)-7(h), Example (1). Accordingly, if the surviving spouse is given a life estate in the family home with a remainder to charity, the gift may be eligible for both a marital and a charitable deduction. Some of the considerations discussed in §§14.4-14.6 apply to this decision.

The wording of a remainder gift in a personal residence to charity should include an express provision covering encumbrances on the property. Without some indication of the testator's intent, the gift passes subject to any mortgage, deed of trust, or other lien existing on the date of death. Prob C §21131. If the encumbrance is not exonerated, the general rule is that the remainder beneficiary must pay the principal and the life tenant must pay only interest. *Boggs v Boggs* (1944) 63 CA2d 576, 147 P2d 116. See also *Estate of Barnhart* (1964) 226 CA2d 289, 37 CR 909.

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§13.21 2. Form: Remainder in Personal Residence to Charity

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13.21-1 Remainder in personal residence to charity

***Gift of Residence*. I give my personal residence, consisting of the real property commonly known as** _ _[*street address*]_ _ **and all improvements on it, to** _ _[*name of beneficiary*]_ _**, if** _ _[*name of beneficiary*]_ _ **survives me, for** _ _[*name of beneficiary*]_ _**'s life. At the death of** _ _[*name of beneficiary*]_ _**, or at my death if** _ _[*name of beneficiary*]_ _ **does not survive me, I give this residence to** _ _[*exact name of qualified charity*]_ _ **if on the date of my death it is an organization described in Internal Revenue Code §2055(a) to which a bequest of an interest in my personal residence is deductible. If it is not such an organization, I give this residence to** _ _[*alternative disposition*]_ _**.**

[*Add one of the following alternatives*]

[*Alternative 1: Encumbrances to be paid by executor*]

Any encumbrances on my personal residence on the date of my death, including any mortgage, deed of trust, or real property taxes and assessments, shall be paid by my executor from the residue of my estate.

[*Alternative 2: Encumbrances to be assumed by life beneficiary*]

I give my personal residence to _ _[*name of beneficiary*]_ _**, subject to any encumbrances on my personal residence on the date of my death, including any mortgage, deed of trust, or real property taxes and assessments.**

Comment: The drafter should include specific direction about the disposition of encumbrances on the property by using Alternative 1 or Alternative 2.

The additional language after the reference to IRC §2055(a) in form 13.21-1 is intended to eliminate the possibility that the "charitable" organization would be an employee stock ownership plan described in IRC §2055(a)(5).

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E. Pourover to Inter Vivos Charitable Remainder Unitrust

§13.22 1. Unitrust Agreement Must Permit Additions

A will that gives the residue of the estate to an existing trust is said to "pour over" to the trust. Probate assets may be poured over to an existing inter vivos charitable remainder unitrust if the trust agreement is drafted to permit additions and if it contains the proper formula for increasing the unitrust amount. Treas Reg §1.664-3(b). See §§14.29-14.30. Additions are not permitted in an annuity trust (see §14.61), and therefore a pourover will provision to an annuity trust is ineffective (Treas Reg §1.664-2(b)).

The provisions of an inter vivos charitable remainder unitrust should be reviewed to verify that additions are permitted and that the formula for adjusting the unitrust amount is accurate. For discussion of additions to unitrusts, see §14.29.

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/§13.23 2. Form: Pourover Distribution to Inter Vivos Unitrust

§13.23 2. Form: Pourover Distribution to Inter Vivos Unitrust

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13.23-1 Pourover distribution to inter vivos unitrust

***Gift of Residue*. I give the residue of my estate to _ _[*name of beneficiary*]_ _, as trustee of the inter vivos charitable remainder unitrust created by me under the trust agreement dated _ _[*date*]_ _, and commonly referred to as the _ _[*name of unitrust*]_ _, to be added to the assets of that trust and administered under the terms of that trust agreement. If at my death the _ _[*name of unitrust*]_ _ is not in existence, or if the residue of my estate is not permitted by law to be distributed to this trustee, then I give the residue of my estate to _ _[*alternative disposition*]_ _.**

Comment: Alternative dispositions include making the gift directly to charity or establishing a testamentary charitable remainder trust. See chap 14. For other residuary gift clauses, see §12.80.

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Source: Estate Planning/California Will Drafting/13 Outright Gifts to Charity/ F. Charitable Gift Annuities/§13.24 1. Charitable Devise Conditioned on Guaranteed Annuity

F. Charitable Gift Annuities

§13.24 1. Charitable Devise Conditioned on Guaranteed Annuity

Some charities will enter into a charitable gift annuity agreement in which they agree to pay a fixed payment referred to as a "guaranteed annuity interest" at least annually to a designated annuitant for life or for a specified term in return for a lump-sum contribution that is substantially more than the value of the annuity. Therefore, the contribution is part gift and part purchase. The amount to be paid to the annuitant is fixed for life or for a specified term and is guaranteed by all the charity's assets. The annuitant must be alive and ascertainable on the date of the decedent's death. Treas Reg §20.2055-2(e)(2)(vi)(a).

If a guaranteed annuity interest uses an individual other than one permitted in Treas Reg §20.2055-2(e)(2)(vi)(a), the interest may be reformed into a lead interest payable for a specified number of years determined by taking the factor for valuing the annuity interest for the named individual's measuring life and identifying the term of years that corresponds to the equivalent term-of-years factor for an annuity interest as provided in Temp Treas Reg §20.2055-2T(e)(3)(iii).

In IRS Letter Ruling 200922013, the IRS issued a favorable ruling concerning a proposed early termination of a split-interest trust having assets far in excess of those necessary to continue payment of annuities to the noncharitable beneficiaries, in which the charitable remaindermen purchased commercial annuities for the benefit of the noncharitable beneficiaries that remained the assets of the purchasing charities to guarantee the trust's obligation to pay the annuities.

A testamentary charitable gift annuity is created by making a specific devise to a charity that is conditioned on the charity's agreement to pay the guaranteed annuity to the testator's nominee. The amount by which the devise exceeds the date-of-death value of the annuity can then qualify for an estate tax deduction. Treas Reg §20.2055-2(e)(2)(vi)(a).

Many charities are either unwilling or unable to assume the obligation of paying an annuity. Furthermore, if the gift is not in trust, the deduction is available only if the charity is an organization regularly engaged in issuing annuity contracts. Treas Reg §20.2055-2(e)(2)(vi)(c). In California, only charities that have qualified with the Insurance Commissioner and have been issued a certificate of authorization may issue annuities. Ins C §§11520-11524. For this reason, the attorney should ascertain whether the charity selected by the client offers gift annuities and, if so, the limits imposed on the minimum contribution or age of the annuitant.

The amount of the gift is determined from valuation tables issued by the United States Treasury Department. The interest rate on which valuations are based changes monthly. The applicable rate is 120 percent of the applicable federal midterm rate determined under IRC §1274(d)(1), rounded to the nearest 0.2 percent. The applicable federal midterm rate is the rate on federal marketable obligations with remaining terms of more than 3 years and not more than 9 years. The tables take into account mortality experience based on the 2000 census. IRC §7520; Temp Treas Reg §20.2031-7T(d)(7).

Charitable gift annuities are exempt from the unrelated business income provisions of IRC §501(m) if they satisfy the following requirements (IRC §514(c)(5)):

- The value of the annuity must be less than 90 percent of the property received (the gift annuity tables make this requirement more onerous than in the past);
- The annuity must be payable over the life of one or two individuals living when the annuity was created;
- The annuity contract cannot guarantee either a minimum or maximum amount of total payments; and
- The annuity contract cannot allow for an adjustment of the annuitant's payments based on the income received by the charity from the gift.

When the annuity is given to two individuals as joint and survivor annuitants, computing the value is more complex and different tables are used. The value of the charitable deduction is also significantly reduced. No more than two joint and survivor annuitants should be designated, because charities that must pay an annuity over the lifetime of more than two annuitants will incur adverse income tax consequences under IRC §514(c)(5).

The usual annuity results in the annuity's being payable to the annuitant on the date of the testator's death. It may be more in line with the client's intent to defer the annuity until the annuitant has reached a particular age, or the client may wish the annuity to be paid to a trust if the annuitant is under a particular age. Before drafting such a clause, the attorney should review the deferral terms with the charity.

Many charities are willing to assist attorneys in computing the value of the charitable deduction portions of a gift annuity. For discussion of valuation of annuities, see Drafting California Irrevocable Trusts, chap 6 (3d ed Cal CEB 1997).

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§13.25 2. Form: Testamentary Charitable Gift Annuity

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13.25-1 Testamentary charitable gift annuity

***Charitable Gift Annuity*. I give the sum of _ _[*amount*]_ _ to _ _[*exact name of charity authorized to issue annuities*]_ _ (charity) if charity agrees to pay to _ _[*name of annuitant*]_ _ (annuitant) from the date of my death and for _ _[*name of annuitant*]_ _'s life a guaranteed annuity, as defined under Treasury Regulation §20.2055-2(e)(2)(vi)(a), at the annual rate being paid on the date of my death by charity to those of annuitant's age on the date of my death. The annuity shall be nonassignable. If on the date of my death (1) charity is not an organization described in Internal Revenue Code §2055(a) to which such a bequest would be deductible, or is unable or unwilling to receive property from my estate conditioned on an agreement to pay the guaranteed annuity on these terms, or (2) _ _[*name of annuitant*]_ _ does not survive me, I direct my executor to _ _[*alternative disposition*]_ _.**

Comment: To carry out this clause, the executor will enter into a gift annuity agreement with the charity. The agreement is a contract that binds the charity to pay the annuity under its terms and conditions in return for the gift under the will distributed to it by the executor. The wording of this clause intentionally avoids trying to fix the terms and conditions of the agreement. The annuity amount depends on the annuitant's age when the testator dies and on the rates then in effect for charitable gift annuities. The will specifies only the amount to be contributed to the charity.

The clause may be drafted so that the amount of the annuity is fixed, leaving the exact cost of the annuity and the amount of the gift to charity uncertain until the testator dies. This is a significant uncertainty, which may not be acceptable to the client. If the amount is fixed, it may be adjusted to the date of the testator's death by reference to a fluctuating index (*e.g.,* the Consumer Price Index), but the amount may not fluctuate thereafter. Treas Reg §20.2055-2(e)(2)(vi)(a).

The additional language after the reference to IRC §2055(a) is intended to eliminate the possibility that the "charitable" organization would be an employee stock ownership plan described in IRC §2055(a)(5).

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§13.26 G. Copyrighted Works of Art

For decedents dying after 1981, a work of art and its copyright are considered separate properties for purposes of the charitable deduction. IRC §2055(e)(4)(A). A charitable deduction is therefore allowable for a gift of an art work to charity whether or not the copyright is also given to the charity. A "work of art" is defined in IRC §2055(e)(4)(B) as any tangible personal property that is copyrighted under federal law. The deduction is limited to qualified contributions defined under IRC §2055(e)(4)(C), which requires that the art work's use be related to the purpose or function constituting the basis for the donee's exemption under IRC §501. In IRS Letter Ruling 200418002, the IRS ruled that restrictions on a gift of an art collection to a museum and foundation will not cause the charitable deduction to be lower than the value at which the collection will be included in decedent's estate. For further discussion, see Estate Planning for Special Assets §§7.42-7.43 (Cal CEB 2004).

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14

Charitable Split-Interest Trusts

Donald J. McCubbin
Mary Pilibos White

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I. PLANNING CHARITABLE TRUSTS

§14.1 A. Limited Scope of Chapter

This chapter covers testamentary gifts in trust benefiting both individuals and charities. It deals primarily with trusts in which the remainder interests pass to charity, known as charitable remainder trusts. Testamentary gifts in trust of an income interest to charity, known as charitable lead trusts, are discussed in §§14.81-14.99. Outright testamentary gifts to charity are discussed in chap 13.

This chapter discusses lifetime charitable gifts, with their important income and gift tax ramifications, only in passing. Both this chapter and chap 13 focus exclusively on gifts made by will. The emphasis is on (1) explaining the basic requirements of qualifying a testamentary gift of a remainder interest in trust to an organization described in IRC §2055(a) for an estate tax charitable deduction and (2) drafting clauses in the will to meet those requirements. For a discussion of lifetime charitable remainder trusts, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

Under most circumstances, the best source of information on drafting a charitable gift is the charitable beneficiary. On request, a charity will provide a copy of its California and federal tax exemption letters. The letters allow the drafter not only to verify the tax-exempt status of the charity but also to confirm the charity's correct and full name.

Most major charities also have material, including printed forms, that they will send on request. These charities often have preferred wording for particular kinds of gifts and appreciate being consulted before the will is executed. Some charities are willing to act as trustee of charitable remainder trusts that name the charity as the remainder beneficiary.

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§14.2 B. Statutory Framework for Charitable Deductions

To qualify for an estate tax charitable deduction, a testamentary gift in trust must meet the IRC §2055 requirements. Generally, that section restricts the deduction to gifts passing only to certain organizations (see §13.3) and severely limits the form of any gift that is not for the charity's exclusive use (*i.e.,* split-interest gifts). Except for a slight variation in the description of qualified charities (see §13.3) and the allowance of a deduction for gifts of qualified employer securities to an ESOP (see IRC §664(g)), the same restrictions apply to income tax charitable deductions under IRC §170 and gift tax charitable deductions under IRC §2522.

If a charity is to receive a remainder interest under a trust created by the donor, all three statutes require that the trust be in the form of either a charitable remainder annuity trust as defined in IRC §664(d)(1) or a charitable remainder unitrust as defined in IRC §664(d)(2). Therefore, IRC §664(d) and its supporting regulations govern charitable remainder trusts whether they are inter vivos or testamentary.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.3 C. Organizations Qualifying for Charitable Deduction

§14.3 C. Organizations Qualifying for Charitable Deduction

The categories of organizations that qualify for an estate tax charitable deduction are set out in §13.3.

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II. TESTAMENTARY CHARITABLE REMAINDER TRUSTS

§14.4 A. Charitable Remainder Trusts With Spouse as Noncharitable Beneficiary

A remainder interest passing to a qualified charity through a testamentary trust is ordinarily deductible under IRC §2055 only if it is in the form of a qualified charitable remainder annuity trust (IRC §664(d)(1)) or a qualified charitable remainder unitrust (IRC §664(d)(2)). IRC §2055(e)(2)(A). This rule is strictly construed. In *Estate of Tamulis v Commissioner* (7th Cir 2007) 509 F3d 343, the court 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 trust provided for distribution of net income to individual beneficiaries for at least 10 years with remainder to charity, and the estate claimed a charitable deduction for the residue following a 10-year term certain 5-percent unitrust. In *Galloway v U.S.* (3d Cir 2007) 492 F3d 219, the court held that no charitable deduction was allowed for a trust that provided that 50 percent of each distribution would pass to charity. There is a limited exception to this rule for an outright distribution of an amount equal to the present value of the remainder interest to a qualified charity in settlement of a bona fide will contest. See *Burdick v Commissioner* (9th Cir 1992) 979 F2d 1369. Distributions from an annuity trust or a unitrust to the noncharity (*e.g.,* the surviving spouse) are limited to periodic payments of a fixed annuity amount or a fixed percentage unitrust amount. IRC §2055(e)(2)(B). See §14.7.

If the testator wishes his or her spouse to be the noncharitable beneficiary, two alternatives are available to avoid estate tax on the trust. The trust can be in the form of (1) a qualified terminable interest property trust (IRC §2056(b)(7)) with a charitable remainder beneficiary or (2) a qualified charitable remainder trust under IRC §2056(b)(8).

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§14.5 1. Qualified Terminable Interest Property (QTIP) Trust With Charitable Remainder

If the testator provides that his or her spouse is to receive all the trust income or to have access to the trust principal, the trust will not be a qualified charitable remainder trust under IRC §2055. The estate tax objective of avoiding estate tax on such a trust can be achieved, however, if the trust property is eligible for the marital deduction election.

If the trust is drafted to entitle the surviving spouse to all the trust income, payable at least annually (IRC §2056(b)(7)(B)(ii)(I)), and if no person has a power to appoint any part of the trust property to anyone other than the surviving spouse (IRC §2056(b)(7)(B)(ii)(II)), then the executor may elect to qualify the trust property for a marital deduction as qualified terminable interest property (QTIP). See chap 19. No estate tax will be imposed when the testator dies. At the surviving spouse's death, the remaining trust property will be included in that spouse's gross estate but will qualify for a charitable deduction as an outright gift to charity. The election must be made for the full value of trust property. In most cases, this can be accomplished by making a formula election for the amount needed to reduce the estate tax to zero. See §19.11. For further discussion, see Drafting California Irrevocable Trusts §18.22 (3d ed Cal CEB 1997); California Estate Planning §23.39 (Cal CEB 2002).

A charitable remainder annuity trust or unitrust with a spouse as income beneficiary differs from a QTIP trust with a charitable remainder in several respects, including the following:

- A QTIP trust may provide for invasion of principal for the benefit of the spouse, whereas an annuity trust or a unitrust income beneficiary is entitled only to the annuity trust or unitrust payments of income.
- The annual payments from a QTIP trust to the spouse must consist of the entire net income, whereas the annual payments from an annuity trust or a unitrust must constitute a certain percentage or a specified sum (for an annuity trust) or the fair market value of the trust (for a unitrust).
- A trustee of a charitable remainder annuity trust or unitrust is prohibited from taking actions that are in violation of the private foundation rules, whereas these rules do not apply to a QTIP trust.
- A charitable remainder annuity trust or unitrust is exempt from income taxation, but distributions may be taxable to the spouse. IRC §664. A QTIP trust is taxable, but its distributions to the spouse are deductible from the taxable income of the trust and are taxable to the spouse. See IRC §§651-662.
- The remainder interest in a QTIP trust need not be irrevocably given to charity, because the spouse may be given the power to appoint the trust property to a noncharitable beneficiary. (Of course, if the power of appointment given to the spouse is a general power, the trust is not a QTIP trust qualifying for the marital deduction under IRC §2056(b)(7) but nevertheless qualifies for the marital deduction under IRC §2056(b)(5).) A charitable remainder annuity trust or unitrust irrevocably grants the remainder interest to charity, although the choice of the charity may be subject to a power of appointment granted to the spouse (or another person) or may be left to the trustee's discretion.

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§14.6 2. Qualified Charitable Remainder Trust With Spouse as Noncharitable Beneficiary

The Internal Revenue Service has issued marital deduction regulations which state that if the surviving spouse is the *only* noncharitable beneficiary of a qualified charitable remainder trust, the estate of the deceased spouse will receive a charitable deduction under IRC §2055 for the value of the remainder interest and a marital deduction under IRC §2056(b)(8) for the value of the annuity trust or unitrust interest. The surviving spouse's interest need not be for his or her lifetime. Treas Reg §20.2056(b)-8. In IRS Letter Ruling 200232015, the IRS allowed a marital and charitable deduction for a testamentary trust that benefited the surviving spouse for life with remainder to a private foundation when the spouse disclaimed the right to discretionary distributions of principal and the trust was reformed into a charitable remainder unitrust.

The strict requirements of charitable remainder annuity trusts and unitrusts eliminate many of the trustee's and spouse's options that would be available if the income interest in the trust were a qualified terminable interest. Invasions of principal are not permitted, for example. Further, the spouse can have no power to appoint the remainder to individuals and no person other than the surviving spouse can be a beneficiary of the charitable remainder trust. In addition, the spouse receives no income tax deduction for the gift of the remainder interest. If the spouse shares the testator's interest in benefiting charity, it may be preferable to give the contemplated trust corpus to the surviving spouse free of trust. The surviving spouse can later create a charitable remainder trust and obtain an income tax deduction for the value of the remainder interest. The testator should consider carefully whether these limitations are outweighed by other considerations favoring charitable remainder annuity trusts and unitrusts, *e.g.,* exemption from income taxation, fixed payments to the spouse, and increased probability of a substantial remainder interest passing to charity. However, in some cases, a unitrust interest may be considered a qualified terminable interest. See §19.7.

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B. Charitable Remainder Annuity Trusts and Unitrusts

§14.7 1. Similarities Between Annuity Trusts and Unitrusts

Charitable remainder annuity trusts and unitrusts have several requirements in common, including:

- The individual beneficiary must be paid an annuity amount (Treas Reg §20.2055-2(e)(2)(vi)) or a unitrust amount (Treas Reg §20.2055-2(e)(2)(vii)) at least annually, for life or a term of years, and must be alive on the date on which the decedent dies.
- If a guaranteed annuity or unitrust interest uses an individual other than one permitted in Treas Reg §20.2055-2(e)(2)(vi)(a), (vii)(a), the interest may be reformed into a lead interest payable for a specified number of years determined by taking the factor for valuing the annuity or unitrust interest for the named individual's measuring life and identifying the term of years that corresponds to the equivalent term-of-years factor for an annuity or unitrust interest as provided in Temp Treas Reg §20.2055-2T(e)(3)(iii).
- The charitable deduction is not allowed if the trust fails to make the annuity or unitrust payments required by the trust instrument. Treas Reg §1.664-1(a)(4). See *Estate of Atkinson v Commssioner* (11th Cir 2002) 309 F3d 1290, cert denied (2003) 540 US 946, 157 L Ed 2d 276, 124 S Ct 388.
- The individual beneficiary's interest must be for either his or her life or a term not to exceed 20 years under Treas Reg §1.664-2(a)(5) (annuity) and Treas Reg §1.664-3(a)(5) (unitrust).
- Nothing other than the annuity amount or unitrust amount may be paid to or for the benefit of a person other than an organization described in IRC §170(c).
- When the individual beneficiary's interest terminates, the trust assets must pass to, or be retained for, the charity.
- The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of any person other than an organization described in IRC §170(c).
- The actuarial value of the charitable remainder interest (determined under IRC §7520) must exceed 10 percent of the initial value of the property placed in the trust. IRC §664(d)(1)(D), (2)(D).

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§14.8 2. Differences Between Annuity Trusts and Unitrusts

The essential difference between an annuity trust and a unitrust is the manner in which the amount payable to the individual beneficiary is determined. An annuity amount must be a specific sum, stated as a fixed dollar amount or as a fixed percentage, and may not be less than 5 percent or more than 50 percent of the initial net fair market value of all the property transferred to the trust. IRC §664(d)(1)(A); Treas Reg §1.664-2(a)(2)(i). A unitrust amount must be a fixed percentage and must be at least 5 percent but not more than 50 percent of the net fair market value of the trust assets valued annually. IRC §664(d)(2)(A); Treas Reg §1.664-3(a)(1)(i).

Unlike a unitrust amount, which is determined annually, an annuity amount is determined just once: at the creation of the trust. That fixed amount is paid each year from the annuity trust regardless of fluctuations in the value of the trust assets. Treas Reg §1.664-3(a)(2)(i). A unitrust is thus often considered to be a better hedge against inflation than an annuity trust. Moreover, Rev Rul 70-452, 1970-2 Cum Bull 199, imposes a 5-percent-probability test on annuity trusts, which effectively limits the maximum amount of the annuity to be paid to the individual beneficiary. That limitation has not been placed on unitrusts. See §14.9.

Furthermore, the unitrust amount may be limited to trust income (see form 14.20-1), whereas annuity amounts may not be limited to trust income. Another difference between annuity trusts and unitrusts is that additional contributions may be made to a unitrust if they are specifically authorized by the trust clauses (see form 14.30-1), but the terms of the annuity trust must expressly prohibit additions (see form 14.62-1).

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§14.9 3. 5-Percent-Probability Test and 10-Percent Charitable Interest Test

No deduction is permitted when more than a 5-percent probability exists that the charitable remainder annuity trust will be consumed by payments of the annuity amount to the individual beneficiary. Rev Rul 77-374, 1977-2 Cum Bull 329; Rev Rul 70-452, 1970-2 Cum Bull 199. This limitation on annuity trusts is an extension of the limit placed on conditional gifts to charity. No deduction is allowed for a gift to charity that is subject to a condition, unless the possibility that the charitable gift will not become effective is so remote as to be negligible. Treas Reg §20.2055-2(b)(1). Under an annuity trust, a fixed sum must be paid annually regardless of the value of trust assets. If the fixed sum exceeds anticipated trust income, principal may be exhausted.

As set forth in Rev Rul 70-452, 1970-2 Cum Bull 199, the charitable deduction is not allowable when the probability exceeds 5 percent that a noncharitable beneficiary will survive the exhaustion of a fund in which the charity has a remainder interest. Any possibility over 5 percent that the contingency will occur and defeat the charity's interest is not considered so remote as to be negligible within the meaning of Treas Reg §20.2055-2(b).

The 5-percent-probability test applies only to annuity trusts. Unitrusts pay a percentage of the value of the trust assets determined each year and therefore never consume the entire trust.

The actuarial value of the charitable remainder interest must exceed 10 percent of the total value of the property placed in trust (computed under IRC §7520). This rule applies to both charitable reminder annuity trusts (IRC §664(d)(1)(D)) and charitable remainder unitrusts (IRC §664(d)(2)(D)). In many cases, this test will render the 5-percent-probability test meaningless.

The IRS issued new valuation tables effective May 1, 2009. The interest rate on which valuations are based changes monthly. The applicable rate is 120 percent of the applicable federal midterm interest rate determined under IRC §1274(d)(1) and rounded to the nearest 0.2 percent. The applicable federal midterm interest rate is the rate on federal marketable obligations with remaining terms over 3 years but not over 9 years. The tables take into account updated mortality experience. IRC §7520; Temp Treas Reg §1.664-4T.

For discussion of valuation of charitable remainder interests, see Drafting California Irrevocable Trusts, chap 6 (3d ed Cal CEB 1997).

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§14.10 4. Payment of Estate Taxes

The governing instrument of a charitable remainder trust should provide for payment of any federal or state estate taxes for which the trust may be liable. The IRS ruled in Rev Rul 82-128, 1982-2 Cum Bull 71, that a charitable remainder unitrust did not qualify for a charitable deduction under IRC §§170(c) and 2522(a) and the trust was disqualified under IRC §664 if the possibility exists that the state apportionment statute would permit payment of estate taxes on the value of the life income interest of the charitable remainder trust from the corpus of that trust. Thus, merely allowing the California apportionment statute (discussed in §26.3) to govern without including the protective provisions suggested by Rev Rul 82-128 could result in disqualification of the charitable remainder trust.

To prevent tax apportionment statutes from having the effect of requiring an equitable apportionment of death taxes from the charitable remainder trust, the trust should require that the income beneficiary of that trust pay from other sources the tax attributable to his or her interest, as a condition to receiving the interest. Although the sample provisions for charitable remainder unitrusts in Rev Procs 2005-56—2005-59, 2005-2 Cum Bull 383, do not include a provision to the effect that the trust is not liable for estate taxes on the grantor's death, such a provision will not disqualify a charitable remainder trust. See IRS Letter Ruling 9512016. See §§26.3-26.7 on California estate tax apportionment statutes.

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§14.11 5. Sample Clauses for Charitable Remainder Trusts

To qualify as a charitable remainder annuity trust or unitrust, a trust must meet all the requirements of IRC §664 and Treas Reg §1.664-2 or §1.664-3. The Internal Revenue Service issued a series of revenue rulings that explain the technical requirements of IRC §664 and offer sample qualifying language.

In 1972, the IRS published a set of sample clauses in Rev Rul 72-395, 1972-2 Cum Bull 340, for both a charitable remainder annuity trust and a charitable remainder unitrust. This ruling was later modified by Rev Proc 89-20, 1989-1 Cum Bull 841; Rev Rul 92-57, 1992-2 Cum Bull 123; and Rev Proc 89-21, 1989-1 Cum Bull 842. The IRS released sample forms of testamentary charitable remainder trusts in Rev Proc 90-30, 1990-1 Cum Bull 534; Rev Proc 90-31, 1990-1 Cum Bull 539; and Rev Proc 90-32, 1990-1 Cum Bull 546. In 2003, the IRS issued Rev Procs 2003-53—2003-60, 2003-2 Cum Bull 230, superseding the sample forms of annuity trusts in Rev Procs 89-21 and 90-32. In 2005, the IRS issued Rev Procs 2005-56—2005-59, 2005-2 Cum Bull 383, superseding the sample forms of unitrusts in Rev Procs 90-30 and 90-31. These revenue rulings and revenue procedures briefly discuss the requirements under the regulations that the clauses are designed to satisfy.

Each of the clauses in this chapter is taken verbatim from, or based on, these revenue rulings and revenue procedures. The text explains the significant differences, if any, between the clauses in the chapter and the wording offered by the IRS.

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III. CHARITABLE REMAINDER UNITRUSTS

A. Distribution to Trustee

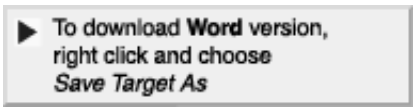
§14.12 1. Identity of Trustee

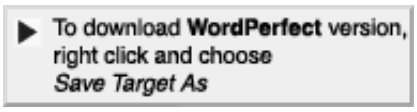
If the trustee is permitted to sprinkle the unitrust amount among the individual beneficiaries (see form 14.18-1), no member of the class of individual beneficiaries should be named as trustee or successor trustee.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.13 2. Form: Distribution to Trustee

§14.13 2. Form: Distribution to Trustee





14.13-1 Distribution to trustee

***Gift of Residue*. I give the residue of my estate, after payment of taxes, costs, and expenses of administration as provided in paragraph _ _[*number*]_ _, to _ _[*name of trustee*]_ _ (the trustee) in trust. It is my intention to establish a charitable remainder unitrust within the meaning of Revenue Procedure 2005-_ _[*56/57/58/59*]_ _ and Internal Revenue Code §664(d)(2) _ _[*and (d)(3)*]_ _. This trust shall be known as the _ _[*name of trust*]_ _ and shall be administered as follows:**

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§14.14 B. Selection of Unitrust Valuation Date

The net fair market value of a charitable remainder unitrust must be determined annually to establish the unitrust amount. If no valuation date is specified, the trustee selects it when completing the first trust income tax return, IRS Form 1041-B. Treas Reg §1.664-3(a)(1)(iv). It is common, however, to specify the first day of the trust's taxable year as the valuation date because that will permit the trustee to determine the exact amount that the individual beneficiary will receive before it is payable. It also makes adjustment to the unitrust amount simpler in short tax years (see §14.27) and in years when there are additions (see §14.29).

The sample clauses in Rev Rul 72-395, 1972-2 Cum Bull 340; Rev Proc 89-20, 1989-1 Cum Bull 841; and Rev Proc 2005-56, 2005-2 Cum Bull 383, specify the first day of the trust's taxable year as the unitrust valuation date. Generally, all trusts that are not completely charitable must use a calendar year tax year. IRC §644.

Revenue Ruling 82-165, 1982-2 Cum Bull 117, modified by Rev Rul 92-57, 1992-2 Cum Bull 123, provides a sample clause for inclusion in the will if a valuation date other than the first day of the taxable year is selected.

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§14.15 C. Selection and Payment of Unitrust Percentage

Charitable remainder unitrusts (CRUTs) must satisfy four requirements related to the values of the various interests:

- Five-percent minimum payment requirement. The unitrust amount paid to a CRUT's noncharitable beneficiaries cannot be less than 5 percent of the value of the trust assets valued annually. IRC §664(d)(2)(A).
- Fifty-percent maximum payment limitation. The unitrust amount paid to a CRUT's noncharitable beneficiaries cannot exceed 50 percent of the value of the trust assets valued annually. IRC §664(d)(2)(A).
- Term of years limitation. A CRUT may have a term equal to the life or lives of individuals living when the trust is created, but if the term is for a term of years, the number of years cannot exceed 20. IRC §664(d)(2)(A).
- Ten-percent minimum charitable benefit rule. The value of the charitable remainder in a CRUT at the time of the transfer to the trust must be at least 10 percent of the initial net fair market value of the trust. IRC §664(d)(2)(D). See §14.19A.

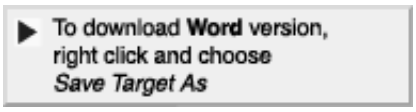
These four restrictions are interrelated. For example, the 10-percent minimum charitable benefit rule can indirectly limit the term of the trust, the annual payout amount, or both. In some circumstances it is impossible to establish a unitrust for the lifetimes of one or more persons without violating the 10-percent minimum charitable benefit rule, even if the unitrust amount is the minimum 5 percent. Under current actuarial tables, a unitrust for the life of a single individual who is younger than age 25 cannot qualify, and neither can a unitrust for the joint lives of two persons and the life of the survivor if the two persons both are under age 37. The trust may provide that the unitrust interest will terminate before the end of the unitrust period on the occurrence of a qualified contingency under IRC §664(f), but the amount of the charitable deduction will be determined without regard to the qualified contingency. The unitrust amount also may be divided between an individual recipient and a charitable recipient. However, to obtain an estate tax charitable deduction for the present value of the unitrust interest passing to a charitable organization, the trust instrument must contain additional provisions. See Rev Proc 2005-56, §6.01, 2005-2 Cum Bull 383. For a payment clause containing the required provisions, see §14.16A.

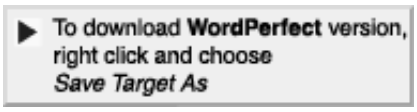
The unitrust amount may be paid to a class of individuals, all of whom are living (life interest) or ascertainable at the testator's death (term of years). Treas Reg §1.664-3(a)(3)(i). To create such an interest, the drafter should use form 14.18-1.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.16 1. Form: Payment of Unitrust Amount to One Recipient

§14.16 1. Form: Payment of Unitrust Amount to One Recipient





14.16-1 Payment to one named recipient

***Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the trustee shall pay to _ _[*name of a living individual*]_ _ (the Recipient) a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the first day of each taxable year of the trust (the valuation date). The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Recipient's death _ _[*or, if earlier, the date on which occurs the _ _[qualified contingency under IRC §664(f)*]_ _]_ _. The unitrust amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of trust assets is incorrectly determined, then, within a reasonable period after the correct value is finally determined, the trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.**

14.16-2 Proration of unitrust amount

***Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in paragraph _ _[*number*]_ _.**

14.16-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the unitrust amount during the unitrust period.**

Comment: The authors have modified the Internal Revenue Service sample clause (see Rev Proc 2005-56, 2005-2 Cum Bull 383) by providing payment options other than equal quarterly installments, and specifying that each installment be paid at the end of the period to which it applies. See §14.15. The editor has modified the sample clause by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

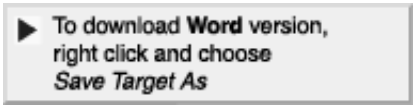
If the unitrust amount is to be paid for a term of years instead of during a recipient's life, this clause may be altered by deleting "the first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Recipient's death" and substituting "the unitrust period shall be a period of _ _[*number not exceeding 20*]_ _ years. The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the _ _[*ordinal number corresponding to the length of the unitrust period, e.g., tenth*]_ _ anniversary of that date." See Rev Proc 2005-57, 2005-2 Cum Bull 392.

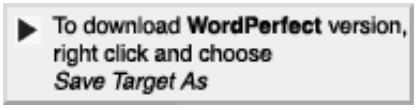
For a clause providing for sprinkling the unitrust amount, see form 14.18-1. For a clause creating a joint and successor unitrust interest, see form 14.20-1. For a clause that creates a unitrust interest limited to trust income, see form 14.22-1. For a clause that creates a unitrust interest limited to trust income that later converts to a standard unitrust interest, see form 14.22A-1. For clauses that must be included in or added to this clause, see forms 14.24-1, 14.26-1, 14.28-1, 14.30-1.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.16A 2. Form: Payment of Part of Unitrust Amount to Charitable Organization

§14.16A 2. Form: Payment of Part of Unitrust Amount to Charitable Organization





14.16A-1 Payment of part of unitrust amount to charitable organization

***Payment of Unitrust Amount*. The unitrust amount is _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the first day of each taxable year of the trust (the valuation date). In each taxable year of the trust during the unitrust period, the trustee shall pay _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of a living individual*]_ _ (the Recipient) and _ _[*number*]_ _ percent of the unitrust amount to _ _[*name of organization described in IRC §§170(c) and 2055(a)*]_ _ (the Charitable Recipient). The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Recipient's death _ _[*or, if earlier, the date on which occurs the _ _[qualified contingency under IRC §664(f)*]_ _]_ _. If the Charitable Recipient is not an organization described in Internal Revenue Code §§170(c) and 2055(a) at the time when any unitrust payment is to be distributed to it, then the trustee shall distribute that unitrust payment to one or more organizations described in Internal Revenue Code §§170(c) and 2055(a) as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion. The unitrust amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of trust assets is incorrectly determined, then, within a reasonable period after the correct value is finally determined, the trustee shall pay to the Recipient and the Charitable Recipient (in the case of an undervaluation) or receive from the Recipient and the Charitable Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.**

14.16A-2 Proration of unitrust amount

***Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in paragraph _ _[*number*]_ _.**

14.16A-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the unitrust amount during the unitrust period.**

Comment: The authors have modified the Internal Revenue Service sample clause (see Rev Proc 2005-56, 2005-2 Cum Bull 383) by providing payment options other than equal quarterly installments, and specifying that each installment be paid at the end of the period to which it applies. See §14.15. The editor has modified the sample clause by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

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3. Rule for Sprinkling Unitrust Amount Among Class

§14.17 a. Independent Trustee Cannot Delay Payment

Under Treas Reg §1.664-3(a)(3)(ii), a trust does not qualify as a charitable remainder unitrust if any person has the power to alter the amount payable to an individual beneficiary in a manner that would cause any person to be taxed as the owner of the trust if the rules under IRC §§671-678 were applicable. It is possible, however, to give the trustee the power to sprinkle the unitrust amount among several named recipients or a class of recipients if the trustee is an independent trustee and the requirements of IRC §674(c) are satisfied. The trustee cannot delay the payment of the unitrust amount, and therefore the full unitrust amount must be paid to some individual recipient in each taxable year of the trust. Treas Reg §1.664-3(a)(1).

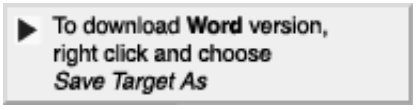
Each individual who receives a life interest must be living and ascertainable when the trust is created, *i.e.,* on the date of the testator's death. If the unitrust amount will be allocated among a class of recipients for a term of years, the members of the class need not all be living and ascertainable on the date of the testator's death. Treas Reg §1.664-3(a)(3)(i).

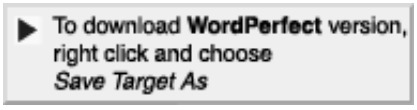
The Internal Revenue Service sample trust forms do not include a sample form for sprinkling payments among a class of recipients. Form 14.18-1 is based in part on a sample clause in Rev Rul 72-395, 1972-2 Cum Bull 340.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.18 b. Form: Payment of Unitrust Amount Sprinkled Among Class of Recipients

§14.18 b. Form: Payment of Unitrust Amount Sprinkled Among Class of Recipients





14.18-1 Payment sprinkled among class of recipients

***Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the trustee shall pay a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the first day of the taxable year, to a member or members of a class of persons consisting of _ _[*names of recipients*]_ _ (the Recipients), in amounts and proportions that the trustee shall, in the trustee's absolute discretion, from time to time determine. The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of death of the last to die of the Recipients. The unitrust amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. The trustee may pay the unitrust amount to any one member of the class or may apportion it among the members in any manner that the trustee from time to time considers advisable. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of trust assets is incorrectly determined, then, within a reasonable period after the correct value is finally determined, the trustee shall pay to the Recipients (in the case of an undervaluation) or receive from the Recipients (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.**

14.18-2 Proration of unitrust amount

***Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in paragraph _ _[*number*]_ _.**

14.18-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipients or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the unitrust amount during the unitrust period.**

Comment: See Comment to §14.16. For clauses that must be included in or added to this clause, see forms 14.24-1, 14.26-1, 14.28-1, 14.30-1.

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4. Rules for Joint and Survivor Recipients

§14.19 a. Payment to Joint and Survivor Recipients Must Total 5 Percent and May Not Exceed 50 Percent

The unitrust amount may be paid to more than one individual on a joint and survivor basis as long as the sum of the percentages is at least 5 percent but not more than 50 percent, as required under IRC §664(d)(2)(A). Treas Reg §1.664-3(a)(2)(i). The wording of form 14.20-1 is limited to the most common situation, in which two recipients share the unitrust amount equally, with the full unitrust amount payable to the surviving recipient. The recipients may be paid different percentages if the aggregate percentage payable is at least 5 percent and does not exceed 50 percent.

When one recipient dies, the full unitrust amount may continue to be paid to the surviving recipient. The surviving recipient may be paid less than the aggregate unitrust amount if (1) a distribution of trust assets is made to the charity that is proportionate to the reduction of the unitrust amount, and (2) the reduced unitrust amount is not less than 5 percent of the reduced trust assets.

A sample clause in Rev Rul 72-395 §7.04, 1972-2 Cum Bull 340, contains the required language for the distribution to charity and the reduction in the unitrust amount paid to the surviving recipient.

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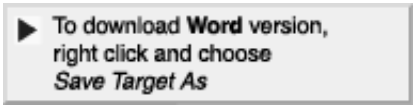
§14.19A b. Charitable Remainder Interest Must Be at Least 10 Percent

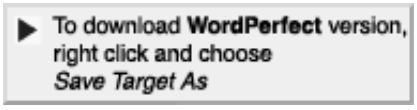
The actuarial value of the charitable remainder interest in a charitable remainder unitrust at the time of contribution or creation must be at least 10 percent. IRC §664(d)(2)(D). The actuarial value of the charitable remainder interest is determined under IRC §7520 when the trust is created or the contribution is made.

A trust that fails this 10-percent remainder requirement may be reformed to satisfy the requirement or instead be declared null and void. See IRC §2055(e)(3)(J), discussed in §14.44.

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§14.20 c. Form: Payment of Unitrust Amount to Joint and Survivor Recipients





14.20-1 Payment to joint and survivor recipients

***Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the trustee shall pay to (1) _ _[*name of a living individual*]_ _ and _ _[*name of another living individual*]_ _ (the Recipients) in equal shares during their joint lives, a unitrust amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the first day of each taxable year of the trust (the valuation date) and, on the death of one (the Predeceasing Recipient), the trustee shall pay the entire unitrust amount to the survivor (the Surviving Recipient). The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Survivor Recipient's death. The unitrust amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of trust assets is incorrectly determined, then, within a reasonable period after the correct value is finally determined, the trustee shall pay to the Predeceasing Recipient and/or the Surviving Recipient (in the case of an undervaluation) or receive from the Predeceasing Recipient and/or the Surviving Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.**

14.20-2 Proration of unitrust amount

***Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in paragraph _ _[*number*]_ _. On the death of the Predeceasing Recipient, the trustee shall prorate on a daily basis the Predeceasing Recipient's share of the next regular unitrust payment between the estate of the Predeceasing Recipient and the Surviving Recipient.**

14.20-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipients or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the unitrust amount during the unitrust period.**

Comment: The authors have modified the Internal Revenue Service sample clause (see Rev Proc 2005-59, 2005-2 Cum Bull 412) by adding a parenthetical direction that each installment be paid at the end of the period to which it applies. See §14.14. The editor has modified the sample clause by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

For clauses that must be included in or added to this clause, see forms 14.24-1, 14.26-1, 14.28-1, 14.30-1.

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D. Payment of Lesser of Income or Fixed Percentage

§14.21 1. Alternative to Payment of Stated Percentage

There is an alternative to the language in form 14.16-1 requiring the trustee to pay the recipient a unitrust amount equal to the stated percentage of the trust assets valued that year, regardless of the trust's income or liquidity. This alternative requires the trustee to pay no more than trust income in taxable years when trust income is less than the value of the fixed percentage. Furthermore, if this alternative language is used, the income beneficiary may receive payments from trust income in years when the income exceeds the value of the fixed percentage, but only enough to make up for payments of less than the fixed percentage in prior years. Treas Reg §1.664-3(a)(1)(i)(b). This type of trust is known as an income-only unitrust. It also may be referred to as a NICRUT (if there is no makeup clause) or a NIMCRUT (if there is a makeup clause). The amount of the charitable deduction is determined without regard to the fact that the unitrust amount paid will be less than the fixed percentage in some years. The sample clause for this alternative (see form 14.22-1) may be found in Rev Proc 2005-56, §6.06, 2005-34 Cum Bull 383.

Treasury Regulation §1.664-3(a)(1)(i)(c) authorizes the use of "flip" unitrusts that initially pay the lesser of income or the unitrust amount and then convert ("flip") into regular unitrusts. This can be highly desirable in the case of a trust that initially holds assets that are not liquid but later sells those assets and invests in securities. By getting rid of the net income limitation after the change in investments, the trustees are free to implement "prudent investor rule/modern portfolio theory" concepts by investing the trust estate in a manner that produces the best total return (including both dividends and capital gains) without being forced to select investments with high dividends but low total return to avoid the net income restriction. See Teitell, *Charitable Remainder Trusts—Final Regulations*, 138 Tr & Est 44 (July 1999), 138 Tr & Est 36 (Aug. 1999).

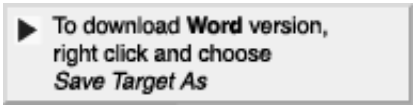
When not preceded by "taxable," "distributable net," "undistributed net," or "gross," the term "income" as defined by IRC §643(b) means the amount of income of the trust for the taxable year, determined by the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends that the fiduciary, acting in good faith, determines to be allocable to principal under the terms of the governing instrument and applicable local law are not considered to be income. Trust income also includes trust accounting principal allocated to income under the trustee adjustment power in Prob C §16336. Treas Reg §1.643(b)-1. However, the income of a charitable remainder unitrust may not be determined by a unitrust amount between 3 and 5 percent, as generally permitted by Treas Reg §1.643(b)-1 and Prob C §16328. Treas Reg §1.664-3(a)(1)(b)(3). This provision recognizes that it would make little sense for the trust to give the recipient the lesser of one unitrust amount and another unitrust amount. For further discussion, see California Estate Planning §24.16 (Cal CEB 2002).

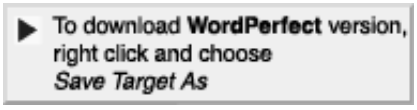
The sample clause for this alternative (see form 14.22A-1) may be found in Rev Proc 2005-56, §6.07, 2005-34 Cum Bull 383.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.22 2. Form: Payment of Lesser of Income or Fixed Percentage (NIMCRUT or NICRUT)

§14.22 2. Form: Payment of Lesser of Income or Fixed Percentage (NIMCRUT or NICRUT)





14.22-1 Payment of lesser of income or fixed percentage

***Payment of Unitrust Amount*. In each taxable year of the trust during the unitrust period, the trustee shall pay to _ _[*name of a living individual*]_ _ (the Recipient) a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _") or (b) the trust income for the taxable year as defined in Internal Revenue Code §643(b) and the applicable regulations. _ _[*The unitrust amount for a taxable year shall also include any amount of the trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph for the year, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph.*]_ _ The valuation date is the first day of each taxable year of the trust. The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Recipient's death. The unitrust amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal. If, for any year, the net fair market value of trust assets is incorrectly determined, then within a reasonable period after the correct value is finally determined, the trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.**

14.22-2 Proration of unitrust amount

***Proration of Unitrust Amount*. For a short taxable year and for the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _ to determine the unitrust amount payable for that year.**

14.22-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the unitrust amount during the unitrust period.**

Comment: The optional language in the first paragraph should be included if the drafter wishes to use a "net income with make-up" unitrust (NIMCRUT) rather than a standard net income unitrust (NICRUT). For a "flip" unitrust that converts from a NIMCRUT or NICRUT to a fixed percentage unitrust, see §14.22A. The authors have modified the Internal Revenue Service sample clause by adding a parenthetical direction that each installment be paid at the end of the period to which it applies. See §14.14. The editor has modified the sample clause by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10. For clauses that must be included in or added to this clause, see forms 14.24-1, 14.26-1, 14.28-1, 14.30-1.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.22A 3. Form: Payment of Lesser of Income or Fixed Percentage ('Flip' Unitrust)

§14.22A 3. Form: Payment of Lesser of Income or Fixed Percentage ("Flip" Unitrust)

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14.22A-1 Payment of lesser of income or fixed percentage

***Payment of Unitrust Amount*.**

(i) *Unitrust amount determined by net income method*. In each taxable year of the trust during the unitrust period, the trustee shall pay to _ _[*name of a living individual*]_ _ (the Recipient) a unitrust amount equal to the lesser of (a) a fixed percentage amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets of the trust, valued as of the valuation date (hereinafter "the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _") or (b) the trust income for the taxable year as defined in Internal Revenue Code §643(b) and the applicable regulations. _ _[*The unitrust amount for a taxable year shall also include any amount of the trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph for the year, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of this paragraph.*]_ _ **The unitrust amount shall be paid in** _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ **installment(s) (each payable at the end of the period to which it applies) from income. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal.**

(ii) *Conversion to fixed percentage method of determining unitrust amount*. Notwithstanding (i) of this paragraph, on the occurrence of _ _[*permissible triggering event as described in Treas Reg §1.664-3(a)(1)(i)(c) and (d)*]_ _ **(hereinafter "the triggering event") and affective as of the first day of the taxable year that immediately follows the triggering event (hereinafter "the effective date of the triggering event"), the trustee shall pay to the recipient in each remaining taxable year of the trust during the unitrust period a unitrust amount equal to** _ _[*same percentage used in (a) of subparagraph (i)*]_ _ **percent of the net fair market value of the trust assets as of the valuation date. Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in subparagraph (i). The unitrust amount shall be paid in** _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ **installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the unitrust amount shall be added to principal.**

(iii) *In general*. The first day of the unitrust period shall be the date of my death and the last day of the unitrust period shall be the date of the Recipient's death. The valuation date is the first day of each taxable year of the trust. If, for any year, the net fair market value of trust assets is incorrectly determined, then, within a reasonable period after the correct value is finally determined, the trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount(s) properly payable and the unitrust amount(s) actually paid.

14.22A-2 Proration of unitrust amount

***Proration of Unitrust Amount*.**

(i) *Proration in years preceding the effective date of the triggering event*. For a short taxable year before the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the fixed percentage amount described in (a) of subparagraph (i) of paragraph _ _[*number*]_ _. In such a year, this prorated fixed percentage amount shall be used in place of the fixed percentage amount described in (a) of subparagraph (i) of paragraph _ _[*number*]_ _ to determine the unitrust amount payable for that year.

(ii) *Proration on and after effective date of triggering event*. For a short taxable year beginning on or after the effective date of the triggering event, which may include the taxable year during which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in (a) of subparagraph (i) of paragraph

_ _[*number*]_ _.

14.22A-3 Payment of taxes on unitrust interest

***Payment of Taxes on Unitrust Interest*. As a condition to payment of the unitrust amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the unitrust amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the unitrust amount during the unitrust period.**

Comment: The optional language in the first paragraph should be included if the drafter wishes to use a "net income with make-up" unitrust (NIMCRUT) for the period before the triggering event rather than a standard net income unitrust (NICRUT). The authors have modified the Internal Revenue Service sample clause by adding a parenthetical direction that each installment be paid at the end of the period to which it applies. See §14.14. The editor has modified the sample clause by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10. For clauses that must be included in or added to this clause, see forms 14.24-1, 14.26-1, 14.28-1, 14.30-1.

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E. Adjustment for Incorrect Valuation

§14.23 1. Mandatory Adjustment Clause

The terms of the trust must require an adjustment in the unitrust amount paid on an incorrect valuation of the trust assets. When there is an undervaluation, the trustee must pay the recipient the amount of the underpayment; when there is an overvaluation, the recipient must reimburse the trust. Form 14.24-1 is based on Rev Proc 2005-56, 2005-2 Cum Bull 383. Payments or repayments must be made within a reasonable period after final determination of the correct trust value. Treas Reg §1.664-3(a)(1)(iii).

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.24 2. Form: Adjustment for Incorrect Valuation (Mandatory)

§14.24 2. Form: Adjustment for Incorrect Valuation (Mandatory)

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14.24-1 Adjustment for incorrect valuation (mandatory)

If, for any year, the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to the Recipient (in the case of an undervaluation) or receive from the Recipient (in the case of an overvaluation) an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid.

Comment: This clause designed for a sole recipient or a variation of this clause must be included in the clause providing for payment of the unitrust amount. See forms in §§14.16, 14.16A, 14.18, 14.20, 14.22, 14.22A.

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F. Deferral of Payment of Unitrust Amount During Probate Administration

§14.25 1. Mandatory Deferral Clause

Under Treas Reg §1.664-1(a)(5), a testamentary charitable remainder unitrust is considered to have been created on the date of the testator's death, even though the trust is not funded and even though payments may not be made by the trust until after a reasonable period of probate administration. Because the charitable deduction is computed as of the date of death and entitlement to the income earned before funding is subject to state law, the Internal Revenue Service has held that the trust must provide that the obligation to pay the unitrust (or annuity trust) amount begins on the date of death. Rev Rul 80-123, 1980-1 Cum Bull 205; Rev Rul 92-57, 1992-2 Cum Bull 123. The sample clause offered as optional in Rev Rul 72-395 §7.02, 1972-2 Cum Bull 340, was later determined by the IRS to be mandatory. See Rev Rul 80-123, 1980-1 Cum Bull 205, as modified by Rev Rul 92-57. Treasury Regulation §1.664-1(a)(5) allows use of either of two methods for retroactively determining the amount of the deferred payment: (1) the exact method or (2) a method that does not provide for adjustment if a revaluation date or dates occur during the period of deferral. Form 14.26-1 is based on sample clauses included in Rev Proc 2005-56, 2005-2 Cum Bull 383.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.26 2. Form: Deferral of Payment of Unitrust Amount During Probate Administration (Mandatory)

§14.26 2. Form: Deferral of Payment of Unitrust Amount During Probate Administration (Mandatory)

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14.26-1 Deferral of payment during probate administration (mandatory)

***Deferral Provision*. The obligation to pay the unitrust amount shall commence with the date of my death, but payment of the unitrust amount may be deferred from this date until the end of the taxable year in which the trust is completely funded. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the trustee shall pay to the Recipient(s) (in the case of an underpayment) or receive from the Recipient(s) (in the case of an overpayment) the difference between any unitrust amounts actually paid, plus interest, and the unitrust amounts payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under Internal Revenue Code §664 prescribe for this computation.**

Comment: This clause must be added to the clause providing for distribution of the unitrust amount. See §§14.16, 14.16A, 14.18, 14.20, 14.22, 14.22A.

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G. Proration of Unitrust Amount

§14.27 1. Mandatory Proration in Short and Final Taxable Years

The trust must require that the unitrust amount be prorated both in short taxable years and in the year that the noncharitable interests terminate. Treas Reg §1.664-3(a)(1)(v). The wording of the form in §14.28 is based on the sample clause offered by the Internal Revenue Service as satisfying this requirement. See Rev Rul 72-395 §6.05, 1972-2 Cum Bull 340; Rev Proc 2005-56, 2005-2 Cum Bull 383.

The optional portion of the clause is based on the wording of Treas Reg §1.664-3(a)(1)(v), which describes the fractions that must be used to adjust the unitrust amount in short and final taxable years of the trust. The optional wording may be added to the mandatory wording to define "on a daily basis." The optional wording requires that the unitrust amount be determined as it would be for a normal taxable year as specified in the particular clause of the trust (see forms 14.16-1, 14.16A-1, 14.18-1, or 14.20-1). That amount must be multiplied in short taxable years by the number of days in the short taxable year over 365 (or 366).

In the final taxable year, the unitrust amount must be multiplied by a fraction, the numerator of which is the number of days in the period beginning on the first day of the taxable year and ending on the last day of the period specified in Treas Reg §1.664-3(a)(5) (*i.e.,* the period of payment of the unitrust amount to the recipient) and the denominator of which is 365 (or 366).

Under Treas Reg §1.664-3(a)(5), the period for payment of the unitrust amount terminates with the death of the recipient, the end of the term of years, or "the regular payment next preceding the termination of the period described in this subparagraph." If the trustee's obligation to pay the unitrust amount is made to terminate with the payment next preceding the termination of the trust (see §14.31), it may be necessary to change the wording of the optional portion of form 14.28-1. No additional charitable deduction is allowable for the increased value of the amount passing to charity when a trust provides for the earlier termination unitrust payment.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.28 2. Form: Proration of Unitrust Amount (Mandatory)

§14.28 2. Form: Proration of Unitrust Amount (Mandatory)

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14.28-1 Proration of unitrust amount (mandatory)

***Proration of Unitrust Amount*. For a short taxable year and for the year in which the unitrust period ends, the trustee shall prorate on a daily basis the unitrust amount described in paragraph _ _[*number*]_ _.**

[*If applicable, add one or both of the following options*]

[*Option 1: Fraction to be used for adjustment*]

For a taxable year of less than 12 months, other than the taxable year in which the unitrust period ends, the unitrust amount required to be paid shall be the fixed percentage of the net fair market value of the trust assets for that year multiplied by a fraction, the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator). In the taxable year in which the interest of the recipient terminates, the unitrust amount required to be paid shall be the fixed percentage of the net fair market value of the trust assets for that year multiplied by a fraction, the numerator of which is the number of days between the beginning of the taxable year and the termination of the recipient's interest, and the denominator of which is 365 (366 if February 29 is a day included in the numerator).

[*Option 2: Valuation date of trust is not first day of taxable year*]

When no valuation date occurs in a taxable year of the trust that is a short taxable year or the taxable year in which the unitrust period ends, the trust assets shall be valued on the last day of the short taxable year or the date on which the unitrust period ends.

Comment: This clause must be added to the clause providing for distribution of the unitrust amount. See forms in §§14.16, 14.18, 14.20, 14.22, 14.22A. The clause assumes that the taxable year ends on the date the unitrust period ends. See, *e.g.,* Rev Proc 2005-56, 2005-2 Cum Bull 383. Compare Treas Reg §1.664-3(a)(1)(v)(b) (final taxable year of the unitrust period) with Treas Reg §1.664-3(a)(1)(v)(a) (short taxable years).

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H. Additional Contributions to Unitrust

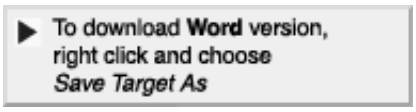
§14.29 1. Mandatory Formula Clause or Prohibition

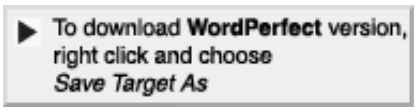
The trust must either prohibit additional contributions after the initial contribution or require that the unitrust amount for the taxable year of the addition be adjusted as provided in Treas Reg §1.664-3(b). The basic sample testamentary forms in Rev Procs 2005-56—2005-59, 2005-2 Cum Bull 383, prohibit additional contributions. The form in §14.29A prohibits additional contributions. The form in §14.30 allows additional contributions and provides for adjustment. The clause is based on the sample alternative clause for inter vivos trusts offered by the Internal Revenue Service as meeting the requirement in Rev Procs 2005-52—2005-55, 2005-2 Cum Bull 326. Use of form 14.30-1 allows future additions to the trust, thus preserving one of the advantages of a unitrust over an annuity trust. See §14.8.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.29A 2. Form: Additional Contributions Prohibited

§14.29A 2. Form: Additional Contributions Prohibited





14.29A-1 Additional contributions prohibited

***Additional Contributions Prohibited*. No additional contributions shall be made to the trust after the initial contribution. The initial contribution, however, shall be deemed to consist of all property passing to the trust by reason of my death.**

Comment: This clause specifies that any property passing to the trust because of the testator's death is considered to be one contribution and part of the initial contribution, somewhat mitigating the effect of the prohibition on additional contributions.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.30 3. Form: Adjustment Clause if Additional Contributions to Unitrust Permitted (Mandatory)

§14.30 3. Form: Adjustment Clause if Additional Contributions to Unitrust Permitted (Mandatory)

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14.30-1 Adjustment clause if additional contributions to unitrust permitted (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: No income limitation on unitrust amount*]

***Additional Contributions*. Notwithstanding paragraph _ _[*number*]_ _, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for any year in which any additional contribution is made shall be _ _[*same percentage as payout rate for initial funding*]_ _ percent of the sum of (a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any postcontribution income from, and appreciation on, such assets during that year) and (b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any postcontribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period. In a taxable year in which an additional contribution is made on or after the valuation date, the assets shall be valued as of the date of the contribution, without regard to any postcontribution income or appreciation, rather than as of the valuation date.**

[*Alternative 2: Net income limitation on unitrust amount (NICRUT)*]

***Additional Contributions*. Notwithstanding paragraph _ _[*number*]_ _, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for any year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage as payout rate for initial funding*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any postcontribution income from, and appreciation on, such assets during that year), and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any postcontribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _") or (b) the trust income for the taxable year as defined in Internal Revenue Code §643(b) and the applicable regulations. In a taxable year in which an additional contribution is made on or after the valuation date, the assets shall be valued as of the date of the contribution, without regard to any postcontribution income or appreciation, rather than as of the valuation date.**

[*Alternative 3: Net income with make-up unitrust (NIMCRUT)*]

***Additional Contributions*. Notwithstanding paragraph _ _[*number*]_ _, if any additional contributions are made to the trust after the initial contribution, the unitrust amount for any year in which any additional contribution is made shall be equal to the lesser of (a) a fixed percentage amount equal to _ _[*same percentage as payout rate for initial funding*]_ _ percent of the sum of (1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any postcontribution income from, and appreciation on, such assets during that year), and (2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any postcontribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins**

with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period (hereinafter "the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _") or (b) the trust income for the taxable year as defined in Internal Revenue Code §643(b) and the applicable regulations. The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph _ _[*number*]_ _ and (a) of this paragraph. In a taxable year in which an additional contribution is made on or after the valuation date, the assets shall be valued as of the date of the contribution, without regard to any postcontribution income or appreciation, rather than as of the valuation date.

[*Alternative 4: Net income "flip" unitrust*]

***Additional Contributions*.**

(i) *Additional contributions made before effective date of triggering event*. Notwithstanding paragraph _ _[*number*]_ _, if any additional contributions are made to the trust after the initial contribution and before the effective date of the triggering event, the unitrust amount for the year in which the additional contribution is made shall be equal to the lesser of:

(a) a fixed percentage amount equal to _ _[*same percentage as payout rate for initial funding*]_ _ percent of the sum of:

(1) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any postcontribution income from, and appreciation on, such assets during that year); and

(2) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any postcontribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period

(hereinafter "the fixed percentage amount described in (a) of paragraph _ _[*number*]_ _") or

(b) the trust income for the taxable year as defined in Internal Revenue Code §643(b) and the applicable regulations.

The unitrust amount for that year shall also include any amount of trust income for the year that is in excess of the fixed percentage amount determined under (a) of this paragraph, but only to the extent that the aggregate of the amounts paid to the Recipient in prior years was less than the aggregate of the amounts determined for all prior years under (a) of paragraph _ _[*number*]_ _ and (a) of this paragraph. In a taxable year in which an additional contribution is made on or after the valuation date, the assets shall be valued as of the date of the contribution, without regard to any postcontribution income or appreciation, rather than as of the valuation date.

(ii) *Additional contributions made on or after effective date of triggering event*. Notwithstanding paragraph _ _[*number*]_ _, if any additional contributions are made to the trust after the initial contribution and on or after the effective date of the triggering event, the unitrust amount for any year in which any additional contribution is made shall be _ _[*same percentage as payout rate for initial funding*]_ _ percent of the sum of:

(a) the net fair market value of the trust assets as of the valuation date (excluding the assets so added and any postcontribution income from, and appreciation on, such assets during that year); and

(b) for each additional contribution during the year, the fair market value of the assets so added as of the valuation date (including any postcontribution income from, and appreciation on, such assets through the valuation date) multiplied by a fraction the numerator of which is the number of days in the period that begins with the date of the contribution and ends with the earlier of the last day of the taxable year or the last day of the unitrust period and the denominator of which is the number of days in the period that begins with the first

day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the unitrust period.

In a taxable year in which an additional contribution is made on or after the valuation date, the assets shall be valued as of the date of the contribution, without regard to any postcontribution income or appreciation, rather than as of the valuation date. Beginning on the effective date of the triggering event, the trustee shall no longer pay the amount equal to the lesser of (a) or (b) in subparagraph (i) of this paragraph and shall not pay any amount of income described in the second sentence of subparagraph (i) of this paragraph.

[*Continue*]

[*If appropriate, add the following option*]

[*Option: Deferral of payment on testamentary additions*]

If any additional contribution is made by will or other testamentary device, the obligation to pay the unitrust amount with respect to that additional contribution shall begin as of the date of the decedent's death, but payment of the unitrust amount may be deferred from this date until the end of the taxable year in which the trust is completely funded. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the trustee shall pay to the Recipient(s) (in the case of an underpayment) or receive from the Recipient(s) (in the case of an overpayment) the difference between any unitrust amounts actually paid, plus interest, and the unitrust amounts payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under Internal Revenue Code §664 prescribe for this computation.

Comment: This clause must be added to the clause providing for distribution of the unitrust amount. See §§14.16, 14.16A, 14.18, 14.20, 14.22, 14.22A.

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§14.31 I. Termination of Trust

Termination of the unitrust amount on the payment date next preceding the death of the individual beneficiary is a permitted optional clause (see Rev Rul 72-395 §7.06, 1972-2 Cum Bull 340) but is not included in this chapter. If a termination clause is used, the wording of the adjustment of the unitrust amount for additional contributions (see §14.30) and the wording of the proration for short and final taxable years (see §14.28) may have to be changed.

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J. Remainder to Qualified Charity

§14.32 1. Required Irrevocable Transfer of Remainder to Charity

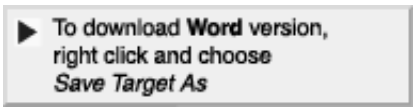
If the entire remainder interest of the unitrust is not irrevocably transferred to one or more qualified charities when the recipient's interest terminates, the charitable deduction will not be allowed. Treas Reg §1.664-3(a)(6)(i). A charity qualifies for a federal estate tax deduction if, at the time the remainder is to be transferred to it, it is an organization described in IRC §2055(a). The wording of form 14.33-1 is based on the sample clause offered by the Internal Revenue Service as meeting the requirements of Treas Reg §1.664-3(a)(6)(i). See Rev Rul 72-395 §§6.02-6.03, 1972-2 Cum Bull 340. See also Rev Proc 2005-56, 2005-2 Cum Bull 383. Because additional contributions to the unitrust are permitted (see form 14.30-1), references to IRC §§170(b)(1)(A) and 170(c) (income tax) and IRC §2522(a) (gift tax) have been added to safeguard the deductibility of future contributions. Such references also serve to ensure that the "charity" will *not* be an employee stock ownership plan described in IRC §2055(a)(5) to which such a gift would not be deductible.

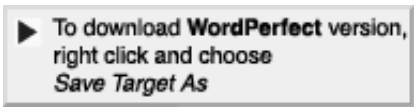
If inter vivos additions are permitted (especially if the trustee or anyone else is given the power to designate other charitable remainder beneficiaries), it is recommended that the remainder beneficiaries be limited to the designation of public charities as defined in IRC §170(b)(1)(A) to avoid application of the contribution limitations under IRC §170(b)(1)(D).

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.33 2. Form: Remainder to Qualified Charity (Mandatory)

§14.33 2. Form: Remainder to Qualified Charity (Mandatory)





14.33-1 Remainder to qualified charity (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: Distribution to one qualified charity*]

***Distribution to Charity*. At the termination of the unitrust period, the trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient under the terms of this trust) to _ _[*name of charity*]_ _ (the Charitable Organization). If the Charitable Organization is not an organization described in Internal Revenue Code §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a) when any principal or income of the trust is to be distributed to it, then the trustee shall distribute the principal or income to one or more organizations described in §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a), as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.**

[*Alternative 2: Distribution to more than one qualified charity*]

***Distribution to Charity*. At the termination of the unitrust period, the trustee shall distribute all of the then principal and income of the trust (other than any amount due the Recipient under the terms of this trust) to:**

[*List percent and exact name of each qualified charity, e.g., 10 percent to Charity A, 20 percent to Charity B, 30 percent to Charity C, and 40 percent to Charity D*]

If any of these organizations is not described in Internal Revenue Code §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a) when any principal or income of the trust is to be distributed to it, the trustee shall distribute the principal or income to the listed organizations that are described in these sections, in the proportion that their respective percentage shares bear to the total of the percentage shares given to the described organizations. If none of the organizations is described in §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a), then the trustee shall distribute the principal or income to one or more organizations described in §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a), as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.

Comment: Although an employee stock ownership plan (ESOP) is an organization described in IRC §2055(a)(5), the additional references to IRC §170(c) in the form (as well as to other IRC sections) ensure that only true charities are permissible recipients.

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K. Prohibited Transactions

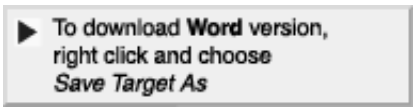
§14.34 1. Mandatory Prohibition Governing Private Foundations

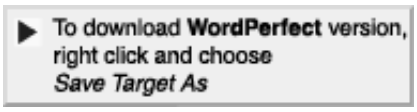
Internal Revenue Code §4947(a)(2) expressly applies the requirements governing private foundations under IRC §§508(e), 4941, and 4943-4945 to all charitable remainder trusts. Under Treas Reg §1.508-3(d), the trust instrument is considered to conform to the requirements for private foundations if state law imposes those requirements by valid statute. Probate Code §§16100-16104 contain all the restrictions required by Treas Reg §1.508-3(d). Although Prob C §§16102-16104 seem to make form 14.35-1 redundant, the clause will draw the trustee's attention to the limitations and act as a safeguard if the trust is administered outside California in a jurisdiction without comparable statutes.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.35 2. Form: Prohibitions Governing Private Foundations (Mandatory)

§14.35 2. Form: Prohibitions Governing Private Foundations (Mandatory)





14.35-1 Prohibited transactions (mandatory)

***Prohibited Transactions*. The trustee shall not engage in any act of self-dealing within the meaning of Internal Revenue Code §4941(d), as modified by Internal Revenue Code §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of Internal Revenue Code §4945(d), as modified by Internal Revenue Code §4947(a)(2)(A).**

Comment: This clause is similar to the sample clause offered by the Internal Revenue Service as meeting the requirements in, *e.g.,* Rev Proc 2005-56, 2005-2 Cum Bull 383.

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L. Investment Restrictions on Trustee

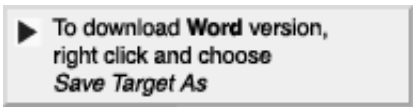
§14.36 1. Trust Cannot Restrict Investment of Trust Assets

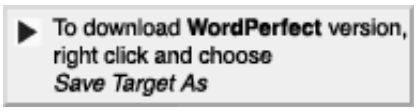
The terms of the trust may not restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Treas Reg §1.664-1(a)(3). Form 14.37-1 is substantially the same as the sample clause offered by the Internal Revenue Service as meeting this requirement. See Rev Rul 72-395 §7.08, 1972-2 Cum Bull 340; Rev Proc 2005-56, 2005-2 Cum Bull 383.

The optional addition to form 14.37-1 may be used if a noncharitable beneficiary will be the trustee and there will not be a corporate cotrustee. Treasury Regulation §1.664-1(a)(7)(i) provides that if "unmarketable assets" are transferred to or held by a trust, the trust will not be a trust with respect to which a deduction is available under IRC §170, §2055, §2106, or §2522, or will be treated as failing to function exclusively as a charitable remainder trust unless, whenever the trust is required to value such assets, the valuation is (1) performed exclusively by an independent trustee, or (2) determined by a "current qualified appraisal" (as defined in Treas Reg §1.170A-13(c)(3)) from a "qualified" appraiser (as defined in Treas Reg §1.170A-13(c)(5)). Generally, the assets of a unitrust must be valued annually to determine distributions. Under Treas Reg §1.664-1(a)(7)(iii), a noncharitable beneficiary or a person who is a related or subordinate party to a noncharitable beneficiary within the meaning of IRC §672(c) is not an independent trustee. Under Treas Reg §1.664-1(a)(7)(ii), "unmarketable assets" are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely held stock, and an unregistered security for which there is no available exemption permitting public sale. The IRS has ruled that a trust containing a provision similar to the optional addition would continue to qualify as a charitable remainder unitrust after the independent trustees were removed. IRS Letter Ruling 200029031.

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§14.37 2. Form: Investment Restrictions on Trustee





14.37-1 Investment restrictions on trustee

***Investment of Trust Assets*. Nothing in this trust instrument shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.**

[*If applicable, add the following option*]

[*Option: Assets without objectively ascertainable market value prohibited*]

The trustee shall not accept, invest in, or hold any assets such as real estate, stock in a closely held corporation, or any other assets that do not have an objectively ascertainable market value and would result in disallowance of the charitable deduction.

Comment: Although not required, form 14.37-1 should be included (as it is in the IRS sample clauses) to ensure that the instrument cannot be construed as restricting realization of income. Such a construction would disqualify the trust. See §14.36.

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M. Trustee's Powers

§14.38 1. Optional Enumeration of Trustee's Powers

The sample language in form 14.39-1 is similar to that proposed in the sample declaration of trust included in Rev Proc 2005-56, 2005-2 Cum Bull 383. The trustee's powers are enumerated in Prob C §§16200-16249.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.39 2. Form: Trustee's Powers (Optional)

§14.39 2. Form: Trustee's Powers (Optional)

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14.39-1 Trustee's powers (optional)

***Governing Law*. Subject to all limitations stated elsewhere in my will, the operation of the trust shall be governed by the laws of the State of California. However, the trustee is prohibited from exercising any power or discretion granted under these laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664(d)(2) _ _[*and (d)(3)*]_ _ and the corresponding regulations.**

Comment: The optional language "and (d)(3)" should be used if the unitrust payments are limited to trust income.

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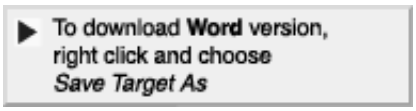
N. Distributions in Kind

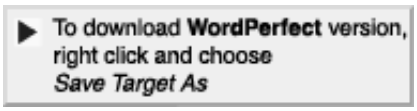
§14.40 1. If Permitted, Basis of Distributions in Kind Must Be "Fairly Representative"

Under Treas Reg §1.664-3(a)(4), either distributions in kind must be expressly prohibited or, if they are permitted, the adjusted basis of the property distributed must be fairly representative of the adjusted basis of the property available for distribution on the date of distribution. Note that gain or loss is realized on distributions of property in kind if the distribution is in satisfaction of a right to receive a specific dollar amount or a right to receive trust income. Treas Reg §1.661(a)-2(f). However, this does not appear to include distributions in kind in satisfaction of the right to receive a unitrust amount from a charitable remainder trust. Form 14.41-1 authorizes distributions in kind and requires that the trustee use the "fairly representative adjusted basis" standard. The clause is based on the sample clause offered by the Internal Revenue Service as meeting the requirements of Treas Reg §1.664-3(a)(4). See Rev Rul 72-395 §7.05, 1972-2 Cum Bull 340.

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§14.41 2. Form: Distributions in Kind





14.41-1 Distributions in kind authorized

***Distributions in Kind*. The trustee may, in the trustee's discretion, (1) make distributions in cash or in kind (including undivided interests in kind), or partly in cash and partly in kind, either prorata or nonprorata, at distribution values determined by the trustee, and (2) make such sales of the trust property as the trustee considers necessary to make distributions. The adjusted basis for federal income tax purposes of any trust property that the trustee distributes in kind must be fairly representative of the adjusted basis for such purposes of all trust property available for distribution on the date of distribution.**

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O. Distributions to Charity Before Trust Termination

§14.42 1. Optional Distribution Before Termination

The trust instrument may authorize or require the trustee to pay any income of a charitable remainder trust in excess of the unitrust amount to a charitable organization. Treas Reg §1.664-3(a)(4). If such distributions are authorized (see form 14.43-1) or required, the trust must either expressly prohibit distributions in kind or specify that the adjusted basis of the property distributed be fairly representative of the adjusted basis of the property available for distribution on the date of distribution. See form 14.41-1 for a clause authorizing distributions in kind and requiring a fairly representative basis standard. See also Rev Rul 72-395 §7.05, 1972-2 Cum Bull 340.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.43 2. Form: Distribution to Charity Before Trust Termination (Optional)

§14.43 2. Form: Distribution to Charity Before Trust Termination (Optional)

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14.43-1 Distribution to charity (optional)

***Distribution of Excess Income*. During the recipient's life, the trustee may pay to _ _[*name of charity*]_ _, if it is a charity described in Internal Revenue Code §§_ _[*170(b)(1)(A),*]_ _ 170(c) _ _[*and/,*]_ _ _ _[*2522(a), and*]_ _ 2055(a) when any income of the trust is to be distributed to it, any income of the trust in excess of the unitrust amount payable to the recipient for the taxable year of the trust in which the income is earned.**

Comment: Although an employee stock ownership plan (ESOP) is an organization described in IRC §2055(a)(5), the additional references to IRC §170(c) in the form (as well as to other IRC sections) ensure that only true charities are permissible recipients.

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P. Trustee's Power to Amend Trust

§14.44 1. Limited Power to Amend Trust

Internal Revenue Code §2055(e)(3) permits "qualified reformation" of the governing instrument of a charitable remainder trust that does not meet the requirements of the Tax Reform Act of 1969. The interest to be reformed must meet the definition of a "reformable interest" in IRC §2055(e)(3)(C). In IRS Letter Ruling 200010019, the IRS ruled that a noncharitable beneficiary's disclaimer of the right to receive discretionary distributions of principal qualified the trust for reformation into a charitable remainder unitrust. Further, the reformation must result in the creation of a "qualified interest" under IRC §2055(e)(3)(D). The changes from a reformable interest to a qualified interest, referred to as a "qualified reformation," can occur only if:

- The difference between the actuarial value at the decedent's death of the qualified interest given to charity in the reformed trust and the actuarial value of the interest given to charity before reformation does not exceed 5 percent;
- Both the reformed and unreformed noncharitable interest of a charitable remainder trust must end at the same time; and
- The reformation must be effective retroactively as of the decedent's death.

For these purposes, it appears that a qualified interest under IRC §2055(e)(3)(D) may consist of two separate interests—a lead interest and a remainder interest—when a trust that provides for less than the required 5-percent annuity or unitrust amount is reformed to increase the annuity or unitrust amount to 5 percent and the reformed trust provides that the increase portion will be paid to charity, with the consequence that the actuarial value of the qualified interest is unchanged. See IRS Letter Ruling 200622005 (CRUT reformed to increase unitrust amount from 4 percent to 5 percent, with 1 percent to be paid to charity). See also IRS Letter Ruling 200726005 (CRAT reformed to increase annuity amount to 5 percent of initial net fair market value of trust assets). While the latter ruling does not specifically state that the entire increase amount is to be paid to charity, it is difficult to see how the reformed trust could otherwise satisfy the requirement that the actuarial value of the qualified interest is not changed by more than 5 percent.

If the actuarial value of the charitable remainder interest in a charitable remainder trust is less than the 10 percent required by IRC §664(d)(1)(D) (annuity trust) and IRC §664(d)(2)(D) (unitrust), the trust may either be reformed or declared void ab initio. IRC §2055(e)(3)(J). Presumably, a voided bequest passes as part of the residue of the testator's will or, if the voided bequest was a residual bequest, passes under the laws of intestate succession. No deduction is allowable for a voided interest.

The reformation may reduce either the payout rate to the noncharitable beneficiaries or the duration of the noncharitable beneficiaries' interest (or both) to gain compliance with the 10-percent remainder requirement. IRC §2055(e)(3)(J)(ii). Unlike the general provisions of IRC §2055(e)(3), which limit the change in the charitable interest upon a reformation to 5 percent, a reformation made to satisfy the 10-percent remainder requirement may increase the charitable interest by more than 5 percent. Thus, for example, a charitable remainder interest could be increased from a negligible value to 10 percent under IRC §2055(e)(3)(J).

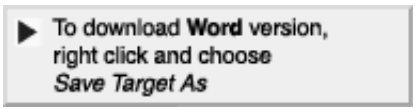
Proceedings to amend or conform a trust instrument to qualify for the estate tax charitable deduction are authorized by Prob C §17200(b)(15).

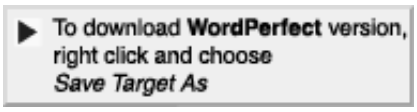
Form 14.45-1 is taken from Rev Procs 2005-56—2005-59, 2005-2 Cum Bull 383, which include a clause granting the trustee a "limited power of amendment."

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.45 2. Form: Limited Power of Amendment

§14.45 2. Form: Limited Power of Amendment





14.45-1 Limited power of amendment

***Limited Power of Amendment*. This trust is irrevocable. However, the trustee shall have the power, acting alone, to amend the trust in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder unitrust within the meaning of Internal Revenue Code §664(d)(2) _ _[*and (d)(3)*]_ _.**

Comment: The optional language "and (d)(3)" should be used if the unitrust payments are limited to trust income.

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Q. "Spendthrift" Clauses

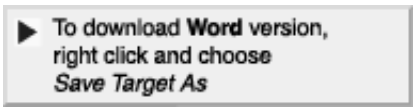
§14.46 1. Optional "Spendthrift" Clause

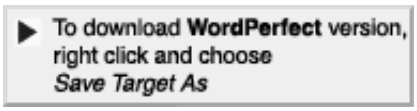
Adding a "spendthrift" clause to a charitable remainder trust is not required. If the noncharitable beneficiary is a spendthrift or needs protection from creditors, the clause may be appropriate. Otherwise, it may deprive the beneficiary of useful flexibility if circumstances change and the beneficiary prefers not to receive income from the trust. Whether such a limitation should be added depends on the circumstances of each case. A form of spendthrift clause is provided in §14.47. On spendthrift clauses, see chap 27.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.47 2. Form: 'Spendthrift' Clause (Optional)

§14.47 2. Form: "Spendthrift" Clause (Optional)





14.47-1 "Spendthrift" clause (optional)

***Spendthrift Clause*. No interest in the charitable remainder unitrust created under my will may be anticipated, assigned, or encumbered by a beneficiary or be subject to any creditor's claim or legal process.**

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§14.48 R. No-Contest Clause

A no-contest clause, traditionally called an "in terrorem clause," is often added to a will as a matter of routine. Under such a clause, any beneficiary who contests the will or any part of it forfeits all benefits that he or she would have received under the will. See §§35.9-35.10. The Internal Revenue Service has ruled that such a clause in a will creating a charitable remainder trust "could obviate the length of the term in which the unitrust payments would be provided to one or more of the beneficiaries." IRS Letter Ruling 7942073. Because that would violate the requirements of Treas Reg §1.664-3(a)(5) that payment be for either the life of the recipient or a term not to exceed 20 years, such a clause is prohibited. The authors are of the opinion, however, that IRC §664(f) allows such a clause. Under IRC §664(f), payment of the unitrust amount may terminate upon the earlier of the occurrence of a qualified contingency (as defined in IRC §664(f)(3)) or on the death of the recipient. See form in §14.16. The amount of the charitable deduction, however, will be determined without regard to the qualified contingency. IRC §664(f)(2). Even application of the clause to charities may be permissible, provided that it is clear that the remainder interest will pass to some qualified charity in any event. See discussion in §§35.9-35.10.

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IV. CHARITABLE REMAINDER ANNUITY TRUSTS

§14.49 A. Summary of Requirements

To qualify a charitable remainder annuity trust for an estate tax deduction under IRC §2055, the trust must meet all requirements of Treas Reg §§1.664-2 and 20.2055-2(e)(2)(v). A sum that can be ascertained on the applicable valuation date must be paid periodically, but not less than annually, to an individual beneficiary. Treas Reg §1.664-2(a)(1)(i). That amount, called the annuity amount, may be a stated dollar amount or a fraction or percentage of the initial net fair market value of the assets placed in trust as finally determined for federal tax purposes (see §14.53). Treas Reg §1.664-2(a)(1)(ii)-(iii).

The annuity amount may be paid to a class of individual beneficiaries (see §14.55) or to joint and survivor individual beneficiaries (see §14.57). Treas Reg §1.664-2(a)(1)(ii), (3)(i). Whether stated as a fixed dollar amount or a fixed percentage, and whether paid to one income beneficiary, a class, or joint and survivor beneficiaries, the annuity amount must be at least 5 percent but not more than 50 percent of the initial net fair market value, as finally determined for federal tax purposes, of the assets placed in trust. IRC §664(d)(1)(A); Treas Reg §1.664-2(a)(2)(i). See also Rev Rul 72-395 §5.01, 1972-2 Cum Bull 340. The annuity amount may be paid for the life of the individual beneficiary, the lives of the beneficiaries, or for a term not to exceed 20 years. Treas Reg §1.664-2(a)(5). The actuarial value of the charitable remainder interest (determined under IRC §7520) must exceed 10 percent of the initial value of the property placed in the trust. IRC §664(d)(1)(D), (2)(D).

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B. Distribution to Trustee

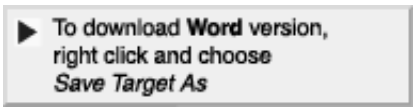
§14.50 1. Identity of Trustee

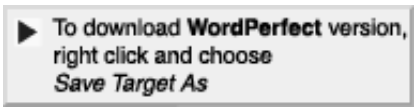
If the trustee is permitted to sprinkle the annuity amount among the individual beneficiaries (see §14.55), no individual beneficiary should be named as trustee or successor trustee. See §14.54.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.51 2. Form: Distribution to Trustee

§14.51 2. Form: Distribution to Trustee





14.51-1 Distribution to trustee

***Gift of Residue*. I give the residue of my estate, after payment of taxes, costs, and expenses of administration as provided in paragraph _ _[*number*]_ _, to _ _[*name of trustee*]_ _ (trustee) in trust. It is my intention to establish a charitable remainder annuity trust within the meaning of Revenue Procedure 2003-57 and Internal Revenue Code §664(d)(1). This trust shall be known as the _ _[*name*]_ _ and shall be administered as follows:**

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C. Selection of Annuity Amount

§14.52 1. Fixed Dollar Amount or Fixed Percentage

The annuity amount must be a fixed sum, stated as either a fixed dollar amount or a fixed percentage of the initial net fair market value of the trust assets. Treas Reg §1.664-2(a)(1). Stating the annuity amount in a testamentary charitable remainder trust as a fixed dollar amount presents several problems if the value of the corpus is uncertain (*e.g.,* as in a residuary trust). In a testamentary charitable remainder trust, unlike an inter vivos trust, a long time may pass between the drafting of the will and the testator's death. During that time, the value of the client's assets may increase or decrease significantly.

The annuity amount must meet several rigid tests. It must be at least 5 percent but not more than 50 percent of the initial net fair market value of the assets funding the trust (IRC §664(d)(1)(A); Treas Reg §1.664-2(a)(2)(i)), but it may not be so great that there is more than a 5-percent probability that the trust will be consumed by the individual recipient (see §14.9). Additionally, the actuarial value of the charitable remainder interest (determined under IRC §7520) must exceed 10 percent of the initial value of the property placed in the trust. IRC §664(d)(1)(D), (2)(D). For these and other reasons (see §14.8), the unitrust form of testamentary charitable remainder trust is usually preferable to an annuity form. When the annuity form is used, it is preferable to state the annuity amount as a percentage of the initial corpus rather than as a fixed dollar amount. If a fixed dollar amount is stated and the corpus is not a specific pecuniary amount, the will should provide that the annuity amount will be the greater of that fixed amount or 5 percent of the initial fair market value of the trust, but not exceeding 50 percent of the initial fair market value of the trust.

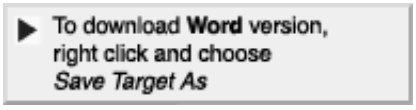
In IRS Letter Ruling 200726007, the IRS approved a reformation of a testamentary charitable remainder annuity trust that was defective because the annuity amount was less than 5 percent. As reformed, the annuity amount will be 5 percent of the initial fair market value of the property of the trust, with each annuity payment split between the individual beneficiary and the charitable remainder beneficiaries. The rather elegant solution of increasing the annuity amount and causing the increase to be paid to the charitable beneficiaries during the lead term was previously approved in the case of charitable remainder unitrusts in IRS Letter Ruling 200622005. See §14.44.

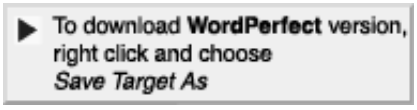
The alternative forms in §14.53 are based on sample clauses offered by the Internal Revenue Service as satisfying the requirements of Reg §1.664-2(a)(1)(iii). See Rev Proc 2003-57, 2003-2 Cum Bull 257. Alternative 2 corresponds to the sample clause in Rev Rul 2003-57, §4, which states the annuity amount as a percentage of the initial net fair market value of the trust as valued for federal estate tax purposes. Alternative 1 corresponds to the alternative provision in Rev Proc 2003-57, §6.01, which states the annuity amount as a fixed dollar amount. Either alternative satisfies the mandatory requirement that the annuity amount be stated as an exact amount. See Treas Reg §20.2055-2(e)(2)(v). The editor has modified the sample clauses by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.53 2. Form: Payment of Annuity Amount to One Named Recipient (Mandatory)

§14.53 2. Form: Payment of Annuity Amount to One Named Recipient (Mandatory)





14.53-1 Payment of annuity amount to one named recipient (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: Payment of sum certain as fixed dollar amount*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to _ _[*name of a living individual*]_ _ (the recipient), an annuity amount equal to the greater of _ _[*dollar amount*]_ _ and 5 percent of the initial net fair market value of the property passing to the trust as finally determined for federal estate tax purposes but not to exceed 50 percent of the initial net fair market value, provided, however, that the annuity amount (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the annuity amount that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installments(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. As a condition to payment of the annuity amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the annuity amount during the annuity period.**

[*Alternative 2: Payment of percentage of net fair market value*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to _ _[*name of a living individual*]_ _ (the recipient) an annuity amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of the property passing to the trust as finally determined for federal tax purposes, provided, however, that the payout percentage (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the percentage that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the trustee shall pay to the recipient (in the case of an undervaluation) or receive from the recipient (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid. As a condition to payment of the annuity amount, the Recipient or the trustee must pay from a source other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipient's right to receive the annuity amount during the annuity period.**

Comment: A fixed dollar annuity amount (see Alternative 1) should be stated only for an annuity trust funded with a fixed pecuniary amount. It should not be used in a residuary charitable annuity trust, because the annuity amount could constitute less than 5 percent of the initial net fair market value of the assets passing in trust as finally determined for federal tax purposes.

Each alternative includes provisos at the end of the first sentence that the annuity may not exceed an amount that

would result either in a charitable remainder interest of less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the recipient's death. The first proviso is required by law to be satisfied. IRC §664(d)(1)(D), (2)(D). The second proviso is intended to avoid the possible loss of the charitable deduction under Rev Rul 77-374, 1977-2 Cum Bull 329. See Rev Proc 2003-57, §5.02(2), 2003-2 Cum Bull 257, 259. The authors strongly recommend inclusion of these provisos. The two primary factors determining the probability of a charity's receiving nothing from the estate and the valuation of its interest—*i.e.,* life expectancy and interest rates—vary and cannot be calculated when the will is drafted. There is, however, the possibility of a conflict between the first proviso and the 5-percent minimum payout requirement. See §14.19A. For a clause providing for sprinkling the annuity amount, see form 14.55-1. For a clause creating a joint and successor annuity interest, see form 14.57-1. For clauses that must be added to this clause, see forms 14.58-1, 14.60-1, 14.62-1.

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D. Rule for Sprinkling Annuity Amount Among Class

§14.54 1. Independent Trustee May Be Authorized to Make Payments

Generally, the trust will not qualify for a charitable deduction if anyone has the power to alter the amount payable to an individual recipient. Treas Reg §1.664-2(a)(3)(ii). It is possible, however, to give the trustee the power to sprinkle the annuity amount among several named beneficiaries or a class of individual beneficiaries if the trustee is an independent trustee and the requirements of IRC §674(c) are satisfied. The full annuity amount must be paid to some individual beneficiary in each taxable year of the trust. Treas Reg §1.664-2(a)(1).

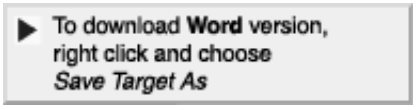
The annuity amount may be paid for the lives of the individual recipients of the class or for a term not to exceed 20 years. The annuity amount is a life interest, and each individual beneficiary must be living and ascertainable at the time of the creation of the trust, *i.e.,* the date of the testator's death. If the annuity amount is payable only for a term of years, the term may not exceed 20 years, but the members of the class need not all be living and ascertainable on the date of the testator's death. Treas Reg §1.664-2(a)(3)(i).

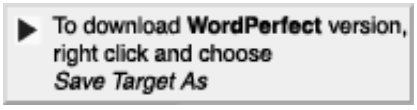
The alternative forms in §14.55 are based on sample clauses offered by the Internal Revenue Service as meeting these requirements. See Rev Proc 2003-57, 2003-2 Cum Bull 257. The clauses assume that the trust will elsewhere provide for termination of the annuity payments with the death of the last surviving annuitant. If that is not the case, the clauses should be modified to specify the recipient of any (prorated) payment due at that time (*e.g.,* the estate of the last member of the class to die). The editor has modified the sample clauses by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.55 2. Form: Payment of Annuity Amount Sprinkled Among Class of Recipients (Mandatory)

§14.55 2. Form: Payment of Annuity Amount Sprinkled Among Class of Recipients (Mandatory)





14.55-1 Payment of annuity amount sprinkled among class of recipients (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: Payment of sum certain as fixed dollar amount*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to a member or members of a class of persons consisting of _ _[*names of recipients*]_ _ (the Recipients), in amounts and proportions that the trustee shall, in the trustee's absolute discretion, from time to time determine, an annuity amount equal to the greater of _ _[*dollar amount*]_ _ and 5 percent of the initial net fair market value of the property passing to the trust as finally determined for federal estate tax purposes but not to exceed 50 percent of the initial net fair market value, provided, however, that the annuity amount (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the annuity amount that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the last Recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The trustee may pay the annuity amount to any one member of the class or may apportion it among the members in any manner that the trustee shall from time to time consider advisable. The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the last Recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. As a condition to payment of the annuity amount, the Recipients or the trustee must pay from a source other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the annuity amount during the annuity period.**

[*Alternative 2: Payment of percentage of net fair market value*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to a member or members of a class of persons consisting of _ _[*names of recipients*]_ _ (the Recipients), in amounts and proportions that the trustee shall, in the trustee's absolute discretion, from time to time determine, an annuity amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the net fair market value of the assets passing in trust as finally determined for federal tax purposes, provided, however, that the payout percentage (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the percentage that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the last Recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The trustee may pay the annuity amount to any one member of the class or may apportion it among the members in any manner that the trustee shall from time to time consider advisable. The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the last Recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. As a condition to payment of the annuity amount, the Recipients or the trustee must pay from a source other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the annuity amount during the annuity period.**

Comment: For clauses that must be added to this clause, see forms 14.58-1, 14.60-1, 14.62-1.

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E. Rules for Joint and Survivor Recipients

§14.56 1. Payment to Joint and Survivor Recipients Must Total 5 Percent and May Not Exceed 50 Percent

The annuity amount, either a fixed dollar amount or a fixed percentage of the initial net fair market value of the trust, that is paid to joint and survivor recipients must not be less than 5 percent or more than 50 percent of the initial net fair market value of the trust assets as finally determined for federal tax purposes. IRC §664(d)(1)(A); Treas Reg §1.664-2(a)(2)(i). In the most common situation, the annuity amount is shared equally by two individual recipients, and after the death of the first to die the total annuity amount is paid to the survivor. This situation is covered by the forms in §14.57.

If the survivor will receive an annuity amount that is less than the aggregate paid while both beneficiaries were alive, two requirements must be met:

(1) There must be a fairly representative distribution (see form 14.73-1) to the charity on the date of death of the first beneficiary to die (Treas Reg §1.664-2(a)(2)(ii)(a)); and

(2) The annuity amount paid to the survivor must be determined by a prescribed mathematical formula (Treas Reg §1.664-2(a)(2)(ii)(b)).

In Rev Rul 72-395 §5.04, 1972-2 Cum Bull 340, the Internal Revenue Service offers a sample clause containing a formula for the minimum annuity amount that may be paid to the survivor after the distribution to the charity.

The alternative forms in §14.57 are based on the sample clauses in Rev Proc 2003-60, 2003-2 Cum Bull 274. See also §14.19. The editor has modified the sample clauses by providing that estate taxes on the trust must be paid from a source other than the trust. See §14.10.

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§14.56A 2. Charitable Remainder Interest Must Be at Least 10 Percent

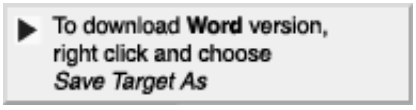
The actuarial value of the charitable remainder interest in a charitable remainder annuity trust at the time of its creation must be at least 10 percent. IRC §664(d)(1)(D). The actuarial value of the charitable remainder interest is determined under IRC §7520 when the trust is created.

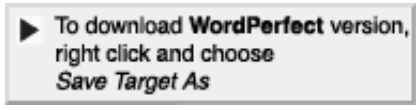
A trust that fails this 10-percent remainder requirement may be reformed to satisfy the requirement or instead be declared null and void. See IRC §2055(e)(3)(J), discussed in §14.44.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.57 3. Form: Payment of Annuity Amount to Joint and Survivor Recipients (Mandatory)

§14.57 3. Form: Payment of Annuity Amount to Joint and Survivor Recipients (Mandatory)





14.57-1 Payment of annuity amount to joint and survivor recipients (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: Payment of sum certain as fixed dollar amount*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to _ _[*name of a living individual*]_ _ and _ _[*name of another living individual*]_ _ (the Recipients) in equal shares during their lifetimes an annuity amount equal to the greater of _ _[*dollar amount*]_ _ and 5 percent of the initial net fair market value of the property passing to the trust as finally determined for federal estate tax purposes but not to exceed 50 percent of the initial net fair market value, and on the death of one (hereinafter the Predeceasing Recipient), the trustee shall pay the entire annuity amount (subject to any proration) to the survivor (hereinafter the Surviving Recipient), provided, however, that the annuity amount (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the annuity amount that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the Survivor Recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the Survivor Recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the initial fair market value of the trust assets is incorrectly determined, then within a reasonable time after the value is finally determined for federal estate tax purposes, the trustee shall pay to the Recipients (in the case of an undervaluation) or receive from the Recipients (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid. As a condition to payment of the annuity amount, the Recipients or the trustee must pay from a source other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the annuity amount during the annuity period.**

[*Alternative 2: Payment of percentage of net fair market value*]

***Payment of Annuity Amount*. In each taxable year of the trust during the annuity period, the trustee shall pay to _ _[*name of a living individual*]_ _ and _ _[*name of another living individual*]_ _ (the Recipients) in equal shares during their lifetimes, an annuity amount equal to _ _[*number no less than 5 and no more than 50*]_ _ percent of the initial net fair market value of all property passing to this trust as finally determined for federal tax purposes, and on the death of one (hereinafter the Predeceasing Recipient), the trustee shall pay the entire annuity amount (subject to any proration) to the survivor (hereinafter the Surviving Recipient), provided, however that the payout percentage (as adjusted to reflect the timing and frequency of the annuity payments) shall not exceed the percentage that would result either in the actuarial value of the charitable remainder interest (under Internal Revenue Code §7520) being less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the Survivor Recipient's death, determined as of the date of my death (or the alternate valuation date, if applicable). The first day of the annuity period shall be the date of my death and the last day of the annuity period shall be the date of the Survivor Recipient's death. The annuity amount shall be paid in _ _[*an annual/equal semiannual/equal quarterly/equal monthly*]_ _ installment(s) (each payable at the end of the period to which it applies) from income and, to the extent that the income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the initial fair market value of the trust assets is incorrectly determined, then within a reasonable time after the value is finally determined for federal estate tax purposes, the trustee shall pay to the Recipients (in the case of an undervaluation) or receive from the Recipients (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid. As a condition to payment of the annuity amount, the Recipients or the trustee must pay from a source**

other than the trust estate with respect to which the annuity amount is to be paid any estate taxes and other death taxes attributable to the Recipients' right to receive the annuity amount during the annuity period.

Comment: On the provisos that the annuity may not exceed an amount that would result either in a charitable interest of less than 10 percent or in a 5-percent probability that the trust corpus will be exhausted before the recipient's death, see Comment in §14.53. For clauses that must be added to this clause, see forms 14.58-1, 14.60-1, 14.62-1.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.58 F. Form: Deferral of Payment of Annuity Amount During Probate Administration (Mandatory)

§14.58 F. Form: Deferral of Payment of Annuity Amount During Probate Administration (Mandatory)

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14.58-1 Deferral of payment during probate administration (mandatory)

***Deferral Provision*. The obligation to pay the annuity amount shall commence with the date of my death, but payment of the annuity amount may be deferred from this date until the end of the taxable year in which the trust is completely funded. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the trustee shall pay to the recipient (in the case of an undervaluation) or receive from the recipient (in the case of an overvaluation) the difference between any annuity amounts actually paid, plus interest, and the annuity amounts payable, plus interest. The interest shall be computed for any period at the rate of interest, compounded annually, that the federal income tax regulations under Internal Revenue Code §664 prescribe for this computation.**

Comment: This form is based on the sample clause in Rev Proc 2003-57, 2003-2 Cum Bull 257. On use of this clause, see §14.25. This clause must be added to the clause providing for distribution of the annuity amount. See §§14.53, 14.55, 14.57.

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G. Proration of Annuity Amount

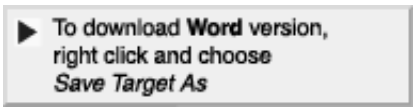
§14.59 1. Mandatory Proration in Short Taxable and Termination Years

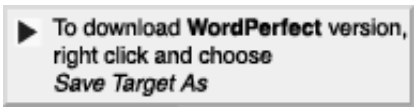
The trust must require that the annuity amount be prorated in short taxable years and in the year in which the trust terminates. Treas Reg §1.664-2(a)(1)(iv). See form in §14.60.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.60 2. Form: Proration of Annuity Amount (Mandatory)

§14.60 2. Form: Proration of Annuity Amount (Mandatory)





14.60-1 Proration of annuity amount (mandatory)

***Proration of Annuity Amount*. The trustee shall prorate the annuity amount on a daily basis for any short taxable year. _ _**[*On the death of the Predeceasing Recipient, the trustee shall prorate on a daily basis the Predeceasing Recipient's share of the next regular annuity payment between the estate of the Predeceasing Recipient and the Surviving Recipient.*]**_ _ In the taxable year of the trust in which the annuity period ends, the trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.**

14.60-2 Taxable year of the trust

***Taxable Year*. The taxable year of the trust shall be the calendar year.**

14.60-3 Termination of annuity amount (optional)

***Termination of Annuity Amount*. The obligation of the trustee to pay the annuity amount shall terminate with the payment next preceding the death of the _ _**[*Recipient/Surviving Recipient*]**_ _.**

Comment: These forms are based on the sample clauses in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274. The clause in form 14.60-1 must be added to the clause providing for distribution of the annuity amount. See §§14.53, 14.55, 14.57. The clause in form 14.60-2 appears to be included in the sample clauses to make clear that the trust is not a qualified revocable trust that can have a taxable year that begins on the date of death under IRC §645. For all other trusts, the taxable year of the trust is the calendar year under IRC §644. The optional termination clause in form 14.60-3 may be used in place of the last sentence of the proration clause in form 14.60-1, as provided in Rev Rul 72-395 §5.06, 1972-2 Cum Bull 340. See §14.63.

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H. Additional Contributions to Annuity

§14.61 1. Trust Must Prohibit Additional Contributions

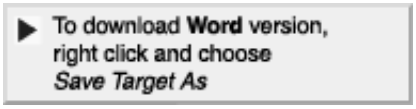
A charitable remainder annuity trust will not qualify for a deduction under IRC §2055 unless its governing instrument expressly prohibits additional contributions after the initial contribution. Treas Reg §1.664-2(b). For testamentary charitable remainder annuity trusts, all property passing to the trust because of the testator's death is considered to be one contribution. Treas Reg §1.664-2(b). Unlike charitable remainder annuity trusts, charitable remainder unitrusts may receive additional contributions without jeopardizing the deduction if the proper formula is specified in the will.

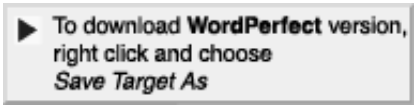
Form 14.62-1 is based on the sample clause offered by the Internal Revenue Service as a satisfactory prohibition. See Rev Proc 2003-57, 2003-2 Cum Bull 257; Rev Proc 2003-60, 2003-2 Cum Bull 274.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.62 2. Form: Additional Contributions to Annuity Prohibited (Mandatory)

§14.62 2. Form: Additional Contributions to Annuity Prohibited (Mandatory)





14.62-1 Additional contributions prohibited (mandatory)

***Additional Contributions Prohibited*. No additional contributions shall be made to the trust after the initial contribution. The initial contribution, however, shall be deemed to consist of all property passing to the trust by reason of my death.**

Comment: This clause specifies that any property passing to the trust because of the testator's death is considered to be one contribution and part of the initial contribution. See §14.61.

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§14.63 I. Termination of Trust

Termination of the annuity amount on the payment date next preceding the death of the individual beneficiary is a permitted optional clause (see Rev Rul 72-395 §5.06, 1972-2 Cum Bull 340) but is not included in this chapter. If a termination clause is added, the wording of the proration for short and final taxable years (see §14.60) may have to be changed.

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J. Remainder to Qualified Charity

§14.64 1. Required Irrevocable Transfer of Remainder to Charity

If the entire remainder interest of the annuity trust is not irrevocably transferred to one or more qualified charities when the recipient's interest terminates, the charitable deduction will not be allowed. Treas Reg §1.664-2(a)(6)(i). A charity qualifies for a federal estate tax charitable deduction if, at the time the remainder is transferred to it, it is an organization described in IRC §2055(a)(1)-(4). Internal Revenue Code §170(c) is normally included because that section is expressly referred to in Treas Reg §1.664-2(a)(6)(i) and the sample clauses in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274. See §14.65.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.65 2. Form: Remainder to Qualified Charity (Mandatory)

§14.65 2. Form: Remainder to Qualified Charity (Mandatory)

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14.65-1 Remainder to qualified charity (mandatory)

[*Add one of the following alternatives*]

[*Alternative 1: Distribution to one charity*]

***Distribution to Charity*. At the death of the _ _**[*survivor*]**_ _ recipient, the trustee shall distribute all of the then principal and income of the trust, including any annuity amount accrued since the regular quarterly payment next preceding the recipient's death (other than any amount due the recipient or the recipient's estate), to _ _**[*name of charity*]**_ _ (the charitable organization). If the charitable organization is not an organization described in Internal Revenue Code §§170(c) and 2055(a) when any principal or income of the trust is to be distributed to it, the trustee shall distribute the principal or income to one or more organizations described in §§170(c) and 2055(a), as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.**

[*Alternative 2: Distribution to more than one charity*]

***Distribution to Charity*. At the death of the _ _**[*survivor*]**_ _ recipient, the trustee shall distribute all of the then principal and income of the trust (other than any amount due the recipient or the recipient's estate), to:**

[*List percent and exact name of each qualified charity, e.g., 10 percent to Charity A, 20 percent to Charity B, 30 percent to Charity C, and 40 percent to Charity D*]

If any of these organizations is not an organization described in Internal Revenue Code §§170(c) and 2055(a) when any principal or income of the trust is to be distributed to it, the trustee shall distribute the principal or income to organizations that are then so described, in the proportion that their respective percentage shares bear to the total of the percentage shares given to the described organizations. If none of the organizations is then so described, the trustee shall distribute the principal or income to one or more organizations described in §§170(c) and 2055(a), as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.

Comment: An organization described in IRC §2055(a)(5) that is not described in IRC §170(c) may not be a charitable remainder beneficiary. Therefore, if the §170(c) requirement is not used, the clause must be limited to an IRC §2055(a)(1)-(4) charity.

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K. Prohibited Transactions

§14.66 1. Mandatory Prohibition Governing Private Foundations

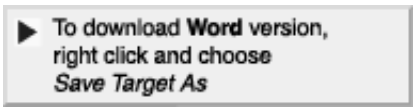
Internal Revenue Code §4947(a)(2) expressly applies the requirements governing private foundations under IRC §§508(e), 4941, and 4943-4945 to all charitable remainder trusts except for payment of the annuity amount to the recipient.

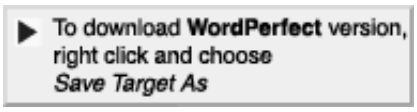
Probate Code §§16102-16104 impose the restrictions enumerated in Treas Reg §1.508-3(d) by statute. Form 14.67-1 will act as a safeguard, however, if the trust is administered outside California in a jurisdiction without comparable statutes. See also §14.34.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.67 2. Form: Prohibitions Governing Private Foundations (Mandatory)

§14.67 2. Form: Prohibitions Governing Private Foundations (Mandatory)





14.67-1 Prohibited transactions (mandatory)

***Prohibited Transactions*. The trustee shall not engage in any act of self-dealing within the meaning of Internal Revenue Code §4941(d), as modified by Internal Revenue Code §4947(a)(2)(A), and shall not make any taxable expenditures within the meaning of Internal Revenue Code §4945(d), as modified by Internal Revenue Code §4947(a)(2)(A).**

Comment: This clause is identical to the sample clause offered by the Internal Revenue Service as meeting the requirements in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274.

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L. Investment Restrictions on Trustee

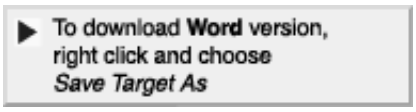
§14.68 1. Trust Cannot Limit Trustee

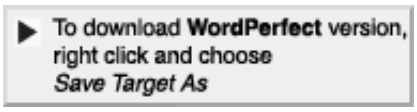
The terms of the trust may not restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Treas Reg §1.664-1(a)(3). Form 14.69-1 is substantially the same as the sample clause offered by the Internal Revenue Service as meeting this requirement. See Rev Proc 2003-57, 2003-2 Cum Bull 257; Rev Proc 2003-60, 2003-2 Cum Bull 274.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.69 2. Form: Investment Restrictions on Trustee (Optional)

§14.69 2. Form: Investment Restrictions on Trustee (Optional)





14.69-1 Investment restrictions on trustee (optional)

***Investment Restrictions*. Nothing in my will shall be construed to restrict the trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.**

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M. Governing Law

§14.70 1. Optional Provision Specifying Governing Law

Form 14.71-1 is similar to the sample clause offered by the Internal Revenue Service in Rev Proc 2003-57, 2003-2 Cum Bull 257 and Rev Proc 2003-60, 2003-2 Cum Bull 274. The clause specifies the governing law of the trust. The trustee's powers under this clause are enumerated in Prob C §§16200-16249.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.71 2. Form: Governing Law (Optional)

§14.71 2. Form: Governing Law (Optional)

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14.71-1 Governing law (optional)

***Governing Law*. Subject to all limitations stated elsewhere in my will, the operation of the trust shall be governed by the laws of the State of California. The trustee, however, is prohibited from exercising any power or discretion granted under these laws that would be inconsistent with the qualification of the trust under Internal Revenue Code §664(d)(1) and the corresponding regulations.**

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N. Distributions in Kind

§14.72 1. If Permitted, Basis of Distributions in Kind Must Be "Fairly Representative"

Under Treas Reg §1.664-2(a)(4), distributions in kind must be either expressly prohibited or permitted by the will. If the will permits such distributions, the adjusted basis of the property distributed must be fairly representative of the adjusted basis of the property available for distribution on the date of distribution. Form 14.73-1 authorizes distributions in kind and requires that the trustee use the "fairly representative adjusted basis" standard. The clause is based on the sample clause offered by the Internal Revenue Service as meeting the requirements of Treas Reg §1.664-2(a)(4). See Rev Rul 72-395 §5.05, 1972-2 Cum Bull 340.

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§14.73 2. Form: Distributions in Kind (Optional)

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14.73-1 Distributions in kind (optional)

***Distributions in Kind*. The trustee may, in the trustee's discretion, (1) make distributions in cash or in kind (including undivided interests in kind), or partly in cash and partly in kind, either prorata or nonprorata, at distribution values determined by the trustee, and (2) make such sales of the trust property as the trustee considers necessary to make distributions. The adjusted basis for federal income tax purposes of any trust property that the trustee distributes in kind must be fairly representative of the adjusted basis for such purposes of all trust property available for distribution on the date of distribution.**

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O. Distribution to Charity Before Trust Termination

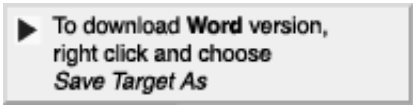
§14.74 1. Optional Distribution Before Termination

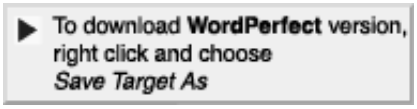
The trust instrument may authorize or require the trustee to pay any income of a charitable remainder trust in excess of the annuity amount to a charitable organization. Treas Reg §1.664-2(a)(4). If such distributions are authorized (see form 14.75-1) or required, the trust must either expressly prohibit distributions in kind or specify that the adjusted basis of the property distributed be fairly representative of the adjusted basis of the property available for distribution on the date of distribution. Form 14.73-1 authorizes distributions in kind and requires a fairly representative basis standard. See Rev Rul 72-395 §5.05, 1972-2 Cum Bull 340.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.75 2. Form: Distribution to Charity Before Trust Termination (Optional)

§14.75 2. Form: Distribution to Charity Before Trust Termination (Optional)





14.75-1 Distribution to charity (optional)

During the recipient's life, the trustee may pay to _ _[*name of charity*]_ _, if it is a charity described in Internal Revenue Code §§170(c) and 2055(a) when any income of the trust is to be distributed to it, any income of the trust in excess of the annuity amount payable to the recipient for the taxable year of the trust in which the income is earned.

Comment: This clause must be added to the clause providing for distribution of the annuity amount. See §§14.53, 14.55, 14.57. Although an employee stock ownership plan (ESOP) is an organization described in IRC §2055(a)(5), the additional reference to IRC §170(c) in the form ensures that only true charities are permissible recipients.

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P. Trustee's Power to Amend Trust

§14.76 1. Optional Power to Amend Trust

Under certain circumstances, a trustee may make a qualified reformation of the governing instrument of a charitable remainder trust. See §14.44. Form 14.77-1 is similar to the sample clause offered by the Internal Revenue Service in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.77 2. Form: Trustee's Power to Amend Trust (Optional)

§14.77 2. Form: Trustee's Power to Amend Trust (Optional)

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14.77-1 Trustee's power to amend trust (optional)

***Limited Power of Amendment*. This trust is irrevocable. However, the trustee shall have the power, acting alone, to amend the trust in any manner required for the sole purpose of ensuring that the trust qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of Internal Revenue Code §664(d)(1).**

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Q. "Spendthrift" Clauses

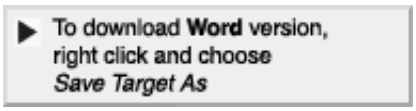
§14.78 1. Optional "Spendthrift" Clause

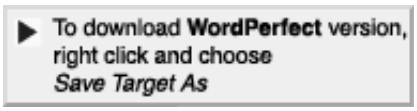
Adding a "spendthrift" clause to a charitable remainder trust is not required. If the noncharitable beneficiary is a spendthrift or needs protection from creditors, the clause may be appropriate. Otherwise, it may deprive the beneficiary of useful flexibility if circumstances change and the beneficiary prefers not to receive income from the trust. Whether such a limitation should be added depends on the circumstances of each case. A form of spendthrift clause is provided in §14.79. On spendthrift clauses, see chap 27.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.79 2. Form: 'Spendthrift' Clause (Optional)

§14.79 2. Form: "Spendthrift" Clause (Optional)





14.79-1 "Spendthrift" clause (optional)

***Spendthrift Clause*. No interest in the charitable remainder annuity trust created under my will may be anticipated, assigned, or encumbered by a beneficiary or be subject to any creditor's claim or legal process.**

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§14.80 R. No-Contest Clause

In the authors' opinion, a no-contest clause is allowed under IRC §664(f). See §14.48 for further discussion.

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V. CHARITABLE LEAD ANNUITY TRUSTS

§14.81 A. Summary of Requirements

When a split-interest charitable trust gives a guaranteed annuity interest or a unitrust interest to a qualified charity and the remainder interest to a noncharity, it is called a charitable income trust or a charitable lead trust (CLT), which, if properly drafted, can qualify for an estate tax charitable deduction. IRC §2055(e)(2)(B). A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living and ascertainable on the date of the testator's death. Treas Reg §20.2055-2(e)(2)(vi)(a).

A guaranteed annuity interest may be expressed as a fixed sum or as a fraction or percentage of the net fair market value, as finally determined for federal estate tax purposes, of the residue of the estate on the appropriate valuation date. Treas Reg §20.2055-2(e)(2)(vi)(a). Because no minimum value is specified, a guaranteed annuity to a charity in a charitable lead annuity trust (CLAT), unlike a charitable remainder annuity trust, may be less than 5 percent of the initial net fair market value of the trust assets. See §14.8.

Similarly, a unitrust interest passing to a charity must be a fixed fraction or percentage of the net fair market value of the trust assets valued annually and paid periodically, but not less often than annually. Treas Reg §20.2055-2(e)(2)(vii)(a). Unlike a charitable remainder unitrust, a unitrust interest in a charitable lead unitrust (CLUT) may be less than 5 percent of the net fair market value of the trust assets. See §14.15. The charity's interest in a CLAT or CLUT may run for a specified term or for the life or lives of an individual or individuals, living and ascertainable on the date of the testator's death. Treas Reg §20.2055-2(e)(2)(vi)(a), (vii)(a). The annuity or unitrust amount, unlike a charitable remainder trust amount, may be paid to a charity for the life of an individual plus a term of years. See §14.7. The interest given to the charity must be either a guaranteed annuity or a unitrust interest. No deduction will be allowed if the charity is given the lesser of an annuity or a unitrust interest. Treas Reg §20.2055-2(e)(2)(vi)(a)-(b), (vii)(a)-(b).

Any income over the annuity or unitrust amount may be distributed to or for the use of the charity, if the trust terms so provide, but the amount of the estate tax charitable deduction will be limited to the fair market value of the guaranteed annuity or the unitrust interest. Treas Reg §20.2055-2(e)(2)(vi)(d), (vii)(d). Unlike a charitable remainder trust, a charitable lead trust is not exempt from income tax on any retained income (including capital gains). See §14.82. During the term of the charity's interest, no distributions may be made for a private purpose unless they are made from assets that, under the trust terms, are devoted exclusively to private purposes and to which IRC §4947(a)(2) does not apply. However, distributions that are payments for full and adequate consideration are not treated as distributions made for private purposes. Treas Reg §20.2055-2(e)(2)(vi)(f), (vii)(e). This rule also does not apply if the interest of the private distributee is in the form of a unitrust interest or the interest is in the form of a guaranteed annuity interest and the trust instrument does not provide for any preference or priority in the payment of the private annuity as opposed to the charitable annuity. Treas Reg §20.2055-2(e)(2)(vi)(f), (vii)(e); *Estate of Minnie L. Boeshore* (1982) 78 TC 523, acq in result 1987-2 Cum Bull 1. In addition, a CLAT must prohibit the acquisition and retention of assets that would give rise to a tax under IRC §4944 if the trustee acquired such assets. Treas Reg §20.2055-2(e)(2)(vi)(e). See §14.95.

This discussion devotes relatively little attention to charitable lead unitrusts (CLUTs), although the text refers to CLTs rather than CLATs when the statements also apply to CLUTs. CLATs produce better transfer tax results than CLUTs. This is the case even in generation-skipping transfer situations, notwithstanding the fact that CLATs, but not CLUTs, are burdened with the provisions of IRC §2642(e), which delay the determination of a CLAT's inclusion ratio until the end of the term of the charitable interest. See §14.84. See also Gopman & Mielnicki, *Planning with Testamentary Charitable Lead Annuity Trusts*, 138 Tr & Est 34 (July 1999).

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B. Tax Considerations in Using CLTs

§14.82 1. Trust's Income Tax Deduction

Unlike a charitable remainder trust, a charitable lead trust is not exempt from income taxes. It is generally taxed as a complex trust and is entitled to a deduction for amounts distributed to charity under IRC §642(c). There are no percentage limitations, but the deduction cannot exceed the trust's gross income for the year of the deduction. The trustee may elect to treat amounts paid in one calendar year as if made in the preceding calendar year. In most cases, a properly drafted CLT will not have a significant income tax liability, because of the IRC §642(c) deduction.

The governing instrument generally can affect the income tax characterizations of the distributions to the charity. IRC §662(b); Treas Reg §1.643(a)-5(b). To maximize the benefit of the deduction and reduce the taxes imposed on the trust's accumulated income (or the income distributed to the remaindermen in the final year of the trust), at least one commentator has suggested that the trust instrument should provide that the charitable distributions are to be paid first from ordinary income, followed in order of priority by short-term capital gain income, long-term capital gain income, unrelated business income (or perhaps that distributions should be made from 50 percent of unrelated business income before long-term capital gains), tax-exempt income, and finally principal. See Teitell, Charitable Lead Trusts §1.05 (1986). The order of payment is significant because no deduction is allowed under IRC §642(c) for any amount allocable to the trust's unrelated business income for the taxable year. IRC §681(a). However, the efficacy of the suggested provision is in doubt. In IRS Letter Ruling 200648025, the IRS ruled that a similar ordering rule in a proposed CLAT will not be given effect for income tax purposes, because it has no economic effect on the distributions independent of tax consequences. Rather, the IRS ruled that the distributions will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes under Treas Reg §1.642(c)-3(b)(2). The IRS has issued proposed regulations that would disregard trust document provisions specifying the sources of income to be used for payments to charity if the provisions have no economic effect independent of income tax consequences. See Prop Treas Reg 1.642(c)-3(b)(2); REG-101258-8, 2008-28 Int Rev Bull 111. See also IRS Letter Rulings 200108032, 199917068, 199915058, 199908002, 9808035, 8819020. The cited regulation currently authorizes an ordering rule providing that payments are made first from taxable income and then from nontaxable income, but the IRS has ruled that the ordering rule still must have economic effect. IRS Letter Ruling 8727072. For further discussion, see Casner & Pennell, Estate Planning §5.9 at 5.114 n22 (6th ed 1998). See also Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts & Beneficiaries §6.09 (3d ed 1999).

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2. Generation-Skipping Transfer Tax

§14.83 a. Normal Inclusion Ratio Calculation

The generation-skipping transfer (GST) tax makes specific provisions with respect to CLATs and CLUTs and treats them differently. For purposes of the GST tax, charities are not skip persons. IRC §2613(b). Accordingly, a transfer to a CLT is never a "direct skip." If the trust will benefit skip persons (persons assigned two or more generations below the grantor), there will eventually be one or more generation-skipping transfers. These may be taxable terminations (when all remaining beneficiaries are nonskip persons) or taxable distributions (whenever a distribution is made to a skip person) or both. IRC §2612. The tax is computed by multiplying the value of the property subject to the transfer by the maximum estate tax rate, which is 45 percent in 2007-2009. IRC §§2001, 2641. This amount is then further multiplied by the inclusion ratio. The GST tax treatment of CLTs is strongly influenced by the rules for computing the inclusion ratio.

In simpler situations, the inclusion ratio is equal to one minus the "applicable fraction." The denominator of the applicable fraction is generally the value of the transferred property at the date of death, and the numerator is the amount of the testator's GST tax exemption, equal to the IRC §2010 estate tax applicable exclusion amount, that the personal representative chooses to allocate to the particular transfer on the testator's estate tax return. IRC §2642. Without special provisions, these rules would make it virtually impossible to create CLTs that would benefit skip persons. It would be foolish, for example, to allocate $1 million of GST exemption to a $1 million trust (thereby producing a fully exempt trust with an applicable fraction of one and, therefore, an inclusion ratio of zero) if the primary trust beneficiary was a charity.

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§14.84 b. Special CLT Inclusion Ratio Rules

Because of the problem described in §14.83, the GST tax contains one special rule applicable to all generation-skipping CLTs, plus two additional rules applicable to charitable lead annuity trusts but not to charitable lead unitrusts. The rule applicable to all CLTs provides that, for purposes of determining the applicable fraction, the value of the denominator is the value of the property in the trust *reduced by* any gift tax or estate tax charitable deduction allowed for the transfer to the trust. IRC §2642(a)(2)(B)(ii)(II).

Thus, if the testator gives $1 million to a CLUT and the present value of the remainder interest at death under IRC §7520 is $200,000, the personal representative need allocate only $200,000 of GST exemption to the trust to create a fully exempt (applicable fraction of one and inclusion ratio of zero) trust. No matter what the value of the trust assets at the end of the charitable lead term, the inclusion ratio will remain zero because that ratio is already determined.

Two additional rules produce very different results in the case of CLATs. First, the applicable fraction is not determined at the beginning of the trust, but instead is determined immediately after the end of the term of the charitable lead interest. IRC §2642(e)(1)(B). The clear purpose of this rule is to prevent excessive leveraging of the GST exemption in the case of annuity trusts. If investment results are good, it would otherwise be possible to create a CLAT that initially has a value of near zero, make the trust fully GST tax exempt with an allocation of very little GST tax exemption, and then end up with a very large GST tax-exempt trust at the end of the charitable term. Such excessive leveraging is less of an issue with a unitrust because unexpectedly high investment performance benefits *both* the charity and the remaindermen, inasmuch as the annual unitrust payment fluctuates with the value of the trust assets.

The second rule applicable only to annuity trusts provides that the numerator of the applicable fraction is the "adjusted" GST exemption allocated to the trust. IRC §2642(e)(1)(A). The adjusted GST exemption is the actual exemption allocated to the trust increased by interest at the IRC §7520 rate used to calculate the amount of the gift or estate tax deduction for the charitable lead annuity interest. IRC §2642(e)(2).

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§14.85 (1) Example of Annuity Inclusion Rules

The annuity inclusion ratio rules work well when the actual investment rate of return is identical to the rate assumed under IRC §7520. Suppose, for example, that a $1 million CLT is established in a month when the IRC §7520 rate is 5 percent. The trust pays an annuity of $200,000 at the end of each year for 5 years. Based on the assumed rate of investment return of 5 percent, the annuity has a present value of $865,900 and the remainder has a *present* value of $134,100, a value that assumes that the actual *future* value of the property left in the trust at the end of the charitable term will be $171,149. If the personal representative allocates $134,100 of GST tax exemption to the trust at the beginning of the term, the adjusted GST tax exemption will be calculated by increasing this amount by the same 5 percent per annum. At the end of the ten years, the adjusted GST tax exemption will be exactly equal to the $171,149 remaining in the trust at that time, resulting in a GST tax inclusion ratio of zero. In terms of GST tax, the trust ends up in the same situation as would have occurred if the testator had made an outright gift to the charity of $865,900 together with an outright gift to a trust for issue of $134,100 that received an identical allocation of GST tax exemption.

However, testators establishing CLATs are gambling that the actual rate of return on trust investments will exceed the IRC §7520 rate. Suppose the actual rate of return for the trust is 7 percent rather than 5 percent. At the end of the term, the remaining balance in the trust will be $252,404, but the adjusted GST tax exemption is still $171,149. If the testator wanted the trust to be fully exempt from GST tax, the personal representative would need to have allocated an additional $81,255 of GST tax exemption to the trust on the estate tax return. IRC §2632(a). In any event, from a GST tax perspective, a CLAT does not produce any special benefits for a trust that will be protected by GST exemption.

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§14.86 (2) Implications of Annuity Inclusion Rules

Two points should be made about the GST tax inclusion ratio rules for CLATs. First, a CLAT remains superior to a CLUT in generation-skipping situations even though the inclusion ratio for CLUTs is determined at the beginning of the term. Under the best of normal circumstances the value of a CLUT remainder grows so slowly that the CLAT will produce better total results even if GST tax must be paid on the increased value. It is simply the price of success.

This leads to the second point, which involves the impact of the GST tax in situations in which the CLAT will distribute to skip persons but the testator has no remaining GST tax exemption for the personal representative to allocate. A CLAT will be useful in these situations, but only to the extent that the planner is able to overcome the fact that GST transfers to skip persons should normally be made in the form of a direct skip, because the GST tax on a direct skip is calculated on a tax-*exclusive* basis (the tax rate *is not* applied to the money to be used to pay the tax), whereas the GST tax on taxable terminations and taxable distributions is calculated on a tax-*inclusive* basis (the tax rate *is* applied to the money to be used to pay the tax). See chap 15.

To overcome the disadvantage of losing the opportunity to make a direct skip, it is simply necessary to make sure that the value of property transferred to the trust that otherwise would be available to make a comparable direct skip is negligible. If, for example, a proposed $1 million nonexempt generation-skipping CLAT produces a charitable lead interest with a present value of $900,000 and a remainder interest with a present value of $100,000, the transaction should be recast so that only $900,000 goes to the CLAT and the remaining $100,000 is used to make a separate direct skip transfer to a trust benefiting only skip persons. For other reasons for minimizing the present value of the CLAT remainder, see §14.90.

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C. When to Use a CLAT

§14.87 1. In General

To assess the benefit of using a CLAT, it is helpful to compare the results of using such a device with the alternative of making two separate gifts: (1) an outright gift to charity of an amount equal to the present value of the charitable interest in the proposed CLAT (as determined by using the IRC §7520 interest rate) and (2) a gift to a trust for remaindermen of the present value of the remainder interest in the proposed CLAT. Assume the trust for the remaindermen will accumulate all income until the end of the charitable term for the proposed CLAT.

If, hypothetically, the selected trust investments for both the proposed CLAT and the alternative proposed trust for remaindermen have a total investment return for the term that is equal to the rate assumed under IRC §7520, the result is a wash. At the end of the proposed term the assets that will remain in the proposed CLAT will have the same value as the assets in the proposed alternative of a separate trust for the remaindermen.

If, however, the actual rate of investment return is higher or lower than the rate assumed under IRC §7520, the value of the remaining assets in the CLAT will similarly be higher or lower than under the proposed trust for remaindermen. Accordingly, the CLAT is desirable only when the §7520 rate is relatively low or there is otherwise reason to believe actual investment performance will exceed the assumed rate.

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§14.88 2. Example of CLAT

Suppose, to provide an extreme example, a testator might make a devise of $1 million to a CLAT with a two-year term. The CLAT will pay $500,000 at the end of each year to the charity. The IRC §7520 rate for the year is 5 percent. Accordingly, the IRS will value the present value of the charitable interest at $929,700 and the present value of the remainder interest at $70,300. These figures assume that the future value of the remainder interest—the amount that will be left in the trust at the end of the term—will be $77,500, which is equal to $70,300 invested at 5 percent for two years compounded annually.

Now assume that the actual rate of investment return is 7 percent. At the end of the two-year term, the amount in the trust will be $109, 910. If, instead, the testator had left $70,300 in trust for two years and that sum had grown at the 7-percent rate, that trust would have a value of only $80,486. As a result of using the CLAT, the remaindermen will receive an additional $29,424 without any increase in estate tax liability. Even if we appropriately discount this figure back to the date of death to determine the extra amount that the testator would have been required to invest at 7 percent for two years to generate the additional $29,424, the amount that has escaped estate tax is $25,700.

The reason the CLAT produces better results is that the remaindermen are receiving the benefit of improved investment performance on a much larger fund than would be the case if they had been the beneficiaries of a much smaller separate trust benefiting only themselves.

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§14.89 a. Benefits of Leverage

When compared to the alternative of making outright gifts to both charities and family members, it becomes clear that the primary advantage of the CLAT is that the benefits to the remaindermen are "leveraged" in that they benefit not only from higher than assumed investment performance on assets having a value equal to the present value of the noncharitable gift, but also from the same higher performance on the assets initially equal in value to the present value of the charitable interest.

The amount of leverage depends on the relative sizes of the initial present values of the charitable and noncharitable gifts. Higher ratios produce higher leverage. Suppose, for example, that the testator's will established a five-year, $1-million CLAT making annual payments of $230,000. The present value of the remainder interest under IRC §7520 will be a mere $3303. The future value of the remainder interest is assumed to be $4215. However, if the actual investment rate of return is 7 percent, the value of the property passing to the noncharitable beneficiaries after five years will be $79,881, more than 15 times the amount projected by the IRS.

The benefits of leverage also depend on the length of the term. If it is assumed that the CLAT assets will continue to produce a high rate of return, a longer term will produce better results if the assumption is correct. However, leverage is reduced as time passes, because the present value of the charitable interest keeps getting smaller and the present value of the remainder interest keeps getting larger.

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§14.90 b. Benefits of Low Present Value Remainder

For several reasons, CLATs should be designed so that the present value of the remainder is negligible when the trust is established. If the present value of the remainder is more than negligible, there are excess funds in the trust that are not producing any of the special benefits associated with the use of a CLAT.

First, the present value of the remainder is the value of the gift for transfer tax purposes. If the trust investment return is unexpectedly lower than the IRC §7520 rate used to value the gift, the gift will have been overvalued. However, this risk is minimized if the gift had little value in the first place.

Second, as noted in §14.89, the greater the ratio between the size of the present value of the charitable interest and the size of the present value of the remainder interest, the greater the benefits of "leverage."

Finally, as noted in §14.86, in situations involving nonexempt generation-skipping CLATs, a large present value for the remainder interest indicates that there are excess funds in the CLAT that should instead be transferred to a trust having only skip-person beneficiaries. This results in a "direct skip" transfer and therefore a lower effective rate of tax than will occur on the taxable termination that occurs at the end of the charitable term.

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§14.91 3. Implicit Assumptions of Favorable Scenarios

In assessing testamentary CLAT projected results, it is necessary to keep in mind a variety of factors. First, the results are unlikely to be favorable unless it is assumed that the testator would have made the large gift to charity in any event.

Second, leverage is a double-edged sword. If the trust's actual investment performance is worse than assumed under IRC §7520, the remaindermen end up substantially worse off than if the testator had made a separate bequest to a trust for their benefit. In this respect, it is important to take administration costs into consideration. Unless these costs are kept to a minimum, it may be exceptionally difficult to achieve favorable results.

Income taxes are also a consideration, but in most cases tax considerations should be modest because of the deductions for the distributions to charity. See §14.82.

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D. CLAT Drafting Requirements

§14.92 1. Overview

Generally, the requirements for drafting a CLAT are somewhat simpler than for a CRAT. The fundamental requirements are that the charitable interests must be annuity or unitrust interests and that all of these payments must be made before payments can be made to noncharitable beneficiaries. It is permissible to establish a completely separate share of the trust to make earlier distributions to noncharitable beneficiaries, but it is simpler to accomplish this with a separate trust. Depending on the size of the charitable interest, most or all of the private foundation excise tax rules will apply to the trust, resulting in modest governing instrument requirements. See §14.95. Because of the limited tax benefits for CLATs, the remaining restrictions are relatively modest. In contrast to a charitable remainder trust (CRT), there are no minimum or maximum term requirements, except for the applicable rule against perpetuities, nor is there a minimum charitable benefit requirement. The IRS has issued sample testamentary CLAT forms in Rev Proc 2007-46, 2007-29 Int Rev Bull 102. The IRS has also issued sample inter vivos CLAT forms in Rev Proc 2007-45, 2007-29 Int Rev Bull 89. For discussion of inter vivos CLATs and forms, see Drafting California Irrevocable Trusts, chap 18A (3d ed Cal CEB 1997).

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2. Required and Highly Desirable Provisions

§14.93 a. Guaranteed Annuity Interest

The CLAT must provide the charity with a "guaranteed annuity interest." Under Treas Reg §1.170A-6(c)(2)(i):

> (A) An income interest is a "guaranteed annuity interest" only if it is an irrevocable right pursuant to the governing instrument of the trust to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term or for the life or lives of an individual or individuals, each of whom must be living at the date of transfer and can be ascertained at such date. … An amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer.
>
> …
>
> (E) Where a charitable interest in the form of a guaranteed annuity interest is transferred after May 21, 1972, the charitable interest generally is not considered a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests.

For the most part, these requirements are straightforward as long as the drafter is not attempting to do something unusual. The trust must be irrevocable, and the payments to charity cannot be subject to conditions. The amount of the payments can be stated in terms of a fixed dollar amount or as a percentage of the value of the trust assets on the date of the transfer. In contrast to requirements for charitable remainder trusts, there are no minimum or maximum distribution requirements. The annuity amount can be described as a formula that will produce a charitable deduction equal to a specified percentage of the value of the trust. This is especially useful in the context of a testamentary CLAT, because the drafter will not know what the IRC §7520 rate will be at the settlor's death.

There is also no limitation on the term of the trust, although the term should be less than the period allowed under the rule against perpetuities. Because it is rarely appropriate for a CLAT to define the lead interest with reference to lives in being, the term will usually be stated as a specific number of years. If so, for a trust created in California, the rule against perpetuities will not be violated as long as the trust will terminate in 90 years. Prob C §21205(b).

Because the interest of the charity must be determinable at the outset, the IRS contends that the trust must prohibit commutation during the trust term. Rev Rul 88-27, 1988-1 Cum Bull 331.

Note that there are exceptions to the general rule that a CLAT cannot permit distributions for private purposes during the term of the charitable annuity. The regulations allow a deduction for a charitable interest in a CLAT even though a private interest begins before the expiration of the charitable interest if the private interest is in the form of a guaranteed annuity interest and the trust instrument does not provide any preference or priority in payment of the private annuity as opposed to the charitable annuity, or the private annuity is payable only from a group of assets devoted exclusively to private purposes. Treas Reg §1.170A-6(c)(2)(i)(E). It is difficult to conceive of a situation in which it would be desirable to draft a trust that would make use of these exceptions.

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§14.94 b. Form: Payment of Guaranteed Annuity

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14.94-1 Payment of guaranteed annuity

***Payment of Guaranteed Annuity*. The "charitable beneficiary" of the trust is _ _[*name of charity*]_ _. The "charitable term" of this trust begins on the date of my death and terminates _ _[*number of years of the lead term*]_ _ thereafter. The "annual annuity amount" is _ _[_ _[*dollar amount*]_ _/_ _[*number*]_ _ *percent of the initial fair market value of the trust/the amount that will produce an estate tax charitable deduction equal to* _ _[*number*]_ _ *percent of the initial fair market value of the trust*]_ _. On the first December 31st during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable term that fall within the current calendar year and a denominator of the number of all days in the current calendar year. On each subsequent December 31st during the charitable term, the trustee shall distribute to the charitable beneficiary the annual annuity amount. The obligation to pay the annual annuity amount shall commence with the date of my death, but payment of the annuity amount may be deferred until December 31st of the year in which the trust is completely funded. Within a reasonable time after December 31st of the year in which the trust is completely funded, the trustee shall pay to the charitable beneficiary the difference between any annuity amounts actually paid and the annuity amounts payable, plus interest. The interest for any period shall be computed at the IRC §7520 rate of interest in effect for the date of my death. On the last day of the charitable term the trustee shall distribute to the charitable beneficiary the annual annuity amount multiplied by a fraction having a numerator of the number of days of the charitable term that fall within the calendar year in which the term expires and a denominator of the number of all days in that calendar year. All such payments shall be made first from ordinary income other than unrelated business income, then from short-term capital gains, then from long-term capital gains, then from unrelated business income, then from tax-exempt income, and then from principal. Undistributed income shall be added to principal. The trustee shall not make any other distributions until the charitable term has expired and all required distributions to the charitable beneficiary have been made. These distributions shall not be prepaid or commuted.**

[*add if annuity amount is described as or based on a percentage of fair market value*]

If the initial fair market value of the trust assets is incorrectly determined, then, within a reasonable period after the value is correctly determined, the trustee shall pay to the charitable beneficiary (in the case of an undervaluation) or shall receive from the charitable beneficiary (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

Comment: The trust should then provide for the disposition of the trust estate following conclusion of the charitable term. These may include retention of the assets in trust. Because no charitable deductions are allowed for subsequent transfers to the trust, the trust instrument should prohibit additional contributions as provided by the IRS sample form in Rev Proc 2007-46, 2007-29 Int Rev Bull 102. See form in §14.62.

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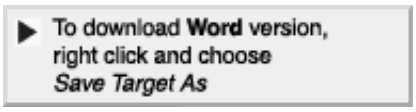
§14.95 c. Private Foundation Provisions

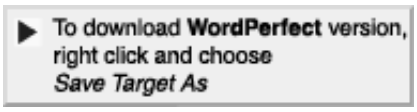
Generally, a CLT is subject to private foundation excise taxes imposed under IRC §§4941-4945. IRC §4947(a)(2). See §§14.34, 14.66. Under IRC §§508(e) and 4947(a)(2) the governing instrument must contain the prohibitions stated in form 14.96-1 except as stated in the form comment. The IRS has ruled that noncharitable remaindermen may be given the power to select charitable recipients of annuity payments and may select private foundations without violating the self-dealing rules, even if they are managers of the selected foundations. IRS Letter Ruling 200029033.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.96 d. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions)

§14.96 d. Form: Annuity Trust or Unitrust Mandatory Clause (Private Foundation Prohibitions)





14.96-1 Private foundation prohibitions

***Private Foundation Prohibitions*. During the charitable term the trustee is prohibited from engaging in any act of self-dealing as defined in Internal Revenue Code §4941(d), from retaining any excess business holdings as defined in Internal Revenue Code §4943(c) that would subject the trust to tax under Internal Revenue Code §4943, from making any investments that would subject the trust to tax under Internal Revenue Code §4944, and from making any taxable expenditures as defined in Internal Revenue Code §4945(d). The trustee shall make distributions at such time and in such manner so as not to subject the trust to tax under Internal Revenue Code §4942.**

Comment: In the rare case that the present value of the lead interest at the inception of the trust is less than 60 percent of the total assets of the trust on that date, the trust will not be subject to IRC §§4943-4944, in which case the prohibitions concerning those sections may be deleted. IRC §4947(b)(3)(A); Treas Reg §1.170A-6(c)(2)(i)(D).

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.97 e. Charitable Deduction Saving Clause

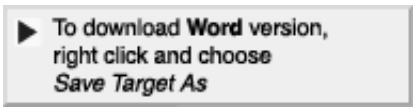
§14.97 e. Charitable Deduction Saving Clause

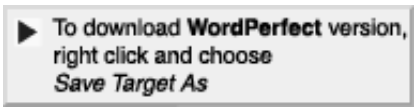
Although not expressly required, it is good practice to provide a saving clause that clarifies the intended tax deductions and provides for selection of an alternate charitable recipient if the named charity later fails to qualify. Because the CLAT is not intended to qualify for an income tax deduction, it is not necessary for the clause to refer to IRC §170. Indeed, this could be undesirable inasmuch as the estate and gift tax deduction provisions in IRC §§2055 and 2522 allow a broader group of recipients than the income tax provisions as a result of the absence of the IRC §170(c) requirement that the recipient be created under the laws of the United States, a state, the District of Columbia, or a possession of the United States. California has a savings statute for CLATs. Prob C §21541.

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Source: Estate Planning/California Will Drafting/14 Charitable Split-Interest Trusts/§14.98 f. Form: Charitable Deduction Saving Clause

§14.98 f. Form: Charitable Deduction Saving Clause





14.98-1 Charitable deduction saving clause

***Purpose of Trust*. I intend that the interest passing to _ _[*name of charity*]_ _ under this trust shall be a guaranteed annuity that qualifies for tax deductions under Internal Revenue Code §§2055 and 2522. All clauses of this instrument shall be interpreted according to this intention. The trustee shall have the power to amend the terms of this instrument in writing without application to any court to the extent permitted by the Internal Revenue Code and applicable Treasury Regulations to qualify and continue to qualify the trust for those deductions. If at any time a distribution is otherwise to be made to _ _[*name of charity*]_ _ and _ _[*name of charity*]_ _ is not an organization described in Internal Revenue Code §§2055(a) and 2522(a), the trustee shall make the distribution to one or more organizations selected by the trustee, at the trustee's discretion, which are then so described.**

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§14.99 g. Other Provisions

A CLAT should include standard trust provisions for establishing and administering a trust, including routine trustee power provisions. Although arguably not required, CLATs usually contain a provision prohibiting additional contributions to the trust. In any event, no tax deduction is allowable for a transfer not made at the inception of the trust. The trust may provide that the remaining trust estate is retained in further trust following expiration of the charitable term.

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15

Generation-Skipping Transfer Tax: Law, Regulations, and Planning

Jon J. Gallo

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I. OVERVIEW AND HISTORY OF GST TAX

§15.1 A. Introduction to GST Tax

The generation-skipping transfer (GST) tax is contained in Chapter 13 of the Internal Revenue Code. The GST tax was enacted as part of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085), which retroactively repealed the 1976 GST tax and substituted a significantly different GST tax in its place. TRA 1986 §1433(a), (c).

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§15.2 B. GST Tax Effective Dates

Generally, Chapter 13 of the Internal Revenue Code applies to all generation-skipping transfers (GSTs) occurring after October 22, 1986, other than inter vivos transfers, for which the effective date is September 25, 1985. TRA 1986 §1433(b). See §15.89. These rules, however, are subject to exceptions and special transition rules. Irrevocable trusts created before the applicable effective date of the GST tax are referred to in this chapter as "protected" trusts.

A testamentary transfer made under a will or revocable trust executed before October 22, 1986, by a person who died before January 1, 1987, without changing the will or revocable trust, is not subject to the GST tax. TRA 1986 §1433(b)(2)(B). Therefore, these trusts are also protected trusts. TRA 1986 §1433(b)(2)(A). See §15.90. Similarly, inter vivos trusts that were irrevocable on September 25, 1985, are not subject to the GST tax, to the extent that transfers from these trusts are not made out of corpus added after September 25, 1987. See §15.92.

The law also exempts GSTs made under a trust that consists of property included in a decedent's gross estate (or reinvestments of that property) and transfers that are direct skips at death, if the decedent was incompetent on October 22, 1986, and remained incompetent through the date of death. See §15.91.

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C. Overview of GST Tax

§15.3 1. Estate Plan Options

Viewed exclusively from the perspective of the GST tax, estate plans fall into one of three categories:

- Those in which a GST *will not* occur;
- Those in which a GST *might* occur; and
- Those in which a GST *will* occur.

Such categories are referred to in this chapter as won't-be, might-be, and will-be estate plans, respectively. See §§15.4-15.6.

Planning and drafting might-be and will-be estate plans pose a unique challenge because the process of minimizing the impact of the GST tax depends largely on proper postdeath utilization of four interrelated elective provisions of the Internal Revenue Code:

- The QTIP election;
- The reverse QTIP election;
- The GST exemption; and
- The transfer tax apportionment rules.

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§15.4 2. Won't-Be Plans

Won't-be plans are encountered if no portion of the testator's estate will pass to "skip persons" (see definition in §§15.8, 15.14) or if the amount passing to skip persons will not exceed the testator's IRC §2631 GST exemption (or whatever portion of that exemption that was not allocated to lifetime transfers). Perhaps the most common example of a won't-be plan is the married couple who execute mirror image wills under which the estate of the first spouse to die will be distributed outright to the survivor and the survivor's estate will be distributed outright to the couple's children, by right of representation, with no portion passing to anyone other than the children or groups composed of grandchildren taking per stirpes as representatives of deceased children. The children are not skip persons, and the grandchildren are exempted by virtue of the predeceased ancestor exception. See IRC §2651(e)(1).

Conservative estate planning may limit won't-be plans solely to situations in which the maximum amount that *could* pass to skip persons will not exceed the GST exemption. The predeceased ancestor exception under IRC §2651(e)(1) discussed in §15.25 requires the actual death of the child. See Treas Reg §26.2651-1(a)(2)(iv) (an IRC §2518 disclaimer is not sufficient to cause the child to be *treated* as a decedent).

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§15.5 3. Might-Be Plans

Might-be plans typically occur when some portion of the decedent's estate will be retained in trust for children until the occurrence of a designated event, *e.g.,* the tenth anniversary of the decedent's death or a child's reaching age 35. Although the plan contemplates eventual outright distribution to the child, a GST will occur if the child dies before the designated event and the trust principal is thereafter retained in trust for or distributed to the deceased child's issue.

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§15.6 4. Will-Be Plans

Will-be plans are found when some or all of the decedent's estate will be distributed to skip persons or retained in trust for the benefit of two or more generation levels of beneficiaries, with at least one generation level composed of skip persons. Examples of will-be plans include outright devises to grandchildren, transfers in trust for the benefit of grandchildren, or transfers in trust providing life estates for children and remainder interests for grandchildren.

Even though the possibility that a GST would occur under a particular might-be plan is statistically unlikely, both might-be and will-be plans must deal with the same technical issues posed by the tax elections discussed in this chapter. The fact that the odds against dying as the result of a particular surgical procedure are a million to one is of little comfort to that statistical odd-man-out who dies! By the same token, if a GST occurs in a might-be plan as the result of the unexpected death of a child, the client must understand that the GST tax will not be discounted by the IRS to reflect the fact that the child's death was statistically unlikely!

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§15.7 D. Relationship to Estate and Gift Tax

In effect, the GST tax is an excise tax levied at a flat rate equal to the maximum estate or gift tax rate in effect at the time of the GST. IRC §2641. Imposition of the GST tax may coincide with an estate tax (*e.g.,* an outright devise to a grandchild or other "skip person" recipient) or a gift tax (*e.g.,* an inter vivos gift to a grandchild or other skip person) or it may be imposed when no estate or gift tax is imposed (*e.g.,* on distribution from or termination of a trust that is not subject to estate or gift tax). IRC §2612.

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II. DEFINITIONS AND STRUCTURE OF GST TAX

§15.8 A. Basic GST Tax Concepts

For the GST tax to be imposed, there must be a generation-skipping transfer (GST) to or for the benefit of a person assigned to a generation two or more generations below that of the transferor. The younger person who receives or benefits from the transfer is called a "skip person." IRC §2613(a).

The following issues must be addressed in understanding the definition and structure of Chapter 13 of the Internal Revenue Code:

- Who is the transferor? See §§15.9-15.13.
- Who is the transferee? See §§15.14-15.22.
- What is the nature of the transfer? See §§15.23-15.33.

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§15.9 B. Determining the Transferor

The GST tax transferor is the last person deemed to have transferred the property in a transfer subject to either estate or gift tax even though there was no transfer under local law. Treas Reg §26.2652-1(a)(1). See §§15.10-15.12. Thus, for example, a deceased surviving spouse will be the transferor of a QTIP trust included in that spouse's estate under IRC §2044 in the absence of what is called a reverse QTIP election (see IRC §2652(a)(3)). Similarly, a lapsed power of withdrawal may result in the holder of the lapsed power being a GST tax transferor to the extent the lapse results in the holder making a gift for gift tax purposes. Treas Reg §26.2652-1(a)(5), Example 5.

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§15.10 1. Transfers at Death

If transferred property is included in an individual taxable estate, the individual becomes the GST tax transferor except in the case of an IRC §2652(a)(3) reverse QTIP election. Thus, for example, the holder of a power of appointment will become the GST tax transferor of property included in the holder's estate under IRC §2041, regardless of whether the power is exercised.

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§15.11 2. Transfer Subject to Gift Tax

In some cases, the GST tax transferor is a person treated as making a gift of the transferred property. IRC §2652(a)(1)(B); Treas Reg §26.2652-1(a)(1). A transfer is treated as subject to gift tax if a gift tax is imposed. IRC §2501(a); Treas Reg §26.2652-1(a)(2).

EXAMPLE: *Identity of transferor.* T transfers $100,000 to a trust for the sole benefit of T's grandchild. The transfer is a completed gift under Treas Reg §25.2511-2. Thus, for purposes of the GST tax, T is the transferor of the $100,000.

NOTE: It is immaterial that a portion of the transfer is excluded from the total amount of T's taxable gifts by reason of IRC §2503(b). Treas Reg §26.2652-1(a)(5), Example 1.

If the gift is of separate property and gift-splitting is used (so that the donor's spouse elects under IRC §2513 to be treated as the donor with respect to half of the gift), each spouse is a transferor of half of the property transferred. IRC §2652(a)(2).

EXAMPLE: *Gift-splitting and identity of transferor.* The facts are the same as in the above example, except that T's spouse, S, consents under IRC §2513 to split the gift with T. For purposes of the GST tax, S and T are each treated as a transferor of $50,000 to the trust. Treas Reg §§26.2652-1(a)(4) and (a)(5), Example 2.

If a beneficiary of a trust makes a gift of a term interest in that trust to a third party and the transfer does not affect the rights of the other beneficiaries, the original transferor remains the transferor.

EXAMPLE: *Effect of transfer of an interest in trust on identity of transferor.* T transfers $100,000 to a trust, providing that all the net income is to be paid to T's child, C, for C's lifetime. At C's death the trust property is to be paid to T's grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for federal gift tax purposes. Because C's transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to *the trust*. Treas Reg §26.2652-1(a)(5), Example 4.

The lapse of a *Crummey* power (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) does not result in the transferor's identity changing to the extent that it is protected from gift tax by virtue of the $5000 / 5-percent "safe harbor." Treas Reg §26.2652-1(a)(5), Example 5. The power holder becomes the transferor only of the excess. Moreover, the initial transfer of property subject to a withdrawal right is a transfer to the trust and not to the power holder.

EXAMPLE: *Effect of lapse of withdrawal right on identity of transferor.* T transfers $10,000 to a new trust, providing that the trust income is to be paid to T's child, C, for C's life and, at C's death, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is a completed transfer within the meaning of Treas Reg §25.2511-2 and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, C becomes a transferor to the extent that C is treated as having made a completed transfer for purposes of Chapter 12 of the Internal Revenue Code. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5000 or 5 percent of the value of the trust property, T remains the transferor of the trust property for purposes of Chapter 13 of the Internal Revenue Code. Treas Reg §26.2652-1(a)(5), Example 5.

The exercise of a nongeneral power of appointment under a trust that has been grandfathered by the effective date of the regulations will be treated as a transfer subject to estate or gift tax (thereby constituting a constructive addition to the trust and changing the transferor) if the power is exercised to postpone or suspend the vesting of absolute

ownership or power of alienation for a period that extends beyond the common law perpetuities period, measured from the date of creation of the trust. In other words, this rule applies if the exercise of the power of appointment extends the perpetuities period that was originally applicable to the trust. An exception is provided for states, such as California, that have adopted the Uniform Statutory Rule Against Perpetuities (Prob C §§21200-21231), by providing that any exercise that does not extend the trust beyond 90 years from creation will not constitute a constructive addition.

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§15.12 3. Special Qualified Terminable Interest Property (QTIP) Election

If a QTIP election is made with respect to a transfer to a trust benefiting a spouse, the spouse normally will become the transferor of the trust for GST tax purposes before anything can pass to a skip person. Either the spouse will be treated as making a transfer by gift under IRC §2523(f) or the transferred property will be included in the spouse's estate under IRC §2044. Treas Reg §26.2652-1(a)(5), Example 3. But for the "reverse QTIP election" provisions of IRC §2652(a)(3), the common consequence under a typical marital deduction estate plan once was that the original transferor was not be able to make full use of his or her GST exemption. The exemption of the original transferor became irrelevant once the transferor changed, and the other GSTs made by the original transferor typically did not exceed the IRC §2010 applicable exclusion amount, which was less than the original transferor's GST exemption. This problem does not arise in 2004-2010, because the GST exemption is equal to the applicable exclusion amount in 2004-2009 (IRC §2631(c)) and the estate tax and the GST tax do not apply, respectively, to decedents dying and generation-skipping transfers in 2010 (IRC §§2210, 2664). See §20.2A. The problem will arise again after 2010, especially if the spouse made GSTs in 2010, because the GST exemption in 2011 and thereafter may be well in excess of the $1 million applicable exclusion amount that is scheduled to apply unless Congress extends the current law, and the GSTs in 2010 will use a portion of the spouse's applicable exclusion amount but will not use any GST exemption.

Under IRC §2652(a)(3), the original transferor can avoid the inability to make full use of available GST exemption by making an election to have a QTIP trust treated as if the QTIP election had not been made. This applies *only* for GST tax purposes. As a result, the original transferor will continue to be treated as the GST tax transferor of the trust even after the spouse is treated as making a transfer of the trust for regular estate and gift tax purposes. Once made, a reverse QTIP election is irrevocable. Treas Reg §26.2652-2(a).

A reverse QTIP election must be made with respect to all the property in the trust to which the QTIP election applies. Protective reverse QTIP elections may be made. Because standard GST tax strategy calls for having trusts that are either completely exempt from tax or completely nonexempt, many estate plans provide for dividing the QTIP into two trusts, with one trust having a value equal to the amount of GST exemption to be allocated to the QTIP. This is referred to as the "exempt trust." The other trust is referred to as the "nonexempt trust." To avoid unnecessary diminution in the value of the exempt trust, it is also standard practice to provide that the estate tax imposed on the QTIP trusts at the spouse's death will be paid exclusively from the nonexempt trust. The regulations favorably take the position that this does not result in the nonexempt trust making a constructive addition of nonexempt assets to the exempt trust. Treas Reg §26.2652-1(a)(4), Example 8. See the form in §15.43.

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§15.13 4. Multiple Transferors

If an asset owned by several persons is transferred, each owner will be treated as a transferor in proportion to his or her interest in the property. If a husband and wife gift split under IRC §2513, each spouse will be treated as the transferor of half of the property transferred. IRC §2652(a)(2).

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C. Determining the Transferee: Skip Persons and Generation Assignments

§15.14 1. Skip Persons and Nonskip Persons

A "skip person" is any individual who is assigned to a generation that is two or more generations below the generation of the transferor. IRC §2613(a)(1). In applying these rules, the transferor and the transferor's spouse are treated as members of the same generation, regardless of the number of years between their ages. IRC §2651(c)(1). A trust is a skip person if all beneficiaries holding a present interest in the trust are skip persons or no person holds a present interest in the trust and no future distributions from the trust may be made to anyone other than skip persons. IRC §2613(a)(2); Treas Reg §26.2612-1(d)(2)(i).

A "nonskip" person is any person who is not a skip person. IRC §2613(b). Nonskip persons include the transferor's spouse (IRC §§2613, 2651(c)), any ancestor of the transferor (see IRC §§2613, 2651(b)), children of the transferor, and other relatives belonging to the same generation as the transferor's children, such as nieces and nephews of the transferor and the transferor's spouse (see IRC §§2613, 2651(b)). If at least one beneficiary of a trust who possesses a present interest is a nonskip person, the trust itself is treated as a nonskip person. IRC §2613.

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§15.15 a. Generation Assignment of Relatives

If the transferee is a relative of the transferor or of the transferor's spouse, the generation assignment is based on the family tree, regardless of the ages of the individuals involved. IRC §2651(b)(1)-(2). For example, a child of the transferor or of the transferor's spouse is one generation below the transferor, and a grandchild is two generations below the transferor.

When there is a transfer to the spouse of a blood relative of the transferor, the spouse is in the same generation as the blood relative, regardless of the spouse's actual age. IRC §2651(c)(2). Adopted persons are treated in the same manner as natural issue, and children of the half blood are treated in the same manner as children of the whole blood. IRC §2651(b)(3). However, the adoption of a grandchild of the transferor or other relative two or more generations below the transferor as the transferor's child will be recognized for generation assignment purposes only if the grandchild was under age 18 at the time of the adoption, and the grandchild was not adopted primarily for the purpose of avoiding GST tax. Treas Reg §26.2651-2. Adoptions of nonrelatives will not be recognized for these purposes. See §15.16. The IRS claim of authority to promulgate these adoption rules is based on an assertion that such adoptions cause persons to have two generation assignments. Under IRC §2651(f)(1), a person who has two generation assignments is assigned to the youngest of the generations except as provided by regulations. Stepchildren are not treated as blood relatives unless they are adopted. IRS Letter Ruling 200150003.

A person who is a descendant of the parents of the transferor (or the transferor's spouse or former spouse) and whose ancestor who is a lineal descendant of such parents is deceased at the time of the transfer subject to estate or gift tax is assigned to the generation one below the lower of either the transferor's generation or the generation of the person's youngest living ancestor who is also a descendant of such parents. The rule does not, however, apply to a person who is not a descendant of the transferor if the transferor has any living descendants at the time of the transfer. IRC §2651(e). For example, in IRS Letter Ruling 200026001, the decedent remained the transferor of a QTIP trust under a reverse QTIP election. See §15.37. As a result, the children of the decedent's deceased niece were assigned to the generation of the niece. This would not have been true, however, if decedent's spouse had become the transferor. Because the spouse had children of her own, the children of the deceased niece were not entitled to a generation reassignment with respect to transfers from the spouse.

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§15.16 b. Generation Assignment of Nonrelatives

For individuals who are not related to the transferor or to the transferor's spouse or former spouse, the generation assignment is determined by comparing the date of birth of the transferee to that of the transferor. IRC §2651(d). The transferor's generation includes nonrelatives whose dates of birth are within 12½ years after that of the transferor. IRC §2651(d)(1). Nonrelatives whose dates of birth are between 12½ years and 37½ years after the transferor's date of birth are regarded as belonging to the first generation below the transferor. IRC §2651(d)(2). Nonrelatives whose dates of birth are between 37½ and 62½ years after that of the transferor are regarded as belonging to the second generation below the transferor. IRC §2651(d)(3). Note that the adoption of a nonrelative more than 37½ years younger than the transferor as the transferor's child will not be recognized under Treas Reg §26.2651-2, based on the theory that such adoptions cause persons to have two generation assignments. For these purposes, a descendant of a spouse or former spouse or parent of the transferor is considered a relative of the transferor. See §15.15.

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§15.17 2. Trusts as Skip Persons

A trust is a skip person if:

- Each beneficiary holding a present interest in the trust is a skip person; or
- No person holds an interest in the trust, and no distributions other than a distribution the probability of which is so remote as to be negligible (including distributions at the termination of the trust) may be made after the transfer to a person other than a skip person. IRC §2613(a)(2); Treas Reg §26.2612-1(d)(2).

A transfer to a trust that meets the definition of a skip person is a GST. IRC §2612(c)(1). In determining whether the trust is a skip person under IRC §2613(a)(2), only beneficiaries with present interests are taken into account. See IRC §2652(c)(1). Thus, if a transferor establishes a trust for three grandchildren and designates the transferor's child as the remainder beneficiary, the trust is treated as a skip person because all beneficiaries with a present interest are skip persons.

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§15.18 a. "Trust" Defined

For purposes of the GST tax, the term "trust" includes analogous arrangements such as life estates and remainders, gifts held by a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925), and insurance and annuity contracts creating successive interests in different beneficiaries. IRC §2652(b)(1), (3). If a trust includes substantially separate and independent shares for different beneficiaries, then each beneficiary's share will be treated as a separate trust for GST tax purposes. IRC §2654(b). A transfer at death in which the identity of the transferee is contingent on the occurrence of a future event is treated as a transfer in trust. However, a transfer at death for which the transferee's identity is contingent on an event that must occur within 6 months of the transferor's death is not considered to be a transfer in trust solely by reason of this contingency. Treas Reg §26.2652-1(b).

The following examples illustrate transfers to trust equivalents:

- Uniform Gifts to Minors Transfers. T transfers cash to an account in the name of T's child, C, as custodian for C's child, GC (who is a minor), under a state statute substantially similar to the Uniform Gifts to Minors Act. For purposes of Chapter 13 of the Internal Revenue Code, the transfer to the custodial account is treated as a transfer to a trust. Treas Reg §26.2652-1(b)(2), Example 1.
- Contingent Transfers. T bequeaths $200,000 to T's child, C. If C does not survive T by more than 6 months, the bequest is payable to T's grandchild, GC. C dies 4 months after T. The bequest is not a transfer in trust because the contingency that determines the recipient of the bequest must occur within 6 months after T's death. The bequest to GC is a direct skip. Treas Reg §26.2652-1(b)(2), Example 2.
- Contingent Transfers. The facts are the same as in the preceding example, except that C must survive T by 18 months to take the bequest. The bequest is a transfer in trust for purposes of Chapter 13, and the death of C is a taxable termination. Treas Reg §26.2652-1(b)(2), Example 3.

It is debatable whether the position taken by the regulations in Example (3) is correct. For a taxable termination to occur in Example (3), a termination of the child's interest must have occurred. IRC §2612(a)(1). Because C failed to survive T by 18 months, however, it is arguable that C never acquired an interest.

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§15.19 b. "Interest in Trust" Defined

A person has an "interest in a trust" for purposes of Chapter 13 of the Internal Revenue Code if

- The person has a present right to receive the principal or income from the trust (other than a future right) (IRC §2652(c)(1)(A));
- The person is one to whom the trustee has the current discretion to distribute principal or income (other than a charitable beneficiary) (IRC §2652(c)(1)(B)); or
- The person 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)(1)(C)).

EXAMPLE: *Interest in trust. T* establishes an irrevocable trust under which the income is to be paid to *T*'s child, *C,* for life. At the death of *C,* the trust principal is to be paid to *T*'s grandchild, *GC.* Because *C* has a present right to receive income from the trust, *C* has an interest in the trust. Because *GC* cannot currently receive distributions from the trust, *GC* does not have an interest in the trust. Treas Reg §26.2612-1(f), Example 12.

NOTE: Because *C* has an interest in the trust, the transfer by *T* of property to the trust is not a GST (*i.e.,* the trust is not a skip person because a nonskip person has a present interest). Accordingly, no GST tax will be incurred until *C*'s death.

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§15.20 c. Nominal Interests Ignored

An interest "used primarily to postpone or avoid" the GST tax is disregarded. IRC §2652(c)(2); Treas Reg §26.2612-1(e)(2)(ii). Thus, if the transferor in the example in §15.19 attempted to avoid the GST tax by providing *C* with a present income interest in the trust, but limited distributions to *C* to not more than one percent of trust income, *C*'s interest probably would be disregarded as nominal and the trust would be treated as a skip person.

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§15.21 d. Support Obligations

In general, a person will be deemed to have an interest in a trust or trust equivalent if principal or income may be used to discharge that person's legal obligation of support arising under state law. However, if the use of such funds is discretionary or under a state law substantially equivalent to the Uniform Gifts to Minors Act (such as the California Uniform Transfers to Minors Act (Prob C §§3900-3925)), this fact will be ignored for purposes of determining whether the person possesses an interest in the trust or trust equivalent. IRC §2652(c)(3). The regulations vary the statutory language slightly by requiring that the discretion must be exercisable in a fiduciary capacity. If grandparent (*GP*) creates a trust for a minor grandchild (*GC*) at a time when *GP*'s child (*C*), who is the parent of *GC,* is obligated under state law to support *GC, C* will not be deemed to have an interest in the trust merely because income is or may be used to discharge his or her obligation to support, unless the trust specifically directs the trustee to discharge *C*'s support obligation. IRC §2652(c)(3); Treas Reg §26.2612-1(e)(2)(i). The significance of treating *C* as not possessing an interest in the trust is that *GP*'s transfer to the trust or trust equivalent will be a direct skip and hence generate an immediate tax liability.

EXAMPLE: *Support obligation. T* establishes an irrevocable trust for the benefit of *T*'s grandchild, *GC.* The trustee has discretion to distribute property for *GC*'s support without regard to the duty or ability of *GC*'s parent, *C,* to support *GC.* Because *GC* is a permissible current recipient of trust property, *GC* has an interest in the trust. *C* does not have an interest in the trust, because the potential use of the trust property to satisfy *C*'s support obligation is within the discretion of a fiduciary. Treas Reg §26.2612-1(f), Example 13.

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§15.22 e. Special Rules for Charitable Trusts

A charitable beneficiary is assigned to the same generation as the transferor. IRC §2651(f)(3). If a transferor establishes a charitable lead trust with current income payments to a charitable beneficiary and, on expiration of the charitable interest, with subsequent income payments to the transferor's grandchildren, the trust is not a skip person, because the only beneficiary with a present interest (the charity) is not a skip person. Thus, the initial transfer to the trust is not a GST. See IRC §§2611(a), 2612(c), 2613(a)(2), (b). A GST will occur on termination of the charitable interest (a taxable termination). IRC §2612(a).

If a transferor establishes a charitable remainder trust with grandchildren as the current income beneficiaries, the trust is a skip person and the initial transfer to the trust is a GST. IRC §§2613(a)(2), 2652(c)(1). In determining the amount of the GST tax, however, the value of the charitable remainder interest is subtracted from the property transferred to the trust. See IRC §2623. This rule also applies to charitable lead unitrusts but not to charitable lead annuity trusts.

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Source: Estate Planning/California Will Drafting/15 Generation-Skipping Transfer Tax: Law, Regulations, and Planning/ §15.23 D. Types of Generation-Skipping Transfers (GSTs)

§15.23 D. Types of Generation-Skipping Transfers (GSTs)

There are three types of GSTs: direct skips, taxable terminations, and taxable distributions. Each type is a statutory term of art. IRC §2611(a).

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1. Direct Skips

§15.24 a. General Rule

A direct skip is a transfer to a skip person (including a trust) that is subject to estate or gift tax. IRC §§2612(c)(1), 2613(a). Thus, except to the extent that a direct skip is sheltered by an exemption from the GST tax, a direct skip is subject to two tax systems at the time of the transfer. Direct skips are taxed on a tax-exclusive basis, which means that the tax is calculated on the value of the property that the skip person receives. IRC §2623. In addition, the GST tax paid by the transferor is an additional taxable gift. IRC §2515.

EXAMPLE: *Direct skip. T* gratuitously conveys Blackacre to *T*'s grandchild. Because the transfer is a transfer to a skip person of property subject to federal gift tax, it is a direct skip. Treas Reg §26.2612-1(f), Example 1.

Only one tax is imposed even though a transfer skips more than one generation. Treas Reg §26.2612-1(a)(1).

EXAMPLE: *Direct skip of more than one generation. T* gratuitously conveys Blackacre to *T*'s great-grandchild. The transfer is a direct skip. Only one GST tax is imposed on the direct skip although two generations are skipped by the transfer. Treas Reg §26.2612-1(f), Example 2.

If a reverse QTIP election is not made with respect to a QTIP trust, the surviving spouse becomes the transferor at his or her death. As a result, any GST that occurs at the survivor's death will be a direct skip.

EXAMPLE: *Direct skip of property held in trust. T* establishes a testamentary trust under which the income is to be paid to *T*'s surviving spouse, *S,* for life, and the remainder is to be paid to a grandchild of *T* and *S. T*'s executor elects to treat the trust as qualified terminable interest property under IRC §2056(b)(7). The transfer to the trust is not a direct skip, because *S,* a person who is not a skip person, holds a present right to receive income from the trust. At *S*'s death, the trust property is included in *S*'s gross estate under IRC §2044 and passes directly to a skip person. The GST occurring at that time is a direct skip because it is a transfer subject to Chapter 11 of the Internal Revenue Code. The fact that the interest created by *T* is terminated at *S*'s death is immaterial because *S* becomes the transferor at the time of the transfer subject to Chapter 11. Treas Reg §26.2612-1(f), Example 5. In some circumstances, the transfer to the grandchild at *S*'s death will not be a GST. See §§15.15, 15.25.

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§15.25 b. Predeceased Ancestor Exception

A transfer is not a direct skip if the transfer is made to a grandchild of the transferor and the parent of the grandchild related by blood to the transferor or the transferor's spouse is deceased at the time of the transfer. Moreover, if the transfer is in trust, a distribution from the trust to the grandchild is not a taxable distribution or termination (*i.e.,* the transferor is "dropped down" to one generation above the grandchild). IRC §2651(e)(1). Treasury Regulation §26.2651-1(a)(2)(iii) provides a 90-day grace period, with the result that the rules apply if the transferor's child dies within 90 days after the transfer and is treated under local law or the governing instrument as having predeceased the transfer (*e.g*., because a clause in the instrument requires survival by 90 days as a condition of the transfer). In the event that a transfer is subject to estate or gift tax more than once, the relevant date for determining generation assignments under the predeceased ancestor exception is the date of the first transfer. Treas Reg §26.2651-1(a)(3). If, for example, the settlor of a qualified personal residence trust (QPRT) fails to survive the term, with the consequence that the residence is included in the settlor's estate, the relevant date is the date of the gift rather than the date of death. The result is mandated by IRC §2651(e)(1)(B) and illustrated in Treas Reg §26.2651-1(c), Example 2.

For purposes of the predeceased ancestor exception (which also applies to more remote descendants), a living descendant is *not* treated as predeceased solely by reason of state law (*e.g.,* state law treats an individual executing a disclaimer as deceased). Treas Reg §26.2651-1(a)(2)(iv). The descendant must in fact be deceased. However, assuming the child actually dies within 90 days after the transfer, it is *possible* that a disclaimer can be used to cure a lack of an effective survival clause. The regulation is ambiguous.

EXAMPLE: T establishes an irrevocable trust providing that trust income is to be paid to T's grandniece, GN, for 5 years or until GN's prior death. At the end of the 5-year period or on GN's prior death, the trust is to terminate and the principal is to be distributed to GN if living, or if GN has died, to GN's then-living descendants, per stirpes. S is a sibling of T and the parent of N. N is the parent of GN. At the time of the transfer, T has no living lineal descendants, S is living, N is deceased, and the transfer is subject to the gift tax imposed by chapter 12 of the Internal Revenue Code. GN is treated as a member of the generation that is one generation below T's generation because S, GN's youngest living lineal ancestor who is also a descendant of T's parent, is in T's generation. As a result, GN is not a skip person and the transfer to the trust is not a direct skip. In addition, distributions to GN during the term of the trust (see §15.27) and at the termination of the trust (see §15.26) will not be GSTs. Treas Reg §26.2651-1(c), Example 5.

Treasury Regulation §26.2652-1(b)(1) provides that a transfer to a trust in which the identity of the transferee is contingent on an event that must occur within 6 months (*e.g.,* survival for that period) is not a transfer in trust. Thus, if a transfer in trust for a child were subject to a 30-day survivorship contingency and (if the child failed to survive) the property would be distributed outright to grandchildren, the child's death within the 30-day period would result in the distribution to the grandchildren being deemed a direct skip. Because the child did not predecease the testator, however, the predeceased ancestor exception would not be available. Example 2 of Treas Reg §26.2652-1(b)(2) deals with this situation and treats the contingent bequest to the grandchild as a direct skip without mentioning the predeceased ancestor exception.

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Source: Estate Planning/California Will Drafting/15 Generation-Skipping Transfer Tax: Law, Regulations, and Planning/ §15.26 2. Taxable Terminations

§15.26 2. Taxable Terminations

A taxable termination is the termination of a beneficiary's interest in a trust as a result of death, lapse of time, or other reasons, unless (Treas Reg §26.2612-1(b)(1)):

- A new transferor is determined at the time of the transfer (*i.e.,* the transfer is subject to estate or gift tax at the time of the termination event);
- Immediately after the termination, a nonskip person has a present interest in the property; or
- After the termination, no distribution may be made from the trust to a skip person.

EXAMPLE: *Taxable termination. T* establishes an irrevocable trust under which the income is to be paid to *T*'s child, *C,* for life. At the death of *C,* the trust principal is to be paid to *T*'s grandchild, *GC.* Because *C* has an interest in the trust, the trust is not a skip person, and the transfer to the trust is not a direct skip. If *C* dies survived by *GC,* a taxable termination occurs at *C*'s death because *C*'s interest in the trust terminates and thereafter the trust property is held by a skip person who occupies a lower generation than *C.* Treas Reg §26.2612-1(f), Example 4.

EXAMPLE: *Taxable termination. T* establishes an irrevocable trust for the benefit of *T*'s child, *C, T*'s grandchild, *GC,* and *T*'s great-grandchild, *GGC.* Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the trustee's discretion. At the death of the second beneficiary to die, the trust principal is to be paid to the survivor. *C* dies first. A taxable termination occurs at that time because, immediately after *C*'s interest terminates, all interests in the trust are held by skip persons (*GC* and *GGC*). Treas Reg §26.2612-1(f), Example 6.

If an event is both a taxable distribution and a taxable termination, it is treated as a taxable termination.

EXAMPLE: *Taxable termination resulting from distribution.* The facts are the same as in the preceding, except that 20 years after *C*'s death the trustee exercises its discretionary power and distributes the entire principal to *GGC.* The distribution results in a taxable termination because *GC*'s interest in the trust terminates as a result of the distribution of the entire trust property to *GGC,* a skip person. Treas Reg §26.2612-1(f), Example 7.

If the interest of two or more generations of skip persons terminates by reason of the same GST, only one taxable termination is deemed to have occurred. See McCaffrey, *Drafting and Planning to Minimize the Generation-Skipping Transfer Tax*, Estate Planning 2005, chap 3 (Cal CEB 2005).

EXAMPLE: *Simultaneous termination of interests of more than one beneficiary. T* establishes an irrevocable trust for the benefit of *T*'s child, *C, T*'s grandchild, *GC,* and *T*'s great-grandchild, *GGC.* Under the terms of the trust, income and principal may be distributed to any or all of the living beneficiaries at the discretion of the trustee. At the death of *C,* the trust property is to be distributed to *GGC* if he or she is then living. If *C* is survived by both *GC* and *GGC,* both *C*'s and *GC*'s interests in the trust will terminate at *C*'s death. Only one taxable termination occurs, however, because both interests will terminate at the same time and as a result of one event. Treas Reg §26.2612-1(f), Example 8.

If property is transferred to a QTIP trust and a reverse QTIP election is made, the surviving spouse does not become the transferor at his or her death. As a result, any GST that occurs at the survivor's death will not be a direct skip but rather a taxable termination.

EXAMPLE: *Special (reverse QTIP) election under IRC §2652(a)(3). T* transfers $1 million to a trust, providing that all trust income is to be paid to *T*'s spouse, *S,* for *S*'s lifetime. *T*'s child *C* is alive at the time of the transfer. At *S*'s death, the trust principal is payable to *GC,* a grandchild of *S* and *T. T* elects to treat all the transfer as a transfer of qualified terminable interest property and also makes the reverse QTIP election for all that property. Because of the reverse QTIP election, *T* continues to be treated as the transferor of the property after *S*'s death for purposes of Chapter 13 of the Internal Revenue Code. A taxable termination rather than a direct skip occurs at *S*'s death.

Treas Reg §26.2652-2(d), Example 1.

If a *portion* of a trust is distributed outright to a skip person by reason of the *death* of a lineal descendant of the transferor, the distribution is a taxable termination rather than a taxable distribution. Treas Reg §26.2612-1(b)(2). If the distribution is made for any reason other than the death of a lineal descendant of the transferor, the distribution is a taxable distribution.

EXAMPLE: *Partial taxable termination. T* creates an irrevocable trust, providing that trust income is to be paid to *T*'s children, *A* and *B,* in proportions determined by the trustee for their joint lives. At the death of the first child to die, half of the trust principal is to be paid to *T*'s then-living grandchildren. The balance of the trust principal is to be paid to *T*'s grandchildren at the death of the survivor of *A* and *B.* If *A* predeceases *B,* the distribution occurring on the termination of *A*'s interest in the trust is a taxable termination and not a taxable distribution. It is a taxable termination because the distribution is a distribution of a portion of the trust that occurs as a result of the death of *A,* a lineal descendant of *T.* It is immaterial that a portion of the trust continues and that *B,* a person other than a skip person, thereafter holds an interest in the trust. Treas Reg §26.2612-1(f), Example 9.

Any distribution of any portion of a trust to a skip person by reason of what would be a taxable termination will not be a taxable termination but will instead be a direct skip if the transfer is subject to estate or gift tax and there is a new transferor.

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§15.27 3. Taxable Distributions

A taxable distribution is a distribution of either income or principal from a trust to a skip person, unless the distribution is either a taxable termination or a direct skip. IRC §2612(b). If the distribution is of taxable income, the GST tax paid is deductible for income tax purposes. IRC §164(a)(4).

EXAMPLE: *Taxable distribution. T* establishes an irrevocable trust under which the trust income is payable to *T*'s child, *C,* for life. When *T*'s grandchild, *GC,* reaches age 35, *GC* is to receive one-half of the principal. The remaining half of the principal is to be distributed to *GC* at *C*'s death. Assume that *C* survives until *GC* reaches age 35. When the trustee distributes one-half of the principal to *GC* on *GC*'s 35th birthday, the distribution is a taxable distribution because it is a distribution to a skip person and is neither a taxable termination nor a direct skip. Treas Reg §26.2612-1(f), Example 10.

The exercise of a *Crummey* withdrawal right by a skip person (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) is a taxable distribution.

EXAMPLE: *Exercise of withdrawal right as taxable distribution.* The facts are the same as in the preceding example, except that *GC* holds a continuing right to withdraw trust principal and, after one year, *GC* withdraws $10,000. The withdrawal by *GC* is not a taxable termination, because the withdrawal does not terminate *C*'s interest in the trust. The withdrawal by *GC* is a taxable distribution to *GC*. Treas Reg §26.2612-1(f), Example 11.

Any GST tax, including interest and penalties, paid from a distributing trust with respect to a taxable distribution is an additional taxable distribution that is deemed to be made on the last day of the taxable year of the trust in which the original taxable distribution was made. IRC §2621(b). Of course, the payment of the tax on the additional taxable distribution is, itself, an additional taxable distribution. This approach ensures that all taxable distributions are deemed to have occurred in the same taxable year, thereby simplifying computation of the GST tax. The formula to compute the total actual and constructive distribution is the actual distribution divided by (1 minus the rate of tax).

EXAMPLE: A trustee distributes $50,000 to the beneficiary when the highest effective estate tax rate is 50 percent and agrees to pay all GST tax attributable to the distribution. The total deemed distribution is $50,000/(1 − 0.50) or $100,000. The tax is $50,000 or an effective tax rate of 100 percent on the taxable distribution.

An individual has a present interest in a trust for purposes of the taxable distribution rule if trust income or principal may be used to satisfy his or her legal obligations, but not merely because a support obligation may be satisfied by a distribution that is either within the discretion of the trustee or made under the Uniform Transfers to Minors Act (Prob C §§3901-3925). A person has an interest in a trust only if the person has a present right to receive distributions of income or principal. A trust is a skip person if all persons having present interests in the trust are skip persons. If a significant purpose of an interest in a trust is to postpone or avoid the GST tax, the interest will be ignored. An interest may have more than one significant purpose.

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§15.28 4. Transfers Not Subject to Generation-Skipping Transfer (GST) Tax

There are three principal exceptions to the categorization of transfers that would otherwise constitute direct skips, taxable terminations, or taxable distributions. See §§15.29-15.31.

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§15.29 a. Qualified Tuition or Medical Expenses

A transfer that, if made inter vivos by an individual, would have qualified for the gift tax exclusion covering payments of qualified tuition or medical expenses under IRC §2503(e) is not a GST. IRC §2611(b)(1). In IRS Letter Ruling 200602002, the IRS ruled that prepayment of a grandchild's private school tuition for multiple future years qualified for both the IRC §2503(e) gift tax exclusion and the IRC §2611(b)(1) GST tax exclusion.

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§15.30 b. Estate or Gift Tax Supersedes GST Tax

A transfer of property in trust that would otherwise be a taxable termination is not treated as a taxable termination subject to the GST tax if the transfer is subject to estate or gift tax at the time of the termination event. Treas Reg §26.2612-1(b)(1)(i). See §15.26.

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§15.31 c. Certain Gifts Qualifying for Annual Exclusion

A transfer that qualifies for the IRC §2503(b) annual gift tax exclusion is not a GST if (IRC §2642(c)):

- The transfer is a direct skip; and
- The transfer is an outright gift, or if made to a trust:
- There is only one beneficiary of the trust;
- No portion of the trust principal or income may be distributed to a person other than the beneficiary;
- Distribution of the entire trust must be made to the beneficiary if the trust terminates during the beneficiary's lifetime; and
- The trust assets must be includable in the beneficiary's estate if the trust does not terminate during the beneficiary's lifetime (i.e., either the beneficiary has a general power of appointment or the remaining trust assets will be distributed to the beneficiary's probate estate).

Transfers in trust that qualify for the gift tax annual exclusion (often because of a *Crummey* power (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82)) but that do not meet the above requirements will be subject to the GST tax.

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§15.32 E. Multiple Skips

Property may remain in trust through the course of several generations, and successive generations may receive benefits from the trust property. Internal Revenue Code §2653(a) is intended to guarantee that a GST tax is collected only once at each generational level. The statute accomplishes this result by:

- Specifying that the individual who was the skip person with respect to the first GST becomes a nonskip person for purposes of subsequent distributions from that trust; and
- Treating the transferor as occupying the generation immediately above the highest generation of any person holding an interest in the trust immediately after the transfer.

In other words, the transferor has "dropped down" one generation.

EXAMPLE 1: T transfers property to an irrevocable trust for the benefit of T's grandchild, GC, and great-grandchild, GGC. During GC's life, the trust income may be distributed to GC and GGC in the trustee's absolute discretion. At GC's death, the trust property passes to GGC. Both GC and GGC have an interest in the trust for purposes of Chapter 13 of the Internal Revenue Code. The transfer by T to the trust is a direct skip, and the property is held in trust immediately after the transfer. After the direct skip, T is treated as being one generation above GC, the highest generation individual having an interest in the trust. Therefore, GC is no longer a skip person, and distributions to GC are not taxable distributions. Because GGC occupies a generation that is two generations below the deemed generation of T, however, GGC is a skip person and distributions of trust income to GGC are taxable distributions. Treas Reg §26.2653-1(b), Example 1.

If no person holds a present interest in the trust immediately after the GST, the transferor "moves down" to one generation above the highest generation assignment of all trust beneficiaries then in existence to whom a distribution could ever be made.

EXAMPLE 2: T transfers property to an irrevocable trust, providing that the income is to be paid to T's child, C, for life. At C's death, the trust income is to be accumulated for 10 years and added to principal. At the end of the 10-year accumulation period, the trust income is to be paid to T's grandchild, GC, for life. At GC's death, the trust property is to be paid to T's great-grandchild, GGC, or to GGC's estate. A GST occurs at C's death. Immediately after C's death and during the 10-year accumulation period, no person has an interest in the trust within the meaning of IRC §2652(c) and Treas Reg §26.2612-1(e) because no one can receive current distributions of income or principal. Immediately after C's death, T is treated as occupying the generation above the generation of GC (the trust beneficiary in existence at the time of the GST who then occupies the highest generation level of any person who may subsequently hold an interest in the trust). Thus, subsequent income distributions to GC are not taxable distributions. Treas Reg §26.2653-1(b), Example 2.

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§15.33 F. Nonresident Aliens

Treasury Regulation §26.2663-2 provides special rules regarding the application of the GST tax to transfers by a transferor who is a nonresident and not a citizen of the United States. Generally, no tax is imposed unless the original transfer was subject to United States estate or gift tax.

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III. CALCULATING THE TAX

A. Historical Background

§15.34 1. Problems With 1976 GST Tax

When the 1976 GST tax was enacted, trusts were viewed as potentially abusive vehicles for tax avoidance. To solve this perceived problem, the 1976 GST tax was "to be substantially equivalent to the transfer tax which would have been imposed if the property actually had been transferred outright to each successive generation." HR Rep No. 1380, 94th Cong, 2d Sess (1976), reprinted in 1976 US Code Cong & Ad News 3356, 3358.

To accomplish this goal, Congress created the fiction of the "deemed transferor" (see former IRC §2612), who was usually the person whose taxable estate was bypassed by the GST. For purposes of computing the former tax, the deemed transferor was treated as the grantor or transferor of the property passing to the next generation. The fiction of the deemed transferor caused several problems. Under some circumstances, difficulties arose either in identifying the deemed transferor or in ascertaining the deemed transferor's applicable estate or gift tax bracket. See former IRC §2602.

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§15.35 2. 1986 GST Tax Approach

The 1986 GST tax attempts to support the existing transfer tax system by imposing a tax at each generation level regardless of whether a trust is involved. In adopting this approach, Congress also simplified the GST tax system. Most taxpayers are removed from the system by the GST exemption, which may be allocated in each taxpayer's discretion (or in his or her executor's discretion) to any GST of which the taxpayer or decedent is the transferor. IRC §2631. The concept of the "deemed transferor" has been eliminated, and all GSTs are now purportedly taxed at a flat rate that is equal to the highest marginal estate and gift tax rate in effect at the time of the transfer. IRC §2641.

This attempt at simplification has been only partially successful. The 1986 GST tax is actually calculated by subjecting the transfer to taxation at the "applicable rate," which is not necessarily the highest marginal estate or gift tax rate then effective. The applicable rate is determined by multiplying the highest effective marginal rate by the "inclusion ratio," which represents the fraction of the transfer, if any, that has not been exempted from the GST tax through use of the transferor's GST exemption. For example, if the highest marginal effective estate tax bracket is 50 percent and half of the property transferred to a trust is exempted from the GST tax through use of the transferor's GST exemption, the inclusion ratio would be one half and the applicable rate would be 25 percent. See IRC §2641.

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B. GST Exemption

§15.36 1. Application of GST Exemption

Each transferor possesses an exemption from the GST tax equal to the IRC §2010 estate tax applicable exclusion amount. IRC §2631. The applicable exclusion amounts for each year are listed in §20.2A. As a general rule, the transferor of property for purposes of the GST tax is the person who (or whose estate) was last subject to estate or gift tax with respect to the transferred property. If a married couple elects to make split gifts for purposes of IRC §2513 (gift taxation), the transfer will be deemed to have been made half by each spouse for purposes of the GST tax, and each spouse may apply all or any portion of his or her GST exemption to that portion of the transfer attributed to that spouse. IRC §2652(a)(2).

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§15.37 2. QTIP Election and Reverse QTIP Election

As previously discussed, a GST exemption may be allocated at death only to property with respect to which the decedent is the transferor. A decedent is the transferor of property passing at death only if such property is subject to estate tax in the decedent's estate. This definition of "transferor" poses no problem when allocating an unmarried decedent's GST exemption or when allocating a married decedent's GST exemption to a credit shelter or bypass trust. Although the married decedent's applicable credit amount insulates the property allotted to the trust from estate tax, the property was nevertheless "subject to" the estate tax and is included in the decedent's taxable estate. Property qualifying for the marital deduction in the gross estate of a married decedent is not part of the decedent's taxable estate, however, and therefore is not "subject to" estate tax at that decedent's death.

Absent other provisions of Chapter 13 of the Internal Revenue Code, however, this definition of transferor once would have required (and may again require) a married couple to choose between full use of the marital deduction and full use of the GST exemption. This could still have happened if the couple made lifetime taxable gifts that did not use any GST exemption.

EXAMPLE: Assume that the first spouse to die dies in 2006, when the IRC §2010 estate tax applicable exclusion amount is $2 million, and his or her gross estate is $2 million (the amount of the GST exemption) after a lifetime taxable gift of $1 million to the couple's children that did not use any GST exemption. If the personal representative elects to use the marital deduction to defer all estate taxes in excess of the deceased spouse's remaining applicable exclusion amount of $1 million, the deceased spouse would be the transferor only of the property allotted to the credit shelter trust ($1 million), and the remaining portion of his or her GST exemption ($1 million) would be wasted. If the personal representative elects to make full use of the deceased spouse's GST exemption, the estate of the deceased spouse could not use the full marital deduction and would have to incur an estate tax. See §15.12.

Coordination of the marital deduction with the GST exemption is accomplished by the reverse QTIP election under IRC §2652(a)(3), which provides that in the case of

> any trust with respect to which a deduction is allowed to the decedent under [IRC] section 2056 by reason of subsection (b)(7) thereof [a QTIP election,] … the estate of the decedent … may elect to treat *all of the property in such trust* for purposes of this chapter as if the election to be treated as qualified terminable interest property had not been made. [Emphasis added.]

The practical consequence of a reverse QTIP election is that the original transferor spouse remains the GST tax transferor of the trust even after the trust is included in the surviving spouse's estate, or is subject to a gift by the surviving spouse. Accordingly, the GST tax on distributions to the QTIP remaindermen will still be determined based on the amount of GST exemption allocated to the trust by the original transferor.

If a QTIP election is made with respect to either a lifetime or a testamentary transfer to a spouse, the surviving spouse becomes the transferor for GST tax purposes because the property transferred is included in the gross estate of the survivor. If the estate plan creates both a credit shelter bypass trust and a QTIP marital deduction trust and a QTIP election is made, the first spouse to die will be treated as the transferor of the credit shelter bypass trust because the property transferred to that trust is included in the gross estate of the deceased spouse, and the surviving spouse will be treated as the transferor of the QTIP trust. Any GST occurring at the surviving spouse's death will be a direct skip and not a taxable termination. As a result, the predeceased ancestor exception will accordingly be available for transfers to a grandchild.

If a reverse QTIP election is made, the identity of the transferor will not change and the original transferor may allocate his or her GST exemption to the QTIP trust. Any GST occurring at the surviving spouse's death will be a taxable termination and not a direct skip. The predeceased ancestor exception will not be available. Once made, a reverse QTIP election is irrevocable. Treas Reg §26.2652-2(a). A reverse QTIP election must be made with respect to all the property in the trust to which the QTIP election applies. Protective reverse QTIP elections may be made. A

reverse QTIP election should not be made to the entire QTIP trust if the election and subsequent allocation of GST exemption would result in an inclusion ratio greater than zero. Instead, the QTIP trust should be severed into two trusts, or the governing instrument should provide for the ab initio creation of an exempt QTIP trust equal to the amount of the transferor's GST exemption allocated to that trust and a nonexempt QTIP trust to which the GST exemption will not be allocated.

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§15.38 C. Integrating GST Exemption and Marital Deduction by Using Formula to Create Exempt and Nonexempt Trusts

In terms of integrating the GST exemption into commonly used marital deduction formula clauses, at least three questions that may arise if the testator made lifetime taxable gifts that did not use any GST exemption (see §15.37) must be considered, two dealing with when the IRS will recognize the creation of separate trusts for purposes of allocating the GST exemption (the separate trust rules), and the other dealing with valuation of property transferred to such separate trusts for purposes of allocating the GST exemption (the valuation rules):

- If the will or trust agreement does not create separate QTIP trusts, will a discretionary division of the QTIP trust by the trustee into separate trusts, either in accordance with a boilerplate provision contained in the governing instrument or in accordance with state law, be recognized for purposes of allocating the GST exemption to one trust and not to the other?
- If the will or trust agreement creates separate trusts, will such trusts be recognized by the IRS for purposes of allocating the GST exemption?
- If the will or trust agreement creates separate trusts, will the property allocated to such trusts be valued using federal estate tax values for purposes of allocating the GST exemption?

The regulations provide detailed drafting rules that affect formula-based planning and drafting (see §§15.39-15.43):

(1) Treas Reg §26.2654-1(a), a separate trust rule, which determines when separate shares of a single trust will be recognized as separate trusts for purposes of allocating the GST exemption;

(2) Treas Reg §26.2654-1(b) states separate trust rules, applicable only when trusts are included in the transferor's gross estate, which specify when a division of a single trust into two or more trusts will be recognized for purposes of Chapter 13 of the Internal Revenue Code; and

(3) Treas Reg §26.2642-2 provides the valuation rules, which determine the value of the transferred property for purposes of determining the GST tax inclusion ratio.

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§15.39 1. Purpose of Trust Division

Internal Revenue Code §2642(b)(2)(A) establishes the general rule that property transferred as a result of the transferor's death will be valued for purposes of determining the inclusion ratio (*i.e.,* for purposes of allocating the GST exemption) using its final federal estate tax value. This section further provides, however, that if the regulatory provisions "respecting allocation of post-death changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned."

The legislative history of IRC §2642(b)(2)(A) provides (S Rep No. 100-445, 100th Cong, 2d Sess, 370 n92 (1988), reprinted in 1988 US Code Cong & Ad News 4515, 4880 n92):

> It is expected that in appropriate circumstances the Secretary of the Treasury will require that property distributed from the estate be fairly representative of the appreciation or depreciation in the value of all property available for the distribution. Cf. Rev Proc 64-19, 1964-1 Cum Bull 682.

An understanding of the "appropriate circumstances" test requires a brief analysis of Rev Proc 64-19, 1964-1 Cum Bull 682, which imposed restrictions on funding pecuniary amount formula marital deduction bequests if the governing instrument provided that the trustee could satisfy such bequests with assets at their value as finally determined for estate tax purposes. If such property experienced postdeath depreciation in value, an opportunity existed to minimize the surviving spouse's estate by funding the marital deduction bequest using depreciated property, even though the deceased spouse's estate would receive a deduction computed on the nondepreciated value of the assets.

EXAMPLE: Assume that the decedent's will used a pecuniary formula marital deduction clause that produced a marital gift of $1 million. Assume further that the decedent's gross estate included publicly traded securities having a date-of-death value of $1 million, but a value of $600,000 at the date on which the marital deduction bequest was to be funded. If the securities were used to fund the marital bequest, the decedent's estate would have had the advantage of a $1 million deduction, while transferring only $600,000 to the surviving spouse (*i.e.,* an amount less than the claimed deduction).

To minimize abuse in the funding of pecuniary amount marital deduction bequests, Rev Proc 64-19 disallows the marital deduction unless state law or the governing instrument requires the trustee to use date-of-distribution values or to select assets for distribution that are fairly representative of appreciation or depreciation in the value of all property available for distribution. Revenue Procedure 64-19 does not apply, inter alia, if the marital deduction bequest (a) is a pecuniary bequest that must be satisfied in cash or the residue of the estate or (b) uses a fractional share formula. An opportunity to minimize the surviving spouse's estate using depreciated property is not present in these cases.

A conceptually analogous, although factually reverse, opportunity for abuse was addressed by IRC §2642(b)(2)(A): the allocation of GST exemption using final federal estate tax values to property that has experienced postdeath appreciation. (This problem would exist, for example, if the decedent's will used a pecuniary formula marital deduction clause that produced a credit shelter gift of $2 million and property having a date-of-death value of $2 million and a date-of-distribution value of $3 million were allocated to the gift, and $2 million of the decedent's GST exemption could achieve an inclusion ratio of zero for the gift by being allocated to such property without regard to postdeath appreciation in value.)

Treasury Regulation §26.2642-2(b)(2) sets forth specific rules for the valuation of property for purposes of determining the denominator of the inclusion ratio. In applying the fairly representative test to the valuation rules, Treas Reg §26.2642-2(b)(3) introduces the requirement that certain bequests carry "appropriate interest."

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§15.40 2. Approach of Regulations to Separate Trusts

For purposes of Chapter 13, IRC §2654(b) provides that a single trust will be treated as two or more trusts if it consists of (1) transfers from different transferors or (2) substantially separate and independent shares of different beneficiaries.

Unfortunately, the regulations seemingly treat the separate share rule as if it were a multiple trust rule. In the examples in Treas Reg §26.2654-1(a)(5), what appear to be two separate bequests to two different beneficiaries (two separate trusts under state law) may be combined into a single trust for purposes of determining the inclusion ratio, if those two separate bequests do not meet the technical requirements of the separate share rule. See §15.41.

Treasury Regulation §26.2654-1(b) authorizes the severance of a single trust into separate trusts if the trusts are included in the gross estate. See §15.42.

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§15.41 a. Separate Share Rule

The regulations generally provide that a portion of a trust is not a separate share unless the share exists "from and at all times after" the creation of the trust. Treas Reg §26.2654-1(a)(1)(i). Unfortunately, the regulations fail to explain when a trust instrument creates separate trusts from the beginning (which would not be subject to IRC §2654(b)) or creates a single trust that is divided into separate trusts at a later date (which would be subject to IRC §2654(b)). Fortunately, the regulations eliminate the requirement that separate shares exist at all times in cases involving trust divisions mandated by the trust instrument if the trusts resulting from the division are recognized as separate trusts under applicable state law. Treas Reg §26.2654-1(a)(1)(iii), (a)(5), Example 8.

In Treas Reg §26.2654-1(a)(5), Example 3, quoted below, a revocable trust provides that, at the settlor's death, $500,000 is to be paid to the settlor's surviving spouse, and the balance of the trust is to be held for the benefit of the settlor's grandchildren in a GST. In this example, all the technical requirements for treating a single trust as consisting of separate and independent shares are deemed to have been met. Thus, the $500,000 bequest to the surviving spouse is not treated as if it were part of the trust corpus being administered for the settlor's grandchildren. The practical effect is that the bequest is not included in the denominator of the applicable fraction for purposes of determining the inclusion ratio.

In Treas Reg §26.2654-1(a)(5), Example 4, however, a similar bequest of $500,000 to a surviving spouse does not meet the technical requirements for treatment as a separate share. As a result, the bequest to the settlor's spouse will not be deemed separate from the trust for the settlor's grandchildren. The practical aspect of Example 4 may be illustrated by assuming that the settlor's estate, net after payment of estate tax, is $1,500,000. If the $500,000 bequest to the settlor's spouse is deemed separate and independent of the $1-million trust for the settlor's grandchildren, allocation of $1 million of the GST exemption will produce an inclusion ratio of zero. If the marital bequest is not separate from the trust for the settlor's issue, allocation of $1 million of the GST exemption produces an inclusion ratio of one-third (1 − ($1 million/$1,500,000)).

A further problem posed by this multiple trust approach is the possibility that the predeceased ancestor exception might not be available. Assume that in the preceding example, the settlor's only child had predeceased him, leaving issue (grandchildren of the settlor). The predeceased ancestor exception will be available if the $1-million trust is treated as a skip person. If the bequest to the settlor's spouse is not treated as separate and apart from the trust for the settlor's issue, however, the $1-million trust will not be treated as a skip person, because a nonskip person (the settlor's spouse) will be deemed to have an interest in the trust.

Because of the importance of Examples 3 and 4, they are set forth in full below.

EXAMPLE: *Pecuniary payment as separate share*. T creates a lifetime revocable trust, providing that at T's death $500,000 is payable to T's spouse, S, with the balance of the principal to be held for the benefit of T's grandchildren. The value of the trust is includable in T's gross estate at T's death. Under the terms of the trust, the payment to S must be made in cash. Under local law, S is entitled to receive interest on the payment at an annual rate of 6 percent, commencing immediately at T's death. For purposes of Chapter 13, the trust is treated as created at T's death, and the $500,000 payable to S from the trust is treated as a separate share. The result would be the same if the payment to S could be satisfied using noncash assets at their value on the date of distribution. Further, the result would be the same if the decedent's probate estate poured over to the revocable trust on the decedent's death and was then distributed in accordance with the terms of the trust. Treas Reg §26.2654-1(a)(5), Example 3.

EXAMPLE: *Pecuniary payment not treated as separate share.* The facts are the same as in the preceding example, except that the bequest to S is to be paid in noncash assets valued at their values as finally determined for federal estate tax purposes. Neither the trust instrument nor local law requires that the assets distributed in satisfaction of the bequest fairly reflect net appreciation or depreciation in all the assets from which the bequest may be funded. S's $500,000 bequest is not treated as a separate share, and the trust is treated as a single trust

for purposes of Chapter 13. Treas Reg §26.2654-1(a)(5), Example 4.

To qualify as creating separate trusts for different beneficiaries under Treas Reg §26.2654-1(a)(1)(ii), a pecuniary formula bequest must meet the following requirements:

(A) The trustee is required to pay appropriate interest or, within 15 months, the trustee must pay or permanently set aside property in satisfaction of the pecuniary amount, as provided in Treas Reg §26.2642-2(b)(4). Appropriate interest means interest payable from the date of the transferor's death or from the date specified under applicable state law, requiring payment of interest at a rate at least equal to the statutory rate of interest under state law or, if there is no statutory rate, not less than 80 percent of IRC §7520 interest at the date of death and not more than 120 percent of §7520 interest at the date of death. See §15.60.

(B) If the amount is payable in kind rather than in cash, the trustee must either use date-of-distribution values or allocate assets in a manner that fairly reflects net appreciation or depreciation in the value of the assets in the fund available to pay the pecuniary amount measured from the date of death to the date of payment.

NOTE: A minimum worth marital deduction formula clause (the lesser of date-of-distribution values or federal estate tax values) does not meet the requirements of the regulations.

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§15.42 b. Mandatory and Discretionary Trust Divisions

Treasury Regulation §26.2654-1(b) authorizes mandatory and discretionary severances of single trusts into separate trusts when the trust is included in the transferor's gross estate. Treasury Regulation §26.2654-1(b)(1)(i) merely requires that the severance be mandated by a direction in the governing instrument providing that the trust is to be divided on the death of the transferor. Treasury Regulation §26.2654-1(b)(1)(ii) has more complex requirements, but can be used when the governing instrument is silent or leaves trust division to the trustee's discretion. In some cases, a trust may be divided into two or more trusts under the more liberal requirements of IRC §2642(a)(3). Under the regulations, a severance is qualified if (1) the trust is severed pursuant to the terms of the governing instrument or local law, (2) the severance is effective under local law, (3) the new trusts are funded within 90 days of the severance, (4) the trust is severed on a fractional share basis, (5) the new trusts provide for the same succession of interests of beneficiaries as provided in the original trust, and (6) the new trusts are completely exempt or nonexempt. (For these purposes, trust assets are valued without regard to any discount or premium arising from the severance.) Treas Reg §26.2642-6(d). Under the regulations, trusts resulting from a severance other than a qualified severance will be treated as separate trusts (with the same inclusion ratio as the original trust) provided that the trusts are recognized as separate trusts under state law. Treas Reg §26.2642-6(h). Generally, however, the division of the marital deduction trust into exempt and nonexempt trusts should be mandated by the governing instrument. See discussion in §15.12. See form in §15.43.

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§15.43 3. Form: Division of Marital Trust Into Exempt and Nonexempt Trusts

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15.43-1 Marital trust divided into exempt and nonexempt trusts

***Division Into Exempt and Nonexempt Trusts*. If any of my generation-skipping transfer (GST) tax exemption is to be allocated to the marital trust, the assets that would otherwise be used to establish a single marital trust shall instead be allocated on a fractional share basis between two marital trusts, one with a GST tax inclusion ratio of one (the "GST Nonexempt Marital Trust") and the other with a GST tax inclusion ratio of zero (the "GST Exempt Marital Trust"). A reverse QTIP election shall be made for the GST Exempt Marital Trust and the estate taxes resulting from inclusion of that trust in the estate of my spouse under Internal Revenue Code §2044 shall be paid from the GST Nonexempt Marital Trust unless the tax will otherwise be paid from a source other than the marital trusts.**

Comment: If a qualified terminable interest property (QTIP) election is made under IRC §2056(b)(7) or §2523(f) with respect to the transferred property, the QTIP trust will be included in the taxable estate of the transferee spouse, who will become the new transferor. Solely for purposes of Chapter 13 of the Internal Revenue Code, IRC §§2044, 2207A, and 2519 do not apply for purposes of determining the transferor's identity. Any GST occurring at the transferee spouse's subsequent death will be a direct skip.

The transferor spouse (or the transferor's executor) may elect under IRC §2652(a)(3) to remain the transferor for purposes of Chapter 13 only by making a reverse QTIP election. The election for transfers occurring at death is made by checking the appropriate box on Part 1 of Schedule R of Form 706, the federal estate tax return. Once made, the election is irrevocable. See Treas Reg §26.2652-2(a).

When the reverse QTIP election has been made, the original transferor may allocate his or her GST exemption to the QTIP trust. A taxable termination and not a direct skip will occur at the transferee spouse's death. The predeceased child exception will be unavailable because it applies only to direct skips to or for the benefit of issue of a predeceased child. It is therefore important to allocate sufficient GST exemption to produce an inclusion ratio of zero. Assuming the testator's remaining unused GST exemption has a value that is less than the value of the QTIP trust, it will be impossible to have a QTIP trust with a zero inclusion ratio unless the QTIP trust is divided into two trusts, one of which has a value equal to the value of the GST exemption. The above clause requires this division and is sufficient to authorize a severance that will be recognized for GST tax purposes. See Treas Reg §26.2654-1(b)(1)(i).

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D. Allocating GST Exemption

§15.44 1. When Exemption May Be Allocated

Each individual (or his or her executor) may allocate the individual's GST exemption at any time from the date of the transfer through the date for filing the individual's estate tax return, including any extensions actually granted. If no estate tax return is required to be filed, the GST exemption may be allocated at any time through the date on which the estate tax return would have been due had a return been required. If property is held in trust, the allocation must be to the entire trust. GST exemption may not be allocated to specific trust assets. Treas Reg §26.2632-1(a). An allocation of GST exemption may be made by a formula. For instance, the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero. Once made, an allocation of GST exemption is irrevocable. Treas Reg §26.2632-1(b)(4)(i).

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§15.45 2. Lifetime Transfers

The GST exemption for lifetime transfers may be allocated by the transferor or his or her executor at any time before the due date of the transferor's federal estate tax return. IRC §2632(a)(1). Allocations during the transferor's lifetime are made on the transferor's gift tax return. If the exemption is not allocated during his or her lifetime, the exemption may be allocated on the transferor's estate tax return. Treas Reg §26.2632-1(a). Once made, an election to allocate GST exemption is irrevocable. However, a subsequently filed but still timely gift tax return may amend any allocation made on a previously filed gift tax return. Treas Reg §26.2632-1(b)(4)(i), (ii).

EXAMPLE 1: *Modification of allocation of GST exemption.* T transfers $100,000 to an irrevocable trust on December 1, 2003. The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 2004. On February 10, 2004, T files a Form 709, allocating $50,000 of GST exemption to the trust. On April 13 of the same year, T files an amended Form 709, allocating $100,000 of GST exemption to the trust in a manner that clearly indicates the intention to modify and supersede the prior allocation with respect to the 2003 transfer. The allocation made on the April 13 return supersedes the prior allocation because it is made on a timely filed Form 709 that clearly identifies the trust and the nature and extent of the modification of GST exemption allocation. The allocation of $100,000 of GST exemption to the trust is effective as of December 1, 2003. The result would be the same if the amended Form 709 decreased the amount of the GST exemption allocated to the trust. Treas Reg §26.2632-1(b)(4)(iii), Example 1.

EXAMPLE 2: *Modification of allocation of GST exemption.* The facts are the same as in the preceding example, except that on July 8, 2004, T files a Form 709, attempting to reduce the earlier allocation. The return is not filed timely. The $100,000 GST exemption allocated to the trust, as amended on April 13, 2004, remains in effect because an allocation, once made, is irrevocable and may not be modified after the last date on which a timely filed Form 709 can be filed. Treas Reg §26.2632-1(b)(4)(iii), Example 2.

In the absence of a contrary election, there is an automatic "deemed" allocation of exemption to all lifetime direct skip transfers even if no Form 709 is filed. The amount of the deemed allocation is normally the amount needed to produce an inclusion ratio of zero. IRC §2632(b)(1). If the transfer exceeds the available exemption, the entire exemption will be deemed allocated. IRC §2632(b)(1). Automatic allocation may be prevented *only* by filing a *timely* Form 709, which describes the transfer and the extent to which automatic allocation will not occur, or by filing a timely Form 709 and paying the GST tax. The return must be filed by the due date plus any extensions actually granted. Such an election would be unusual unless the transferor's remaining exemption is to be allocated to other transfers in the same year. The election not to allocate and the automatic allocation are irrevocable after the due date. IRC §2632(b)(3); Treas Reg §26.2632-1(b)(1)(ii). The transferor may allocate less than the amount necessary to reduce the exclusion ratio to zero, but, once made, this allocation is irrevocable. IRC §2631(b).

In the absence of a contrary election, there is also an automatic deemed allocation of exemption to lifetime transfers to trusts defined as "GST trusts" and the transferor may elect deemed allocation for transfers to any trust. IRC §2632(c).

EXAMPLE: Assume that the transferor establishes a trust, which provides income for child C for life, followed by distribution of principal to grandchild GC at C's death. The transfer of property to the trust is not a direct skip because C, who possesses a present interest in the trust, is not a skip person. If the transferor has not elected deemed allocation for the trust and the trust is not a "GST trust" or the transferor has elected not to have deemed allocation apply to the trust, and the transferor wishes to allocate GST exemption to such a transfer, GST exemption may be allocated on Form 709. The return must identify (a) the trust to which the allocation is being made, (b) the amount of GST exemption being allocated, and (c) the value of the trust principal at the time of the allocation unless the allocation is made on a timely return and the inclusion ratio will be zero. Treas Reg §26.2632-1(b)(2)(i), (4)(i). The regulations authorize allocation by formula, *i.e.,* "the amount necessary to produce an inclusion ratio of zero." See Treas Reg §26.2632-1(b)(2)(i), (4)(i). The return should set forth the inclusion

ratio.

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§15.46 3. Effective Date of Allocation to Lifetime Transfers

An election to allocate all or a portion of the transferor's GST exemption to lifetime nondirect skip transfers is made on the transferor's gift tax return. This allocation may be made on either a timely filed or a late return. See IRC §2642(b)(1).

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§15.47 a. Timely Filed Gift Tax Return

If the gift tax return is timely filed and the transferor either relies on the deemed allocation rules (*i.e.,* does not opt out of the automatic allocation rules for direct skips and transfers to GST trusts under Treas Reg §26.2632-1(b)(2), or elects to have automatic allocation apply to any trust under IRC §2632(b)(3), (c)(5); Treas Reg §26.2632-1(b)(3)) or affirmatively allocates a portion of the available exemption to the transfer under IRC §2632(a), the allocation is effective on the date of the transfer (IRC §2642(b)(1)(B)) and the value of the property transferred as determined for gift tax purposes also controls for purposes of determining the inclusion ratio (IRC §2642(b)(1)(A)). For retroactive allocations to previous transfers to trusts, the allocation is effective immediately before the death of the beneficiary giving rise to the allocation, but the inclusion ratio is determined using the value of the property transferred on the date of the transfer if the allocation is made on a timely filed gift tax return for a gift made in the year of the beneficiary's death. IRC §2632(d). Relief from late allocations and elections may be allowed under IRC §2642(g). See Notice 2001-50, 2001-2 Cum Bull 189. See also IRS Letter Rulings 200316031, 200241040, 200227017, 200223016, 200218001. For proposed IRS rules and procedures for seeking and granting relief that specifically address applications for extensions of time, see Prop Treas Reg §26.2642-7 and notice of proposed rulemaking in REG-147775-06, 2008-19 Int Rev Bull 916.

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§15.48 b. Late Gift Tax Return

If the election to allocate is made on a late gift tax return, and relief is not allowed under IRC §2642(g), the allocation does not relate back to the date of the transfer but is instead effective from and after the date of filing the return. IRC §2642(b)(3)(B). Moreover, for purposes of determining the inclusion ratio, the property transferred is valued as of the date of the late filing. IRC §2642(b)(3)(A). The transferor may elect to value property in trust (except for a life insurance policy, if the transferor has died) on the first day of the month in which the late allocation is made. Treas Reg §26.2642-2(a)(2).

NOTE: For these purposes, Form 709 is deemed filed on the date it is postmarked to the IRS address as directed in forms or other guidance published by the IRS. Treas Reg §26.2632-1(b)(4)(ii)(A)(1). A late allocation to a trust may be made on a Form 709 that is timely filed with respect to another transfer. A late allocation is irrevocable when made. Treas Reg §26.2632-1(b)(4)(ii)(A)(2).

Late filing can have substantial adverse consequences when the transfer is made to a trust, because taxable events occurring before the filing of the late election are unlikely to be exempt from the GST tax. In addition, more of the transferor's GST exemption will have to be allocated if the value of the transferred property appreciates between the date of the transfer and the date of the late filing.

EXAMPLE: *Effective date of late allocation of GST exemption.* T transfers $100,000 to an irrevocable GST trust on December 1, 2003. The transfer to the trust is not a direct skip. The date prescribed for filing the gift tax return reporting the taxable gift is April 15, 2004. On February 10, 2004, T files a Form 709 and allocates $50,000 to the trust. The allocation is effective as of December 1, 2003. Treas Reg §26.2632-1(b)(4)(iii), Example 3.

If a late allocation of GST exemption occurs on the same day as a GST, the allocation is treated as having been made immediately before the transfer.

EXAMPLE: *Effective date of late allocation of GST exemption.* T transfers $100,000 to an irrevocable GST trust on December 1, 2003, in a transfer that is not a direct skip. On April 15, 2004, T files a Form 709 on which T properly elects out of the automatic allocation rules with respect to the entire transfer; T does not make an allocation of GST exemption on Form 709. On September 1, 2004, the trustee makes a taxable distribution from the trust to T's grandchild in the amount of $30,000. Immediately prior to the distribution the value of the trust assets was $150,000. On the same date, T allocates GST exemption to the trust in the amount of $50,000. The allocation of GST exemption on the date of the transfer is treated as having preceded the taxable distribution. At the time of the GST, the trust has an inclusion ratio of 0.6667 (1 − ($50,000/150,000)). Treas Reg §26.2632-1(b)(4)(iii), Example 4.

If it is unclear whether allocation of a GST exemption on a Form 709 is late or timely, the regulations provide that the allocation will be effective in the following order (Treas Reg §26.2632-1(b)(4)(ii)(A)(1)):

(i) To any transfer to the trust disclosed on the return as to which the allocation is timely;

(ii) As a late allocation; and

(iii) To any transfer not disclosed on the return as to which the allocation is timely.

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§15.49 4. Estate Tax Inclusion Period (ETIP)

Allocation of GST exemption (including an automatic allocation) to property subject to an estate tax inclusion period (ETIP) is effective no earlier than the termination of the ETIP. IRC §2642(f). A transfer to a GST trust is similarly treated as made at the termination of the ETIP. IRC §2632(c)(4); Treas Reg §26.2632-1(b)(2)(i), (c)(1). An ETIP is the period during which the value of transferred property would be includable (other than by reason of IRC §2035) in the gross estate of the transferor or the spouse of the transferor. Treas Reg §26.2632-1(c)(2)(i).

Under an exception, there is no ETIP if it can be ascertained by actuarial standards that there is less than a 5-percent probability that the property will be included in the gross estate of the transferor spouse. Treas Reg §26.2632-1(c)(2)(ii)(A).

Under another exception, there is no ETIP if the spouse has a *Crummey* withdrawal power permitting withdrawal of not more than the greater of $5000 or 5 percent of the trust corpus for a period not exceeding 60 days. Treas Reg §26.2632-1(c)(2)(ii)(B).

Allocation of GST exemption will be effective upon termination of the ETIP if the allocation is made on a Form 709 filed by the due date that would apply to a taxable gift occurring at the time the ETIP terminates.

EXAMPLE: *Allocation of GST exemption during ETIP.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. If T dies within the 9-year period, the value of the trust principal is includable in T's gross estate under IRC §2036(a). Treas Reg §20.2036-1(c). Thus, the trust is subject to an ETIP. T files a timely Form 709, reporting the transfer and allocating $100,000 of GST exemption to the trust. The allocation of GST exemption to the trust is not effective until the termination of the ETIP. Treas Reg §26.2632-1(c)(5), Example 1.

If a GST occurs during the ETIP, however, a prior allocation of GST exemption will be deemed to be effective immediately before the GST.

EXAMPLE: *Effect of prior allocation on termination of ETIP.* The facts are the same as in the preceding example, except that the trustee has the power to invade trust principal on behalf of T's grandchild, GC, during the term of T's income interest. In the fourth year, when the value of the trust is $200,000, the trustee distributes $15,000 to GC. The distribution is a taxable distribution. The ETIP with respect to the property distributed to GC terminates at the time of the taxable distribution. See Treas Reg §26.2632-1(c)(3)(iii). Solely for purposes of determining the trust's inclusion ratio with respect to the taxable distribution, the prior $100,000 allocation of GST exemption (as well as any additional allocation made on a timely ETIP return) is effective immediately before the taxable distribution. See Treas Reg §26.2642-1(b)(2). The trust's inclusion ratio with respect to the taxable distribution is therefore 0.50 (1 − (100/200)). Treas Reg §26.2632-1(c)(5), Example 2.

If the transferor's spouse consented to have the transfer treated as half made by that spouse (gift splitting), neither the transferor nor the consenting spouse may allocate GST exemption to the transferred property during the ETIP.

EXAMPLE: *Split-gift transfers subject to ETIP.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. T files a timely Form 709, reporting the transfer. T's spouse, S, consents to have the gift treated as half made by *S* under IRC §2513. Because S is treated as transferring half of the property to T's grandchild, S becomes the transferor of half of the trust for purposes of Chapter 13 of the Internal Revenue Code. Because the value of the trust would be includable in T's gross estate if T died immediately after the transfer, S's transfer is subject to an ETIP. If S should die prior to the termination of the trust, S's executor may allocate S's GST exemption to the trust, but only to the portion of the trust for which S is treated as the transferor. However, the allocation does not become effective until the earlier of the expiration of T's income interest or T's death. Treas Reg §26.2632-1(c)(5), Example 3.

An ETIP terminates on the first to occur of the following:

- The death of the transferor (Treas Reg §26.2632-1(c)(3)(i));
- The time when no portion of the transferred property is includable in the transferor's gross estate (other than by reason of IRC §2035) or, for an individual who is a transferor solely by reason of gift splitting, when no portion would be includable in the gross estate of the transferor's spouse (other than by reason of IRC §2035) (Treas Reg §26.2632-1(c)(3)(ii));
- The time of any GST, with respect to the property subject to that GST (Treas Reg §26.2632-1(c)(3)(iii)); or
- For an ETIP arising by reason of an interest or power held by the transferor's spouse, at the first to occur of:
- The death of the spouse (Treas Reg §26.2632-1(c)(3)(iv)(A)); or
- The time when no portion of the property would be includable in the spouse's gross estate (other than by reason of IRC §2035) (Treas Reg §26.2632-1(c)(3)(iv)(B)).

EXAMPLE: *Transfer of retained interest as ETIP termination.* The trust instrument provides that trust income is to be paid to T for 9 years or until T's prior death. The trust principal is to be paid to T's grandchild on the termination of T's income interest. Four years after the initial transfer, T transfers the income interest to T's sibling. The ETIP with respect to the trust terminates on T's transfer of the income interest because, after the transfer, the trust property would not be includable in T's gross estate (other than by reason of IRC §2035) if T died at that time. Treas Reg §26.2632-1(c)(5), Example 4.

It is important to note that if the transferor makes a gift to an irrevocable insurance trust over which his or her spouse possesses a *Crummey* demand right, the transfer subject to the *Crummey* right would be includable in the gross estate of the transferor's spouse during the period that the withdrawal right was exercisable, including any period during which the right "hangs." The effect of this provision would be to delay allocation of the transferor's GST exemption until the power lapses unless the withdrawal power is limited to fit within the exception described in Treas Reg §26.2632-1(c)(2)(ii)(B).

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§15.50 5. Transfers at Death

If the GST occurs at the transferor's death, any unused portion of the exemption may be allocated on a timely filed estate tax return. IRC §§2631(a), 2632(a). Allocations are made by the executor. Treas Reg §26.2632-1(d)(1). If no executor or administrator is appointed, qualified, or acting within the United States, the executor is the person in actual or constructive possession of the largest portion of the value of the decedent's gross estate. Treas Reg §26.2652-1(d)(1).

Any portion of the exemption that is not allocated by the executor on the estate tax return is deemed first to be allocated to direct skips and then to trusts. IRC §2632(e)(1). The automatic allocation is made in proportion to the respective amounts of the nonexempt portions of properties within each category. IRC §2632(e)(2). No automatic allocation will occur to any trust that will have a new transferor for the entire trust before any GST, *e.g.,* a QTIP trust with respect to which a special QTIP election is *not* made. No automatic allocation will occur to any trust during the first 9 months following the decedent's death if (a) no GST occurs during that time and (b) at the end of nine months, no future GST can occur from that trust (*e.g.,* a disclaimer that vests the trust in a nonskip person).

If the automatic allocation rules apply, automatic allocation will occur on the due date for filing Form 706, whether or not the form is actually filed. Automatic allocation is irrevocable and a late attempt by the executor to allocate is ineffective. IRC §2631(b).

The allocation is made on Form 706 with respect to property included in the gross estate. The allocation is effective as of the date of death if the form is filed on or before the due date, including any extensions actually granted.

A timely allocation of GST exemption to a lifetime transfer not included in the gross estate but with respect to which the time for filing the decedent's gift tax return has not occurred may be made by the executor on a timely filed Form 709.

Treasury Regulation §26.2632-1(d)(1) provides that a late allocation to a lifetime transfer not included in the gross estate is made on Form 706, Form 706NA, or Form 709 (filed on or before the due date of the estate tax return). A late allocation is effective on the date of filing.

An allocation of GST exemption to a trust, whether or not funded when Form 706 is filed, is effective if the notice of allocation clearly identifies the trust and the amount of GST exemption allocated. As previously noted, a formula may be used.

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6. Effect of Allocation

§15.51 a. Direct Skips

If GST exemption is allocated to a direct skip, a fraction of the transfer equal to the exemption allocated divided by the value of the transferred property is effectively not subject to the GST tax. See IRC §2642(a), (c)(1). For example, if $100,000 of the transferor's GST exemption is allocated to a $300,000 gift to a grandchild, the GST tax will be calculated at a tax rate bracket that effectively imposes a tax on only $200,000.

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§15.52 b. Transfers in Trust

If the GST exemption is allocated to a transfer in trust, a fractional share of the property in the trust is effectively exempt from the GST tax for future GSTs. See IRC §2642(a), (c)(2). The numerator of the fraction is the allocated portion of the exemption, and the denominator is the value of the trust corpus. IRC §2642(a)(2).

This effective reduction in the GST tax rate is accomplished by reducing the applicable rate to reflect the portion of the transferred property that is not subject to the GST tax. For example, if $100,000 of the transferor's GST exemption is allocated to a $300,000 transfer to a trust that provides for successive life estates for a child and a grandchild, the rate applying to the taxable termination occurring at the child's death will be two thirds of the maximum effective estate tax bracket then in effect. If a transfer in trust is a direct skip (*e.g.,* a transfer to a trust in which only the transferor's grandchildren possess present interests), the same reduction in the applicable rate will apply to the GST tax imposed on the transfer to the trust.

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E. Determining Applicable Rate

§15.53 1. Effective Tax Rate Applied to Transfer

GSTs are subject to tax at a flat rate, equal to the highest marginal estate tax rate in effect at the time of the transfer. IRC §2641. (For GSTs in years after 2010, the applicable tax rate is the maximum estate and gift tax rate in effect without regard to the IRC §2001(c)(2) 5-percent surcharge on estates in excess of $10 million. Treas Reg §26.2641-1.) This flat rate will not apply to the entire transfer, however, if a portion of that transfer has been exempted from the GST tax through use of the transferor's GST exemption, equal to the IRC §2010 applicable exclusion amount in 2004-2009 and $1 million (plus cost-of-living adjustments from a base year of 1997) in 2011 and thereafter. IRC §§2631(a), 2642(a). The applicable exclusion amounts are listed in §20.2A.

Congress was faced with two approaches to calculating the GST tax when part of the transfer is exempt from tax:

- Apply the flat rate to only the portion of the transfer that is subject to the GST tax; or
- Adjust the flat rate to reflect the effective tax rate applicable to the transfer and apply that effective rate to the entire transfer.

In the interests of long-term simplicity, Congress chose the second approach, as described in §15.54. See IRC §§2641-2642.

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§15.54 2. Inclusion Ratio for Nonexempt Portion

The inclusion ratio is the means by which the flat rate is adjusted to reflect the effective tax bracket applicable to the entire transfer. The inclusion ratio reflects the portion of the transferred interest (which can range from 0 to 100 percent) that is subject to the GST tax. See IRC §2642. The inclusion ratio is computed by subtracting the applicable fraction from one. IRC §2642(a)(1). The applicable fraction represents the fraction of the transferred interest (which can range from 0 to 100 percent) that has been exempted from the GST tax by use of the IRC §2631 GST exemption. IRC §2642(a)(2). See §15.55. If a trust has an inclusion ratio of greater than zero and less than one, the trust may be divided into two trusts, one with an inclusion ratio of zero and one with an inclusion ratio of one, if the trust is divided on a fractional basis and the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as the original trust. IRC §2642(a)(3).

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§15.55 3. Applicable Fraction for Exempt Portion

The inclusion ratio is the means by which the flat rate is adjusted to reflect the effective tax bracket applicable to the entire transfer. Except for ETIPs and charitable lead annuity trusts, the numerator of the applicable fraction is the amount of GST exemption allocated to the transfer. Treas Reg §26.2642-1(b). In an ETIP, the numerator is the sum of the exemption previously allocated, reduced (but not below zero) by the nontax amount of prior GSTs with respect to the trust, plus any GST exemption allocated on a timely ETIP return filed after termination of the ETIP. The nontax amount of a prior GST is the amount of the GST tax multiplied by the applicable fraction at the time of the GST.

As a general rule, the denominator of the applicable fraction is the value of the property transferred.

EXAMPLE: *Computation of inclusion ratio.* T transfers $100,000 to a newly created irrevocable trust, providing that income is to be accumulated for 10 years. At the end of 10 years, the accumulated income is to be distributed to T's child, C, and the trust principal is to be paid to T's grandchild. T allocates $40,000 of T's GST exemption to the trust on a timely filed gift tax return. The applicable fraction with respect to the trust is 0.40 ($40,000 (the amount of GST exemption allocated to the trust) over $100,000 (the value of the property transferred to the trust)). The inclusion ratio is 0.60 (1 − 0.40). If the maximum federal estate tax rate is 50 percent at the time of a GST, the rate of tax applicable to the transfer (applicable rate) will be 0.30. See Treas Reg §26.2642-1(d), Example 1.

For purposes of determining the applicable fraction, the value of the property transferred is reduced by the sum of (IRC §§2503(e), 2505(b); Treas Reg §26.2642-1(c)):

- Any federal estate tax and any state death tax incurred by reason of the transfer that is chargeable to the trust and is actually recovered from the trust;
- The amount of any charitable deduction allowed under IRC §2055, §2106, or §2522 with respect to the transfer; and
- For a direct skip, the value of the portion of the transfer that is a nontaxable gift.

EXAMPLE: *Denominator of applicable fraction of QTIP trust.* T bequeaths $1,500,000 to a trust in which T's surviving spouse, S, receives an income interest for life. At the death of S, the property is to remain in trust for the benefit of C, the child of T and S. At C's death, the trust is to terminate, and the trust property is to be paid to the descendants of C. The bequest by T qualifies for the estate tax marital deduction under IRC §2056(b)(7) as qualified terminable interest property. The executor does not make the reverse QTIP election under IRC §2652(a)(3)(A). As a result, S becomes the transferor of the trust at S's death when the value of the property in the QTIP trust is included in S's gross estate under IRC §2044. For purposes of computing the applicable fraction with respect to the QTIP trust at S's death, the denominator of the fraction is reduced by any federal estate tax (whether imposed under IRC §2001, §2101 or §2056A(b)) and state death tax attributable to the trust property that is actually recovered from the trust. Treas Reg §26.2652-2(d), Example 3.

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§15.56 4. Inclusion Ratio for Nontaxable Gifts

If a transfer is an outright direct skip that is not in trust, and is exempt from gift tax by virtue of the annual exclusion (IRC §2503(b)) or the medical or educational expense exemption (IRC §2503(e)), the inclusion ratio is zero. IRC §2642(c)(1). If a transfer is a direct skip in trust, the transfer will have an inclusion ratio of zero only if (IRC §2642(c)(2)):

- There is only one beneficiary of the trust;
- During the life of the beneficiary, no portion of the corpus or income of the trust may be distributed to or for the benefit of any person other than that beneficiary; and
- The assets of the trust will be includable in the beneficiary's gross estate if the trust does not terminate before the beneficiary dies.

EXAMPLE: *Gift entirely nontaxable.* On December 1, 1996, T transfers $10,000 to an irrevocable trust for the benefit of T's grandchild, GC. GC possesses a right to withdraw any contributions to the trust such that the entire transfer qualifies for the annual exclusion under IRC §2503(b). Under the terms of the trust, the income is to be paid to GC for 10 years or until GC's prior death. On the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. The transfer to the trust is a direct skip. T made no prior gifts to or for the benefit of GC during 1996. The entire $10,000 transfer is a nontaxable transfer. For purposes of computing the tax on the direct skip, the denominator of the applicable fraction is zero, and thus the inclusion ratio is zero. Treas Reg §26.2642-1(d), Example 2.

If a transfer is nontaxable in part, solely for purposes of computing the GST tax, the transfer is divided into a nontax portion with an automatic inclusion ratio of zero and a tax portion to which the transferor may allocate GST exemption. If the automatic allocation rules apply, the tax portion will also have an inclusion ratio of zero unless the transferor files a timely gift tax return and opts not to have the automatic allocation rules apply.

EXAMPLE: *Gift nontaxable in part.* T transfers $12,000 to an irrevocable trust for the benefit of T's grandchild, GC. Under the terms of the trust, the income is to be paid to GC for 10 years or until GC's prior death. On the expiration of GC's income interest, the trust principal is payable to GC or GC's estate. Further, GC has the right to withdraw $10,000 of any contribution to the trust such that $10,000 of the transfer qualifies for the annual exclusion under IRC §2503(b). The amount of the nontaxable transfer is $10,000. Solely for purposes of computing the tax on the direct skip, T's transfer is divided into two portions. One portion is equal to the amount of the nontaxable transfer ($10,000) and has a zero inclusion ratio; the other portion is $2000 ($12,000 − $10,000). With respect to the $2000 portion, the denominator of the applicable fraction is $2000. Assuming that T has sufficient GST exemption available, the numerator of the applicable fraction is $2000 (unless T elects to have the automatic allocation provisions not apply). Thus, assuming T does not elect to have the automatic allocation not apply, the applicable fraction is 1 ($2000/$2000 = 1) and the inclusion ratio is zero (1 − 1 = 0). Treas Reg §26.2642-1(d), Example 3.

EXAMPLE: *Gift nontaxable in part.* Assume the same facts as in the preceding example, except that T files a timely Form 709 electing that the automatic allocation of GST exemption not apply to the $12,000 transferred in the direct skip. T's transfer is again divided into two portions: a $10,000 portion with a zero inclusion ratio and a $2000 portion with an applicable fraction of zero (0/$2000 = 0) and an inclusion ratio of 1 (1 − 0 = 1). Treas Reg §26.2642-1(d), Example 4.

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§15.57 5. Inclusion Ratio for Charitable Lead Annuity Trusts

Under IRC §2642(e), the inclusion ratio of a charitable lead annuity trust is not determined until the charitable interest terminates. At that time, the numerator of the applicable fraction is the amount of the GST exemption allocated at the time of the transfer, increased by an interest factor equal to the interest rate used in determining the charitable deduction (the "adjusted GST exemption"). The denominator of the applicable fraction is the fair market value of all property in the trust immediately after termination of the charitable lead annuity. Treas Reg §26.2642-3(a). For purposes of determining the adjusted GST exemption, the interest rate is compounded annually for the actual period of the charitable lead annuity trust. Treas Reg §26.2642-3(b).

If a late allocation of GST exemption is made to a charitable lead annuity trust, the regulations provide that the adjusted GST exemption is the amount of GST exemption allocated to the trust, increased by the interest factor for the period beginning on the date of the late allocation and continuing for the balance of the term of the trust. Treas Reg §26.2642-3(b). This provision does not appear to be supported by the statute.

To a great degree, this provision eliminates use of the charitable lead annuity trust as a means of leveraging the GST exemption. Charitable lead unitrusts are not affected by the amendment, because the built-in inflation-reflective ability of a unitrust reduces the possibility of leveraging.

If more GST exemption is allocated to a charitable lead annuity trust than is necessary to produce an adjusted GST exemption equal to the value of the property at the end of the trust term, the excess allocation is not void. Unlike most other situations involving excess allocations, the excess is lost to the taxpayer under these circumstances. Treas Reg §26.2642-3(b).

EXAMPLE: T creates a charitable lead annuity trust for a 10-year term with the remainder payable to T's grandchild. T timely allocates an amount of GST exemption to the trust, which T expects will ultimately result in a zero inclusion ratio. At the end of the charitable lead interest, however, because the property has not appreciated to the extent T anticipated, the numerator of the applicable fraction is greater than the denominator. The inclusion ratio for the trust is zero. No portion of the GST exemption allocated to the trust is restored to T or T's estate. Treas Reg §26.2642-3(c).

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§15.58 6. Valuation of Lifetime Transfers

Treasury Regulation §26.2642-2(a)(1) establishes the general rule that for purposes of determining the denominator of the applicable fraction, the value of property transferred during the transferor's lifetime is its fair market value on the effective date of the allocation. In the case of a timely allocation under Treas Reg §26.2632-1(b)(4)(ii), the denominator of the applicable fraction is the fair market value of the property as finally determined for gift tax purposes.

A late allocation to a trust is based on the value of the property on the effective date, *e.g.,* the date of filing. For purposes of making a late allocation, the transferor may elect to treat the allocation as having been made on the first day of the month during which the late allocation is made. This rule does not apply to life insurance. The election is not valid until filed with the IRS and is made by stating on Form 709 (i) that the election is being made, (ii) the applicable valuation date, and (iii) the fair market value of the assets on the valuation date. Treas Reg §26.2642-2(a)(2).

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§15.59 7. Valuation of Transfers at Death

Treasury Regulation §26.2642-2(b) establishes the general rule that, for purposes of determining the denominator of the applicable fraction, the value of property included in the transferor's gross estate is its value as determined for estate tax purposes. Internal Revenue Code §2032A property is valued at its *reduced* value, provided the IRC §2032A recapture agreement expressly provides for recapture of the GST tax. Treas Reg §26.2642-2(b)(1).

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§15.60 8. Rules for Pecuniary Bequests

Special rules apply to pecuniary bequests under Treas Reg §26.2642-2(b)(2)(i):

- If the pecuniary bequest is satisfied in cash, the denominator of the applicable fraction is the pecuniary amount.
- If the pecuniary bequest is satisfied in kind, the denominator of the applicable fraction is the pecuniary amount only if the payment must be made on the basis of (a) the date of distribution; or (b) the value of the property as of some other date, which may include the date of death, as long as the payment must be satisfied on a basis that fairly reflects net appreciation and depreciation occurring between the valuation date and the date of distribution of all assets from which the distribution could have been made. Otherwise, the denominator is the date of distribution value of the property. Treas Reg §26.2642-2(b)(2)(ii).

The regulations provide special rules when GST exemption is allocated to a *residual* transfer following a pecuniary bequest. These rules will apply to the allocation of GST exemption to the residuary trust in an estate plan that uses a pecuniary amount marital deduction formula, followed by a residuary credit shelter trust, or to a mirror-image plan that uses a pecuniary amount credit shelter bequest, followed by a residuary marital deduction trust. The general rule is that the denominator of the applicable fraction with respect to allocation of GST exemption to a residual trust that follows a pecuniary credit shelter bequest or a pecuniary marital deduction bequest is the estate tax value of the assets available to satisfy the pecuniary payment, less the pecuniary amount, only if the following requirements are met:

- The pecuniary payment must carry "appropriate interest." Treas Reg §26.2642-2(b)(4).
- If the pecuniary bequest is satisfied in kind, the governing instrument or local law must require that (a) the bequest is satisfied on the basis of the value of the distributed property as of the date of distribution, or (b) the property distributed must fairly reflect net appreciation and depreciation occurring between the valuation date and the date of distribution of all assets from which the distribution could have been made. Treas Reg §26.2642-2(b)(3)(ii).

Appropriate interest means interest payable from the date of death or from the date specified under applicable state law requiring payment of interest at a rate (a) at least equal to the statutory rate of interest under state law or, if there is no statutory rate, 80 percent of IRC §7520 interest at the date of death and (b) not more than the greater of the statutory rate under state law or, if there is no statutory rate, 120 percent of IRC §7520 interest at the date of death. See Treas Reg §26.2642-2(b)(4). In California, a pecuniary bequest bears interest from one year after the testator's death, at a specified rate. See Prob C §§12001, 12003.

If the governing instrument fails to provide for appropriate interest, it will nevertheless be deemed to do so to the extent that (a) the entire payment is made or property is irrevocably set aside (*i.e.,* segregated and held in a separate account) to satisfy the entire pecuniary payment within 15 months after the transferor's death, or (b) the governing instrument or applicable local law requires the executor or trustee to allocate to the pecuniary payment a prorata share of the income earned by the fund from which the pecuniary payment is to be made between the date of death and the date of payment. Treas Reg §26.2642-2(b)(4)(ii).

If the pecuniary bequest does not carry appropriate interest (or does not qualify for the "safe harbor" described in the preceding paragraph) and the pecuniary bequest is not satisfied in kind, the denominator of the applicable fraction is the estate tax value of the assets available to satisfy the pecuniary payment, reduced by the discounted present value of the pecuniary payment, determined using the interest rate applicable under IRC §7520 at the death of the transferor and the period between the date of the transferor's death and the date of payment. Treas Reg §26.2642-2(b)(3)(i). The effect of such discounting is to reduce the value of the pecuniary payment, thereby requiring an increase in the amount of GST exemption that must be allocated to the residue if a zero inclusion ratio is desired.

Date-of-distribution values must be used to determine the denominator of the applicable fraction if the pecuniary bequest is satisfied in kind unless the governing instrument or local law requires that either:

- The bequest is to be satisfied on the basis of the value of the distributed property as of the date of distribution;

or

- The property distributed in satisfaction of the bequest must fairly reflect net appreciation and depreciation occurring between the date of death and the date of distribution of all assets from which the distribution could have been made. Treas Reg §26.2642-2(b)(3)(ii).

If estate tax values may be used to allocate GST exemption, postdeath appreciation in value will not be taken into consideration. For example, assume that *D*'s estate has a date-of-death value of $1 million which is divided between a $400,000 pecuniary amount marital deduction bequest and a residuary bypass trust to be funded with the residue of *D*'s estate. Assume further that no portion of *D*'s GST exemption was allocated during *D*'s lifetime and that *D*'s estate appreciates to $1,200,000 by the due date of *D*'s federal estate tax return. If federal estate tax values may be used, *D*'s GST exemption will be sufficient to produce an inclusion ratio of zero for both trusts. If date-of-distribution values must be used, the residual trust will have an inclusion ratio greater than zero.

EXAMPLE: T transfers $100,000 to a newly created irrevocable trust on December 15, 1996. The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer. On November 15, 1997, T files a Form 709, allocating $50,000 of GST exemption to the trust. Because the allocation was made on a late-filed return, the value of the property transferred to the trust is determined on the date on which the allocation is filed (unless an election is made under Treas Reg §26.2642-2(a)(2) to value the trust property as of the first day of the month in which the allocation document is filed with the IRS). On November 15, 1997, the value of the trust property is $150,000. As of November 15, 1997, the applicable fraction with respect to the trust is 0.333 ($50,000 (the amount of GST exemption allocated to the trust) divided by $150,000 (the value of the trust principal on the effective date of the GST exemption allocation)), and the inclusion ratio is 0.667 (1.0 − 0.333). Treas Reg §26.2642-2(c), Example 1.

EXAMPLE: The facts are the same as in the preceding example, except that the value of the trust property is $80,000 on November 15, 1997. The applicable fraction is 0.625 ($50,000/ $80,000) and the inclusion ratio is 375 (1.0 − 0.625). Treas Reg §26.2642-2(c), Example 2.

EXAMPLE: T transfers $100,000 to a newly created irrevocable trust on December 15, 1996. The trust provides that income is to be paid to T's child for 10 years. At the end of the 10-year period, the trust principal is to be paid to T's grandchild. T does not allocate any GST exemption to the trust on the gift tax return reporting the transfer.

NOTE: On November 15, 1997, T files a Form 709, allocating $50,000 of GST exemption to the trust. T elects to value the trust principal on the first day of the month in which the allocation is made under the election provided in Treas Reg §26.2642-2(a)(2). Because the late allocation is made in November, the value of the trust is determined as of November 1, 1997. Treas Reg §26.2642-2(c), Example 3.

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§15.61 9. Finality of Inclusion Ratio

Treasury Regulation §26.2642-5 provides that the inclusion ratio for direct skips becomes final on expiration of the statute of limitations to assess any additional GST tax, including additional tax payable as a result of cessation of qualified use under IRC §2032A(c), with respect to the direct skip. The inclusion ratio of a trust for purposes of determining taxable distributions and taxable terminations becomes final on the later of (1) the expiration of the statute of limitations for assessment with respect to the first GST tax return filed using that inclusion ratio, or (2) the expiration of the statute of limitations for assessment of the transferor's estate tax. The trust can still be divided, however, into a trust with an inclusion ratio of zero and a trust with an inclusion ratio of one. IRC §2642(a)(3).

If a gift tax return is timely filed, the gift tax value is used to determine the inclusion ratio, whether there is an actual or deemed allocation of the GST exemption. IRC §2642(b)(1). If the exemption is allocated on a late-filed gift tax return, the value of the property at the time of the filing is used to determine the denominator of the applicable fraction. IRC §2642(b)(3). If the property is transferred at death, the value of the property as finally determined for federal estate tax purposes is used, including any change in valuation as the result of elections under IRC §§2032 and 2032A. IRC §2642(b)(2)(A). These rules also apply to qualified terminable interest property included in the estate of the transferor's spouse, if the spouse is treated as the transferor for GST tax purposes. IRC §2642(b)(4).

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§15.62 10. Redetermination of Applicable Fraction

The applicable fraction must be redetermined whenever additional exemption is allocated to the trust or when certain changes occur with respect to trust principal. As a general rule, the numerator of the redetermined applicable fraction is the sum of the amount of the GST exemption currently being allocated to the trust (if any) plus the value of the nontax portion of the trust, and the denominator of the redetermined applicable fraction is the value of the trust principal immediately after the event occurs. The nontax portion of a trust is determined by multiplying the value of the trust assets, determined immediately before the event, by the then applicable fraction. Treas Reg §26.2642-4. For example, assume that $100,000 is transferred in trust, and $70,000 of GST exemption is allocated to the trust. The applicable fraction is 0.70. If the applicable fraction must be redetermined at a time when the value of the trust principal, immediately before the event causing the redetermination, is $150,000, the nontax portion is $105,000 ($150,000 × 0.70).

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§15.63 a. Property Added to Trust

If property is added to an existing trust, the applicable fraction must be recomputed to reflect the additional transfer. IRC §2642(d)(1). The recomputed numerator is the nontax portion of the existing trust plus the exemption allocated to the subsequent transfer. IRC §2642(d)(2)(A). The recomputed denominator is the value of the trust immediately after the addition, reduced by (Treas Reg §26.2642-1(c)(1)):

- Any federal estate tax and any state death tax incurred by reason of the transfer that is chargeable to the trust and actually recovered from the trust;
- The amount of any charitable deduction allowed under IRC §2055, §2106 or §2522 with respect to the transfer; and
- For a direct skip, the value of the portion of the transfer that is a nontaxable gift. Treas Reg §26.2642-4(a)(1).

EXAMPLE: *Allocation of additional exemption.* T transfers $200,000 to an irrevocable trust under which the income is payable to T's child, C, for life. On the termination of the trust, the remainder is payable to T's grandchild, GC. At a time when no ETIP exists with respect to the trust property, T makes a timely allocation of $100,000 of GST exemption, resulting in an inclusion ratio of 0.50. Subsequently, when the entire trust property valued at $500,000 is includable in T's gross estate, T allocates an additional $100,000 of T's unused GST exemption to the trust. The inclusion ratio of the trust is recomputed at that time. The numerator of the applicable fraction is $350,000 ($250,000 (the nontax portion as of the date of allocation) plus $100,000 (the GST exemption currently being allocated)). The denominator is $500,000 (the date-of-allocation fair market value of the trust). The inclusion ratio is 0.30 (1 − 0.70). Treas Reg §26.2642-4(b), Example 1.

Additions that taint a grandfathered trust will be treated as separate trusts with their own inclusion ratios. All distributions from and terminations with respect to such a trust will be treated as consisting of a proportionate share of both the tainted and grandfathered portions. See Treas Reg §26.2601-1(b)(1)(iv).

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§15.64 b. Consolidation of Existing Trusts

If separate trusts created by one transferor are consolidated, a single applicable fraction for the consolidated trust is determined. The numerator of the redetermined applicable fraction is the sum of the nontax portions of each trust immediately before the consolidation. Treas Reg §26.2642-4(a)(2).

EXAMPLE: *Multiple transfers to a trust, allocation both timely and late.* On December 10, 1993, T transfers $10,000 to an irrevocable trust that does not satisfy the requirements of IRC §2642(c)(2). T makes identical transfers to the trust on December 10, 1994, 1995, and 1996, and on January 15, 1997. Immediately after the transfer on January 15, 1997, the value of the trust principal is $40,000. On January 14, 1998, when the Form 709 value of the trust principal is $50,000, T allocates $30,000 of GST exemption to the trust. T discloses the 1997 transfer on the filed on January 14, 1998. Thus, T's allocation is a timely allocation with respect to the transfer in 1997, $10,000 of the allocation is effective as of the date of that transfer, and on and after January 15, 1997, the inclusion ratio of the trust is 0.75 (1 − ($10,000/$40,000)). The balance of the allocation is a late allocation with respect to prior transfers to the trust and is effective as of January 14, 1998. In redetermining the inclusion ratio as of that date, the numerator of the redetermined applicable fraction is $32,500 ($12,500 (.25 × $50,000) (the nontax portion of the trust on January 14, 1998) plus $20,000 (the amount of GST exemption allocated late to the trust)). The denominator of the new applicable fraction is $50,000 (the value of the trust principal at the time of the late allocation). Treas Reg §26.2642-4(b), Example 2.

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§15.65 c. Trust Included in Transferor's Gross Estate

If a trust is included in the transferor's gross estate, the applicable fraction is redetermined if additional GST exemption is allocated to the property by the transferor's executor. The numerator of the redetermined applicable fraction is an amount equal to the nontax portion of the property immediately after the death of the transferor, increased by the amount of GST exemption allocated to the trust by the transferor's executor. Treas Reg §26.2642-4(a)(3).

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§15.66 d. Trust Subject to IRC §2032A Recapture Tax

If an additional estate tax is imposed under IRC §2032A and a §2032A election was made that was effective under Treas Reg §26.2642-2(b), the applicable fraction with respect to the property is redetermined as of the date of the transferor's death. Any available GST exemption not allocated at the death of the transferor (or at a prior recapture event) is automatically allocated to the property. The denominator of the applicable fraction is the fair market value of the property at the date of the transferor's death, reduced by:

- Any federal estate tax and any state death tax incurred by reason of the transfer that is chargeable to the trust and actually recovered from the trust;
- The amount of any charitable deduction allowed under IRC §2055, §2106 or §2522 with respect to the transfer; and
- The amount of the additional GST tax actually recovered from the trust. Treas Reg §26.2642-4(a)(4)(i).

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§15.67 e. Additional Example of Redetermination of Applicable Fraction

EXAMPLE: *Excess allocation.* (i) T creates an irrevocable trust for the benefit of T's child and grandchild in 1996, transferring $50,000 to the trust on the date of creation. T allocates no GST exemption to the trust on the Form 709 reporting the transfer. On July 1, 1997 (when the value of the trust property is $60,000), T transfers an additional $40,000 to the trust.

(ii) On April 15, 1998, when the value of the trust is $150,000, T files a Form 709, reporting the 1997 transfer and allocating $150,000 of GST exemption to the trust. The allocation is a timely allocation of $40,000 with respect to the 1997 transfer and is effective as of that date. Thus, the applicable fraction for the trust as of July 1, 1997, is 0.40 (($40,000/$100,000 ($40,000 + $60,000)).

(iii) The allocation is also a late allocation of $90,000, the amount necessary to attain a zero inclusion ratio on April 15, 1998, computed as follows: $60,000 (the nontax portion immediately before the allocation (0.40 × $150,000)) plus $90,000 (the additional allocation necessary to produce a zero inclusion ratio based on a denominator of $150,000)/$150,000 equals one and, thus, an inclusion ratio of zero. The balance of the allocation ($20,000 ($150,000 less the timely allocation of $40,000 less the late allocation of $90,000)) is void. Treas Reg §26.2642-4(b), Example 3.

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F. Calculating and Paying GST Tax

§15.68 1. Property Subject to GST Tax

The GST tax rate applicable to a transfer is determined by multiplying the maximum federal estate tax rate in effect at the time of the transfer by the inclusion ratio. IRC §2641.

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§15.69 a. Direct Skips

The tax on direct skips is tax exclusive; *i.e.,* the taxable amount of a direct skip is the value of the property received by the transferee. IRC §2623. The dollars used to pay the GST tax are not subject to the GST tax. If the direct skip is subject to gift tax under Chapter 13 of the Internal Revenue Code, however, the amount of the gift for purposes of Chapter 13 is increased by the amount of the GST tax paid by the transferor. IRC §2515.

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§15.70 b. Taxable Terminations

The taxable amount of a taxable termination is the value of the property subject to the termination, reduced by the expenses, indebtedness, and taxes attributable to the property subject to the termination that would have been deductible under IRC §2053 if the property had been subject to estate tax. IRC §2622. The tax calculation accordingly is tax inclusive.

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§15.71 c. Taxable Distributions

The taxable amount of a taxable distribution is the value of the property received by the transferee, reduced by the expenses incurred in the determination, collection, or refund of the GST tax. IRC §2621.

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§15.72 2. Understanding the Hierarchy of GSTs

As described in §§15.68-15.71, not all GSTs are treated equally. The highest tax rate (300 percent) is incurred with respect to taxable terminations of and taxable distributions from trusts that were subject to estate tax at the transferor's death. The lowest tax rate (125 percent) is generated by lifetime direct skips. This disparity in tax consequence is caused by the tax-exclusive treatment of taxable gifts and lifetime direct skips, as opposed to the tax-inclusive treatment of property subject to estate tax or passing by reason of a taxable termination:

- If property is transferred as a lifetime direct skip, both the gift tax and the GST tax will be imposed only on the value of the property transferred. The dollars used to pay those taxes are not themselves taxed (although the GST tax paid with respect to a lifetime direct skip is treated as an additional taxable gift).
- If property is transferred as a direct skip at death, the GST tax will be imposed only on the value of the property transferred, but the estate tax will be imposed on the entire value of the estate, which includes the dollars used to pay both the estate tax and the GST tax.
- If property is transferred at death and a taxable distribution or a taxable termination subsequently occurs with respect to that property, the estate tax will be imposed on the entire value of the estate, which includes the dollars used to pay the estate tax and the dollars that will be used to pay the GST tax. The GST tax will then be imposed on the value of the property remaining after payment of the estate tax.

The hierarchy of GSTs is illustrated by the examples in §§15.73-15.75. In all examples, T is the transferor, C is T's child, and GC is C's child and T's grandchild. Assume that the transferor is in the 50-percent marginal estate, gift, and GST tax bracket and does not allocate GST exemption to the transferred property.

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§15.73 a. Lifetime Direct Skip

The lowest rate of tax (125 percent of the amount received by the beneficiary) is incurred by a lifetime direct skip.

EXAMPLE: T transfers $1 million to GC. Transfer taxes will total $1,250,000, computed as follows:

50% gift tax on transfer	=	$500,000
50% GST tax on transfer	=	$500,000
50% gift tax on GST tax	=	$250,000
		$1,250,000

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§15.74 b. Direct Skip at Death, Taxable Distributions From Trusts Created During Lifetime, and Taxable Terminations From Trusts Created During Lifetime

Direct skips at death, taxable distributions from trusts created by lifetime gifts, and taxable terminations with respect to such trusts share the middle ground. In all three situations, the transfer taxes will amount to 200 percent of the amount received by the beneficiary.

EXAMPLE: *Direct skip at death.* T transfers $1 million to GC by will. The formula is ($1 million (devise) + $500,000 (GST tax))/(1 − 0.50) = total taxes plus devise or $3 million. In other words, T must have $3 million of net worth to pay a 50-percent estate tax or $1,500,000 and have $1,500,000 left. Of this sum, the bequest to GC is $1 million, and the $500,000 balance represents the GST tax. Total taxes amount to $2 million or 200 percent of the $1-million bequest to GC.

EXAMPLE: *Taxable distribution from trust created during lifetime.* T makes a lifetime taxable gift of $1 million to a trust for the benefit of C and GC. The trust is not a skip person. Gift taxes of $500,000 are incurred. During C's lifetime, the trustee distributes the $1 million to GC. The entire $1 million is subject to the GST tax as a taxable distribution. The GST tax is $500,000, and GC nets $500,000. Total taxes amount to $1 million or 200 percent of the $500,000 received by GC after payment of the direct skip GST tax.

EXAMPLE: *Taxable termination from trust created during lifetime.* The facts are the same as in the preceding example, except that the $1 million is retained in trust at C's death. The results are the same as in the preceding example, with the trust retaining $500,000 after payment of the GST tax. Once again, total transfer taxes amount to 200 percent of the amount retained in trust for GC's benefit.

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§15.75 c. Taxable Distributions and Taxable Terminations From Trust Established at Death

The highest transfer tax rate is encountered in taxable distributions from and taxable terminations with respect to trusts in which the original transfer was subject to estate tax.

EXAMPLE: T leaves $1 million by will to a trust for the benefit of C and GC. The trust is not a skip person. The formula to determine the estate tax is $1 million (devise)/(1 − 0.50) equals total taxes plus devise or $2 million. In other words, T's estate must include $2 million to be able to pay a 50-percent estate tax or $1 million and have $1 million left to transfer to the trust for the benefit of C and GC. At C's death or the earlier distribution of the trust to GC, the entire $1 million is subject to a 50-percent GST tax, leaving $500,000 to be received by or retained in trust for the benefit of GC. Total transfer taxes are $1,500,000 or 300 percent of the amount transferred to GC.

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§15.76 d. GST Tax Planning Implications

Several conclusions may be drawn from these examples of GST tax calculations in §§15.74-15.75:

- Lifetime direct skips are the least costly method of making taxable GSTs.
- Not only are lifetime direct skips the cheapest GST, but lifetime transfers permit the transferor to shift future income and appreciation to the recipient. As a result, lifetime allocation of the transferor's GST exemption to trusts in which GSTs will occur in later generations (*e.g.,* distributions to great-grandchildren) may represent a more efficient use of the GST exemption than allocating this exemption to lifetime outright direct skips.
- In contrast, the most expensive GSTs are taxable terminations or taxable distributions from trusts established at death.
- Transfers that are postponed until the transferor's death cause all lifetime appreciation and accumulated income to be subjected to the tax-inclusive estate tax at the transferor's death. Allocation of GST exemption at the transferor's death is the least efficient use of this exemption.
- If GST exemption is allocated at the transferor's death, it may be necessary to choose between allocating the exemption to direct skips occurring by reason of the transferor's death and allocating exemption to trusts in which a GST will subsequently occur. The same reasoning that applies to lifetime direct skips, discussed above, applies to this situation.
- The effect of the GST tax is not so much in raising revenue but in deterring certain types of estate plans that, for all practical purposes, are almost prohibitive under these rules. Plans that the drafter should avoid under the GST tax include testamentary direct skips and sprinkling trusts that are not sheltered by the transferor's GST exemption.

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3. Filing Return and Paying Tax

§15.77 a. Tax on Direct Skips

If a direct skip is not from a trust, the return is filed and the tax is paid by the transferor. Payment of the tax is not an additional transfer subject to the GST tax but is an additional taxable gift from the transferor to the transferee that is subject to gift tax. IRC §2603(a)(3).

If a direct skip is from a trust, the return is filed and the tax is paid by the trustee. IRC §2603(a)(2).

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§15.78 b. Taxable Terminations

For a taxable termination, the trustee files the return and pays the GST tax. IRC §2603(a)(2).

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§15.79 c. Taxable Distributions

For a taxable distribution, the transferee files the return and pays the GST tax. IRC §2603(a)(1).

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§15.80 d. Tax Returns Due

Transfer tax returns are due on April 15 of the year following the year in which the GST occurs. IRC §2662(a). The distributee or trustee may obtain an automatic 6-month extension of time to file the return using Form 7004. 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 transfer 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 23A.

The transfers are reported on the following forms: Form 706-GS(D) (Generation-Skipping Transfer Tax Return for Distributions) and Form 706-GS(T) (Generation-Skipping Transfer Tax Return for Terminations).

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§15.81 4. Tax Proration Clauses

Internal Revenue Code §2603(b) establishes the general rule that the GST tax is apportioned or charged against "the property constituting" the GST. The transferor bears the tax on direct skips (other than direct skips from a trust), the trustee bears the tax on taxable terminations, and the transferee bears the tax on taxable distributions. The burden of the GST tax may be shifted by the instrument creating the transfer but only if the instrument refers specifically to the GST tax. A general tax proration or apportionment clause charging all transfer taxes against the residue will not be sufficient to change the statutory scheme of apportionment.

This general rule of apportionment should be discussed with the client, particularly if the estate plan in question involves nontrust direct skips. For example, if the client wishes to leave $2 million outright to a grandchild and an existing dispositive instrument charges all "death" taxes against the residue, the attorney should determine whether:

- The client intends the devise to be inclusive of the GST tax. If so, the new or revised instrument should make clear that the GST tax will not be charged against the residue. As a result, the gift will include the dollars from which the GST tax will be paid, so that the gift will actually consist of the amount remaining after the taxes are paid. In this example, assuming a tax rate of 50 percent, the GST tax will be $666,667, and the grandchild will receive a net amount of $1,333,333 after payment of the GST tax.
- The client intends the devise to be exclusive of the GST tax. If so, the new or revised instrument should make clear that the GST tax will indeed be charged against the residue. As a result, the gift will represent the net amount that the client intends the grandchild to receive. In this example, a GST tax of $1 million will be paid from the residue of the client's estate, thereby reducing the amount passing to residuary beneficiaries.

The attorney must also take the tax reimbursement provisions of IRC §2207A into consideration. Section 2207A provides that, unless waived or modified by the surviving spouse's will, the estate of a surviving spouse is entitled to be reimbursed for the incremental estate tax increases occasioned by inclusion of qualified terminable interest property in that spouse's taxable estate. Unless the ramifications of IRC §2207A are carefully thought through, this section may result in the waste of a portion of the predeceased spouse's GST exemption, unfairly burdening the beneficiaries of the QTIP trust with a disproportionately large share of the estate tax assessed against the surviving spouse's estate, or, if the beneficiaries of the QTIP trust and the surviving spouse's estate are not the same, the possible imposition of gift tax if reimbursement is waived.

EXAMPLE: A married couple with one child has an all community property net worth of $7 million after a $200,000 taxable gift to the child. The couple intended to use the marital deduction to defer all estate taxes until both husband and wife were deceased and to use their respective GST exemptions to insulate as much as possible of each estate from the GST tax. The "exempt" assets will remain in trust for their child's lifetime and eventually pass to their grandchildren. Assets in excess of the exempt amount will be distributed outright to the child after both spouses are deceased. The husband died in 2009. His estate was divided between a $3.4 million credit trust and a $100,000 QTIP marital trust. His $3.5 million GST exemption was allocated between the trusts, after a reverse QTIP election was made, producing inclusion ratios of zero. During the remainder of the wife's lifetime, her estate and the trusts did not increase in value, with the result that her taxable estate at death in 2009 is $3.6 million ($3.5 million of separate estate plus $100,000 of qualified terminable interest property).

NOTE: If no deductions are made, estate taxes will be $90,000. If the qualified terminable interest property had not been included in the wife's estate, estate taxes would have been $45,000. If the wife's will provided for IRC §2207A reimbursement in accordance with the statutory scheme, $45,000 of GST tax-exempt qualified terminable interest property would be shifted to the nonexempt side of the wife's estate.

This example assumes that waiving reimbursement will not be treated as a "tainting" constructive addition to the exempt QTIP trust, which is consistent with the position taken by Treas Reg §26.2652-1(a)(5), Example 8.

Although waiving reimbursement will apparently not constitute a tainting addition to an otherwise exempt trust, the

beneficiaries may well be making a taxable gift. See *Boyd v Commissioner* (7th Cir 1987) 819 F2d 170, in which the court held that waiver of reimbursement under IRC §2206 (life insurance) was a "bequest" that could be disclaimed.

Asserting the right of reimbursement may impose a disproportionate burden on the beneficiaries of the QTIP trust. In the above example, IRC §2207A entitled the estate of the surviving spouse to reimbursement of $45,000, calculating the reimbursement using the marginal tax brackets of the estate. All other statutory reimbursement provisions of the Internal Revenue Code, however, provide for reimbursement based on the ratio that the value of the property giving rise to the tax bears to the taxable estate (*i.e.,* reimbursement using the average tax rate of the estate, giving effect to all deductions and credits). Had this approach been adopted in IRC §2207A, in the above example the qualified terminable interest property would represent approximately 2.8 percent of the taxable estate, and the surviving spouse's estate therefore would have been entitled to reimbursement of $2500. In appropriate circumstances (*e.g.,* when the qualified terminable interest property will pass to persons other than the beneficiaries of the surviving spouse's estate), the surviving spouse may wish to waive reimbursement in excess of the amount calculated using the average rate. See McCaffrey, *Drafting and Planning to Minimize the Generation-Skipping Transfer Tax*, Estate Planning 2005 §3.21 (Cal CEB 2005).

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G. Income Tax Aspects of GSTs

§15.82 1. Income Tax Deduction for GST Tax

If a GST tax is paid with respect to a distribution of taxable income, the GST tax is deductible when the beneficiary's taxable income is computed. IRC §164(a)(4).

If an item of gross income is subject to the GST tax by reason of a direct skip or of a taxable termination that occurs at and as the result of the transferor's death, and if that item would have seen income in respect of a decedent had it been subject to estate tax, a deduction is allowed (under principles applicable to the estate tax) for the portion of the GST tax attributable to that item. IRC §691(c)(3).

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§15.83 2. Redemption of Closely Held Stock

Internal Revenue Code §303(d) authorizes stock redemptions to pay the GST tax occurring at the transferor's death. Internal Revenue Code §6166, which authorizes extensions of time for payment of estate tax when the estate largely consists of closely held stock, also applies to direct skips occurring at the transferor's death.

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3. Basis Adjustments

§15.84 a. Basis Increase for GST Tax

Property subject to the GST tax receives a basis adjustment (increase) analogous to that for estate and gift tax purposes. See IRC §§1014-1015, 2654(a)(1). Different adjustments are prescribed for direct skips and taxable distributions (see §15.85) and taxable terminations (see §15.86) occurring as a result of death.

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§15.85 b. Adjustment for Direct Skips and Taxable Distributions

The basis of property transferred in a direct skip or taxable distribution is the adjusted basis of the property immediately before the transfer, increased (but not above fair market value) by the portion of the GST tax that is attributable to the appreciation in value of the property transferred over the adjusted basis of the property. IRC §2654(a)(1).

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§15.86 c. Adjustment for Taxable Terminations

The basis of property transferred in a taxable termination that occurs by reason of death is the fair market value of the property as determined for imposition of the GST tax. If the inclusion ratio is less than one, any step-up in basis or step-down in basis is limited by the inclusion ratio. For example, if property with an adjusted basis of $1000 and a fair market value of $5000 is subject to a taxable termination occurring by reason of death and if the inclusion ratio is one half, the property will receive a new basis of $3000 ($1000 adjusted basis + ($4000 × .50)). See IRC §2654(a)(2).

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H. Effective Date and Transition Rules

1. Prospective Application of GST Tax

§15.87 a. Retroactive Repeal of Former Law

The former version of the GST tax was repealed, retroactive to its effective date, June 11, 1976. The practical effect of this retroactive repeal is that the former GST tax is treated as if it never existed.

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Source: Estate Planning/California Will Drafting/15 Generation-Skipping Transfer Tax: Law, Regulations, and Planning/ §15.88 b. Effective Date of Current Law

§15.88 b. Effective Date of Current Law

The 1986 GST tax applies to all GSTs made after October 22, 1986. The 1986 GST tax also applies to lifetime transfers made on or after September 25, 1985. Treas Reg §26.2601-1.

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§15.89 c. Inter Vivos Transfers Between September 25, 1985, and October 22, 1986

For purposes of filing the GST tax return and paying the tax, inter vivos transfers that occurred after September 25, 1985, and on or before October 22, 1986, are treated as if they occurred on October 23, 1986. Treas Reg §26.2601-1(a)(2). This rule applies to certain transfers to and from trusts. See Treas Reg §26.2601-1(a)(3).

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§15.90 2. Transfers Before 1987 Under Wills and Revocable Trusts Executed Before October 22, 1986

If the testator died before January 1, 1987, transfers that occur under a will or revocable trust executed before October 22, 1986, are not subject to the GST tax. Treas Reg §26.2601-1(b)(2).

The regulations provide numerous examples of permissible and impermissible amendments to grandfathered wills and revocable trusts. See Treas Reg §26.2601-1(b)(2)(iv), (vi)-(vii).

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§15.91 3. Transfers After 1986 When Testator Had Mental Disability on October 22, 1986

The GST tax does not apply to the following transfers if, on October 22, 1986, the transferor was under a mental disability, was unable to change the disposition of his or her property, and did not regain competence to dispose of the property before his or her death (Treas Reg §26.2601-1(b)(3)):

- Transfers under a trust, to the extent that the trust consisted of property included in the gross estate of a decedent (other than property transferred by the decedent after October 22, 1986); or
- Transfers constituting direct skips that occur by reason of the transferor's death, except for direct skips that result from the application of IRC §2044 to a marital deduction trust and that are attributable to property transferred to the trust after October 21, 1988. TRA 1986 §1433(b)(2)(C), as amended by §1014(h)(5) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) (Pub L 100-647, 102 Stat 3342).

In IRS Letter Ruling 200015008, creation of a revocable trust under a substituted judgment court order did not result in the incompetent person losing her exemption from GST tax.

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§15.92 4. Trusts Irrevocable on September 25, 1985

The GST tax does not apply to any transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that the transfer is not made out of corpus added to the trust after September 25, 1985. If additions are made, the GST tax applies to a prorata portion of any GST under the trust. Treas Reg §26.2601-1(b)(1)(i).

However, the regulations provide that an exercise, release, or lapse of a general power of appointment under a will or inter vivos trust executed before the applicable effective date is treated for GST tax purposes as a transfer by the person holding the power. Treas Reg §26.2601-1(b)(1)(i). In *Estate of Eleanor R. Gerson* (2006) 127 TC 139, aff'd (6th Cir 2007) 507 F3d 435, the Tax Court held that the regulation is valid even though it was promulgated in response to a court decision reaching the opposite conclusion. The Sixth Circuit affirmed the Tax Court decision, finding that the statutory reference to a "transfer under a trust" is ambiguous and the regulation provides a reasonable interpretation of the statute.

In *Simpson v U.S.* (8th Cir 1999) 183 F3d 812, nonacq 2000-1 Cum Bull xvi, the court held that a general power of appointment marital deduction trust appointed to grandchildren in 1993 was not subject to GST tax because the trust was irrevocable on September 25, 1985. The Ninth Circuit followed *Simpson* in *Bachler v U.S.* (9th Cir 2002) 281 F3d 1078. The Second Circuit had previously held that a surviving spouse made a constructive addition to a grandfathered trust when she failed to exercise the right to withdraw one-half of the trust estate and allowed the property subject to the power to pass to skip persons. *E. Norman Peterson Marital Trust v Commissioner* (2d Cir 1996) 78 F3d 795. The precedential value of *Bachler* is limited because the case involved a powerholder who died before the effective date of the regulation and the opinion stated that the court did not express any opinion on the validity of the regulation.

With respect to possible loss of grandfathered status in situations not involving a general power, the regulations address changes resulting from the following (Treas Reg §26.2601-1(b)(4)):

- Exercises of discretionary trustee powers to distribute to a new trust or retain trust principal in a continuing trust (*e.g.,* a trustee spray power that includes the power to distribute to a new trust for a minor);
- Settlements of bona fide controversies;
- Judicial construction of instruments; and
- Other changes.

Generally, an exercise of a trustee's discretionary power to distribute to a new trust will not cause loss of exempt status if the trustee has the power under the trust instrument or state law at the time the trust became irrevocable to make distributions to a new trust or retain trust principal in a continuing trust.

Changes in trust terms resulting from settlements of bona fide controversies generally will not result in loss of the exemption if the settlement is the product of arm's-length negotiations. The settlement still may result in a constructive addition to the trust. See §15.93.

Changes resulting from a judicial construction will not result in loss of the exemption if there is a bona fide issue regarding the meaning of the provisions in question and the construction is consistent with applicable state law.

Other changes will not result in loss of the exemption if the modification (1) does not shift a beneficial interest to a person with a lower-generation assignment and (2) does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

The basic statement of the applicable rules is followed by examples, which make clear that there is no loss of exemption in a variety of routine situations involving such things as divisions of trusts and mergers of trusts.

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§15.93 5. Constructive Additions to Trusts

Generally, constructive additions to grandfathered trusts occur when there is a release, exercise, or lapse of a power of appointment that is treated as a taxable transfer for estate or gift tax purposes. A constructive addition may also occur if an obligation of a trust is paid by a third party. A settlement agreement may result in a constructive addition to the trust if the value of trust interests given up exceeds the value of the consideration received under the agreement. See IRS Letter Ruling 200210018. In any case of constructive addition, the trust will no longer be grandfathered with respect to the portion of the trust attributable to the addition. Treas Reg §26.2601-1(b)(1)(v).

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16

Creating Powers of Appointment

Gordon A. Schaller
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I. PLANNING APPOINTMENT POWERS

§16.1 A. Nature of Power of Appointment

Simply put, a power of appointment is a power to dispose of property. The power can be as broad or as limited as its creator desires. Skillfully employed, a power of appointment can be an invaluable tool in estate planning. The drafter must be aware, however, of the possibility of adverse tax consequences of a power of appointment if the power is inappropriately drafted.

This chapter focuses on the creation of powers of appointment. See chap 11 on exercise of powers of appointment.

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§16.2 B. Reasons for Creating Powers of Appointment

A power of appointment can be used to accomplish many objectives, including the following:

- To enable the donee to make a decision about the ultimate disposition of the property subject to the power, so that the beneficiaries' current needs and circumstances (relating to, *e.g.,* marriage, divorce, financial status, lifestyle) can be taken into consideration when the power is ready for exercise.
- To allow the donee to accomplish his or her own dispositive objectives as opposed to those of the creator of the power.
- To save taxes or to secure a tax objective achieved by the existence of the power. For example, to take advantage of the graduated estate tax scale after 2010 and credits available in the estate tax system that are not available in the generation-skipping transfer (GST) tax system (such as the IRC §2013 prior transfer property (PTP) credit), a power of appointment for a non-skip person donee may be used to convert a GST tax into an estate tax. The power of appointment also may be used to extend the termination date of a trust so that the trust assets are exempt from GST tax and estate tax for as long as they remain in the trust. See chap 15.
- To give the surviving spouse a general power of appointment over the trust property as necessary to qualify the trust for the marital deduction. See IRC §2056(b)(5). For discussion of marital deduction trusts, see chaps 17-20.

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II. POWER RULES AND DEFINITIONS

§16.3 A. Relationship Between State Law and Federal Tax Law

Although the Internal Revenue Code defines the powers that will cause the donee to incur estate or gift tax consequences (see IRC §§2041, 2514), state law determines the nature and scope of the power of appointment and is often referred to in applying the Internal Revenue Code. For example, state law may determine whether the decedent received a special or a general power of appointment. See *Gunn v U.S.* (D Kan 1964) 233 F Supp 931 (absent collusion or fraud, court upheld state probate court's determination that general power of appointment had been created). In some circumstances, state law is ignored. For example, federal law specifically provides that a power of appointment includes all powers that are in substance and effect powers of appointment regardless of local property law connotations. See Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1).

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.4 B. Common Law and Statutory Rules

§16.4 B. Common Law and Statutory Rules

In California, powers of appointment are governed by common law rules except to the extent modified by statutory rules. Prob C §600. However, many important definitions are now statutory and certain case law may no longer be authoritative.

Following is a summary of California statutory rules on powers of appointment, which applies to both special and general powers of appointment (unless otherwise noted):

- The "donor" is the person who creates or reserves a power of appointment. Prob C §610(e).
- The "donee" is the person to whom a power of appointment is given or in whose favor a power is reserved. Prob C §610(e).
- The "appointee" is the person in whose favor a power of appointment is exercised. Prob C §610(a).
- A "permissible appointee" is a person in whose favor a power of appointment may be exercised. Prob C §610(f).
- "Appointive property" is either the property or the interest in the property that is the subject of the power of appointment. Prob C §610(b).
- The "creating instrument" is the deed, will, trust agreement, or other writing or document that created or reserved the power of appointment. Prob C §610(c).
- A power of appointment may be "general" for some appointive property, or an interest in appointive property or a specific portion of it, and "special" for other appointive property. Prob C §611(e). "General" and "special" powers of appointment are discussed in detail in §§16.11, 16.27-16.28.
- A power of appointment is "testamentary" if it is exercisable only by a will. Prob C §612(a).
- A power of appointment is "presently exercisable" at the time in question to the extent that an irrevocable appointment can be made. Prob C §612(b).
- A power of appointment is "not presently exercisable" if it is postponed. A power is "postponed" if:
- The creating instrument provides that the power may be exercised only after a specified act or event occurs or a condition is met, and that act or event has not occurred or the condition has not been met (Prob C §612(c)(1)); or
- The creating instrument provides that an exercise of the power is revocable until a specified act or event occurs or a condition is met, and that act or event has not occurred or the condition has not been met (Prob C §612(c)(2)).
- A power of appointment is "imperative" when the creating instrument shows the intent that the permissible appointees benefit even if the donee fails to exercise the power. An imperative power can exist even though the donee has the privilege of selecting some and excluding others of the permissible appointees. Prob C §613.
- All other powers of appointment are "discretionary." The donee of a discretionary power may exercise or not exercise the power as the donee chooses. Prob C §613.

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§16.5 C. Jointly Held Powers

It is possible to create a jointly held power, *i.e.,* a power held by two or more donees. If such a power of appointment is created, it may be exercised *only* by all donees. However, if one or more of the donees dies, becomes legally incapable of exercising the power, or releases it, the power may be exercised by the others unless the creating instrument expressly prohibits them from doing so. Prob C §634.

If the creator of the power clearly desires that all donees must act and that the power will terminate if there is only one donee, the drafter should insert an express clause in the creating instrument to carry out that intent. This may be used in the generation-skipping transfer (GST) tax arena, where a tax savings may arise if an estate tax is payable instead of a GST tax. For example, if the testator creates a trust for his or her child and the child is given a general power of appointment over the trust, an estate tax instead of a GST tax will be payable when the child dies.

A joint general power will create a general power of appointment, but at the same time the joint power will limit the donee's power to exercise the general power of appointment. This will only work if the joint powerholder does not have a substantial interest in the property subject to the power that is adverse to the other joint powerholder. See §16.18.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.6 D. 'Exclusive' and 'Nonexclusive' Powers

§16.6 D. "Exclusive" and "Nonexclusive" Powers

The donor may control the exercise of a special power of appointment by placing limitations in the instrument creating the power. For example, the donor may specify that an appointee will receive either a minimum or a maximum amount or share. Prob C §652(b). Such a power of appointment is sometimes referred to as "nonexclusive." In the absence of such a limitation, the selection of the permissible appointees is at the discretion of the donee, who may exclude any one or more of the appointees or may appoint all or any part of the property to any one or more of them. Prob C §652(a). Such a power is sometimes referred to as "exclusive."

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§16.7 E. When Power Is Considered to Be Created

A power of appointment created by will generally is considered to be created on the date of the testator's death. A power of appointment created by inter vivos instrument is considered to be created on the date on which the instrument takes effect. The fact that the power is revocable or that the donee is not ascertainable on that date does not delay the date on which the power is created. If the holder of the power creates a second power, however, the latter power is created at the time of exercise of the first power. Treas Reg §20.2041-1(e).

The date on which the power is considered to be created will determine whether the power is governed by rules applicable to powers created on or before October 21, 1942, or by rules applicable to powers created after that date. In *Powers v U.S.* (1997) 37 Fed Cl 709, a general power of appointment was created by the will of a decedent who died in 1949. Therefore, the property subject to the power of appointment was included in the estate of the power holder, who died in 1993. See discussion in §16.13.

This date will also be relevant for calculating the 9-month period during which the powerholder may exercise a disclaimer. A disclaimer under California law is conclusively presumed to have been filed within a reasonable time if it is filed within 9 months after (1) the death of the creator of the interest or (2) the interest becomes indefeasibly vested, whichever is later. Prob C §279(b). If not filed within the stated time, the disclaimant has the burden of establishing that the disclaimer was filed within a reasonable time. Prob C §279(f). Under federal law, the holder of a power of appointment has 9 months from its creation to disclaim. Treas Reg §25.2518-2(c)(3)(i). The requirements under federal law are more restrictive than the California requirements.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.8 F. Revocability of Exercise or Release of Power

§16.8 F. Revocability of Exercise or Release of Power

Unless made expressly irrevocable in the will or the instrument of exercise, exercise of a power of appointment in a testamentary trust is revocable if the interest in the present or future appointive property has not been transferred or become distributable under the appointment. See Prob C §695(b). See chap 11 on exercise of a power of appointment. The release of a power of appointment is irrevocable, however, unless the power to revoke is reserved in the release instrument. Prob C §695(c).

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§16.9 G. Power to Create a Trust

Probate Code §15200, governing creation of trusts, includes a provision that a trust may be created by exercise of a power of appointment to a person as trustee. Prob C §15200(d). The statute appears to apply to both general and special powers of appointment. In the past, it was common to find a clause in the instrument authorizing the individual to create a trust by exercise of the power of appointment. California statutory law has now rendered such a clause unnecessary. To avoid any dispute, the power to create a trust should be made explicit in the will.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.10 H. Disposition on Default of Appointment

§16.10 H. Disposition on Default of Appointment

The will should provide a default clause in case the donee does not validly or effectively appoint property before his or her death. If the will does not contain such a clause, disposition will be as prescribed by Prob C §§671 (failure to make imperative appointment) and 672 (effect of release or ineffective appointment) or by Prob C §282 (effect of disclaimer).

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III. GENERAL POWERS

§16.11 A. Nature of General Power of Appointment

Under California state law, a general power of appointment is defined as a power exercisable in favor of any of the following (alone or in addition to others): the donee, the donee's estate, the donee's creditors, or the creditors of the estate. Prob C §611(a). For all practical purposes, the definition of a general power of appointment in the Internal Revenue Code is identical to that in the Probate Code. See IRC §§2041(b) (estate tax), 2514(c) (gift tax). If the decedent was entitled to exercise the power in favor of any one of the four categories, he or she had a general power of appointment. See *Estate of Rebecca Edelman* (1962) 38 TC 972.

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§16.12 B. Rights of Holder

If the general power of appointment is presently exercisable, the rights of the donee of the power are the same as those of a person having the right to revoke a trust. Prob C §15803. These rights include the right to consent or withhold consent to an action that may be taken and the right to receive notice of action. Prob C §§15800-15802.

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C. Tax Consequences to Holder

§16.13 1. Pre-1942 and Post-1942 Powers

Powers of appointment created on or before October 21, 1942, are subject to tax rules that differ from those relating to powers created after this date. Broadly speaking, property subject to a post-1942 general power of appointment is includable in the holder's gross estate if it is possessed at death, whether or not it is exercised. See Treas Reg §20.2041-3. For definition of general powers of appointment, see §16.11. Property subject to a pre-1942 general power of appointment is includable in the holder's gross estate only if the power was exercised by will or by specified dispositions. Treas Reg §20.2041-2(a).

A failure to exercise a pre-1942 general power of appointment, or a complete release of such a power, is not considered to be an exercise of a general power of appointment. Treas Reg §20.2041-2(d). Nevertheless, pre-1942 general powers may be exercised inadvertently. In *Estate of Sarah W. Greve*, TC Memo 2004-191, for example, the court held that property subject to a pre-1942 testamentary general power was included in the estate of the power holder because the power was exercised by a residuary clause in a will under state law. The court rejected an attempt by the executor to disclaim the power, noting that disclaimers of transfers made before January 1, 1977, must be made within a reasonable time after knowledge of the existence of the disclaimed interest. See §12.19. Post-1942 powers are not considered to be general powers if they can be exercised only with the consent or joinder of the creator or a person having a substantial adverse interest in the property. Treas Reg §20.2041-3(c). Pre-1942 powers are not considered to be general powers if they can be exercised only in conjunction with another person, regardless of whether that person's interest is adverse or not. Treas Reg §20.2041-2(b).

For further information on taxation of pre-1942 powers, see IRC §2041(a)(1), (b)(1)(B); Treas Reg §20.2041-2. For discussion of taxation of post-1942 powers, see §§16.14-16.16.

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§16.14 2. Estate Taxation

If the donee dies holding a post-1942 general power of appointment, the property subject to the power will be included in his or her gross estate for federal estate tax purposes. IRC §2041(a). A general power does not exist at the donee's death if its exercise was conditioned on the occurrence of a contingency not within the donee's control that has not occurred at the time of the donee's death. See Reg §20.2041-3(b). For example, if the power of appointment is exercisable only after the donee reaches age 40 and he or she dies before reaching that age, then the donee does not have a general power of appointment.

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§16.15 3. Gift Taxation

The exercise or release of a general power of appointment is deemed a transfer of property (see IRC §2514(b)) and therefore constitutes a taxable gift by the donee under IRC §2501.

With the exception of the "five or five" withdrawal power, discussed in §16.17, the lapse of a post-1942 general power of appointment constitutes a release of the power and is a transfer subject to estate or gift tax. IRC §2041(a)(2), (b)(2); IRC §2514(b), (e).

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§16.16 4. Income Taxation

The existence of a power of appointment may have the effect of shifting the income tax burden from the trust to the holder of the power of appointment. A donee who holds a general power of appointment exercisable solely by himself or herself to vest trust corpus or income in himself or herself is treated as the owner of that portion of the trust subject to the power for income tax purposes. IRC §678(a)(1).

If the *donee* partially releases the power, but retains controls that would subject a donor to income tax as the owner of the trust under IRC §§671-677, the donee is treated as the owner of that portion of the trust over which he or she previously possessed the power. IRC §678(a)(2). If the *grantor* is treated as the owner under IRC §§671-677, however, IRC §678(a) will not apply and the donee will not be treated as the owner. IRC §678. Similarly, if (a) the donee renounces or disclaims the power after a reasonable time after he or she becomes aware of its existence or (b) the holder in his or her capacity as a trustee has only the power to apply income to discharge support obligations but does not use the power, then IRC §678(a) will not apply. IRC §678(c)-(d). See also discussion of the income tax implication of the "five or five" withdrawal power in §16.17.

When the donee is a trustee-beneficiary, IRC §678(a)(1) can have negative tax consequences. If the trust requires a mandatory payout of income, §678(a)(1) does not result in a hardship, because income will actually be paid to the trustee-beneficiary. If the trust gives the trustee discretion to distribute or accumulate income, however, the result could be quite harsh; the trustee-beneficiary could be taxed on all trust income, regardless of how much income the trustee-beneficiary received. To avoid this problem, a cotrustee or special trustee can be appointed to sprinkle the income. The cotrustee who has a power to distribute income to himself or herself with another cotrustee's or a special trustee's consent will not be treated as the owner of trust income under IRC §678(a), because the power may be exercised only with a third party. Treas Reg §1.678(a)-1(b). See form 28.16-1 for a clause nominating a special trustee.

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§16.17 D. Five or Five Withdrawal Power

As stated in §11.19, the general rule is that a lapse of a power constitutes a taxable release of a power. The "five or five" withdrawal power constitutes an exception to this rule. The five or five power is a noncumulative power of withdrawal that does not exceed in any calendar year the greater of (1) 5 percent of the aggregate value (at the time of the lapse) of the assets from which the exercise of the lapsed powers could have been satisfied or (2) $5000. IRC §2041(b)(2). For example, if the trust property is worth $100,000 and the beneficiary has the noncumulative right to withdraw $5000 annually, failure to exercise this right for any year before the year of death has no estate tax consequences.

The rule applies only to a lapse during the donee's life. In the year of the donee's death, the value of the property subject to the power would be included in his or her estate for estate tax purposes. Rev Rul 79-373, 1979-2 Cum Bull 331. The method of calculating the amount of the trust estate to be included in the donee's estate for estate tax purposes is set out in the regulations. The regulations require an annual determination of the percentage of the trust, in excess of the five or five power, that could have been appointed under the lapsed power. The aggregate of these percentages is applied to the value of the trust estate on the date of the donee's death (but not to exceed 100 percent of this trust estate). See Treas Reg §20.2041-3(d)(4).

If the power to withdraw is a power to withdraw from the principal of the trust, then the 5-percent limitation is calculated on the value of the principal of the trust. If the power to withdraw is a power to withdraw from income only, then the 5 percent is calculated on the value of the income. Rev Rul 66-87, 1966-1 Cum Bull 217.

If the trust is a generation-skipping trust, the lapse of the five or five power may have generation-skipping transfer tax consequences. See chap 15.

The five or five power is useful to provide the surviving spouse or some other beneficiary with a power of withdrawal that is not limited by the trustee's discretion. For a five or five withdrawal power, see form 21.31A-1.

The holder of a five or five power may be taxable on trust income (and possibly capital gain) attributable to the portion of the corpus subject to the five or five power regardless of whether that income is actually paid to the holder or required to be paid currently to other beneficiaries. See IRC §§661-668, 678(a)(1); Treas Reg §1.671-3(b)(1), (c); Rev Rul 67-241, 1967-2 Cum Bull 225. The income tax consequences following the lapse of such a power are unclear. In situations when the ruling has been advantageous to the taxpayer, the IRS has consistently ruled that the power holder continues to be subject to income tax after the lapse of the power. See IRS Letter Ruling 200022035. This is based on a cursory reading of IRC §678. But this conclusion is highly debatable because §678 refers to a "release" or "modification" rather than a lapse. For discussion of the issue, see Early, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status*, 65 J Tax 198 (Apr. 1985) and Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 105 (Feb. 1998). Fortunately, the IRS has never shown much inclination to raise the issue on examination, perhaps because it is hardly clear what result would most benefit the government in the long run, and some tax practitioners consistently file returns that implicitly take the position that §678 does not apply after the lapse and that all subsequent income is taxed as trust income and not income of the power holder.

In Rev Rul 85-88, 1985-2 Cum Bull 201, the Internal Revenue Service ruled that when a donee held a right of withdrawal in two identical trusts created by the same grantor, the amounts should be aggregated for purposes of calculating the five or five power. Although the lapse of a five or five power does not have taxable consequences, the surviving spouse has a general power of appointment to the extent of the five or five power in the year of his or her death. See *Estate of E.H. Kurz* (1993) 101 TC 44, aff'd (7th Cir 1995) 68 F3d 1027.

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E. Exceptions to General Powers

§16.18 1. Post-1942 Power Subject to Joint Exercise by Person Having Adverse Interest

Under Prob C §611(c), the following is not a general power of appointment: a post-1942 power exercisable by the donee only in conjunction with a person having a substantial interest in the appointive property that is adverse to exercise of the power in favor of the donee, the donee's estate, the donee's creditors, and the creditors of the estate. Although similar language appears in the Internal Revenue Code, IRC §§2041(b)(1)(C) and 2514(c)(3) specifically provide that a person is considered to have such a substantial adverse interest if, after the donee's death, he or she may exercise a power over the property in favor of himself or herself, his or her estate, his or her creditors, or creditors of his or her estate. IRC §§2041(b)(1) (estate tax), 2514(c)(3) (gift tax).

An interest adverse to the exercise of the power is "substantial" if it is not insignificant in relation to the total value of the property. The regulations are not helpful in determining what is insignificant. See Treas Reg §20.2041-3(c)(2). Fortunately, there are no common estate planning strategies that rely on the use of the "substantial adverse interest" rule.

If the holder of a power of appointment is a surviving spouse, any power held jointly with another person (whether adverse or not) will not qualify for the marital deduction. The power must be exercisable by the surviving spouse "alone and in all events" to qualify for the deduction. Treas Reg §20.2056(b)-5; Rev Rul 82-156, 1982-2 Cum Bull 216.

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§16.19 2. Power to Consume Limited by Ascertainable Standard

A power to consume, invade, or appropriate property for the decedent's benefit that is limited by an ascertainable standard relating to the decedent's health, education, support, or maintenance is not considered a general power of appointment. IRC §2041(b)(1)(A). See also Prob C §16081(c) (unless a broader power is intended by express reference to Prob C §16081(c), a beneficiary with power to take trust property for his or her own benefit must exercise it only for his or her health, education, support, or maintenance within the meaning of IRC §2041).

On drafting requirements for creating the requisite ascertainable standard, see §16.21.

Although the income tax rules make no exception for general powers limited by an ascertainable standard (see IRC §678), the courts have held that, if the power is limited by a reasonably definite standard, a nongrantor donee will not be treated as the owner of a trust. See *U.S. v De Bonchamps* (9th Cir 1960) 278 F2d 127; *Eva V. Townsend* (1945) 5 TC 1380. In *Townsend,* the Tax Court concluded that a surviving spouse was only taxable on that portion of the trust income necessary to meet the standard provided in the will. Many practitioners avoid this issue by naming a cotrustee, although it is not necessary to do so and often is not desired by the surviving spouse.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/ F. Disguised General Powers/ §16.20 1. Power to Alter, Amend, Terminate, or Revoke

F. Disguised General Powers

§16.20 1. Power to Alter, Amend, Terminate, or Revoke

An unlimited power to alter, amend, terminate, or revoke a trust is a general power of appointment unless that power will not benefit the holder of the power. Although this power is normally reserved for the donor of a living trust, it may also be given to others, including a trustee.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/ 2. Power to Consume Not Limited by Ascertainable Standard/§16.21 a. Failure to Articulate Proper Standard

2. Power to Consume Not Limited by Ascertainable Standard

§16.21 a. Failure to Articulate Proper Standard

A beneficiary may be granted the power to consume all or any portion of trust property. Under this power, the donee may consume trust property only for his or her own use. This power does not limit the holder to consuming only according to need; it may include luxuries. A power to consume not limited by an ascertainable standard is considered to be a general power of appointment. IRC §2041. See §16.11.

To prevent the power from being classified as a general power for tax purposes, it must be limited by a standard that is ascertainable and that a court of equity can measure and enforce. The test of an ascertainable standard is whether a court of competent jurisdiction can measure the exercise in terms of money. *Ithaca Trust Co. v U.S.* (1929) 279 US 151, 49 S Ct 291, 73 L Ed 647. For detailed discussion of the law applicable to ascertainable standards, see Halbach, *Tax-Sensitive Trusteeships*, 63 Or L Rev 381 (1984).

The power need not be limited to providing the appointee with bare necessities, but it must be limited to the purposes specified in the Internal Revenue Code. Treasury Regulation §20.2041-1(c)(2) provides several examples of drafting language that creates the requisite ascertainable standard by which a power to consume should be limited so as not to constitute a general power of appointment:

- For support in reasonable comfort (but see caveat below);
- For maintenance in health and reasonable comfort (but see caveat below);
- For support in an accustomed manner of living;
- For education, including college and professional education; or
- For medical, dental, hospital, nursing, and invalidism expenses.

Failure to follow the explicit requirements of the Internal Revenue Code and regulations for an ascertainable standard may result in unnecessary adverse taxation. If the drafter does not carefully follow the wording of the regulations, the power may be considered to be a general power. The authors recommend that the power be granted in terms taken verbatim from Treas Reg §20.2041-1(c)(2). See form 21.31-1.

If a power to consume is expanded beyond the stated ascertainable standard, adverse tax consequences may result because the power will no longer be an "excepted" power. Purposes that remove the power from an "ascertainable standard" include providing for a beneficiary's "comfort," "welfare," "benefit," "best interest," "enjoyment," and "happiness." See *Lehman v U.S.* (5th Cir 1971) 448 F2d 1318; *Estate of John Russell Little* (1986) 87 TC 599; *Estate of Janice McNear Towle* (1970) 54 TC 368. See also Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2); *Estate of Nunn* (1974) 10 C3d 799, 112 CR 199 (construing "need"); *Estate of Allgeyer* (1976) 60 CA3d 169, 129 CR 820 (construing "comfort"). Such words should never be used in the clause granting a power that is not meant to be a general power of appointment, even though Treas Reg §20.2041-1(c)(2) refers to support or maintenance "in reasonable comfort" as an acceptable standard. "Reasonable support" is preferable to "support in reasonable comfort." The "needs" of the beneficiary for "health" and "support" are an ascertainable standard (Treas Reg §20.2041-1(c)(2)); however, the power to use trust property for "any special need" not limited to standards of health, education, support, or maintenance described in IRC §2041(b)(1)(A) is a general power (IRS Letter Ruling 8601003).

In determining whether a power is limited by an ascertainable standard, the attorney need not ascertain whether the beneficiary is required to exhaust his or her other income before the power can be exercised. Treas Reg §20.2041-1(c)(2).

If a surviving spouse's power to distribute is limited by an ascertainable standard, the trust property will not be included in the survivor's estate under IRC §2041 even though he or she is a trustee and a beneficiary. This is true whether the power is one of withdrawal for the spouse's own benefit or a discretionary power to appoint property to others. Some practitioners believe that if the spouse has a power of withdrawal, however, he or she may be considered to be the owner of the trust for income tax purposes and will be taxed on the income of the trust (including the capital gain). See IRC §678(a)(1). However, this result is not clear. Some commentators contend that the grantor trust rules

were never intended to apply when a withdrawal power was subject to a "reasonably definite standard" (see IRC §674(b)(5)(A) and (d)). Indeed, the only appellate case on the issue in almost half a century reflects such an assumption. See *U.S. v De Bonchamps* (9th Cir 1960) 278 F2d 127. As a practical matter, the IRS has shown no inclination to revisit the issue since the *De Bonchamps* decision, perhaps because it is hardly clear that any particular resolution of the question would benefit the government over time. At least in the Ninth Circuit, including California, it seems safe to take the position that IRC §678 does not apply and to report the income as being trust income.

In any event, the issue can be eliminated by requiring that the exercise of the power of withdrawal be contingent on another person's consent, because under IRC §678(a)(1) a holder is treated as an owner only if the power is exercisable solely by himself or herself. If the survivor's autonomy in withdrawing trust property is of primary importance, the testator may prefer the risk of additional income taxation to the necessity of obtaining another's consent to withdrawal. The attorney should bear in mind that, for a trust to qualify for the marital deduction, the surviving spouse's power of appointment may not be shared and must be exercisable by the surviving spouse "alone and in all events." Treas Reg §20.2056(b)-5.

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§16.22 b. Effect of Imposition of Ascertainable Standard Under State Law

A trustee's power to make distributions to himself or herself will not cause inclusion if state law prohibits the exercise of that power or limits the exercise of that power to an ascertainable standard. See Rev Proc 94-44, 1994-2 Cum Bull 683; IRS Letter Ruling 200014002.

Under Prob C §16081(c), an ascertainable standard applies unless the settlor or testator clearly indicates that a broader power is intended *by express reference to Prob C §16081(c)*. Probate Code §16081(c) does not apply to a power held by a spouse of a marital deduction trust. Prob C §16081(d).

In *Brantingham v U.S.* (7th Cir 1980) 631 F2d 542, the court ruled that Massachusetts state law would limit the exercise of a spouse's power to invade trust principal for her "maintenance, comfort and happiness" to an ascertainable standard relating to "health, education, support or maintenance." The IRS has not acquiesced in this decision. Rev Rul 82-63, 1982-1 Cum Bull 135.

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§16.23 c. Power to Invade Principal for "Emergency"

In *Estate of Sowell v Commissioner* (10th Cir 1983) 708 F2d 1564, the court determined that language in a trust authorizing invasion of corpus "in case of emergency or illness" was the same as "need" and therefore did not create a general power of appointment.

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§16.24 3. Power to Withdraw

An unlimited power to withdraw trust assets is a general power of appointment. However, the power to withdraw may cover all the principal or a specified portion, limited in amount, time, conditions, or otherwise. For example, an unlimited power to withdraw up to $25,000 to purchase a residence is a general power to the extent of $25,000. If the power to withdraw is limited by the "five or five" power exception, however, then the only property that will be included in the surviving spouse's estate will be the property subject to the five or five power at the time of the donee's death. See §16.17.

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§16.25 4. Power to Discharge Legal Obligation of Support

Because a power of appointment that may be exercised to discharge the donee's legal obligation of support is considered a power exercisable in favor of the donee or his or her creditors, it is a general power of appointment. Treas Reg §20.2041-1(c)(1). Under California law, a power to distribute property for the benefit of a person in discharge of the donee's obligation of support, which is limited by an ascertainable standard relating to the person's health, education, support, or maintenance, is not a general power of appointment. Prob C §611(b).

There is no such express exception under federal law, however, because the "ascertainable standard" referred to in IRC §2041(b)(1)(A) (see §16.19) relates only to the donee of the power (*i.e.,* the decedent). Apparently, under federal law, a power simply to make discretionary payments to a beneficiary to whom one owes a duty of support may be considered a general power. This is true even if (1) there is an ascertainable standard limiting the donee's power to consume trust property for his or her own benefit and (2) distributions for support are not authorized. See IRS Letter Ruling 8924011. See also Covey, *Recent Developments Concerning Estate, Gift and Income Taxation—1989*, U Miami Inst Est Plan §112.3 (1990). On income tax implications when property is used to fulfill the donee's legal obligation of support, see §16.16.

This hidden power is significant when a parent of a minor beneficiary acts as trustee of a trust. The adverse effects may be avoided by using a special trustee who has no obligation of support to the minor beneficiary. To prevent the power from being considered a general power of appointment, however, the parent may not have the power to remove the special trustee. See IRS Letter Rulings 9036048, 8916032. Alternatively, the trust may provide that the trustee is precluded from discharging his or her obligation of support to the minor beneficiary by distribution of trust property. Such a clause reiterates the prohibition of Prob C §16082, which provides that a person who holds a power to appoint or distribute trust property to others may not use the power to discharge his or her legal obligations unless the trust instrument specifically provides otherwise.

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§16.26 5. Power to Remove Trustee and Appoint Successor

A donee's unrestricted power to remove a trustee and appoint himself or herself as trustee may be a general power of appointment because, after doing so, the donee is considered to have all the powers of the trustee. If the trustee's powers to benefit the donee would be a general power when held by the donee, the donee is considered to have a general power of appointment. Treas Reg §§20.2041-1(b)(1), 20.2036-1(b)(3).

Under Rev Rul 95-58, 1995-2 Cum Bull 191, however, a donee's power to remove a trustee without cause and appoint an individual or corporate successor trustee who is not related or subordinate to the donee within the meaning of IRC §672(c) is not a general power of appointment. Related and subordinate parties under IRC §672(c) include the settlor's spouse, parents, issue, siblings, employees, controlled corporations, and a business executive's subordinates.

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IV. SPECIAL OR LIMITED POWERS

§16.27 A. Nature of Special Power

According to Prob C §611(d), any power of appointment that is not "general" is "special." The primary characteristic of a special (or limited) power of appointment is that the power cannot be exercised in the donee's favor, either directly or indirectly. For example, if the donee were able to satisfy his or her creditors by exercising the power of appointment, he or she would be indirectly benefited. Within the stated limits, the special power may be as broad or as narrow as the donor chooses. For example, a power to appoint to *anyone* other than the donee, the donee's estate, the donee's creditors, or the creditors of the estate is a special power of appointment even though the permissible appointees are substantially unlimited.

Although special powers of appointment are not defined in the Internal Revenue Code, the regulations provide that a power is not a general power if by its terms it is either (1) exercisable only in favor of one or more designated persons other than the decedent, the decedent's estate, the decedent's creditors, or the creditors of the estate; or (2) expressly not exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the estate. Treas Reg §20.2041-1(c)(1). See Forsberg, *Special Powers of Appointment: The Key to Flexibility in Planning*, 27 Est Plan 13 (Jan. 2000).

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§16.28 B. Purpose

A special power of appointment is extremely useful when the donor wishes (1) to grant the donee flexibility to alter the dispositive provisions in light of circumstances that develop after the donor's death and (2) at the same time to restrict the class of potential appointees. It may be used to give a parent donee the power to use the trust assets to control his or her children (using the threat of disinheritance). It may also be used to optimize generation-skipping transfer tax planning (discussed in chap 15) by transferring exempt assets to skip persons and nonexempt assets to non-skip persons.

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C. Tax Consequences

§16.29 1. In General

Assets that are subject to a special power of appointment will not be included in the donee's gross estate for federal estate tax purposes. IRC §2041(a)(2). (This may be an undesirable result for generation-skipping transfer tax purposes.) Similarly, the lapse or release of such a power has no gift tax implications. IRC §2041(b)(1)(A). The donee will not be treated as the owner for income tax purposes unless he or she may use the income to support a person that the donee is legally obligated to support. IRC §678(a).

If the donor of a gift retains a special power of appointment over the gift, the gift to the remainder beneficiary is incomplete until the power is exercised or released. Treas Reg §25.2511-2(b). This aspect of a special power of appointment is used to postpone completion of a transfer when the withdrawal power lapses in *Crummey* trusts (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82). Additionally, if a beneficiary entitled to income from a trust exercises a lifetime special power over that trust, the actuarial value of the income stream given away by virtue of the exercise will be a taxable gift by the beneficiary. Rev Rul 79-327, 1979-2 Cum Bull 342. Retention of a contingent testamentary power of appointment, however, may be insufficient to make a gift incomplete. IRS Letter Ruling 199908022. See Handler & Dunn, *Retaining Testamentary Power of Appointment*, 138 Tr & Est 12 (Jan. 2000).

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§16.30 2. Successive Powers (Delaware Tax Trap)

If a special power is exercised by will or by a disposition with retained possession and enjoyment to create another power of appointment, and the second power of appointment may have the effect of postponing vesting of the property for a period ascertainable without regard to the date of creation of the first power, then the first power is a taxable power of appointment. IRC §2041(a)(3). This provision prevents the tax-free passing of property from generation to generation by the use of successive special powers of appointment. A similar rule applies to gift tax. IRC §2514(d).

The Tax Court has indicated that this rule is not applied independently of the state law analysis of the rule against perpetuities. *Estate of Mary M. Murphy* (1979) 71 TC 671, acq 1979-1 Cum Bull 1. In California (as in most states), the permissible period during which vesting may be suspended is measured from the date on which the first power was created. See Prob C §21212. This may have the effect of avoiding this trap, except when the power that is created is a presently exercisable general power of appointment.

In Delaware, the perpetuities period is measured from the date of exercise of the power of appointment, enabling absolute ownership of property to be indefinitely suspended through successive exercises of special powers of appointment. 25 Del Code Ann §501. Hence the name "Delaware tax trap."

If the power that is created is a general power of appointment presently exercisable by the donee alone, California law provides that the perpetuities period is extended. See Prob C §21225(g). It is arguable that IRC §§2041(a)(3) and 2514(d) apply under these circumstances.

In the generation-skipping transfer (GST) tax system, it is sometimes desirable to convert a GST tax, which is imposed at the maximum estate tax rate, into an estate tax by taking advantage of IRC §2041(a)(3). In this way, the desired tax savings are achieved without granting a child a general power of appointment. See Blattmachr & Pennell, *Using "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J Tax 242 (Apr. 1988). The tax savings will disappear in 2006 when the arrival of the $2 million applicable exclusion amount will result in each dollar of estate value in excess of $2 million being taxed at the then-maximum rate of 46 percent that applies to GSTs.

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V. RIGHTS OF DONEE'S CREDITORS

A. General Powers of Appointment

§16.31 1. Creditors' Rights Cannot Be Negated

The donor of a general power of appointment cannot nullify or alter the rights given creditors of the donee in Prob C §§682-684 by any language in the instrument creating the power. Prob C §680.

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§16.32 2. Creditors Must Exhaust Nonappointive Property

If the general power of appointment is presently exercisable, the donee's creditors may reach the property during the donee's lifetime to the same extent that the property would be subject to their claims if the donee owned it. Before they may resort to the appointive property, however, creditors must exhaust the property owned by the donee. Prob C §682(a); *Estate of Masson* (1956) 142 CA2d 510, 298 P2d 619. If the donee still holds a testamentary or inter vivos general power of appointment at death, then to the extent that the estate is insufficient to satisfy expenses of administration and claims of creditors of the estate, the appointive property is "subject to such claims and expenses" as if "the property had been owned by the donee." Prob C §682(b). The rule in Prob C §682(a)-(b) applies whether or not the power was exercised. Prob C §682(c).

It appears that the appointive property should also be subject to payment of funeral and last-illness expenses. Although these expenses are technically neither expenses of administration nor claims of creditors, and thus are not included in the literal language of Prob C §682(b), they must be paid from the decedent's property before claims having lower priority. Prob C §11420.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.33 B. Special Powers of Appointment

§16.33 B. Special Powers of Appointment

Property subject to a special power of appointment is not subject to claims of the donee's creditors or creditors of the donee's estate or to expenses of administration of the donee's estate. Prob C §681.

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VI. CONFLICT OF LAWS

§16.34 A. Law of Creation and Exercise of Power

Not infrequently, the donor and donee of a power of appointment must consider potential conflict of law problems in either the state of creation of the power or the state of exercise of the power, or both. See chap 11 on problems relating to exercise of the power.

The rules regarding governing law differ according to whether the appointive property is immovable (real property) or movable. When in doubt, the drafter should try to comply with the rules applicable to both immovables (see §16.35) and movables (see §16.36) by specifying in the will or revocable trust as many rules as possible, *e.g.,* the method to be employed in exercising the power, the persons to be served with notice of the exercise, the document of exercise, whether the document of exercise must be acknowledged and recorded, and any other procedural aspects.

Unless it is clear that the states involved will accept the donor's designation of controlling law, the drafter should assume that this designation will not be effective and draft accordingly. The will drafter should also ensure that the powers of appointment given in the will comply with the rule against perpetuities of the state where the property is situated. See §11.17.

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§16.35 B. Law Governing Immovables

When a power of appointment applies to real property (including estates less than a fee), the general rule is that the law of the situs governs both the creation and the exercise of the power of appointment. Restatement (Second) of Conflict of Laws §§241, 243, 249, 251, 278, 281 (1971). For example, a legal life estate in a parcel of land, followed by a testamentary power of appointment, is governed by the law of the state where the land is situated.

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§16.36 C. Law Governing Movables

A power of appointment created by will concerning movable property is generally governed by the law of the decedent's domicile on the date of death. Restatement (Second) of Conflict of Laws §260 (1971). The will is interpreted according to the laws in the testator's domicile on the date of the will's execution. Restatement §263. Thus, the validity of the will ordinarily determines whether a valid power of appointment was created, but the power must also comply with the rule against perpetuities of the state governing the will's validity.

With regard to testamentary trusts of movables, the validity of trust clauses is generally determined by local law of the state designated to govern the trust's validity, provided that that state has a substantial relation to the trust. Without such a designation, the determination is based on the law of the testator's domicile at death. Restatement §269.

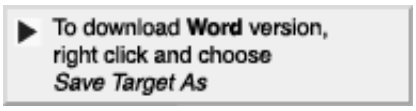
The administration of a trust is ordinarily determined according to the law of the situs of administration where a trust is located. For a testamentary trust, this is usually the testator's domicile on the date of death, but it may be changed if the will clearly indicates a different intent.

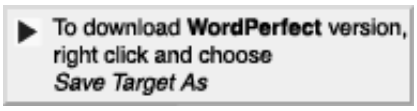
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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/ VII. POWER FORMS/§16.37 A. Form: Lifetime Power of Appointment Created

VII. POWER FORMS

§16.37 A. Form: Lifetime Power of Appointment Created





16.37-1 Lifetime power of appointment created

[*Add one of the following alternatives*]

[*Alternative 1: General power of appointment*]

At any time during the life of the beneficiary designated below, the trustee shall distribute all or any part of the trust (including accrued income and undistributed income) to one or more persons and entities (including the beneficiary or the beneficiary's estate), on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document specifically referring to and exercising this power of appointment.

Beneficiary: _ _[*Name of beneficiary*]_ _

[*Alternative 2: Special power of appointment (broad power)*]

At any time during the life of the beneficiary designated below, the trustee shall distribute all or any part of the trust (including accrued income and undistributed income) to one or more persons and entities, other than the beneficiary, the beneficiary's estate or creditors, or creditors of the beneficiary's estate, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document specifically referring to and exercising this power of appointment.

Beneficiary: _ _[*Name of beneficiary*]_ _

[*Alternative 3: Special power of appointment (narrow power)*]

At any time during the life of the beneficiary designated below, the trustee shall distribute all or any part of the trust estate (including accrued income and undistributed income) to one or more of the group consisting of the class specified below, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in paragraph _ _[*number*]_ _.

Beneficiary: _ _[*Name of beneficiary*]_ _ **Class:** _ _[*Name of class*]_ _

Comment: See form 16.40-1 for a clause for disposition in case the donee does not exercise the power of appointment.

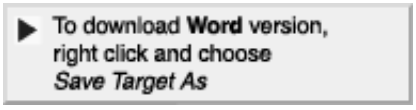
The testator may wish to limit the invasion power in Alternative 3 to an amount below $5000 or 5 percent of the principal of the trust, especially if the trust estate is not substantial. Some attorneys prefer to omit the 5-percent alternative, leaving only the provision that the beneficiary may withdraw up to $5000 (or a lesser amount), because the clause is then simpler to draft and administer. If the tax benefits of the "five or five" power are desired, the beneficiary's right of withdrawal must be noncumulative, as provided in form 21.31A-1. For income tax reasons, some attorneys believe that a beneficiary should not be given a five or five power in a will that provides for no income, or only discretionary payments of income, to the beneficiary. See IRC §673. This and other tax aspects of five or five powers are discussed in §16.17. Because the withdrawal power is a general power of appointment, the withdrawable amount will be included in the beneficiary's estate if the power exists on the date of death. This clause seeks to minimize that possibility by providing, in effect, that the power does not exist in any year that the beneficiary is not alive on the last

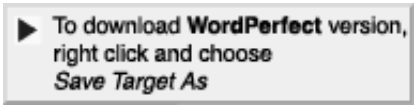
day of the year.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.38 B. Form: Testamentary Power of Appointment Created

§16.38 B. Form: Testamentary Power of Appointment Created





16.38-1 Testamentary power of appointment created

[*Add one of the following alternatives*]

[*Alternative 1: General power of appointment*]

At the death of the beneficiary designated below, the trustee shall distribute any remaining balance of the trust estate (including accrued income and undistributed income) to one or more persons and entities (including the beneficiary's estate), on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in paragraph _ _[*number*]_ _

Beneficiary: _ _[*Name of beneficiary*]_ _

[*Alternative 2: Special power of appointment (broad power)*]

At the death of the beneficiary designated below, the trustee shall distribute any remaining balance of the trust estate (including accrued income and undistributed income) to one or more persons or entities other than the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the estate, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in paragraph _ _[*number*]_ _.

Beneficiary: _ _[*Name of beneficiary*]_ _

[*Alternative 3: Special power of appointment (narrow power)*]

At the death of the beneficiary designated below, the trustee shall distribute any remaining balance of the trust estate (including accrued income and undistributed income) to one or more of the group consisting of the class specified below, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in paragraph _ _[*number*]_ _

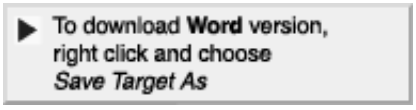
Beneficiary: _ _[*Name of beneficiary*]_ _
Class: _ _[*Name of class*]_ _

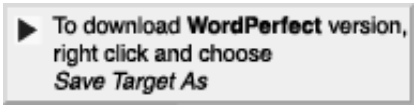
Comment: Examples of the class of intended beneficiaries for whom the power may be exercised (see Alternative 3) are the testator's spouse, his or her issue, and the spouses of the testator's issue.

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§16.39 C. Form: Release and Disclaimer of Powers Authorized





16.39-1 Disposition of power on disclaimer and release

Notwithstanding any other provision of my will, any power created by my will may be released, disclaimed, or restricted in scope, whether the power is expressly granted in my will or implied by law. Any power may be released to the extent and in the manner set forth in Probate Code §661 or disclaimed to the extent and in the manner set forth in Probate Code §§260-295, if these Probate Code sections exist on the date of exercise of the release or disclaimer. Any released or disclaimed power shall pass to and may be exercised by the following person: _ _[*Name*]_ _.

Comment: This clause may help solve potential conflict of laws problems that may arise when the laws of one state are not the same as the laws of another state and when the power must comply with the laws of both states. On releases, see chap 11. The clause should refer to the actual sections of the Probate Code. Otherwise, language that is intended to ensure the power to release or renounce, but that is less broad than these statutes, might be construed as limiting the power. Although this clause specifies that the statutes must exist on the date of exercise of the release or disclaimer, the drafter might specify that the statutes must exist when the will is executed. Alternatively, the will may provide that, in case of a release or disclaimer, the property will pass to certain named persons. See form 16.40-1.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.40 D. Form: Disposition of Property on Default of Appointment

§16.40 D. Form: Disposition of Property on Default of Appointment

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16.40-1 Disposition of property on default of appointment

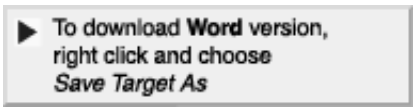
If any of the property subject to power of appointment by the donee under paragraph _ _[*number*]_ _ of my will is not effectively appointed by the donee (because the donee fails to exercise the power, makes an invalid or ineffective attempt to exercise the power, effectively revokes an exercise of the power, or irrevocably releases, disclaims, or renounces the power), the property shall be distributed as specified below:

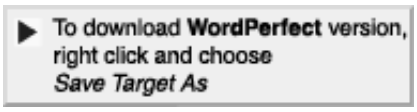
Comment: See §16.10.

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Source: Estate Planning/California Will Drafting/16 Creating Powers of Appointment/§16.41 E. Form: Joint Power of Appointment

§16.41 E. Form: Joint Power of Appointment





16.41-1 Joint power of appointment

Notwithstanding any other provision of my will, the power of appointment in paragraph _ _[*number*]_ _ shall be exercised by the beneficiary only if the power of appointment is jointly exercised in the same manner by _ _[*name of joint powerholder*]_ _.

Comment: If the joint powerholder is not a person with a substantial adverse interest as described in IRC §2041(b)(1), then the joint exercise requirement will not convert this power of appointment from a general to a limited power of appointment. See §16.18. This clause converts what would otherwise have been a generation-skipping transfer tax into an estate tax. This result may also be achieved by giving an independent trustee the power to grant a general power of appointment to a beneficiary. See chap 15.

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Marital Deduction: Overview and Formula Clauses

Robert J. Durham, Jr.

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I. ROLE OF MARITAL DEDUCTION IN ESTATE PLANNING

§17.1 A. Purpose of Marital Deduction

The federal estate tax marital deduction and the gift tax marital deduction allow married couples to pass unlimited amounts of property to each other without transfer tax consequences. Taxpayers can defer all federal wealth transfer taxes until the death of the second spouse to die, and all the marital property will be available for the surviving spouse's support. A limited marital deduction was in effect before 1981. See §17.2. The limited marital deduction may still apply to decedents with wills executed before 1981. See §17.3.

These deductions achieve a deferral, but not necessarily a reduction, in transfer tax because a prerequisite for obtaining a deduction is that the property must be transferred to the surviving spouse in such a manner that the property will be subject to tax in the survivor's estate if it has not been consumed. This usually shifts the tax burden and any attendant liquidity problems to members of the next generation, who usually receive the property at the survivor's death. This tax deferral opportunity is probably the single most important estate planning tool available to married individuals.

The marital deduction does not apply to same-sex spouses or registered domestic partners (see Fam C §297.5) treated as spouses under California law. Although the IRS generally relies on state law for its definition of spouse, the Defense of Marriage Act (1 USC §7) prohibits the IRS from relying on state law when that definition would treat same-sex spouses or partners as spouses.

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§17.2 B. Limited Marital Deduction Before 1981

Congress enacted the marital deduction to equalize the treatment of marital property in common law and community property jurisdictions. See Revenue Act of 1948 (Pub L 80-471, 62 Stat 110). The maximum marital deduction, which amounted to half of the decedent's net separate property, equaled the gross estate less community property minus the proportion of deductions for debts, expenses, and losses attributable to separate property.

Section 2002(a) of the Tax Reform Act of 1976 (TRA 1976) (Pub L 94-455, 90 Stat 1854) increased the maximum marital deduction to the greater of $250,000 or half of the adjusted gross estate, which amounted to half of the decedent's net separate property.

Under these rules, many estates were still subject to tax on a portion of the marital property at the death of the first spouse, and taxed property that passed to the surviving spouse was subject to taxation a second time in the surviving spouse's estate.

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§17.3 C. Transition Rule for Wills Executed Before 1981

Section 403 of the Economic Recovery Tax Act of 1981 (ERTA) (Pub L 97-34, 95 Stat 301) changed the marital deduction scheme by allowing all interspousal transfers to be made tax free. ERTA adopted an unlimited marital deduction rule for both estate and gift tax that was applicable to both separate and community property. As a result, estate tax was levied on the marital property unit as a whole, usually following the surviving spouse's death.

The unlimited marital deduction is not always available in cases involving wills of married persons if the will was executed before September 12, 1981. Under California law, if a will dated September 12, 1981, or earlier indicates the testator's intention to make a gift that provides the testator's estate with the maximum marital deduction, then the will passes to the recipient an amount equal to the maximum marital deduction that would have been allowed at the testator's death for federal estate tax purposes under the law existing before the enactment of ERTA. Prob C §21523. Whenever a client has a will or trust that might be subject to the ERTA transition rule, the will or trust should be updated to state expressly whether the client wishes to make use of the unlimited marital deduction. (Most wills drafted as long ago as 1981 require other changes as well and should be redone entirely.)

If a testator dies without amending such an old will, several strategies are available for obtaining an unlimited marital deduction if the heirs desire that result. In some cases, the bypass trust will fortuitously qualify for the marital deduction if a QTIP election is made. In other cases, disclaimers by other family members may increase the value of the property passing to the spouse. However, disclaimers that cause additional assets to pass to a QTIP trust may not be qualified disclaimers under IRC §2518 if the disclaimants retain a remainder interest in the QTIP trust, as often will be the case with children of the deceased testator. See IRS Letter Ruling 200846003 (disclaimers that caused retirement account to pass to QTIP trust as contemplated by premarital agreement when deceased spouse instead named her children as designated beneficiaries of the account were not qualified disclaimers because the QTIP remainder will pass to a trust benefiting the children).

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§17.4 D. Marital Deduction and Generation-Skipping Transfer (GST) Exemption

Each individual has a generation-skipping transfer (GST) exemption equal to the applicable exclusion amount in 2004-2009 and a GST exemption equal to $1 million, adjusted for inflation from a base year of 1997, in 2011 and thereafter. IRC §2631. Each individual also has an estate and gift tax unified credit that shields from tax an amount that increases from $2 million in 2006-2008 to $3.5 million in 2009 (returning to $1 million in 2011 and thereafter), provided that lifetime transfers do not exceed the IRC §2505 gift tax applicable exclusion amount of $1 million. The estate tax and GST tax do not apply to estates of decedents dying and transfers in 2010, although the gift tax continues to apply. IRC §§2010(a), 2210 (estate tax), 2502(a), 2505 (gift tax). See discussion in §20.2.

Accordingly, a testator's available GST exemption may exceed the value of the property that can pass free of estate tax. Under a typical estate plan that takes advantage of the "credit shelter amount" by establishing a bypass trust having a value equal to that amount, the bypass trust assets are the only assets that do not pass to the spouse or a marital deduction trust. This may result in a failure to make use of a portion of the testator's GST exemption if the testator dies after 2010, unless the testator's plan provides for establishing a separate qualified terminable interest property (QTIP) trust in the amount of the excess GST exemption and making a "reverse QTIP" election for that trust under IRC §2652(a)(3). See §§15.38-15.43, 19.13. Even in 2004-2009, when the GST exemption is equal to the applicable exclusion amount, failure to use a portion of the testator's GST exemption may occur unless a reverse QTIP election is made if the estate plan provides for making a QTIP election for a portion of the bypass trust. See discussion in §20.18A.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.5 E. California Estate Tax

§17.5 E. California Estate Tax

California imposes an estate tax, which is sometimes referred to as a "pick up" tax. The tax equals the amount of the IRC §2011 federal estate tax credit for state death taxes (repealed in 2005). In most cases this merely results in taxes being paid to California (if any) that otherwise would be paid to the United States. As a consequence, the tax has little impact on marital deduction planning. See Rev & T C §§13302-13303. See also Rev & T C §§13501-13557.

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II. MARITAL DEDUCTION PLANNING

§17.6 A. Overview of Planning Options

The transfer tax system has a significant impact on planning options for married couples. If, for example, the value of a deceased spouse's estate will exceed the IRC §2010 applicable exclusion amount available in that spouse's year of death, it is typically the case the clients will desire that some of the deceased spouse's property pass in a manner qualifying for the marital deduction to avoid unnecessary imposition of estate tax on the death of the first spouse. On the other hand, marital deduction transfers in excess of the amount needed to reduce the first death tax to zero can be desirable if there is relative certainty that the surviving spouse's estate will be too small to trigger an estate tax liability, because property included in the survivor's estate will receive a new date-of-death value tax basis under IRC §1014. Assuming assets appreciate between the two deaths, this can result in lower capital gain taxes being owed by the heirs.

Because of changing applicable exclusion amounts and considerable uncertainty regarding future legislation concerning a single year of estate tax repeal (which would also change income tax basis on death rules), it generally has become quite difficult for planners to determine whether taxes will be owed on the death of either spouse except in cases of wealthier older clients. In the face of such uncertainty, most planners believe that current plans should assume the worst concerning potential hazards of estate tax payments, assuming deaths will occur early and asset appreciation will be high. If these assumptions prove incorrect in the future, plans can be modified by the clients or by duly authorized conservators or attorneys-in-fact acting on the clients' behalf. See chap 3.

For decedents dying in 2009, IRC §2010 provides a unified credit of $1,455,800 that eliminates payment of any transfer tax for taxable gifts aggregating $3.5 million or less provided that lifetime gifts do not exceed $1 million. IRC §§2010(a) (estate tax), 2502(a) (gift tax). See discussion in §20.2. If all property passes outright to the surviving spouse, the credit will not be used and the transferred property will be taxed in the surviving spouse's estate. For example, in a community property estate of $5 million, the unnecessary estate tax will be $675,000 (45 percent of survivor's estate in excess of $3.5 million) if both spouses die in 2009 and the net value stays constant until the second spouse dies. For this reason, if a married couple owns enough property to create an estate tax, a typical marital estate plan will provide that the lesser of the predeceased spouse's property or part of that property equal to the spouse's applicable credit amount will be set aside in a tax-exempt manner.

The bypass trust is a common form of this type of set aside. See chap 20. The set-aside property may be held for the surviving spouse's benefit. If the set aside is done properly, the property is not taxed in the second estate.

The bypass trust may be referred to by a variety of terms: the "B" trust, "exemption equivalent" trust (based on terminology preceding the "applicable exclusion amount" under IRC §§2010(a) and 2505(a), discussed in §20.2), "credit shelter" trust, "credit" trust, "family" trust, or "nonmarital" trust. This book uses the term "bypass" trust.

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§17.7 B. Estate Tax Splitting

For decedents dying after 2010, the progressive nature of estate tax rates may allow the tax planner to reduce the overall estate tax paid in large estates by choosing to pay some tax in the estate of the first spouse to die. The maximum marginal rate is 55 percent on estates in excess of $3 million (plus a 5-percent surcharge for estates between $10 million and $17,184,000) unless Congress changes the law in the meantime. IRC §2001(c). If all the property in excess of the applicable exclusion amount is placed in the survivor's estate, a greater total estate tax may be paid because taxes will be assessed at a higher marginal rate in the survivor's estate than the rates that will be available after 2010 (41 to 53 percent) for up to $2 million of value in the estate of the first spouse to die.

The client may consider building into the plan the flexibility to make these decisions at the first death. See §17.91 on postmortem reconstruction.

In deciding whether to defer the tax or equalize estates, the planner must consider a number of factors. If, on the one hand, the planner decides to completely defer the tax:

- The surviving spouse may consume or give sufficient portions of the remaining estate to offset the anticipated savings under equalization. Because of the lower effective tax rate on gifts (see §17.8), an aggressive gift program may be more effective to reduce tax than tax equalization between the estates.
- The value of the assets held by the survivor may decline in value.
- All assets included in the surviving spouse's estate will receive a new tax basis at the death of the surviving spouse.
- Changes in the tax laws may result in lower or no estate tax in the second estate.
- The clients may insist that the survivor have complete and unfettered control of all property over the amounts sheltered by the applicable credit amount.

If, on the other hand, the planner decides to equalize the estates:

- Equalization and use of the IRC §2013 prior transfer property (PTP) credit will produce substantial tax savings if the survivor dies soon after the first spouse's death.
- Appreciation of the additional property that is transferred to the bypass trust will not be included in the survivor's estate.
- The trustee may accumulate income or make discretionary distributions to other family members if the survivor does not need income from the property.
- Estate taxes may increase in the future through a change in rates or a change in the allowable credit.

The will may direct the payment of tax at the death of the first spouse to die. A more appropriate time to make this decision is usually after the first death, when the executor of the estate may use a combination of partial or full election for QTIP property, or disclaimer, to optimize the tax result in the estate. See §17.42 on QTIP elections.

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§17.8 C. Lifetime Gifts

Planners with clients who have large estates should consider lifetime gift programs to minimize transfer tax. Most clients are familiar with the provision of the code that allows them to give $13,000 per donee per year (in 2009 and 2010) without incurring a gift tax. See IRC §2503(b). Few clients realize, however, that the effective rate of the gift tax on taxable transfers can be substantially less than the rate on a testamentary transfer, because the gift tax paid is excluded from the computation base in the donor's estate if more than 3 years elapse between the date of the gift and the donor's death (see IRC §2035).

For clients with substantial property, lifetime taxable gifts will produce better tax results than testamentary giving. This is a natural product of the fact that the estate tax is tax-inclusive and the gift tax is tax-exclusive. Lifetime gifts that use the donor's applicable credit amount may affect the structure of the estate plan set out in the will. There may be a smaller bypass trust if the decedent has used some or all of the lifetime gift exemption (*e.g.*, $1 million rather than the usual $2 million if the decedent has used the entire $1 million exemption).

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§17.9 D. Split of Control and Tax Benefit

The testator may achieve deferral of taxation under the marital deduction and still control the ultimate disposition of the property. This split of control and tax benefit is clearly illustrated by a comparison of the power of appointment trust under IRC §2056(b)(5) (see §§17.20-17.21) and the qualified terminable interest property (QTIP) trust under IRC §2056(b)(7) (see §17.22). Both trusts pay all the income at least annually and for life to the surviving spouse. In the power of appointment trust, the surviving spouse controls who ultimately receives the property. In the QTIP trust, the predeceased spouse controls who ultimately receives the property, although certain withdrawal powers or special powers of appointment may allow the survivor to alter the plan.

The segregation of control and tax benefit adds flexibility to marital deduction planning. Using a QTIP trust, a predeceased spouse may control his or her share of community property and separate property without losing the tax deferral. The assertion of control may serve a number of purposes, including protecting the trust estate from the claims of the survivor's creditors, providing independent management of assets, protecting a survivor against artful and designing persons, and providing the necessary structure to allow the predeceased spouse to take advantage of the full generation-skipping tax exemption. Although this flexibility allows the estate planner more creativity in serving clients, it also heightens the potential for conflict of interest. Conflicts of interest and other ethical issues are discussed in §§1.21-1.32.

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§17.10 E. Nontax Considerations

Tax savings are usually not the client's first priority. The client most often views the will as making provision for the protection and support of the survivor followed by an orderly transfer of the assets to the next generation. Even in large estates in which marital tax planning may be linked with lifetime gifts and generation-skipping considerations, the client may view tax considerations as an unwelcome complicating factor. These considerations also apply to same-sex spouses or domestic partners who are not eligible for the estate and gift tax marital deduction. See §17.1.

The attorney's challenge is to address both tax and nontax considerations in conferences with the client, thus enabling the client to make informed judgments about potential tax savings and family aims.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.11 F. Community Property

§17.11 F. Community Property

A California estate may consist of a combination of community, quasi-community, and separate property. After ERTA (see §17.3), there is no distinction between community property and separate property in applying the marital deduction, except in those limited situations in which ERTA does not apply. On the death of a person with a spouse or registered domestic partner, one-half of the community property belongs to the surviving spouse or partner and the other half to the decedent. Prob C §100; Fam C §297.5. Community property expressly declared in a transfer document to be community property with right of survivorship passes to the survivor, subject to the same procedures as property held in joint tenancy. CC §682.1. Quasi-community property is actually separate property that is subject to the California equivalent of a common law state "forced share" statute, in that one-half of this separate property passes to the survivor if the parties are domiciled in California at the owner's death. Prob C §101. If the property of spouses was community property under the laws of a non-California domicile, it retains its community character for federal estate tax purposes. Prob C §§66, 6101.

Providing for the disposition of each spouse's community property interest in a qualified plan or IRA presents another set of issues. Under California law, interests of husband and wife or domestic partners in retirement benefits earned during marriage are community property. See Fam C §2610 (division of retirement plans on dissolution of marriage according to community property interests in the plan).

Federal pension law permits distribution of the nonemployee's community property interest in the plan to the nonemployee spouse as an alternate payee on dissolution under a qualified domestic relations order (QDRO), as an exception to the antiassignment and alienation rule. IRC §§401(a)(13)(B), 414(p). In addition, although transfers of IRA interests on dissolution do not require a QDRO, they are permitted and nontaxable. IRC §408(d)(6). IRA distributions that are transferred to the nonemployee spouse or partner, however, are taxable to the employee spouse or partner. *Michael G. Bunney* (2000) 114 TC 259.

Community property rights in employee benefits remain community property at death. See Prob C §§5000-5705. The nonemployee spouse or registered domestic partner controls disposition of his or her community property interest in the employee's IRA by executing a consent to the employee's choice of beneficiary. Without the consent of the nonemployee spouse or partner, the employee's beneficiary designation operates only to transfer his or her community property interest. Prob C §5020. Note that the survivor can set aside the transfer of his or her one-half interest in each community property asset under Prob C §5021 even though he or she is already receiving more than a one-half share of the total community property. *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240; *Estate of Wilson* (1986) 183 CA3d 67, 227 CR 794. This assumes that the survivor has not made a valid transmutation of each community property asset to the decedent's separate property. See §10.11C. If the nonemployee spouse or partner consents to a beneficiary designation by the employee, that consent is irrevocable after the death of the nonemployee spouse or partner. Prob C §5030. As a consequence, control of the beneficiary designation on an IRA requires the participation of both spouses or partners.

In *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754, the 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 arising under state law that is 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. In *Branco v UFCW—N. Cal. Employers Joint Pension Plan* (9th Cir 2002) 279 F3d 1154, the court held that a dissolution decree was not a QDRO to the extent that it assigned rights to payments to be made after the death of the nonparticipant spouse. In *Marriage of Shelstead* (1998) 66 CA4th 893, 78 CR2d 365, the court held that a QDRO may not give the nonparticipant spouse the right to name a successor in interest on death. See also *Kennedy v Plan Administrator for DuPont Sav. & Inv. Plan* (2009) 555 US ___, 172 L Ed 2d 662, 129 S Ct 865 (simple waiver of plan benefits by former spouse was not a QDRO); *Marriage of Padgett* (2009) 172 CA4th 830, 91 CR3d 475 (amended order enforcing former spouse's community property interest in plan benefits was not a QDRO). However, a community property interest held by a nonparticipant same-sex domestic partner is not preempted, because same-sex domestic partners are not treated as spouses for purposes of federal law. See §17.1.

The participant spouse's community property interest in a qualified plan is also effectively preempted by ERISA because the *Boggs* decision indicates that the nonparticipant spouse is entitled to the plan benefits on the death of the participant spouse with no reduction in the survivor's share of other community property, unless the survivor has executed a valid waiver and consent to a beneficiary designation naming someone other than the nonparticipant spouse. Such a waiver and consent would appear to represent a gift by the nonparticipant spouse to the recipients of the survivor's interest in the other property that is not protected by the estate tax marital deduction and is not reduced by the value of the survivor's retained interest.

Some attorneys have advocated use of a nonprorata division of community property by agreement to divide IRA or qualified plan benefits to give the nonemployee spouse control over the disposition of his or her community property interest if the nonemployee spouse predeceases the employee spouse. The agreement provides that both halves of the employee benefits are included in the employee spouse's share and an amount of other community property assets, equivalent to the nonemployee spouse's interest in the employee benefits, is included and disposed of in the nonemployee spouse's estate. The agreement will produce the desired result only for an IRA, however, because the nonemployee spouse's estate has no community property interest in qualified plan benefits under *Boggs*. Agreements providing for nonprorata division of community and quasi-community property are authorized by Prob C §§100(b), 101(b). The transfer of community property and quasi-community property to a revocable trust is presumed to be such an agreement. Prob C §104.5. It is not clear whether these provisions reduce the risk that a nonprorata division will result in a taxable sale or exchange.

The risk is particularly acute for retirement benefits because these are income in respect of a decedent (IRD) and do not receive a step-up in basis on the death of the employee spouse. However, a nonprorata division of community property ordinarily will not result in a taxable sale or exchange provided that the distributing fiduciary has the power to make nonprorata distributions. See §17.81D. The presumption of agreement for nonprorata division does not apply to a devise to a testamentary trust or a transfer to an unfunded (or partly funded) revocable trust under a pourover will. Nevertheless, the trustee has the power to make nonprorata distributions of community property even in the absence of an agreement under Prob C §16246. On the other hand, the agreement by itself does not allow the deceased spouse's executor to make a nonprorata division of nontrust property that includes the community property interest of the surviving spouse.

In some cases, the agreement is intended to permit the trustee to fully fund a bypass trust on the death of the employee spouse when other assets are insufficient and the nonemployee spouse is named as the designated beneficiary of an IRA. This allows the nonemployee spouse to roll over the IRA into an IRA in the name of the spouse. However, it is unclear whether an agreement is needed to permit a trustee to take into account community property passing to the surviving spouse outside the trust. In any event, it may still be possible for the surviving spouse to roll over the IRA benefits if a revocable trust or testamentary trust is named as the designated beneficiary of the IRA (which would ordinarily require the benefits to be paid out over the lifetime of the surviving spouse) even if the surviving spouse is not the sole trustee with exclusive authority to determine whether the IRA is allocated to a marital trust that gives the spouse unlimited withdrawal powers, as generally required. See IRS Letter Rulings 200807025, 200705032, 200704033.

For further discussion and a form providing for a trustee to take into account the effect of the proposed agreement on community property passing outside the trust, see Drafting California Revocable Trusts §§10.8A-10.8B (4th ed Cal CEB 2003).

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§17.11A G. Effect of Portable Exemption

Marital deduction planning could be affected if Congress adopts a portable estate tax exemption. As proposed, the portable exemption would permit the surviving spouse to elect to apply the deceased spouse's applicable exclusion on the death of the surviving spouse. The decedent's applicable exclusion amount would be added to the survivor's applicable exclusion amount in determining the survivor's taxable estate. The proposal would not require the deceased spouse to have any assets to transfer the entire amount of the unused exemption to the survivor. The portable exemption would have a number of consequences for estate planning.

First, it would no longer be necessary to create a trust for the decedent's property at the first death, unless the decedent wishes to control disposition of the property, whenever it is reasonably certain that the combined estates of the spouses on the second death will be less than twice the applicable exclusion amount ($3.5 million in 2009). Thus, a married couple with less than $7 million in community property that is unlikely to appreciate in value could simply execute reciprocal wills leaving the entire property to the surviving spouse. Those spouses would be able to obtain a step-up in basis of the entire property to fair market value on the date of death of the survivor.

Second, there would be no need for spouses to consider creating a disclaimer trust for the decedent's property at the first death as a precaution whenever it is likely that the combined estates of both spouses on the second death will be less than the survivor's applicable exclusion amount.

Third, it would no longer be necessary for spouses to make lifetime marital deduction gifts to allow less wealthy spouses to fully utilize the applicable exclusion amount.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.12 III. QUALIFYING FOR MARITAL DEDUCTION

§17.12 III. QUALIFYING FOR MARITAL DEDUCTION

The essential elements of the marital deduction concept are:

- A surviving spouse who is a citizen of the United States (see §17.14); and
- Property included in the decedent's gross estate that passes to the surviving spouse (see §17.15) and qualifies as deductible (see §17.16).

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§17.13 A. Decedent as United States Citizen or Resident

There is no requirement that the *decedent* be a United States citizen or resident in order for a gift to the decedent's spouse to qualify for the marital deduction. Treas Reg §20.2056(a)-1(a).

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§17.14 B. Surviving Spouse

For the marital deduction to be available, there must be a surviving spouse. The burden of proving survivorship and marital status is on the decedent's personal representative. Treas Reg §20.2056(a)-1(b)(1). There is no minimum survival time. The Internal Revenue Service will accept a provision in a will that, in case of simultaneous death, one or the other spouse will be considered to have survived. However, the will cannot change the actual order of death. *Estate of Kwang Lee*, TC Memo 2007-371.

A legal separation or an interlocutory decree of dissolution that has not finally terminated the marriage does not affect marital status. Rev Rul 57-368, 1957-2 Cum Bull 896; *Marriner S. Eccles* (1953) 19 TC 1049, acq 1957-2 Cum Bull 4, aff'd (4th Cir 1953) 208 F2d 796. The validity of marriages and divorces is a matter of state law. Rev Rul 76-155, 1976-1 Cum Bull 286; Rev Rul 58-66, 1958-1 Cum Bull 60. On the effect of legal separation on intestate succession under California law, see §10.7A. On the effect of legal separation on marital status, see §10.7B.

If the surviving spouse is not a United States citizen, the regular marital deduction is not available, but a somewhat similar, although temporary, deduction is available if the property is placed in a qualified domestic trust. IRC §§2056(d), 2056A. See §17.26.

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§17.15 C. Property Passing to Surviving Spouse Must Be Included in Estate

To qualify as deductible, the property must first be included in the decedent's gross estate for federal estate purposes. IRC §2056(a). It must then pass to the surviving spouse in a form specified in IRC §2056(b)-(c). The purpose of these sections is to ensure that, if the surviving spouse does not consume the property, it will later be included in the survivor's estate at his or her death. The deduction is a deferral, not a credit or exemption.

The Internal Revenue Code defines the passing requirement broadly. An outright gift, a gift in trust, a gift by operation of law (*e.g.,* joint tenancy), or a transfer by contract satisfy the requirement. Contract provisions may include not only insurance but also designation of the surviving spouse as the beneficiary of employee death benefits or other annuity-type benefits includable in the taxable estate under IRC §2039. Treas Reg §20.2056(c)-1(a)(6). Similar treatment is given to payments made by a decedent's estate to the decedent's surviving spouse under an antenuptial agreement. Rev Rul 68-271, 1968-1 Cum Bull 409. Various postmortem events (*e.g.,* disclaimers, settlements of contests that represent enforceable rights of the surviving spouse, and election under property right statutes) also relate back to the date of death and qualify under the passing requirements. See Treas Reg §20.2056(c)-2. On spousal elections concerning property rights, see *Estate of Brandon v Commissioner* (8th Cir 1987) 828 F2d 493; *Hastings v U.S.* (D Md 1985) 86-1 USTC 13,662, 57 AFTR2d 1564.

For computation of the marital deduction, the value of the deductible interest is subject to certain reductions:

- Specified debts and expenses allowable as deductions under IRC §2053 that are paid out of or chargeable against interests in property passing to the surviving spouse (Treas Reg §20.2056(a)-2(b)(2) and Treas Reg §20.2056(b)-4(d));
- Losses during administration deductible under IRC §2054 that occurred with respect to those property interests (Treas Reg §20.2056(a)-2(b)(3)); and
- Death taxes that are paid out of or chargeable against those property interests (see §17.30).

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§17.16 D. Property Must Pass in Deductible Form; Terminable Interest Rule

Property passing to the surviving spouse must pass in deductible form and cannot violate the so-called terminable interest rule. A terminable interest, which is generally not deductible, is any interest in property that will terminate or fail either on the mere lapse of time or on the occurrence or nonoccurrence of some event or contingency. IRC §2056(b)(1). Common examples include a term of years or measurement of the time of enjoyment by death or remarriage. A property interest that is a terminable interest will be nondeductible if another interest in the same property passed from the decedent to some other person for less than adequate and full consideration and the other person or his or her heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest. Similarly, if the decedent directs the executor to purchase a terminable interest (*e.g.,* an annuity), it will not be deductible. If the interest passing to the surviving spouse may be satisfied out of a group of assets that included nondeductible interests, it may be only partly deductible. See examples in Treas Reg §20.2056(b)-1(c)(2).

The theory behind the terminable interest rule is the same as that behind the rule that property be included in the deceased spouse's estate, *i.e.,* the estate tax on the property will be deferred until the survivor's estate if the property has not been consumed. If what passes to the surviving spouse is outright ownership, the property will clearly be in the spouse's estate. If what passes is an interest, however, the property may not be in the survivor's estate. "Property" includes all rights that are subject to ownership; an "interest" may refer to a lesser quantum of rights in the property. From a tax standpoint, this distinction is important when the interest does not convey sufficient ownership to cause inclusion in a taxable estate. The most common example of this is a life income interest that disappears at the death of the life tenant and is not an includable interest in the tenant's estate. Such an interest is a terminable interest.

Not all terminable interests are nondeductible. There are a number of exceptions to the terminable interest rule, including certain interests in property that are not outright ownership but are structured in such a way that any of the property not consumed by the surviving spouse will be included in the surviving spouse's estate for tax purposes at death. Each of the following otherwise nondeductible interests qualifies for the marital deduction:

- A life interest in property with a general power of appointment over any remaining property at the death of the life tenant (IRC §2056(b)(5); see §§17.20-17.21);
- A life interest in property that the executor, by making a qualified terminable interest property (QTIP) election, designates as property to be taxed in the surviving spouse's estate (IRC §2056(b)(7); see §17.22);
- Life insurance or annuity payments for life with the power to control the disposition of any remaining value under the contract at death (IRC §2056(b)(6); see §17.34); and
- A life interest in a qualifying charitable remainder trust when the surviving spouse is the only noncharitable beneficiary (IRC §2056(b)(8); see §17.27).

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IV. STRUCTURING THE MARITAL GIFT

§17.17 A. Outright Gift to Surviving Spouse

Giving property outright to the surviving spouse is the simplest way to qualify the property for the marital deduction. The outright gift vests full control of the property in the surviving spouse. The gift is part of his or her taxable estate at death if it has not been consumed.

This may not be the most advantageous method if:

- The decedent's estate and gift tax credit has not been fully used;
- Continuing management control by a trustee is appropriate;
- The decedent wants to control the ultimate distribution of his or her property following the surviving spouse's death; or
- The assets may remain in the surviving spouse's name alone and require probate administration before passing to others at the surviving spouse's death.

If the testator wishes the survivor to have management control of the property without the necessity of probate administration, the surviving spouse may serve as trustee of a trust into which the gift is transferred. Ordinarily, a QTIP trust will be used (see §17.22) but a general power of appointment trust may be used if the testator also wishes the spouse to have control over disposition of the property (see §17.23).

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§17.18 B. Legal Life Estate With Power of Appointment

A legal life estate in property with a general power of appointment over the property will meet the requirements for the marital deduction. Because the surviving spouse will have control and management of the property, this method is similar to an outright gift. The power of appointment will allow the spouse to control the ultimate disposition of the property, but the property will pass to the remaindermen named in the will if the survivor does not exercise the power. On legal life estates, see Covey, ed., Practical Drafting, 739-765, 845-846, 963-964, 1099, 1126-1127, 1586-1588 (1984).

Another means of meeting the requirements for the marital deduction is to use a trust with the surviving spouse serving as trustee. This method takes advantage of the statutory provisions for trust administration, the flexibility offered in trust planning, and the ease with which a successor trustee can take over the administration.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.19 C. Gifts in Trust

§17.19 C. Gifts in Trust

A gift to a trust will qualify for the marital deduction if the trust provisions meet specific requirements. The most common forms of such trusts are the power of appointment trust (see §§17.20-17.21), qualified terminable interest property trust (see §17.22), estate trust (see §17.25), qualified domestic trust (see §17.26), and charitable split interest trust (see §17.27).

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1. General Power of Appointment Trust (IRC §2056(b)(5))

§17.20 a. Income and Power of Appointment Requirements

A gift to a trust will qualify for the marital deduction as a general power of appointment trust under IRC §2056(b)(5) if:

- The trust pays all income (see §17.21) no less frequently than annually to the spouse for life; and
- The spouse has a general power of appointment exercisable by the spouse alone over the trust property during life, at death, or both.

No other person may be a beneficiary of the trust, although the surviving spouse may be given a power to appoint property to third persons. IRC §2056(b)(5). The trust will not qualify for the marital deduction if, for example, the trustee has power to distribute property to the testator's children.

The power of appointment requirement may be satisfied in a number of ways: the survivor may have a general testamentary power, a lifetime power of withdrawal, a lifetime general power, or a combination of one or more of these powers. See §18.15.

See §17.14 on the effect of legal separation or interlocutory decree of dissolution on marital status. General power of appointment trusts are seldom used in contemporary estate planning because QTIP trusts are generally preferred. See §17.24.

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§17.21 b. Income May Be From Separate Trust or Specific Portion of Trust

One of the requirements of IRC §2056(b)(5) is that the surviving spouse be entitled to all income "from the entire interest, or all the income from a specific portion thereof...." This requirement is most commonly met by establishing a separate trust, called either the marital deduction trust or the survivor's trust, used in conjunction with a bypass trust. It is possible to qualify an interest in one trust (a specific portion) for the marital deduction. See §18.12 for further discussion.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.22 2. Qualified Terminable Interest Property (QTIP) Trust

§17.22 2. Qualified Terminable Interest Property (QTIP) Trust

A qualified terminable interest property (QTIP) trust has the lifetime income features of a power of appointment trust, but need not permit the spouse to alter the disposition of the trust principal. For advantages of power of appointment trusts, see §17.23. For advantages of QTIP trusts, see §17.24. For further discussion of QTIP trusts, see chap 19.

To qualify for the marital deduction, the QTIP trust must provide that (see IRC §2056(b)(7)):

- The surviving spouse is entitled to all income from the property, payable annually or at more frequent intervals; and
- No person, including the surviving spouse, has a power to appoint any part of the property to any person other than the surviving spouse during his or her lifetime.

The executor must make an affirmative election for QTIP treatment on the federal estate tax return. Once the election is made, it is irrevocable. IRC §2056(b)(7)(B)(v).

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3. Power of Appointment and QTIP Trusts Compared

§17.23 a. Advantages of Power of Appointment Trusts Over QTIP Trusts

In choosing between a power of appointment trust and the more common qualified terminable interest property (QTIP) trust, a client who wishes to give the surviving spouse outright ownership may choose the former. Both types of trusts provide for probate avoidance and management of assets. Both may address the survivor's incapacity or the survivor's inability to resist fraud or undue influence. The key difference between a power of appointment trust and a QTIP trust is that, in a power of appointment trust, the survivor controls the ultimate disposition of trust property.

The power of appointment trust can also be used to continue a lifetime gift program when a power of withdrawal is provided or the support invasion power does not require consideration of the spouse's other assets. On the power of appointment trust, see chap 18.

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§17.24 b. Advantages of QTIP Trusts Over Power of Appointment Trusts

The qualified terminable interest property (QTIP) trust has become a popular alternative to the power of appointment trust because a QTIP trust can accomplish several goals that a power of appointment trust cannot:

- The testator can control the ultimate disposition of the property;
- The option to elect that only part of the QTIP trust will qualify for tax deferral adds tax-planning flexibility; and
- The QTIP trust is useful in generation-skipping transfer (GST) tax planning.

The testator's control of ultimate disposition is particularly significant when each spouse wishes to ensure that his or her share of the property will reach the intended beneficiaries after providing for the survivor. This may be important, for example, when there are children from a prior marriage.

In a postmortem tax-planning situation, the executor's ability to use a partial election to shift or balance estate tax burdens may be much more convenient than the use of disclaimers. In some situations, it will be relevant that a third party executor holds the partial election power whereas only the surviving spouse (or his or her legal representative) has the power to disclaim. As a practical matter, it is usually easier for a neutral, third party executor to make tax decisions by election instead of relying on a beneficiary's willingness to disclaim a gift. The spouse's participation may be impossible, inconvenient, or impractical.

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§17.25 4. Estate Trust

The estate trust is the only form of gift in trust that does not require that all income from the trust property be paid on a current basis to the surviving spouse. Instead, the estate trust can provide for the discretionary payment of principal and income to the surviving spouse, as long as the principal and accumulated income is paid to the surviving spouse's estate at death. Only the surviving spouse is a permissible beneficiary, and all the remaining property must be distributed to the spouse's probate estate at death. Because nothing passes to a third party, the transfer to the spouse is not a terminable interest and the trust therefore qualifies for the marital deduction without meeting the special requirements for exceptions to the terminable interest rule. Treas Reg §20.2056(c)-2(b)(1); Rev Rul 72-333, 1972-2 Cum Bull 530; Rev Rul 68-554, 1968-2 Cum Bull 412.

An estate trust can be a useful option in situations in which the beneficiary spouse is not competent and has an existing will that will ultimately distribute the estate in the manner desired by the competent spouse. For example, an estate trust might be used to hold interests in a family business in a situation where the interests do not produce income and the family wants to delay estate taxation as long as possible.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.26 5. Qualified Domestic Trust (QDOT)

§17.26 5. Qualified Domestic Trust (QDOT)

Internal Revenue Code §2056(d) disallows the estate and gift tax marital deduction for property passing to a surviving spouse who is not a citizen of the United States, unless the property:

- Passes to a qualified domestic trust (QDOT) that meets the statutory requirements set forth in IRC §2056(d); or
- Passes to the surviving spouse and is subsequently contributed or assigned by the surviving spouse to a QDOT before the date on which the decedent's estate tax return is filed. For further discussion of QDOT trusts, see chap 19.

To be a QDOT, the trust must:

- Have at least one trustee who is a United States citizen or a domestic corporation;
- Authorize the citizen or domestic corporate trustee to withhold the IRC §2056A tax on any distribution of principal;
- Meet any other requirements prescribed by the Secretary of the United States Treasury to ensure collection of any tax imposed by IRC §2056A(b); and
- Have an executor who made an irrevocable election on the estate tax return with respect to the trust (IRC §2056A(a)).

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.27 6. Charitable Split Interest Trust (IRC §2056(b)(8))

§17.27 6. Charitable Split Interest Trust (IRC §2056(b)(8))

If an individual by will creates a qualified charitable remainder annuity trust or unitrust and the only noncharitable beneficiary is the testator's spouse, the disallowance rule for terminable interests does not apply. IRC §2056(b)(8). The testator's estate will receive a charitable deduction for the amount of the remainder interest and a marital deduction for the value of the annuity or the unitrust interest. Treas Reg §20.2056(b)-8(a)(1). However, a charitable split interest trust has the considerable disadvantage that no additional distributions can be made to the surviving spouse.

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D. Related Considerations

§17.28 1. Selection of Trustee

To select the most appropriate person to serve as trustee, the client must have a basic understanding of the trustee's investment and administrative duties. In addition to investment and management of the trust assets, the trustee will be responsible for ensuring that the trust is fully funded and that the proper tax elections are made. The attorney should discuss with the client the funding procedures for the trust and the various tax elections that the trustee will make and implement with the executor.

In discussing the trustee's duties with the client, the attorney should emphasize the need for a trustee with the special expertise required by the position. This does not mean that the attorney should encourage the client to select someone other than the surviving spouse or a family member as trustee. Professional assistance is available to help the trustee perform his or her duties. The main prerequisites for the post should be the client's trust and confidence in the nominee and the nominee's ability to form a good working relationship with the surviving spouse. For further discussion, see chap 28.

If the spouse or a family member serves as trustee, the attorney should discuss with the client conflicts of interest that may arise in funding, tax elections, exercise of discretionary powers, and general administration. If a private professional fiduciary is considered, the attorney should candidly discuss the fact that fiduciary insurance may not be available to protect the estate and its beneficiaries. If a corporate trustee is chosen, the client should closely examine the fee schedule and become familiar with the trust company or bank nominated.

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§17.29 2. Income Tax Planning

Many marital deduction trusts provide for the automatic distribution of current trust income to the surviving spouse. The marital deduction trust may be part of a plan, however, in which the bypass trust provides for the "sprinkling" of income for a group of beneficiaries with a variety of income tax results. If an estate trust is used, a number of sophisticated income tax questions may arise about the character of the distributions. See chap 23A.

Except for fractional share trusts, all marital deduction trusts may give rise to significant income tax consequences when the marital deduction trust is funded. Depending on the nature of the client's assets, the attorney may wish to discuss with the client the income tax effects of the marital funding clauses. See §§17.49-17.75.

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3. Trust Administrative Provisions

§17.30 a. Underproductive Property

In all marital deduction trusts other than the estate trust, the spouse must be able to force the trustee to convert or dispose of underproductive property. Treas Reg §20.2056(b)-5(f)(4); Prob C §21524(c). See §29.22 for a clause for this purpose. In IRS Letter Ruling 200339003, the IRS ruled that the spouse's power to compel the trustee to convert trust assets to productive assets qualified closely-held corporate stock for the martial deduction, even though the corporation had never paid dividends. An alternative is to provide that principal must be allocated to income to compensate for deficient income. For example, if principal consists of unimproved real property and cash, the trust can direct that the cash be used to pay the equivalent of a reasonable return on the principal. The retention of a personal residence in a marital deduction trust is not considered to be the retention of underproductive property. Treas Reg §20.2056(b)-5(f)(4); Treas Reg §20.2056(b)-7(h), Example (1). See §§29.15-29.16, 29.19-29.22, 30.12, 31.25-31.26 for further discussion.

An estate trust may be useful if the testator wishes the trustee to continue to hold underproductive property (*e.g.,* stock in a closely held company, unimproved real property) but does not want the spouse to be able to compel the trustee to convert the property. As an alternative, giving the trustee the power to convert principal to income may solve this problem.

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§17.31 b. Funding Delay

If the spouse is entitled for life to all the income from the trust or a specific portion of the trust payable at least annually, the interest will not fail to qualify for the marital deduction merely because the spouse is not entitled to the income from estate assets for the period before distribution of the assets by the executor. The will may not authorize, and the executor may not delay, distribution beyond the period reasonably required for administration of the estate. Treas Reg §20.2056(b)-5(f)(9). The will must provide that the trust is entitled to all the income earned during the period of administration on the amounts distributed to the trust. The distribution of principal and accumulated income may be periodic.

See §30.23 for further discussion.

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c. Saving Clauses and Protective Legislation

§17.32 (1) Purpose and Effect of Saving Clause

Many wills include a provision that the instrument must be construed in such a manner as to qualify it for the marital deduction, and that the executor and trustee may have no powers inconsistent with that purpose. For a sample clause, see §17.33. California law attempts to provide this protection even if it is not included in the will. The Probate Code provides that the terms of a will containing a marital deduction gift "shall be construed to comply with the marital deduction provisions of the Internal Revenue Code." Prob C §21522(a). Fiduciaries may not take an action or have a power that may impair the marital deduction as applied to the marital deduction gift. Prob C §21522(b).

The statute does not apply, however, unless the will indicates that the gift is intended to qualify for the marital deduction. In *Davis v Commissioner* (9th Cir 2005) 394 F3d 1294, the court held that a discretionary income interest for the surviving spouse in a revocable trust did not qualify for a marital deduction even though the trustee's discretion was not limited by an ascertainable standard. The court concluded that Prob C §21522 did not apply because there was no evidence that the transfer was intended to qualify for the marital deduction. See *Estate of Heim v Commissioner* (9th Cir 1990) 914 F2d 1322, discussed in §17.39.

The statutes governing marital deduction gifts in trust are very specific. They provide that the spouse must be the only beneficiary of principal or income as long as the spouse is alive. Prob C §21524(a). The income must be paid at least annually, and the spouse may require the trustee to make unproductive property productive. Prob C §21524(b)-(c). Any accumulated or accrued income at the spouse's death must be paid to the spouse's estate, unless the will provides a different disposition that qualifies for the marital deduction. Prob C §21524(d).

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.33 (2) Form: Marital Deduction Intention

§17.33 (2) Form: Marital Deduction Intention

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17.33-1 Marital deduction intention

I intend this marital trust to qualify for the marital deduction under the applicable provisions of the Internal Revenue Code. I direct that neither the executor nor the trustee take any action or exercise any power that will impair the marital deduction. This direction does not limit the executor's power of election or nonelection under Internal Revenue Code §2056(b)(7).

Comment: This clause may be added to the marital deduction formula clauses in §§17.52, 17.76, 17.81C.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.34 d. Annuities

§17.34 d. Annuities

An annuity will generally qualify for the marital deduction if (1) no benefit or refund will be paid to anyone after the surviving spouse's death or (2) any benefit or refund is subject to a general power of appointment held by the surviving spouse. Treas Reg §20.2056(b)-1(g), Example (3); IRC §2056(b)(6), (b)(7)(C). The marital deduction regulations generally do not allow a marital deduction with respect to annuities paid from trusts.

The will may not direct the executor to (1) pay an annuity amount to a surviving spouse who does not have a power of appointment over the property generating the annuity or (2) purchase an annuity for the surviving spouse's benefit and qualify it for the marital deduction. Treas Reg §§20.2056(b)-1(b), 20.2056(b)-1(f), 20.2056(b)-1(g), Example (7).

Directing a fiduciary to create or purchase an annuity for the surviving spouse is treated differently from joint and survivor annuities in existence before the death of the first spouse to die. Governed by IRC §2056(b)(7)(C), joint and survivor annuities in existence before the first death are included in the decedent's estate under IRC §2039 and automatically qualify for the marital deduction under the QTIP rules unless the executor affirmatively elects out of such treatment on the decedent's estate tax return. Only joint and survivor annuities included in the decedent's estate under IRC §2039 qualify for the marital deduction; annuities purchased by the executor or created out of property over which the surviving spouse did not have a power of appointment do not qualify.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.35 e. Administration Expenses Claimed as Income Tax Deductions

§17.35 e. Administration Expenses Claimed as Income Tax Deductions

If all estate administration expenses are deducted on the estate tax return, there usually will be no reduction in the principal of the bypass trust. If expenses are not deducted on the estate tax return, there will be a reduction in the bypass trust to the extent that the marital deduction regulations provide that charging such expenses to the marital deduction qualifying gift will reduce the allowable marital deduction. Under Treas Reg §20.2056(b)-4(d), only expenses incurred for managing property passing to the marital gift can be paid from the marital gift without reducing the deduction. Such "management" expenses are generally limited to the same type of ongoing investment expenses normally incurred while property is held in a trust. They do not include any "transmission" expenses related to all of the activities necessary to pass the property from the decedent to the recipient, such as probate costs, legal fees, and estate tax compliance expenses. To the extent transmission expenses are not deductible or are claimed as income tax deductions, the marital deduction formula will automatically reduce the size of the bypass trust as the formula increases the size of the marital trust gift in order to make up for the loss of the estate tax administration expense deduction.

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§17.36 f. Tax Payment Clauses

Tax payment clauses in some wills reduce the value of the spouse's interest in marital deduction property. If the clause imposes the burden of estate taxes on property interests passing to the surviving spouse, the portion of the property used to pay the tax does not pass to the surviving spouse and thereby reduces the marital deduction. This may result in a lower net amount passing to the spouse, a lower marital deduction, and an increase in estate tax. An instruction to pay the taxes out of the residue may have this effect.

For example, in *Estate of Betty Pace Miller*, TC Memo 1998-416, aff'd (5th Cir 2000) 2000-1 USTC ¶60,370, 85 AFTR2d 1047, a boilerplate clause providing that all taxes were charged to the residue without apportionment resulted in estate tax being charged against the devise to the spouse. In *McKeon v U.S.* (9th Cir 1998) 151 F3d 1201, a boilerplate clause in a will providing that all taxes were charged to the decedent's revocable trust estate in the event residuary assets were insufficient was determined to be ambiguous, with the result that statutory proration was applied and the marital deduction was preserved. The court applied equitable apportionment under Utah law despite a similar clause in *Estate of John David McCoy*, TC Memo 2009-61, but cautious practitioners should not rely on that decision.

If the will does not contain a tax clause and the estate is probated in California, the spouse's marital deduction interest will normally be relieved of any portion of the tax burden under the apportionment statutes in Prob C §§20100-20125. Because the California statutes are clearly worded and effective, many practitioners allow them to control by omitting any tax payment clause in the will. See chap 26. If a tax clause, other than a clause incorporating the California apportionment statute, is used in the will, it should specify that no taxes or costs of administration may be charged against marital deduction assets.

The attorney should ensure that any tax resulting from a disclaimer is paid from the appropriate source. If apportionment takes place, the disclaimed property will bear its proportion of the tax. The bypass trust may be reduced, however, if the tax is paid from the residue and the property does not pass to the bypass trust.

A similar reduction of the bypass trust may occur if only part of the property passing to a qualified terminable interest property (QTIP) trust is subject to an election qualifying it for the marital deduction. The usual method of solving this problem is to provide in the will that tax resulting from a partial election is paid from the nonelected property. For a detailed discussion, see §19.18.

In drafting tax payment clauses, the attorney must pay attention to the payment of taxes at the surviving spouse's death. Generally, tax payment clauses direct payment of taxes out of all, or some part of, the assets that caused the tax. If generation-skipping transfer (GST) tax considerations are not involved, the drafter need determine only the effect of the clause on the beneficiaries. When a "reverse QTIP election" is made under IRC §2652(a)(3), however, full use of the decedent's GST exemption will be made only if, at the surviving spouse's death, the GST tax-exempt QTIP trust is not reduced by the estate tax attributable to the GST tax-exempt qualified terminable interest property. In such situations, it is appropriate to provide that the estate tax that would be charged against the GST tax-exempt QTIP trust shall instead be charged either to the nonexempt QTIP or to assets of the surviving spouse. See chap 15.

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§17.37 g. Successive Interests and Payment of Accrued Income

In both the power of appointment trust and the qualified terminable interest property (QTIP) marital deduction trust, the trustee pays all the income at least annually to the surviving spouse. See §§17.20, 17.22. Usually, these trusts are not funded immediately after the decedent's death, because the property is subject to administration.

A trust will not fail to qualify for the income payment requirement merely because the spouse is not entitled to the income from the estate assets for the period before distribution of those assets by the executor, unless the executor is authorized or directed by the decedent's will to delay distribution beyond the period reasonably necessary for administration of the estate. Treas Reg §20.2056(b)-5(f)(9). This requirement relates to the time of receipt of the income. It does not authorize use of the income for administration purposes.

All income must be paid to the surviving spouse for life. This includes income accrued ("stub" income) and not yet paid at the surviving spouse's death. Although the income need not be literally paid to the spouse, if it is not paid to the spouse or his or her estate, the spouse must have a testamentary general power of appointment over the income unless a QTIP trust is used, in which case a testamentary power of appointment may be unnecessary. See §19.7.

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§17.38 h. Ineligible Assets

The will should provide that the marital deduction gift may be satisfied only with assets that qualify for the marital deduction. This will avoid the trap in IRC §2056(b)(2) that is commonly known as "the unidentified asset rule." Under this rule, if assets that may be used to satisfy the gift include property that will not qualify for the marital deduction, then the deduction is reduced by the value of the nonqualifying property whether or not it is used to satisfy the gift.

EXAMPLE: A wife receives a share of the residue worth $85,000 under her husband's will. If an estate asset is a terminable interest (*e.g.,* a leasehold for a term of years retained by the decedent worth $60,000), and the executor has the right to distribute the entire lease to the widow in satisfaction of the gift to her, then the marital deduction is reduced by the entire value of the lease (*i.e.,* by $60,000). If the executor may distribute only an undivided interest in the lease (*e.g.,* a one-third interest) to her in satisfaction of the gift, then only the value of that undivided interest ($20,000) reduces the marital deduction. See IRC §2056(b)(2); Treas Reg §20.2056(b)-2.

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4. Disqualifying Contingencies

§17.39 a. Survival for Longer Than Six Months

Survivorship clauses are designed to prevent the unnecessary probate of assets in the survivor's estate if the spouse does not survive the testator by a specified period. If the spouse is required to survive the testator by more than 6 months, however, the gift to the spouse will not qualify for the marital deduction even if the spouse does survive. IRC §2056(b)(3); Treas Reg §20.2056(b)-3(b).

Similarly, a requirement that the spouse survive until the distribution of the testator's estate renders the spouse's interest under the will a terminable interest that does not qualify for the marital deduction. Treas Reg §20.2056(b)-3(d), Example (4). The spouse's interest is a terminable interest because it could be defeated by his or her death before the distribution of the testator's estate. The fact that the interest is not defeated is immaterial; the mere possibility of its defeat causes forfeiture of the marital deduction.

NOTE: If the marital deduction is denied under such a clause and the property does pass to the surviving spouse, the property will be subject to tax a second time in the survivor's estate. For further discussion of the terminable interest rule, see §17.16.

Although the Internal Revenue Code allows use of the 6-month survival limitation without jeopardizing the marital deduction, use of such a clause may not always be desirable. One objection is that the marital deduction is defeated if the spouse does not survive the 6-month period. In that case, the survivorship clause will prevent a second probate of the same assets, but the tax savings from use of the marital deduction in the first estate may substantially exceed the cost of a second probate. Many practitioners prefer to rely on the use of a disclaimer, if appropriate, rather than risk the loss of the marital deduction with a survivorship clause.

Under no circumstances should the drafter use a survivorship clause or delay of vesting in the spouse, *e.g.,* "until distribution of the estate" or "until probate of my will." Although Prob C §21525(a) attempts to limit any survivorship clause for a marital deduction gift in a will to 6 months if the survivorship requirement expressed in the will exceeds or may exceed 6 months, this saving clause should be relied on only in an emergency. The Internal Revenue Service tends to disregard such state statutes or to interpret them in such a way as to make them ineffective. Compare IRS Letter Ruling 8816001 (IRS disregarded statute because it provided that period specified in excess of 6 months would be limited to 6 months, and in this case there was no period in excess of 6 months specified) with IRS Letter Ruling 8809003 (only apparent change in facts was that surviving spouse was personal representative of deceased spouse's estate, and state law allowed distribution at any time without court supervision).

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§17.40 b. Remarriage of Surviving Spouse

If the marital gift or trust terminates or is reduced when the surviving spouse remarries, the interest will not qualify for the marital deduction. Treas Reg §20.2056(b)-1(b); Treas Reg §20.2056(b)-7(d)(3). A clause that makes the spouse ineligible for principal distributions in case of remarriage (assuming the clause is not void under CC §710 (see *Estate of Guidotti* (2001) 90 CA4th 1403, 109 CR2d 674)), however, will not disqualify a valid qualified terminable interest property (QTIP) trust as long as the condition does not affect the spouse's right to income and the trust meets the other requirements for QTIP qualification. IRS Letter Ruling 8943057.

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§17.41 c. Incapacity of Surviving Spouse

Because termination of a spouse's benefits in case of incapacity clearly renders the interest a terminable one, it will not qualify for the marital deduction even if the incapacity does not occur. *Starrett v Commissioner* (1st Cir 1955) 223 F2d 163; *Estate of Dorothy M. Walsh* (1998) 110 TC 393. Accumulation of income in case of incapacity is not permitted either. See *Estate of Merle Allen Whiting*, TC Memo 2004-68 (trust provision allowing accumulation of income in case of incapacity did not result in loss of marital deduction; under state law, the disability provision must give way to decedent's expressed intention to qualify for marital deduction). As discussed in §§18.14 and 19.9, however, both a power of appointment trust and a qualified terminable interest property trust can give the surviving spouse an inter vivos general power of appointment over trust income, thus qualifying for the marital deduction without requiring actual distribution. See forms 18.23-1, 19.23-1.

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§17.42 d. Executor's Election

Under the marital deduction regulations, a trust may qualify for a QTIP election even if the surviving spouse's required lifetime income interest is contingent on the executor making the election. Treas Reg §20.2056(b)-7(d)(3)(i). In the case of a partial election, in a trust providing that the surviving spouse is entitled to income from the portion of the trust that the executor elects to treat as QTIP property, the regulations provide that when the surviving spouse's interest in the trust otherwise meets the requirements of qualifying income interest for life, the executor may elect QTIP treatment for any portion of the trust. Treas Reg §20.2056(b)-7(h), Example (6). For further discussion of partial elections and segregation of QTIP assets, see §19.12.

Although an executor's election is not a disqualifying contingency, there are other reasons why it is not advisable to make the spouse's income interest contingent on the executor's election. First, it is arguable that the spouse makes a gift of the income interest if the spouse is the executor and does not make the election. Second, it is common practice not to make a QTIP election when the surviving spouse has a short life expectancy. In such a case, it is desirable that the spouse nevertheless have a mandatory income interest in the trust to generate a large IRC §2013 prior transfer property (PTP) credit when the tax is computed on the survivor's estate. See §17.59.

In IRS Letter Ruling 200218003, the IRS ruled that the portion of the deceased spouse's estate eligible for the credit in the case of a partial election is the value of the income interest in the portion of the trust for which the QTIP election is not made. The credit is available only if the surviving spouse was not so sick on the date of the first death that Treas Reg §20.7520-3(b)(3)(i) will apply. Under that regulation, the valuation tables cannot be used to determine life expectancy if, as of the deceased spouse's death, the survivor's health is such that there is at least a 50-percent probability that the survivor will die within one year. The credit is not allowed, however, if both spouses die in a common accident. Treas Reg §20.7520-3(b)(3)(iii); *Estate of Judith U. Harrison* (2000) 115 TC 161.

EXAMPLE: A married couple has $11 million of community property on the death of the deceased spouse in 2009. Under the formula, $3.5 million passes to the bypass trust and $2 million passes to the QTIP trust. Assuming an IRC §7520 interest rate of 5 percent and a 65-year-old surviving spouse, the value of the income interest in the QTIP trust is $1,079,260 ($2 million × 0.53963). The QTIP election is not made, so the tax on the death of the deceased spouse is $900,000. If the surviving spouse also dies in 2009, the credit is $313,334 ($900,000 × [$1,079,260/($4,000,000 − $900,000)]). The survivor's estate is $5.5 million (assuming no appreciation) and the tax on the death of the survivor is $586,666 ($900,000 − $313,334). The total tax on the two estates is $1,486,666 ($900,000 + $586,666). If the QTIP election had been made, the survivor's taxable estate would be $7.5 million and the tax on the death of the survivor would be $1,800,000 (.45 × $4,000,000).

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§17.43 e. Forced Election Provisions

A forced election clause comes into play when the testator attempts to fund the trust with both halves of the community property. The clause requires the surviving spouse to elect to take under the will or to take his or her interest in the community property. When no marital deduction is sought, the clause may be a useful tool, but it is rarely used. Use of the clause may result in adverse tax consequences. If the spouse elects to take under the will, the value of the spouse's "contribution" (or the forfeited community interest) must be compared to the benefit received.

Under IRC §2702, the retained income interest in the spouse's half of the community property is assigned a value of zero because it is not a qualified interest. Therefore, the consideration passing from the spouse is the full value of the spouse's half of the community property. This results in two unfortunate consequences:

(1) The value of any marital deduction gift under the will is reduced by the value of the community property interest relinquished by the surviving spouse.

(2) Because the spouse retains an interest in the transferred property, if the value of the benefit is not equal to the full value of the surviving spouse's transfer (which it usually will not be), then the transferred property will be included in the surviving spouse's estate under IRC §2036 as well as constitute a gift to the remainder beneficiaries at the time of the transfer.

The drafter should carefully consider the tax ramifications of such transfers before including a forced election clause in the will.

For detailed discussion of requirements by which a surviving spouse may claim a share in the estate contrary to the terms of the will, see 1 Casner & Pennell, Estate Planning §§3.4-3.4.7 (6th ed 1998).

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§17.44 f. Foreign Death Tax Credit

If, to satisfy a marital deduction gift, the executor uses property in the gross estate that is eligible for a foreign death tax credit, the foreign death tax credit will be lost. Although this is not really a disqualifying contingency as to the marital transfer, it will have the effect of unnecessarily increasing the transfer tax liability in either the decedent's or the survivor's estate. For this reason, the funding clause in the will should provide that (1) the executor must take into account all available credits, and (2) a marital transfer may not be funded with property eligible for a foreign death tax credit unless no other property is available for that purpose. See IRC §2014; Treas Reg §20.2041-3.

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§17.45 5. Simultaneous Death Statutes

The simultaneous death statutes in most states create a presumption that the testator is the survivor as to his or her property interests if the order of death cannot be proved. See Prob C §§220-226. If the importance of saving tax with the marital deduction outweighs the usual objectives of simultaneous death clauses and statutory presumptions favoring the testator's survival, the drafter should design the will language accordingly.

In many instances, a clause establishing the survival of the testator's spouse when the order of death cannot be determined will be appropriate. Such a clause will qualify a gift for the marital deduction. Treas Reg §20.2056(c)-2(e). Most clauses of this type refer only to property passing under the will. It is unclear whether the drafter may modify such a clause to affect joint tenancy property.

If the testator's spouse has substantial property of his or her own, use of such a clause may not be appropriate. The drafter should analyze the facts of each case to determine whether this type of clause is useful.

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V. FUNDING AND ALLOCATION

§17.46 A. Unlimited Marital Deduction

As discussed in §17.6, the unlimited marital deduction permits the passing of all the deceased spouse's property to the surviving spouse without the payment of estate tax. This is often not the best plan, however, because it will not use the applicable credit amount of the first spouse to die.

If the testator wishes to achieve the maximum amount of marital deduction that will benefit his or her estate, the attorney must choose a method that will also utilize the applicable credit amount. For testators with substantial estates, drafters commonly use a marital deduction formula clause (see §§17.49-17.89). For testators with small estates, many drafters use a disclaimer will (see §17.47).

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B. Disclaimer Will

§17.47 1. Purpose of Disclaimer Trust

The disclaimer will distributes the testator's property outright to the surviving spouse unless the surviving spouse chooses to disclaim or refuse the outright transfer of all or a portion of the gift. Any property that the surviving spouse disclaims is redirected by the will into a bypass trust, usually for the spouse's benefit. Either because of the trust provisions or because the executor does not make a qualified terminable interest property election, the property in the bypass trust does not qualify for the marital deduction and is taxable in the testator's estate.

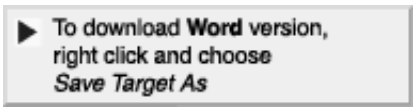
As long as the amount of the disclaimed property does not exceed the testator's available applicable exclusion amount, no tax will be paid. The decision whether to use the testator's applicable exclusion amount or to disregard it and pass all property to the surviving spouse is delayed until the surviving spouse makes the decision after the testator's death. Such a plan is attractive when the combined property of the spouses may equal or exceed the amount one of them alone could shelter in some years using the applicable exclusion amount—$2 million in 2006-2008, $3.5 million in 2009, and $1 million in 2011 and thereafter (IRC §2010(a); see §20.2)—and future appreciation is uncertain. The disclaimer will preserves the simplicity of the outright spousal gift while retaining the option to take advantage of the predeceased spouse's applicable exclusion amount if appropriate in the future. See form 17.48-1 for a clause providing this option.

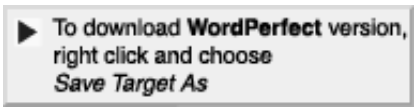
A major disadvantage of relying on disclaimers is the risk that the spouse will not make a necessary disclaimer. This may occur for a variety of reasons, including inadvertence or the surviving spouse's insecurity resulting from the decedent's death. Further, a surviving spouse can be given a broad power of appointment over a bypass trust. This cannot be done with a disclaimer trust because disclaimed property must pass without direction by the person making the disclaimer. Treas Reg §25.2518-2(e).

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.48 2. Form: Disclaimer Trust

§17.48 2. Form: Disclaimer Trust





17.48-1 Disclaimer trust

If my spouse survives me, I give the residue of my estate to my spouse. If my spouse effectively disclaims all of my spouse's interest in all or any portion of any outright gift or gift in trust, then I give that gift, or that disclaimed portion of the gift, to the _ _[*name of trust*]**_ _.**

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.49 C. Overview of Formula Clauses

§17.49 C. Overview of Formula Clauses

For maximum estate tax savings, a testator will usually want to leave to the marital gift the minimum amount necessary to avoid incurring any estate taxes. Such a plan is generally accomplished through the use of a marital deduction formula clause. A formula clause is preferable to a specific bequest or devise of property or a gift of a fixed pecuniary amount because the formula self-adjusts to take into account such factors as (1) the amount of the applicable credit, which is subject to change by action of Congress; and (2) the amount that can pass tax free on the testator's death, which depends on the value of taxable gifts made by him or her while alive.

The purpose of a formula clause is to determine how much of the testator's property should be allocated between the marital and nonmarital gifts or shares. As discussed above, the marital share can be left outright to the surviving spouse or to a QTIP trust established for the surviving spouse's benefit, and the nonmarital share will usually pass to the bypass trust. These shares may be further divided into subshares for administrative convenience (if allowed under the trust instrument or by court order), for different beneficiaries (*e.g.,* the bypass trust can be divided into separate shares for each child), or for tax purposes.

The will must address not only the amounts passing to the marital share and nonmarital share under the formula but also the allocation of trust assets to those shares and related issues.

The formula clause is generally preceded by a clause stating that the trust estate will be divided into a marital trust and a bypass trust.

Once the amounts passing to the marital share and nonmarital share are calculated under the formula, the will must address the allocation of assets to those shares.

There are two types of marital deduction formula clause:

(1) *Pecuniary amount formula clause*. This type of clause provides an amount of dollars that will produce the maximum beneficial marital deduction. The pecuniary amount to be determined under the formula can be either the amount of the marital share (called a pecuniary marital formula) or the amount of the nonmarital share (called a pecuniary bypass, sometimes referred to as a reverse pecuniary formula). A simple version of a pecuniary marital formula would be:

I give to the marital trust the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable on my death after taking into account allowable credits.

(2) *Fractional share formula clause*. This type of clause is phrased in terms of the fractional share of the trust property that will produce the maximum beneficial marital deduction. A simple version of such a clause would read:

I give to the marital trust the smallest fractional share of my estate that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable on my death, taking into account allowable credits.

Formula clauses minimize present estate taxes by using the testator's applicable credit amount. Such clauses produce the same estate tax result regardless of the value of the testator's gross estate or the value of taxable gifts previously made by him or her.

There are, however, a number of disadvantages to formula clauses:

- Because a complex funding clause may be difficult for a client to understand, it will require careful explanation by the attorney.
- Determination of the amount passing under a formula clause to the marital trust (and bypass trust) may not be possible until all valuation issues and deductions have been settled for federal estate tax purposes. The choice between alternate valuation date and date-of-death valuation may be relevant in making this division. But see IRC §2032, which requires a resulting decrease in federal estate tax as a prerequisite to election of alternate date valuation. The marital formula clause is frequently designed to produce no tax at the testator's death. The

election may require a disclaimer by the spouse or a partial QTIP election to generate a federal estate tax. The formula amount may also be affected by whether the allowable deductions for costs of administration are claimed as deductions against the estate tax or the estate's income taxes. See §17.35.

- If the value of the estate property changes during the period of administration following the testator's death, complex income tax issues will arise in the choice of assets used to fund the formula gifts and in the timing of the funding.
- Depending on how the clause is drafted, a true pecuniary formula clause will shift the appreciation or depreciation in the estate after the testator's death to either the marital trust or the bypass trust, and the use of certain assets to fund those trusts may cause the recognition of income or capital gain or loss. These issues may result in substantial conflicts of interest between the surviving spouse and the beneficiaries of the bypass trust. When an interested person is serving as a fiduciary, these conflicts must be identified and resolved.

The attorney must determine which type of clause is most appropriate to include in the will early in the planning stages of drafting. Although the consequences of the choice of clause may not be realized until the testator's death, which could occur many years after the will is drafted, delaying this choice until the testator's death could leave the deduction amount totally within the executor's discretion and thereby result in loss of the marital deduction. Some flexibility can nevertheless be preserved at the drafting stage by anticipating strategies involving disclaimers. See §17.47.

For an in-depth treatment of formula clauses, see Pennell, *Estate Tax Marital Deduction*, Tax Management Portfolios 843-2d, p A-121 (2005).

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§17.50 D. Pecuniary Marital Formula

If a pecuniary amount marital deduction formula is used, several funding clauses may be used to determine how assets should be allocated to satisfy that pecuniary amount. For the pecuniary marital formula, these funding alternatives are known generally as the "date-of-distribution value" (see §17.65), "fairly representative" (see §17.66), and "minimum worth" (see §17.67) funding plans. The "pecuniary bypass" marital formula (see §§17.75-17.81A), which makes a pecuniary gift to the bypass trust and leaves the residue to the marital trust, also may be coupled with either the date-of-distribution value or fairly representative funding plans. The minimum worth funding plan may not, however, be used with the pecuniary bypass marital formula.

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§17.51 1. Overview of Pecuniary Marital Formula

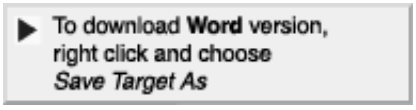
A pecuniary marital formula makes a gift of a pecuniary amount, calculated under the formula, to the marital trust. (The gift may also be made outright to the surviving spouse.) The date of distribution value, fairly representative, and the minimum worth funding plans may all be used to govern the allocation of assets to satisfy the marital gift calculated under the formula.

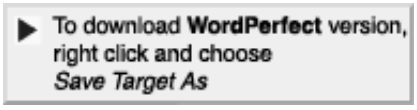
Because the marital gift is a pecuniary amount under the formula, it will not share in the estate income earned during the period of administration following the testator's death, unless the instrument affirmatively provides that the pecuniary amount be treated as a residuary bequest solely for the purpose of income allocation during the period of estate administration. If, however, the marital gift is not made within one year after the testator's death, as a general pecuniary gift it bears interest at a rate equal to 3 percent less than the legal rate on judgments in effect one year after the testator's death. Prob C §§12001, 12003. A clause in the will overriding the state law interest requirement may result in a reduction of the amount of the marital deduction or in the marital gift not qualifying for the marital deduction at all. See Treas Reg §20.2056(b)-5(f)(9). Such a clause may also present problems in allocating the testator's generation-skipping transfer tax exemption to the residual bypass trust. See Treas Reg §26.2642-2(b)(3); §15.35.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.52 2. Form: Pecuniary Marital Formula (Bypass Trust as Residue)

§17.52 2. Form: Pecuniary Marital Formula (Bypass Trust as Residue)





17.52-1 Pecuniary marital formula (bypass trust as residue)

***Pecuniary Marital Formula Gift*. If my spouse survives me, I give to the marital trust a pecuniary amount equal to the minimum amount necessary as a federal estate tax marital deduction to entirely eliminate (or reduce to the maximum extent possible) any federal estate tax on my death, after taking into account all factors relevant to this estate tax objective, including but not limited to:**

(1) All deductions claimed and allowed in determining the estate tax payable by reason of my death.

(2) The net value of all other property included in my gross estate, whether or not it passes under this will and whether it passes at the time of my death or has passed before my death to or in trust for my spouse, so that it is included in my gross estate and qualifies for the federal estate tax marital deduction. If my spouse disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded.

(3) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for: (a) death taxes paid in the estate of one whose death occurs after mine; or (b) any state death tax unless, and to the extent, a death tax would be payable to the state or states regardless of the federal credit.

I give the residue of my estate to the bypass trust.

17.52-2 Satisfaction of amount

My executor shall satisfy the minimum pecuniary amount of the gift to the marital trust as so determined in cash or in kind, or partly in each, and shall allocate to the marital trust only assets that are eligible for the federal estate tax marital deduction. Any insurance on my spouse's life and any assets for which a credit for foreign death taxes is allowable for federal estate tax purposes shall be allocated to the bypass trust, unless there is insufficient other property to fully fund the marital trust.

[*Add one of the following alternatives*]

[*Alternative 1: Date-of-distribution value funding*]

Assets allocated in kind shall be considered to satisfy this amount on the basis of their net fair market values on the date or dates of allocation to the marital trust.

[*Alternative 2: Fairly representative funding*]

Assets allocated in kind shall be considered to satisfy this amount on the basis of their net fair market values as finally determined for federal estate tax purposes. My executor shall select property to satisfy this amount so that any appreciation or depreciation that has occurred in the value of my estate between the applicable valuation date and the date of allocation shall be fairly apportioned between the marital trust and the bypass trust.

[*Alternative 2: Minimum worth funding*]

Assets allocated in kind shall be considered to satisfy this amount on the basis of their net fair market values as finally determined for federal estate tax purposes, but in no event shall the aggregate value of such assets on the date or dates of allocation to the marital trust be less than this pecuniary amount.

Comment: In form 17.52-1, if there is no marital trust and the marital deduction amount will be distributed outright to

the surviving spouse, the words "marital gift" rather than "marital trust" should be used. If the estate includes qualifying special use valuation property, the pecuniary marital formula in this section should be used rather than the pecuniary bypass formula in §17.76. See §17.88.

If the drafter wishes to provide for a reverse qualified terminable interest property ("reverse QTIP") marital trust, a clause addressing this issue should be added immediately before the final sentence of form 17.52-1. For suggested language and discussion, see §15.43.

See §17.53 for factors to be included in the pecuniary marital formula. For discussion of funding issues and the advantages and disadvantages of the funding plans in a pecuniary marital formula, see §§17.64-17.74.

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§17.53 3. Factors Included in Pecuniary Marital Formula

The pecuniary marital formula provides that several factors must be taken into account before the minimum amount necessary as a marital deduction may be determined. If more property than is determined under the formula is given to the marital deduction gift, the amount subject to tax will be reduced without fully utilizing the testator's applicable credit amount. In determining the appropriate amount of the marital deduction gift to minimize taxes, the formula does take into account, however, gifts to or for the surviving spouse both under the will (*e.g.,* specific gifts) and from other sources (*e.g.,* insurance).

Even though it may not be possible to eliminate taxes on the testator's death in certain circumstances (*e.g.,* when there are taxable bequests, assets held in joint tenancy, or life insurance proceeds passing to others), the formula nevertheless yields the smallest amount necessary as a marital deduction with respect to the property passing under the testator's will to minimize the taxes due.

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§17.54 a. Federal Estate Tax Deductions

The deductions allowed on the testator's federal estate tax return make up the first factor to take into account under the pecuniary marital formula. The formula creates the minimum amount of marital deduction that will result in no federal estate tax. In computing the testator's taxable estate, various deductions are permitted for items such as claims, administration expenses, and the marital deduction. To the extent that a deduction is allowed for administrative or other expenses, less of a marital deduction will be needed to obtain the optimal result.

EXAMPLE: If the testator's gross estate has a value of $3 million, deductions totaling $1 million will be required to obtain a taxable estate of $2 million: the maximum amount that can be sheltered by the applicable exclusion amount in 2006-2008. If no other deductions are claimed or allowed on the testator's federal estate tax return, a $1-million marital deduction will be required (and will be computed under the formula) to achieve the desired result. If, instead, administration expenses totaling $100,000 are claimed and allowed on the testator's estate tax return, a marital deduction of only $900,000 will be required (and computed under the formula) to achieve the desired result.

The phrase "claimed and allowed" is used instead of only "claimed" in the formula because a deduction claimed on the return may not be allowed or the fiduciary may later decide to claim the deduction on the trust's income tax return rather than on the estate tax return. See §17.79.

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§17.55 b. Other Property Passing to Surviving Spouse

The second factor to consider under the pecuniary marital formula is that less of a marital deduction is required with respect to the property passing under the testator's will if other gifts required to be made under the will or outside the will (*e.g.,* through a trust, joint tenancies, or life insurance) are includable in the testator's gross estate and qualify for the marital deduction.

EXAMPLE: In the example discussed in §17.54, the formula yielded a marital gift of $900,000, assuming that administrative expenses were allowed as an estate tax deduction. If the testator's gross estate includes $2,400,000 of property passing through probate and $600,000 payable to the surviving spouse and qualifying for the marital deduction through a revocable trust, then a marital deduction of only $300,000 will be required with respect to property passing through probate (and computed under the formula) to achieve the desired result. Under this assumption, the value of the testator's probate property is $2,400,000, $100,000 of administration expenses will be paid, and a marital deduction gift of $300,000 will be made, leaving the $2,000,000 for the bypass trust.

The last sentence of the second factor provides that a disclaimer by the surviving spouse should not be considered in applying the formula. The effect of a disclaimer by the surviving spouse is to shift to the bypass trust amounts otherwise allocable to the marital trust. Without a direction to disregard the disclaimer, however, the self-adjusting nature of the formula would take the disclaimer into account and possibly negate its intended effect. There are situations in which it is desirable to use disclaimers to generate an estate tax on the first death—particularly if the surviving spouse has a short life expectancy and there is an opportunity to claim an IRC §2013 credit for taxes on prior transfers in the surviving spouse's estate. In these situations, when the marital deduction qualifying gift is not made to a QTIP trust, a partial disclaimer by the surviving spouse may be used to produce the same result as a partial QTIP election by the executor. See §17.42. The drafter should be aware, however, that this feature of the formula also may result in inadvertent payment of estate tax if the surviving spouse disclaims any portion of the marital trust in other situations. See *Estate of David Katz*, TC Memo 2004-166. On disclaimers, see §§17.47-17.48.

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§17.56 c. Federal Estate Tax Credits

The third factor of the formula provides that all credits available to the testator's estate must be taken into account in making the calculation under the formula, including the IRC §2010 applicable credit, the IRC §2012 credit for gift taxes paid (see §17.57), the IRC §2013 prior transfer property (PTP) credit (see §17.59), and the IRC §2014 foreign death tax credit (see §17.60). The IRC §2011 state death tax credit (repealed in 2005) is only taken into account, however, to the extent that doing so does not cause a state tax to be paid that could otherwise be avoided. See §17.58.

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§17.57 (1) Adjusted Taxable Gifts

The gross estate, which is the figure on which all the calculations made in the funding clauses are based, does not include adjusted taxable gifts (*i.e.,* the taxable gifts made by the testator while alive). Although the gross estate does not include adjusted taxable gifts, adjusted taxable gifts are considered in the calculation of the tax payable under IRC §2001. Therefore, the references in the formula to calculating the amount that will produce no tax or the minimal amount of tax automatically take into account the testator's adjusted taxable gifts and any IRC §2012 credit for gift taxes paid that may be allowed if the transferred property is included in the testator's gross estate. Some attorneys, including the consulting editor, prefer that the formula clarify that no federal estate tax may be incurred and that adjusted taxable gifts must be taken into account. Either approach is acceptable.

In applying the formula, attorneys should be aware that the IRS may challenge the value of reported gifts unless there was adequate disclosure of valuation issues in a gift tax return. IRC §§2001(f), 6501(c). Adequate disclosure protects against the possibility that the IRS will later challenge entitlement to annual gift tax exclusions when computing the estate tax after the 3-year limitation period of IRC §6501(a). See Treas Reg §20.2001-1(b).

Under Treas Reg §301.6501(c)-1(f)(2), the requirements for adequate disclosure can require highly detailed information and legal analysis. Separate disclosure regulations apply to transactions involving the special valuation rules of IRC §§2701 (transfers of business interests when the transferor retains other interests in the same business) and 2702 (transfers to retained-interest trusts). Amended gift tax returns may be filed for the purpose of making adequate disclosure. Rev Proc 2000-34, 2000-2 Cum Bull 186.

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§17.58 (2) State Death Tax Credit

The pecuniary marital formula clause provides that the IRC §2011 state death tax credit must be taken into account only to the extent that doing so does not result in imposition of an otherwise avoidable state death tax. Without this qualification, the formula can result in an augmented bypass trust that produces no federal estate tax but requires payment of state death tax.

In 2001, the tentative federal estate tax on an estate of $727,175 was $19,304, which equaled the state death tax credit and therefore produced no federal estate tax. To claim the state death tax credit, however, the estate must actually pay the state death tax to the state. In a state like California, which imposes a "pick-up tax" equal to the state death tax credit allowed under federal law, the $19,304 would have been payable to California. Rev & T C §13302.

The state death tax credit was repealed in 2005 and replaced by the IRC §2058 deduction for state death taxes paid. The deduction has no effect in California, because the "pick-up tax" results in no state tax after repeal of the credit. In 2011, the state death tax credit is scheduled to be restored, shielding a maximum gross estate of $1,093,786 with a state death tax credit of $38,452.

Without including the qualifying language in the formula, the testator's desire to have no estate taxes paid on his or her death would be frustrated because, even though no federal estate taxes would be paid, a state death tax would still have to be paid. Thus, the formula provides that the state death tax credit may not be taken into account if it requires an otherwise avoidable estate tax to be paid. The qualifying language should always be used to achieve a no-tax result for a client whose entire estate has a situs in California and other states with pick-up taxes that conform to the federal applicable exclusion amount. Unlike the California estate tax, which precludes a state tax that exceeds the federal credit, the pick-up tax in a number of states did not conform to the 2004 increase from $1 million to $1.5 million or the 2006 increase from $1.5 million to $2 million. The pick-up tax in these states may exceed the federal credit. If the client has substantial assets with a situs in a state that imposes a death tax exceeding the federal credit, the drafter should analyze the clause to determine its appropriateness. For further discussion, see Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§17.59 (3) Credit for Tax on Prior Transfers

Generally, the IRC §2013 prior transfer property (PTP) credit will also be taken into account under the pecuniary marital formula. This credit is for taxes paid in the estate of another person (the transferor) on property that is included in the decedent's estate. Phased out over a 10-year period, the credit is the lesser of the estate tax attributable to the property in the transferor's estate or the estate tax attributable to the property in the decedent's estate. The credit is a 100-percent credit if the death of the decedent (*i.e.,* the client/testator) occurs within 2 years after the death of the transferor. The credit is reduced by 20 percent for each additional 2-year period.

If the testator dies within 2 years after the death of a transferor of property to him or her, this credit will be a powerful tool to pass additional property to the bypass trust. If, however, the testator dies more than 2 years after a transferor, the reduction in the credit amount to 80 percent (or less) of the tax would cause some tax to be paid on his or her death. Under the formula, no additional property will pass to the bypass trust under these circumstances because the formula operates to eliminate the payment of all tax.

Although the IRC §2013 credit is available in situations in which the transferor dies *after* the testator (as would be relevant if, for example, the transferor made an inter vivos gift to the testator that was later included in the transferor's estate for some reason), the formula provides for ignoring the credit under these circumstances in order to preclude a contention by the IRS, however dubious, that a portion of the marital deduction gift was subject to a prohibited contingency.

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§17.60 (4) Foreign Death Tax Credit

The pecuniary marital formula also takes into account the IRC §2014 credit. The purpose of this credit is to limit the effect of double taxation when the gross estate includes property situated within a foreign country with respect to which that foreign country has been paid an estate, inheritance, legacy, or succession tax. The credit is limited to the portion of the federal estate tax (after use of the applicable credit amount, state death tax credit, and gift tax credit) attributable to the foreign property.

The formula provides that any property eligible for the foreign death tax credit should not be used to satisfy the marital gift unless no other property is available. Under Treas Reg §20.2014-3(b)(1), property with respect to which a marital deduction is allowed does not give rise to the foreign death tax credit, because property used to fund a marital gift does not produce a tax.

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§17.61 4. Specific Allocation to Bypass Trust

Certain assets may be specifically allocated to the bypass trust or away from the marital trust. Examples of such assets include insurance on the surviving spouse's life, property giving rise to a foreign death tax credit, and insurance proceeds or qualified plan benefits of which the bypass trust is the beneficiary or recipient. See §17.63.

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§17.62 5. Residue of Estate

The residue of the estate is allocated to the bypass trust under the pecuniary marital formula. Conversely, under the pecuniary bypass formula, which takes into account the same factors described in §§17.53-17.60 to determine the pecuniary amount passing to the bypass trust, the residue instead passes to the marital trust. See §17.75. Similarly, the formula used to achieve a fractional division of the trust estate uses the same factors set forth in the pecuniary marital formula. See §17.81B.

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§17.63 6. Funding Marital Gift

The pecuniary formula only minimally addresses the issue of funding the marital gift. Although requiring the gift to be satisfied in cash is one way to fulfill the gift (Rev Proc 64-19, 1964-1 Cum Bull 682; see §17.64), such a requirement would be highly impractical when a potentially large pecuniary amount must be funded, and could necessitate the sale of a substantial portion of the testator's estate, with attendant income tax consequences (if the assets appreciate in value after the testator's death) and administrative expense. Thus, the clause provides that the pecuniary amount may be satisfied in cash or in kind or partially in each.

The clause also prohibits allocation to the marital gift of assets that do not qualify for the marital deduction. The clause does not permit allocation to the marital trust of assets with respect to which a foreign death tax is paid and that will give rise to a foreign death tax credit if the assets are also subject to the federal estate tax. See §17.60.

The clause includes a direction to allocate insurance on the spouse's life to the bypass trust. The insurance on the spouse's life is likely to increase substantially in value from the date of the testator's death (when it will be valued at its interpolated terminal reserve value or its lesser replacement cost) to the date of the spouse's death (when it will be valued at its face amount).

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7. Overview of Funding Issues When Pecuniary Marital Formula Is Used

§17.64 a. Revenue Procedure 64-19

To understand the purposes of the various funding alternatives, the drafter must be familiar with Rev Proc 64-19, 1964-1 Cum Bull 682, which was intended to eliminate certain abuses in the funding of pecuniary formula marital gifts. These abuses occurred when fiduciaries selected assets to fund the marital deduction gift using their federal estate tax values, even though the assets had decreased in value between the valuation date and the distribution date. Other assets that had increased in value would thereby be left for allocation to the bypass trust. This course of action reduced the value of the marital gift that would be subject to estate tax on the spouse's death.

Revenue Procedure 64-19 requires that in-kind funding of the marital deduction trust under a pecuniary formula be accomplished at the fair market value of the assets at the time of distribution or that assets distributed to satisfy the marital deduction gift be fairly representative of the postdeath appreciation or depreciation of the trust estate. 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, except that it is unclear whether gifts labeled as "fractional shares" are pecuniary gifts when the will 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 for satisfying the gift.

EXAMPLE: Assume the testator's gross estate was valued at $5 million, including $1 million passing to the surviving spouse through a revocable trust. Therefore, the property passing under the testator's will was valued at $4 million. Assume further that the probate estate consists of $3,200,000 in cash (from which $100,000 of administrative expenses is paid) and two assets, each having a federal estate tax value of $400,000: Blackacre, which has increased in value to $500,000 on the date of distribution; and Whiteacre, which has decreased in value to $300,000 on the date of distribution.

At the date of distribution, there will have been no net appreciation or depreciation in the estate assets (although administration expenses will have been paid). In the example discussed in §17.55, the effect of Rev Proc 64-19 is to preclude the allocation of only Whiteacre in full satisfaction of the $400,000 marital gift determined under the formula. Such an allocation would have left Blackacre and the remaining $3,100,000 in cash, assets having an aggregate value of $3,600,000, for allocation to the bypass trust, thereby shifting $100,000 from the marital gift to the bypass trust.

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§17.65 b. "Date-of-Distribution Value" Funding

"Date-of-distribution value" funding is sometimes referred to as "true worth" or "true value" funding because the marital gift receives property having a value equal to the amount of the marital deduction. Under this method of funding, the executor is directed to distribute assets to the spouse or the marital trust having an aggregate value on the date or dates of distribution equal to the dollar amount computed under the pecuniary formula.

Assets distributed in kind in satisfaction of the pecuniary amount will be valued at their date-of-distribution values rather than at their federal estate tax values. Changes in the values of estate assets therefore will not affect the value of the marital deduction gift on the date on which it is satisfied, unless the aggregate value of the assets available for distribution decreases to a value less than the amount of the pecuniary gift to be made. Thus, if the estate appreciates or depreciates during probate administration, the appreciation or depreciation will be borne by the bypass trust.

EXAMPLE: In the example discussed in §17.64, if Whiteacre is allocated in satisfaction of the marital gift when date-of-distribution value funding is used, it will be valued at only $300,000: its date-of-distribution value. An additional $100,000 of cash or a 20-percent interest in Blackacre (having a date-of-distribution value of $100,000 or 20 percent of $500,000) will also need to be allocated to the marital gift to make up for the loss in value of Whiteacre. In general, it is recommended that this formula not be used when the testator owns assets that may be subject to volatile appreciation or depreciation (*e.g.,* sports teams, racing horses, certain kinds of stock investments).

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§17.66 c. "Fairly Representative" Funding

The "fairly representative" funding clause directs the executor to use the federal estate tax values of assets, rather than their date-of-distribution values, in funding the pecuniary marital amount. This alternative is taken from Rev Proc 64-19, 1964-1 Cum Bull 682, which provides that when assets used to satisfy a pecuniary marital gift are valued at their federal estate tax values (rather than their date-of-distribution values), the assets must have an aggregate value fairly representative of the appreciation or depreciation of all the assets then available to satisfy the pecuniary gift.

The values of assets used in fairly representative funding are their federal estate tax values. The formula should provide that an asset available for distribution that has been acquired after the testator's death should be valued at its income tax basis.

EXAMPLE: In the example discussed in §17.64, because there has been no appreciation or depreciation in the trust estate as a whole, the assets chosen for distribution to the marital gift under a fairly representative funding plan also must have no appreciation or depreciation in the aggregate. Any amount of cash can be used to satisfy the gift. If an interest in Whiteacre (which includes depreciation) is allocated to the marital gift, an identical interest in Blackacre (which includes an equivalent amount of appreciation) must also be allocated to the marital gift to achieve a distribution that in the aggregate allocates no appreciation or depreciation to the marital gift. The largest share of Whiteacre that could be allocated to the marital gift under a fairly representative funding plan would be 50 percent (having a value of $150,000 and depreciation of $50,000), with a 50-percent share of Blackacre (having a value of $250,000 and appreciation of $50,000) also being given to the marital gift.

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§17.67 d. "Minimum Worth" Funding

"Minimum worth" funding blends the date-of-distribution value and the fairly representative funding plans in the context of a pecuniary marital formula. This funding plan provides that assets must be allocated in satisfaction of the pecuniary amount at the lesser of (a) their bases for federal income tax purposes or (b) their values on the date or dates of distribution. (Under IRC §1014(a), for decedents dying after 2010, if an asset is included in the testator's estate, the asset's value for estate tax purposes becomes its income tax basis.)

EXAMPLE: In the example discussed in §17.64, any amount of cash can be used to satisfy the marital gift. Whiteacre would be valued at its lesser value of $300,000 on the date of distribution, and Blackacre would be valued at its lesser federal estate tax value of $400,000. Thus, Blackacre (having a date-of-distribution value of $500,000) could be allocated in complete satisfaction of the $400,000 marital gift. If Whiteacre is used to satisfy the marital gift, an additional $100,000 in cash or a one-fourth interest in Blackacre (having an estate tax value of $100,000) must be allocated to the marital gift to fully satisfy it.

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§17.68 e. Allocation Effects of Funding Plan

The most obvious effect of the chosen funding plan concerns allocation of appreciation or depreciation in the value of assets while the testator's probate estate is being administered. When the pecuniary gift is to the marital trust, date-of-distribution value funding allocates all appreciation of the assets to the bypass trust. The appreciation thus will not be subject to federal estate tax on the surviving spouse's later death—an obviously favorable result. If the assets depreciate, however, the same funding plan forces the bypass trust to bear the entire burden of the depreciation, which will result in an augmented marital trust subject to possible federal estate tax on the surviving spouse's death.

Because too many factors are unknown when the will is drafted (*e.g.,* the nature of future assets, the testator's date of death, and the economic conditions existing at that time), the drafter is unlikely to be able to determine whether the testator's estate will appreciate or depreciate during administration. Although the conservative approach of the fairly representative funding plan does not produce as favorable a result when the estate assets appreciate in value (because a proportionate share of the appreciation will be allocated to the marital gift), it does not produce as unfavorable a result when the estate assets depreciate in value (because a proportionate share of the depreciation will be allocated to the marital gift).

When the value of the estate depreciates during probate administration, the minimum worth funding plan forces the bypass trust to bear the burden of the depreciation because assets will be valued at their lower date-of-distribution values in satisfaction of the marital gift. This is the same unfavorable result that occurs under the date-of-distribution value funding plan. When trust assets appreciate, however, the minimum worth funding plan provides that assets be allocated in satisfaction of the marital gift at their lower date-of-death values, thereby causing some of the appreciation to be allocated to the marital trust. Thus, not only does minimum worth funding produce the same unfavorable result as date-of-distribution value funding when the estate depreciates, but it does not produce the same favorable result when the assets appreciate.

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§17.68A f. Income Tax Effects of Funding Plan

A number of income tax issues arise in connection with funding that are also affected by the chosen funding plan. The most prominent tax issue is whether gain or loss is recognized when the pecuniary marital gift is satisfied with appreciated or depreciated assets. For income tax purposes, any property used to satisfy the pecuniary marital gift is treated as if it had been sold for its fair market value on the date of distribution. Thus, gain or loss is realized when property that has appreciated or depreciated in value during the period of probate administration is distributed in kind in satisfaction of the pecuniary marital gift. The amount of gain or loss is equal to the amount by which the fair market value of the property on the date of distribution is greater than or less than its income tax basis, usually its date-of-death value. Unlike funding through a revocable trust, an estate's loss is not disallowed under IRC §267

A related issue is whether income in respect of a decedent (IRD; defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b)) should be allocated in satisfaction of the pecuniary marital gift. Because any property used to satisfy the pecuniary marital gift is treated for income tax purposes as if it had been sold for its fair market value on the date of distribution, the executor's allocation of IRD in satisfaction of the pecuniary marital gift causes the acceleration of recognition of IRD into the year of distribution, even though the majority of IRD payments may not be received until some time in the future.

The drafter must consider another significant income tax issue: whether payments made in satisfaction of the pecuniary marital gift will carry out distributable net income (DNI; defined in IRC §643(a)) when made from the probate estate. See chap 23A. Although a distribution in satisfaction of a specific bequest does not carry out DNI (IRC §663(a)(1)), a distribution under a pecuniary marital formula is not a specific bequest because the amount determined under the formula is not considered to be fixed on the date of death (the amount depends on postdeath administration expenses claimed by the fiduciary and allowed on the testator's federal estate tax return, as discussed in §17.35; see Treas Reg §1.663(a)-1(b)). Therefore, a distribution under a pecuniary marital formula will carry out DNI unless the marital share is a separate share under IRC §663(c). The marital share is a separate share if date-of-distribution funding is used, because the marital share does not share in appreciation or depreciation. The marital share is not a separate share if fairly representative or minimum-worth funding is used. See Treas Reg §1.663(c)-4(b).

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8. Comparison of Funding Plans Used With Pecuniary Marital Formula

a. Date-of-Distribution Value Funding

§17.69 (1) Advantages of Date-of-Distribution Value Funding

The advantages of the pecuniary marital formula with date-of-distribution value funding include:

- *Flexibility in choice of assets to fund the marital deduction gift*. Because the executor may choose the assets that will be distributed to satisfy the pecuniary amount from the entire probate estate not specifically bequeathed elsewhere under the testator's will, the executor will be able to satisfy various goals and desires. For example, the testator's interest in a residence may be distributed in satisfaction of an outright marital gift or assets may be allocated among various beneficiaries to facilitate efficient management of the testator's business. One consideration is that an asset with large growth potential will be taxed on the spouse's death unless it is put in the bypass trust. On the disadvantages of this flexibility, see §17.70.
- *Protection of value of property passing for the surviving spouse's benefit*. Although the executor's allocation of specific assets between the marital trust and the bypass trust may not be a major concern when the surviving spouse receives the income from the bypass trust as well as from the marital gift, the testator may want to ensure that the marital trust receives the full amount calculated under the formula in certain circumstances. In a depreciating market, the decrease in value of the probate estate will not be reflected in the value of property distributed in satisfaction of the pecuniary marital gift when date-of-distribution value funding is used, unless the aggregate value of the assets declines to a value less than the amount of the pecuniary gift. Thus, the testator's intention to protect his or her surviving spouse will be carried out.
- *Allocation of appreciation to bypass trust*. In an appreciating market, any rise in value of assets during probate administration and before funding the marital gift will be allocated solely to the bypass trust. As discussed in §20.3, property allocated to the bypass trust escapes estate taxation on the testator's death and on the death of the surviving spouse to the extent it passes to third parties. The fact that the pecuniary marital gift does not receive a share of the appreciation of the trust estate as a whole does not jeopardize the marital deduction unless the funding of the gift is delayed beyond a reasonable time. *Connecticut Nat'l Bank v U.S.* (D Conn 1990) 90-2 USTC ¶60,043, 66 AFTR2d 5852, rev'd on other grounds (2d Cir 1991) 937 F2d 90.
- *DNI.* When date-of-distribution value funding is used, it will not draw out distributable net income (DNI; defined in IRC §643(a)) from the funding entity. See §17.68.
- *Ease of administration*. Use of date-of-distribution value funding does not necessitate adjusting the fixed value of the marital gift by the amount of income received or gain or loss recognized during probate administration. If, however, the marital gift is not satisfied within one year following the testator's death, the marital gift will bear interest at a rate equal to 3 percent less than the legal rate on judgments in effect one year after the testator's death. Prob C §§12001, 12003. Nonetheless, doing a simple interest calculation is usually substantially easier than allocating income, gains, and losses.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.70 (2) Disadvantages of Date-of-Distribution Value Funding

§17.70 (2) Disadvantages of Date-of-Distribution Value Funding

The disadvantages of the pecuniary marital formula with date-of-distribution value funding include:

- *Recognition of gain and loss*. Gain and loss are recognized on the distribution of property in kind to satisfy the pecuniary marital gift because that pecuniary gift is considered to be a fixed obligation, and the satisfaction of that obligation is treated as though the executor sold the asset and gave cash in the amount of the value of the distributed asset to the surviving spouse or marital trust. The distributee thereby takes a new basis in the appreciated asset at its distributed value, and the estate realizes gain or loss on the difference between the asset's basis (generally date-of-death value) and its value as of the date of distribution. Unlike a funding through a revocable trust, however, loss is recognized upon distribution from an estate. Additionally, it is often impractical to make substantial preliminary distributions from the probate estate to minimize the potential gains or losses and imposition of interest on the pecuniary marital gift.
- *Reappraisals*. The funding will require an appraisal of any property distributed in kind because, under the date-of-distribution value plan, the transfer in satisfaction of the pecuniary marital amount is made using date-of-distribution values. Appraisals made as of the date of the testator's death may be helpful but will not be determinative of date-of-distribution values. Often, the date-of-distribution appraisal will not be a problem, *e.g.,* when the assets distributed in kind are securities that are publicly traded and daily valuation is readily available, or when the value of the asset selected for distribution has clearly remained unchanged. Appraisal may be difficult and expensive in other situations, *e.g.,* when the assets distributed are real property or closely held business interests. The cost of the date-of-distribution appraisal may be minimized by using the same appraiser who performed the date-of-death appraisal. The attorney will have to carefully explain the reasons for the date-of-distribution appraisal to executors who have already endured appraisals for the estate tax return and probate inventory and who may view subsequent appraisals as unnecessary, costly, and wasteful.
- *Funding errors*. If the marital gift is incorrectly funded because of inadequate appraisals or otherwise, the spouse may later have to deal with income, estate, and gift tax issues arising as a result of the incorrect funding. The Internal Revenue Service is likely to treat underfunding of the marital trust as a gift by the spouse to the bypass trust; the IRS may treat overfunding as a gift by the beneficiaries of the bypass trust to the spouse (directly or through the marital trust). These issues may be particularly difficult to address because they may not be raised until the death of the spouse.
- *IRD problems*. In choosing assets for distribution in kind, the executor will need to identify items that represent income in respect of a decedent (IRD; defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b)). The use of IRD property to satisfy a pecuniary gift causes an acceleration of the income represented by the IRD property into the tax year of distribution. Leases, death benefits, installment notes, and similar IRD items should be handled with great care. If the existence or possible existence of IRD items is identified in the planning stage, the draftsperson may avoid the IRD trap by making a specific, preresidual bequest of the right to receive the IRD; a specific gift of IRD does not accelerate the income. IRC §691(a)(2). Avoiding the IRD trap with a specific gift, however, may have other substantive consequences. For example, because the recipient of the IRD property is certain to have an income tax liability when the IRD is ultimately paid, the recipient will be left with less than a recipient of equally valued non-IRD property. (This may be an advantage in some circumstances, *e.g.,* after the spouse's death or in a harmonious family situation.)
- *DNI*. When a pecuniary formula is used, whether funded in cash or in kind, it will draw out distributable net income (DNI; defined in IRC §643(a)) from the probate estate. The executor should advise the spouse or the trustee of the marital trust (who in turn will advise the spouse entitled to all the income from the marital trust) of the income tax liability caused by the distribution. See IRC §§662(a)(2), 663(a)(1)
- *Conflicts of interest*. An executor who is also a beneficiary directly under the will or through one or more trusts may have a conflict of interest with other beneficiaries when selecting assets for allocation to the various trusts. See §17.81I.

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b. Fairly Representative Funding

§17.71 (1) Advantages of Fairly Representative Funding

The fairly representative funding plan, when used together with a pecuniary marital formula, has at least two distinct advantages over the date-of-distribution value funding plan:

- *No recognition of gain*. No gain (or loss) will be recognized for income tax purposes when the pecuniary amount is satisfied with assets valued at their estate tax values. Because assets used to satisfy the pecuniary amount will have income tax bases equal to their estate tax values (see IRC §1014(a)), the recognized gain or loss will be zero. For decedents dying in 2010, when IRC §1014 does not apply, IRC §1040 similarly provides that gain on use of appreciated property to satisfy a pecuniary bequest is recognized only to the extent that the fair market value of the property on the date of the exchange exceeds the value on the date of death.
- *Sharing burden of depreciation*. If, in the aggregate, the value of assets depreciates following the testator's death, the residual bypass trust alone will not bear the economic burden of the decrease in value, but instead the burden will be shared proportionately by the marital gift and the bypass trust.
- *Draw out of DNI*. There may be less of a draw out of distributable net income (DNI; defined in IRC §643(a)) because, under IRC §643(e)(2), the amount of DNI carried out will be limited to the lesser of basis or fair market value unless the fiduciary elects to recognize gain on the distributions under IRC §643(e)(3). In practice, this advantage may not be significant.

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§17.72 (2) Disadvantages of Fairly Representative Funding

The disadvantages of the pecuniary marital formula with fairly representative funding include:

- *Overfunding or underfunding*. Because federal estate tax values rather than date-of-distribution values are used, the fairly representative formula tends to either overfund or underfund the marital deduction gift (and conversely to underfund or overfund the bypass trust). If the trust assets appreciate in value, assets fairly representative of that appreciation will be allocated to the marital gift, thereby overfunding the gift. If instead the trust assets depreciate in value, assets fairly representative of that depreciation will be allocated to the marital gift, thereby underfunding the gift. Overfunding of the marital gift would defeat the goal of placing as much property as possible into the bypass trust to escape estate taxation on the surviving spouse's death. This is commonly the goal when the surviving spouse is the beneficiary of both the bypass and marital trusts during his or her lifetime and the testator is relatively unconcerned over the allocation of specific assets. If the goal is to make a specified amount available to the surviving spouse, either outright or in trust, this result will be frustrated when the assets depreciate in value and the marital gift is underfunded.
- *Reappraisals*. The funding will require an appraisal of any property distributed in kind because, under the fairly representative plan, assets used to satisfy the marital gift must be representative of the appreciation or depreciation of all assets available to satisfy the marital gift. To satisfy this requirement, *every* asset must be reappraised to determine the aggregate appreciation or depreciation of the assets available to satisfy the marital gift. This reappraisal may be more involved and expensive than the revaluation required to implement a date-of-distribution value funding plan in which only the property used for funding need be revalued; even under a date-of-distribution value funding plan, however, the executor may want to have all assets revalued to facilitate the selection of assets to be used to satisfy the marital gift.
- *Limited choice of assets*. The fairly representative formula restricts the executor's choice of assets to fund the pecuniary amount. For example, if the assets in the aggregate have appreciated, there will be a limit to the number of depreciated assets that can be allocated in satisfaction of the marital gift. Thus, in the example discussed in §17.64, in which Blackacre has appreciated $50,000 and Whiteacre has depreciated $50,000, no more than a 50-percent interest in either Blackacre or Whiteacre can be allocated to the marital gift if fairly representative funding is used.
- *DNI.* When a pecuniary formula is used with other than date-of-distribution value funding, whether funded in cash or in kind, it will draw out distributable net income (DNI; defined in IRC §643(a)) from the funding entity. See §17.68. The executor should advise the surviving spouse or the trustee of the marital trust (who will in turn advise the surviving spouse entitled to all the income from the marital trust) of the income tax liability caused by the distribution. See IRC §§662(a)(2), 663(a)(1).

Many fiduciaries feel that the easiest way to comply with the funding requirement is to allocate a prorata share of each asset to the marital gift, even though such an approach turns the clause into a fractional share clause and precludes the choice of only selected assets to fund the marital gift. The formula need not be interpreted in such a restrictive sense, however. After determining the total appreciation or depreciation during probate administration and the marital portion's share of the appreciation or depreciation, the executor can choose among the estate assets in such a manner that (1) the aggregate basis of the selected assets equals the marital deduction amount and (2) the aggregate fair market value of the selected assets at distribution equals the proper portion of the total assets available for distribution. The nature of the estate assets will determine the difficulty of such calculations. Conflict-of-interest issues may also arise in connection with selecting assets for allocation to the various trusts. See §17.81I.

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c. Minimum Worth Funding

§17.73 (1) Advantages of Minimum Worth Funding

The advantages of the pecuniary marital formula with minimum worth funding include:

- *No recognition of gain, but recognition of loss*. Because an asset used to satisfy the marital gift under the minimum worth plan will not be considered to be worth more than its basis, there can be no recognition of gain. If, however, an asset has depreciated in value, it will be used to satisfy the marital gift at its lower date of distribution value. This gives rise to a loss for income tax purposes equal to the amount of depreciation during probate. Unlike the situation with a revocable trust, the loss will be allowed.
- *Flexibility in choice of assets*. Use of the minimum worth formula preserves the fiduciary's ability to choose among assets to fund the marital gift. Because assets must be distributed at the lesser of their fair market value or basis, there is no opportunity to fund the marital gift with depreciated assets valued at their estate tax values and thereby violate Rev Proc 64-19, 1964-1 Cum Bull 682. Thus, the complexities of implementing the fairly representative funding approach are avoided.
- *Limited reappraisals*. The minimum worth funding plan requires reevaluation of only assets that are actually used to fund the marital gift and that have decreased in value during the period of probate administration. For purposes of minimum worth funding, assets that have appreciated in value are valued at their lower estate tax values, and no date-of-distribution appraisal will be required—at least when it is clear that a given asset has appreciated; even under minimum worth funding, however, the executor may want to have all assets revalued to facilitate the selection of assets to be used to satisfy the marital gift.

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§17.74 (2) Disadvantages of Minimum Worth Funding

The disadvantages of the pecuniary marital formula with minimum worth funding include:

- *Underfunding of bypass trust*. Because the assets allocated to the marital gift will be valued at the *lower* of their date-of-distribution value or their estate tax value, more assets may be required to fully fund the marital gift than under the other two funding plans. The additional assets required to fully fund the marital gift reduce the residual assets that will fund the bypass trust, and thus the testator's applicable credit amount cannot be "leveraged."
- *Conflict-of-interest issues*. The minimum worth funding plan may also present difficult conflict-of-interest issues. The primary conflict is the potential for overfunding the pecuniary marital gift by satisfying it with appreciated assets valued at their lower bases. As with any overfunding of the marital gift, this overfunding results in subjecting a greater amount of property to estate tax in the estate of the surviving spouse and causing the bypass trust, perhaps with beneficiaries other than the surviving spouse, to be underfunded. In addition, because of the executor's discretion, the charitable deduction for a charitable remainder trust may be jeopardized.

The executor must make sophisticated decisions in balancing these considerations against the need to distribute certain assets in satisfaction of the marital gift or to retain certain assets for distribution to the bypass trust that will satisfy the beneficiaries' business or emotional needs. If the beneficiaries disagree about the distribution of assets, the executor must exercise great care in choosing assets for funding under this plan. For discussion of conflicts of interest in funding, see §17.81I.

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E. Pecuniary Bypass Marital Formula

§17.75 1. Overview of Pecuniary Bypass Marital Formula

The pecuniary bypass formula, sometimes called the "reverse pecuniary," "pecuniary credit," or "residuary marital" clause, allocates the pecuniary amount to the bypass trust instead of the marital gift. The formula provides that the bypass trust has a value equal to the property shielded from tax by the testator's available applicable credit amount. The considerations relating to income in respect of a decedent (IRD; defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b)), distributable net income (DNI; defined in IRC §643(a)), and recognition of gain and loss in connection with the funding of the nonmarital gift are the same as those relating to the funding of the pecuniary marital gift under a pecuniary marital formula. See §17.68.

From an administrative point of view, the pecuniary bypass formula may be useful if the nonmarital gift will be substantially smaller than the marital gift. Under these circumstances, the fact that a smaller pecuniary amount must be funded produces correspondingly less administrative complexity with respect to appraisals and issues concerning recognition of gain and loss. To avoid gain if date-of-distribution value funding is used in a $10-million estate, for example, it will be easier to find assets worth $1.5 million that have not appreciated than it will be to find assets worth $8.5 million that have not appreciated.

Both date-of-distribution value and fairly representative funding clauses may be used with a pecuniary bypass formula clause. The minimum worth funding plan may not be used in conjunction with a pecuniary bypass formula clause because it would allow the executor to overfund the bypass trust and correspondingly underfund the marital gift, thereby violating the requirements of Rev Proc 64-19, 1964-1 Cum Bull 682.

Because the gift to the bypass trust is a pecuniary amount under the formula, it will not share in estate income earned during probate administration, unless the will provides otherwise. At most, if the nonmarital gift is not made within one year after the testator's death, as a general pecuniary gift it bears interest at a rate equal to three percentage points less than the legal rate on judgments in effect one year after the testator's death. Prob C §§12001, 12003. A clause in the will overriding the state law interest requirement may result in unnecessarily overfunding the residual marital gift. Such a clause may also present problems in allocating the testator's generation-skipping transfer tax exemption to the residual marital trust, if a reverse qualified terminable interest property (QTIP) election is made. See Treas Reg §26.2642-2(b)(3); §15.35. For discussion of reverse QTIP elections, see §15.12.

Unlike the pecuniary marital formula, the pecuniary bypass formula provides that the bypass trust has a value equal to the property shielded from tax by the testator's available applicable credit amount. If more property than is determined under the formula is given to the bypass trust, an amount will be subject to tax on the testator's death, thereby causing an estate tax to be paid on the testator's death. The formula does, however, take into account taxable gifts made under the will (*e.g.,* specific gifts) and from other sources (*e.g.,* joint tenancy property, life insurance, Totten trusts and revocable trusts) in determining the appropriate amount that can pass to the bypass trust to maximize use of the testator's applicable credit amount.

In some circumstances (*e.g.,* when nonprobate gifts exceed the amount that can be sheltered by the applicable credit amount) it is not possible to have zero tax on the testator's death, and the formula will therefore yield a bypass trust value of zero.

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§17.76 2. Form: Pecuniary Bypass Marital Formula (Marital Trust as Residue)

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

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

17.76-1 Pecuniary bypass formula (marital trust as residue)

***Pecuniary Bypass Formula Gift*. If my spouse survives me, I give to the bypass trust a pecuniary amount equal to the maximum amount (if any) that can be allocated to that trust without producing (or increasing) any federal estate tax, after taking into account all factors relevant to this estate tax objective, including but not limited to:**

(1) All deductions claimed and allowed in determining the estate tax payable by reason of my death.

(2) The net value of all other property included in my gross estate, whether or not it is given under this will and whether it passes at the time of my death or has passed before my death to or in trust for any person or entity, so that it is included in my gross estate and does not qualify for the federal estate tax marital deduction. If my spouse disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded.

(3) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for: (a) death taxes paid in the estate of one whose death occurs after mine; or (b) any state death tax unless, and to the extent, a death tax would be payable to the state or states regardless of the federal credit.

If my spouse survives me, I give the residue of my estate to the marital trust.

17.76-2 Satisfaction of amount

My executor shall satisfy the maximum pecuniary amount of the gift to the bypass trust as so determined in cash or in kind, or partly in each, and shall allocate to the bypass trust any assets that are not eligible for the federal estate tax marital deduction. Any insurance on my spouse's life and any assets for which a credit for foreign death taxes is allowable for federal estate tax purposes shall be allocated to the bypass trust, unless there is insufficient other property to fully fund the marital trust.

[*Add one of the following alternatives*]

[*Alternative 1: Date-of-distribution value funding*]

Assets allocated in kind shall be considered to satisfy this amount on the basis of their net fair market values on the date or dates of allocation to the bypass trust.

[*Alternative 2: Fairly representative funding*]

Assets allocated in kind shall be considered to satisfy this amount on the basis of their net fair market values as finally determined for federal estate tax purposes. My executor shall select property to satisfy this amount so that any appreciation or depreciation that has occurred in the value of my estate between the applicable valuation date and the date of allocation shall be fairly representative between the marital trust and the bypass trust.

Comment: In form 17.76-1, if there is no marital trust and the marital deduction amount will be distributed outright to the surviving spouse, the words "marital gift" rather than "marital trust" should be used. The will should provide for an alternate disposition of the residue in the event the spouse does not survive. See §12.80.

If the estate includes qualifying special use valuation property, the pecuniary marital formula in §17.52 should be used rather than the pecuniary bypass formula in this section. See §17.88.

If the drafter wishes to provide for a reverse qualified terminable interest property ("reverse QTIP") marital trust, a clause addressing this issue should be added immediately before the final sentence of form 17.76-1. For suggested language and discussion, see §15.43.

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§17.77 3. Factors Included in Pecuniary Bypass Formula

The factors included in the pecuniary bypass formula are essentially the same as those set forth in the marital pecuniary formula, as discussed in §§17.53-17.60, except that the minimum-worth funding plan may not be used with the pecuniary bypass marital formula. See §§17.50, 17.67.

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§17.78 4. Charitable Remainder Bypass Trust

If the bypass trust is a qualified charitable remainder trust, the pecuniary bypass formula automatically allocates to the bypass trust an amount sufficient to fund both the charitable remainder interest in the trust and a noncharitable lead interest equal to the maximum amount that can pass to noncharitable beneficiaries under the trust and produce no tax.

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§17.79 5. Administration Expenses Claimed as Income Tax Deductions

The pecuniary bypass formula automatically charges administration expenses claimed as income tax deductions to the bypass trust to the extent that the marital deduction regulations provide that charging such expenses to the marital deduction qualifying gift reduces the allowable marital deduction. See §17.35.

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6. Overview of Funding Issues When Pecuniary Bypass Formula Is Used

§17.80 a. Date-of-Distribution Value Funding

Under the date-of-distribution method of funding, the executor is directed to distribute assets to the bypass trust having an aggregate value on the date or dates of distribution equal to the dollar amount computed under the pecuniary formula.

Assets distributed in kind in satisfaction of the pecuniary amount will be valued at their date-of-distribution values rather than their federal estate tax values. Changes in the values of assets during probate therefore will not affect the value of the gift to the bypass trust on the date on which it is satisfied, unless the aggregate value of the assets available for distribution decreases to a value less than the amount of the pecuniary gift to be made. Thus, if the probate estate appreciates or depreciates during administration, the net appreciation or depreciation will be borne by the marital trust.

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§17.81 b. Fairly Representative Funding

The fairly representative funding clause directs the executor to use the federal estate tax values of assets, rather than their date-of-distribution values, in funding the pecuniary amount. This alternative is taken from Rev Proc 64-19, 1964-1 Cum Bull 682, which provides that when assets used to satisfy a pecuniary marital gift are valued at their federal estate tax values, rather than their date-of-distribution values, the assets must have an aggregate value fairly representative of the appreciation or depreciation of all the assets then available to satisfy the pecuniary gift. Although Rev Proc 64-19 technically deals only with a pecuniary marital formula, the same considerations apply equally to a pecuniary bypass formula.

The values of assets used in fairly representative funding are their federal estate tax values. An asset available for distribution that has been acquired after the testator's death should be valued at its income tax basis.

Except for the issue of income earned during administration, the considerations in selecting a pecuniary bypass formula with fairly representative funding are identical to a standard pecuniary marital formula with fairly representative funding. See §17.66.

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§17.81A 7. Comparison of Date-of-Distribution Value Funding and Fairly Representative Funding Used With Pecuniary Bypass Formula

When a pecuniary bypass formula is used with date-of-distribution value funding, the value of the bypass trust is frozen. If the assets of the estate appreciate or depreciate during probate administration, the appreciation or depreciation will be allocated solely to the marital trust. If a fairly representative funding plan is used instead of a date-of-distribution value funding plan, the bypass trust will bear its proportionate share of appreciation and depreciation.

Thus, both date-of-distribution value and fairly representative funding, when used with a pecuniary bypass formula, may cause the marital gift to be underfunded. Although this underfunding may appear to create a troublesome problem with respect to the availability of the marital deduction in the testator's estate, the Internal Revenue Service has held that allocation of depreciating assets to the marital trust will not result in a disqualification of the marital deduction as long as funding takes place within a reasonable time. See Rev Rul 90-3, 1990-1 Cum Bull 175. See also IRS Letter Ruling 8928004 (marital context); Rev Rul 81-20, 1981-1 Cum Bull 471; IRS Letter Ruling 8339005 (charitable context). This result is sound because, even if all the testator's property is left to the surviving spouse, the property could depreciate during administration and result in the surviving spouse receiving less than the date-of-death value of the testator's estate.

Like the funding of a pecuniary marital gift, any property used to satisfy a pecuniary gift to the bypass trust is treated, for income tax purposes, as if it had been sold for its fair market value on the date of distribution. Therefore, the use of appreciated or depreciated assets to satisfy the gift to the bypass trust under a date-of-distribution value funding plan will result in the recognition of gain or loss to the extent thereof. Similarly, the trustee's allocation of income in respect of a decedent (IRD; defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b)) in satisfaction of the pecuniary gift to the bypass trust causes acceleration of recognition of the IRD into the year of distribution.

Underfunding of the marital gift will result if the residuary marital gift pays the capital gains taxes resulting from funding the bypass trust with appreciated assets. Because the net marital gift under these circumstances is greater than the allowed deduction, however, the IRS is unlikely to challenge the marital deduction under these circumstances.

Distributions to the bypass trust will also carry out distributable net income (DNI; defined in IRC §643(a)) if a fairly representative funding plan is used instead of a date-of-distribution value funding plan because the amount determined under the pecuniary marital formula is not considered to be fixed on the date of death and the bypass trust is not a separate share under IRC §663(c). See chap 23A. The amount depends on postdeath administration expenses claimed by the executor and allowed on the testator's federal estate tax return, as discussed in §17.68. See Treas Reg §1.663(a)-1(b). When a pecuniary bypass formula is used with date-of-distribution value funding, the bypass trust is a separate share because the bypass trust does not share in appreciation or depreciation. See Treas Reg §1.663(c)-4(b).

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F. Fractional Share Marital Formulas

§17.81B 1. Overview of Fractional Share Marital Formulas

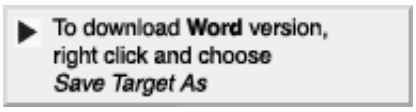
As its name implies, the fractional share marital formula directs the executor to divide the testator's property into two fractional shares. Except for the fact that the shares are not equal in value, this results in a distribution similar to that which occurs when an estate passes to individuals in shares. If the assets increase in value during administration, all shares proportionately share in the benefits of the increase. Similarly, all shares proportionately share in reductions in asset value.

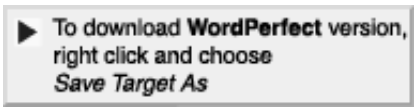
After the fraction is determined under the formula, a prorata funding plan requires allocation to the marital trust of the same fractional share of each asset available for allocation. The remaining fractional share of each asset will be left for allocation to the bypass trust.

A nonprorata funding plan allows a nonprorata allocation of assets in satisfaction of the fractional share marital gift calculated under the formula. This approach attempts to incorporate the advantages of the funding plans used with pecuniary formulas in the context of a fractional share formula by allowing the executor the flexibility to avoid distribution of a fractional share of each and every asset in satisfaction of the marital and nonmarital gifts. With nonprorata funding, the amount of the marital gift is first determined by multiplying the marital fraction determined under the formula by the date-of-distribution value of the assets available for allocation to the marital gift and the bypass trust. Assets having an aggregate date-of-distribution value equal to this amount are then selected by the executor to satisfy the gift.

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§17.81C 2. Form: Fractional Share Marital Formula





17.81C-1 Fractional share marital formula

***Fractional Share Marital Formula Gifts to Marital and Bypass Trusts*. If my spouse survives me by 30 days, I give the residue of my estate in shares to the marital trust and the bypass trust. The marital trust share shall equal the smallest fractional share of the residue that, if taken as a federal estate tax marital deduction, will entirely eliminate (or reduce to the maximum extent possible) any federal estate tax on my death, after taking into account all factors relevant to this estate tax objective, including but not limited to:**

(1) All deductions claimed and allowed in determining the estate tax payable by reason of my death.

(2) The net value of all other property included in my gross estate, whether or not it is given under this will and whether it passes at the time of my death or has passed before my death to or in trust for my spouse, so that it is included in my gross estate and qualifies for the federal estate tax marital deduction. If my spouse disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded.

(3) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for: (a) death taxes paid in the estate of one whose death occurs after mine; or (b) any state death tax unless, and to the extent, a death tax would be payable to the state or states regardless of the federal credit.

The bypass trust share shall equal the remaining share of the residue.

These shares shall be determined using the values of assets as finally determined for federal estate tax purposes. The residuary gifts to the marital trust and bypass trust may be satisfied in cash or in kind, in undivided interests, or partly in each, each such asset to be valued for this purpose on the date it is distributed. Any assets that are not eligible for the federal estate tax marital deduction shall be allocated to the bypass trust. Any insurance on my spouse's life and any assets for which a credit for foreign death taxes is allowable for federal estate tax purposes shall be allocated to the bypass trust, unless there is insufficient other property to fully fund the marital trust.

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3. Comparison to Pecuniary Funding Formulas

a. Fractional Share Formula With Prorata Funding

§17.81D (1) Prorata Funding Not Compelled

Under current law, it is no longer advisable to establish estate plans that compel trusts to be funded on a prorata basis (each trust receiving the same fractional share of each and every asset). Generally, all wills and trusts should authorize nonprorata funding of distributions. In the case of trusts, this is also authorized by statute. See Prob C §16246. If a will fails to contain such an authorization, the probate court can determine the allocation. Prob C §11950. If a will fails to authorize nonprorata funding, care should be taken to avoid making a nonprorata allocation that takes the form of an agreement between the beneficiaries, as this may result in the beneficiaries being deemed to have made a sale or exchange causing recognition of gain. Rev Rul 69-486, 1969-2 Cum Bull 159.

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§17.81E (2) Disadvantages of Prorata Funding

Generally, the best personal and tax benefits can be accomplished by not funding each trust with the same fractional share of each and every asset. Among other things, it is often difficult to sell fractional shares of property. Thus, prorata funding is likely to produce situations in which both the bypass trust and the marital trust must sell an asset, even though it may be undesirable for one trust or the other to make such a sale.

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b. Fractional Share Formula With Nonprorata Funding

§17.81F (1) Advantages of Nonprorata Funding

Use of the fractional share marital formula with nonprorata funding eliminates the problem of recognition of gain that is associated with pecuniary formulas (other than pecuniary gifts that are essentially fractional share gifts because they provide for funding at estate tax values, with the pecuniary gift receiving assets that are fairly representative of the appreciation or depreciation of the estate assets as a whole; see §17.81). Funding a pecuniary gift in kind at date-of-distribution values can result in recognition of gain if assets have appreciated. In contrast, the IRS has long and consistently taken the view that no gain is recognized when a fiduciary allocates assets among fractional shares, as long as the fiduciary has the power to make the allocation without the consent of the recipients. Rev Rul 69-486, 1969-2 Cum Bull 159.

The Internal Revenue Service's approach to this problem is reflected in IRS Letter Ruling 8447003. In this ruling, the IRS cited the established rule that realization of gain or loss occurs only on a distribution of appreciated assets in satisfaction of either a right to receive a specific dollar amount or a right to receive specific property other than that distributed, now extended to include a distribution of appreciated assets in satisfaction of a right to trust accounting income. (The language is drawn from Treas Reg §1.661(a)-2(f)(1).) The IRS determined that a direction to distribute an amount equal to one-fourth of the trust principal on the date of distribution did not result in realization of gain, because the distribution was not a fixed gift of a specific dollar amount (the value of the trust principal fluctuated over time). According to the IRS, "a distribution of a portion of principal or residue, whether pro-rata or non-pro-rata, valued at the time of distribution is not a taxable event."

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§17.81G (2) Disadvantages of Nonprorata Funding

Use of the fractional share marital formula with nonprorata funding has the following disadvantages:

- *Reappraisals*. The primary disadvantage of using nonprorata funding is the need to reappraise all assets in the estate available for allocation each time a distribution is to be made. This is necessary so that the appreciation and depreciation of all the assets will be shared by the marital trust and bypass trust, to satisfy the rationale behind Rev Proc 64-19, 1964-1 Cum Bull 682, discussed in §17.64. The reappraisal burden can be major or minor, depending on the types of assets included in the estate.
- *Overfunding of marital gift*. In contrast to a pecuniary formula with date-of-distribution value funding, a fractional share formula with nonprorata funding ensures that the fractional allocation will not freeze the value of property distributed to either the marital gift or the bypass trust. Similar to a pecuniary gift with fairly representative funding, a fractional share formula cannot pass appreciation to the bypass trust or have depreciation borne by the marital gift, which would in either case reduce the estate tax on the death of the surviving spouse.
- *Conflicts of interest*. An executor who is also a beneficiary of one or more trusts may have a conflict of interest with other beneficiaries when selecting assets for allocation to the various trusts. See §17.81I.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.81H G. Summary of Planning Considerations

§17.81H G. Summary of Planning Considerations

In advising clients about which formula and funding option to choose, the attorney should analyze the nature and value of the assets, the personalities of the clients and beneficiaries, and the tax goals to be achieved through the estate plan. Balancing the interests of multiple members of the client's family may be difficult, especially where it is an extended family with antagonistic members. Nevertheless, the client's (or drafters) choice of formula and funding option will affect not only the amounts passing to the marital and nonmarital gifts but also the nature of the estate administration, including the following issues:

- Recognition of gain or loss on funding;
- Allocation and possible acceleration of recognition of income in respect of a decedent (IRD, defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b));
- Drawout of distributable net income (defined in IRC §643(a));
- Pass-through of losses and excess deductions;
- Appraisal and reappraisal of assets; and
- Periodic readjustment of distributions.

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H. Distribution and Allocation

§17.81I 1. Executor's Discretion to Allocate

In many of the formula clauses, the executor has the discretion to allocate various assets entirely to one trust to the exclusion of the other trust. Because each trust may have different beneficiaries (either current or remainder), the exercise of this discretion can have significant effects. The executor is placed in a position of conflict between the beneficiaries of each trust in allocating assets of the probate estate. When the executor is also a beneficiary, he or she may ultimately decide on an allocation that is personally beneficial. Language either absolving the executor of liability in making funding decisions or giving the executor guidance is therefore recommended in the administrative provisions of the will.

In some cases, such as when a marital pecuniary formula with minimum worth funding is used, the executor's exercise of discretion will even affect the date-of-distribution value of the property passing to the residual bypass trust. In effect, the executor has the power to manipulate the values of the marital trust and the bypass trust. This is also true when the executor has discretion to allocate income in respect of a decedent (IRD; defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b)) in a situation in which using the IRD to fund a gift does not accelerate the IRD: The trust funded with IRD will have a built-in income tax liability and will therefore be underfunded relative to the other trust. (If the IRD is accelerated when used to satisfy a pecuniary gift, the residual gift will be decreased by the tax attributable to the IRD.)

If, however, the surviving spouse is the income beneficiary of both the marital trust and the bypass trust, and the testator's estate contains sufficient other property to fully fund the bypass trust, it will generally be advantageous to specifically allocate IRD to the marital trust in a preresiduary gift, *i.e.,* a gift that is not in satisfaction of a pecuniary amount determined under the formula. In this manner, the value of the property in the marital trust subject to estate tax on the surviving spouse's death will be reduced by the income tax paid as the IRD is received, but the assets in the bypass trust will not be similarly reduced.

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§17.82 2. Timing

The timing of funding and allocation is influenced by a number of factors, which the attorney should keep in mind at the drafting stage:

- *Court administration.* If the decedent's property is administered by a court, the timing of distributions and allocations will be greatly affected. Distributions will usually be delayed until at least 4 months after the issuance of letters. Thereafter, such issues as payment of creditors and arrangements for the payment of federal estate tax will often control the timing of asset distribution. When distributions do take place, there will be income tax ramifications for the estate and the beneficiaries.
- *Distributions to surviving spouse.* If the will provides for distributions to be made directly to the surviving spouse, the executor will make decisions about the choice of assets and timing of the distributions.
- *Distributions to trustee of testamentary trust.* If distributions are to be made to the trustee of a testamentary trust, the trustee will participate with the executor in the choice of assets and timing of the distributions.

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I. Specific Directions Concerning Certain Assets

§17.83 1. Personal Residence

Allocation of the decedent's personal residence is usually determined by the executor or trustee as a funding decision of estate administration. If the client requests specific directions in the will, the attorney should consider both the tax results of the allocation and the resulting ownership of the residence.

Clients often have strong preferences about the disposition of their personal residence under the estate plan. At one time, attorneys were able to accommodate their clients by making an outright distribution of the decedent's interest in the residence to the surviving spouse. With the rapid rise in real estate values, however, this may not be a workable alternative. Because the house may represent a substantial portion of the decedent's property, an outright gift of it may result in a failure to fully fund the bypass trust.

If the decedent's property is more than sufficient to fund the bypass trust, the house may be distributed outright to the survivor or may be held for the survivor's benefit in either a power of appointment marital deduction trust or a qualified terminable interest property trust. The holding of the decedent's interest in either of these two marital trusts will not violate the requirement that marital deduction property be income producing. The surviving spouse's right to live in the residence will be interpreted as an income equivalent. Treas Reg §20.2056(b)-5(f)(4); Treas Reg §20.2056(b)-7(h), Example (1). See §§29.15-29.16, 29.19-29.22, 29.51-29.52, 30.12, 31.25-31.26 for further discussion.

A plan that specifies that the decedent's interest in a residence is to be held in the bypass trust is less common. Assuming the spouse does not have an unrestricted right to withdraw capital gains that would cause grantor trust treatment under IRC §678, the IRC §121 exclusion will not be available for the trust's interest in the residence. If other interests in the residence are owned by the surviving spouse or a typical "survivor's trust" (which gives the spouse the right to withdraw the trust estate at any time and is therefore a grantor trust under IRC §678), the IRC §121 exclusion will be available for those interests. See Rev Rul 85-45, 1985-1 Cum Bull 183; Rev Rul 66-159, 1966-1 Cum Bull 162; IRS Letter Ruling 200018021. Assuming that the exclusion is available for those interests, the survivor may be able to exclude up to the joint return amount of $500,000 rather than the individual return amount of $250,000 if the residence is sold within 2 years after the decedent's death. IRC §121(b)(4). However, the amount of the exclusion may be reduced for periods of nonqualified use in the preceding 5-year period, excluding periods of nonqualified use at the end of the 5-year period and temporary absences due to health conditions. IRC §121(b)(5). This consideration may be important if the residence is not community property because in that case only the decedent's share of the property would receive a step-up in basis at death. See discussion in §3.34.

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2. Stock in Closely Held Business

§17.84 a. Redemption Under IRC §303

Generally, redemption of stock in a closely held corporation results in a dividend that is taxed as ordinary income unless the shareholder is redeeming substantially all of his or her stock. See IRC §§302, 318.

In estate administrations, however, corporate stock may be redeemed in a value necessary to pay state and federal death taxes and funeral and administration costs with the redemption treated as capital gain rather than ordinary income. IRC §303. For §303 to apply:

- The beneficiary of the stock must be directly or indirectly obligated to pay the death taxes, funeral expenses, and costs of administration; and
- The closely held stock must constitute more than 35 percent of the gross estate value reduced by the IRC §§2053 and 2054 deductions (referred to as the "adjusted gross estate").

If the stock is in the marital deduction trust, IRC §303 treatment will usually not be available, because the marital deduction trust is not chargeable with the taxes or costs of administration. If the estate plan contemplates no tax payment on the death of the first spouse to die, allocation to the marital deduction trust will result in the §303 stock's being available in the estate of the second spouse for redemption and favorable treatment. The drafter should discuss these alternatives with the client.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.85 b. Deferred Tax Payment Under IRC §6166

§17.85 b. Deferred Tax Payment Under IRC §6166

Taking advantage of deferred tax payment under IRC §6166 requires special planning and drafting. If the decedent's closely held business is more than 35 percent of the adjusted gross estate, the estate may be eligible for a 14-year (9-year in the case of certain holding company stock) payment period with interest only for the first 4 years (IRC §6166(f)(1)), or a 5-year payment period in the case of stock in qualifying lending and finance businesses, and a 2-percent interest rate on the tax owed on the first $1 million of property (plus cost-of-living adjustments) in excess of the applicable exclusion amount (IRC §6601(j)). The remaining deferred tax bears interest at the regular federal rate on underpayments, adjusted quarterly. IRC §6601(a). Interest paid cannot be deducted for estate or income tax purposes. IRC §§163(h)(2)(E), 2053(c)(1)(D).

For the estate to be eligible for deferred tax payment, either the business must have fewer than 45 owners or the decedent's gross estate must include 20 percent or more of the capital of the business. IRC §6166(b)(1). If neither test is satisfied, the estate may elect to treat capital interests owned by certain family members as included in the decedent's gross estate for purposes of the 20-percent test, but in that case the 14-year payment period will be shortened to 10 years and the 2-percent interest rate will not apply to the deferred tax. IRC §6166(b)(7). See IRS Letter Ruling 200529006. Stock or partnership interests owned by a husband and wife are treated as owned by one shareholder or partner. IRC §6166(b)(2). Deferral is not available for passive assets held by the closely held business (*i.e.,* assets not used in carrying on a trade or business). IRC §6166(b)(9). In Rev Rul 2006-34, 2006-2 Cum Bull 1171, the IRS issued guidance concerning the factors likely to be relevant in determining whether an interest in real property is an asset used in carrying on a trade or business for IRC §6166 purposes. In general, the ruling compares the level and type of services performed by the decedent (or the business entity in which the decedent had an interest) with the services performed by independent contractors. In particular, the ruling distinguishes a situation in which the decedent owned an office park managed and operated almost entirely by a management company in which the decedent had no ownership interest (office park is a passive asset) from one in which the facts are the same except that the decedent owned 20 percent of the stock of the management company (office park is an asset used in a trade or business).

The election to pay taxes in installments must be made on a timely filed estate tax return, and the IRS cannot grant an extension of time to make the election, because the due date for making the election is prescribed by statute. IRC §6166(d); IRS Letter Ruling 200721006.

To the extent that the estate tax is paid in installments under the provisions of IRC §6166, a lien for payment of the tax is imposed on the assets of the decedent's estate, except for those used to pay debts and administration expenses, for 10 years after the date of the decedent's death or until sooner paid in full. IRC §6324. The executor can also make an election to provide a special lien on the closely held business interests for the entire deferral period under IRC §6324A in lieu of a bond that may be required by the IRS under IRC §6165. However, the Tax Court has held that the IRS cannot require a bond or lien for every estate election. *Estate of Edward P. Roski, Sr.* (2007) 128 TC 113. The IRS has issued interim guidance in response to the *Roski* decision 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 to pay tax in installments. Notice 2007-90, 2007-46 Int Rev Bull 1003. As prescribed in the interim guidance, expectation of survival for the deferral period is a primary consideration both in accepting a special lien in lieu of a bond and in asking for a bond or special lien in the first place.

The IRS has since issued additional guidance in the form of a program manager technical advice memorandum. PMTA 2009-046, 2009 TNT 129-21, Tax Analysts Doc No. 2009-15307. 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. However, the IRS cannot require that the value of the collateral securing a lien exceed the deferred tax plus the first 4 years of interest.
- 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 such purposes if it received a discounted value for purposes of computing the estate tax value.
- The property used to secure a lien need not be property that was included in the decedent's estate.

For appreciating businesses or businesses that will not be eligible for IRC §6166 treatment in the estate of the second spouse to die, payment of tax in the estate of the first spouse and use of §6166, linked with IRC §303, may provide an attractive planning alternative. Provisions in the will should not prevent the use of these options. See Mezzullo, *Estate Planning for Owners of Closely Held Business Interest*s*,* Tax Management Portfolios 809-3d (2009).

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§17.86 c. S Corporation Stock

Since repeal of the *General Utilities* doctrine and restructuring of the corporate income tax rate, S corporation status is common. The attorney must consider the presence of S corporation stock in drafting. Only trusts that are grantor trusts, nongrantor trusts subject to an IRC §678 power, voting trusts, qualified subchapter S trusts (QSSTs), or electing small business trusts (ESBTs) may hold S corporation stock for more than 2 years after the testator's death without jeopardizing the election. IRC §1361(c)(2), (d).

The drafter should anticipate QSST or ESBT qualification if the testator's assets include S corporation stock. For a QSST, this will require that (1) a trust created under the will must distribute all its income to one current income beneficiary; and (2) if the trust distributes principal during the current beneficiary's lifetime, it may distribute only to that beneficiary. For an electing small business trust, this will require that (1) the trust must only have individuals, estates, and certain charitable organizations as beneficiaries (a charity's beneficial interest must be contingent), and (2) no beneficiary can have acquired its interest by purchase.

A qualified terminable interest property trust will qualify as a QSST because of the income distribution requirements and the principal distribution restrictions. Although an inter vivos power of appointment marital deduction trust may not qualify as a QSST, it will still qualify as a QSST as a trust that is subject to an IRC §678 power. See IRC §1361(c)(2). Because of the discretionary income distribution power in the trustee, an estate trust will not qualify as a QSST. It will, however, qualify as an electing small business trust.

Not only tax qualification but also control over the business require the drafting attorney to consider subchapter S stock carefully. The surviving spouse will usually have the power to require that the marital deduction trust property be made productive, and the payment of regular dividends may not be consistent with corporate business planning. See Treas Reg §20.2056(b)-5(f)(4).

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§17.87 3. Partnership Interests

If the will includes a pecuniary marital formula, partnership interests may create an income tax problem. The allocation of such interests in satisfaction of the pecuniary amount may be a taxable sale. If these holdings are extensive, the will should contain specific provisions on the allocation of those assets. For further discussion, see Moore, *Partnerships in Estate Administration: A Proposed Roadmap Through the Thicket,* 26 U Miami Inst Est Plan, chap 15 (1992).

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§17.88 4. Special Use Property (IRC §2032A)

Internal Revenue Code §2032A permits the executor to value real property used for farming or in a closely held business at its special use value rather than its fair market value. This special use valuation may not reduce the value of the gross estate by more than $750,000. IRC §2032A(a)(2). This amount is increased (in $10,000 increments, to $1,000,000 in 2009) for changes in the cost of living. IRC §2032A(a)(3). The option may be very valuable, and the presence of a pecuniary marital formula in the will may be quite important.

The satisfaction of a pecuniary marital gift, while included in the gross estate at its IRC §2032A value, may be distributed to satisfy the marital gift at the fair market value on the date of distribution. Treas Reg §20.2056(b)-4(a). The difference between the fair market value and the §2032A value will thereby increase the value held in the bypass trust. In addition, gain recognition rules are different for §2032A property. The executor's distribution of §2032A property in satisfaction of a pecuniary gift will not result in recognition of gain to the extent of the difference between the fair market value (adjusted for postdeath depreciation) and the §2032A value. Instead, the surviving spouse will receive the property at the §2032A basis. IRC §1040. Careful drafting produces not only present tax advantages but also the opportunity for additional planning. See Estate Planning for Special Assets, chap 3 (Cal CEB 2004).

If the surviving spouse, who is a qualified heir under IRC §2032A(c)(7)(C)(i), receives the IRC §2032A property, the recapture period under §2032A will terminate on the earlier of the spouse's death or 10 years. IRC §2032A(c)(1). That termination option would not be available if the property were held in the bypass trust. In addition, the presence of the §2032A property in the spouse's estate may make possible a valuation in that estate under §2032A that may be linked with deferred payment of estate taxes under IRC §6166. The choice of marital deduction formula clause will be crucial in preserving these planning opportunities. A specific gift of the qualified real property or a fractional share marital gift will limit the marital deduction to the §2032A value of the property. Accordingly, it is necessary to use a pecuniary marital formula. See §17.52. For discussion of recapture tax apportionment issues under IRC §2032A, see §26.20.

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5. Qualified Family-Owned Business Interest (QFOBI) Deduction (IRC §2057)

§17.88A a. Overview

Under IRC §2057, an estate tax deduction is allowed for the adjusted value of the qualified family-owned business interests (QFOBIs) included in an estate. The stated maximum amount of the deduction is $675,000, but this is misleading because, as a result of the election, the IRC §2010 applicable exclusion amount that would otherwise apply to estates of decedents dying after 2010 is reduced from $1 million to $625,000. IRC §2057(a). A portion of the reduced applicable exclusion amount is restored if the allowable QFOBI deduction is less than $675,000, but the total value of the QFOBI deduction plus the applicable exclusion amount cannot exceed $1.3 million. Thus, the net value of the deduction cannot exceed $300,000. The deduction is repealed in 2004-2010. IRC §2057(j).

As further discussed in §§17.88B-17.88O, eligibility for the deduction is severely limited by a variety of predeath and postdeath requirements intended to ensure that the deduction is available only for property actively used in a family business in situations in which the family business interests exceed, with some adjustments, 50 percent of the value of the estate. The estates most likely to qualify are those of farmers and ranchers, whose estates may also qualify for special use valuation under IRC §2032A. See §17.88.

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§17.88B b. QFOBI Defined

Generally, a qualified family-owned business interest (QFOBI) is an interest in a proprietorship or entity carrying on a trade or business. In most cases, the family must own at least 50 percent of the business, but the estate can qualify with levels of family ownership of only 30 percent if members of two families own 70 percent of the business or members of three families own 90 percent. IRC §2057(e). The principal place of the business must be located in the United States, and interests will not qualify if they are publicly traded. In addition, as a practical matter, an interest is not a QFOBI unless it meets the qualified-heir requirement discussed in §17.88C, because only interests satisfying that requirement qualify when the 50-percent test described in §§17.88E-17.88F is applied, and only such interests are deductible. Assets of a business that consist of cash or marketable securities in excess of day-to-day working capital needs are not treated as QFOBIs, and neither are various other passive-investment type assets. IRC §2057(e).

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§17.88C c. Qualified Heir Requirement; Definition of Member of Family

Generally, a deduction is allowed only for QFOBIs included in the gross estate that "are acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of section 2032A(e)(9))." IRC §2057(b)(2). An interest will satisfy the requirement if it passes to a member of the decedent's family. IRC §§2032A(e)(1), 2057(i)(1). Under IRC §2032A(e)(2), incorporated by reference in IRC §2057(i)(2),

> "member of the family" means, with respect to any individual, only (A) an ancestor of such individual; (B) the spouse of such individual; (C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual; or (D) the spouse of any lineal descendant described in subparagraph (C).

Under IRC §2057(i)(1), the term "qualified heir" also includes any active employee of the trade or business who has been so employed for at least 10 years before the decedent's death. Thus, it is possible to take advantage of IRC §2057 by having the estate or revocable trust sell the business to a qualifying employee, although the employee may expect a discount in return for assuming the recapture risk.

It is important to note that, because of the phrase "within the meaning of section 2032A(e)(9)" in IRC §2057(b)(2), property may be treated as passing to a qualified heir even though it is purchased by a qualified heir. A plan that provides for purchase by a qualified heir may facilitate the equal treatment of family members. It may also (for example, in the case of a sale from the estate to a sibling of the decedent) make it possible to take advantage of IRC §2057 even though no devisee of the estate is a qualified heir.

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§17.88D d. Trust as Qualified Heir

A trust will qualify as a qualified heir if it would qualify as a qualified heir under IRC §2032A. IRC §2057(i)(3)(L). The law with respect to IRC §2032A is uncertain, but IRC §2032A(g) provides:

> APPLICATION OF THIS SECTION AND SECTION 6324B TO INTERESTS IN PARTNERSHIPS, CORPORATIONS AND TRUSTS.—The Secretary shall prescribe regulations setting forth the application of this section and section 6324B in the case of an interest in a partnership, corporation, or trust which, with respect to the decedent, is an interest in a closely held business (within the meaning of paragraph (1) of section 6166(b)). For purposes of the preceding sentence, an interest in a discretionary trust all the beneficiaries of which are qualified heirs shall be treated as a present interest.

The last sentence was added by the Economic Recovery Tax Act of 1981 (ERTA) (Pub L 97-34, 95 Stat 172). There was never a "present interest" provision in the statute, but the Report of the Conference Committee on the Tax Reform Act of 1976 (Pub L 94-455, 90 Stat 1520) had stated that "[t]he conferees intend to make it clear that the rules for special valuation apply to property which passes in trust. Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property." S Rep No. 94-1236, 94th Cong, 2d Sess, 610 (1976), reprinted in 1976-3 (vol 3) Cum Bull 807, 960.

Although these authorities leave many unanswered questions, it appears clear that a trust will be a qualified heir if all beneficiaries are qualified heirs. Although there is some case law authority for ignoring de minimis contingent interests held by persons who are not qualified heirs, prudence suggests avoiding such interests when drafting a trust that is intended to meet the qualified-heir requirement. Prudence further suggests that drafters make sure that the person who will provide the required postdeath material participation (see §17.88I) is a "member of the family" of each beneficiary of the trust.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.88E e. 50 Percent of Adjusted Gross Estate Requirement--Rationale

§17.88E e. 50 Percent of Adjusted Gross Estate Requirement—Rationale

To be eligible for the IRC §2057 qualified family-owned business deduction, the sum of the adjusted value of the qualified family-owned interests in the estate *that pass to qualified heirs,* plus certain gifts of such interests made to qualified heirs, must *exceed* 50 percent of the "adjusted gross estate" as defined in IRC §2057(c). IRC §2057(b)(1). The detailed, complex formula for determining whether this test is met implicitly reflects the following policy judgments:

- *Gifts of QFOBIs.* Gifts of qualified business interests to qualified heirs other than the spouse should not cause the estate to fail the 50-percent test if the qualified heirs continue to hold the gifted QFOBIs until the transferor's death. Accordingly, the amounts of such gifts are included in both the numerator and denominator of the fraction. However, gifts to the spouse are not included in the numerator. IRC §2057(b)(3)(A)(ii). They are included in the denominator to the extent they are made within 10 years of death, with the result that these gifts make it more difficult to meet the 50-percent test. IRC §2057(c)(2)(A)(i). Some commentators have questioned whether the treatment of QFOBI gifts to the spouse is appropriate.
- *Gifts of Other Assets.* The decedent should not be allowed to meet the 50-percent requirement by making gifts of nonbusiness property. Accordingly, gifts other than gifts of qualified family-owned business interests to qualified heirs are included in the denominator of the fraction if made within 3 years of death, even when not otherwise included in the estate. Again, the 3-year period is extended to 10 years in the case of gifts to the spouse. IRC §2057(c)(2)(A)(ii)-(iii).
- *Debts*. It is often difficult to sort out whether any particular indebtedness is indebtedness of the business (which reduces the net value of the business share) or personal indebtedness. Accordingly, for administrative convenience, a relatively bright-line test is established that treats all indebtedness (claims against the estate and secured indebtedness deductible under IRC §2053(b)(3)-(4)) as indebtedness of the business *except* (1) indebtedness secured by the residence that qualifies for the IRC §163(h)(3) interest deduction; (2) indebtedness attributable to medical and educational expenses; plus (3) the first $10,000 of additional indebtedness. IRC §2057(d). When a decedent's debts reduce the net value of the QFOBIs without a dollar-for-dollar increase in business assets, the result is to reduce both the numerator and the denominator of the fraction, making it more difficult to qualify. Further, in the case of smaller estates, the reduced value of the QFOBIs may result in a reduced deduction even if the 50-percent test is satisfied.
- *Passive Assets*. The QFOBI deduction is intended to protect estates that consist primarily of the assets of an active trade or business. It is not intended to benefit estates that have substantial passive investment assets, such as securities. Accordingly, the value of QFOBIs does not include such assets even when the assets are owned by the corporation or other business entity conducting the business. IRC §2057(e)(2)(C)-(D). However, an asset can be a passive investment with respect to the testator and still be a QFOBI if it is used in a trade or business by a member of the family. IRC §2057(e)(2). See §17.88G.

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§17.88F f. 50 Percent of Adjusted Gross Estate Requirement—Calculation

The numerator of the fraction is computed by first adding the values of (1) qualified family-owned business interests (QFOBIs) in the estate; (2) adjusted taxable gifts of such interests passing to qualified heirs; and (3) annual exclusion gifts of such interests made to qualified heirs. The total is then reduced by indebtedness other than (a) indebtedness secured by a residence deductible under IRC §163(h)(3); (b) indebtedness for education and medical expenses; and (c) $10,000 of other indebtedness.

In determining the amount of the QFOBIs, it is necessary to exclude (1) personal-holding-company type assets not used in a trade or business, and (2) cash and securities in excess of expected day-to-day working capital needs. IRC §2057(e)(2)(C)-(D). The Conference Report for the Taxpayer Relief Act of 1997 (Pub L 105-34, 111 Stat 788) clarifies that working capital needs are to be determined using an analysis similar to that set forth in *Bardahl Mfg. Corp.*, TC Memo 1965-200, and do not include accumulations for future capital acquisitions. H Conf Rep No. 105-220, 105th Cong, 1st Sess, 397 (1997), reprinted in 1997 US Code Cong & Ad News 1129, 1209. See *Knight Furniture Co.,* TC Memo 2001-19. In *Estate of Duane B. Farnam* (2008) 130 TC 34, the court held that debt owed by the family business corporation to the deceased shareholders did not constitute QFOBIs. Accordingly, the decedents' estates were not entitled to claim the IRC §2057 deduction.

The denominator of the fraction is calculated by first adding the values of (1) the gross estate; (2) adjusted taxable gifts of QFOBIs passing to qualified heirs; (3) annual exclusion gifts of such interests made to qualified heirs; (4) any additional gifts to the spouse made within 10 years; and (5) gifts made to others within 3 years of death to the extent the additional gifts were not excluded by the annual gift tax exclusion. The resulting subtotal is then reduced by (1) debts deductible for estate tax purposes under IRC §2053(a)(3)-(4); and (2) the value of any gifts that would otherwise be counted twice in computing the denominator because the gifts are included in the gross estate for some reason.

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§17.88G g. Predeath Ownership and Material Participation Requirement

During the 8-year period ending on the decedent's death, there must have been periods aggregating 5 or more years during which (1) the qualified family-owned business interests were owned by the decedent or a member of the decedent's family, and (2) the decedent or a member of the decedent's family participated materially in the operation of the business (within the meaning of IRC §2032A(e)(6)). IRC §2057(b)(1)(D).

The material participation requirement is intended to prevent use of IRC §2057 in circumstances where a family business is merely a passive investment. The definition of "material participation" is elaborated in Treas Reg §20.2032A-3(a), (e)-(f).

The ownership and material participation requirements do not require that the owner be actively involved in the trade or business. Also, there is no requirement similar to the IRC §2032A "qualified use" requirement that might impose an obligation to have an equity interest in the business. It is quite permissible, for example, for the decedent to own real estate that is leased to a family member for a fixed rental, provided the real estate is used by the family member for a trade or business and the same or another family member materially participates in the trade or business. IRC §2057(e)(2). Such real estate may qualify even though it was acquired from another family member only a short time before the owner's death.

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§17.88H h. Election Requirement

The statutory requirements for making an IRC §2057 election are virtually the same as for IRC §2032A, and notably include the requirement that the qualified heirs execute an agreement consenting to the application of the recapture tax provisions of the statute. IRC §2057(h), (i)(3)(H). These provisions can result in the imposition of a lien on the QFOBIs under IRC §6324B. IRC §2057(h), (i)(3)(P). An important issue with respect to the statute, unresolved at the time of its enactment, is whether the election and related consent agreement can effectively make the election only for enough QFOBIs to take advantage of the deduction. For example, if your client has $5 million in QFOBIs, can the election be made for only $675,000 of them, thereby minimizing the amount of property subject to an IRC §6324B lien, and also minimizing the amount of property subject to potential recapture tax?

Under IRC §2032A, the IRS has allowed partial elections, provided the election is made for sufficient property to satisfy the IRC §2032A(b)(1)(B) requirement that the qualified real property have a value equal to 25 percent of the estate. Treas Reg §20.2032A-8(a)(2). That requirement was ruled invalid in *Miller v U.S.* (CD Ill 1988) 680 F Supp 1269. Although it is still possible that the IRS will take a similar approach when it adopts regulations, the August 2004 version of the United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706, clearly permits partial elections without requiring that the election be made for a particular minimum amount of property. For discussion of the similar July 1998 version, see *Reading the T Leaves: New Form 706 Provides Important QFOBI Deduction Answers*, 20 CEB Est Plan Rep 37 (Oct. 1998).

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§17.88I i. Postdeath Ownership and Material Participation Requirements

Tax benefits of the IRC §2057 deduction will be recaptured if any of the following events occur before the earlier of the death of the qualified heir or the expiration of 10 years:

1. There is a failure to meet the postdeath material participation requirement;

2. A qualified heir disposes of any portion of the QFOBI to a person other than a member of that qualified heir's family;

3. The qualified heir ceases to be a citizen and does not comply with security requirements applicable to noncitizens; or

4. The principal places of business cease to be located in the United States. IRC §2057(f)(1)(A)-(D).

Section 2057(f)(1)(A) incorporates by reference the postdeath material participation requirement in IRC §2032A(c)(6)(B):

> (B) during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating more than 3 years during which —
> (i) in the case of periods during which the property was held by the decedent, there was no material participation by the decedent or any member of his family in the operation of the farm or other business, and
> (ii) in the case of periods during which the property was held by any qualified heir, there was no material participation by such qualified heir or any member of his family in the operation of the farm or other business.

Under these rules, the time limit for beginning material participation after death depends on the extent to which material participation occurred before death. This is usually not a problem, however, because another provision permits a delay of up to 2 years in commencing postdeath material participation. IRC §2057(i)(3)(G), incorporating IRC §2032A(c)(7). To the extent this provision is used, the 10-year recapture period is postponed.

In IRS Letter Ruling 200327016, the IRS ruled that an IRC §303 redemption of stock to pay death taxes and administration expenses was not a disposition under IRC §2057(i)(3)(O), which incorporates rules applicable under portions of IRC §6166 relating to the installment payment of estate taxes. In IRS Letter Ruling 200252084, however, the IRS ruled that a corporation's redemption of all of a qualified heir's stock was not a transfer to a "member of the qualified heir's family" within the meaning of IRC §2057(f)(1)(B), even though all of the other shareholders of the corporation were members of the heir's family. Therefore, the proposed redemption would trigger the recapture tax. See §17.88J.

When designing an estate plan intended to qualify for the IRC §2057 deduction, counsel should give careful attention to the fact that the persons whose activities can satisfy the material participation requirement will shift as a result of the decedent's death. In the predeath period, the decedent's family members must materially participate; in the postdeath period, material participation must be provided by a member of the qualified heir's family. Thus, for example, a sibling, niece, or nephew of a decedent can provide the necessary material participation in the predeath period, but they cannot, if the property passes to the decedent's children, provide the material participation in the postdeath period. If the sibling, niece, or nephew is the only person who will be active in the business, the plan might provide for a sale by the executor (or the trustee of the decedent's revocable trust) to that person. The sale can be made by the executor but cannot be made by decedent's children, because the sibling, niece, or nephew is a member of the decedent's family and therefore a qualified heir of the decedent, but the sibling, niece, or nephew of the decedent is an uncle, aunt, or cousin of the decedent's child, and therefore cannot purchase the child's interests without triggering recapture.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.88J j. Recapture Tax

§17.88J j. Recapture Tax

The events that trigger recapture tax are described in §17.88I. The period during which the tax benefits of the IRC §2057 QFOBI deduction may be recaptured is 10 years (or until the earlier death of the qualified heir). In a departure from the all-or-nothing provisions of IRC §2032A, the amount of the additional (or "recapture") tax is a percentage of the amount of the estate tax that was saved as a result of making the IRC §2057 election. 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 10 percent in the tenth year. IRC §2057(f)(2)(B). Interest on the amount of the additional tax accrues at the rate for underpayments, retroactively from the original due date of the estate tax (9 months after death). There are no IRC §6166 installment payment provisions for the "additional estate tax," so the IRC §2057 election should not be made without a reasonable belief that there will not be an early recapture. The recapture tax continues to apply despite the repeal of the deduction in 2004. See IRC §2057(j).

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.88K k. Planning Considerations

§17.88K k. Planning Considerations

Only a small percentage of estates will qualify for the IRC §2057 QFOBI deduction, typically those involving farms and ranches. When an estate may qualify, a custom plan is required to ensure that both the predeath and postdeath requirements can be met with reasonable certainty and without disrupting normal estate planning objectives. A few of the problems most likely to arise are described in §§17.88L-17.88O.

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§17.88L (1) Relationship of IRC §2032A and IRC §2057

An estate may qualify for benefits under both IRC §2032A and IRC §2057. Note, however, that the reduction in value under IRC §2032A (see §17.88) might cause failure of the 50-percent test under IRC §2057 because of the decrease in value of the business property. Note further that the IRC §2057 deduction is not available in 2004-2009 while the IRC §2032A special use valuation remains available. When both statutes may be available on the death of the testator and it is appropriate to use the benefits under one of these statutes but not both, the planner should keep in mind the following differences between the statutes:

- A greater valuation deduction is available under IRC §2032A;
- Use of IRC §2032A results in the property having a lower capital gain basis;
- Payment of retroactive interest is mandatory under the recapture provisions of IRC §2057, but not those of IRC §2032A;
- The reduction in value under IRC §2032A reduces the value of the property for purposes of allocating GST exemption; and
- In connection with marital deduction planning, there is no double deduction problem under §2032A. See §17.88N.

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§17.88M (2) Aligning Benefits and Burdens

As under IRC §2032A, planners generally should try to ensure that the beneficiaries who benefit from an IRC §2057 deduction are the same beneficiaries who suffer the burden of recapture. Consider, for example, what happens if the plan states, "I give Business to Daughter and residue to Son, with estate tax to be paid from the residue." Daughter may oppose a proposed IRC §2057 election because she will receive no benefit and will be exposed to the risk of paying recapture tax if a recapture event occurs.

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§17.88N (3) Marital Deduction Issue

A problem arises if QFOBIs are allocated to a spouse or marital deduction trust under a standard marital deduction estate plan, because IRC §2056(b)(9) states:

> DENIAL OF DOUBLE DEDUCTION.—Nothing in this section or any other provision of this chapter shall allow the value of any interest in property to be deducted under this chapter more than once with respect to the same decedent.

Pending regulatory guidance, planners should normally make sure that at least the first $675,000 of QFOBIs pass to a qualified heir other than the surviving spouse. Otherwise, the benefits of the QFOBI deduction may be canceled out by an equivalent reduction in the marital deduction. If the surviving spouse is a member of the QFOBI recipient's family, it is probably permissible for the recipient to sell the QFOBIs to the spouse. This can be desirable for two reasons. First, the spouse is usually the heir with the shortest life expectancy, and the death of a qualified heir during the recapture period terminates the recapture period. Second, it is often desirable to claim another QFOBI deduction for the spouse's estate, in which case transferring the QFOBIs to the spouse will help ensure that the survivor's estate will qualify. This may also increase the portion of the survivor's estate that will qualify for installment payment of estate taxes under IRC §6166.

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Source: Estate Planning/California Will Drafting/17 Marital Deduction: Overview and Formula Clauses/§17.88O (4) Hidden Gift by Spouse

§17.88O (4) Hidden Gift by Spouse

Under a typical marital deduction estate plan, the use of IRC §2057 may increase the value of the credit shelter gift from $1 million to $1.3 million. This decreases the value of the marital gift and raises the issue of whether the spouse has made a gift if the spouse's consent was needed to make the election. Although the IRS has never raised such a contention in connection with an analogous issue under IRC §2032A, it may be desirable to make sure that the spouse does not have the power to prevent the election. The fiduciary discretion to make the election can be given to an independent person who is neither the spouse nor a beneficiary of the credit shelter gift. The need for the spouse's individual consent to the election can be avoided by having the required QFOBIs pass to other individuals or to a separate bypass trust that does not benefit the spouse.

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§17.89 6. Income in Respect of Decedent (IRD) Property

Income in respect of a decedent (IRD) is a right to receive future payments. Typical examples of IRD property include a promissory note, a contract right or other installment obligation, a lease, an undistributed share of profits in a business for the year of death, annuity death benefit payments (often in place of pension or retirement pay), a share in accounts receivable, and entitlement to future commissions. (IRD is defined in IRC §691(a)(1) and Treas Reg §1.691(a)-1(b).) The distribution of the right to receive these payments by the estate may trigger large amounts of ordinary income taxable at the time of distribution even though the majority of the payments may not be received until some time in the future.

The provisions in the will can control and minimize acceleration of income or inadvertently create income tax situations that may destroy the overall estate plan. The type of gift used determines the income tax consequences of funding it. Different rules apply to the funding of specific, pecuniary, fractional, and residuary gifts.

The distribution by the executor of the right to receive future IRD when that distribution is made to satisfy a specific gift will not trigger income to the estate. Treas Reg §1.691(a)-4. The recipient of the property reports the income when received and is also entitled to a deduction for estate tax attributable to the property. IRC §691(a)(1), (c). When the executor distributes IRD property in satisfaction of a fixed dollar devise or in satisfaction of a pecuniary formula gift, the distribution is considered to be a sale or exchange, triggering ordinary income. The estate will include in gross income the fair market value of the right to receive the future payments of IRD on the income tax return for the year of the transfer. Treas Reg §§1.691(a)-2(a), 1.1014-4(a)(3). By contrast, if the executor distributes IRD in satisfaction of a fractional or percentage share gift, this is a distribution of a portion of the residuary estate for which the estate will have no reportable income. Treas Reg §1.661(a)-2(f)(1).

Neither the estate nor the noncharitable residuary devisees will recognize income if the will authorizes nonprorata distributions and the executor distributes IRD to the shares of the residuary estate passing to charity. IRS Letter Ruling 200234019.

If the will contains a pecuniary gift or a pecuniary marital formula, and the client holds or is likely to acquire IRD property, the will should contain specific provisions covering the disposition of the IRD property. Failure to include such directions may have disastrous tax consequences.

For further discussion of IRD in pecuniary marital formulas, see §§17.68, 17.70. For discussion of IRD in pecuniary bypass formulas, see §§17.81A, 17.81D; for discussion of when the executor has discretion to allocate IRD, see §17.81I.

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§17.90 VI. SURVIVOR'S SHARE OF PROPERTY

Property of spouses or domestic partners in California may include community property, quasi-community property, community property with right of survivorship, and community property that the spouses or partners have created by transmuting quasi-community or separate property. The rights of the parties vary depending on the makeup of the property and who may be the survivor. Any community property with right of survivorship passes without administration to the survivor. CC §682.1; Fam C §297.5(c). There may also be practical reasons why the survivor chooses to administer his or her property in the estate of the first to die. In probate administration, if the community property share of the survivor is also administered, the survivor is protected from unfiled or untimely file creditors' claims. Prob C §§13502, 13553. The will may provide for the probate administration of all the property of both spouses or partners and for a survivor's trust (the traditional *A* trust). The survivor's trust may be made up only of the survivor's property interests or may also be a power of appointment marital deduction trust in the case of spouses under IRC §2056(b)(5).

The client's choices in gift planning should be carefully integrated with any provisions in the will on administration of the survivor's property.

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§17.91 VII. POSTMORTEM RECONSTRUCTION AND GIFTS

After a client's death, the attorney may use disclaimers and elections to produce desired tax effects in the estate or to adjust to changed circumstances. Disclaimers and elections may also offer the opportunity for the attorney administering the estate to correct flaws in the will. The drafting attorney's primary goal is to provide a flexible document that can make later use of these tools.

For example, the will should specify the disposition of disclaimed property and provide for the source of tax payment when the executor makes or does not make an election or partial election or a beneficiary disclaims. The structure of the will should not preclude or inhibit the use of these postmortem techniques. For a discussion of election techniques, see Hart, *The Disclaimer: A Gift to the Postmortem Planner,* Estate Planning 1990, chap 6 (Cal CEB 1991). For detailed discussion of allocation of death tax burdens, see chap 26.

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18

Marital Deduction Power of Appointment Trusts

Melitta Fleck

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I. MARITAL DEDUCTION TRUST PLANNING

§18.1 A. Alternative to QTIP Trust

After discussing the appropriate use of a marital deduction general power of appointment trust (see §§18.2-18.6), this chapter describes the requirements for such a trust. The clauses necessary to create a power of appointment trust may be found in §§18.21-18.28.

Qualified terminable interest property (QTIP) trusts are discussed in chap 19. Power of appointment trusts and QTIP trusts are compared in §§17.23-17.24. The formula provisions by which marital deduction trusts are funded are discussed in §§17.46-17.89.

If the spouse is not a United States citizen, a power of appointment trust must be used with caution. At a minimum, the required provisions of a qualified domestic trust, described in §§19.32-19.40 should be used.

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B. When to Use Power of Appointment Trust

§18.2 1. Control by Surviving Spouse

A power of appointment trust is useful when the testator's primary concerns for the surviving spouse are asset management and probate avoidance. See §18.10 for discussion of payments in case of the surviving spouse's incapacity. Because a general power of appointment trust is equivalent to outright ownership of trust property (see §18.7), it should not be used if the testator wants to limit the surviving spouse's control over ultimate disposition of the trust assets.

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§18.3 2. Lifetime Gifts by Surviving Spouse

A power of appointment trust is also useful when the spouse intends to continue or to embark upon a lifetime gift program. The surviving spouse may make lifetime gifts out of the trust by exercising a power of withdrawal or an inter vivos power of appointment. The testator can limit the donees of gifts from a power of appointment trust by not giving the surviving spouse complete power to withdraw the power of appointment trust assets during the survivor's lifetime.

Under a qualified terminable interest property (QTIP) trust, inter vivos gifts cannot be made to anyone other than the surviving spouse. See §19.7. Inter vivos gifts out of a QTIP trust must first involve a transfer to the surviving spouse (if authorized by the instrument), or the spouse must invade the trust for his or her benefit (if authorized by the instrument) and then make a gift to the donee. Under these circumstances, the deceased spouse cannot limit the permissible donees of the surviving spouse.

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§18.4 3. Assignment of Income Interest

A general power of appointment trust permits the surviving spouse to make assignments of the income interest in the marital deduction trust property, unless prohibited by a "spendthrift" clause in the will. An assignment of an income interest in a qualified terminable interest property trust has significantly different tax consequences.

For further discussion of spendthrift clauses as they affect marital deduction trusts, see §27.6. See form 27.8-1 for a clause.

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§18.5 4. Avoiding State Inheritance or Estate Tax on Out-of-State Property

In a less common situation in which a general power of appointment trust may be advisable, the testator owns property subject to taxation in states that do not "pick up" the IRC §2011 federal estate tax credit for state death taxes (see §17.58) and have not enacted legislation qualifying a qualified terminable interest property trust for the state death tax marital deduction. In such states, the marital deduction is only available if a general power of appointment trust is used. The assets of the general power of appointment trust may be limited to assets that would not otherwise qualify for the state estate tax marital deduction. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§18.6 5. Generation-Skipping Transfer (GST) Tax Planning

A general power of appointment trust can waste part of the generation-skipping transfer (GST) tax exemption of the first spouse to die if the decedent made lifetime taxable gifts. The drafter can avoid this result by making a "reverse QTIP election." See §19.13. Consequently, a power of appointment trust should not be the only marital trust used in estates in which GST tax planning is involved. When GST tax planning is appropriate, part of the GST exemption will be applied to the bypass trust and a qualified terminable interest property trust equal to the unused GST exemption should be established. See chap 15.

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§18.6A 6. Appointment Power Valuation Issues

Use of a general power of appointment trust may result in a loss of valuation discounts that would otherwise be available on the death of the testator. Unlike QTIP trust property (see §19.16), property in a general power of appointment trust is aggregated with the surviving spouse's property for valuation purposes. *Estate of Aldo H. Fontana* (2002) 118 TC 318.

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§18.7 II. POWER OF APPOINTMENT EXCEPTION TO TERMINABLE INTEREST RULE

The marital deduction will be allowed under IRC §2056(b)(5) for a general power of appointment trust. A general power of appointment trust qualifies for the marital deduction as an exception to the terminable interest rule because the spouse's control over the property makes him or her the complete owner of the property.

Five conditions must be met to fulfill the statutory requirements for the exception:

(1) The spouse must be entitled to all the income from the trust or a specified portion of the income for life;

(2) Income must be payable to the spouse at least annually;

(3) The spouse must have a general power of appointment over the entire trust or a specific portion of the trust;

(4) The power held by the spouse must be exercisable by the spouse alone and in all events; and

(5) No other person may have the power to appoint any part of the trust to any person other than the spouse.

If these requirements are met, the assets of the trust are considered to pass to the surviving spouse, and no part of the trust is considered to pass to any person other than the surviving spouse.

The typical estate plan involving a power of appointment trust utilizes at least two trusts, a bypass trust and a marital deduction trust, with the marital deduction trust granting the required income interest and power of appointment.

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III. REQUIREMENTS FOR POWER OF APPOINTMENT TRUSTS

§18.8 A. Income Requirements for Power of Appointment Trusts

Internal Revenue Code §2056(b)(5) specifies two income requirements for power of appointment trusts. The regulations describe the requirements as follows:

- The surviving spouse must be entitled during his or her lifetime to (1) all income from the entire interest, (2) a specific portion of the entire interest, or (3) a specific portion of all income from the entire interest. Treas Reg §20.2056(b)-5(a)(1). In some cases, a unitrust interest may satisfy this requirement. See §19.7.
- The income must be payable to the surviving spouse at least annually. Treas Reg §20.2056(b)-5(a)(2).

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1. Spouse's Right to All Income Annually

§18.9 a. Income Must Be Paid Currently Without Accumulation

Income must be payable to the surviving spouse when it is earned. In Rev Rul 72-283, 1972-1 Cum Bull 311, the Internal Revenue Service disallowed a marital deduction when the trust instrument provided for income to be paid quarterly to the surviving spouse in the year after it was earned.

An interest passing in trust will not satisfy the income distribution requirement if the income is required to be accumulated in whole or in part or if it may be accumulated in the discretion of anyone other than the surviving spouse. Treasury Regulation §20.2056(b)-5(f)(8) makes clear that the annual-payment-of-income condition requires income to be distributable to the spouse. The requirement is also met if the spouse has "such command over the income that it is virtually [*his or*] hers." Treas Reg §20.2056(b)-5(f)(8).

Although the trust cannot require income accumulation or that income be accumulated in the discretion of a person other than the surviving spouse, the document can provide the spouse with the right to require distribution of the trust income at least annually and, to the extent that distribution is not required, that trust income be accumulated and added to corpus. See §18.14.

The spouse's income rights may be satisfied despite the fact that there may be some delay in payment of income from estate assets before assets are distributed to the trust. The spouse's right to current income is satisfied even though the spouse's right to income from estate assets, for the period before the executor's distribution of the assets to the trust under the decedent's will, is delayed until distribution occurs unless the decedent's will authorizes the executor to delay distribution beyond the period reasonably required for administration of the decedent's estate. Treas Reg §20.2056(b)-5(f)(9). See Prob C §§12000-12007 on distribution of income accruing during estate administration.

Income that is accrued but undistributed at the surviving spouse's death must be subject to the survivor's power of appointment. Treas Reg §20.2056(b)-5(f)(8).

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§18.10 b. Payment to Spouse Under Legal Disability

A trust provision (and a similar provision of applicable state law) giving the trustee discretion to distribute income payable to a surviving spouse (1) to a court-appointed legal representative of the surviving spouse under legal disability or, if none is appointed, (2) to a relative, will not cause loss of the marital deduction. Rev Rul 85-35, 1985-1 Cum Bull 328. This ruling is based on a finding by the Internal Revenue Service that the spouse had the right to all the income and that such a provision was intended to facilitate payment on behalf of the spouse and was not a restriction on the spouse's enjoyment of the trust property. See §19.9 for discussion of a similar ruling regarding qualified terminable interest property trusts.

See §18.14 on problems that may accompany a mandatory payout of income.

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§18.11 c. Administrative Restrictions Do Not Disqualify Trust

Under Treas Reg §20.2056(b)-5(f)(1), the payment-of-income requirement is met if the terms of a trust and applicable local law provide the surviving spouse with

> substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust.

See also Rev Rul 69-56, 1969-1 Cum Bull 224. If the trust gives the surviving spouse enforceable rights that will preserve for him or her the requisite degree of enjoyment, the income requirement is met despite rules under either the trust instrument or state law for the management of trust property and the allocation of receipts and expenditures that appear to place limitations on the income payout. For example, rules allocating receipts and expenses between principal and income (including provisions that treat stock dividends as principal, provisions for a depletion or a depreciation charge against income if trust assets are subject to depletion or depreciation, and provisions for trustee's commissions and other charges against income) are unlikely to defeat this exception to the terminable interest rule. Treas Reg §20.2056(b)-5(f)(2)-(3).

Similarly, the trustee's administrative powers (*e.g.,* the power to apply all income for the spouse's benefit, the power to retain assets passing to the trust (including such non-income-producing assets as a residence or other property for the spouse's personal use)) will not disqualify the trust. A power to retain trust assets that are not income producing will not disqualify the trust if the terms of the trust or the applicable rules for trust administration give the spouse the right to direct the trustee to make the property income producing or to sell the property within a reasonable period of time. Treas Reg §20.2056(b)-5(f)(4).

A "spendthrift" clause providing that the surviving spouse's right to income will not be subject to assignment, alienation, pledge, attachment, or claims of creditors also will not disqualify the trust. Treas Reg §20.2056(b)-5(f)(7). Protective spendthrift clauses that may cut off payments to the surviving spouse, however, will disqualify the trust and should not be used in a marital deduction trust.

A number of examples of broad administrative powers that will not cause disallowance of the marital deduction are set forth in Rev Rul 69-56, 1969-1 Cum Bull 224. See also Rev Rul 66-39, 1966-1 Cum Bull 223.

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§18.12 2. Income From Specific Portion

Internal Revenue Code §2056(b)(5) qualifies transfers for the marital deduction if the surviving spouse is entitled to all the income from the entire interest passing from the decedent or all the income from a specific portion of the entire interest passing from the decedent. Although the typical estate plan using a power of appointment trust uses two trusts (a bypass trust and a marital deduction trust with the full marital deduction trust being subject to the required income distribution and power of appointment), it is possible to create only one trust of which a portion qualifies for the marital deduction by an overlap of the surviving spouse's income interest and the general power of appointment. Internal Revenue Code §2056(b)(10) provides that a "specific portion" does not include pecuniary portions but "only includes a portion determined on a fractional or percentage basis." See also Treas Reg §20.2056(b)-5(c).

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§18.13 3. California Marital Deduction Saving Statute

The requirement that income be distributed to the surviving spouse at least annually need not be spelled out in the trust instrument if applicable local law compels such frequent distribution. See Treas Reg §20.2056(b)-5(e). Probate Code §21524(b) provides that if a marital deduction gift (defined in Prob C §21520(b) as a transfer of property intended to qualify for the marital deduction) is made in trust, the transferor's spouse is entitled to all the income from the marital deduction property for life, payable at least annually.

Thus, because California law requires distribution of income at least annually, the failure to provide for this requirement in a trust instrument will not disqualify the trust for the marital deduction. A prudent drafter, however, will incorporate the required income distribution provisions in the trust provisions and rely on state law only as a fall-back provision.

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§18.14 4. Problems With Mandatory Income Payout

The typical marital deduction trust that meets the income distribution requirements of IRC §2056(b)(5) by directing that all current income of the trust be distributed to the surviving spouse at least annually may create an undesired result if the surviving spouse becomes incompetent. See Alternative 1 in form 18.23-1 for a clause. While the surviving spouse is competent, the problem does not exist; the surviving spouse can receive and use income paid from the trust and voluntarily recontribute any unused income distributions to the trust without negative tax consequences. The income is taxable to the surviving spouse in all events; contribution to the marital deduction trust does not result in a gift transfer, because the spouse holds a general power of appointment over the trust. The benefit of recontributing income to the trust is probate avoidance at the surviving spouse's death.

If the surviving spouse is under a legal disability, however, his or her ability to receive and use or recontribute the distributed income to the trust is impaired. Thus, although the testamentary plan of the deceased spouse may have been to avoid a conservatorship at the survivor's incapacity or a probate at the survivor's death, income accumulations outside the marital deduction trust may require a conservatorship and probate.

One solution to this problem is to draft the marital deduction trust to provide the surviving spouse with the right to require distribution of the trust income at least annually. If the distribution is not requested, the trust income may be accumulated and added to corpus. The surviving spouse's power of appointment is supplemented by giving the trustee a discretionary power to make distributions of income to or for the benefit of the surviving spouse for health, education, and support. This provision meets the income requirements of IRC §2056(b)(5) (see Treas Reg §20.2056(b)-5(f)(8)) and provides a level of flexibility in the event of the surviving spouse's incapacity. See Alternative 2 in form 18.23-1 for a clause.

A second solution is to give the spouse a general power of appointment over income. Alternative 3 in form 18.23-1 accomplishes this purpose and gives the trustee discretion to make income distributions to or for the spouse's benefit. The clause is based on language in Treas Reg §20.2056(b)-7(h), Example (3). In addition, Alternative 3 in form 18.23-1 eliminates the need for a separate provision for distribution of principal as provided in §18.24.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/§18.15 B. Requirement of General Power of Appointment

§18.15 B. Requirement of General Power of Appointment

In addition to the income requirements discussed in §§18.8-18.14, IRC §2056(b)(5) specifies three principal requirements for a power of appointment trust:

(1) The surviving spouse must have the power to appoint the entire interest or the specific portion to himself or herself or to his or her estate (Treas Reg §20.2056(b)-5(a)(3));

(2) The surviving spouse's power must be exercisable by the survivor alone and (whether exercisable by will or during life) must be exercisable in all events (Treas Reg §20.2056(b)-5(a)(4)); and

(3) The entire interest or the specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse (Treas Reg §20.2056(b)-5(a)(5)).

The surviving spouse's power of appointment can be a general testamentary power, a lifetime power of withdrawal, a lifetime general power, or a combination of one or more of these powers. If a testamentary power is used alone, the spouse must be able to appoint to his or her estate to ensure that the power qualifies for the marital deduction. See Rev Rul 74-120, 1974-1 Cum Bull 282, in which the Internal Revenue Service held that under New York law the power to appoint to any "person or persons" included a power to appoint to the spouse's estate.

The particular power or combination of powers used will determine the amount of control that the surviving spouse will have over the property. Clearly, a combination of all these powers gives the spouse virtual control whereas the use of only the testamentary power means that the spouse will be able to control the disposition of the property only at death. See, *e.g.*, *Estate of Sylvia Gore*, TC Memo 2007-169 (survivor's purported withdrawal and assignment of assets to family limited partnership did not result in completed transfers, because the trust had never been funded and decedent retained control and use of transferred assets). Exercise of the general power may not be subject to contingencies or certain events and may not be made a joint power. Any restriction other than a requirement regarding the form needed to exercise the power (*e.g.,* in a writing delivered to the trustee or with specific reference to the instrument creating the power) may result in loss of the deduction.

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§18.16 1. IRC §2056 Power Compared With IRC §2041 Power

A general power of appointment that meets the definition of a general power under IRC §2041 may not meet the requirements of IRC §2056. Internal Revenue Code §2056(b)(5) requires that the surviving spouse have a power

> to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others).

Thus, although a power to appoint to the decedent's creditors, or to creditors of the spouse's estate, constitutes a general power of appointment under IRC §2041, clauses granting this power will not meet the requirements of IRC §2056. If, however, the spouse can appoint to himself or herself or to his or her estate, the fact that the survivor can also appoint to others does not defeat the marital deduction.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/§18.17 2. Power Over Specific Portion

§18.17 2. Power Over Specific Portion

Internal Revenue Code §2056(b)(10) now provides that a "specific portion" does not include pecuniary portions but "only includes a portion determined on a fractional or percentage basis." See also Treas Reg §20.2056(b)-5(c). See discussion in §18.12.

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§18.18 3. Exercisable by Spouse Alone and in All Events

The general power of appointment must be exercisable only by the surviving spouse. Therefore, a requirement that someone must join the spouse in exercise of the power will defeat the marital deduction. Treas Reg §20.2056(b)-5(g)(3).

EXAMPLE: In *Estate of Harry K. Draper,* TC Memo 1988-201, the surviving spouse, who was a cotrustee of the trust along with one of her sons, had a life estate in the trust with the remainder going to her sons. The cotrustees had the power to invade the trust principal. Because the spouse did not have the sole, unrestricted power to invade the trust on her behalf, the tax court did not allow a marital deduction for the trust.

Further, the power must be exercisable "in all events"; *i.e.,* the power must exist immediately after the decedent's death and cannot be cut off during the surviving spouse's life other than by exercise or release. Although the power must be exercisable before the estate distributes the property subject to the power, actual distribution to the designated appointee may be delayed for the period of administration. The power is not exercisable in all events if it can be terminated during the surviving spouse's life by an event such as remarriage. See Treas Reg §20.2056(b)-5(g)(3)-(4).

The trust will not be disqualified by a requirement that reasonable notice be given to the trustee when a lifetime power is exercised or by a requirement that a power exercisable by will be exercised by a will executed after the decedent's death that makes specific reference to the power. Treas Reg §20.2056(b)-5(g)(4). The testator may also designate takers in default of the exercise of the power by his or her surviving spouse. However, a binding agreement between the spouses requiring the surviving spouse to exercise the power only in favor of certain persons will disqualify the trust for marital deduction purposes. Treas Reg §20.2056(b)-5(g)(2).

To prevent an inadvertent exercise of a power of appointment at the surviving spouse's death, the will should require that the power of appointment be exercisable only by specific reference to it. In addition, it may be advisable to provide in the surviving spouse's will that the power is not being exercised, if that is the case.

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§18.19 4. No Power in Third Person to Appoint to Person Other Than Spouse

A transfer intended to qualify for the marital deduction is nondeductible to the extent that the decedent creates a power in any other person, including a trustee, to appoint part of the interest to any person other than the surviving spouse, if the power is "in opposition to that of the surviving spouse." Treas Reg §20.2056(b)-5(j). A power in a third person, including a trustee, to appoint only to the surviving spouse does not defeat the marital deduction. If the power is exercised, the property subject to the power simply becomes property distributed to the surviving spouse and taxable in the surviving spouse's estate, thus meeting the tax deferral goal of the marital deduction.

If, however, another person has a power (*e.g.,* a special power to appoint to the decedent's children) that could be exercised to divert property from the surviving spouse's estate free of tax, the power will disqualify the trust. A power to distribute to the spouse for the support of minor children will not disqualify the trust. Treas Reg §20.2056(b)-5(j). Similarly, a power held by a third person that is exercisable only after the surviving spouse's death will not disqualify the trust. Treas Reg §20.2056(b)-5(j), Example (1).

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§18.20 C. Selection of Trustee

The trustee may be a third party or the surviving spouse. If the survivor is the trustee and the power to invade principal is limited by an ascertainable standard, the survivor will not be taxed on undistributed capital gain. If the invasion power is fully discretionary and the survivor is the trustee, the survivor will be considered the owner of the trust for all tax purposes. IRC §678; *U.S. v De Bonchamps* (9th Cir 1960) 278 F2d 127.

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IV. GENERAL POWER OF APPOINTMENT TRUST CLAUSES

§18.21 A. Introduction to General Power of Appointment Trust Clauses

Sections 18.22-18.28 contain the clauses necessary to create a general power of appointment marital deduction trust. The clauses provide for the distribution of income (see §18.23), the distribution of principal (see §18.24), and a general power of appointment over the trust (see §18.25). The clauses in §18.28 present two alternative distributions of any assets remaining in the trust estate at the surviving spouse's death.

Also included are clauses instructing the trustee on the relevance of other income sources in making discretionary distributions (see §18.26) and identifying a beneficiary if the surviving spouse disclaims all or part of the power of appointment trust (see §18.27).

If the surviving spouse is not a United States citizen, the qualified domestic trust provisions must also be included. See §§19.32-19.40.

Other clauses that the drafter may include in a general power of appointment trust are discussed in other chapters. See §§17.33, 19.32-19.40 on marital deduction savings clauses; chap 27 on "spendthrift" clauses; §§31.21-31.22 on payment of the beneficiary's expenses from the trust; chap 26 on the issues involved in tax payment clauses.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/ B. Distribution of Income/§18.22 1. Form: Introduction to Marital Appointment Trust

B. Distribution of Income

§18.22 1. Form: Introduction to Marital Appointment Trust

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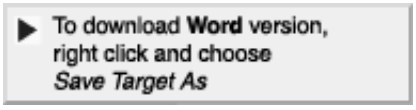
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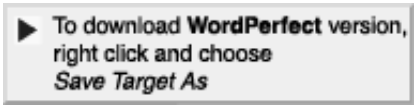
18.22-1 Introduction to general power of appointment marital deduction trust

The trustee shall hold, administer, and distribute all property allocated to the marital appointment trust as follows:

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§18.23 2. Form: Distribution of Income





18.23-1 Distribution of income

[*Add one of the following alternatives*]

[*Alternative 1: Payment of all income*]

***Payment of Income*. The trustee shall pay the entire net income of the marital trust to my spouse, during my spouse's lifetime, in quarter-annual or other convenient installments.**

[*Alternative 2: Power to withdraw all income*]

***Payment of Income*. The trustee shall pay to or for my spouse all or part of the net income of the trust, as requested by my spouse at any time or from time to time but at least annually.**

[*Alternative 3: Spouse's general power of appointment over income; trustee's discretionary distribution of income*]

***Payment of Income and Principal*. At any time during the life of my spouse, the trustee shall distribute all or part of the trust (including accrued and undistributed income) to or for one or more persons and entities (including my spouse or my spouse's estate), on terms and conditions (outright, in trust, or by creating further powers of appointment) as my spouse shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment. Undistributed income shall remain trust accounting income from year to year, continuously subject to this general power of appointment. At the death of my spouse, the trustee shall add to principal any accrued and undistributed income not distributed by this general power of appointment. The trustee shall then distribute the accrued and undistributed income according to my spouse's exercise of any general or special testamentary power of appointment. If my spouse does not exercise this power, the trustee shall distribute the accrued and undistributed income according to the distribution provisions in paragraph _ _[*number*]_ _.**

To the extent that my spouse does not exercise this power of appointment for my spouse's own benefit, the trustee shall pay to or for my spouse as much of the net income as the trustee considers necessary for my spouse's health, education, support, maintenance, comfort, welfare, or happiness to maintain at a minimum my spouse's accustomed manner of living. The trustee shall add to principal any undistributed net income.

Comment: See discussion of alternatives in §18.14.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/ C. Distribution of Principal/§18.24 1. Form: Payment of Principal

C. Distribution of Principal

§18.24 1. Form: Payment of Principal

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18.24-1 Payment of principal

[*Add one of the following alternatives*]

[*Alternative 1: Discretionary payment of principal (ascertainable standard)*]

***Payment of Principal*. In addition to the net income, the trustee shall pay to or for my spouse as much of the principal, up to the whole of the trust, as the trustee considers necessary for my spouse's health, support, and maintenance to maintain at a minimum my spouse's accustomed manner of living.**

[*Alternative 2: Power to withdraw principal*]

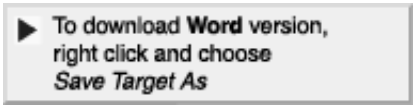
***Payment of Principal*. The trustee shall pay to or for my spouse all or part of the principal of the trust, as requested by my spouse at any time or from time to time.**

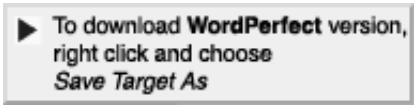
Comment: This clause is not needed if Alternative 3 is used in form 18.23-1 (distribution of income and principal).

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/§18.25 2. Form: Spouse's General Power of Appointment (Broad Standard)

§18.25 2. Form: Spouse's General Power of Appointment (Broad Standard)





18.25-1 Spouse's lifetime general power of appointment (broad standard)

***Power of Appointment*. The trustee shall distribute any remaining balance of the marital trust to one or more persons and entities (including my spouse's estate), on terms and conditions (outright or in trust) and in any proportion that my spouse shall appoint in a written instrument filed with the trustee, specifically referring to and exercising this power of appointment. If my spouse does not effectively appoint all the trust estate, the trustee shall distribute this property according to the distribution provisions in paragraph _ _[*number*]_ _.**

Comment: As discussed in §18.15, the surviving spouse must have a general power of appointment over all or part of the trust estate. It can be a lifetime power or a testamentary power. To make form 18.25-1 a testamentary power, the drafter should add the phrase "At the death of my spouse" at the beginning of the clause. For distribution provisions if the power is not exercised, see §18.28.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/ D. Miscellaneous Clauses/§18.26 1. Form: Relevance of Other Income Sources

D. Miscellaneous Clauses

§18.26 1. Form: Relevance of Other Income Sources

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18.26-1 Relevance of other income sources

[*Add one of the following alternatives*]

[*Alternative 1: Other income sources relevant*]

In making distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and reasonably available.

[*Alternative 2: Other income sources not relevant*]

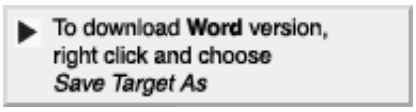
In making distributions, the trustee may not consider any other income or resources of my spouse.

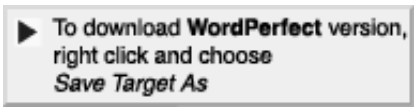
Comment: This clause may be added to Alternative 1 providing for discretionary distributions in form 18.24-1.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/§18.27 2. Form: Disclaimer Beneficiary

§18.27 2. Form: Disclaimer Beneficiary





18.27-1 Disclaimer beneficiary

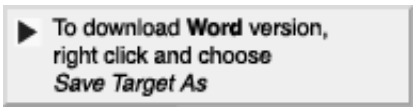
***Distribution of Disclaimed Interest*. If my spouse effectively disclaims all my spouse's beneficial interest in all or part of this trust, the trustee shall distribute the trust, or the portion of the trust that corresponds to the disclaimed interest, to the _ _[*name of trust*]_ _.**

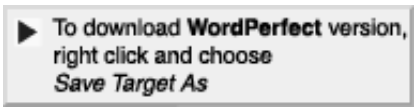
Comment: Typical beneficiaries of disclaimed interests are the bypass trust or the disclaimer trust. See chap 20.

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Source: Estate Planning/California Will Drafting/18 Marital Deduction Power of Appointment Trusts/§18.28 3. Form: Distribution to Separate Trust at Surviving Spouse's Death

§18.28 3. Form: Distribution to Separate Trust at Surviving Spouse's Death





18.28-1 Distribution to separate trust at surviving spouse's death

[*Add one of the following alternatives*]

[*Alternative 1: Distribution to separate trust*]

***Distribution if Power of Appointment Not Exercised*. At the death of my spouse, the trustee shall distribute any trust property not effectively appointed under the preceding paragraph to the trustee then in office of the _ _[*name of trust*]_ _.**

[*Alternative 2: Distribution according to terms of separate trust*]

***Distribution if Power of Appointment Not Exercised*. At the death of my spouse, the trustee shall distribute any trust property not effectively appointed under the preceding paragraph according to the distribution provisions of the _ _[*name of trust*]_ _.**

Comment: Retaining the assets in trust until the testator's children reach a certain age is a common estate plan. Alternative 1 anticipates a separate family "pot" trust or a separate child's trust. See chap 22.

When the will creates a separate bypass trust that also terminates at the surviving spouse's death, it may be more convenient to cross-refer to the bypass trust (see Alternative 2) than to duplicate its distribution provisions. For the power of appointment clause, see §18.25.

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19

Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts

Melitta Fleck

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I. MARITAL DEDUCTION QUALIFYING TRUSTS

§19.1 A. Drafting QTIPs and QDOTs

This chapter discusses the requirements for qualified terminable interest property (QTIP) trusts (see §§19.7-19.15) and qualified domestic trusts (QDOTs) (see §§19.32-19.33). Sections 19.21-19.31 contain the clauses necessary to create a QTIP trust. The clauses necessary for implementing a QDOT may be found in §19.40. An alternative clause authorizing the trustee to modify the QTIP trust to qualify as a QDOT is provided in §19.41.

Chapter 18 discusses power of appointment trusts. QTIP trusts and power of appointment trusts are compared in §§17.23-17.24. The formula provisions by which marital trusts are funded are discussed in §§17.46-17.89.

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B. When to Use Qualified Terminable Interest Property (QTIP) Trust

§19.2 1. Control by Testator

A QTIP trust qualifies for the marital deduction without providing the surviving spouse with a general power of appointment over the trust. See IRC §2056(b)(7). This means that, after death, the testator may control disposition of his or her property while also qualifying a portion of the estate for the marital deduction.

The testator may provide the surviving spouse with some discretion over the ultimate distribution of the QTIP trust assets by granting the spouse a power to appoint the trust property among a class of beneficiaries identified by the testator. This power must, however, be exercisable only on or after the surviving spouse's death. No person may have a power to appoint any of the trust property to any person other than the surviving spouse. Unlike the power over a general power of appointment trust, the power over a QTIP trust may not be held even by a surviving spouse during his or her lifetime. IRC §2056(b)(7)(B)(ii)(II); Treas Reg §20.2056(b)-7(d)(1); Treas Reg §20.2056(b)-7(h), Example (4). Accordingly, the QTIP trust limits the surviving spouse's ability to make lifetime gifts of trust assets even to a narrow group of recipients designated by the testator in a limited power of appointment.

Control by the testator is particularly useful when there are children by a former marriage. Even individuals in single marriages may wish to control disposition of their portion of the estate at the surviving spouse's death or limit it by giving the surviving spouse, at most, a limited testamentary power of appointment. This ensures ultimate distribution of the testator's assets according to his or her wishes and prevents transfer to others, *e.g.,* the surviving spouse's new spouse, the surviving spouse's children by a subsequent marriage.

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§19.3 2. Generation-Skipping Transfer (GST) Tax Planning

The QTIP provisions allow for a "reverse QTIP election" that makes the testator the transferor of any portion of the QTIP trust that the executor elects to treat in this manner, even though the executor has made a QTIP election for that portion. As a result of a reverse QTIP election, the testator will be considered the transferor of the elected portion of the QTIP trust for generation-skipping transfer (GST) tax purposes while the surviving spouse, at his or her death, will still be considered the transferor of that portion for estate tax purposes. IRC §2652(a)(3).

Frequently, for decedents dying after 2010, the executor will allocate a portion of the decedent's IRC §2631 GST exemption to the bypass trust and the remaining portion of the exemption to a QTIP trust for which a reverse QTIP election has been made. This takes full advantage of the testator's GST exemption and allows the surviving spouse to allocate the survivor's $1-million GST exemption (plus cost-of-living adjustments from a base year of 1997) to the survivor's estate or to a separate QTIP trust for which the reverse QTIP election was not made. The regulations take the position that a reverse QTIP election may not be made with respect to a portion of a QTIP trust but instead may only be made with respect to "all of the property in the trust to which the QTIP election applies." Treas Reg §26.2652-2(a). The reverse QTIP election may be made only with respect to QTIP trusts; no other marital trusts are eligible for this election.

Without the reverse QTIP election, a portion of the testator's GST exemption will be lost. If the testator uses a marital trust and a bypass trust to reduce the estate tax at his or her death to zero, for GST purposes he or she is the transferor of the applicable credit amount trust only. Accordingly, the maximum amount of the GST exemption that can be allocated to a trust for which the testator is the transferor for GST tax purposes is the value of the bypass trust. After 2010, when the bypass trust may again have a value of $1 million, the inflation-adjusted $1-million GST exemption is likely to be much larger.

For further discussion of the reverse QTIP election, see §§15.9, 15.31, 15.86, 19.13.

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§19.4 3. Accumulation of Income

The income requirement of a QTIP trust is met even though the accrued but undistributed income is not payable to the surviving spouse's estate or subject to his or her general power of appointment. Treas Reg §20.2056(b)-7(d)(4). The accumulated income is taxable in the surviving spouse's estate under IRC §2044(a). Treas Reg §20.2044-1(d)(2).

As discussed in §18.9, income of a general power of appointment trust that is accumulated but undistributed at the surviving spouse's death must be subject to the surviving spouse's general power of appointment and may be distributed to the next successive beneficiaries without endangering the marital deduction only after the spouse fails to exercise the general power. Although the regulations do not require similar provisions for accrued income of QTIP trusts, prudent drafters may subject such income to a general power. See discussion of *Estate of Howard v Commissioner* (9th Cir 1990) 910 F2d 633 in §19.7.

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§19.5 4. Postmortem Tax Planning

The QTIP trust permits postmortem planning by allowing the executor to elect to qualify only a portion of the QTIP trust for the marital deduction. This provides the opportunity to create a taxable estate at the death of the first spouse to die without requiring a disclaimer. For discussion of QTIP elections, see §19.11.

State inheritance taxes may be greater under a general power of appointment trust than under a QTIP trust. Under an inheritance tax that taxes transfers to a surviving spouse, a bequest to the surviving spouse that qualifies for the federal estate tax marital deduction may result in a substantial inheritance tax. In such a case, use of a QTIP trust in which the spouse has a life interest and the descendants have remainder interests may result in inheritance tax savings because the value of the property subject to tax is spread among several beneficiaries.

In addition, property subject to a QTIP disposition that is taxed in the predeceased spouse's estate may not be subject to the inheritance tax in the surviving spouse's estate. This issue may be important for California practitioners whose clients have real property or tangible personal property located in states with an inheritance tax. It may be advisable to provide for a QTIP disposition of these assets even if the balance of the estate qualifies for the marital deduction by use of the general power of appointment trust.

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II. QTIP EXCEPTION TO TERMINABLE INTEREST RULE

§19.6 A. Definition of Terms in QTIP Trust

Certain transfers of "qualified terminable interest property," as defined in IRC §2056(b)(7)(B), qualify for the marital deduction. The statute defines "qualified terminable interest property" as property: (1) which passes from the decedent, (2) in which the surviving spouse has a qualifying income interest for life, and (3) to which an election under IRC §2056(b)(7)(B) has been made. "Property" is defined as either an entire interest in property or a specific portion of the entire interest. See Treas Reg §20.2056(b)-7(b)(1)(ii).

The term "qualifying income interest for life" with respect to a QTIP trust has the same meaning as with respect to a general power of appointment trust. See Treas Reg §20.2056(b)-7(d)(2), which references Treas Reg §20.2056(b)-5(f). See discussion in §§18.8-18.9.

See §19.7 for further discussion of the income requirement. On the surviving spouse's right (or the right of his or her estate) to recover additional estate taxes attributable to qualified terminable interests, see §19.17.

QTIP requirements and the limitations on powers over qualified terminable interest property are discussed in §§19.7-19.15. The purpose of these restrictions is to ensure that the value of the property not consumed by the surviving spouse is subject to estate or gift tax. Qualified terminable interest property will be subject to tax at the earlier of (1) the date on which the surviving spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest or (2) the date of the surviving spouse's death.

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B. QTIP Requirements

§19.7 1. Qualifying Income Interest for Surviving Spouse

As noted in §19.6, to create qualified terminable interest property, the surviving spouse must be given a "qualifying income interest for life." IRC §2056(b)(7)(B)(ii). This term is defined in the statute to require that

- The surviving spouse must be entitled to all the income from the property, payable at least annually, or have an interest for life in the property; and
- No person, including the surviving spouse, may have a power to appoint any part of the property to any person other than the surviving spouse unless the power is exercisable only at or after the surviving spouse's death.

The income interest must be for life and not for a term of years or any other shorter period of time. The surviving spouse must have the right to all the income from the property or from a "specific portion" of the property. See §17.32. For discussion of the impact of an income interest that is contingent on the executor's QTIP election, see §17.42. In some cases, a unitrust interest may satisfy the income requirement. See §19.7A. The income must be payable at least annually. See §19.7B. Any transfer of QTIP trust property by the surviving spouse that diminishes the survivor's right to all income from the property may be subject to gift tax, as discussed in §19.8. This result is often intended but in some cases may be inadvertent. In *Estate of Thelma G. Hurford*, TC Memo 2008-278, the Tax Court raised the issue of whether a transfer of QTIP property to a family limited partnership (FLP) might terminate the qualified income interest on the specific facts of the case. In Field Service Advice 199920016, the IRS had concluded that the conversion of QTIP trust assets into FLP interests was not a disposition of the QTIP income interest because the spouse continued to receive the same income after formation of the FLP.

In general, the rules for power of appointment trusts in IRC §2056(b)(5) apply in determining whether the income requirement is met for purposes of IRC §2056(b)(7). Treas Reg §20.2056(b)-7(d)(2). See §19.4 for discussion of accumulated income; the rule for QTIP trusts is different than for power of appointment trusts. See §19.10 on principal distribution rules. For alternative clauses giving the spouse a qualifying income interest, see §19.23.

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§19.7A a. Qualifying Unitrust Interest

A trust subject to California law may be deemed to pay a spouse all "income" if it provides for unitrust distributions to the spouse that are not less than 3 percent nor more than 5 percent, per year, of the fair market value of the trust assets determined annually or averaged on a multiple-year basis. Prob C §16328; IRC §§2056(b)(5), (b)(7)(B)(ii), 2523(e), (f); Treas Reg §§1.643(b)-1, 20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1). Existing marital deduction qualifying trusts may be converted into unitrusts under Prob C §§16336.4-16336.7. A converted unitrust generally must give the surviving spouse a 4-percent interest unless the survivor and the remainder beneficiaries agree to provide a different amount, but a drafted unitrust can give the spouse a greater or lesser unitrust interest. For QTIP trusts funded with equity securities, the converted unitrust will often pay the spouse a larger amount than trust accounting income. Comparable results in terms of support can be achieved by giving the spouse a "five or five" withdrawal power (see §21.31A) in addition to an income interest, but a unitrust interest may be easier for the spouse and the remainder beneficiaries to understand and accept. On the other hand, a traditional income trust may provide for greater flexibility in postdeath planning because a converted unitrust can be reconverted into a traditional income interest after 3 years, while the statutory conversion provisions cannot be used to convert a drafted unitrust into a traditional income trust. See Prob C §16336.4(h). However, the trust document may give the trustee the power to convert a drafted unitrust to an income trust.

A drafter who desires to draft a marital deduction qualifying trust that provides for a unitrust payment may wish to exclude the residence and other personal use property from the calculation of the unitrust amount—instead giving the spouse the exclusive right to possess or control such property. For a statutory attempt to achieve this result, see Prob C §16336.4(e)(4)(a). The spouse's right to use trust property in kind—property that cannot be appointed to anyone other than the spouse—combined with the spouse's right to compel the trustee to make trust property productive of income (while not ensuring that particular property will not be sold, unless specifically provided) gives the spouse a substantially equivalent interest in the property.

NOTE: It is usually desirable to exclude personal use property from the unitrust calculation. If residential property occupied by the survivor is included in calculating the unitrust amount, the trustee may have a fiduciary obligation to the remainder beneficiaries of the trust to insist that the survivor pay fair market rent for use of the property (or to pay rent, if the survivor is the trustee), although this amount is likely to be less than the unitrust amount and result in a net cash payment to the survivor. Because the QTIP trust property will be included in the survivor's estate in any event, unitrust payments that may be included in the survivor's estate do not have transfer tax consequences, but the payment of rent to the trust may have income tax consequences because the trust is not treated as owned by the survivor for income tax purposes.

If there is uncertainty as to whether all intended marital deduction transfers will be subject to the law of a state that permits satisfying a right to "income" by payment of a unitrust amount, it may be desirable to provide that the spouse will be subject to a traditional income right with respect to any such property. See the preamble discussion of "Definition of Income" in TD 9102, 2004-1 Cum Bull 366, in which the Treasury Department indicates that a governing instrument provision defining "income" as a unitrust amount will not be recognized as providing an income interest in the absence of state law authorization. For an alternative clause giving the spouse a qualifying unitrust interest, see §19.24.

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§19.7B b. Payment of Trust Income

If the will does not direct the required annual payment of income, state law determines whether payment of the income must be made annually. Treas Reg §20.2056(b)-7(d)(2). Under California law, a spouse is entitled to all the income of a marital deduction gift at least annually and for life. Prob C §21524(b). This rule may be limited by the definition of a marital deduction gift as one that is intended to qualify for the marital deduction.

EXAMPLE: In *Estate of Carl I. Heim,* TC Memo 1988-433, aff'd (9th Cir 1990) 914 F2d 1322, the decedent left a will that transferred everything to his wife if she survived until distribution of the estate. The estate attempted to avoid the disqualifying survivorship provision by applying Prob C §21525(a), which provides that a survivorship requirement in a will that contains a marital deduction gift is limited to 6 months. The court held that the statute did not apply because the decedent's will reflected no intention to qualify the gift for the marital deduction.

Ordinary income from the QTIP trust is taxed and distributed to the surviving spouse. Under Treas Reg §20.2056(b)-7(d)(4), income accumulated between the last distribution date and the date of the surviving spouse's death ("stub" income) that is not distributed to the surviving spouse or the surviving spouse's estate will not disqualify the trust. Such income is taxed in the surviving spouse's estate under Treas Reg §20.2044-1(d)(2). Despite this rule, many trust plans give to the surviving spouse a general power of appointment over such accumulated and undistributed income. See Alternative 2 in form 19.23-1. Other plans give undistributed income to the surviving spouse's estate at his or her death, although this is not recommended because it may create an unnecessary probate if the amount of accumulated income is large.

Probate Code §21524(b) provides that if a marital deduction gift is made in trust, the income earned between the date of the last distribution of income and the date of the spouse's death is payable to the spouse's estate unless the governing instrument provides for a different disposition that qualifies for the marital deduction.

In two cases, the Ninth and Eleventh Circuits held that stub income that was not required to be distributed to the surviving spouse or his or her estate did not disqualify the trust for QTIP purposes. See *Estate of Howard v Commissioner* (9th Cir 1990) 910 F2d 633; *Estate of Shelfer v Commissioner* (11th Cir 1996) 86 F3d 1045. The *Howard* decision focused on Treas Reg §20.2056(b)-7(d)(4); *Shelfer* found Treas Reg §20.2056(b)-5(f)(8) particularly pertinent. This regulation states that it is sufficient for QTIP purposes if the stub income is subject to the surviving spouse's power to appoint, and that, if the spouse had a power of appointment over the trust corpus, the power necessarily extends to the undistributed income.

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§19.8 2. Gift Tax on Transfer of QTIP Income Interest

If the surviving spouse makes a gift of all or a portion of her income interest, the value of a gifted income interest is taxable under IRC §2511. The gift will also trigger a deemed gift of the entire remainder interest even if the spouse retains a portion of the income interest. IRC §2519. See §19.8A. As a consequence, the total gift is the value of the trust reduced by the value of any retained income interest that is a "qualified interest." IRC §§2511, 2519, 2702; Treas Reg §25.2519-1(a), (g), Examples 4-5. To offset the imposition of the gift tax, the QTIP assets are no longer taxable in the surviving spouse's estate under IRC §2044. IRC §2044(b). A purchase of the remainder interest also may be treated as a gift. See §19.8B.

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). In IRS Letter Ruling 200604006, the IRS ruled that this "net gift" treatment was available for a surviving spouse's nonqualified disclaimer of all interests in the QTIP trust. See also IRS Letter Ruling 200801009 (values of income interest and remainder interest must be computed separately when spouse exercises right to recover gift tax attributable to gift of remainder). By making the QTIP election and subsequently making a nonqualified disclaimer, the QTIP trust is taxed as a gift made by the survivor. The tax result is the same as if the decedent had made an outright marital deduction gift to the spouse followed by a gift by the spouse. This strategy may be appealing if the spouse wants to disclaim the QTIP interests for reasons other than taxes.

The spouse makes an additional gift if the spouse fails to exercise the IRC §2207A(b) right of recovery, and any delay in the exercise of the right is treated for gift tax purposes as an interest-free loan. Treas Reg §25.2207A-1(b). 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).

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§19.8A a. Deemed Gift of Remainder Interest

The gift of a portion of the QTIP income interest 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 a portion of the income interest is retained by the surviving spouse, an equivalent portion of the QTIP assets will be included in the survivor's estate under IRC §2036. This does not result in double taxation of the IRC §2036 portion because gifts of property later included in the estate are ignored when computing the estate tax. IRC §2001(b). However, the deemed gift uses up the spouse's gift tax applicable exclusion amount and it will result in a prepayment of estate taxes without interest if gift tax is paid on property later included in the spouse'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 impact of IRC §2519 can be further mitigated in these cases by dividing trusts into multiple trusts before assigning the income interest in one of them. See IRS Letter Rulings 200530014, 200250033, 200137022, 200044034.

EXAMPLE: On the decedent's death, the decedent's one-half share of an $11 million community property estate is divided into a $3.5 million bypass trust and a $2 million QTIP trust. The spouse divides the QTIP trust into two $1 million QTIP trusts and assigns the income interest in one of them to the remainder beneficiaries. The result is a $1 million taxable gift shielded by the gift tax applicable exclusion amount. On the spouse's death, the second QTIP trust is included in the spouse's gross estate. Assume that both QTIP trusts and the spouse's share of the estate have doubled in value and the estate tax rate is 50 percent. The spouse's gross estate is $13 million ($11 million estate plus $2 million QTIP trust) and the spouse's taxable estate is $10.5 million after application of the $2.5 million remaining unused applicable exclusion amount to the spouse's estate. After payment of $5.25 million in estate taxes ($4.25 million paid by the estate and $1 million paid by the QTIP beneficiaries), the QTIP beneficiaries receive $3 million and the spouse's beneficiaries receive $6.75 million, for a total of $9.75 million. If the gift of the QTIP income interest were not made, the spouse's gross estate would be $15 million ($4 million QTIP trust plus $11 million estate) and the spouse's taxable estate would be $11.5 million. After payment of $5.75 million in estate taxes ($3.75 million paid by the estate and $2 million paid by the QTIP beneficiaries), the QTIP beneficiaries would receive $2 million and the spouse's beneficiaries would receive $7.25 million, for a total of $9.25 million.

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 $500,000 in estate tax on $1 million of appreciation. Note, however, that the amount received by the spouse's beneficiaries is actually less. This may be important if the spouse's beneficiaries and the QTIP beneficiaries are not the same.

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§19.8B b. Purchase of QTIP Remainder Interest

The IRS also takes the position that the surviving spouse's purchase of the QTIP remainder interest is a gift under IRC §2519. The value of the gift is the purchase price or the present value of the remainder, whichever is greater. Rev Rul 98-8, 1998-1 Cum Bull 541. The IRS concluded that the spouse's commutation of the income interest was essentially a sale of the income interest to the trustee or the remaindermen in exchange for an amount equal to the value of the remainder interest. The IRS cited *Estate of Helen M. Novotny* (1989) 93 TC 12, in which the surviving spouse and remaindermen divided the sales proceeds of the QTIP property proportionally based on the respective values of their interests and the court indicated that the commutation constituted a disposition of the income interest as discussed in §19.8. However, some commentators have questioned this conclusion. See Lipoff, *Revisiting Purchases of Remainder Interests in QTIP Trusts*, 27 Est Plan 114 (Mar./Apr. 2000).

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§19.9 3. Effect of Spouse's Incapacity on Receipt of Income

To qualify for a marital deduction under the QTIP provisions, all income must be distributable to the surviving spouse. See §19.7. If the drafter uses a clause such as Alternative 1 in form 19.23-1, the trustee must distribute all the net income to the surviving spouse, which may necessitate the establishment of a conservatorship to receive income if the spouse becomes legally incapacitated. Obviously, the establishment of a conservatorship will frustrate the original plan in creating a trust.

This problem can be avoided by giving the spouse a power to withdraw income (see Alternative 2 in form 19.23-1), thus qualifying the trust for the QTIP deduction without requiring actual distribution.

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§19.10 4. No Restrictions on Powers Over Principal

There is no restriction on the power of the surviving spouse or anyone else to invade trust principal during the spouse's lifetime if the invasion is made only for the spouse's benefit. See IRC §2056(b)(7)(B)(ii)(II). The invasion power may or may not be subject to an ascertainable standard. A power held by the surviving spouse that is not limited by an ascertainable standard creates a general power of appointment over the property and enlarges the surviving spouse's interest and gross estate. Although the lapse of a "five or five" power does not have taxable consequences, the surviving spouse has a general power of appointment to the extent of the five or five power in the year of his or her death. See *Estate of E.H. Kurz* (1993) 101 TC 44, aff'd (7th Cir 1995) 68 F3d 1027. See §16.17.

The restriction against a power to appoint to someone other than the surviving spouse does not apply to a power exercisable only at or after the surviving spouse's death. IRC §2056(b)(7)(B)(ii)(II). Thus, for example, property that is not otherwise a terminable interest may be placed in a testamentary trust with all the income payable to the surviving spouse for life. At the surviving spouse's death, the property may be distributed either as the testator specifically provided or as directed by the exercise of a power given to the surviving spouse, the trustee, or another person. Alternatively, the trust may continue after the surviving spouse's death for the benefit of others, *e.g.,* as a "sprinkling" trust for the deceased spouse's issue. For clauses, see forms 19.27-1, 19.29-1.

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§19.11 5. QTIP Election

The protections afforded by the QTIP provisions are elective and operate only if the executor of the deceased spouse's estate makes an election on the estate tax return to treat property as qualified terminable interest property. IRC §2056(b)(7)(B)(v). The income interest of the spouse may be contingent if the *only* contingency is the executor's QTIP election. Treas Reg §20.2056(b)-7(d)(3)(i).

Because of confusion regarding making the QTIP election on earlier permutations of the Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return, the current form provides that the executor is deemed to have made the election with respect to any property (1) satisfying the QTIP requirements, (2) listed on Schedule M of the return, and (3) not expressly identified as being excluded from the election. Thus, in most cases, simply listing property satisfying the QTIP requirements on Schedule M is sufficient to make the QTIP election. No affirmative action is required to make a QTIP election for a joint and survivor annuity. The election is deemed made unless the executor takes action to avoid the election. IRC §2056(b)(7)(C).

In some cases, executors inadvertently make QTIP elections that are not necessary to reduce the estate tax liability to zero, either because the value of the estate is less than the applicable exclusion amount or because the executor makes the election for both the credit shelter trust and the marital trust. In these cases, 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. In IRS Letter Ruling 200535026, for example, the IRS ruled that an inadvertent QTIP election for a bypass trust was null and void. See also IRS Letter Ruling 200729028 (QTIP election made for all estate property did not apply to bypass trust). 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 executor makes an election with respect to more trust property than is necessary to reduce the estate tax liability to zero. Rev Proc 2001-38, 2001-1 Cum Bull 385. See, *e.g.*, IRS Letter Ruling 200422050. In other cases, executors may fail to make necessary QTIP elections because they are unaware of inter vivos taxable gifts and therefore believe that the estate tax would be zero even without an election. In these cases, the IRS may grant an extension of time to make the election. See IRS Letter Rulings 200526017, 200215025.

PRACTICE TIP: The problem may be avoided by stating on the return that the amount of the deduction is the amount derived from application of the marital deduction formula, and then indicating the presumed amount—in this case, zero. The use of formula QTIP elections is expressly authorized by Treas Reg §20.2056(b)-7(h), Examples (7)-(8).

In IRS Letter Ruling 200323010, the IRS allowed the estate to file an amended return clarifying that its original QTIP election was made only for the marital trust and correcting the amount of the deduction when the value shown on Schedule M was not enough to reduce the estate tax to zero. In IRS Letter Ruling 200219003, however, the IRS refused to allow the estate an extension to file an amended return to reduce the QTIP election for property passing to the marital trust, because a partial QTIP election was needed to reduce the estate tax liability to zero. The QTIP election must be made on the last estate tax return filed by the executor on or before the return's due date including extensions or, if a timely return is not filed, on the first estate tax return filed by the executor after the due date. Treas Reg §20.2056(b)-7(b)(4).

Unlike a disclaimer, the QTIP election does not affect who takes an interest in the property. The spouse will receive an income interest in the property whether the election is made or not. The only consequences of the election are to fix the tax consequences in the testator's estate and later in the surviving spouse's estate. If the surviving spouse's income interest is contingent on the executor's QTIP election, however, then the foregoing will not hold true. Such a contingency is now allowed by the IRS. See the discussion in §17.42.

The testator can direct that the executor make a QTIP election. See Alternative 1 in form 19.28-1. The election may have unfortunate results, however. Generally, it is advisable to leave the election to the executor's discretion and hold

the executor harmless for a good-faith decision. See Alternative 2 in form 19.28-1. The will may contain certain precatory language suggesting the factors that the executor should take into account in deciding whether to make an election and whether to make a total or partial election. Mandating the election may unnecessarily limit tax planning options if the surviving spouse dies shortly after the deceased spouse. Under these circumstances, a partial election can be made to equalize the estates. In addition, an election can be used to underutilize the marital deduction to produce (1) estate taxes in the estate of the first spouse to die and (2) an IRC §2013 prior transfer property (PTP) credit in the surviving spouse's estate. See §17.59. Similar results can be created by a partial disclaimer. An election can be used to overutilize the marital deduction when the surviving spouse has a contingent income interest and it is unnecessary to use all the deceased spouse's applicable exclusion amount to reduce estate taxes to zero in the surviving spouse's estate.

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§19.12 6. Partial Elections and Segregation of QTIP Property

The QTIP election can be made for less than all the property in which the surviving spouse receives a qualifying income interest. The regulations require that the election be expressed as a percentage or fractional share so that the elective part will reflect its proportional share of appreciation or depreciation of property passing from the decedent in which the surviving spouse has a qualifying income interest. Use of a formula clause is advisable because the QTIP election is irrevocable and a value adjustment may be made on audit. See Treas Reg §§20.2056(b)-7(b)(2)(i), 20.2056(b)-7(h), Examples (7)-(8), which include formula clause language making partial elections. Formula QTIP elections are discussed in California Trust Administration §12.26A (2d ed Cal CEB 2001).

Separate trusts can be divided to reflect a partial QTIP election. Treasury Regulation §20.2056(b)-7(b)(2)(ii) sets forth the rules when a single QTIP is divided:

(1) the division must be authorized under the governing instrument or local law;

(2) the division must be complete by the end of the period of estate administration;

(3) the trust must be divided by the time the estate tax return is filed or, if not, an unequivocal intention to make such division must be reflected on the estate tax return;

(4) although the division must be done on a fractional or percentage basis, a nonprorata division of assets may be made; and

(5) the division must be made based upon the fair market value of the trust assets on the date of the division.

In IRS Letter Ruling 9505007, the IRS allowed an extension of time to divide a QTIP trust into multiple trusts in connection with a partial election made on the return. See also Treas Reg §20.2056(b)-7(h), Example (9).

Treasury Regulation §20.2056(b)-7(b)(2)(ii) indicates that the division may be made on a fairly representative basis rather than as a fraction of each asset.

A direction to create two separate funds following a partial QTIP election does not disqualify the trust for which the election was made if the division is made according to the fair market value of the trust assets at the time of the division and the creation of separate trusts allows some flexibility for the fiduciary. For example, Treas Reg §20.2044-1(d)(3) makes clear that principal invasions can be directed to be made from the trust or a portion of the trust for which a QTIP election has been made before invasions are made from other trusts or the nonelected portion of a QTIP trust. See Treas Reg §20.2044-1(e), Example (4). The authority to invade only the elective trust gives the trust significant flexibility because the invasion of the elective share will reduce the amount of the trust that will be subject to tax at the surviving spouse's death while preserving assets held in nonelected trusts.

Segregation of the elected and nonelected shares into separate trusts eliminates the requirement to recalculate the percentage of the elected and nonelected shares if estate taxes attributable to the nonelected share are charged to that share. Segregation also allows the trustee to pursue different investment strategies for the two trusts. It may be advisable, for example, to invest the elected portion to maximize yield and to invest the nonelected portion to maximize growth.

After the fractional or percentile share of the elected and nonelected trusts is determined, the trustee may fund the elected QTIP trust and the nonelected QTIP trust on a nonprorata basis and will not be required to take a percentile or fractional share of each and every asset in funding the separate trusts. Treas Reg §20.2056(b)-7(b)(2)(ii)(B). However, assets must be allocated on the basis of fair market value at the time of allocation. Treas Reg §20.2056(b)-7(b)(2)(ii)(C).

For a discussion of QTIP treatment of elected property when the surviving spouse has no interest in the nonelected property, see §17.42.

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§19.13 7. "Reverse QTIP Election" for GST Tax Planning Purposes

The "reverse QTIP election" may play a significant role in planning for a married couple's use of their generation-skipping transfer (GST) tax exemptions (see IRC §2631(a)). The GST exemption applies only to property as to which the decedent is considered the transferor, which means that the property must be subject to the estate tax at the decedent's death. See IRC §2652(a)(1)(A). Property in the bypass trust is subject to the estate tax, although the applicable credit amount shields it from tax. Property in a QTIP trust as to which an election has been made is not subject to estate tax in the deceased spouse's estate and, without the reverse QTIP election, the surviving spouse rather than the first spouse to die will be the transferor for GST tax purposes.

Without the reverse QTIP election, for decedents dying after 2010, the couple has the choice of either allocating a portion of the GST exemption to the bypass trust and losing the remaining portion because the remainder of the decedent spouse's property goes to the QTIP trust (and is not subject to tax in the decedent's estate), or using all the GST exemption by allocating the exemption and an equivalent amount of property to the bypass trust and incurring an estate tax at the death of the first spouse to die. The reverse QTIP election permits the spouses to use all the GST exemption and the marital deduction. See §15.31 for an example of how the reverse QTIP election works.

To accomplish the goals of eliminating federal estate tax payable at the testator's death and using the entire GST exemption, the will should authorize the executor to (1) divide the QTIP trust into two trusts and (2) allocate to one trust the part of the GST exemption not used for the bypass trust. See forms in §15.86. The reverse QTIP election should be made, so that the decedent is treated as the transferor of the QTIP trust. If the executor elects to qualify the QTIP trust for the marital deduction, the transferor of the trust at the surviving spouse's death is the surviving spouse and not the decedent who originally established the trust. See IRC §2044(c). If the executor does not elect to qualify all or a portion of the trust as a QTIP trust for the marital deduction, the decedent is the transferor of the nonqualified portion of the trust.

Partial reverse QTIP elections may not be made. IRC §2652(a)(3). A reverse QTIP election will result in the decedent's being treated as the transferor of all the trust. Accordingly, a separate trust is required for any elected QTIP trust for which a reverse QTIP election will be made. If the testator intends to create a QTIP trust that is larger than the unused GST exemption, the trust will be only partially exempt from the GST tax unless it is divided into two trusts as discussed above. The regulations allow a reverse QTIP election to be made with respect to a divided trust if (1) the division is authorized under the governing instrument or local law; (2) the division occurs before the estate tax return is required to be filed (including extensions) or a reformation proceeding is commenced by that time; (3) the division is either done on a prorata basis or in compliance with technical requirements specified in Treas Reg §26.2654-1(b)(1)(ii); and (4) the trust is divided by the time the estate tax return is filed or, if not, an unequivocal intention to make this division must be reflected on the estate tax return and supporting documentation must be included with the return. Treas Reg §26.2654-1(b)(2). The election may be made on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, by simply making the QTIP election for the divided trust on Schedule M and allocating GST exemption to the trust on Schedule R. For a clause granting authority to divide the trust, see form 15.43-1.

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§19.14 8. Annuities as Qualified Terminable Interest Property

The marital deduction regulations generally do not allow a marital deduction with respect to annuities paid from trusts for decedents dying after October 23, 1992. Treas Reg §20.2056(b)-7(e). Based on these regulations, if a marital deduction is desired, it is not advisable to use an annuity. See discussion in §17.34.

Directing a fiduciary to create an annuity for the surviving spouse is treated differently from joint and survivor annuities in existence before the death of the predeceased spouse. The QTIP election is automatic for joint and survivor annuities unless the executor elects not to have QTIP treatment apply. IRC §2056(b)(7)(C). Thus, a donee spouse's interest in a joint and survivor annuity qualifies as qualified terminable interest property for which a QTIP election is considered to be made unless the executor or donor elects otherwise.

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§19.15 9. Charitable Remainder Trust Interests

Although qualified terminable interest property may include income interests in pooled income funds, the marital deduction regulations take the position that a surviving spouse's interest in a charitable remainder trust, although qualifying for the marital deduction, may not be treated as qualified terminable interest property. See IRC §2056(b)(8); Treas Reg §§20.2056(b)-7(h), Example (13), 20.2056(b)-8.

Only if the surviving spouse is the only noncharitable beneficiary of a charitable remainder trust will the marital deduction be available for the surviving spouse's interest. IRC §2056(b)(8); Treas Reg §20.2056(b)-8(b). A charitable remainder trust providing payments to the spouse for life and then to a child for life does not qualify for the estate tax marital deduction. The remainder interest continues to qualify for the charitable deduction.

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C. QTIP Trust Property at Surviving Spouse's Death

§19.16 1. Inclusion of QTIP Trust Property in Surviving Spouse's Taxable Estate

If the surviving spouse has not disposed of any of the qualifying income interest during his or her lifetime (see §19.7), the value of the property held in a QTIP trust is included in the surviving spouse's estate at his or her death. IRC §2044. The trust property is included in the survivor's estate even if the survivor did not receive the income. See *Estate of Valeria M. Miller*, TC Memo 2009-119.

Property included in the surviving spouse's gross estate under IRC §2044 is treated as passing from the spouse to the persons who received the property at the spouse's death and is valued in the same manner as other property includable in the surviving spouse's gross estate. Accrued but undistributed income is also included in the survivor's taxable estate regardless of whether it is directed to be distributed to the surviving spouse's estate or to subsequent beneficiaries. See §19.4.

The property is includable in the estate of the surviving spouse at its date-of-death value (or alternate valuation date value). IRC §2044; Treas Reg §20.2044-1(d)(1). Property included in the estate of the surviving spouse obtains a new income-tax basis in the hands of the distributees. See §19.20. Interests in property such as blocks of stock or partnership interests owned by the surviving spouse and the QTIP trust are not aggregated, however, for purposes of valuing the property to be taxed on the survivor's death, at least if the spouse lacks any power to direct the disposition of the QTIP. *Estate of Harriett R. Mellinger* (1999) 112 TC 26, acq in result 1999-2 Cum Bull xvi.

If a partial election is made, a fractional share of the entire property will be included in the surviving spouse's estate unless the elected share is allocated to a separate trust. If a partial election is made with respect to a single trust, the percentage of the trust that is includable in the survivor's estate is reduced if principal distributions are made from the elected portion of the trust. See Treas Reg §20.2044-1(d)(3). See also Treas Reg §20.2044-1(e), Example (4).

Whenever the surviving spouse holds a qualifying income interest for life in any property, a QTIP election and QTIP deduction are presumed to have been taken in the predeceased spouse's estate. Treas Reg §20.2044-1(c). To avoid the inclusion of property in the surviving spouse's estate, the executor must establish that a deduction was not taken when the qualifying income interest was created. Treas Reg §20.2044-1(c). Given this burden, it is advisable to retain the predeceased spouse's estate tax return until settlement of the surviving spouse's estate.

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2. Payment of Tax on QTIP Trust Property

§19.17 a. Surviving Spouse's Right of Recovery

At the surviving spouse's death, the estate tax attributable to qualified terminable interest property that is includable in the survivor's estate (plus interest and penalties attributable to the tax) is recoverable from the beneficiaries of that property. IRC §2207A; Treas Reg §20.2207A-1. The right to recover the tax applies unless the surviving spouse waives this right in his or her will or revocable trust. The amount recoverable is the difference between the federal estate tax due from the estate and the federal estate tax that would have been payable if the value of the qualified terminable interest property had not been includable in the survivor's gross estate. Treas Reg §20.2207A-5(a). Accordingly, the tax allocable to the qualified terminable interest property is calculated at the highest marginal rates applicable to the surviving spouse's estate. The executor has the right to recover estate tax attributable to qualified terminable interest property under IRC §2207A. If the executor fails to exercise this right, it passes to the persons on whom the tax liability falls. The possibility of indirect gifts exists when the right to recover is not exercised. If the executor or the beneficiaries on whom the burden of the tax falls do not exercise their right to recover the estate tax from persons receiving the qualified terminable interest property, the failure to exercise the right of recovery is an indirect gift by the persons who are charged with the tax to the persons from whom the tax was recoverable. The amount of the gift is the amount that would have been recoverable. The gift is considered to have been made when the right to recover is no longer enforceable; the gift is treated as a gift even if recovery is impossible. Treas Reg §20.2207A-1(a)(2).

The right of recovery and the indirect gift on failure to exercise the right do not apply if the surviving spouse's will provides that a recovery may not be made. Thus, if the surviving spouse's will waives the right of recovery, estate taxes attributable to qualified terminable interest property includable in the surviving spouse's estate may not be recovered from the beneficiaries.

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§19.18 b. Effect of Tax Apportionment Clauses

The rules discussed in §19.17 underscore the importance of the apportionment of death taxes in any estate plan. The tax clause is particularly significant when the estate will ultimately be shared by a surviving spouse and his or her issue and the deceased spouse's issue by a prior marriage. QTIP trusts, which are frequently used in these circumstances, allow the decedent to provide benefits to the surviving spouse while ensuring that benefits are also provided to the decedent's issue by a prior marriage. Under these circumstances, the drafter should carefully review the tax clauses and the apportionment of tax allocable to QTIP interests. See chap 26.

At the death of the first spouse to die, it is important to determine how the estate tax on the property transferable to a QTIP trust will be apportioned if the executor does not elect to qualify for the marital deduction. The testator's will should provide that taxes attributable to the nonelected portion of the QTIP trust be charged to that portion of the trust. If the taxes are charged to the residue of the estate that may be distributable outright to the testator's issue, the testator's issue may be unfairly burdened with a tax liability attributable to property that they will not actually receive until the surviving spouse's death.

Similarly, the surviving spouse's will may give the survivor's estate to his or her children by a prior marriage. If the surviving spouse's will provides for the payment of all death taxes from the residue of the estate, the survivor's issue may be unfairly burdened with the estate tax payable on qualified terminable interest property that is includable in the survivor's taxable estate but that is distributable to the deceased spouse's children.

One approach is for the will that creates the QTIP trust to direct that estate taxes attributable to the qualified terminable interest property—either at the death of the first spouse to die (as a result of the failure to make an election for all the QTIP trust assets) or at the surviving spouse's death—be paid from the qualified terminable interest property unless the surviving spouse's will provides otherwise. With a possible exception (see §19.19), the surviving spouse's will should reflect a parallel provision allocating estate taxes generated by the inclusion of qualified terminable interest property to that property. A direction to apportion taxes under Prob C §§20100-20225 does not achieve this result, because the statutes prorate tax against the qualified terminable interest property at the average rate rather than at the top rate that the surviving spouse's estate is entitled to recover under IRC §2207A. For a different approach, however, see §§26.11, 26.19, 26.34.

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§19.19 c. Payment of GST Tax on QTIP Trust

An exception to the general rule stated in §19.18 may exist when the spouses use a QTIP trust to maximize generation-skipping transfer (GST) tax benefits. See §19.13. In this context, the question of the proper source of the payment of the estate tax attributable to the QTIP trust at the surviving spouse's death attains additional importance. The estate planning goal is to preserve the GST tax-exempt QTIP trust intact at the surviving spouse's death and to avoid reduction of the exempt trust by the estate tax attributable to the QTIP trust for decedents dying after 2010. This assumes that the QTIP trust was created primarily for GST tax-exemption purposes, so that the beneficiaries of the QTIP trust are the same as the beneficiaries of the balance of the estate. If the beneficiaries are not the same, the client faces a difficult choice.

If the beneficiaries of the QTIP trust and of the estate are the same and the goal is to preserve the full IRC 2631 GST exemption, it is advisable to direct payment of the estate tax on the exempt QTIP trust from sources other than the trust. Estate taxes can be directed to be paid from a nonexempt marital trust or from the residue of the surviving spouse's estate. The payment of estate tax attributable to the GST tax-exempt trust from a source other than that trust will not result in a constructive addition to the trust in the amount of the tax paid. If a constructive addition has occurred, the inclusion ratio for the trust would need to be recomputed and the trust would be only partially exempt from the GST tax. The regulations state that a failure to exercise the right to recover tax attributable to a QTIP trust will not be considered a constructive addition to the trust. Treasury Regulation §26.2652-1(a)(4), Example 7, provides as follows:

> Under local law, the beneficiaries of S's residuary estate (which bears all estate taxes under the will) could compel the executor to exercise the right of recovery but do not do so. Solely for purposes of chapter 13, the beneficiaries of the residuary estate are not treated as having made an addition to the trust by reason of their failure to exercise their right of recovery.

The testator's will could provide that any tax recoverable from the exempt trust must be payable from a source other than the exempt trust if it is determined at the time payment is due that no constructive addition to the exempt trust will result. Otherwise, the tax could be directed to be paid from the exempt trust. In addition, the surviving spouse's will could waive the right of recovery under IRC §2207A.

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§19.19A d. California Estate Tax on QTIP Trust

The right of recovery created by IRC §2207A relates only to the federal estate tax payable. It does not include any state death tax: either an inheritance tax that may be generated if the QTIP trust includes real property located in another state, or an estate tax equal to the IRC §2011 credit (repealed in 2005). The federal statutes do not identify the source of payment of this estate tax. A provision in the QTIP trust or in the surviving spouse's will should direct the source of payment of all taxes resulting from the inclusion of the qualified terminable interest property in the surviving spouse's taxable estate.

The amount of tax attributable to the qualified terminable interest property will be defined at the top marginal rates applicable to the estate rather than at the average rate if the QTIP trust or the will of a surviving spouse directs that the death taxes allocable to the QTIP trust must equal the excess of death taxes payable at the surviving spouse's death over death taxes that would have been payable at the surviving spouse's death if the qualified terminable interest property had not been included in his or her estate. Probate Code §20110(b)(2) does, however, provide that any California estate tax is to be prorated in the same manner as the federal estate tax under IRC §2207A.

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§19.20 3. Basis of Qualified Terminable Interest Property

Qualified terminable interest property includable in the surviving spouse's estate is treated as if the surviving spouse were the decedent for purposes of IRC §1014 and receives a basis equal to the fair market value of the property on the date of the surviving spouse's death. IRC §1014(b)(10). See Treas Reg §20.2044-1(b). (For estates of decedents dying in 2010, however, property for which the election is made apparently will not be treated as acquired from the surviving spouse for purposes of allocating the spouse's aggregate basis increase under IRC §1022.) Qualified terminable interest property as to which the QTIP election is not made will only be included in the deceased spouse's estate and will receive no further basis adjustment.

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D. QTIP Trust Clauses

§19.21 1. Introduction to QTIP Trust Clauses

Sections 19.22-19.27 contain the dispositive provisions for a QTIP marital deduction trust. The clauses provide for the distribution of income (see §19.23) and principal (see §19.25) and a special power of appointment over the trust (see §19.27). Clauses authorizing or directing the executor to make the QTIP election may be found in §19.28. Form 19.29-1 presents two alternative distributions of the assets remaining in the trust estate at the surviving spouse's death.

To qualify the trust for the marital deduction when the surviving spouse is not a United States citizen, see form 19.40-1. For clauses instructing the trustee on the relevance of other income sources in making discretionary distributions, see form 19.26-1.

Other clauses that the drafter may include in a QTIP trust are discussed in various chapters of this book. See §§17.32-17.33 on marital deduction savings clauses; chap 27 on "spendthrift" clauses. For discussion of the payment of beneficiary's expenses from the trust, see §§31.21-31.22. Chapter 26 covers the issues involved in tax payment clauses, including the right of reimbursement for tax on qualified terminable interest property under IRC §2207A. See §§26.11, 26.19. Section 15.58 discusses the relationship between the right of reimbursement and the generation-skipping transfer tax. Chapters 28-31 address the powers of the trustee.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/ 2. Distribution of QTIP Trust Income/§19.22 a. Form: Introduction to QTIP Trust

2. Distribution of QTIP Trust Income

§19.22 a. Form: Introduction to QTIP Trust

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19.22-1 Introduction to QTIP trust

The trustee shall hold, administer, and distribute all property allocated to the QTIP trust as follows:

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.23 b. Form: Distribution of QTIP Trust Income

§19.23 b. Form: Distribution of QTIP Trust Income

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19.23-1 Distribution of QTIP trust income

[*Add one of the following alternatives*]

[*Alternative 1: Payment of all income*]

Income to Spouse for Life. **During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse the entire income of the trust in quarter-annual or more frequent installments payable at the end of the period and no person shall have the power to appoint any part of the trust property to any person other than my spouse. Despite the foregoing, trust income earned between the last distribution date and the date of my spouse's death shall not be distributed to my spouse or my spouse's estate but shall instead be distributed in accordance with the provisions of this trust for distribution of property following my spouse's death.**

[*Alternative 2: Power to withdraw all income*]

Income to Spouse for Life. **During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Income not immediately requested by my spouse shall remain subject to my spouse's right to income and may be withdrawn at any time until my spouse's death. No person shall have the power to appoint any part of the trust property to any person other than my spouse during my spouse's lifetime. Trust income earned between the last distribution date and the date of my spouse's death, and any other trust income not requested by my spouse before death, shall not be distributed to my spouse or my spouse's estate but shall instead be distributed in accordance with the provisions of this trust for distribution of property following my spouse's death.**

[*Alternative 3: Unitrust income interest*]

Income to Spouse for Life. **During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse in each taxable year of the trust, in quarter-annual or more frequent installments payable at the end of the period, a unitrust amount equal to _ _**[*number not less than 3 percent and not greater than 5 percent*]**_ _ percent of the net fair market value of the trust assets, valued annually on the first day of the trust's taxable year for federal income tax purposes. This valuation shall be made in such reasonable manner as the trustee shall, in the trustee's discretion, determine. In a taxable year of the trust that is less than 12 months and in the year of the death of my spouse, the amount to be paid by the trust shall be a fraction of _ _**[*number not less than 3 and not greater than 5*]**_ _ percent. The numerator of that fraction shall be the number of days in the trust's first taxable year or the number of days in the trust's year preceding the day on which the primary beneficiary died, and the denominator shall be 365. _ _**[*My spouse shall have the exclusive and unrestricted right to possession and control of any residential property or tangible personal property of the trust, including the right to occupy residential property as a personal residence or to rent the property and receive the income, and the trustee shall not pay the unitrust amount with respect to any such property of the trust.*]**_ _ Despite the foregoing, the unitrust amount for the period between the last distribution date and the date of my spouse's death shall not be distributed to my spouse or my spouse's estate but shall instead be distributed in accordance with the provisions for distribution of the remaining property of this trust on the death of my spouse. No person shall have the power to appoint any part of the trust property to any person other than my spouse. This provision is intended to satisfy the right of my spouse to a qualifying income interest for life as provided in Treasury Regulation §20.2056(b)-7(d)(2), incorporating the definition of "income" in Treasury Regulation §20.2056(b)-5(f).** _ _[*For this reason, the trustee shall pay to or apply for the benefit of my spouse in quarter-annual or more frequent installments the entire net income of the trust with respect to any property of the trust during any period in which the property is subject to the law of a jurisdiction that does not permit satisfying a right to income by payment of a unitrust amount and the trustee shall not pay the unitrust amount with respect to such property during that period.*]_ _

Comment: The form is intended to satisfy the requirements for a qualifying income interest for life, as discussed in §19.7.

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§19.24 c. Form: Payment of QTIP Unitrust Amount

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19.24-1 Payment of QTIP unitrust amount

Income to Spouse for Life. **During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse in each taxable year of the trust, in quarter-annual or more frequent installments payable at the end of the period, a unitrust amount equal to _ _**[*number not less than 3 and not greater than 5*]**_ _ percent of the net fair market value of the trust assets, valued annually on the first day of the trust's taxable year for federal income tax purposes. This valuation shall be made in such reasonable manner as the trustee shall, in the trustee's discretion, determine. In a taxable year of the trust that is less than 12 months and in the year of the death of my spouse, the amount to be paid by the trust shall be a fraction of _ _**[*number not less than 3 and not greater than 5*]**_ _ percent. The numerator of that fraction shall be the number of days in the trust's first taxable year or the number of days in the trust's year preceding the day on which the primary beneficiary died, and the denominator shall be 365. _ _**[*My spouse shall have the exclusive and unrestricted right to possession and control of any residential property or tangible personal property of the trust, including the right to occupy residential property as a personal residence or to rent the property and receive the income, and the trustee shall not pay the unitrust amount with respect to any such property of the trust.*]**_ _ Despite the foregoing, the unitrust amount for the period between the last distribution date and the date of my spouse's death shall not be distributed to my spouse or my spouse's estate but shall instead be distributed in accordance with the provisions for distribution of the remaining property of this trust on the death of my spouse. No person shall have the power to appoint any part of the trust property to any person other than my spouse. This provision is intended to satisfy the right of my spouse to a qualifying income interest for life as provided in Treasury Regulation §20.2056(b)-7(d)(2), incorporating the definition of "income" in Treasury Regulation §20.2056(b)-5(f).** _ _[*For this reason, the trustee shall pay to or apply for the benefit of my spouse in quarter-annual or more frequent installments the entire net income of the trust with respect to any property of the trust during any period in which the property is subject to the law of a jurisdiction that does not permit satisfying a right to income by payment of a unitrust amount and the trustee shall not pay the unitrust amount with respect to such property during that period.*]**_ _**

Comment: The form is intended to satisfy the requirements for a qualifying income interest for life, as discussed in §19.7. The form provides a unitrust alternative to the traditional income interest provided by form 19.23-1.

The first block of optional language requires the trustee to disregard the value of a residence (among other types of property) used in kind by the surviving spouse in calculating the unitrust amount, as trustees of a converted unitrust are permitted to do under Prob C §16336.4(e). This provision is intended to prevent the erosion of trust principal and avoid the need to pay rent on the property.

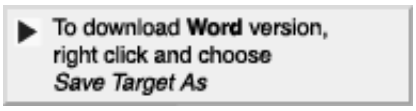
The second block of optional language is designed to ensure that the trust will continue to qualify for the marital deduction if there is a chance that the settlors may relocate to another state.

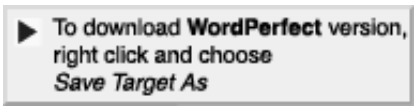
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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/ 3. Distribution of QTIP Trust Principal/§19.25 a. Form: Discretionary Payment of Principal

3. Distribution of QTIP Trust Principal

§19.25 a. Form: Discretionary Payment of Principal





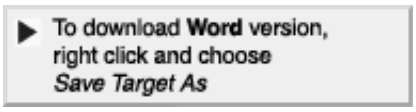
19.25-1 Discretionary payment of QTIP trust principal (ascertainable standard)

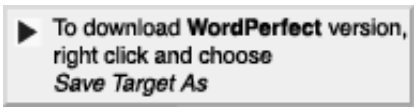
***Discretionary Distributions*. In addition to the net income, the trustee shall pay to or apply for the benefit of my spouse as much of the trust principal, up to the whole of the trust, as the trustee considers appropriate for my spouse's health, support, education, and maintenance to maintain at a minimum my spouse's accustomed manner of living.**

Comment: See §19.10 on powers over principal.

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§19.26 b. Form: Relevance of Other Income Sources





19.26-1 Relevance of other income sources

[*Add one of the following alternatives*]

[*Alternative 1: Other income sources relevant*]

In making distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and readily available.

[*Alternative 2: Other income sources not relevant*]

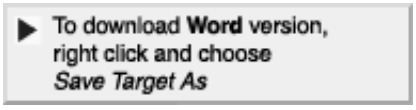
In making distributions, the trustee may not consider any other income or resources of my spouse.

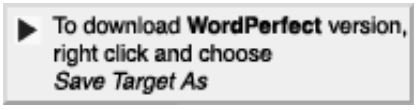
Comment: This clause may be added to form 19.25-1.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.27 c. Form: Surviving Spouse's Testamentary Special Power of Appointment

§19.27 c. Form: Surviving Spouse's Testamentary Special Power of Appointment





19.27-1 Spouse's testamentary special power of appointment

***Special Power of Appointment*. At the death of my spouse, the trustee shall distribute any remaining balance of the trust estate (excluding accrued income and undistributed income) to one or more of my descendants and their spouses _ _[*or domestic partners*]_ _, including surviving spouses _ _[*or domestic partners*]_ _, on terms and conditions (outright, in trust, or by creating further powers of appointment) as my spouse shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment.**

19.27-2 Distribution if power of appointment not exercised

***Distribution if Power of Appointment Not Exercised*. The trustee shall distribute any trust property not effectively appointed by my spouse under the preceding paragraph to the trustee then in office of the _ _[*name of trust*]_ _.**

Comment: See §19.10 on powers over principal.

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§19.28 4. Form: QTIP Election Provisions

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19.28-1 QTIP election

[*Add one of the following alternatives*]

[*Alternative 1: Election mandatory*]

***QTIP Election*. I direct my executor to elect under Internal Revenue Code §2056(b)(7) to treat the marital trust as qualified terminable interest property for the purpose of qualifying for the federal estate tax marital deduction.**

[*Alternative 2: Election optional*]

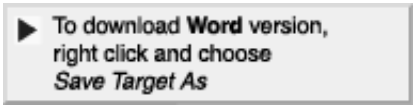
***QTIP Election*. I request but do not require my executor to make an election under Internal Revenue Code §2056(b)(7) to qualify all or part of the marital trust for the federal estate tax marital deduction. I recognize that the marital trust will not qualify for the marital deduction if my executor does not make this election. In exercising this discretion, my executor may consider all relevant factors, including the health and life expectancy of my spouse and the impact of the Internal Revenue Code §2013 prior transfer property credit.**

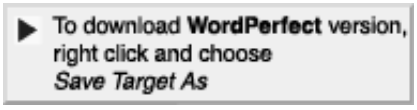
Comment: Alternative 1 is not recommended. See discussion of QTIP elections in §§17.12, 19.11-19.12.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.29 5. Form: Distribution on Surviving Spouse's Death

§19.29 5. Form: Distribution on Surviving Spouse's Death





19.29-1 Distribution on surviving spouse's death

[*Add one of the following alternatives*]

[*Alternative 1: Distribution to separate trust*]

***Distribution on Spouse's Death*. On the death of my spouse, the trustee shall distribute the remaining trust property to the trustee then in office of the _ _[*name of trust*]_ _.**

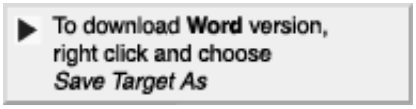
[*Alternative 2: Distribution according to terms of separate trust*]

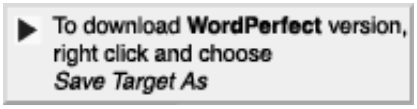
***Distribution on Spouse's Death*. On the death of my spouse, the trustee shall distribute the remaining trust property according to the distribution provisions of the _ _[*name of trust*]_ _.**

Comment: This clause may be used if the trust does not give the spouse a special power of appointment over the remainder. See §19.27. See chap 12 on outright gifts. See §19.7 on disposition of accrued income. See also chap 20 on bypass trusts; chap 21 on trusts for children, who are typical distributees of QTIP trust property at the surviving spouse's death.

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§19.30 6. Form: Payment of Taxes on Surviving Spouse's Death





19.30-1 Payment of taxes on surviving spouse's death

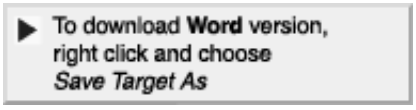
***Payment of Death Taxes*. Unless my spouse's will provides otherwise, the trustee shall use the nonexempt trust to the extent that it is sufficient to pay all taxes resulting from my spouse's death and attributable to the marital trust.**

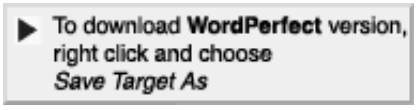
Comment: The purpose of this clause is to ensure that the nonexempt rather than the exempt QTIP trust is used to pay the taxes on the QTIP trust if the QTIP trust is divided. The clause is not needed if form 15.43-1 is used. For an alternative form of tax payment clause, see form 26.36-1.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.31 7. Form: Division of Trusts Reflecting Partial QTIP Election

§19.31 7. Form: Division of Trusts Reflecting Partial QTIP Election





19.31-1 Division of trusts reflecting partial QTIP election

***Division of Trust*. If a partial qualified terminable interest property (QTIP) election is made for this trust, the trustee may divide the trust into separate trusts to reflect the partial election. The division shall be made on a fractional basis. The separate trusts need not be funded with a prorata portion of each asset held by the undivided trust, but the division of the trust must be made on the basis of the fair market value of the assets of the trust at the time of division.**

Comment: This clause complies with Treas Reg §20.2056(b)-7(b)(2)(ii)(B)-(C). See §19.12. For a clause authorizing division of the trust into one or more trusts for purposes of facilitating the reverse QTIP election, see form 15.43-1.

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III. MARITAL DEDUCTION FOR TRANSFERS TO NONCITIZEN SPOUSE

§19.32 A. Taxation of Noncitizen Transfers

In general, United States citizens, no matter where they reside, and persons who reside in the United States, no matter what their citizenship, are subject to United States transfer tax with respect to all of their assets or interests in assets whether within or outside the United States. IRC §§2001(a), 2511(a). In contrast, nonresidents who are not United States citizens are subject to transfer tax only with respect to those of their assets or interests in assets that are situated or deemed situated within the United States. IRC §§2101(a), 2103, 2511(a). Although nonresidents can take advantage of gift-tax exclusions, such as the IRC §2503(b) annual exclusion or the IRC §2503(e) exclusion for medical and educational expenses, they can make only $60,000 worth of taxable transfers for estate tax purposes without incurring an estate tax and they can make no taxable transfers for gift-tax purposes without incurring a gift tax. IRC §§2102, 2505.

An important exception to these rules is that the gift tax does not apply to the transfer of intangible assets by a nonresident even if those assets are situated in the United States, unless the donor lost United States citizenship within the previous 10 years and the donor (1) had a net worth of at least $2 million on the date of loss of citizenship, (2) had an average annual net income *tax* of $136,000 per year (in 2008) for the 5 years preceding that date (except for certain narrowly defined classes of dual citizens and minors), or (3) failed to certify under penalty of perjury that the donor met the requirements of the tax law during that 5-year period or to submit such evidence of such compliance as the IRS may require. IRC §§877, 2501(a)(2)-(3), 2511(b); Treas Reg §§25.2511-1(b), 25.2511-3.

Deductions for a nonresident's debts are limited, however, to a prorata share of the debts equal to the percentage of the nonresident's estate that is subject to tax in the United States. IRC §2106(a)(1). In *Estate of Hong Hing Fung* (2001) 117 TC 247, aff'd (9th Cir 2003) 2003-1 USTC ¶60,460, 91 AFTR2d 1228, the court allowed a marital deduction for only the portion of the United States properties equal to the surviving spouse's share of the decedent's worldwide estate as a transfer by the noncitizen spouse. See §19.32A. On joint tenancy marital property held with a noncitizen spouse, see §19.32B.

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§19.32A 1. When Marital Deduction Allowed

Citizenship or residence of the deceased transferor is irrelevant to the availability of the marital deduction, but the surviving spouse's citizenship is relevant. The marital deduction is allowed for a decedent who is not a citizen or resident of the United States to the same extent that it is allowed for the estate of a deceased citizen or resident of the United States. See IRC §2106(a)(3). An estate tax marital deduction for property passing to a surviving spouse who is not a citizen of the United States is not allowed unless the property passes to a qualified domestic trust (QDOT) that meets the statutory requirements set forth in IRC §2056A(a). IRC §2056(d). See §19.33. Attorneys should inquire about the citizenship of their clients in every estate planning representation. See the client interview checklist in §2.2. See also the client questionnaire in §2.5.

Section 2056(d) does not make the marital deduction available merely because property passes in a QDOT. Although the Internal Revenue Code is not entirely clear on this issue, the Internal Revenue Service requires that transfers made to a QDOT not only satisfy the requirements of a QDOT, but also qualify for the marital deduction under the normal rules of IRC §2056 (*i.e.,* by use of a QTIP trust, a general power of appointment trust, or an estate trust). Treas Reg §20.2056A-2(b)(1).

There are additional restrictions on the availability of the marital deduction for transfers to noncitizen spouses. Inter vivos gifts are subject to a $128,000 (plus cost-of-living adjustments after 2008) annual exclusion. IRC §2523(i). Any gifts over $128,000 are subject to tax without regard to the marital deduction; there is no inter vivos equivalent of the QDOT to qualify transfers for the marital deduction. The $128,000-per-year exclusion for gifts to a noncitizen spouse is created by substituting $100,000 (as adjusted) for the $10,000 limit in IRC §2503(b). Thus, any gift to a noncitizen spouse must qualify both under the present interest rules of §2503(b) and under the marital deduction rules. In *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664, for example, the court held that gifts of membership units in a limited liability company were gifts of future interests that did not qualify for annual gift tax exclusions. A QTIP trust qualifies for the marital deduction but creates a present interest only for the value of the income interest in the trust. A QTIP trust with a *Crummey* power over $100,000 per year (as adjusted) may qualify the transfer both as a present interest and for the marital deduction (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82).

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§19.32B 2. Joint Tenancy Marital Property

Different joint ownership rules apply when the surviving spouse is a noncitizen than when the spouse is a citizen. Internal Revenue Code §2056(d) negates application of the IRC §2040(b) rule that automatically excludes half of qualified property jointly owned between spouses from the deceased spouse's gross estate, resulting in application of the consideration-furnished test. The entire property is includable in the estate of the first spouse to die unless the executor substantiates the surviving spouse's contribution. If the contribution cannot be substantiated, the entire value of the joint property will be includable in the first spouse's estate (increasing the value of the transfer to the surviving spousal joint tenant), which may not qualify for the marital deduction. The surviving joint tenant may qualify the transfer for the marital deduction if the property is transferred or irrevocably assigned to a QDOT before the date on which the estate tax return is made. See IRC §2056(d)(2)(B).

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.33 B. Requirements for Qualified Domestic Trust (QDOT)

§19.33 B. Requirements for Qualified Domestic Trust (QDOT)

No estate tax marital deduction is available for a testamentary transfer to a noncitizen spouse unless it is in the form of a qualified domestic trust (QDOT), as defined in IRC §2056A. IRC §2056(d).

The trust must meet the following requirements to qualify as a QDOT (IRC §2056A(a)):

- Except as provided in regulations prescribed by the Secretary of the Treasury, the trust instrument must provide that at least one trustee is a U.S. citizen or a domestic corporation. See paragraph (3) in form 19.40-1 for the option of using a U.S. bank as trustee to meet the security requirements for a QDOT.
- The trust instrument must provide that no distribution (other than a distribution of income) may be made unless the trustee is a U.S. citizen or a domestic corporation that has the right to withhold from distribution the estate tax imposed under IRC §2056A.
- The trust must meet the requirements of regulations issued by the Secretary of the Treasury to ensure the collection of any tax. See Treas Reg §§20.2056A-1—20.2056A-13. The detailed provisions of Treas Reg §20.2056A-2(d)(1)(i)-(ii), setting out U.S. bank, bond, or letter of credit security requirements for a QDOT, are broadly summarized in paragraph (3) in form 19.40-1. Special rules have been provided in the case of an incompetent settlor. See Treas Reg §20.2056A-2(d)(6)(ii). For antiabuse rules, see Treas Reg §20.2056A-2(d)(1)(v).
- The executor must make an irrevocable election on the estate tax return to treat the trust as a QDOT. Like the qualified terminable interest property election, the election to treat the trust as a QDOT must be made on an estate tax return and, once made, it is irrevocable. IRC §2056A(d). The election must be made on the last return filed before the due date or the first return filed after the due date, but in some cases the IRS may grant an extension of time to make the election on a supplemental return. Treas Reg §20.2056A-3(a); IRS Letter Ruling 200821030. The applicable rules for marital trusts for U.S. citizen surviving spouses also must be satisfied before the QDOT election may be made. See Treas Reg §20.2056A-2(b)(1).
- A QDOT can be created or fine-tuned by use of a reformation to qualify a trust that would otherwise not meet the tests for a QDOT. Treas Reg §20.2056A-4(a)(1). See §19.36A. Court reformation is also possible if reformation by the trustee is not permitted. Treas Reg §20.2056A-4(a)(2). See §19.36.

NOTE: Some foreign countries prohibit trusts or prohibit them from having a U.S. trustee. In either case, the marital deduction would not be available under the usual rules for qualification as a QDOT. The Secretary of the Treasury has the power to prescribe regulations that would permit exceptions to the usual requirements for qualifying as a QDOT. See IRC §2056A(a)(1) (requirement of at least one U.S. trustee subject to regulatory exception) and IRC §2056A(c)(3) (to the extent provided in regulations, "trust" includes other arrangements that have substantially the same effect as a trust). The House Committee Report on these provisions indicates that any such regulations would permit a marital deduction for nontrust arrangements or for trusts without a U.S. trustee only under circumstances where the United States would retain jurisdiction, including adequate security to impose a tax on transfers by the surviving spouse of the property transferred by the decedent. H Conf Rep No. 220, 105th Cong, 1st Sess, 719 (1997), reprinted in 1997 US Code Cong & Ad News 1129, 1531.

The noncitizen surviving spouse may act as a cotrustee with the required United States trustee.

The United States trustee's power to withhold tax does not result in the QDOT's failure to meet the QTIP trust and general power of appointment trust exceptions to the terminable interest rule of IRC §2056. IRC §2056A(b)(14). The executor's election to treat the trust as a QDOT is required to be made on the estate tax return of the deceased spouse. The election is irrevocable and may not be made if the return is filed more than one year after the due date for filing the return, including extensions. IRC §2056A(d).

Multiple QDOTs should be carefully coordinated. If more than one QDOT is created for the same decedent, the tax rate applied to distributions from each QDOT will be the highest estate tax rate applicable at the deceased spouse's death unless the deceased spouse's executor designates either a United States citizen or a domestic corporation to be

responsible for filing the returns and paying the tax for all QDOTs. IRC §2056A(b)(2)(C).

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C. Qualifying for Marital Deduction When No QDOT Established

§19.34 1. Postdeath Transfer to QDOT

If the decedent's will or revocable trust fails to establish a QDOT, transfers to the noncitizen surviving spouse may still qualify for the marital deduction if property is transferred, or assigned under an irrevocable assignment enforceable under local law, to a QDOT before the date on which the deceased spouse's estate tax return is made, and on or before the last date that the QDOT election may be made. IRC §2056(d)(2)(B); Treas Reg §§20.2056A-2(b)(2), 20.2056A-4(b); Temp Treas Reg §20.2056A-4T. A surviving spouse or the decedent's executor may effectively create such a trust.

In IRS Letter Ruling 200352005, however, the IRS denied a request for an extension of time to transfer additional assets to a QDOT. The IRS ruled that the extension could not be granted because the deadline for making an irrevocable assignment is statutory. The surviving spouse transferred the wrong amount because the decedent's estate tax return preparer failed to recognize that jointly owned property is not treated as owned equally by both spouses under IRC §2040(b) if the surviving spouse is not a citizen. See §19.32.

A postdeath transfer of property received by a surviving spouse to a QDOT has gift tax and income tax consequences. See Treas Reg §20.2056A-4(b)(5). If the surviving spouse is a United States resident and does not retain sufficient powers over the trust, the transfer of property to the trust may result in a taxable gift of the remainder interest in the trust. This result is undesirable because the IRC §2702 special valuation rule overvalues gifts to trusts paying income to the donor. Retention of a power of appointment over the trust prevents the gift from being considered complete.

The surviving spouse will also be treated as the grantor of the trust for income tax purposes. If the surviving spouse is the grantor for income tax purposes, the capital gain realized in the trust is taxable to the spouse. The negative impact of this result is ameliorated by the fact that, if the trustee reimburses the surviving spouse for any income tax due under these circumstances, the reimbursement is not a distribution subject to estate tax. IRC §2056A(b)(15).

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§19.35 2. Noncitizen Spouse Becomes Citizen

The marital deduction is also available for transfers to a noncitizen spouse if the noncitizen spouse becomes a United States citizen before the estate tax return is filed and was a resident of the United States at all times after the decedent's death and before becoming a citizen. IRC §2056(d)(4); Treas Reg §20.2056A-1(b).

In addition, the transfer may qualify indirectly for the marital deduction if the surviving spouse becomes a United States citizen after the federal estate tax return is filed. IRC §2056A(b)(12); Treas Reg §20.2056A-10. Either of the following sets of requirements must be satisfied:

- The surviving must have been a resident of the United States at all times between the date of the decedent's death and the date on which citizenship was obtained, or no taxable distributions were made from the QDOT before the spouse became a United States citizen (regardless of the residency status of the spouse); and timely notice of the surviving spouse's citizenship is provided by a United States trustee of the QDOT by filing a final Form 706-QDT on or before April 15, plus extensions, of the year following the year in which the spouse became a citizen (Treas Reg §20.2056A-10(a)); *or*
- The spouse must elect (1) to treat any taxable distributions from the QDOT as a taxable gift made by the spouse for purposes of IRC §2001(b)(1)(B) (adjusted taxable gifts); and (2) to treat any previous reduction in the §2056A estate tax by reason of the decedent's applicable credit amount as a reduction in the spouse's applicable credit amount for purposes of determining the amount of the credit allowable with respect to taxable gifts made by the surviving spouse during or after the taxable year in which the spouse became a citizen by making the elections on a timely filed Form 706-QDT on or before April 15, plus extensions, of the year following the year in which the spouse became a citizen (Treas Reg §20.2056A-10(b)).

Note that IRC §2056A does not impose any notice requirement, and the instructions for Form 706-QDT do not indicate that the filing is mandatory when the surviving spouse becomes a citizen. In IRS Letter Ruling 200719002, the IRS granted an extension of time to satisfy the notice requirement when the trustee inadvertently failed to file the required notice, but it is debatable whether the trust should incur the expense of obtaining an extension of time rather than merely filing the return late when no election is required because the surviving spouse was a resident at all times following the decedent's death or because there have never been any distributions subject to QDOT tax. Regardless of whether the final Form 706-QDT is filed timely or late, the trustee in these circumstances should check the "No" box in Part II, line 4, in answer to the question of whether the spouse elects to treat all prior taxable distributions as taxable gifts.

PRACTICE TIP: Subject to all applicable nontax considerations, the drafter should consider authorizing the surviving spouse to become the sole trustee if he or she becomes a United States citizen after the deceased spouse's death and meets the requirements discussed in this section.

In the great majority of cases in which the spouse becomes a citizen the spouse will have been a resident at all times after the decedent's death. If the requirements are satisfied, the QDOT is no longer subject to the QDOT tax.

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§19.36 3. Judicial Reformation to Conform to QDOT Rules

If the decedent transfers assets to a QTIP trust, a general power of appointment trust, or an estate trust that does not meet the requirements of a QDOT but would otherwise qualify for the marital deduction, the trust may qualify as a QDOT if the trust is judicially reformed. The proceeding to reform must be started on or before the due date for filing the decedent's estate tax return, including extensions. IRC §2056(d)(5); Treas Reg §20.2056A-4(a)(2).

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.36A 4. Reformation by Trustee to Conform to QDOT Rules

§19.36A 4. Reformation by Trustee to Conform to QDOT Rules

The necessity for a judicial reformation in order to meet QDOT requirements can be avoided by authorizing the trustee to reform the trust to meet those requirements. The reformation must be completed by the due date (including extensions) for filing the estate tax return. IRC §2056(d)(5)(A)(i); Treas Reg §20.2056A-4(a)(1). Often it is anticipated that a client's noncitizen spouse will become a citizen long before the client's death. In such cases the drafter may decide against including detailed QDOT provisions in the will—instead substituting a provision granting the trustee the necessary reformation power. See Alternative 2 in form 19.40-1.

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D. Tax on QDOT Principal Distributions

§19.37 1. Imposition of QDOT Tax

A QDOT is subject to estate tax at the rates of the deceased spouse. The tax is imposed on the first to occur of the following events:

- Distributions are made during the lifetime of the surviving spouse;
- The QDOT ceases to meet the requirements imposed by the regulations; or
- The surviving spouse dies.

With certain exceptions, all distributions made during the surviving spouse's life are taxed on the amount or value of the distribution at the date of distribution. IRC §2056A(b)(1)(A). The exceptions include distributions of income to the surviving spouse, not including capital gains and items allocated to corpus under applicable local law (IRC §2056A(b)(3)(A); Treas Reg §20.2056A-5(c)(2)), distributions to the surviving spouse "on account of hardship" (IRC §2056A(b)(3)(B); Treas Reg §20.2056A-5(c)(1), and certain miscellaneous distributions, including any distribution to reimburse a spouse for income tax paid by the spouse on an item of income to which the spouse was not entitled under the terms of the trust (IRC §2056A(b)(15); Treas Reg §20.2056A-5(c)(3)(iv)). The tax continues to apply in 2010, when the estate tax is repealed. IRC §2210(b)(1).

In this context, "income" has the same meaning as it does in IRC §643(b), subject to modifications in the QDOT regulations. IRC §2056A(c)(2); Treas Reg §20.2056A-5(c)(2). The term "hardship" is not defined in the statute. However, "hardship" is defined in the regulations as an immediate and substantial financial need relating to the spouse's health, maintenance, or support, or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support, provided that the spouse is not able to obtain funds for such purposes for other reasonably available sources. Treas Reg §20.2056A-5(c). The exception for reimbursement of income tax is intended to cover situations in which the trust beneficiary is taxed on income that is not actually distributed (*e.g.,* capital gain) and that may be retained by the trust but taxable to the surviving spouse for income tax purposes.

An estate tax is also imposed during the surviving spouse's lifetime if the QDOT ceases to meet the requirements imposed by the regulations. The tax imposed under these circumstances is imposed as if the surviving spouse had died on the date when the trust no longer qualified as a QDOT. IRC §2056A(b)(4); Treas Reg §20.2056A-5(a)(3).

At the death of the surviving spouse, the fair market value of the assets held in the QDOT, including any accumulated income, is subject to estate tax as if the assets had been included in the estate of the predeceased spouse. IRC §2056(b)(1)(B). The tax does not apply in 2010, when the estate tax is repealed. IRC §2210(b)(2). See §19.38 for discussion of the amount of tax.

The payment of any estate tax attributable to distributions from the QDOT during the surviving spouse's lifetime is a distribution subject to the estate tax. IRC §2056A(b)(11). This creates a tax on a tax.

The estate tax imposed during the surviving spouse's lifetime is due on the fifteenth day of the fourth month following the calendar year in which the taxable event occurs. The estate tax imposed because of the surviving spouse's death, and the tax on any distributions occurring in the calendar year in which the surviving spouse dies, is due nine months after the date of the surviving spouse's death. IRC §2056A(b)(5); Treas Reg §20.2056A-11.

Each trustee is personally liable for the tax due, subject to an application for discharge for personal liability under IRC §2204. IRC §2056A(b)(6); Treas Reg §20.2056A-11(d). See also Treas Reg §20.2056A-2(d)(1)(v) (QDOT status forfeited if trust uses any arrangement that has as a principal purpose avoidance of liability for QDOT tax).

Form 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts, should be used to report taxable distributions from QDOTs, trusts that no longer meet the requirements of a QDOT, or the death of the surviving spouse. See Treas Reg §20.2056A-11.

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§19.38 2. Amount of QDOT Tax

The tax imposed under IRC §2056A on a QDOT is a tax on the estate of the deceased spouse and not on the surviving spouse's estate. Treas Reg §20.2056A-6(a).

The QDOT is subject to tax at the incremental estate tax rates of the first spouse to die. As a result, the surviving spouse's applicable credit amount and the graduated rates that would normally apply to the surviving spouse's estate are not available to the QDOT. Internal Revenue Code §2056A(b)(10) provides certain benefits, however, if the property remaining in a QDOT at the surviving spouse's death is also includable in the surviving spouse's estate. These benefits would apply for QTIP trusts for which the appropriate election was made or for general power of appointment or estate trusts. Under these circumstances, QDOT assets qualify for alternate valuation, special use valuation, distributions in redemption of stock to pay death taxes, credits for estate death taxes and foreign death taxes, the charitable deduction, the marital deduction, and extensions of time for payment of estate tax. See Treas Reg §20.2056A-6(b).

If the testator creates a QDOT for the surviving spouse's benefit and directs that assets remaining in the trust pass to a qualified charity, the trust will qualify for the federal estate tax marital deduction at the testator's death. At the surviving spouse's death, the assets remaining in the trust will be subject to estate tax in the decedent's estate as well as in the surviving spouse's estate. Under these circumstances, a charitable deduction is available to the deceased spouse's estate. See IRC §2056A(b)(10). The surviving spouse's estate qualifies for the charitable deduction under IRC §2055, without reliance on IRC §2056A.

Similarly, the deceased spouse's estate will be entitled to a marital deduction if the surviving spouse transfers the QDOT assets (*e.g.,* by exercise of a general power of appointment) to a second spouse. Thus, the estate of the deceased spouse is entitled to the benefit of the marital deduction if the surviving spouse remarries and appoints the QDOT assets received from the first spouse to the second spouse.

The amount of the estate tax is the additional amount of tax that would have been owed by the estate of the first spouse to die if the current value of the property now being taxed had been added back into the transferor's estate. The property is taxed at its value at the time the tax is imposed, although the rate of tax is the rate in effect at the death of the first spouse to die. See Treas Reg §20.2056A-6(a). There is no provision for an estate-tax type income-tax-basis adjustment for any increase in value between the date of the first spouse's death and the date of imposition of the estate tax (*e.g.,* the date of the surviving spouse's death), but a basis adjustment is available for distributions giving rise to tax under IRC §2056A(b)(1)(A). Treas Reg §20.2056A-12.

If the deceased spouse's estate tax has not been finally determined, the tax is imposed on the QDOT at the highest rate of tax in effect at the deceased spouse's death. When the deceased spouse's estate tax is finally determined, the estate is entitled to a refund, plus interest of any excess tax paid. IRC §2056A(b)(2)(B). The claim for a refund must be filed no later than one year after the date of the final determination of the deceased spouse's estate tax liability.

If the QDOT property is included in the surviving spouse's estate and the surviving spouse is a resident or citizen of the United States at death, the surviving spouse's estate will be entitled to an IRC §2013 prior transfer property credit in the amount of the estate tax imposed on the QDOT. This credit is allowed for the full amount of the tax regardless of the number of years between the two deaths. The credit is only available for property that would have qualified for the estate tax marital deduction if IRC §2056(d) did not exist. IRC §2056(d)(3); Treas Reg §20.2056A-7. The availability of the credit indicates that the estate tax is intended to be paid once rather than to be applied twice on the same property.

In many cases, the combined tax attributable to the estate of the first spouse to die and to the surviving spouse's estate will be less than would have been paid had the surviving spouse been a citizen. Use of a QDOT allows the first spouse's estate to run through the lower estate tax brackets while deferring the tax until the surviving spouse's death. The surviving spouse's estate may also be able to take advantage of the protection of the applicable credit amount and the low tax brackets.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.39 3. QDOT Drafting Considerations

§19.39 3. QDOT Drafting Considerations

Estate planning situations involving noncitizen spouses must be drafted on a case-by-case basis with careful consideration being given to:

- Whether the noncitizen surviving spouse is likely to be a citizen or resident of the United States at the survivor's death (with the result that all assets of the survivor will be subject to United States estate tax);
- Whether the deceased spouse has nontax reasons for not leaving all property outright to the surviving spouse; and
- Whether the assets and comfort needs of the surviving spouse make it desirable to use part of the applicable exclusion amount for the purpose of making transfers to the survivor which will not be retransferred to a QDOT.

In all events, the planner should not assume that it will be desirable to fund a bypass trust with the full applicable exclusion amount.

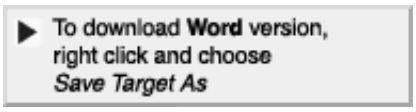
If the survivor will likely become a citizen of the United States, it may be appropriate to draft a standard marital deduction trust estate plan, using a QTIP or general power of appointment trust, and modifying the trust terms with form 19.40-1 (QDOT provisions) or form 19.41-1 (power to reform trust to qualify as QDOT). If the survivor will be a resident, but not a citizen, the planner, at a minimum, must develop a plan dealing with property that cannot conveniently be administered in a QDOT. This includes most tangible personal property. This problem may be resolved if the survivor has assets that can be used to purchase such items from the decedent's estate, but may otherwise require devising such property outright to the spouse and using up part of the applicable exclusion amount.

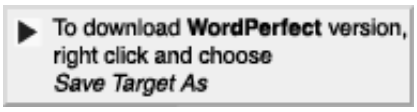
If the surviving spouse will leave the country and not be subject to United States estate tax on assets outside the United States, the planner may want to consider giving the spouse the applicable exclusion amount outright.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.40 E. Form: Qualified Domestic Trust Provisions

§19.40 E. Form: Qualified Domestic Trust Provisions





19.40-1 Qualified domestic trust provisions

Qualifying Trust as QDOT. **If the transfer to the QTIP Trust will not qualify for the marital deduction because of Internal Revenue Code §2056(d), applicable when a Surviving Settlor is not a United States citizen, the following additional provisions shall apply to the QTIP Trust:**

(1) At least one trustee of the QTIP Trust shall be an individual United States citizen or a United States domestic corporation. If at any time the trust does not have such a trustee, the trustee shall appoint one.

(2) Each trustee who is a United States citizen or is a United States domestic corporation shall have the right to withhold from any trust distribution, other than a distribution of trust income to the Surviving Settlor, the tax imposed on the distribution under Internal Revenue Code §2056A.

(3) The trustee must comply with the requirements for security arrangements for qualified domestic trusts as set forth in Treasury Regulation §20.2056A-2(d)(1)(i) or §20.2056A-2(d)(1)(ii).

[*If desired, add the following option*]

[*Option: Summary of requirements*]

These requirements are summarized below:

(a) Trust in Excess of $2 Million. If the fair market value of the assets passing to the 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 United States Bank as Trustee requirements (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 United States 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 United States trustee nor any other person may 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 on.

(b) Trust of $2 Million or Less. If the fair market value of the assets passing to the trust (determined without reduction for any indebtedness) is $2 million or less on the relevant valuation date, then the trustee must comply with either the United States 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 consists of foreign real property, 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 personal residence of _ _[*name of noncitizen spouse*]_ _.

(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 personal residence of _ _[*name of noncitizen spouse*]_ _.

(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 United States trustee is hereby authorized to enter into alternative plans or arrangements with the Internal Revenue Service under Treasury Regulation §20.2056A-2(d)(4) to ensure collection of the deferred estate tax, in lieu of the provisions contained herein.

(g) All references to "Treasury Regulation" in this document shall be references to regulations published under Title 26 of the Code of Federal Regulations as in effect on the date of execution of this document, or, in the event that any such regulation is amended or superseded thereafter, to the regulation (or any successor regulation) as so amended.

(h) The use of the dollar sign ($) shall indicate amounts stated in United States dollars. If this trust fails to qualify for the marital deduction solely by reason of the provisions of Internal Revenue Code §2056(d) or §2056A, the trustee of this trust shall have the power, without application to any court, to reform this trust as necessary or useful to satisfy the requirements of those statutes and related Treasury Regulations. The trustee in its discretion may reform only a part of the trust, first dividing the trust into shares.

[*Continue*]

(4) It is my intention that the marital trust qualify for the marital deduction available to my estate under Internal Revenue Code §§2056 and 2056A and the regulations pertaining to those sections or any corresponding or substitute provisions applicable to my estate. In no event shall the trustee take any action or have any power that will impair the marital deduction, and all provisions regarding the marital trust shall be interpreted to conform to this primary objective. Specifically, I will direct my executor and the trustee of the marital trust to comply with any requirements that the Internal Revenue Service may prescribe by regulation, as provided by Internal Revenue Code §2056A, and to take any and all actions necessary to comply with those requirements, including amending or reforming the trust terms, without application to any court, for the purpose of complying with any of those requirements.

The provisions in the preceding four numbered paragraphs shall not apply if my spouse becomes a citizen of the United States before the day on which the federal estate tax return is filed and my spouse was a resident of the United States at all times after my death and before becoming a citizen of the United States.

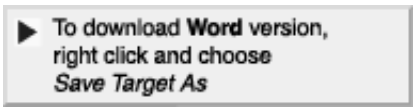
Comment: This form may be added to the provisions for either a QTIP or a general power of appointment trust. It may also be adapted for incorporation in a QDOT established by the surviving spouse.

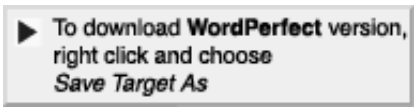
As an alternative to paragraph (3), the trust instrument may state: "This trust must be administered in compliance with Treasury Regulation section 20.2056A-2 paragraphs (d)(1)(i)(A), (B), or (C)." Treas Reg §20.2056A-2(d)(1)(i). Paragraph (3) adopts the sample trust language regarding security arrangements contained in Rev Proc 96-54, §4, 1996-2 Cum Bull 386. This sample language "meets all of the requirements under §20.2056A-2(d)(1)(i)(A), (B), and (C), and (d)(1)(ii)." Rev Proc 96-54, §3. Cautious drafters may wish to use the optional addition to paragraph (3) summarizing the requirements of the regulations. For an alternative form, see §19.41.

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Source: Estate Planning/California Will Drafting/19 Qualified Terminable Interest Property Trusts and Qualified Domestic Trusts/§19.41 F. Form: Power to Reform Trust to Qualify as QDOT

§19.41 F. Form: Power to Reform Trust to Qualify as QDOT





19.41-1 Power to reform trust to qualify as QDOT

Power to Reform Trust to Qualify as QDOT. **When the transfer to the QTIP Trust does not qualify for the marital deduction under Internal Revenue Code §2056(d), the trustee of the trust is authorized to modify the terms of the QTIP Trust in a manner that results in the trust being a qualified domestic trust as defined in Internal Revenue Code §2056A. In making such modifications, the trustee shall not modify any provisions concerning trust distributions or increase the Surviving Settlor's powers with respect to such distributions unless there is no other way to qualify the trust. In making other modifications, the trustee may exercise reasonable discretion in determining the manner in which the trust will comply with Internal Revenue Code §2056A and related Treasury Regulations. The modified trust provisions may authorize the United States trustee to further amend the trust from time to time so as to satisfy any requirements imposed by Internal Revenue Code §2056A regulations as a prerequisite to using such regulation-authorized method of securing payment of the QDOT tax as the United States trustee determines is then appropriate.**

Comment: This form may be added to the provisions for either a QTIP or a general power of appointment trust. For an alternative form, see §19.40. The trustee should 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).

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20

Bypass Trusts and Disclaimer Trusts

Gordon A. Schaller
Timothy J. Kay

I. CREDIT SHELTER TRUST PLANNING §20.1

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§20.1 I. CREDIT SHELTER TRUST PLANNING

This chapter discusses two components of marital deduction planning, the bypass trust and the disclaimer trust. The bypass trust, discussed in §§20.2-20.26A, is intended to utilize the applicable credit amount to shelter the applicable exclusion amount in the testator's estate. The disclaimer trust, discussed in §§20.27-20.33, is part of an estate plan in which the testator distributes property outright to the surviving spouse, who may then disclaim all or part of the gift to utilize the deceased spouse's credit shelter amount.

In this book, the term "bypass trust" is used to describe a type of trust that is also referred to by numerous other terms, *e.g.,* the "B trust," the "credit shelter trust," the "credit trust," the "family trust," and the "nonmarital trust."

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II. BYPASS TRUST

A. Purpose of Bypass Trust

§20.2 1. Using Estate and Gift Tax Credit to Shelter Applicable Exclusion Amount

The federal estate and gift tax system provides each United States citizen or resident with a total estate and gift tax credit ("applicable credit amount") of $1,455,800 in 2009. See IRC §2010(a). This credit permits a decedent to transfer up to $3.5 million in 2009 ("applicable exclusion amount"), excluding gifts that qualify for the annual exclusion under IRC §2503(b) and certain other gifts, without paying gift or estate tax, provided that lifetime transfers do not exceed the gift tax applicable exclusion amount of $1 million. IRC §2505(a). The estate tax is repealed in 2010 and restored in 2011 with an applicable credit amount of $345,800 and an applicable exclusion amount of $1 million. See table in §20.2A. For estate and gift tax rates, see §20.2B. For marital deduction planning considerations, see §20.2C.

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Source: Estate Planning/California Will Drafting/20 Bypass Trusts and Disclaimer Trusts/§20.2A a. Applicable Exclusion Amount

§20.2A a. Applicable Exclusion Amount

The following table shows the applicable exclusion amounts for the years 1999-2011 and thereafter, and a calculation of the tax credit amount that applies to each exclusion amount.

Year	*Applicable Exclusion Amount*	*Applicable Credit Amount*
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 and thereafter	$1,000,000	$345,800

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§20.2B b. Transfer Tax Rates

For decedents dying in 2009, the estate tax rate is 45 percent. For decedents dying after 2010, the tax rate ranges from 41 percent to a maximum of 55 percent. IRC §2001(c). As a result of the interaction between the tax rate table and the IRC §2505 gift tax applicable exclusion amount, gift taxes are imposed at rates between 41 percent (on amounts over $1 million) and the maximum estate tax rate.

In 2009, the maximum 45-percent estate tax rate applies to transfers in excess of $3.5 million. In 2010 (the year of estate tax repeal), the gift tax will be imposed at a flat rate of 35 percent on aggregate gifts in excess of $1 million. IRC §2502(a).

A separate estate tax table with a maximum rate of 20 percent shielding approximately the first $3 million of gross estate applies to decedents dying while in active service of the United States armed forces and victims of certain terrorist attacks. IRC §2201. See IRS Pub 3920, Tax Relief for Victims of Terrorist Acts; *Estate of Kalahasthi* (CD Cal 2008) 2008-2 USTC ¶50,506, 102 AFTR2d 5805.

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§20.2C c. Marital Deduction Planning Considerations

The following discussion assumes that neither spouse made lifetime taxable gifts that would reduce the available applicable exclusion amount at death. If the first spouse to die leaves all of his or her property to the surviving spouse in a form that qualifies for the marital deduction, the property will not be taxed in the deceased spouse's estate. The marital deduction, however, only defers estate taxation until the surviving spouse's death. At the survivor's death, the property will be taxed in his or her estate to the extent that the estate, as augmented by the marital deduction qualifying gift, exceeds the applicable exclusion amount. Thus, the testator's applicable credit amount will have been essentially wasted.

The primary purpose of a bypass trust is to shelter the testator's applicable exclusion amount from taxation in the surviving spouse's estate by holding property in such a manner that it does not qualify for the marital deduction and is otherwise not includable in the surviving spouse's estate. If the bypass trust qualifies as a qualified terminable interest property (QTIP) trust, the trustee will be directed not to make the QTIP election under IRC §2056(b)(7)(B)(v). See §20.16. The bypass trust will shelter less than the testator's applicable exclusion amount to the extent that the testator makes other devises of property that do not qualify for the marital or charitable deduction. If the amount is greater than the unused applicable exclusion amount reduced by other nondeductible devises, estate tax will be payable at the first death.

Use of the bypass trust should be considered whenever the combined estate of a married couple exceeds, or may exceed, the applicable exclusion amount. Of course, the testator may exclude the surviving spouse by simply leaving the applicable exclusion amount to other persons, either outright or in trust. The bypass trust itself may be created for beneficiaries other than the surviving spouse. Typically, however, the surviving spouse is a beneficiary of the bypass trust, along with the testator's children, so that the survivor may benefit from the property that constitutes the testator's applicable exclusion amount while taxation in the survivor's estate is minimized. Plans that intentionally trigger an estate tax liability at the first death are most commonly used in situations involving children by a prior marriage and a young surviving spouse.

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2. Using Bypass Trust in Coordination With Marital Deduction

§20.3 a. Application of Deceased Spouse's and Survivor's Applicable Credit Amounts

As discussed in chap 17, the federal estate and gift tax laws provide an unlimited deduction for estate and gift tax purposes for transfers by a United States citizen or resident to a United States citizen spouse. See IRC §§2056, 2523.

By combining the marital deduction with the bypass trust, property in the testator's estate worth up to the sum of both spouses' applicable exclusion amounts can pass to ultimate beneficiaries without being subject to federal estate taxes in either spouse's estate. In the bypass trust, the deceased spouse's applicable exclusion amount would be sheltered by his or her applicable credit amount and would not be included in the survivor's estate. Up to the amount of the surviving spouse's applicable exclusion amount of the marital deduction property received from the testator would be sheltered from estate taxation by application of the survivor's own applicable credit amount, assuming that the survivor had no other assets at death.

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§20.4 b. When Estate Is Small

When the combined assets of a married couple are less than the applicable exclusion amount (see §20.2A), creation of a bypass trust usually cannot be justified for tax reasons. Neither spouse will be subject to estate taxation in any case, and the income tax savings made by placing the property in trust will be negligible. See IRC §1(e)(2).

For small estates, however, a bypass trust may be desirable for reasons other than tax savings. For instance, a bypass trust may provide a means of surrogate financial management for an incapacitated spouse. A bypass trust may also enable the testator to designate remainder beneficiaries when the spouses have conflicting dispositional objectives, which may occur, *e.g.,* if there are children from previous marriages. Finally, a bypass trust may enable the testator to provide some degree of creditor protection to the surviving spouse.

A disadvantage of using a bypass trust that is not needed for estate tax purposes is that the trust assets will not receive a new IRC §1014 date-of-death tax basis on the death of the surviving spouse. A potential solution for this problem is the QTIPable bypass trust discussed in §20.18A.

Special care must be taken to fund the bypass trust. A formula clause may leave nothing to fund the marital trust. Unless that is one of the client's goals, funding the bypass trust by disclaimer may be more effective. See §17.48.

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§20.5 c. When Estate Is Large

In estates that exceed twice the applicable exclusion amount, one of the attorney's primary considerations is the extent to which estate taxation should be deferred until the death of the surviving spouse. A common estate planning technique combines a bypass trust and the unlimited marital deduction to defer all taxes at the death of the first spouse to die, regardless of the size of that spouse's estate. This requires the creation of a bypass trust to hold the amount sheltered by the federal applicable credit amount and a gift of the remainder of the decedent's estate to the surviving spouse in a form that qualifies for the unlimited marital deduction.

The advantage of this technique is that no federal estate tax is due at the death of the first spouse to die. Deferral of all estate taxation until the surviving spouse's death will not always be advantageous, however. For instance, if the first spouse to die had a significantly smaller estate than the surviving spouse, lower tax rates may apply to the smaller estate under IRC §2001, although the difference disappears for decedents dying in 2007-2009, when the tax rate is 45 percent on all estates in excess of the applicable exclusion amount, only to reappear in 2011 following a year of estate tax repeal in 2010. In such a case, a greater amount of taxes may be payable in the survivor's estate than the combined taxes that would have been payable if some taxes had been paid at the lower rates of the estate of the first spouse to die. Another disadvantage is that increased applicable exclusion amounts may result in the entire estate passing to the bypass trust. See §20.5A.

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Source: Estate Planning/California Will Drafting/20 Bypass Trusts and Disclaimer Trusts/§20.5A d. Increased Applicable Exclusion Amount Problems

§20.5A d. Increased Applicable Exclusion Amount Problems

Subject to a variety of possible adjustments, a bypass trust is generally funded with assets having a value equal to the applicable exclusion amount—the value of property that can pass without imposition of estate tax. Because IRC §2010 provides for increasingly large applicable exclusion amounts ($2 million in 2006-2008, $3.5 million in 2009), then a year of estate tax repeal, then an applicable exclusion amount of only $1 million, the plan drafter will not know the value of the property that will pass to this trust. In many cases the trust may end up receiving all assets not specifically devised to others. The plan drafter must make sure that the client's distribution objectives will be satisfied even if the bypass trust is unexpectedly large or small.

Consider, for example, the case of later-life second marriage in which one client has $3 million in assets and the other has virtually none. Suppose the wealthy client wishes to provide a $1 million gift to his children and grandchildren and leave the other $2 million to a trust benefiting the spouse for her lifetime—perhaps an IRC §2056(b)(7) QTIP trust for reasons described in §20.18A. In this situation, the marital deduction formula will not necessarily make the desired division of the wealthy client's estate. The drafter cannot simply provide that the entire bypass trust gift will pass to the children, because this could result in everything passing to the children. Instead, the terms of the bypass trust may need to provide that the bypass trust is to be divided into shares in some manner.

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§20.6 B. Formula Trust Funding

Funding of marital deduction and bypass trusts is most commonly created by formula provisions. For the advantages and disadvantages of various formulas, see §§17.46-17.89. If the surviving spouse fails to fund the bypass trust according to the formula, or misappropriates assets of the trust after funding, the assets that should have been allocated to the bypass trust may be included in the survivor's estate under IRC §2033. See *Estate of Hester v U.S.* (WD Va 2007) 2007-1 USTC ¶60,537, 99 AFTR2d 1288, aff'd (4th Cir 2008) 2008-2 USTC ¶60,568, 102 AFTR2d 6714, cert denied sub nom *Bishop v U.S.* (2009) 173 L Ed 2d 1158, 129 S Ct 2168 (misappropriated QTIP trust assets that otherwise would have been included in survivor's estate under IRC §2044 commingled with personal assets).

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C. Beneficiaries and Structure

§20.7 1. Bypass Trust Drafting Considerations

The attorney can draft a bypass trust to benefit the testator's surviving spouse, issue, or any other intended beneficiaries. The trust can provide for the distribution of all net income or for discretionary income payments to one or more beneficiaries. Principal can be payable at the trustee's discretion, when the beneficiaries reach particular ages, or on the occurrence of certain events.

If the surviving spouse will be the trustee, the drafter must take special care to avoid trustee powers that will constitute a general power of appointment in the survivor. See §20.9. Because the purpose of the bypass trust is to keep trust property out of the surviving spouse's estate, the surviving spouse or his or her estate should never be a remainder beneficiary.

In a typical family bypass trust, the surviving spouse and the couple's issue will be income beneficiaries, with distribution of the trust corpus to issue after the spouse's death. If someone other than the surviving spouse is the income beneficiary and the objective of the bypass trust is to prevent trust assets from being taxable in the beneficiary's estate at the time of his or her death, then the considerations discussed in §20.9 with reference to the surviving spouse apply to such a beneficiary.

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§20.8 2. Distribution of Entire Net Income or Fixed Amount

The trustee may be directed to distribute the entire net income of the trust each year, a fixed amount of income, or both principal and income. This type of distribution clause is common when there is only one current income beneficiary of the bypass trust, *e.g.,* the surviving spouse, one of the testator's children. If there is more than one current income beneficiary, the trustee is commonly given discretion to "sprinkle" income among the beneficiaries and to accumulate undistributed income. See §§21.11-21.12.

If the testator wishes to give a spouse-trustee a discretionary power to distribute, rather than a fixed amount, the power must be limited by an ascertainable standard to avoid the inclusion of trust property in the surviving spouse's estate. See §20.10.

For clauses providing for distribution of an annuity or unitrust amount, see §21.8. On periodic distribution considerations generally, see §§21.6-21.23.

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3. Discretionary Distributions: Avoiding Spousal General Power of Appointment

§20.9 a. Potential Inclusion of Trust Property

Because a major objective of the bypass trust is to keep trust property out of the surviving spouse's estate, the drafter should not give the survivor powers that constitute a general power of appointment as defined in IRC §2041(b) and Treas Reg §20.2041-1(c). A general power of appointment is a power that can be exercised in favor of the holder, the holder's estate or creditors, or the creditors of the holder's estate. If the survivor is deemed to have a general power of appointment, the trust property subject to that power will be included in the survivor's estate, thus defeating the purpose of the bypass trust.

For full discussion of general powers of appointment and their tax consequences, see chap 16.

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§20.10 b. When Spouse Is Trustee

Counsel must take particular care to limit powers when the surviving spouse acts as trustee of the bypass trust. Any provision for discretionary payments of principal and income from the bypass trust to the survivor should use an ascertainable standard to avoid giving the survivor a general power of appointment over property subject to a discretionary power. See IRC §2041. In addition to estate taxation in the surviving spouse's estate, the following consequences may result when the surviving spouse acts as trustee of the bypass trust:

- *Income taxation.* If the spouse is the sole trustee and may vest principal or income in himself or herself, he or she may be treated as the owner of the trust for income tax purposes whether or not payment of the principal or income is subject to an ascertainable standard. See IRC §678(a)(1). See §16.16.
- *Gift taxation.* A power to "sprinkle" income among other beneficiaries (*e.g.,* the testator's children) in the absence of an ascertainable standard may result in imposition of a gift tax. See Treas Reg §25.2511-1(g)(2). See §16.15.
- *Disclaimed property.* If the bypass trust will receive marital gifts disclaimed by the spouse-trustee, who will retain a discretionary power to distribute principal or income that is not limited by an ascertainable standard, the disclaimer will not be qualified. See IRC §2518(b)(4); Treas Reg §25.2518-2(e)(2). See §20.30.

As discussed in §16.19, a power will not be considered a general power if it is limited by an ascertainable standard. A limitation qualifies as an ascertainable standard if it is stated in terms of the beneficiary's need for support, health, maintenance, or education. For example, discretion limited by what the trustee reasonably considers "necessary for support, health, and education" is an ascertainable standard, but discretion limited by what the trustee considers "appropriate for comfort, welfare, and happiness" is not. See Treas Reg §20.2041-1(c)(2).

For clauses providing for discretionary distribution limited by an ascertainable standard, see forms 20.22-1, 20.26A-1, 20.33-1.

If maximum flexibility in the distribution of trust assets is desired, the client should consider naming a special trustee to exercise the powers. If there is a special trustee with broad distributive powers, not subject to an ascertainable standard, the surviving spouse should not be given the power to remove the trustee and appoint himself or herself in place of the independent trustee. Such a power in the surviving spouse may constitute a general power of appointment. Treas Reg §§20.2036-1(b)(3), 20.2041-1(b)(1).

For further discussion of the power to remove the trustee, see §16.26. For a clause providing for broad distributive powers by a special trustee, see form 28.41-1.

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§20.11 c. Consent to Discretionary Distribution by Person With Adverse Interest

If the spouse's power to distribute for his or her own benefit without an ascertainable standard requires the consent of a person having a substantial interest in the trust that is adverse to the surviving spouse's interest, the spouse's power will not be considered a general power of appointment. See IRC §2041(b)(1)(C). However, even if the bypass trust provides for persons with adverse interests (*e.g.,* children who are named as remainder beneficiaries) to act successively as cotrustees with the spouse, such persons may predecease the beneficiary or otherwise cease to be available to give the requisite consent. Therefore, when the spouse is trustee or cotrustee, the prudent drafter will limit the power to distribute by an ascertainable standard. If the testator does not wish to limit the discretionary distribution power, it should be exercisable only by trustees other than the spouse to avoid the risk of including the bypass trust in the spouse's estate. See §28.9 on the independent trustee; §16.18 on joint exercise by a person with an adverse interest.

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§20.12 d. Distribution to Persons to Whom Spouse Owes Duty of Support

A power of appointment that may be exercised to discharge the donee's legal obligation of support is a power exercisable in favor of the donee or his or her creditors and, therefore, is a general power of appointment. Treas Reg §20.2041-1(c)(1). If the testator wishes that the spouse act as a trustee and that there be discretionary distribution to beneficiaries to whom the spouse may owe a duty of support (*e.g.,* the couple's minor children), the drafter should include a provision expressly precluding the trustee from discharging his or her obligation to support a beneficiary by distribution of trust property. Alternatively, the trust may require the surviving spouse to choose a special trustee who will have the exclusive power to make all decisions involving distribution or allocation to such a beneficiary, as discussed in §16.25.

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e. Principal Invasion Powers

§20.13 (1) Limitation by Ascertainable Standard or "Five or Five" Power

As discussed in chap 16, a surviving spouse's power to invade trust principal for his or her own benefit, whether or not the survivor is a trustee of the bypass trust, will be considered to be a general power of appointment causing inclusion in the powerholder's estate, unless the power is limited by an ascertainable standard. See IRC §2041(b)(1)(A). Alternatively, the survivor may be given the power to invade principal for any reason if the invasion power is limited in any calendar year to the greater of $5000 or 5 percent of the value of the principal at the time the power lapses (*i.e.,* a "five or five" power). See IRC §2041(b)(2); Treas Reg §20.2041-3(d)(3). Because the portion of the trust subject to withdrawal by the surviving spouse in the year of death will be includable in the surviving spouse's estate, part of the tax benefit of the bypass trust may be lost using a five or five power, although the risk of inclusion can be minimized. See §16.14. For a form of five or five power that does this, see form 21.31-1.

If there is an independent trustee and the spouse has no right to invade principal, a broad discretion to invade principal for the spouse's benefit may be given to the trustee. See IRC §2041(b)(1)(A). See chap 16 on creation of powers of appointment; §28.8 on "tax-sensitive" trustees.

Whenever power is given to invade bypass trust principal for the surviving spouse, the drafter should consider a provision requiring that, before the power can be exercised, the principal of the marital trust must be exhausted. See §20.14.

For full discussion of invasion of principal powers, see §§21.28-21.36. On income tax considerations of powers to invade principal, see §16.16.

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§20.14 (2) Exhaustion of Marital Trust Principal

The will may provide that the principal of the marital trust must be exhausted before distribution of principal is made to the surviving spouse from the bypass trust. Such a provision will tend to reduce the surviving spouse's taxable estate, which will include whatever remains of the marital trust at the surviving spouse's death. The trust estate of the bypass trust will pass free of the estate tax. Therefore, if a power to invade principal is provided in the bypass trust, the drafter should consider adding a provision that makes exhaustion of marital trust principal a precondition to distribution of bypass trust principal. See form 20.23-1. However, such a clause may be undesirable if there is a substantial possibility that no estate tax will be owed on the survivor's death. In such cases, it may be desirable to increase the size of a QTIP trust and reduce the size of the bypass trust in order to increase the value of property that will receive a new date-of-death value basis under IRC §1014. Given the uncertainties regarding the future of the estate tax, it will often be best to avoid such a provision and leave matters to the discretion of the trustee.

Payments of principal to any beneficiary other than the surviving spouse during the survivor's lifetime should be made only from the bypass trust. Otherwise, the marital deduction will be lost. See §§18.8, 19.7.

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§20.15 4. Surviving Spouse's Special Power of Appointment

The surviving spouse may be given a special or limited (*i.e.,* nongeneral) power of appointment, which will allow the spouse to appoint the bypass trust property in favor of a defined class of people. If the class does not include the surviving spouse, his or her estate, his or her creditors, or the creditors of his or her estate, the appointment power will not cause inclusion of the trust principal in the survivor's estate. See IRC §2041(b)(1); Treas Reg §20.2041-1(c)(1)(a). For example, the power to appoint the bypass trust to any of the decedent's issue will permit the surviving spouse to vary the remainder interests of the bypass trust in light of circumstances arising after the decedent's death. If, however, the surviving spouse owed a duty of support to a member of the class to whom trust property is appointed, the power may constitute a general power of appointment for purposes of IRC §2041. See §20.12.

For special powers of appointment clauses, see chap 16.

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§20.16 5. Similarity to Qualified Terminable Interest Property Trust

A bypass trust in which the surviving spouse is the sole lifetime income beneficiary may resemble a marital deduction qualified terminable interest property (QTIP) trust. See chap 19. If the testator's executor were to elect under IRC §2056(b)(7)(B)(v) to qualify the trust as a QTIP trust, the trust property would be included in the survivor's estate, thus defeating the purpose of the bypass trust.

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§20.17 6. Allocation of Generation-Skipping Transfer (GST) Exemption

If the bypass trust is drafted to split benefits between beneficiaries in two or more generations younger than the decedent's generation, the assets may be subject to a generation-skipping transfer (GST) tax. See IRC §§2601-2613. A GST tax will not be imposed when the beneficiaries are the surviving spouse or the surviving spouse and the children of the decedent. For full discussion of GST tax considerations, see chap 15.

As discussed in §§15.31-15.32 and 19.13, planning for maximum use of the GST exemption involves allocating the exemption between the bypass trust and the reverse qualified terminable interest property trust.

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§20.18 7. Distribution of Trust Property at Death of Surviving Spouse

At the surviving spouse's death, the bypass trust may terminate and trust assets may be distributed to another trust or outright to named beneficiaries or a class of beneficiaries. Alternatively, the bypass trust may be combined with assets from, *e.g.,* the marital deduction trust to form a new trust, usually for the benefit of the surviving children. See, *e.g.,* Drafting California Revocable Trusts §§14.21-14.27 (4th ed Cal CEB 2003) for discussion of bypass trust distribution options.

In this book, the bypass trust terminates on the date of the surviving spouse's death, and the trust assets are distributed according to the dispositive provisions in form 20.26-1.

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§20.18A 8. QTIPable Bypass Trust

In some cases it may be appropriate to provide a bypass trust with distribution terms that will give the executor of the deceased spouse the option of making an IRC §2056(b)(7) qualified terminable interest property (QTIP) election for all or a portion of the bypass trust. The strategy is particularly appropriate if there is a substantial possibility that inclusion of the bypass trust in the surviving spouse's estate will not result in the estate being liable for estate tax. If the facts known at death confirm that the survivor's estate probably will not pay estate tax, the executor of the deceased spouse will make the QTIP election in the hope that the resulting IRC §2044 inclusion of the trust assets in the survivor's estate will result in a new IRC §1014 date-of-death income tax basis on the survivor's death. A form of QTIPable bypass trust is provided in §20.26A.

If estate plan will provide for the creation of a QTIP trust in any event, the objectives of a QTIPable bypass trust can be accomplished by simply creating the QTIP trust and providing that a partial election will result in the division of the two trusts. See §§19.21-19.31. In such cases it is not necessary to use a marital deduction formula to determine the sizes of the two trusts, although some planners believe the formula should be used in any event as modest protection against the risk of an accidental QTIP election for the entire trust. If the estate plan makes the marital deduction gift in the form of a transfer to the spouse or a survivor's trust, a marital deduction formula will be used to establish the size of the bypass trust.

A significant drawback to using a QTIPable bypass trust involves the difficulty of providing benefits for persons other than the spouse. In order to qualify as a QTIP trust, a trust must provide all income to the spouse for life and no person can have a power to appoint property to anyone other than the spouse during the life of the spouse. IRC §2056(b)(7)(B)(ii). This limitation is unavoidable for any portion of the trust for which the election is made. To a limited extent it now appears possible to provide different distribution terms for all or any portion of the trust for which the election is *not* made. See §17.42. Accordingly, the trust instrument can provide the required limited distribution terms, but further provide that different distribution terms will apply for any portion of the trust for which the election is not made. If a trust contains such an alternate disposition, the drafter should consider giving an independent person the power to determine the extent to which the executor will make the QTIP election. Otherwise, there is a risk that the IRS could argue that an election decision has resulted in a gift. For example, if the spouse is the executor and gives up the mandatory income interest as a result of a decision to forego the QTIP election, it might be argued that the spouse has made a gift of that income interest. This result presumably can be avoided by naming an independent trustee/executor or by requiring the trustee/executor to follow the dictates of a nonbeneficiary in making the QTIP election decision.

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Source: Estate Planning/California Will Drafting/20 Bypass Trusts and Disclaimer Trusts/ D. Bypass Trust Forms/§20.19 1. Form: Introduction to Bypass Trust

D. Bypass Trust Forms

§20.19 1. Form: Introduction to Bypass Trust

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20.19-1 Introduction to bypass trust

The trustee shall hold, administer, and distribute all property allocated to the bypass trust as follows:

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§20.20 2. Form: Designation of Beneficiaries

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20.20-1 Designation of beneficiaries

The beneficiaries of this trust are listed below:

Income beneficiary: _ _[*Name*]_ _, my spouse
Principal beneficiary: Class composed of my spouse and my descendants

Comment: If the income beneficiaries include the testator's descendants as well as the surviving spouse, the identification of the income beneficiary should be the same as that for the principal beneficiary. The class of beneficiaries can, of course, be expanded to include whomever the testator directs.

If the spouse will be one of the principal beneficiaries, the drafter should ensure that appropriate restrictions are imposed on the spouse's power to invade principal. Otherwise, the survivor may be considered to have a general power of appointment. See §20.9. See also Alternative 3 in form 20.21-1 and Alternative 1 in form 20.22-1.

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§20.21 3. Form: Payment of Income

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20.21-1 Payment of income

[*Add one of the following alternatives*]

[*Alternative 1: Payment of all net income*]

Income to Spouse for Life. **The trustee shall pay to or apply for the benefit of my spouse all the net income of the trust in convenient installments at least annually.**

[*Alternative 2: Payment of income as requested*]

Income to Spouse for Life. **During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Undistributed income shall be added to principal.**

[*Alternative 3: Income to be sprinkled (ascertainable standard)*]

Income to Spouse for Life. **The trustee shall pay to or apply for the benefit of my spouse as much of the net income as the trustee considers necessary for my spouse's health, education, support, or maintenance to maintain my spouse's accustomed manner of living. The trustee shall add to principal any undistributed net income.**

[*Alternative 4: Income to be sprinkled (broad standard)*]

Income to Spouse for Life. **The trustee shall pay to or apply for the benefit of my spouse as much of the net income as the trustee considers necessary for my spouse's health, education, support, maintenance, comfort, welfare, or happiness to maintain at a minimum my spouse's accustomed manner of living. The trustee shall add to principal any undistributed net income.**

Comment: The mandatory payment of income to the spouse as provided by Alternative 1 in form 20.21-1 is generally undesirable if the spouse may not need the income. The addition of income to the spouse's estate would defeat the purpose of the bypass trust. As an alternative, the spouse may be given a "five or five" withdrawal power. See §20.13. For a form of "five or five" withdrawal power, see form 21.31A-1.

This provision gives the surviving spouse an unrestricted right to withdraw 5 percent of the trust principal each year. If there is no separate disposition of income, the instrument should provide for adding income to principal. Typically a "five or five" withdrawal power is used in conjunction with a provision that permits the trustee to make discretionary distributions to the spouse for health, education and support. See Alternative 1 in form 20.22-1.

When sprinkling powers are used and the spouse is also a principal beneficiary, the same standard should be used for distributions of both principal and income if there is a separate disposition of income. This effectively eliminates the need to distinguish between principal and income. The broad standard provided by Alternative 4 in form 20.21-1 and Alternative 2 in form 20.22-1 may not be used if the spouse is both the trustee and a principal beneficiary. For discussion of principal and income, see chap 30.

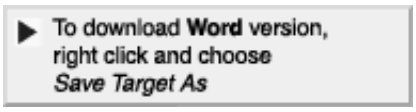
If the spouse serves as trustee and owes a duty of support to any of the beneficiaries to whom income may be "sprinkled," the trust should include a provision precluding discharge of the duty to support or appointing a special trustee to distribute trust property to such beneficiaries (see §28.9). See §20.12. If the surviving spouse is not the only income beneficiary, the clause should be modified accordingly.

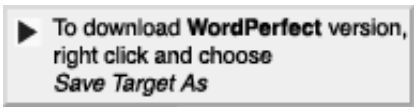
See §§21.15-21.16 for trustee guidelines on the relevance of a beneficiary's other resources in making discretionary distributions.

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Source: Estate Planning/California Will Drafting/20 Bypass Trusts and Disclaimer Trusts/§20.22 4. Form: Distribution of Principal

§20.22 4. Form: Distribution of Principal





20.22-1 Distribution of principal

[*Add one of the following alternatives*]

[*Alternative 1: Ascertainable standard*]

If the trustee considers the income to be insufficient, the trustee shall pay to or for the principal beneficiary as much of the principal as the trustee considers necessary for the principal beneficiary's health, education, support, or maintenance to maintain the principal beneficiary's accustomed manner of living.

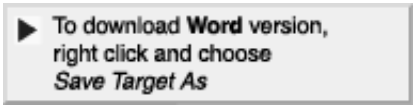
[*Alternative 2: Broad standard*]

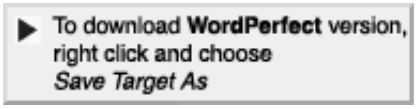
If the trustee considers the income to be insufficient, the trustee shall pay to or for the principal beneficiary as much of the principal as the trustee considers necessary for the principal beneficiary's health, education, support, maintenance, comfort, welfare, or happiness to maintain at a minimum the principal beneficiary's accustomed manner of living.

Comment: See §§21.15-21.16 for trustee guidelines on the relevance of a beneficiary's other resources in making discretionary distributions. The broad standard may not be used if the spouse is both the trustee and a principal beneficiary.

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§20.23 5. Form: Exhaustion of Marital Deduction Trust Principal Before Bypass Trust Principal Is Invaded for Surviving Spouse's Benefit





20.23-1 Exhaustion of marital deduction trust principal

Payments from principal to my spouse shall not be made from the bypass trust until the marital deduction trust has been exhausted, and afterwards from the bypass trust.

Comment: This clause may be undesirable from a tax perspective if there is a significant possibility that no estate tax will be payable on the death of the surviving spouse. See §20.14.

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§20.24 6. Form: Surviving Spouse's Special Power of Appointment

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20.24-1 Spouse's lifetime special power of appointment

At any time during my spouse's life, the trustee shall distribute all or any part of the trust (including accrued income and undistributed income) to one or more of the groups listed below, on terms and conditions (outright, in trust, or by creating further powers of appointment) as my spouse shall appoint in an acknowledged document specifically referring to and exercising this power of appointment.

Beneficiaries: Group composed of my descendants and their spouses, including widows and widowers

Comment: See §§16.37-16.38 for other powers of appointment clauses.

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§20.25 7. Form: Disclaimer of Trust Interest; Distribution Provisions

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20.25-1 Disclaimer of trust interest; distribution provisions

If my spouse disclaims the right to income with respect to all or a fractional share of the bypass trust without disclaiming rights to principal, the income so disclaimed shall be added to principal and the trustee shall pay to my spouse as much of the trust property as the trustee in its discretion determines is appropriate for my spouse's health, education, support, and maintenance. In exercising its discretion, the trustee may consider other income and resources available to my spouse to such extent, if any, as the trustee deems appropriate.

If my spouse effectively disclaims all my spouse's beneficial interest in all or any portion of this trust, the trustee shall distribute the trust, or the portion of the trust that corresponds to the disclaimed interest, according to the distribution provisions in paragraph _ _[*number*]_ _.

Comment: This form permits the surviving spouse to separately disclaim the right to income and the right to discretionary distributions of principal. See form 20.26-1 for distribution provisions.

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§20.26 8. Form: Distribution at Surviving Spouse's Death

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20.26-1 Distribution at surviving spouse's death

At my spouse's death, the trustee shall distribute the remaining trust estate to _ _[*name of trust, beneficiary, or class of beneficiaries*]**_ _.**

Comment: See chap 22 for discussion of trusts for children, who are typical distributees of trust property at the survivor's death. Alternative dispositions may be made to named beneficiaries or to classes of beneficiaries. See chap 12 on outright gifts.

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§20.26A 9. Form: QTIPable Bypass Trust

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20.26A-1 Distribution during spouse's lifetime

After my death, the entire net income of the bypass trust shall be paid to my spouse during my spouse's entire lifetime in convenient installments at least annually. In addition, the trustee may pay or apply for the benefit of my spouse such amounts of principal as the trustee considers appropriate for my spouse's health, education, support, and maintenance. No person shall have the power to appoint any part of the trust property to any person other than my spouse. Notwithstanding any other provision of the trust, my spouse shall have the power to require that the trustee make unproductive property productive or convert it to productive property within a reasonable time. Notwithstanding the foregoing, trust income earned between the last distribution date and the date of my spouse's death shall not be distributed to my spouse or my spouse's estate but shall instead be distributed along with the other assets of the trust estate to _ _[*name of trust, beneficiary, or class of beneficiaries*]**_ _.**

In the event the Internal Revenue Code §2056(b)(7) QTIP election is not made for all or any portion of the bypass trust within the time required by law, the foregoing distribution provisions shall cease to apply and the bypass trust shall thereafter be distributed as follows: _ _[*describe*]**_ _.**

Comment: For a discussion of this form, see §20.18A. If the form is used, the drafter should add form 19.30A-1. That form *permits* division of the trust in the event of a partial QTIP election. If partial election will result in one portion of the trust having different distribution provisions than the other portion, the form should be modified to make division mandatory.

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III. DISCLAIMER TRUST

A. Use of Disclaimer Trust

§20.27 1. Purpose of Disclaimer Trust

In the context of marital deduction planning, a disclaimer trust is a trust that will be created if a surviving spouse disclaims a transfer of property from the deceased spouse to the surviving spouse (or a survivor's trust that is revocable by the survivor). In the absence of an express provision for such a trust, any property disclaimed by the surviving spouse would typically pass immediately to younger generation beneficiaries—a fact that might discourage the spouse from making the disclaimer. In some cases, a disclaimer trust is used as a substitute for a formula clause bypass trust. In these cases the purpose of the trust is to make use of the deceased spouse's applicable exclusion amount. In other cases, the disclaimer trust is used in addition to a regular bypass trust in order to more evenly divide the estates and, perhaps, take advantage of the IRC §2013 previously taxed property credit. This can be particularly useful if it becomes obvious shortly after the death of the first spouse that the second spouse will die soon. See §17.42.

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§20.28 2. Disclaimer Trust Problems

The use of a disclaimer trust in lieu of a marital deduction formula bypass trust can be an alluring option in cases where it is uncertain whether the assets of the surviving spouse will otherwise have a value in excess of the estate tax applicable exclusion amount. See §20.2. Given uncertainties concerning tax laws and client wealth, it may seem desirable to postpone issues concerning the size of the bypass trust until the first death. In assessing this strategy, it is important to consider that (1) disclaimer trusts are relatively useless in cases in which the first spouse to die will want to benefit persons who are not the natural objects of the bounty of the surviving spouse; (2) there is always a risk that there will be a failure to make an effective disclaimer within the IRC §2518(b)(2) time limit—particularly if the survivor is infirm or there is a failure to seek immediate tax advice because it is obvious that no tax will be imposed on the estate of the deceased spouse; (4) there is a risk that a right to make a disclaimer will be inadvertently waived by acts constituting an "acceptance" of the disclaimed property that is prohibited by IRC §2518(b)(3); and (5) a surviving spouse cannot be given a power of appointment over the remainder of a disclaimer trust. Treas Reg §25.2518-2(e)(2).

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§20.29 3. Providing for Spouse's Beneficial Use of Disclaimed Property

To constitute a qualified disclaimer, the entire disclaimed interest must pass to a person other than the disclaimant. IRC §2518(b)(4)(B). A special exception, however, is made for the spouse of the donor. The spouse may make a qualified disclaimer of a gift and still receive benefits in the disclaimed property. IRC §2518(b)(4)(A); Treas Reg §25.2518-2(e)(2).

To take advantage of the spouse's right to retain an interest in disclaimed property that will be kept out of his or her estate, the will should provide that the disclaimed property passes into a trust of which the spouse is a lifetime beneficiary. See Prob C §282(a) (testator may provide for specific disposition in event of disclaimer). If the testator fails to provide for disposition of the disclaimed property, it will pass as though the disclaiming spouse had predeceased the decedent. See Prob C §282(a).

Without a provision ensuring the surviving spouse's beneficial enjoyment of the disclaimed property, the spouse may be unwilling to make the disclaimer despite the estate tax savings that would result for ultimate beneficiaries. The will can also provide that if the spouse disclaims his or her interest in the "disclaimer trust," the property will pass as if the spouse had predeceased the decedent. See form 20.33-1.

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B. Elements of Disclaimer Trust

§20.30 1. Limiting Discretionary Distributions by Surviving Spouse-Trustee

The disclaiming spouse may be the lifetime beneficiary, or one of several beneficiaries, of a disclaimer trust. In addition, the spouse may even act as trustee. For the disclaimer to qualify, however, the surviving spouse may not retain the right, as trustee or otherwise, to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to federal estate and gift tax. Therefore, any discretionary powers held by the spouse to distribute or appoint trust property must be limited by an ascertainable standard. Treas Reg §25.2518-2(e)(2); Treas Reg §25.2518-2(e)(5), Examples (4)-(6). The spouse also may not retain an income interest in the property and disclaim only the remainder interest. Treas Reg §25.2518-3(b). See *Walshire v U.S.* (8th Cir 2002) 288 F3d 342. Apparently, the spouse may retain a noncumulative "five or five" withdrawal power over the disclaimed property. See Treas Reg §25.2518-2(e)(5), Example (7).

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§20.31 2. Disqualification by Special Power of Appointment

If the surviving spouse has a nongeneral power of appointment over the disclaimed assets that is not subject to an ascertainable standard, the disclaimer will not qualify. If a special power of appointment is itself disclaimed, however, the requirements for a qualified disclaimer may be met. See Treas Reg §25.2518-2(e)(5), Example (5).

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§20.32 3. Bypass Trust as Recipient of Disclaimed Property

The bypass trust itself can be designed as the recipient of the surviving spouse's qualified disclaimer if the trust is structured to meet the requirements for a qualified disclaimer. If the disclaimed portion of a marital gift will be used to fund a bypass trust that gives the survivor powers to direct beneficial enjoyment of trust property that are not limited by an ascertainable standard, the surviving spouse must disclaim these powers to comply with the qualified disclaimer provisions. See §20.30.

If the testator wishes the surviving spouse to have powers over property in the bypass trust that are incompatible with the qualified disclaimer requirements, then a separate disclaimer trust, meeting those requirements, should be established. Further, there is no point in providing that disclaimed property passes to a bypass trust that benefits persons the survivor will not want to benefit. This will deter the survivor from making the disclaimer regardless of tax considerations. In *Estate of Leona Engelman* (2003) 121 TC 54, the court held that the survivor's personal representative could not make a qualified disclaimer to fund the disclaimer trust because the survivor's exercise of a power of appointment over the survivor's trust resulted in an acceptance of property passing to that trust from the deceased spouse's estate. The survivor's disposition differed significantly from the disposition provisions of the disclaimer trust.

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§20.32A 4. Disclaimer Trust as Sole Trust After First Death

In some cases a disclaimer trust is used as an alternative to a bypass trust for the purpose of taking advantage of the deceased settlor's applicable exclusion amount and reducing the size of the survivor's taxable estate. Generally, this is desirable only when it is very unlikely given the age of the spouses and scheduled increases in the applicable exclusion amount that the spouses' estates will pay any estate tax. In that context the disclaimer trust is a useful protection against the modest possibility that one of the spouses unexpectedly will die before the scheduled increases take effect or the spouses will acquire enough property in the meantime to create an estate tax problem, or the possibility that the scheduled increases will not take effect.

For larger estates, there are a number of disadvantages to using a disclaimer trust as an alternative to a bypass trust. The disadvantages include the risk that there will be an inadvertent failure to meet the stringent IRC §2518 requirements for a valid disclaimer. See §20.28.

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Source: Estate Planning/California Will Drafting/20 Bypass Trusts and Disclaimer Trusts/§20.33 C. Form: Disclaimer Trust

§20.33 C. Form: Disclaimer Trust

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20.33-1 Disclaimers by surviving spouse

DISCLAIMERS BY SURVIVING SETTLOR

A. *Purpose of Disclaimer Trust.* This Division is intended to preserve the possibility that taxes can be saved on my death if my spouse makes a disclaimer of property otherwise passing to her. My spouse is not required to make a disclaimer of any property but it is my hope that my spouse will consult a competent tax professional promptly after my death to inquire whether a disclaimer might be beneficial.

B. *Establishment of Disclaimer Trust*. If my spouse makes a qualified disclaimer of any property passing to her as a result of my death, the disclaimed property shall be held be distributed to the trustee of "the Disclaimer Trust" and administered and distributed as provided in this Division of my will.

C. *Trustee*. My spouse shall be the trustee of the Disclaimer Trust. If my spouse fails to qualify or ceases to act, and fails to nominate a successor, _ _[*name*]_ _ shall be the trustee. Each trustee of this trust shall have the power to name the trustee's successor.

D. *Distributions During Spouse's Lifetime.* During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse all of the trust income in quarter-annual or more frequent intervals, plus as much of the principal as the trustee in its discretion determines is appropriate for my spouse's health, education, and support. In exercising its discretion, the trustee may take into account other income and resources available to my spouse to such extent, if any, as the trustee deems appropriate.

C. *Spouse's Disclaimer of Mandatory Income Interest*. If my spouse also disclaims the right to receive mandatory income distributions from the Disclaimer Trust without disclaiming rights to principal, income shall be added to principal and the Trustee shall pay to my spouse as much of the trust property as the trustee in its discretion determines is appropriate for my spouse's health, education, and support. In exercising its discretion, the trustee may consider other income and resources available to my spouse to such extent, if any, as the trustee deems appropriate.

D. *Spouse's Disclaimer of All Rights in Disclaimer Trust*. If my spouse disclaims all rights to principal and income with respect to all or a fractional share of the Disclaimer Trust, the property so disclaimed shall be distributed in the manner provided in the next paragraph, except that solely for the purpose of applying the survivorship requirements in the next paragraph, my spouse will be deemed to have died on the date of my death.

E. *Distribution on Spouse's Death.* On the death of my spouse, the remaining trust property shall be distributed as follows: _ _[*Specify*]_ _

F. *Trustee Powers*. The trustee of the Disclaimer Trust shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.

G. *Exculpation of Trustee.* The trustee of the Disclaimer Trust, shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in the business of acting as a trustee.

Comment: The trustee powers provision in paragraph F is based on form 29.8-1. The exculpation provision in paragraph G is based on form 28.48-1.

Because it is unlikely that a surviving spouse will make a disclaimer unless the terms of the of the disclaimer trust are highly favorable to the spouse. Accordingly the drafter may recommend that the spouse be given a "five or five" withdrawal power in addition to rights to all income and liberal discretionary principal withdrawal. See form 21.31A-1. The regulations expressly allow inclusion of a "five or five" power in a disclaimer trust. Treas Reg §25.2518-2(e)(5), Example (7).

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21

Overview of Trust Distributions

Gordon A. Schaller
Timothy J. Kay

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/ I. FORMAT OF TESTAMENTARY TRUSTS/§21.1 A. Trust Distribution Planning

I. FORMAT OF TESTAMENTARY TRUSTS

§21.1 A. Trust Distribution Planning

This chapter contains:

- An overview of the design of the testamentary trust;
- A guide to the chapters in this book discussing the various segments of the trust;
- A general analysis of trust distribution and termination clauses and a guide for determining whether a proposed trust constitutes a specialized trust that requires specific distribution and termination provisions;
- Checklists for gathering the information necessary for planning the trust in general and for planning a standard trust's distribution and termination clauses in particular; and
- Forms for standard distribution and termination clauses, with accompanying discussion of their use.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.2 B. Standard Testamentary Trust Format

§21.2 B. Standard Testamentary Trust Format

Testamentary trusts are created as discrete subsections of wills. A will may contain several trusts or no trusts. These trusts may be substantially identical to continuing trusts created by a revocable trust that becomes irrevocable on the death of the settlor. A trust may have one or several beneficiaries. A trust may be "certain" (to commence when funded by a direct grant of property under the will) or "contingent" (to operate only if described conditions arise, *e.g.,* a child's trust that operates only if the child is below a certain age at the surviving spouse's death). The trust's term will be as provided in the will, limited only by the rule against perpetuities (see chap 34).

Although a variety of trusts can be created, standard trust formats have developed as a matter of custom, to promote comprehensive and efficient drafting. Typically, a testamentary trust consists of the following segments:

- *Gift to the trust.* This segment is not found in the trust itself but in the body of the will before the trust subsection or in the body of one trust from which the property will be transferred to another trust. For sample clauses, see, *e.g.,* §§17.53, 17.56, 28.13.
- *Introductory sentence.* The introductory sentence announces the beginning of the will's trust subsection, which is also designated by article or paragraph number and title. The following is a common introductory sentence: "The trustee shall hold, administer, and distribute all property allocated to _ _[*trust name or designation, e.g., the children's trust*]_ _ as follows:. …"
- *Beneficiary identification.* This segment names the persons who will receive distributions of trust income and principal before trust termination, as in the following: "The beneficiaries of this trust are: Income beneficiaries: _ _[*Names*]_ _; principal beneficiaries: _ _[*Names*]_ _" The remainder beneficiaries (*i.e.,* those who will receive the remainder of the trust principal and accrued undistributed trust income when the trust terminates) are sometimes also named in this segment. In this book, however, the identification of these beneficiaries occurs in the sections on trust termination and final distribution. See §21.38.
- *Instructions for distribution of trust income and principal.* This segment specifies the amounts and frequency of distributions, the identity of the beneficiaries to whom distribution will be made, and (if distribution is discretionary) any standards governing the trustee's discretion to distribute. For discussion of trust distribution clauses in various trust types, see chaps 14 (charitable trusts), 17-20 (marital deduction, bypass, and disclaimer trusts), 22 (children's trusts), and 23 (special needs trusts).
- *Instructions for trust termination.* This segment describes when the trust will terminate and to whom and how the trust remainder will then be distributed. See §§21.37-21.38 for detailed discussion and examples of termination clauses.
- *Office of trustee.* After naming the trustee and any alternates and special trustees, this segment describes the conduct of the trustee in relation to the trust (*e.g.,* corporate trustee's self-dealing, trustee's duty to account) and the trustee's bonding and compensation. See chap 28 for discussion and sample clauses.
- *Trustee asset management powers.* Chapter 29 discusses and provides sample clauses for this trust segment, which grants or restricts trustee powers to, *e.g.,* purchase, sell, and otherwise invest in assets on behalf of the trust or engage in business.
- *Trustee accounting powers and duties.* This series of clauses defines what is principal and income for the trust, provides rules for amortization and depreciation, and allocates certain expenses among beneficiaries. The powers may comprise part of the same segment as the trustee management and administrative powers or be organized as a separate segment. Chapter 30 discusses and provides sample clauses for these powers.
- *Trustee administrative powers.* These clauses describe how the trustee will allocate assets on distribution (*e.g.,* prorata or nonprorata, whether the trustee will consider the tax bases of the assets). When relevant, the segment may permit joint management of the assets of separate trusts or trustee termination and distribution of the assets of a very small trust. The powers may be found in the same segment as the trustee management and accounting powers or in a separate segment. Chapter 31 provides sample clauses for these powers.
- *Miscellaneous clauses.* This segment contains the statement that trustee powers are exercisable only in the

trustee's fiduciary capacity, the perpetuities savings clause (if needed), choice of law, and the like. (Definitions of terms used in the trust (*e.g.,* "issue," the "spendthrift" clause) provided elsewhere in the will apply to the trust unless otherwise stated.) For discussion and sample clauses, (some miscellaneous trust clauses), chap 34 (rule against perpetuities).

NOTE: The terminology for trustee powers and duties varies among practitioners. For example, what the authors of this book call "management powers" are often called "administrative powers." The information provided in the various powers clauses is fairly standard in most trusts, however. For instance, powers given to the trustee in relation to real property management will always include the power to rent, unless that power is specifically omitted.

The major difference among sets of trustee powers clauses is the degree of detail provided and the topics covered, *i.e.,* whether the drafter uses a "long" or "short" set of trustee powers and duties. On the one hand, the powers provided in chaps 29-31, selected as appropriate to the trust and organized into sets, make up a fairly "long" set of powers. A "short" set, on the other hand, may be found in §29.60. In that set, fewer powers are granted because of the less extensive set of properties likely to be managed, accounted for, and distributed by the trustee; some of the powers clauses are shorter adaptations of clauses found in chaps 29-31.

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II. DRAFTING DISTRIBUTION AND TERMINATION CLAUSES

§21.3 A. Determining Whether Trust Has Specialized Requirements

This chapter provides information for drafting distribution clauses for standard trusts in which specialized distribution clauses are *not* required.

The drafter must select other distribution clauses, or apply the standard trust's clauses only after careful thought, when the trust's beneficiary is a charity, a minor, or a disabled person eligible for public benefits, and in trusts designed to qualify assets for the marital deduction. Thoughtful drafting of distribution and termination clauses is essential to achieve the objectives of the specialized trust and to avoid exposing the trustee and beneficiary to adverse financial consequences and the practitioner to liability for malpractice. These considerations apply equally to similar distribution clauses in a funded revocable trust.

To determine whether a trust is a specialized trust, the drafter should ask whether:

- A trust beneficiary is a charity (see chap 14);
- The trust contains a marital deduction provision (see chaps 17-19);
- The trust is a bypass or disclaimer trust (see chap 20);
- The trust beneficiary is a child (see chap 22); or
- The trust beneficiary is a disabled individual who is or may become eligible for public benefits (see chap 23).

If a trust is a specialized trust, the drafter should still review the drafting checklist in §21.5 for information that must be included in distribution clauses and suggested variations in those clauses. After reviewing the checklist, however, the drafter should consult the chapter in this book that applies to the appropriate specialized trust for information on drafting specific distribution and termination clauses. The drafter also should consider the income tax consequences of distributions to the beneficiaries. See chap 23A.

If the trust will not be a specialized trust, the drafter should use the checklist in §21.5 as the first step in planning the trust and designing its clauses. Although the checklist is designed for use during the client interview, it can also be used as a postinterview drafting checklist.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/ B. Collecting Information/§21.4 1. Checklist: Trust Information

B. Collecting Information

§21.4 1. Checklist: Trust Information

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NOTE: The drafter will be able to obtain most of the material required in this checklist during the initial client interview. See §§2.1-2.2.

A. Income Beneficiary

1. Name(s):_____
   _____
   _____
2. Relationship(s) to testator: _____
   _____
   _____
3. Present age(s):_____

   (If the beneficiary is a minor, distributions must be made to a representative for the minor. If the beneficiary will not reach the age of majority during the term of the trust, distribution on trust termination will also be to a representative. See chap 22 (trusts for children). A representative will also be necessary if an adult beneficiary is unable to handle his or her affairs. See §§31.6-31.8.)

4. Disabilities? _____

   (If the beneficiary is disabled, a special needs trust may be appropriate. See chap 23.)

5. Economic status

   a. Income: _____

   b. Other resources: _____

   c. Tax bracket: _____

      (This information, together with information about the proposed trust corpus (see item D), influences which mode of distribution will be most appropriate. For example, for a needy beneficiary, distribution of all net income plus invasion of principal may be appropriate. For a financially secure beneficiary, restricted income distribution may be desirable to avoid adverse tax consequences. On taxation to an income beneficiary, see chap 23A.)

6. Is there a dependency relationship between the beneficiary and the proposed trustee? _____ (If the beneficiary is a dependent of or entitled to support from the proposed trustee, the trustee's distribution power may result in adverse tax consequences to the trustee. See §28.8.)

B. Remainder Beneficiary

1. Name(s): _____
   _____
   _____
2. Any requirements for beneficiary status (*e.g.,* survival until time for distribution)?
   _____
   _____
3. Relationship(s) to testator: _____
   _____
   _____
4. Present age(s) (see item A(3)): _____
5. Disabilities (see item A(4))? _____
6. Economic status

Income: _____

Other resources: _____

Tax bracket:_____

(See item A(5). On effect of asset tax basis on remainder beneficiary, see §31.3.)

7. Is there a dependency relationship between the beneficiary and the proposed trustee (see item A(6))? _____

C. Trust Objectives

1. Objective for income beneficiaries
   a. Provide full support: _____
   b. Supplement outside income and resources: _____
   c. Provide some discretionary income: _____
2. Objective for remainder beneficiaries
   a. Receive fixed proportion of trust corpus: _____
   b. Receive maximum possible amount after limited distributions to income beneficiaries (*e.g.,* trust serves as receptacle for growth assets until termination date): _____
   c. Receive whatever remains at termination after preference has been given to income beneficiaries' needs: _____

   (The testator's intention determines the limits, if any, on invasion of principal for the income beneficiary (see checklist in §21.5, item C) and conditions for trust termination (see checklist in §21.5, item F).)

D. Nature of Trust Assets

1. Assets to be retained (*e.g.,* residence, share of closely held corporation):
   _____
   _____
2. Assets requiring active personal management (*e.g.,* farm, small business):
   _____
   _____
   _____
3. Income-generating assets:_____
   _____
   _____
4. Appreciating assets: _____
   _____
   _____

   (The type of assets affects the possible distribution pattern. For example, low-income, high-growth assets make high income payments difficult unless the assets are converted to income-generating assets.)
5. Approximate percentage of
   a. Liquid assets: _____
   b. Illiquid assets: _____
6. With regard to illiquid assets, objective is to
   a. Distribute in kind: _____
   b. Retain in trust for use by beneficiary (*e.g.,* a residence): _____
   c. Retain for appreciation and sell on trust termination: _____

E. Trust Termination (see checklist in §21.5, item F)

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.5 2. Checklist: Distribution and Termination Clause

§21.5 2. Checklist: Distribution and Termination Clause

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A. Distribution of Trust Income

1. Are there multiple income beneficiaries? _____ If yes, mode of distribution will be
   a. In equal shares: _____
   b. Sprinkled among beneficiaries: _____
2. Timing of distributions
   a. At definite specified intervals, *e.g.,* monthly :
   _____
   b. Discretionary, with specified minimum interval (see §21.10):
   _____
   c. As needed for specified purposes (see §§21.13-21.14):
   _____
3. Amount of income to be distributed
   a. Entire net income: _____
   b. Less than entire net income: _____
   c. Annuity or unitrust amount (see §21.8): _____
   (1) Annuity (see §21.8): _____
   (2) Unitrust amount (see §21.8): _____
   (3) Should fixed amount change in accordance with external factors (*e.g.,* see §21.8 for change based on Consumer Price Index; see also item A(3)(f))? _____
   d. Discretionary with trustee (see §21.11 on standards governing trustee's exercise of discretionary income distribution):
   _____
   e. Determined by or in conjunction with third party
   (1) Special trustee (see §28.9): _____
   (2) Adversely interested cotrustee (see §28.7): _____
   (3) Conditions, if any, on exercise of special trustee's powers (*e.g.,* powers may be exercised only with regard to certain beneficiaries (see §§21.29, 28.9, 28.40-28.41, 29.31 on using special trustee or cotrustee to avoid tax problems) or only on exercise of beneficiary's right to request distribution (see §21.31)):_
   _____
   _____
   (4) Standards or guidelines, if any, for exercise of special trustee's powers:
   _____
   _____
   f. Should distribution amount change on review of circumstances? _____ If yes, how often should circumstances be reviewed?
   (1) Annually: _____
   (2) Semiannually: _____
   (3) At trustee's discretion: _____
   (4) Other (specify): _____
   _____
   _____

4. Method of making distributions

   a. To beneficiary directly: _____

   b. To third party for benefit of beneficiary: _____ Name of third party and relationship to beneficiary (*e.g.,* minor's parent, vendors) if to be identified: _____
   _____

   c. To or for beneficiary, as determined at trustee's discretion: _____

B. Disposition of Undistributed Accumulated Income (when income beneficiary receives less than all net income)

1. Added to corpus: _____

2. Distributed to other beneficiar(y/ies)

   a. Identity of other distributee beneficiar(y/ies):

   b. If multiple beneficiaries, mode of distribution

   (1) In equal shares (see §21.22): _____

   (2) Sprinkled among beneficiaries (see §21.22): _____

   c. Other conditions on distribution (see items A(2)-(4)):

C. Invasion of Trust Principal

1. May any trust principal be distributed before trust termination? _____ If no, go to item D.

2. Beneficiaries for whom principal may be invaded

   a. Income beneficiar(y/ies):

   b. Remainder beneficiar(y/ies):

3. Circumstances triggering invasion power

   a. Income insufficient to meet fixed income amount: _____

   b. Income insufficient to meet purpose for which it is distributed (*e.g.,* education): _____

   c. Beneficiary's request: _____

   d. Trustee's discretion: _____

   e. Other (specify): _____
   _____
   _____

4. Limitations on invasion power

   a. Broad standard (see form 21.30-1): _____

   b. Ascertainable standard (see forms 21.30-1—21.31-1): _____

   c. "five or five" powers (see form 21.31A-1): _____

   d. Conditioned on approval of cotrustee or special trustee (see §§28.7-28.9): _____

   e. Other (*e.g.,* for specified use only, preference given to one beneficiary over another):
   _____
   _____

5. Other conditions applying to principal invasions

   a. Is income beneficiary who is receiving principal also a remainder beneficiary? _____

   b. If yes, is principal received set off against this beneficiary's remainder share? _____

D. Loans

1. Is trustee permitted or directed to make loans to beneficiaries? _____ If no, go to item E.

2. Limitations on loan amount, if any: _____

3. Is loan a charge against beneficiary's receipts under the trust? _____ If yes, charge will be against beneficiary's

   a. Future income payments: _____

   b. Future distributions of principal: _____

c. Remainder share: _____

4. Terms for repayment (*e.g.,* repayment when principal is due to be distributed, repayment at trustee's discretion):
_____
_____

E. Beneficiary Insolvency

1. Will there be controls on distribution in case beneficiary becomes bankrupt or insolvent (see §21.17)? _____ If no, go to item F. If yes, state nature of control

a. Cessation of or limitations on distributions to beneficiary (see form 21.17A-1): _____

b. Trustee's discretion to make distributions to beneficiaries other than insolvent party (see form 21.17B-1): _____

c. Other (specify): _____
_____
_____

F. Trust Termination

1. Event on which termination occurs

a. Income beneficiary's death: _____

b. Date certain (*e.g.,* beneficiary reaches specified age (specify date)):

c. Exhaustion of trust principal: _____

d. Diminution of trust principal below given amount (specify amount):
_____

e. Other occurrence (specify): _____
_____
_____

2. Distribution on termination

a. Beneficiary eligibility requirements (*e.g.,* survival until trust termination):
_____
_____

b. Alternative beneficiar(y\ies) if remainder beneficiary becomes ineligible:
_____
_____

3. Beneficiary shares

a. Equal: _____

b. Sprinkled by trustee: _____

c. Other (specify): _____
_____
_____

4. Special rules for paying distributions (*e.g.,* if ultimate beneficiaries are minors, payment to trust or under California Uniform Transfers to Minors Act (Prob C §§3900-3925):_____
_____
_____

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III. PERIODIC DISTRIBUTIONS

§21.6 A. Selecting Type of Periodic Distribution

Traditionally, most long-term trusts have contained separate dispositive provisions for the distribution of "income" and the distribution of "principal." This practice likely began in an era when most trust income consisted of rents (including shares of crops) received from real property, and trust principal consisted of family lands. In that context, it was often assumed that the trust income should always be distributed currently—a presumption that is still embodied in CC §733, which provides, in effect, that all income must be currently distributed unless there is a valid direction for accumulation.

Many contemporary estate planners have now made compelling arguments that such traditional trust designs are obsolete. See, *e.g.,* Hoisington, *Modern Trust Distribution Design and Implementing Investment Strategies*, Estate Planning 1998 §5.13 (Cal CEB 1998). The primary reason for making this argument is that trusts that provide for the distribution of traditional "income" force the trustee to make bad investment choices. This is due to the fact that trustees should try to obtain the best "total investment return" (taking into account not only dividends and interest, but also capital appreciation) and getting that kind of return is best done by investing in equity securities that produce very low rates of traditional trust income. If a trustee must sell equity securities and buy bonds to generate the "income" needed to support the income beneficiary, the consequence will be an inferior investment portfolio.

A second problem with trusts that distinguish between "principal" and "income" is that it is frequently difficult to do this. Some of the more troublesome questions that arise include: If a trust owns oil and gas property, what percentage of receipts should be allocated to principal in order to take into account the depletion of the remaining oil or gas? What portion of building rents should be allocated to a depreciation reserve if the building is clearly depreciating, but inflation is nevertheless causing increases in the fair market value of the building? What, if anything, should be done about the impact of inflation on the value of principal for a bond or other debt instrument?

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B. Payment of Fixed or Formula Amounts and Annuities

§21.7 1. Common Payment Options

In view of the problems created by "income" distribution provisions, it is now strongly recommended—outside the context of trusts that must pay an income interest to qualify for the IRC §2056 marital deduction—that drafters of new trusts avoid trust distribution provisions that compel the trustee to distinguish between principal and income. There are two basic approaches to doing this. One is to simply declare that income is to be added to principal and the trustee is then to make such distributions as the trustee deems appropriate for stated purposes—often including the beneficiary's health, education, maintenance, and support. A drawback of such a purely discretionary approach to distribution is that it increases the risk of dissension among beneficiaries. Even if this is not the case, the current primary beneficiary may feel uncomfortable asking for generous distributions even though the testator intended such generosity.

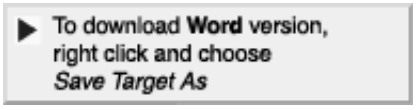
A second approach is to provide for mandatory distributions according to a formula. If desired, the trust may then provide for augmenting the formula distributions with additional discretionary distributions. One of the most widely recommended formulas causes distribution of a "unitrust" amount. A unitrust amount is a stated percentage of the value of the trust assets. In some cases, a unitrust amount may be used, even in the marital deduction context. See §19.7. Normally, the value of the trust assets is redetermined annually, as is required in the case of charitable trusts. See §21.8A. To smooth out distribution amounts, some unitrust provisions provide for paying a percentage of the average value of the trust assets over several annual valuation dates.

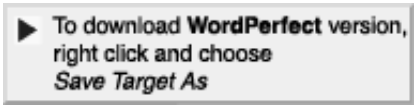
A distribution formula can also establish an "annuity." A simple annuity provides for distributing a fixed dollar amount every year. Many practitioners believe that annuity trusts should require the trustee to annually increase the dollar amount by increases in the cost of living. A trust might also provide that the initial annuity payment is to be a dollar amount increased by increases in the cost of living from the date of the will until the date of death. See §21.8. Some trusts also provide that the initial annuity amount should not be more or less than a certain percentage of the fair market value of the trust.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.8 2. Form: Payment of Annuity Amount

§21.8 2. Form: Payment of Annuity Amount





21.8-1 Payment of annuity amount

***Payment of Annuity Amount*. The trustee shall pay to or for _ _[*name of beneficiary*]_ _, at monthly intervals, a sum of money equal to the "annuity amount." The annuity amount is _ _[*dollar amount*]_ _ multiplied by the "cost of living increase percentage." Payments shall be made on the first day of each calendar month that begins after my death and before the death of the annuitant. The cost of living increase percentage for the first twelve payments is the percentage increase between the date of this will and the date of my death. Thereafter, the cost of living increase percentage shall be adjusted annually for subsequent changes in the cost of living. The cost of living increase percentage shall be determined by the trustee, using the Consumer Price Index For All Urban Consumers. If this index is not available, the trustee shall choose a reasonably comparable index. Any trust income not distributed under this provision shall be added to principal.**

Comment: Bureau of Labor Statistics' consumer price index information can be obtained at http://www.bls.gov/cpi.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.8A 3. Form: Payment of Unitrust Amount

§21.8A 3. Form: Payment of Unitrust Amount

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21.8A-1 Payment of unitrust amount.

***Payment of Unitrust Amount*. The trustee shall pay to or for _ _**[*name of beneficiary*]**_ _, at monthly intervals, a sum of money equal to the "unitrust amount." The unitrust amount is _ _**[*e.g., 0.025*]**_ _ percent of the fair market value of the trust estate at the beginning of the accounting period. Until the trust is fully funded, the value of the trust estate at the beginning of the accounting period includes the value of the assets of my estate that will later be distributed to the trust. Payments shall be made on the first day of each calendar month that begins after my death and before the death of the distributee. Any trust income not distributed under this provision shall be added to principal.**

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§21.9 4. Frequency of Payment

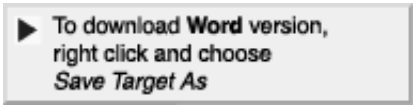
Although payments must be made at reasonable intervals if the instrument does not direct the frequency of the payments (Restatement (Second) of Trusts §182 (1959)), both the trustee and the beneficiaries will benefit if the will specifies the minimum intervals at which income payments must be made.

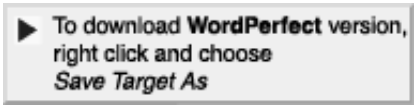
In selecting the payment interval, the drafter should consider the amount of income that the trust corpus is likely to generate, the testator's goals for the payments (*e.g.,* for the beneficiary's support, to supplement the beneficiary's other income, or for a particular purpose such as education) and, if relevant given the testator's goals, the beneficiary's needs. For example, the payment clauses in §§21.8-21.8A provide for monthly payments. If desired, a separate frequency of payment clause may be used. See §21.10.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.10 5. Form: Frequency of Payment

§21.10 5. Form: Frequency of Payment





21.10-1 Frequency of payment

***Frequency of Payment*. The trustee shall make the payments directed in paragraph _ _[*number*]_ _ in convenient installments at least _ _[*annually/quarterly/monthly*]_ _.**

Comment: This clause may be used if the frequency of payment is not specified in the payment clause. See §21.9 on selecting the length of time between distributions.

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C. Discretionary Distribution of Income

1. Discretionary Distributions in General

§21.11 a. Reasons to Provide Guidelines for Discretionary Distributions

When the trustee has discretion to make distributions to income beneficiaries, the prudent drafter will provide guidelines for exercising this discretion. Without guidelines, the trustee may not be able to determine whether the testator intended to make a large or small gift of income, to provide supplemental or basic support for a beneficiary, to treat beneficiaries equally or according to need, to preserve principal as long as possible, or to invade principal on behalf of the income beneficiaries. The forms in §§21.12-21.14 suggest typical guidelines provided to trustees who are given discretionary distribution powers.

There are compelling and often overriding tax reasons to provide particular standards for the trustee, especially when he or she is also a beneficiary or is personally responsible for the beneficiary's support. Careful drafting is required to avoid creating a power of appointment in the trustee, which will have adverse income or estate tax consequences to the trustee. See chap 16 on powers of appointment generally; §§16.14-16.16 on the tax consequences of a trustee's power of appointment; §§16.19, 16.21 on using an ascertainable standard to avoid creating a power of appointment.

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§21.12 b. Form: Discretionary Distribution of Income

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21.12-1 Discretionary distribution of income

[*Add one of the following alternatives*]

[*Alternative 1: Distribution to one beneficiary*]

***Distribution of Income*. The trustee shall pay to or for the income beneficiary for the beneficiary's lifetime as much of the net income as the trustee, in the trustee's discretion, considers necessary for the income beneficiary's health, education, support, or maintenance to maintain at a minimum the income beneficiary's accustomed manner of living.**

[*Alternative 2: Distribution among beneficiaries (general sprinkling provision)*]

***Distribution of Income*. As long as any of the group consisting of _ _[*names*]_ _ are living, the trustee shall pay to or for any one or more of them as much of the trust income as the trustee, in the trustee's discretion, considers necessary for their support, health, and education. In making these payments, the trustee may pay more to or apply more for some beneficiaries than others and may make payments to or applications of benefits for one or more beneficiaries to the exclusion of others.**

[*If applicable, add the following option*]

[*Option: Distribution of current or accumulated income to issue of named beneficiaries*]

In addition to other payments authorized by this paragraph, the trustee may, in the trustee's discretion, pay to or for one or more of the issue of _ _[*names*]_ _ any current net income of the trust not otherwise distributed under this paragraph and any net income previously accumulated and added to principal.

Comment: The drafter may wish to add a statement to Alternative 1 specifying the time as of which the beneficiary's living standard will be determined, *e.g.,* the date on which the will is executed or the date of the testator's death. The drafter must add an instruction telling the trustee the frequency of distributions. See form 21.10-1 for suggested language. See forms 21.17A-1 and 21.17B-1 for optional additions to Alternative 1 providing, respectively, for restriction or redirection of distributions to bankrupt or insolvent beneficiaries.

If the trustee is also a beneficiary, none of the clauses in this form should be used. See §21.11. Instead, the drafter should use the special trustee provision in form 28.16-1.

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2. Distributions for Specific Purposes

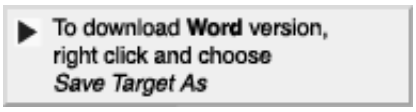
§21.13 a. Directions to Use Distributions for Specific Purposes

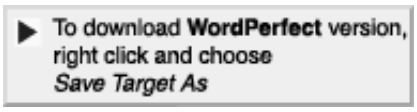
It is not uncommon for a testator to want income distributions to be used for a particular purpose, *e.g.,* education. For suggested clauses for this and other purposes, see form 21.14-1 and those in §§22.26, 22.28, 22.30, and 22.32-22.33.

The testator may want to give the trustee the power to lend to the beneficiary (from income or principal) or draw from principal for an enumerated purpose. See form 21.33-1 (lending power); form 21.30-1 (trustee invasion of principal). When loans are made, they may be charged against the beneficiary's ultimate distributive share, so that when the trust terminates the borrower receives what would have been his or her share, less principal and any interest outstanding on the loan.

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§21.14 b. Form: Distributions for Specific Purposes





21.14-1 Distributions for specific purposes

The trustee may make distributions to enable the beneficiary to (1) pursue a trade school, college, or graduate school education if, in the trustee's opinion, the education is productively pursued; (2) make a reasonable down payment on a primary residence; or (3) obtain capital to enter any business or profession that, in the trustee's discretion, is likely to prove useful or profitable to the beneficiary.

Comment: The drafter should use this type of clause when the testator would like distributions to be put to particular uses. This clause can be adapted to describe any other uses that the testator wants to name or to require that payments be for specified purposes. The drafter should place the clause after an income distribution clause or a principal distribution clause, depending on the distribution formula. For example, the testator may wish to apply regular trust income to tuition and support for schooling, but a large distribution of principal may be required to provide capital for a business. For alternative income distribution clauses, see §21.12. For alternative principal distribution clauses, see §21.30.

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3. Consideration of Beneficiary's Other Resources

§21.15 a. Reasons to Provide Guidelines for Consideration of Other Resources

When the testator intends the trust to provide support for a beneficiary, or to provide income for a certain purpose, the testator may want the trustee to consider the beneficiary's other resources when determining income amounts to be distributed. For suggested clauses permitting and prohibiting trustee consideration of the beneficiary's other resources, see form 21.16-1.

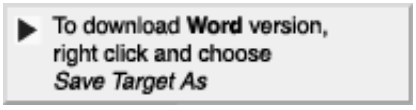
In some situations, the drafter may also want to suggest including a clause that cuts off, or redirects to other parties, distributions that would otherwise go to a bankrupt beneficiary or to a beneficiary experiencing other financial difficulties that may expose his or her assets to creditors. See form 21.16-1. Otherwise, the trust assets may go to waste; once the assets are distributed, they will be available to nonbeneficiary creditors. This clause provides protection in addition to that provided by a "spendthrift" clause, which protects trust assets from beneficiaries' creditors before distributions by preventing assets from being distributed if they would be vulnerable to creditors after distribution. See chap 27. Problems are also confronted when a surviving spouse loses capacity and can no longer enjoy assets by using property in kind. In *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639, for example, the court held that the trustee of a bypass trust could consider the surviving spouse's other assets, including a residence owned by the spouse who lived in a residential care facility, in deciding whether to invade trust principal for the spouse's support, in the absence of a contrary provision in the trust document. The court cited *Estate of Ferrall* (1953) 41 C2d 166, 176, 258 P2d 1009, for the proposition that a trustee should consider a beneficiary's other resources before making a distribution of principal unless the trust document shows another intent.

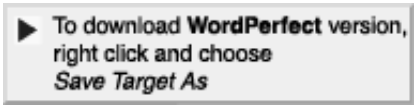
In *Howard v Howard* (Or App 2007) 156 P3d 89, the court held that the trustee of a bypass trust that provided for mandatory payment of net income to the surviving spouse need not consider the surviving spouse's resources in making investment decisions that may favor income production even though the instrument allowed the trustee to consider other resources in making discretionary distributions.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.16 b. Form: Trustee's Consideration of Beneficiary's Other Resources

§21.16 b. Form: Trustee's Consideration of Beneficiary's Other Resources





21.16-1 Trustee consideration of beneficiary's other means of support

[*Add one of the following alternatives*]

[*Alternative 1: Trustee may consider other means of support*]

In making distributions, the trustee may, in the trustee's discretion, consider any other income or resources of the beneficiary known to the trustee and readily available.

[*Alternative 2: Trustee shall consider other means of support*]

In making distributions, the trustee shall consider any other income or resources of the beneficiary known to the trustee and readily available.

[*Alternative 3: Trustee shall not consider other means of support*]

In making distributions, the trustee shall not consider any other income or resources of the beneficiary.

Comment: This clause may be added to Alternative 1 in form 21.12-1. See discussion of alternatives in §21.15.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.17 4. Distributions Restricted or Redirected on Beneficiary's Insolvency or Bankruptcy

§21.17 4. Distributions Restricted or Redirected on Beneficiary's Insolvency or Bankruptcy

In some situations, the drafter may also want to suggest including a clause that cuts off, or redirects to other parties, distributions that would otherwise go to a bankrupt beneficiary or to a beneficiary experiencing other financial difficulties that may expose his or her assets to creditors. Otherwise, the trust assets may go to waste; once the assets are distributed, they will be available to nonbeneficiary creditors. See form 21.17A-1 and form 21.17B-1.

These clauses provide protection in addition to that provided by a "spendthrift" clause, which protects trust assets from beneficiaries' creditors before distributions by preventing assets from being distributed if they would be vulnerable to creditors after distribution. See chap 27.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.17A a. Form: Distributions Restricted on Beneficiary's Insolvency or Bankruptcy

§21.17A a. Form: Distributions Restricted on Beneficiary's Insolvency or Bankruptcy

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21.17A-1 Distributions restricted on beneficiary's insolvency or bankruptcy

If the trustee determines that the income beneficiary has become insolvent, or if the beneficiary files for protection from creditors in a United States Bankruptcy Court, the trustee shall cease making the payments directed in paragraph _ _[*number*]_ _ as soon as possible after making the determination of insolvency or learning of the beneficiary's filing, and shall thereafter pay to or for the beneficiary only those sums of income that the trustee, in the trustee's discretion, determines to be necessary for the beneficiary's food, clothing, shelter, and basic medical care, taking into consideration all other income and resources reasonably available to the beneficiary.

Comment: Form 21.17A-1 allows the trustee to cease distributions when the payments may be diverted to third party creditors rather than being received by the intended beneficiary. The drafter can adapt the clause to apply to other situations and payment directives. The drafter may want to provide clear directions for determining insolvency, *e.g.,* reliance on the beneficiary's own statement. Compare form 21.17A-1 with form 21.16-1 on determining the beneficiary's outside means of support. This clause may be added to Alternative 1 in form 21.12-1.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.17B b. Form: Distributions Redirected on Beneficiary's Insolvency or Bankruptcy

§21.17B b. Form: Distributions Redirected on Beneficiary's Insolvency or Bankruptcy

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21.17B-1 Distributions redirected to others on beneficiary's insolvency or bankruptcy

If the trustee determines that the income beneficiary has become insolvent, or if the beneficiary files for protection from creditors in a United States Bankruptcy Court, the trustee shall cease making the payments directed in paragraph _ _[*number*]_ _ as soon as possible after making the determination of insolvency or learning of the beneficiary's filing, and shall thereafter pay the trust income to or for the following then-living successor income beneficiaries: _ _[*names*]_ _.

Comment: Form 21.17B-1 directs that income that would otherwise be distributed to the insolvent or bankrupt beneficiary be redirected to other beneficiaries. The mode of distribution to the successor beneficiary may be identical to that which applied to the insolvent or bankrupt beneficiary, or a different pattern may be appropriate (particularly if there are multiple successor beneficiaries). In any event, instructions for distribution to the successor beneficiaries must be provided in the trust in the same detail as instructions for distribution to the original beneficiaries. This clause may be added to Alternative 1 in form 21.12-1.

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5. Testator's Distribution Preferences

§21.18 a. Testator's Statement of Distribution Preferences Among Beneficiaries

A statement in the trust describing the testator's particular preferences regarding distributions among beneficiaries or between income and remainder beneficiaries may be required. Such a statement will prove helpful to the trustee.

When there are multiple income beneficiaries, the will should state whether the trustee (1) must pay out income in equal shares or in other proportions or (2) has the discretion to "sprinkle" the income among the beneficiaries as the trustee sees fit. The testator may even give the trustee the discretion to omit distributions to one or more of the beneficiaries. When this type of clause is used, the testator must decide whether distributions made to the same beneficiaries on termination of the trust should be in equal shares, in other proportions, or adjusted for amounts distributed during the trust term. See §22.42 on the family "pot" trust. See also form 22.49-1 (sprinkling clause).

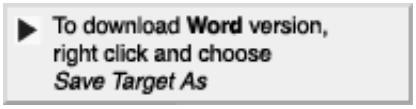
If the distribution clause permits invasion of principal for distribution to one or more income beneficiaries, the drafter should include a statement explaining whether the trustee should try to retain some principal for the remainder beneficiaries before it is entirely consumed by the income beneficiaries. Of course, the testator can protect the principal by limiting the withdrawal power. In many instances, the testator may want to permit the trustee to pay out principal to income beneficiaries only in emergencies, thus preserving most of the trust corpus for the remainder beneficiaries.

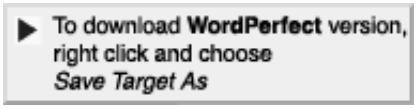
For sample statements of distribution preferences, see forms 21.19-1, 21.20-1. The testator's distribution guidelines may be adapted to apply to the distribution of either income or principal, or both. In any case, they must be compatible with the trust's primary directives for distribution. See §21.32 for clauses stating the testator's preference to favor the income or remainder beneficiaries when the trustee makes decisions about principal invasion.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.19 b. Form: Trustee Discretion to Sprinkle Distributions Among Multiple Income Beneficiaries

§21.19 b. Form: Trustee Discretion to Sprinkle Distributions Among Multiple Income Beneficiaries





21.19-1 Trust distributions (payments sprinkled among beneficiaries)

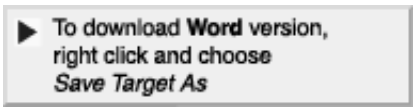
The trustee may, in the trustee's discretion, make distributions under this paragraph that benefit one or more beneficiaries more than others or even completely exclude one or more beneficiaries.

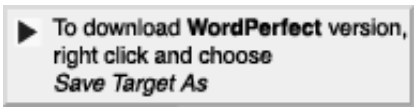
Comment: This clause may be added to Alternative 2 in form 21.12-1.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.20 c. Form: Income Beneficiary as Primary Beneficiary

§21.20 c. Form: Income Beneficiary as Primary Beneficiary





21.20-1 Income beneficiary as primary beneficiary

In determining whether to make a distribution and the amount of the distribution to be made, the trustee shall consider the income beneficiary as the primary beneficiary of the trust and the interests of the other beneficiaries as secondary to the interests of the primary beneficiary.

Comment: The drafter can use this clause when (1) there are separate income and principal beneficiaries, (2) the trustee has the right to invade the principal for the benefit of the income beneficiary, and (3) the testator wants the trustee to favor the income beneficiary when deciding whether to invade the principal. The clause can be adapted as necessary, even to naming certain beneficiaries for preferential treatment. This clause may be added to Alternative 1 in form 21.12-1.

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§21.21 d. Distribution of Income to Third Party for Beneficiary

The income payment clauses in this chapter direct that payments be made "to" or "for" the beneficiary. Instead of, or in addition to, these clauses, the drafter may wish to include a clause that provides more detail when permitting or directing payments to parties other than the beneficiary. Such clauses are most useful when the beneficiary is a minor or disabled. For sample clauses, see form 31.7-1.

The testator may also want to give the trustee the right to compensate or reimburse trust beneficiaries' guardians, conservators, or other caretakers whose services create personal financial burdens. These payments will be considered to be for the beneficiaries' benefit, even though the caretakers receive the funds. For sample clauses, see §22.26.

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C. Disposition of Undistributed Income

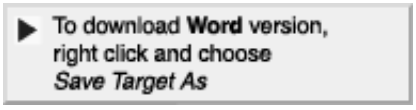
§21.22 1. When to Direct Application of Undistributed Income

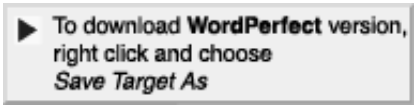
Unless the trust directs distribution of all net trust income, the trust must instruct the trustee on disposition of undistributed income. If there is no direction in the will, the accumulated income will belong to the remainder beneficiaries. CC §733. Either the income can be accumulated and added to principal (the typical pattern), or it can be distributed to other income beneficiaries. If the income is to be paid to other beneficiaries, the drafter must provide the names of the beneficiaries and the terms, *e.g.,* whether each payment is a set amount or a discretionary amount, divided in set proportions or "sprinkled" among a group of beneficiaries. See form 21.19-1 for an example of a sprinkling power.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.23 2. Form: Disposition of Undistributed Income

§21.23 2. Form: Disposition of Undistributed Income





21.23-1 Disposition of undistributed income

[*Add one of the following alternatives*]

[*Alternative 1: Undistributed income added to principal*]

***Disposition of Undistributed Income*. Any undistributed income shall be accumulated and added to principal.**

[*Alternative 2: Distribution of remaining current net income and previously accumulated income to others (discretionary)*]

***Disposition of Undistributed Income*. After making the payments directed in paragraph _ _[*number*]_ _, the trustee may pay any remaining current net income of the trust and any net income previously accumulated and added to principal to _ _[*name of beneficiary*]_ _. Any current net income of the trust not distributed by the trustee under paragraph _ _[*number*]_ _ or this paragraph shall be accumulated and added to principal.**

[*Alternative 3: Distribution of remaining income to others (mandatory)*]

***Disposition of Undistributed Income*. After making the payments directed in paragraph _ _[*number*]_ _, the trustee shall pay any remaining current net income of the trust to _ _[*name of beneficiary*]_ _.**

Comment: Alternative 1 describes the most common direction regarding excess income. It is often integrated into the paragraph directing income distribution as the final sentence.

In Alternative 2, the drafter still must provide for accumulation of undistributed income in case the trustee decides to leave any current net income undistributed.

In Alternative 3, the drafter cannot include the directive regarding previously accumulated income.

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IV. SPECIAL PROVISIONS FOR INCOME EARNED DURING PROBATE ADMINISTRATION

§21.24 A. Statement of Probate Income Problem

The income beneficiaries of a testamentary trust are entitled to the income of the trust estate from the date of the testator's death unless the will specifies some other date, *e.g.,* when the estate is distributed. Prob C §§12002, 16340; *Estate of Platt* (1942) 21 C2d 343, 131 P2d 825; *Estate of Schiffmann* (1948) 86 CA2d 638, 195 P2d 484. However, the will usually specifies another date for the beginning of an income interest, at least implicitly. For example, the surviving spouse's entitlement to net income of a marital deduction qualifying trust funded by a pecuniary formula devise with date-of-distribution funding commences on the date of distribution. See California Trust Administration §14.56A (2d ed Cal CEB 2001).

The beneficiary of a general pecuniary legacy in trust including a pecuniary formula marital gift is entitled to interest on his or her trust share beginning 1 year after the testator's death, unless the will provides otherwise. Prob C §12003. However, the executor is under no duty to pay income or interest during probate administration. *Estate of Marre* (1941) 18 C2d 184, 190, 114 P2d 586. On distribution of the trust estate, the net income from the trust property accumulated during probate administration must be distributed to the testamentary trustee for further distribution to the income beneficiaries of the trust, assuming the income interest began on the date of death. Prob C §§12006, 16340. See *Estate of Marre, supra*. If the executor does not segregate income and principal during administration, that duty will fall on the trustee. *Estate of de Laveaga* (1958) 50 C2d 480, 486, 326 P2d 129.

The right to income from the trust or interest on a pecuniary devise may be of little solace to a beneficiary if the executor does not make the payments during administration of the estate. The same problem arises for beneficiaries who may receive discretionary distributions from a testamentary trust after final distribution of the estate. If the will authorizes the executor to make the payments, they are allowable in the executor's accounts, provided that the estate is solvent and distribution is made to the testamentary trust as contemplated by the testator. *Estate of Rider* (1926) 199 C 742, 251 P 805.

Unless the payments are made under an order for preliminary distribution, however, the executor would have to restore them to the estate personally if the estate proved insolvent or if estate assets proved insufficient to establish the contemplated trust in full. Consequently, a professional executor is unlikely to make the payments, although a friend or relative acting as executor may be willing to do so. See §§32.21-32.26 on the executor's liability. For discussion of alternatives to preliminary distributions, see §21.25. For discussion of preliminary distributions made without court order, see California Decedent Estate Practice §25.32 (2d ed Cal CEB 2009).

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§21.25 B. Possible Solutions to Probate Income Problem

The estate planner should consider the following alternatives to provide for a beneficiary who will need funds during the time between death and distribution—an interval of at least 6 months (*i.e.,* a creditors' period of 4 months, at least 1 month for commencement of probate proceedings, and 1 month for preparation and calendaring of the petition for distribution). These steps are particularly appropriate for a surviving spouse, a minor child, or an incapacitated adult child who cannot obtain funds as a family allowance under Prob C §6540:

- *Joint tenancy bank account.* If the testator creates a modest joint tenancy bank account with the beneficiary, funds will be available immediately after the testator's death. The drafter should not suggest this alternative if the testator does not want the potential beneficiary (1) to have joint tenancy rights while the testator is alive or (2) to receive the money in a lump sum. A "pay-on-death" or Totten trust account solves the first problem but not the second.
- *Insurance policy.* The testator can purchase a small insurance policy that is made payable to the beneficiary, possibly in monthly installments over the estimated period of probate administration. If the testator is young and insurable, however, this solution may prove too costly over a long period. If the testator is elderly, he or she may be uninsurable.
- *Inter vivos trust.* The attorney can create a funded revocable trust to supplement the will. This alternative may be desirable if the testator or the intended beneficiary is too old, young, ill, or incompetent to justify the preceding alternatives. Another benefit of a revocable trust is that it can be written in conjunction with the will so that no payments will be duplicated.
- *Trust for maintenance.* If support funds are required during probate administration for persons not entitled to them under Prob C §6540, the residuary trust can be designated a "trust for maintenance" and include authorization for current income payments by the executor. See *Estate of Marre* (1941) 18 C2d 184, 114 P2d 586; *Estate of Zuber* (1956) 146 CA2d 584, 304 P2d 247. But see discussion in §21.26 for possible problems.
- *Additional family allowances.* A family allowance also may be given to adult children who are not incapacitated and to the decedent's parents who were dependent in whole or in part on the decedent for support. Prob C §6540. Whether to award a family allowance for those persons, however, is left to the court's discretion. A testator who wishes to ensure that provision is made for those individuals should not depend on the future award of a family allowance.
- *Order for preliminary distribution.* The executor may petition the court for an order for preliminary distribution to establish the testamentary trust and fund it with a portion of the estate assets, including the accumulated income of the estate.

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§21.26 C. Avoiding Duplication of Payments of Trust Income and Family Allowance

When the income beneficiaries of the trust receive a family allowance (see Prob C §§6540-6541, 6543(b)) during probate administration, withholding trust income from them during that time may not create any hardship. In this situation, the testator can avoid double payments to the beneficiaries by providing in the will that the trust income must be withheld to the extent of the family allowance paid. An alternative is to provide that they will not be entitled to any of the trust income earned during probate. Form 21.27-1 contains these alternative clauses.

Persons entitled to a family allowance under Prob C §6540 are (1) the surviving spouse or registered domestic partner (see Fam C §297.5(c)), (2) the decedent's minor children, (3) physically or mentally incapacitated adult children who are unable to earn a living and who depended on the decedent for support, and (4) adult children who are not incapacitated and parents of the decedent who were at least partially dependent on the decedent for support.

Although a family allowance may be paid to the testator's children, clauses like form 21.27-1 will probably not apply to distributions to the children. A family allowance is payable to a decedent's children only while they are minors (except for incapacitated and dependent adult children). Because income payments from a trust for minor beneficiaries are normally discretionary with the trustee, the problem of double payments is unlikely to arise as long as the trustee is alert to the double payment issue. See chap 22 on children's trusts.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.27 D. Form: Disposition of Probate Income

§21.27 D. Form: Disposition of Probate Income

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21.27-1 Disposition of probate income

[*Add one of the following alternatives*]

[*Alternative 1: Probate income added to principal to the extent of family allowance paid to beneficiary*]

***Disposition of Probate Income*. To the extent of any family allowance paid to any beneficiary of this trust, income or interest earned during probate administration that the beneficiary would otherwise be entitled to receive from the trustee shall become part of the principal of the trust estate.**

[*Alternative 2: All probate income added to principal*]

***Disposition of Probate Income*. All income or interest earned or accrued during probate administration that any beneficiary of the trust estate would otherwise be entitled to receive from the trustee shall become part of the principal of the trust estate.**

[*If applicable, add the following option*]

[*Option: Allocation of probate income to income*]

***Disposition of Probate Income*. The trustee may, in the trustee's discretion, allocate to income rather than principal any item that would be considered taxable income to the trust.**

Comment: Use of Alternative 1 will avoid double payments to a beneficiary receiving a family allowance.

A clause such as the optional addition to Alternative 2 permitting the trustee to allocate to income, rather than principal, items taxable to the trust as income is appropriate, particularly when the trust is required to distribute all income each taxable year. The drafter must use extreme caution before adding the optional wording, however, because it can make substantial receipts that are taxable as income (*e.g.,* a lump-sum distribution from a pension plan) currently distributable. Furthermore, a trustee-beneficiary should not be given such power, because income and estate tax problems may be created. See IRC §§678, 2041, discussed in §28.8. See also chap 16. The optional clause is unnecessary in a discretionary trust if the trustee has a broad power to distribute principal, because the trustee can then distribute the income in the year received.

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V. DISTRIBUTION OF PRINCIPAL

§21.28 A. When Invasion Powers May Be Used

Trustees are often given latitude to invade principal if the trust income is insufficient to meet the trust's distribution goals. For example, forms 21.8-1 and 21.8A-1, directing distribution of an annuity or unitrust amount, imply the power to invade principal because the direction to pay a set amount will otherwise be meaningless if the trust income alone cannot provide the full amount. It is also usually appropriate to include a principal invasion clause when the testator wants the trustee to apply discretion to make distributions sufficient to meet particular needs of the beneficiary.

Some testators want to make trust principal available to beneficiaries without removing the principal from income production. If this is the case, they can give the trustee the power to lend principal to the beneficiary. If the beneficiary is a remainder beneficiary, then any loan funds and interest remaining unpaid at the time for distribution of the remainder can be taken off the top of the amount otherwise distributable to the borrower. For a clause giving the trustee power to lend principal, see form 21.33-1.

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§21.29 B. Limiting Invasion Powers of "Tax-Sensitive" Trustee

If the trustee is also a beneficiary or has the power to distribute principal for the benefit of persons whom the trustee is obligated to support, the drafter must avoid granting the trustee broad powers that will be construed as a general power of appointment. Otherwise, the trustee may face serious adverse tax consequences. For discussion of the potential tax problems and strategies for avoiding them, see chap 16. In brief, the trustee's power to invade principal can be effectively limited as follows:

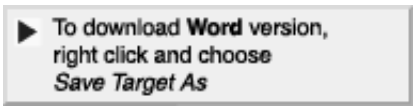
- By making distributions subject to an "ascertainable standard relating to the [*beneficiary's*] health, education, support, or maintenance" (IRC §2041(b)(1)(A); see §16.19);
- By restricting the amount that can be withdrawn in a calendar year to the greater of $5000 or 5 percent of the aggregate value of the principal, measured at the end of the year or at the trust's termination (a "five or five" power) (IRC §2041(b)(2); see §16.17); or
- By requiring that the power be shared with a cotrustee who is an "adverse party" or by forbidding principal distributions to the "tax-sensitive" beneficiary unless directed by a third party special trustee (see IRC §2041(b)(1)(C)(ii) on use of the adverse party; §28.9 on use of the "special" trustee).

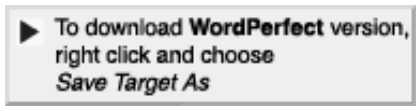
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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/ C. Invasion of Principal/§21.30 1. Form: Discretionary Power to Invade Principal When Income Is Insufficient

C. Invasion of Principal

§21.30 1. Form: Discretionary Power to Invade Principal When Income Is Insufficient





21.30-1 Discretionary power to invade principal when income is insufficient

[*Add one of the following alternatives*]

[*Alternative 1: Distribution of full amount considered necessary*]

***Distribution of Principal*. If trust income is insufficient to pay sums as directed in paragraph _ _[*number*]_ _, the trustee shall pay from principal the amount that the trustee considers necessary to do so.**

[*Alternative 2: Distribution limited to dollar amount*]

***Distribution of Principal*. If trust income is insufficient to pay sums as directed in paragraph _ _[*number*]_ _, the trustee shall pay from principal the amount, not to exceed a total of _ _[*amount*]_ _, that the trustee considers necessary to do so.**

[*Alternative 3: Distribution limited by ascertainable standard*]

***Distribution of Principal*. If, in the trustee's judgment, extraordinary circumstances exist that create hardship for the beneficiary so that, even with the distribution of income as directed in paragraph _ _[*number*]_ _, the beneficiary's standard of living is or may be reduced below the minimum necessary for the beneficiary's health, support, and maintenance, the trustee shall pay to or for the beneficiary all or part of the principal that the trustee considers necessary for the beneficiary's health, support, and maintenance. Examples of such a hardship include a health emergency requiring extraordinary outlays of funds for treatment, significant uninsured property losses resulting from a natural disaster, or financial reverses caused by market forces.**

Comment: The drafter should use Alternative 1 when the trustee is directed to make income payments for a particular purpose. For discussion and forms, see §§21.11-21.14. Alternative 2 is also for use when the trustee is directed to make income payments for a particular purpose, but it limits the principal invasion amount. The limit can be stated as a dollar amount or a percentage of the total original principal, as the drafter chooses. See form 21.31A-1 for a formula clause for the "five or five" power, a specialized type of limitation on the principal invasion power for use when there is a trustee-beneficiary or a beneficiary with withdrawal power. See §21.29 on limiting principal invasion powers in "tax-sensitive" situations; §16.17 on the five or five power.

Alternative 3 is an example of a clause that limits principal invasion to special circumstances. Note that it is geared toward an income distribution clause that requires distributions necessary for the beneficiary's "health, support, and maintenance," an ascertainable standard for income distribution. See §21.29 on ascertainable standards. If the purposes of income distribution differ from those listed in Alternative 3, the drafter should amend the appropriate portion of the hardship clause. The drafter can also tailor the examples of hardship to particular characteristics of the beneficiary or the trust assets. For example, old beneficiaries are likely to have health problems, and young beneficiaries are prone to encounter accidents or financial hardship.

Because Alternative 3 allows invasion up to the entire principal balance, it may be used when the income beneficiary is the testator's primary concern. If the testator wishes to preserve trust corpus for remainder beneficiaries, the clause should limit the invasion, and an accompanying purpose clause could further clarify the relative importance of the beneficiaries. See form 21.32-1 for clauses stating further guidelines for the trustee.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.31 2. Form: Principal Invasion on Beneficiary's Request Limited by Ascertainable Standard

§21.31 2. Form: Principal Invasion on Beneficiary's Request Limited by Ascertainable Standard

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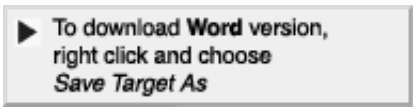
21.31-1 Principal invasion on beneficiary's request limited by ascertainable standard

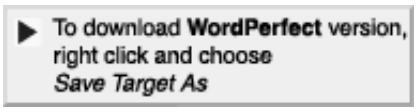
***Distribution of Principal*. In addition to any other payments to the beneficiary, the trustee shall, on the beneficiary's written request, pay to the beneficiary amounts from principal that the trustee considers reasonably required for the beneficiary's health, education, support, or maintenance to maintain at a minimum the beneficiary's accustomed manner of living.**

Comment: Clauses authorizing principal distributions on the beneficiary's request are typically used when the income beneficiary is also a remainder beneficiary. This clause contains a typical ascertainable standard. The drafter may want to delete "education" if that is not appropriate under the circumstances of the trust. The drafter may also broaden the standard if an ascertainable standard is not necessary. See §§16.19, 16.21, 21.11 on "ascertainable," and broader, standards.

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§21.31A 3. Form: "Five or Five" Withdrawal Power





21.31A-1 "Five or five" withdrawal power

***Withdrawal Power*. In addition to any other payments to which the beneficiary is entitled, the trustee shall, on the written request of the beneficiary, pay to the beneficiary any amounts from principal that the beneficiary requests. Provided however:**

(1) The beneficiary shall have no withdrawal rights under this provision during any calendar year in which the beneficiary is not alive on the last day of the calendar year, but the written request may be delivered in advance.

(2) The right to request a withdrawal in a calendar year shall lapse at 6 p.m. on the last day of the calendar year. Any request delivered to the trustee after that time shall be void. Time is of the essence.

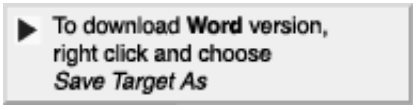
(3) The maximum amount that may be withdrawn under this provision in any calendar year is the greater of $5000 or 5 percent of the value of the principal of the trust, determined as of the close of business on the last day of the calendar year. The trustee may delay actual distribution for a reasonable time. If the beneficiary fails to survive until actual distribution, the distribution shall be paid to such person or entity as the beneficiary has directed, if any, and otherwise to the beneficiary's estate. Any such directive must be signed by the beneficiary and delivered to the trustee during the beneficiary's lifetime.

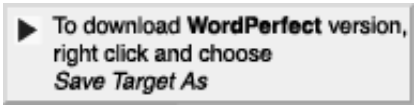
Comment: Clauses authorizing principal distributions on the beneficiary's request are typically used when the income beneficiary is also a remainder beneficiary. This clause gives the income beneficiary a power to invade principal limited by the $5000 or 5-percent exception ("five or five" power) described in §21.29. These five or five powers are routinely used when the primary motivation for creating the trust was to avoid having the trust property included in the estate of the favored beneficiary for tax purposes. Because the withdrawal power is a general power of appointment, the maximum withdrawable amount nevertheless will be included in the beneficiary's estate if the power exists on the date of the beneficiary's death. This clause seeks to minimize that possibility by providing, in effect, that the power does not exist in any year unless the beneficiary survives until the last day of the year. When a five or five power is used as an alternative to a provision for mandatory payment of income to the spouse in a bypass trust, the term "my spouse" may be used in place of the term "the beneficiary" in this clause. See §20.21.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.32 4. Form: Statement of Testator's Intent Regarding Power to Invade Principal

§21.32 4. Form: Statement of Testator's Intent Regarding Power to Invade Principal





21.32-1 Statement of testator's intent regarding exercise of discretionary power to invade principal

[*Add one of the following alternatives*]

[*Alternative 1: Exercise power to benefit income beneficiary*]

In exercising the discretionary power to invade principal, the trustee should be aware that my primary purpose in establishing this trust is to promote the income beneficiary's welfare. The interests of other beneficiaries in the trust are secondary to the interests of the income beneficiary.

[*Alternative 2: Exercise power to preserve principal*]

In exercising the discretionary power to invade principal, the trustee should be aware that I intend (1) the remainder beneficiaries to receive as much of the principal as possible and (2) the principal to be invaded only to the extent required to provide the income beneficiary with the basic requisites of food, clothing, shelter, and medical care, and only when income payments and the income beneficiary's other resources do not suffice for those basic necessities.

Comment: Alternative 1 is useful when the testator wants to give the trustee a liberal power to invade principal for the income beneficiary's needs and is little concerned that principal be preserved for the remainder beneficiaries. The drafter should use Alternative 2, however, when the testator intends the principal invasion power only to ensure that the trustee can maintain the income beneficiary's basic needs. Alternative 2, must be adapted to suit the income distribution directives of the particular trust. This clause may be added to form 21.30-1.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.33 5. Form: Power to Lend Principal to Beneficiary

§21.33 5. Form: Power to Lend Principal to Beneficiary

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21.33-1 Power to lend principal to beneficiary

***Power to Lend Principal to Beneficiary*. On written request by a remainder beneficiary of this trust, the trustee may lend sums to that beneficiary in amounts and on terms that the trustee considers prudent and fair to the trust. If any loan remains unpaid at the time for distribution to the borrower of a share of the trust principal, the trustee shall charge the loan's outstanding balance of principal and interest against the borrower's distributable share before distributing any of that share to the borrower.**

Comment: If the drafter wants to include this clause or one like it, he or she should ensure that no trust management power clauses interfere with the trustee's exercise of this power. See chap 29 on trustee management powers. The drafter should also consider the effect of a remainder beneficiary's untimely death before final distribution of the trust.

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§21.34 6. Preliminary Distributions

A preliminary distribution is a distribution of trust corpus to a remainder beneficiary before the trust has terminated and before final distribution of the remainder. Preliminary distributions are often authorized in trusts for children, to give a beneficiary access to trust principal for specific purposes such as taking advantage of a business opportunity or purchasing a residence. See §§22.47, 22.50-22.51 for further discussion and clauses.

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7. Expenses; Taxes

§21.35 a. Last-Illness and Funeral Expenses; Death Taxes

The testator may wish to provide in the testamentary trust for payment of a beneficiary's last-illness and funeral expenses and other debts incurred for the beneficiary's support. It is unclear whether the trustee is authorized to pay the beneficiary's last-illness and funeral expenses under a trust directing payments for a beneficiary's support. See 2 Scott & Ascher on Trusts §13.2.4 (5th ed 2006). Therefore, the drafter of a support trust should specifically state that the trustee may pay a beneficiary's last-illness and funeral expenses if the beneficiary's probate estate is not large enough to cover these expenses. See form 21.36-1.

Form 21.36-1 will not prevent the beneficiary's estate from deducting funeral expenses if the estate rather than the trust pays the expenses, because the trustee's power to pay is discretionary and the beneficiary's estate is primarily liable for those expenses. If the testator *requires* the trustee to pay the expenses, however, either the beneficiary's estate will lose the deduction for funeral expenses or the amount paid will be included in the beneficiary's estate for federal estate tax purposes.

See chap 26 on payment of death taxes.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.36 b. Form: Trustee Authorized to Pay Beneficiary's Last-Illness and Funeral Expenses

§21.36 b. Form: Trustee Authorized to Pay Beneficiary's Last-Illness and Funeral Expenses

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21.36-1 Trustee authorized to pay beneficiary's last-illness and funeral expenses and obligations incurred for support

***Payment of Expenses and Obligations*. At the death of _ _[*name*]_ _, the trustee may, in the trustee's discretion, use income or principal of the trust to pay _ _[*name*]_ _'s last-illness and funeral expenses and other obligations incurred for _ _[*name*]_ _'s support.**

Comment: This clause expresses the testator's intent that the trustee have the authority, but not the duty, to pay the beneficiary's last-illness and funeral expenses and other debts for support. See §21.35 on the importance of including such an express provision in the will. If the testator wishes, the clause may be drafted in general terms to apply to any trust beneficiary.

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VI. TRUST TERMINATION AND RULES FOR DISTRIBUTION ON TERMINATION

§21.37 A. Description of Terminating Event and Distributive Pattern on Termination

Clauses in the will describing trust termination must state both when the trust will end and where the remainder of the trust assets must then go.

The event causing termination can vary from a beneficiary's reaching a certain age (which is typical for children's trusts; see form 22.58-1), to reduction of trust corpus to a size that is not economical to administer (see §31.28 and forms in §31.29), to the death of a lifetime income beneficiary. In any event, a trust other than a charitable trust must terminate within the time prescribed by the California rule against perpetuities. That period is no later than 21 years after a life in being on the date on which the testator died (Prob C §21205(a)) or 90 years from the date on which the interest was created, whichever is greater (Prob C §21205(b)). On the rule against perpetuities, see chap 34.

Testamentary trusts are often designed to last for the life of one or more beneficiaries. The trust terminates at the death of the life beneficiary, or the last survivor of multiple beneficiaries, when the remaining trust assets are distributed to one or more named remainder beneficiaries. A will usually need not include a clause expressly terminating the trust. The clause naming the lifetime beneficiaries or describing distributions to them usually specifies the trust's duration. See, *e.g.,* form 21.38-1. The will need only direct the trustee to distribute the trust remainder when the antecedent estate ends.

Distribution of a remainder to a named beneficiary after the conclusion of a prior life estate does not usually present drafting problems, although the impact of the generation-skipping transfer tax should always be considered. See chap 15. The drafter should take care, however, to name an alternate remainder beneficiary should the primary remainder beneficiary not survive. Otherwise, the remainder will pass to the beneficiary's estate or the testator's surviving heirs by intestate succession, depending on the terms of the remainder interest.

If there are multiple beneficiaries, the will must describe in what shares they will take and provide alternative distributive patterns in the event one or more do not survive to take the gift (*e.g.,* a gift over to the remaining beneficiaries, in equal or other shares; a gift over to another party). For a beneficiary who is a minor, under some other legal disability, or unable to manage the property, the drafter should also include a clause providing for distribution to a third party (*e.g.,* a parent, custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925), conservator, or trustee) to hold or administer the assets for the beneficiary. See §31.7 for a sample clause.

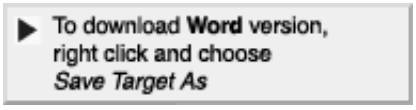
Occasionally, a testator may prefer that the life beneficiary's last-illness expenses or death taxes be paid from the remainder before distribution to the remainder beneficiary. See §21.35 on paying a beneficiary's last-illness expenses and death taxes.

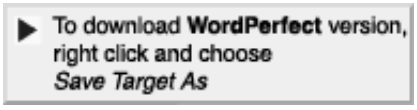
See §21.38 for sample termination clauses that can be adapted to any situation. These clauses terminate the trust at the death of the income beneficiary and distribute the estate outright in several alternative dispositions: familial and nonfamilial. The clauses suggest only some of the ways in which trust distributions can be made. One typical variation terminates a child's trust at the child's death by distributing the remainder to the *child's* then-living descendants.

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Source: Estate Planning/California Will Drafting/21 Overview of Trust Distributions/§21.38 B. Form: Distribution on Termination

§21.38 B. Form: Distribution on Termination





21.38-1 Distribution on termination

[*Add one of the following alternatives*]

[*Alternative 1: Outright to descendants*]

***Distribution of Remainder*. At the death of the income beneficiary, the trustee shall distribute the remaining trust estate to my then-living descendants, by right of representation.**

[*Alternative 2: Outright to descendants, decedent's heirs*]

***Distribution of Remainder*. At the death of the income beneficiary, the trustee shall distribute the remaining trust estate to my then-living descendants, by right of representation. If no descendants survive me, I give the residue to my heirs, with their identities and respective shares to be determined under California law in effect on the date of execution of my will relating to the succession of separate property not acquired from a parent, grandparent, or previously deceased spouse.**

[*Alternative 3: Outright to descendants, specified class*]

***Distribution of Remainder*. At the death of the income beneficiary, the trustee shall distribute the remaining trust estate to my then-living descendants, by right of representation. If no descendants survive me, the trustee shall distribute the remaining trust estate in equal shares to those of the following class then living: _ _**[*Names of beneficiaries*]**_ _**.

[*Alternative 4: Outright to descendants, named beneficiaries*]

***Distribution of Remainder*. At the death of the income beneficiary, the trustee shall distribute the remaining trust estate to my then-living descendants, by right of representation. If no descendants survive me, the trustee shall distribute the remaining trust estate to the following beneficiaries, provided that any shares not otherwise effectively disposed of by these gifts shall be added on a prorata basis to the shares that are effectively distributed: _ _**[*Names of beneficiaries*]**_ _.**

[*Alternative 5: Outright to specified class*]

***Distribution of Remainder.* At the death of the income beneficiary, the trustee shall distribute the remaining trust estate in equal shares to those of the following class then living: _ _**[*Names of beneficiaries*]**_ _.**

[*Alternative 6: Outright to named beneficiaries*]

***Distribution of Remainder*. At the death of the income beneficiary, the trustee shall distribute the remaining trust estate in equal shares to the following then-living beneficiaries, provided that any shares not otherwise effectively disposed of by these gifts shall be added on a prorata basis to the shares that are effectively distributed: _ _**[*Names of beneficiaries*]**_ _.**

Comment: If there is more than one income beneficiary, the opening phrase of each form should be changed to "At the death of the last survivor of _ _[*names of income beneficiaries*]_ _…."

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22

Trusts for Children

Gordon A. Schaller
Michele M. Mulrooney

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§22.1 I. TRANSFERS FOR BENEFIT OF CHILDREN

Testamentary transfers of property for the benefit of children are an integral part of many estate plans. This chapter concentrates on how these transfers can best be achieved.

The chapter first discusses and compares the three major ways to transfer property to children: testamentary trusts, guardianships, and custodianships. See §§22.4-22.15. The chapter then discusses trusts for children in general terms, paying particular attention to the advantages and disadvantages of a family pot trust as compared to separate trusts for each child. See §§22.18-22.20. The latter sections of the chapter cover drafting considerations regarding trusts for children (see §§22.21-22.41), family pot trusts (see §§22.42-22.52A), and separate trusts for each child (see §§22.53-22.58). These considerations apply equally to continuing trusts created by a revocable trust that becomes irrevocable on the death of the settlor.

Sections 22.49-22.52 contain a sample family pot trust. An alternative form of family pot trust is provided in §22.52A. A sample separate trust for each child is included in §22.58. In a typical will of a married testator, these trust clauses would follow dispositions to a surviving spouse. In a typical will of an unmarried testator, these clauses would directly dispose of the residue of the estate.

NOTE: Although the trust clauses in this chapter refer to the beneficiary as a minor child, they can be adapted for a beneficiary of any age.

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II. TESTAMENTARY TRUSTS FOR CHILDREN; ALTERNATIVES

§22.2 A. Who Is a "Minor"?

The age of majority in California is 18 for most purposes. Fam C §§6500-6502. A minor who has entered into a valid marriage, is on active duty in the United States armed forces, or has received a declaration of emancipation is "emancipated" (Fam C §7002) and considered to be an adult for the purpose of dealing with his or her property affairs. Under Fam C §7050, an emancipated minor may:

- Enter into a binding contract;
- Buy, sell, or otherwise deal with real and personal property;
- Sue or be sued;
- Compromise claims;
- Make or revoke a will;
- Make a gift outright or in trust;
- Convey or release expectant interests;
- Exercise or release powers of appointment;
- Create a revocable or irrevocable trust;
- Revoke a revocable trust;
- Elect to take under or against a will;
- Disclaim interests; and
- Make Probate-Code-type elections.

An emancipated minor may also enter into insurance contracts and deal with shares of stock of domestic or foreign corporations and membership in a nonprofit corporation as if he or she were an adult. Fam C §§7051-7052.

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§22.3 B. Circumstances Requiring Third Party Management of Minor's Property

Although there is no legal impediment to a minor's owning property outright, many of the minor's dealings with the property are limited by law. For example, an unemancipated minor cannot delegate a power or enter into a contract relating to an interest in real property or to any personal property not in his or her immediate possession. Fam C §6701. A minor may disaffirm most contracts. Fam C §6700. Consequently, as a practical matter, third parties such as brokers and title companies will not knowingly deal with a minor. See generally California Guardianship Practice §2.30 (Cal CEB Annual); 4 Witkin, Summary of California Law, *Sales* §233 (10th ed 2005); on minors, see 1 Witkin, Summary, *Contracts* §§29-33; on incompetents, see 1 Witkin, Summary, *Contracts* §§50-57.

A testator who intends to leave property by will to a minor should arrange for distribution of the property to a trustee, custodian, or guardian of the estate. See §§22.4-22.15.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.4 C. Trusts, Guardianships, and Custodianships

§22.4 C. Trusts, Guardianships, and Custodianships

A testamentary trust, guardianship of the estate, and custodianship are the three main ways for a testator to transfer property to minors:

- A testamentary trust is a legal entity in which an adult (trustee) selected by the testator administers the testator's property for the benefit of a minor or children under the terms of the trust instrument. See chap 7 for an overview of testamentary trusts.
- A guardianship of the estate is a legal relationship in which an adult is appointed by the court to manage a minor's estate. See Prob C §§1500-1516. The guardianship terminates when the minor dies, is adopted, attains majority, or is emancipated under Fam C §7002. Prob C §1600. Procedures for establishing guardianships, and the circumstances under which a guardianship may be necessary or desirable, are discussed in chap 25.
- A custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) is a legal arrangement in which an adult (custodian) selected by the testator manages property for the benefit of a minor until the minor reaches a specified age up to 25. The custodian manages the property under the provisions of CUTMA. Custodianships are discussed in §§22.13-22.15.

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D. Advantages of Testamentary Trusts Over Guardianships of Estate

§22.5 1. Flexibility in Termination Date

A guardianship of a minor's estate terminates when the minor dies, reaches age 18, or is emancipated (Prob C §1600), regardless of his or her ability to handle financial matters. In a trust, termination by distribution of all the corpus to a minor can be postponed beyond the minor's attainment of legal majority (except to the extent that the rule against perpetuities limits the postponement; see chap 34). Testamentary trusts are sometimes even set up to last for the entire lifetime of a minor.

A trust can provide for continued support of a minor even after the minor's adoption. In the case of a guardianship, the adoptive parents' assumption of the duty of support may result in the cutting off, or at least the limiting, of the use of guardianship funds. See Fam C §3900. This may have the effect of discouraging an adoption that is beneficial to the minor.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.6 2. Less Court Supervision

§22.6 2. Less Court Supervision

The appointment of a trustee (or successor trustee) does not require the time and expense of court proceedings and approval. In contrast, a person may serve as guardian only after court appointment. See §24.4 on the distinction between nomination and appointment of a guardian. Unlike guardianships, trusts created under wills are not subject to probate court supervision unless the testator provides for such supervision. Prob C §17300. Even if the testator requests court supervision, the supervision is less stringent for trusts than court supervision of guardianships. For the most part, the practical consequences of the distinction between supervised and unsupervised trusts are not great. See California Trust Administration §15.2 (2d ed Cal CEB 2001).

Although not comprehensive, the following discussion illustrates the difference between court supervision of trusts and court supervision of guardianships:

- Although guardians must file an inventory and appraisal (Prob C §2610), no such duty is imposed on testamentary trustees.
- A guardian must file an account a year after his or her appointment and at least biennially thereafter, unless the court orders more frequent accounts. Prob C §2620(a). A petition to terminate a guardianship following the death of the ward must include accounts for the period that ended at the date of death and a separate account for the period after the date of death. Prob C §2620(b). The accounts must include original account statements from any institution, financial or otherwise, in which money or other assets of the estate are held or deposited. Prob C §§2620(c), 2890, 2892. A testamentary trustee must account at least annually to the current beneficiaries. Prob C §§16062 (duty to account), 16063 (contents of account). See also Prob C §§16060 (duty to keep beneficiaries reasonably informed), 16061 (duty to render reports upon request); *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538 (remainder beneficiary not entitled to annual account may be entitled to "particular account"). Any limitation or 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 as defined in Prob C §21350.5 (see §1.35). Prob C §16062(e).
- The court must generally approve loans, notes, mortgages, leases (except month-to-month leases and those in which the monthly rent does not exceed $5000 for a term of not more than two years; see Prob C §2555), agreements for sale, and other documents before a guardian may execute or agree to them. Prob C §§2540, 2550. See chap 29 for will clauses giving the trustee authority to act without court approval in these areas.

EXAMPLE: In a guardianship, when income is insufficient for the child's support, the guardian may wish to sell or encumber guardianship property to raise more money. If so, the guardian must comply with Prob C §§2540-2557, requiring court authorization, confirmation, or direction for sales or mortgages. In addition, before the sale of the ward's residence or property valued in excess of $10,000, that property must be appraised by a probate referee. Prob C §2943(b). No such restrictions apply to trusts under a properly drafted trust instrument.

- The appointment of the trustee or successor trustee does not require the type of court approval required for a parent's nomination of a guardian. See §24.4 on the distinction between nomination and appointment of a guardian.

See §§22.7-22.8 for additional examples of trust flexibility.

NOTE: The lack of court supervision is not always an advantage. Particularly when a trustee is an unsophisticated individual, judicial supervision may be the best way to protect not only the beneficiaries but also the trustee.

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§22.7 3. Control Over Fiduciary's Investment Powers

A principal advantage of a trust is that the testator can direct the trustee's investment of trust assets. The trustee is subject to the "prudent investor" rule (see Prob C §16047), although the testator may expand or restrict this standard by express provision in the trust (Prob C §16046(b)). See §§29.10-29.11. Trustees need not seek prior court approval to invest funds.

Trustees can be given broad investment powers (see forms in §29.13) to which more specific authority may be added. See, *e.g.,* dictum in *Estate of Jones* (1955) 130 CA2d 196, 208, 278 P2d 701, on the broad effect of express authority in the will to deal with property as if it were the trustee's own.

In contrast, the testator cannot determine the investment powers of a guardian. Many investments must be authorized by court order (see, *e.g.,* Prob C §§2570, 2573; see also Prob C §2574 (investment not subject to court authorization)). Some types of investments are usually disapproved for guardianship funds, *e.g.,* unsecured loans, many debenture bonds, secured or unsecured loans, or transactions with the ward's near relatives. See California Guardianship Practice §§13.46-13.47 (Cal CEB Annual).

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§22.8 4. Flexibility in Providing for Children

A testamentary trust allows the testator to specify the kind of support to be given to his or her children. If inclined, the testator may give precise directions. For example, the testator may direct in the trust instrument that the trustee provide the minor children with an education in an expensive East Coast boarding school and an annual holiday abroad. This flexibility is not available under a guardianship, because the Probate Code determines the kind of support that a guardian may provide. See Prob C §§2420-2422.

In addition, with one guardianship, a testator cannot provide for the needs of all his or her children. For each minor child, a separate guardianship must be established that cannot benefit anyone other than the minor or persons whom the minor is legally obligated to support. If all the funds in one minor's guardianship are depleted because of unusually heavy expenses for, *e.g.,* health care or education, funds in the guardianships of the testator's other minor children will be unavailable to help. If a single trust is established for all the testator's children, however, the trustee can be given authority to make distributions to or for the children according to each of their needs. See §22.49. This type of family pot trust allows the testator the flexibility to provide for unusual expenses incurred by one child. See §§22.18-22.20 on family pot trusts versus separate trusts for each child.

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§22.9 5. Protection Against Creditors

"Spendthrift" clauses to protect assets from creditors, easily established in trusts (see chap 27), are not possible in guardianships. For provisions requiring payment of a minor's debts out of guardianship funds, see Prob C §§2430-2431.

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§22.10 6. Possible Avoidance of Administration of Child's Estate

If a minor dies during a guardianship, the guardianship property is considered to be part of the minor's probate estate. See *Estate of Livermore* (1901) 132 C 99, 64 P 113. The devolution of the guardianship assets into the probate estate may trigger the need for administration of the minor's estate. If the trust has been properly drafted, however, trust property can be kept out of a minor's probate estate at the minor's death.

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§22.11 7. Flexibility in Tax Planning

A testator can structure a trust to enable the trustee to minimize tax costs while providing for a minor beneficiary. Depending on the trust provisions, income may be made taxable to the trust rather than to the beneficiary except to the extent that it is actually distributed to the beneficiary. See IRC §§641-663. The tax rates applicable to trusts are compressed, however, so that trusts rapidly become subject to the highest marginal tax rates. IRC §1(e). In contrast, income earned during a guardianship is ordinarily taxable to the minor whether it is actually distributed to the minor or not. See Treas Reg §1.641(b)-2(b).

Further, if the trustee of a trust for several minor beneficiaries has discretion in making distributions, income may be "sprinkled" among lower tax-bracket beneficiaries to lower tax liability. No such savings are possible in a guardianship. In fact, because a guardianship estate is not a separate taxable entity, a guardianship presents very little opportunity for tax planning. See California Guardianship Practice §14.7 (Cal CEB Annual). See chap 23A for a detailed discussion of trust income taxation. See also California Trust Administration, chap 11 (2d ed Cal CEB 2001).

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§22.12 8. Common Misconceptions About Trusts

Many clients and some attorneys prefer guardianships of the estate for reasons that do not hold up under examination:

- *Expense.* Although trusts are assumed to be more expensive than guardianships, the cost differential is rarely great. The difference between the costs of drafting a trust and a guardianship is seldom substantial, and there is usually little if any difference between trustee and guardian fees. Whether they act as guardian or trustee, most banks and trust companies in California annually charge approximately 0.75 percent of the market value of the principal subject to their control. A qualified friend or relative of the testator who consents to act as guardian for little or no fee may be persuaded to act as trustee on the same basis.
- *Reluctance of corporate fiduciaries.* The assumption that corporate fiduciaries are reluctant to accept small estates is frequently correct, but the conclusion that a guardianship is preferable does not always follow. Most institutions will not accept either a guardianship of the estate or a trust unless the net value of the estate is at least $500,000. The reluctance of a bank or trust company to accept a small estate can sometimes be overcome if either the client or the attorney is a valued customer. Otherwise, the testator must find an individual who is willing to serve as trustee. Willing persons are ordinarily no more reluctant to serve as trustee than to act as guardian.
- *Justification of trust administration.* The assumption that small estates do not justify the drafting of trust provisions may be unwarranted in two respects:
- The estate may be larger than the client anticipated. For instance, if the client provided insurance for the lifetime care of the client's spouse and for the children's support during minority, and the spouse dies before or at the same time as the client, the insurance proceeds may amply justify trust administration for the children's benefit.
- A trust may be more advantageous to a small estate than a guardianship. For example, a trust may be preferable to a guardianship in an estate in which the principal asset has greater value left intact than divided. Similarly, property requiring greater freedom in its management than is available to a guardian under the restrictions discussed in §§22.6-22.7 (*e.g.,* a going business) is a good candidate for trust administration.
- *Utility of trusts.* A trust is assumed to have no utility if the estate is thought to be too small to be invested profitably in anything but a savings account in a bank or savings and loan association. This assumption lacks merit because many corporate fiduciaries maintain common trust funds in which small accounts enjoy advantages similar to those enjoyed by investors in mutual funds or other investment companies. Some corporate fiduciaries make standby trust agreements available that may be unfunded until activated. Although these trust agreements do not provide the flexibility of an individually prepared document, they can be an excellent vehicle for smaller trusts.

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E. Custodianships Under California Uniform Transfers to Minors Act (CUTMA)

§22.13 1. Statutory Requirements

A custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) is a legal arrangement in which property devised (or given) to a minor is managed and expended for the minor's benefit by an adult (custodian) selected by the testator (or donor) until the minor reaches age 18. At this time, the custodian transfers all remaining custodial property to the minor. See Prob C §§3914(a), 3920. If the testator desires the custodianship to continue after the minor reaches age 18, the will must specify the age at which the custodianship will terminate. The testator cannot delay termination, however, beyond the beneficiary's 25th birthday. Prob C §3920.5(c).

A custodianship cannot have multiple minor beneficiaries. Further, only one adult may be named as custodian. Prob C §3910. The testator may designate successor custodians to serve, in a specified order of priority, if the originally designated custodian is unable, declines, or is ineligible to serve or resigns, dies, becomes incapacitated, or is removed. The testator's designation of successors takes precedence over a designation by a custodian. Prob C §3918(b). CUTMA confirms that a personal representative or trustee may select a custodian if none is nominated by the testator or if all those nominated are unable to act. Prob C §3905(c).

There are no longer any limits on the types of property that may be devised to a minor under CUTMA. See Prob C §§3901(f), 3909(a)(7). Probate Code §3909 specifies the method of transfer of money, securities, life or endowment insurance policies, annuity contracts, real property, tangible personal property, and any other property. See form 22.14-1.

When investing custodial property, the custodian must abide by the standard of care that would be followed by a prudent person dealing with another's property. Prob C §3912(b). The custodian is not limited by any other statute restricting investments by fiduciaries. Prob C §3912(b). The custodian is authorized, however, to retain in the custodianship any property received from the testator. Prob C §3912(b)(2).

CUTMA places few restrictions on the custodian's power to use custodial funds for the minor's benefit. Probate Code §3914(a) provides:

> A custodian may deliver or pay to the minor or expend for the minor's benefit as much of the custodial property as the custodian considers advisable for the use and benefit of the minor, without court order and without regard to (1) the duty or ability of the custodian personally, or of any other person, to support the minor or (2) any other income or property of the minor which may be applicable or available for that purpose.

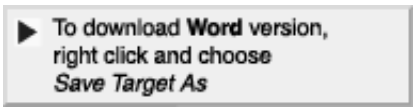
A custodianship is not court supervised. CUTMA provides court access, however, for decisions about particularly significant issues. See, *e.g.,* Prob C §§3914(b) (petition process to compel custodian to distribute funds), 3919 (petition to compel accounting).

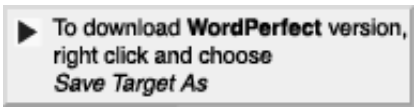
For discussion of tax issues posed by CUTMA, see California Estate Planning, chap 8 (Cal CEB 2002). For further discussion of custodianships, see Drafting California Irrevocable Trusts §§12.23-12.37 (3d ed Cal CEB 1997); 13 Witkin, Summary of California Law, *Personal Property* §§139-150 (10th ed 2005).

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.14 2. Form: Devise to Minor Under CUTMA

§22.14 2. Form: Devise to Minor Under CUTMA





22.14-1 Devise to minor under CUTMA

[*Add one of the following alternatives*]

[*Alternative 1: Named custodian*]

***Specific Gift*. I give** _ _[*gift*]_ _ **to** _ _[*name of beneficiary*]_ _**. If** _ _[*name of beneficiary*]_ _ **is under age** _ _[*number 18 to 25*]_ _ **at the time of my death, I give this gift to** _ _[*name of custodian*]_ _ **as custodian for** _ _[*name of beneficiary*]_ _ **under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925), until the beneficiary reaches age** _ _[*number 18 to 25*]_ _**.**

[*Alternative 2: Custodian to be named by executor*]

***Power to Name Custodian*. If any beneficiary of my estate is under age** _ _[*number 18 to 25*]_ _ **at the time of my death, I authorize my executor, in my executor's sole discretion, to make an irrevocable transfer of that beneficiary's gift to a custodian who is selected by my executor for the minor, under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925), until the beneficiary reaches age** _ _[*number 18 to 25*]_ _.

Comment: Form 22.14-1 provides for termination at any age between 18 and 25. See discussion in §22.13. If the testator does not desire to name custodians for particular beneficiaries, Alternative 2 should be used as a "safety net" so that a gift under the will will not require a guardianship. Alternative 1 is designed to be included in the division of the will providing for gifts of property. Alternative 2 is designed to be included in the division of the will nominating the executor and providing for the executor's powers.

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§22.15 3. Comparison of Custodianships and Testamentary Trusts

A custodianship is a type of trust. Its terms are set forth in the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). It does not share some of the disadvantages of guardianships (discussed in §§22.5-22.12) because, like a testamentary trust, a custodianship is not court supervised and does permit a termination date beyond age 18. A custodianship is particularly attractive for small devises to minors because it does not require the extensive legal drafting necessary to establish other testamentary trusts.

The biggest disadvantage of a custodianship is its rigidity: A testator cannot structure its terms to suit the beneficiary's particular needs or the testator's estate planning objectives. Although the testator can delay termination of a custodianship beyond age 18, termination cannot be postponed past the beneficiary's 25th birthday. See §22.13. The testator who does not want a minor beneficiary to have complete control over the devise to him or her until age 30 or 40 must steer clear of a custodianship. So too must a testator who desires multiple fiduciaries or a family pot trust. CUTMA does not permit co-custodians or multiple beneficiaries. See §22.13.

A custodianship will not allow a testator to specify how a fiduciary for a minor may deal with property under his or her control, because a custodian's investment powers are set forth in Prob C §3912. In addition, under Prob C §3914(a), a custodian has practically unlimited powers to expend custodial property for the minor's benefit. In contrast, a testamentary trust can be crafted to give broad or narrow investment powers to the trustee and to authorize the trustee to make distributions only according to guidelines specified by the testator.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.16 F. Gift Delivered to Parent of Minor With Small Estate

§22.16 F. Gift Delivered to Parent of Minor With Small Estate

Under Prob C §3412(d), the testator may make a gift not exceeding $5000 in value to a minor by paying or delivering it to the parent who is entitled to the minor's custody on the parent's oath that the minor's estate, including the gift to be received, does not exceed $5000. Prob C §3412(d). Custodial property held under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) is excluded from the $5000 value. Prob C §3400(b)(1). Payment or delivery of the gift may be made, under the circumstances stated above, to the minor's parent, even if the minor has a guardian of the estate. Prob C §§3400-3402. See California Guardianship Practice §2.32 (Cal CEB Annual).

If the minor's estate is not expected to exceed $5000, exclusive of property held under CUTMA, this device will normally avoid guardianship. The attorney should alert the donor that the assets in question must be relinquished to the minor on majority (age 18). Prob C §3300.

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§22.17 G. Court-Ordered Disposition of Gift

If a minor does not have a guardian of the estate "and there is money belonging to the minor" (Prob C §3410(a)(2)), a petition for a court order under Prob C §§3410-3413 may be filed by a custodial parent or "the person holding the money." Prob C §3411. The court may order one or more of the following:

- The money must be deposited or invested in a bank in California or other specified financial institutions, or in a single-premium deferred annuity, subject to withdrawal only on court authorization. Prob C §3412(a).
- The money must "be held on any other condition that the court in its discretion determines to be in the best interests of the minor," provided that the money belonging to the minor does not exceed $20,000. Prob C §3412(c).
- All or any part of the money must be transferred to a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925). Prob C §3412(b).

If the court does not order one of the above actions, a guardian of the estate must be appointed and the money paid to the guardian.

Under any of these alternatives, the money must be turned over to the individual when he or she reaches age 18. Prob C §3300. For this reason, the procedure authorized in Prob C §§3410-3413 is generally only suitable if nominal amounts are involved. For further discussion, see California Guardianship Practice §2.40 (Cal CEB Annual).

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§22.18 III. FAMILY POT TRUST VERSUS SEPARATE TRUSTS

An estate plan for a married client with children often includes a testamentary trust for the family's benefit. The will typically creates a trust for the primary benefit of the surviving spouse, although distributions may be made directly to or for the benefit of the children during the spouse's lifetime. The will may provide that, at the surviving spouse's death, the trust will be handled in one of two ways:

(1) *Family pot trust.* The trust continues as a single trust for the benefit of all the children (and perhaps the issue of deceased children). The trustee is given discretion to distribute principal and income among the children according to standards described in the trust. Termination of the trust and distribution of all trust assets are postponed often until the youngest child reaches a specified age or achieves a certain level of education. For further discussion and sample clauses, see §§22.42-22.52A.

(2) *Separate trust for each child.* The trustee is required to divide the trust assets into as many equal shares as there are then-living children and deceased children who leave then-living issue. Each share is administered as a separate trust. The terms of each trust may differ to accommodate each beneficiary's particular needs. For further discussion and sample clauses, see §§22.53-22.58.

Each of these approaches has its merits. See §§22.19-22.20 for discussion of the advantages of each. In the final analysis, the approach depends primarily on the testator's values; the size of the estate; the number, ages, and needs of the children or other beneficiaries; and the manner in which the testator desires to provide for them.

A third approach is a single trust with directions to the trustee to disburse the income, or the principal and income, equally among the children. This alternative is generally unacceptable because it bears the disadvantages of both of the two basic approaches and the advantages of neither.

PITFALL: The decision about the type of trust to establish for children or other minor beneficiaries often has generation-skipping transfer tax implications. See §§15.11-15.12.

For general discussion of single trusts versus multiple trusts, see §7.18.

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§22.19 A. Advantages of Family Pot Trust

The family pot trust is preferable to a separate trust for each child when the testator's estate is small (*e.g.,* the assets of the estate are worth $200,000 or less), although the individual circumstances of each client should be carefully reviewed. Because of fixed expenses of trust administration, especially the minimum fee required by corporate trustees, a small estate should not be divided into separate trusts. It may be unwise even for a moderate or large estate to be divided into separate trusts if a major part of the estate consists of a closely held business or a similar asset that is difficult to divide economically. But see §22.48.

A family pot trust is particularly attractive to the testator who wants a single trust to bear his or her children's unequal financial burdens. For example, one child may incur large expenses due to a serious illness or accident. If the estate had been divided into separate trusts for each child, these expenses would seriously deplete that child's trust, leaving very little for the child's on-going support. In contrast, if the estate had been placed in a family pot trust, the expenses would be paid from the "pot" of all the testator's funds and there probably would be enough remaining to adequately support all the testator's children.

Another advantage of a family pot trust is that it avoids unfairness to a younger child who needs support from family funds longer than older children. The family pot trust ensures that funds will be available to pay for educational and other needs of all children at least to a certain age. When the youngest child reaches that age, the trust property can be divided into separate trusts or distributed.

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§22.20 B. Advantages of Separate Trusts

The establishment of separate trusts enables each child solely to enjoy the benefits of his or her trust. The assets of one child's trust are not available to any other child. This eliminates the arguments over comparative needs and demands that sometimes occur among the testator's children when they are beneficiaries of a family pot trust. The shares of the testator's estate going to each trust need not be equal, allowing for differences based on current circumstances or expected needs.

Separate trusts also enable older children to receive their shares of principal when they reach a particular age (*e.g.,* 25 or 30). Family pot trusts commonly make older children wait for distribution of principal until the youngest child reaches a certain age. See §22.52.

Separate trusts are particularly well suited to large estates. When each separate trust is large, the risk that a child's needs for support, education, and medical care will dissipate his or her trust is greatly reduced. Separate trusts are also appropriate when the children will have adequate means for support apart from the testator's estate.

Another advantage of separate trusts is that each child will be taxed on current and accumulated income only from his or her own trust. Otherwise, unless the trust comes within the separate share rule of IRC §663(c), the tax consequences of distributions to children in different years may vary considerably. On income tax rules applicable to trusts, see §§7.20-7.21. See also Lane & Zaritsky, Federal Income Taxation of Estates and Trusts (3d ed 2001).

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IV. GENERAL CONSIDERATIONS WHEN DRAFTING TRUSTS FOR CHILDREN

§22.21 A. Distributions of Trust Income

One important aspect of a testamentary trust for children is the testator's direction for distributions of trust income. The testator may direct that:

- All or a fixed percentage of net annual income must be paid out to the beneficiaries;
- All income must be accumulated and added to principal for a specified period of time; or
- The trustee has the discretion to distribute income to the beneficiaries or accumulate the income and add it to principal.

Most trusts for children give the trustee the discretion to distribute income and avoid directing the trustee to distribute a fixed amount each year. This flexibility allows the trust to adjust to the changing needs of the beneficiaries. On fixed payments versus discretionary payments, see §21.6.

If the testator gives the trustee discretion to distribute income, the testator should specify the purposes for which the trustee may make distributions. See §§22.23-22.33 on the purposes for which a trustee may be authorized to distribute income.

As noted in §7.21, whenever a trustee is not required to pay out currently all the net income of the trust, the will should state the disposition of any undistributed net income. If the testator wants undistributed income to be accumulated and added to principal (as is usually the case), this desire should be expressed in the will. CC §724.

When considering directions to distribute income, the testator should pay attention to income tax considerations. Distributions of income to children in amounts that will "use up" their personal exemptions (IRC §151) and distributions to beneficiaries in income tax brackets lower than the trust's tax bracket will significantly reduce the overall tax burden. However, the unearned income of a beneficiary under age 19 (age 24 in the case of a student) is taxed at his or her parents' marginal tax rate. IRC §§1(g), 152(c) ("kiddie tax"). That tax rate may be higher than the trust's marginal rate. On income tax rules applicable to trusts, see §§7.20-7.21. See also Lane & Zaritsky, Federal Income Taxation of Estates and Trusts (3d ed 2001).

The testator should always keep in mind the parents' legal obligation to support the minor beneficiaries of the trust. An income distribution to a minor is treated as income to the parents for tax purposes to the extent that it discharges the parents' obligation of support. Treas Reg §1.662(a)-4. This is true regardless of whether the parents are trustees with discretionary power over income payments. IRC §662(a)(1)-(2); Treas Reg §1.662(a)-4. The testator should be particularly careful not to give a parent legally obligated to support a trust beneficiary the power to determine distributions to that beneficiary in a capacity other than that of trustee. If the testator does give a parent this power, all trust income will be taxable to the parent regardless of whether it is used for the beneficiary's support. IRC §678(c); Treas Reg §1.678(c)-1(b).

The existence and extent of a legal obligation of support are determined by local law. Treas Reg §1.662(a)-4. See *Joanne L. Sharon,* TC Memo 1989-478 (California taxpayers' parental obligation of support did not include obligation to pay private high school and college tuition or European tours). But see *Christopher Stone,* TC Memo 1987-454 (California taxpayers' parental obligation of support included obligation to pay private high school tuition). For cases about what constitutes a support obligation, see Drafting California Irrevocable Trusts §§5.20-5.23 (3d ed Cal CEB 1997).

The testator should bear in mind that a child given the sole power to vest trust principal or income in himself or herself will be taxed on the income from that portion of principal to which the power applies. IRC §678(a)(1). See *Hirschmann v U.S.* (2d Cir 1962) 309 F2d 104; *Ella E. Russell* (1941) 45 BTA 397. See also Irrevocable Trusts §9.53.

In addition to income tax consequences, the attorney should inform the testator of the possible estate tax consequences that flow from different provisions for distribution of trust income. The Internal Revenue Code provides that a power of appointment that can be exercised to discharge a legal obligation of the holder of the power is a general power of appointment for estate tax purposes. Treas Reg §20.2041-1(c)(1). Therefore, a trustee's power to

apply principal or income to discharge the trustee's legal support obligations may cause the trust assets to be included in the trustee's gross estate for federal estate tax purposes.

Similarly, a child who has the exclusive power to vest trust principal or income in himself or herself will incur federal estate tax liability under IRC §2041. See §28.8. These federal estate tax burdens can be avoided if the power to distribute in these instances is limited to an ascertainable standard (*i.e.,* for health, education, support, or maintenance). IRC §2041(b)(1)(A). See §§16.19, 21.29.

On principal and income issues, see §§7.19, 30.8-30.12. See also California Trust Administration, chap 8 (2d ed Cal CEB 2001).

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.22 B. Distributions of Principal

§22.22 B. Distributions of Principal

The testator should authorize the trustee to distribute funds from (invade) the principal of the trust if the anticipated available income is insufficient to carry out the testator's purposes. Most testators establishing testamentary trusts for children give one of the following principal invasion powers to their trustees:

- The broad power to invade principal whenever the trustee considers it to be necessary;
- The power to invade principal for the children's health, education, support, or maintenance;
- The limited power to invade principal only for narrowly defined purposes (*e.g.,* a health emergency, a college education);
- The limited power to invade principal when trust income is insufficient to pay the fixed amount that the trustee is required to distribute to the children periodically; or
- The power to invade principal for specified purposes on written request by the beneficiary.

Broader types of principal invasion powers are frequently included in the income distribution clause of a trust. For example, trustees are authorized to distribute principal and income for the children's health, education, support, or maintenance. On principal invasion powers in general, see §§7.22, 21.28-21.36. On preliminary distributions from principal, see §21.34.

Like income distribution clauses, principal invasion provisions of a trust can have serious estate and income tax consequences. See §22.21.

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§22.23 C. Purposes for Which Trustee May Distribute Income or Principal

Testamentary trusts often authorize distributions for a combination of purposes (*e.g.,* for health, education, support, or maintenance). These purposes limit the scope of the trustee's powers to distribute income, invade principal, or do both. It is important that the drafter carefully express in the will the testator's intent about the scope of the trustee's distribution powers. On the one hand, a broad set of purposes, such as the "care, comfort, support, maintenance, pleasure, welfare, happiness, and recreation" of the beneficiaries, may imply benefits beyond those intended. On the other hand, limiting distributions to purposes such as "emergencies" may prove too restrictive.

The choice and drafting of purposes for which distributions may be made may have serious income and estate tax ramifications. See §22.21.

For related forms, see §§22.49 (distributions in family pot trust), 22.58 (distributions in separate child's trust).

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.24 1. Support

§22.24 1. Support

Authorization for distributions for a beneficiary's "support" is a common provision in trusts for children. In determining the meaning of "support," the trustee is guided primarily by his or her understanding of the testator's intent. When determining that intent, the trustee may consider the size of the trust estate and each child's particular situation in life. 2 Scott & Ascher on Trusts §13.2.4 (5th ed 2006). The trustee is also guided by the parent's legal duty to support his or her minor child. Unfortunately, the extent of this duty is unclear. For detailed discussion of this duty, see Drafting California Irrevocable Trusts §5.20 (3d ed Cal CEB 1997).

When a substantial trust estate is involved, the testator should clarify his or her intent by specifying the nature of the support to be given. The testator may provide, for example, that the support:

- Be "generous";
- Be consistent with the child's "accustomed manner of living" at the death of the testator or the testator's spouse;
- "Include a reasonable number of luxuries"; or
- "Include reasonable amounts of domestic and foreign vacations."

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§22.25 a. Aid to Persons Caring for Children

Related to the issue of "support" is assistance to the person who cares for the children. This individual is often the children's guardian of the person. The testator may want to help the guardian by minimizing the financial burden of raising the children or by compensating the guardian for it. Three common alternative methods of assisting the guardian are (see form 22.26-1):

(1) Authorizing the trustee to make payments to the guardian;

(2) Authorizing payments for support of the guardian and his or her family; and

(3) Compensating the guardian from trust assets.

The first two methods differ slightly. The first is intended to ease the burden on the guardian; the second is for support for the guardian. The drafter must consider the income tax consequences to the trust and the guardian of each of the three methods.

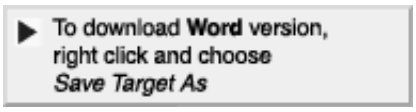
Under either of the first two methods, the guardian could be treated for income tax purposes as a trust beneficiary, subject to the general income tax principles applicable to beneficiaries (see §22.21) and taxable on distributions to the extent that there is distributable net income (DNI) (see chap 23A). The third method, compensation, is clearly taxable to the guardian as income under IRC §61.

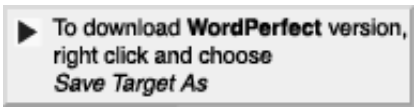
See §§22.31-22.33 on housing for the testator's children.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.26 b. Form: Payments to Persons Caring for Children

§22.26 b. Form: Payments to Persons Caring for Children





22.26-1 Payments to persons caring for children

[*Add one of the following alternatives*]

[*Alternative 1: Payments to ease guardian's financial burden*]

***Payments to Guardians of Minor Children*. If a guardian of the person is appointed for any of my minor children who are beneficiaries of this trust, distributions for the support and maintenance of that child may, in the trustee's discretion, include payments necessary to ease the trustee's discretion, include payments necessary to ease the financial burden imposed on the guardian and his or her spouse and children by my child's presence in the guardian's household.**

[*Alternative 2: Payments for guardian's support*]

***Payments to Guardians of Minor Children*. If a guardian of the person is appointed for any of my minor children who are beneficiaries of this trust, distributions for the support and maintenance of that child may, in the trustee's discretion, include payments for the support and maintenance of the guardian and his or her spouse and children for the duration of the guardianship.**

[*Alternative 3: Compensation for guardian: fixed rate*]

***Payments to Guardians of Minor Children*. If a guardian of the person is appointed for any of my minor children who are beneficiaries of this trust, the trustee shall compensate the guardian for his or her services at the following rate for the duration of the guardianship: _ _[*dollar amount*]_ _ per month for each child of mine subject to the guardianship. This compensation shall be paid first from trust income and then from principal if necessary. This compensation shall not duplicate any other compensation provided for the guardian in my spouse's will.**

[*Alternative 4: Compensation for guardian: rate adjusted for inflation*]

***Payments to Guardians of Minor Children*. If a guardian of the person is appointed for any of my minor children who are beneficiaries of this trust, the trustee shall pay the guardian, at monthly intervals, an amount equal to the "compensation rate" for each child of mine subject to the guardianship. The compensation rate is _ _[*dollar amount*]_ _ multiplied by the "cost of living increase percentage." The cost-of-living increase percentage for the first twelve payments is the percentage increase between the date of this will and the date of my death. Thereafter, the cost-of-living increase percentage shall be adjusted annually for subsequent changes in the cost of living. The cost-of-living increase percentage shall be determined by the trustee, using the Consumer Price Index for All Urban Consumers _ _[*for the area in which the guardian resides*]_ _. If this index is not available, the trustee shall choose a reasonably comparable index. This compensation shall be paid first from trust income and then from principal if necessary. This compensation shall not duplicate any other compensation provided for the guardian in my spouse's will.**

Comment: Payments to or for the benefit of the guardian's children could cause generation-skipping transfer (GST) tax problems, depending on the children's age and relationship to the testator. See chap 15 for discussion of the GST tax.

Alternatives 2 and Alternative 3 call for payments to end when the guardianship does. The drafter should modify these clauses if the testator desires payments to continue beyond the guardianship.

Alternative 3 may be used in addition to Alternative 2 if the testator wants to guarantee a minimum rate of compensation to the guardian.

Alternative 4 should be in place of Alternative 3 if the testator wants the compensation rate to be adjusted to keep pace with inflation. Bureau of Labor Statistics' consumer price index information can be obtained at

http://www.bls.gov/cpi.

All of these alternative clauses are written for trusts with multiple minor beneficiaries. The attorney should modify the clauses if he or she is drafting a separate trust for each child.

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§22.27 c. Payment of Deceased Beneficiary's Last-Illness and Funeral Expenses and Other Debts

The availability of funds to pay a deceased beneficiary's last-illness and funeral expenses and other debts from a trust that provides for the beneficiary's "support" has been the subject of litigation. See 2 Scott & Ascher on Trusts §13.2.4 (5th ed 2006). Although a child is unlikely to die before termination of a trust created for his or her benefit, it is still good practice for the drafter to include a clause indicating the testator's intent about payment of these expenses. The clause should specify whether income or principal or both may be used for payments to forestall charges of favoritism to either income beneficiaries or remainder beneficiaries.

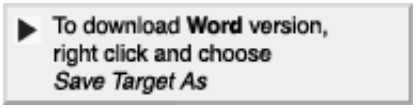
On payment of a beneficiary's death taxes attributable to trust assets, see §§31.19-31.20.

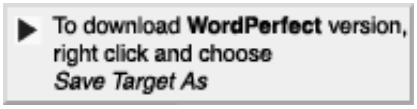
If the testator wants the trust to pay funeral expenses, the attorney should explain to him or her the tax consequences of directing, rather than authorizing, the trustee to pay these expenses. If the trustee's power to pay is discretionary and the estate pays the expenses, the estate is permitted to deduct them on its income or estate tax return because the estate is primarily liable for those expenses. If the testator requires the trustee to pay the expenses, however, either the child's estate will lose the deduction for funeral expenses or the amount paid will be included in the child's estate for federal estate tax purposes.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.28 d. Form: Trustee's Discretion to Pay Beneficiary's Last-Illness and Funeral Expenses and Obligations Incurred for Support

§22.28 d. Form: Trustee's Discretion to Pay Beneficiary's Last-Illness and Funeral Expenses and Obligations Incurred for Support





22.28-1 Trustee's discretion to pay beneficiary's last-illness and funeral expenses and obligations incurred for support

***Payment of Expenses and Obligations*. If a beneficiary for whom the trustee is directed to make payments for support dies, the trustee may use principal or income of the trust to pay the beneficiary's last-illness and funeral expenses and other debts incurred for the beneficiary's support.**

Comment: This clause expresses the testator's intent that the trustee have the authority, but not the duty, to pay the beneficiary's last illness and funeral expenses and debts for support. See §22.27.

See form 31.22-1 for a clause permitting payment of last-illness and funeral expenses and obligations incurred for the support of a spouse or partner.

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2. Education

§22.29 a. Guidance to Trustee Regarding "Education"

The testator may wish to give the trustee guidance on the type of education to be paid for by the trust for the testator's children. The attorney should explore the following questions with the testator:

- Should the trust pay for private day or boarding schools? For private universities?
- Should the trust underwrite only an undergraduate education? Only graduate work?
- Should payments for education include payments for vocational training?
- Should payments for education be discontinued if the child's scholastic standing is not satisfactory? If the child does not obtain a bachelor's degree in 4 years?
- Should payments for education include payments for social and other extracurricular activities?
- Should the trust pay for travel to and from school? How many of these trips should be financed?
- Should the trust pay for studies abroad? Should payments for education include travel that has educational value?
- Should the trust pay for private lessons in, *e.g.,* music or sports?
- Should payments for education cease when the child reaches a particular age?

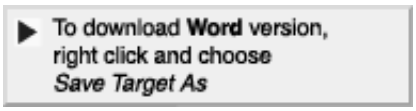
Although these matters may be left to the trustee's discretion, if the testator has a strong opinion on a particular matter, the drafter should express this in the will.

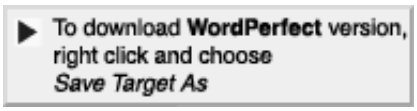
For examples of the many ways that a trust may define "education," see form 22.30-1.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.30 b. Form: Definition of 'Education'

§22.30 b. Form: Definition of "Education"





22.30-1 Definition of "education"

[*Add one of the following alternatives*]

[*Alternative 1: Broad definition*]

Definition of "Education." **Whenever this trust calls for payments for a beneficiary's education, the term "education" is meant to include vocational, undergraduate, and graduate studies at an institution of the beneficiary's choice if, in the trustee's discretion, they are pursued to advantage by the beneficiary. The trustee may pay for the beneficiary's living and travel expenses reasonably related to the beneficiary's studies.**

[*Alternative 2: Narrow definition*]

Definition of "Education." **Whenever this trust calls for payments for a beneficiary's education, the term "education" is meant to include an undergraduate education substantially equal in expense (including room and board) to that of an undergraduate education at one of the University of California campuses. If a beneficiary wants to attend a more expensive university or obtain a graduate degree, the trustee may lend the beneficiary the funds to do so. The trustee shall fix the terms of the loans. The loans shall not exceed in the aggregate _ _[*number*]_ _ percent of that beneficiary's putative share of the trust estate. If not paid by the time of division of the trust into separate shares for distribution, the outstanding balance on these loans shall be charged against that beneficiary's share of the trust.**

Comment: Alternative 1 allows the trustee to decide whether the course of study is being pursued to advantage by the beneficiary, thereby reducing the risk that the beneficiary will become a "professional" student. If that is not a concern of the testator, the drafter should delete the appropriate language from the first sentence.

Alternative 2 is appropriate for a family pot trust. See §22.19. It should be modified if the attorney is drafting a separate trust for each child. On putative shares, see §22.47.

On absolute discretion versus reasonable discretion, see §29.6.

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3. Housing

§22.31 a. Delineating Trustee's Authority to Provide Home for Children

To minimize the risk of later conflicts over the testator's intent, the testator should delineate the trustee's power to expend funds to provide a home for the testator's children. If the children are to live in their guardian's residence, the trustee should be authorized to make payments to cover their share of the guardian's housing expenses. If the children and their guardian are to live in the testator's residence, the will should describe the financial arrangements between the trust and the guardian. See forms in §§22.32-22.33.

Although Prob C §16220 permits the trustee to retain the testator's residence in the trust, for the sake of clarity and completeness the will should expressly authorize the trustee to do so. See form 22.33-1. See also §§31.23-31.24 on trustee authorization to permit beneficiary to occupy trust's residential property.

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§22.32 b. Form: Authorization to Make Payments for Housing Expenses

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22.32-1 Authorization to make payments for housing expenses

***Payment of Housing Expenses*. If my children reside with the person appointed as guardian of the person of any one of them, the trustee is authorized to make payments to or other arrangements with the guardian that the trustee considers necessary or desirable to compensate the guardian for my children's share of the housing expenses. The purpose of this provision is to permit the guardian to supply housing to my children without financial loss.**

If the guardian takes any of my children into his or her own home and it becomes appropriate to remodel the residence or buy a larger house, the trustee is authorized to use trust funds to assist the guardian with the related expenses. If the trustee expends funds for remodeling or purchasing a residence with the guardian, the trustee shall enter into an agreement with the guardian by which the trust acquires a fair ownership interest in the residence.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.33 c. Form: Retention and Use of Testator's Residence as Home for Children

§22.33 c. Form: Retention and Use of Testator's Residence as Home for Children

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22.33-1 Retention and use of testator's residence as home for children

***Retention of Residence*. If all or a portion of my residence is held in trust, the trustee may retain the residence in the trust for rent-free occupancy by my children. If any of my children has a guardian of the person, the trustee may allow the guardian and the guardian's spouse and minor children, if any, to reside, rent free, in this residence along with my children until my youngest child reaches age _ _**[*number*]**_ _ If only a portion of my residence is held in trust, the trustee may seek to arrange for occupancy of the other portion by my children and their guardian.**

All costs of maintaining and repairing the residence (or, if the trust owns a portion of it, that part of costs allocable to the trust's interest, together with any rent or other fees paid to the owner of the other portion) shall be paid by the trust out of either income or principal as the trustee, in the trustee's discretion, decides.

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

[*Option 1: Retention if not occupied by children (discretionary)*]

If my residence is held in this trust but none of my children reside in it, it is my wish, but not my direction, that the property be retained in the trust even if it produces no rental income and is not expected to increase in value. I further request that my children be consulted before any plans are made to sell the residence, although their opinions about sale terms and whether the house should be sold are not binding on the trustee.

[*Option 2: Retention if not occupied by children (mandatory)*]

If my residence is held in this trust but none of my children reside in it, I direct that the property be retained in the trust even if it produces no rental income and is not expected to increase in value.

Comment: If the testator's estate plan calls for separate trusts for each child, the second paragraph should be modified to explain how the costs will be borne by the several trust funds. If the testator wants to ensure that the residence is not sold, the drafter should use option 2 in place of option 1.

If the testator wishes to allow the guardian to remain in the residence indefinitely, the first paragraph should be modified to give the trustee the discretion to allow the guardian to remain in the residence. Often, testators allow the guardian to live in the house until the age that the youngest child is expected to graduate from college (*i.e.,* 22 or 23). This gives the guardian some time after the beneficiary attains majority to make alternative housing arrangements and also allows the child a "home" to visit during school vacations and holidays.

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D. Trustee's Consideration of Outside Resources Before Making Discretionary Payments

§22.34 1. Importance of Specifying Whether Trustee Should Consider Beneficiary's Outside Resources

A child may have significant resources outside the trust, which may affect the extent to which the testator wants trust assets to be used for the child's support. The law is unclear on what the trustee should do if the will is silent on this issue. Compare *Estate of Ferrall* (1953) 41 C2d 166, 258 P2d 1009, and *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639 (trustee may consider outside resources), with *Estate of Patten* (1963) 217 CA2d 167, 31 CR 767 (trustee may not consider outside resources). Therefore, the testator should provide explicit instructions on this matter for the trustee in the will. On what a trustee should do in the absence of instructions, see California Trust Administration §2.72 (2d ed Cal CEB 2001).

Whether outside resources should be considered depends on a variety of factors, *e.g.,* the testator's values, the size of the trust estate, the nature and extent of the child's resources, and the circumstances of other income and remainder beneficiaries. For instance, if the trust calls for distributions to a child for life with the remainder to the child's heirs, it might be desirable to require the child to consume his or her own assets first to minimize the child's death taxes. On the other hand, requiring the child to expend his or her own assets first might cause the child to feel resentful.

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§22.35 2. Drafting Considerations

The testator has three basic choices about consideration of a beneficiary's nontrust resources:
(1) The testator may direct the trustee not to consider outside resources;
(2) The testator may authorize, but not direct, the trustee to consider outside resources; or
(3) The testator may direct the trustee to consider outside resources.

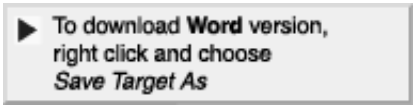
The third choice is problematic if the beneficiary has or is likely to have illiquid assets. For example, the beneficiary may own or acquire a piece of real property or stock in a closely held corporation that cannot be readily sold at its true value. If the trustee must require the beneficiary to sell this kind of asset and consume the proceeds before the trustee distributes funds to the beneficiary, the beneficiary may suffer a financial loss undesired by the testator. See, *e.g., Estate of Patten* (1963) 217 CA2d 167, 31 CR 767 (trustee abused discretion by declining to provide support for surviving spouse on ground that she should have sold or leased her house and used proceeds for her support before receiving discretionary payments from trust). But see *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639 (trustee may decline to invade principal for support of surviving spouse when the spouse owned residential property that could be used for support and lived in a residential care facility). To deal with this problem, the testator who desires trustee consideration of nontrust resources may either (a) direct the trustee to consider only resources "reasonably available" to the beneficiary for his or her use or (b) exclude the beneficiary's illiquid assets from trustee consideration. For further discussion of the problem of a beneficiary's illiquid assets, see California Trust Administration §2.74 (2d ed Cal CEB 2001).

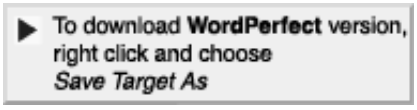
If the testator wants the trustee to consider other resources, the will should protect the trustee by limiting this consideration to assets "of which the trustee has actual knowledge." The trustee can be further protected by a provision permitting the trustee to rely on a financial statement provided by the beneficiary or the guardian listing the beneficiary's nontrust resources. See Trust Admin §2.72. The testator should also decide whether the trustee should consider the beneficiary's capacity to work before making distributions from the trust. See form 22.36-1. See also Trust Admin §2.73.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.36 3. Form: Trustee Consideration of Beneficiary's Other Resources

§22.36 3. Form: Trustee Consideration of Beneficiary's Other Resources





22.36-1 Trustee consideration of beneficiary's other resources

[*Add one of the following alternatives*]

[*Alternative 1: Trustee may consider other resources*]

When determining the amounts to be distributed, the trustee may take into consideration any other income or resources of a beneficiary of which the trustee has actual knowledge and which are reasonably available for the purposes set forth above. The trustee may also consider other means of support available to the beneficiary, including the capacity for gainful employment after completing his or her education and the obligation of any others to support the beneficiary.

[*Alternative 2: Trustee shall consider other resources*]

When determining the amounts to be distributed, the trustee shall consider any other income, resources, or means of support available to any beneficiary.

[*Alternative 3: Trustee shall not consider other resources*]

When determining the amounts to be distributed, the trustee shall not consider any other income, resources, or means of support available to any beneficiary.

Comment: See discussion in §22.34. If the testator prefers the trustee not to consider the beneficiary's capacity for work, the appropriate language should be eliminated from the clause. The clause may be added to the clause providing for distribution of income or principal to one or more beneficiaries. See §§22.49, 22.58.

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§22.37 E. Restrictions on Assignment and Protection From Creditors

The testator may want to protect the child's interest in the trust from creditors' claims or judgments and to prohibit the child from giving away his or her interest or pledging it as security for a loan. The testator may do so by including "spendthrift" provisions in the trust. See chap 27.

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F. Distributions to Minor Child or Beneficiary Under Disability

§22.38 1. Need for Specific Clauses

When distributions will be made to a minor child or a disabled beneficiary, a guardian or conservator is often appointed to receive them. See 3 Scott & Ascher on Trusts §17.14.1 (5th ed 2007); Restatement (Second) of Trusts §182, Comment d (1959). If, however, the trustee is explicitly authorized to apply funds for the beneficiary's benefit, to entrust them to the beneficiary's caregiver, or to give them directly to the minor, the administrative problems and expense of a guardianship or conservatorship may be avoided.

Probate Code §§3400-3401 are not usually helpful to the trustee who is required to make payments to a minor but is not given any directions about how to do so. These sections authorize the trustee to deliver money or other property belonging to a minor to the minor's parent to be held in trust for the minor until age 18 but only if the minor's total estate, including the assets to be delivered, does not exceed $5000. The California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) authorizes a trustee to transfer property to a custodian for the minor until age 18, when the will does not expressly authorize such a transfer, but requires court authorization for transfers exceeding $10,000 unless the custodian is a trust company or an individual designated as trustee by the terms of a trust instrument that does not require a bond. Prob C §3906(c)(3).

The will should provide ways for the trustee to make distributions to or for a minor that minimize administrative burdens and expenses.

For further discussion, see §§31.6-31.8.

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§22.39 2. Drafting Considerations

It is advisable for the will to give the trustee the following distribution alternatives when a beneficiary is a minor or under some other disability:

- Payments may be made to the guardian of the estate or the conservator;
- Payments may be made to the guardian of the person, a custodian (selected by the trustee) under the California Uniform Transfers to Minors Act (Prob C §§3900-3925), and a parent or any other suitable adult for the beneficiary's benefit;
- Payments may be applied for the beneficiary's benefit; or
- Payments may be made directly to a minor beneficiary if he or she is sufficiently mature.

Providing maximum flexibility for the trustee, these alternatives give the trustee the means to avoid court appointment of a guardian or conservator. For a related clause, see form 31.7-1.

If a disabled beneficiary is receiving or is likely to receive public benefits for support, the testator should consider structuring the trust as a "special needs" trust so that the beneficiary's benefits are not jeopardized by the trust. See chap 23.

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§22.40 G. Distribution of Remainder

The will must specify the termination date of the trust and provide for distribution of the remaining assets. A trust, other than a charitable trust (see §7.12, chap 14), must terminate within the time prescribed by California's rule against perpetuities. See Prob C §21205. On California's rule against perpetuities, see chap 34.

The will need not include a clause expressly terminating the trust. It is sufficient if the clause creating the antecedent estate specifies its duration. In that case, the will need only direct the trustee on how to distribute the remainder when the antecedent estate ends. See, *e.g.,* form 22.52-1.

A distribution of the trust remainder may be a "taxable distribution" or a "taxable termination" subject to the generation-skipping transfer tax. For complete discussion of that tax, see chap 15.

On trust termination and distribution of remainder assets, see §§21.37-21.38.

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§22.41 H. Designing Trusts for "Postponed" Child

Sometimes a testator requests the attorney's advice about structuring a trust to encourage the development of a "postponed" child, *i.e.,* a child who is perceived as immature and unlikely to reach maturity by age 25 or 30. See Gallo & Gallo, *Estate Planning for the Postponed Generation*, Estate Planning 1987 §3.2 (Cal CEB 1988). Some attorneys avoid giving such advice, believing that attorneys lack the expertise to advise parents on how to correct their children's problems.

Other attorneys believe that, as counselors, they may advise the testator about trust provisions that are designed to encourage the child's development. If such advice is given, it is wise to remind the testator that the attorney is not in a position to consider whether, in light of the child's temperament and history, he or she is likely to respond positively to trust conditions. See Estate Planning 1987, chap 3, for a variety of trust options for a postponed child, including delayed distributions, distributions to reward productive behavior such as educational achievement and worthwhile employment, service by the child as cotrustee, and principal distributions after a term of years beginning at the testator's death.

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§22.42 V. FAMILY POT TRUST

Sample clauses of the main terms of a family pot trust (see §§22.18-22.19) are provided in §§22.49-22.52, calling for:

- Payment ("sprinkling") of principal and net income to one or more of the testator's children in the trustee's discretion according to need until the trust terminates. See §22.49. The trustee is authorized, but not required, to consider other known resources reasonably available for the children's use. See §§22.34-22.36.
- Accumulation of undistributed income and addition to principal. See §22.21.
- Preliminary distributions for specified purposes. See §22.50.
- Termination of the trust when the youngest child reaches a specified age or completes his or her education. See §22.52. For an alternative short form of family pot trust, see §22.52A.

Particularly important drafting considerations are discussed in §§22.43-22.48.

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A. Family Pot Trust Drafting Considerations

§22.43 1. Guidelines for Discretionary Distributions

The will should express the testator's intent regarding the purposes for which the trustee may make distributions of principal and income. If the purposes include support or education, the drafter should consider clarifying what the testator means by those words. See §§22.24-22.33.

The unique feature of a family pot trust is the trustee's power to "sprinkle" trust funds among beneficiaries according to need. Because this may cause conflict among beneficiaries, the cautious drafter usually includes a clause authorizing the trustee to make payments to some beneficiaries to the exclusion of others. This provision should eliminate any question about the testator's intent. See Prob C §652; Restatement (Second) of Property, Donative Transfers §21.1 (1977).

The drafter should bear in mind the estate tax implications of the standards chosen to guide the trustee's discretionary distributions. On ascertainable standards, see §§16.19, 21.29.

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§22.44 2. Support of Family of Deceased Child

If the testator desires, the trustee may be authorized to contribute to the support of the family of the testator's child who dies before or during administration of the trust. See form 22.49-1. The authorizing clause can be limited so that the trustee is permitted to make distributions only to the issue of the deceased child, thereby excluding the surviving spouse from beneficiary status. The attorney should determine the generation-skipping transfer tax consequences of such a clause if distributions to grandchildren of the testator are contemplated. For more detailed discussion of such taxes, see chap 15.

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§22.45 3. Distributions Charged Against Entire Trust Estate

The purpose of a family pot trust is to permit unequal distributions of principal and income, if needed or desired, based on criteria established by the testator, without adjustments to the ultimate distributive shares of the children. To accomplish that purpose, the trust should specify that, on termination, the remaining trust assets will be divided equally among the testator's children regardless of the amount each has received during the term of the trust. See §22.52. This specification may be qualified by a provision that calls for principal distributions above a certain amount to be charged to the distributive share of the beneficiary of those distributions.

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§22.46 4. Termination Date and Final Distribution

Setting the date for termination of a family pot trust is not an easy task. Many testators choose not to condition termination on the oldest child's reaching a certain age, because they believe this would be unfair to their younger children. The trust will pay the oldest child's education and support until the designated age; the younger children will have to rely at an earlier age on their share of the trust remainder. Because of these concerns, many testators delay termination and distribution until their youngest child reaches a particular age or completes his or her formal education. See, *e.g.,* form 22.52-1. The drafter should also include language to cover the possibility that the triggering event does not occur, *e.g.,* the youngest child dies. See form 22.49-1.

Delaying termination of the trust until the youngest child reaches a certain age, however, may cause a hardship for the older children. Trust funds that the older children are likely to need for business opportunities or for the purchase of a residence may be unavailable because of this delay. This problem can be eliminated by special clauses allowing for limited preliminary distributions of principal for such purposes. See form 22.50-1. These preliminary distributions should be permitted, however, only if the amount of the remaining trust assets is large enough to provide for the younger children.

If the testator wishes to provide opportunities for his or her wayward or immature children to become productive adults, the circumstances under which preliminary distributions may be made or the trust may be terminated should further that aim. For example, such a testator may wish to delay trust termination until the children reach age 40 or 45 or until they achieve a specified objective, such as completion of higher education. For an excellent discussion of the options available to a testator who wants to structure a trust for this purpose, see Gallo & Gallo, *Estate Planning for the Postponed Generation*, Estate Planning 1987 (Cal CEB 1988). See also §22.41.

When the trust terminates, the remaining assets are divided into separate shares for each child. The testator has a variety of options for disposing of these shares. Each child may receive his or her share outright. Alternatively, the shares of some or all of the children may be placed into separate trusts, each with the same or different terms.

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§22.47 5. Preliminary Distributions

Particularly if the family pot trust delays termination until the youngest child reaches a specified age, the testator may want to permit the trustee to distribute funds for purposes not covered by the usual guidelines for discretionary distributions (*e.g.* assisting a child to purchase a home or to start a business). These preliminary distributions are a way of balancing the needs of older and younger children. For clauses, see §§22.50-22.51.

The testator should specify the purposes for which the trustee may make preliminary distributions and, if desired, the minimum age at which a child may receive a preliminary distribution. Except for very large trust estates, it is advisable for the testator to set some limits on the amounts of the preliminary distributions to ensure that the support or education of all the children is not jeopardized.

One common method of limiting a preliminary distribution is to restrict it to an amount no larger than a certain fraction of the child's putative share of the trust. "Putative share" is that portion of the entire trust estate that would be distributable to a particular child, after considering all previous loans and advances, if the entire trust were divided into separate trusts on the date that the distribution to be measured against the putative share is made. See form 22.50-1. Another method is simply to instruct the trustee not to make a preliminary distribution if, in his or her judgment, the distribution will jeopardize the trust's capacity to provide for the continuing support and education of the testator's children. See form 22.50-1.

The effect of a preliminary distribution on the distributee's share when the trust is terminated also requires the testator's consideration. The testator can choose either that there be no adjustments to each child's ultimate distributive share of the trust or that adjustments be made. If the testator chooses the latter option, as most do, the trust should describe how the adjustments should be made. See form 22.52-1 for a suggested method for adjustments for preliminary distributions.

One further consideration for the testator is what he or she wants the trustee to do if the trust calls for adjustments for a preliminary distribution but a child's final share is insufficient to cover his or her preliminary distribution. The testator has three options:

(1) Have the trustee compel the child to make up the difference, even if this means a lawsuit against the child (see Alternative 1 in form 22.51-1);

(2) Have the trustee ignore the negative balance and divide the remaining balance of the trust among the other beneficiaries (see Alternative 2 in form 22.51-1); or

(3) Authorize the trustee to decide whether the child should be required to make up the preliminary distribution.

For further discussion of preliminary distributions, see §21.34.

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§22.48 6. S Corporation Stock

Although a family pot trust has more than a single beneficiary and therefore does not qualify as a qualified subchapter S trust (QSST), such a trust qualifies as an electing small business trust (ESBT) under IRC §1361(e). Because an ESBT's income attributable to the S stock is taxed to the ESBT at the highest marginal income tax rates, however, there may be an income tax cost as compared with a QSST, the income of which will likely be taxed to its beneficiary at lower rates. IRC §641(d). If the potential income tax cost of an ESBT is too great, the testator's estate plan can be altered somewhat with respect to the S stock. One possible modification calls for the S stock to be divided equally at the testator's death and placed into separate QSSTs for each of the testator's children. The balance of the testator's assets would then be distributed to a family pot trust.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/ B. Family Pot Trust Clauses/§22.49 1. Form: Principal and Income Sprinkled Among Children

B. Family Pot Trust Clauses

§22.49 1. Form: Principal and Income Sprinkled Among Children

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22.49-1 Principal and income sprinkled among children until youngest child reaches specified age

The trustee shall hold, administer, and distribute all property allocated to the children's trust as follows:

***Distribution of Principal and Income*. The trustee shall pay to or for my children who survive me by 30 days as much of the principal and net income of the trust as the trustee, in the trustee's discretion, considers necessary for their health, education, support, or maintenance. Any undistributed net income shall be accumulated and added to principal.**

In exercising the trustee's discretion, the trustee shall take into account:

(1) The value of the trust assets and the relative current and future needs of each beneficiary;

(2) The tax consequences of any distribution or failure to distribute; and

(3) Any other factors that the trustee considers relevant.

In exercising the discretion conferred in this paragraph, the trustee may make distributions that benefit one or more of my beneficiaries more than others or that completely exclude others. Any distribution shall be charged against the trust estate as a whole and not against the ultimate distributive share of the beneficiary to whom or for whose benefit the distribution was made.

The trustee shall continue to make the discretionary distributions called for in this paragraph until my youngest child has reached age _ _[*number*]**_ _.**

[*If applicable, add the following option*]

[*Option: Support of family of deceased child*]

If any of my children dies before or during administration of this trust and is survived by issue, the trustee may also pay to or for the child's then-living issue as much of the principal and net income of the trust as the trustee, in the trustee's discretion, considers necessary for their health, education, support, or maintenance.

Comment: The wording of form 22.49-1 assumes that, after the testator's spouse or domestic partner, the trust is the primary or contingent beneficiary of the testator's residuary gift. The optional addition includes distributions to issue of a deceased child. If appropriate, the drafter may expand that clause to include support for the deceased child's spouse, at least until remarriage. On "issue," see §§12.29, 12.34.

Form 22.49-1 sets out an "ascertainable standard." See §16.19. For elaborations on the meaning of "support," see §§22.24-22.28. For broad and narrow definitions of "education," see §§22.29-22.30. On a beneficiary's housing needs, see §§22.31-22.33. On trust payment of a deceased beneficiary's expenses, see §§22.27-22.28. For definitions of "children," see §§12.29, 12.33.

In addition to form 22.49-1, the drafter should include a clause expressing the testator's intent about whether the trustee should consider a beneficiary's other resources when making distributions. For suggested clauses, see form 22.36-1. The attorney should also draft a clause expressing the testator's intent about the frequency of payments. See §§21.9-21.10.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/ 2. Preliminary Distribution Clauses/§22.50 a. Form: Preliminary Distributions

2. Preliminary Distribution Clauses

§22.50 a. Form: Preliminary Distributions

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22.50-1 Discretionary preliminary distribution

***Preliminary Distributions*. The trustee shall have the sole discretion to make preliminary distributions of principal from time to time to any of my children who have reached age _ _[*number*]_ _ if there are valid and productive reasons (*e.g.,* starting a business, buying a home) for making the distributions. The trustee shall not make any preliminary distribution if the trustee determines, in the trustee's sole discretion, that the remaining principal and income will not be adequate for the support, health, education, and maintenance of my other children.**

[*If applicable, add the following option*]

[*Option: Fixed ceiling*]

The total value of all preliminary distributions to a child may not exceed _ _[*number*]_ _ percent of that child's putative share. "Putative share" means that portion of the entire trust estate that would be distributable to a particular child, after considering all previous loans and advances, if the entire trust were divided into separate trusts on the date that the distribution to be measured against the putative share is made. The value of each preliminary distribution shall be its value at the time the distribution was made.

Comment: If the testator desires, the trustee may be authorized to make preliminary distributions. The main clause permits the trustee to make preliminary distributions when this would place the support of the testator's other children at risk. The optional addition limits aggregate preliminary distributions to a specified percentage of the amount otherwise distributable (child's putative share).

If the testator prefers, the purposes for which preliminary distributions are authorized may be made more restrictive than they are in these clauses. For discussion of preliminary distributions, see §22.47. For alternative clauses providing for reimbursement or nonreimbursement of excess preliminary distributions, see §22.51.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.51 b. Form: Preliminary Distributions in Excess of Child's Ultimate Share

§22.51 b. Form: Preliminary Distributions in Excess of Child's Ultimate Share

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22.51-1 Preliminary distributions in excess of child's ultimate share

[*Add one of the following alternatives*]

[*Alternative 1: Reimbursement required*]

If, for any reason, any child of mine receives preliminary distributions that exceed, in the aggregate, the ultimate share distributable to this child under paragraph _ _[*number*]_ _, the trustee shall require the child to reimburse the trust for the excess distributions. The value of each of the child's preliminary distributions shall be its value at the time the distribution was made.

[*Alternative 2: Reimbursement not required*]

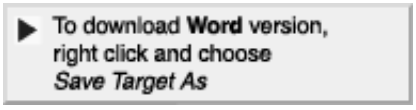
If, for any reason, any child of mine receives preliminary distributions that exceed, in the aggregate, the ultimate share distributable to this child under paragraph _ _[*number*]_ _, the trustee shall not require the child to reimburse the trust for the excess distributions but shall distribute the remaining balance of the trust estate among the other beneficiaries as provided in that paragraph. The value of each of the child's preliminary distributions shall be its value at the time the distribution was made.

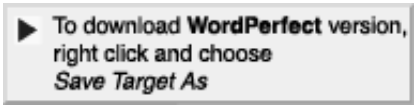
Comment: See §22.47. The paragraph referred to in these clauses is the one describing how the trustee should divide the trust at termination. See form 22.52-1. This clause may be added to form 22.50-1.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.52 3. Form: Termination of Trust and Distribution of Remainder

§22.52 3. Form: Termination of Trust and Distribution of Remainder





22.52-1 Termination of trust and distribution of remainder

***Distribution of Remainder*. When all of my then-living children have reached age _ _[*number*]_ _, the trustee shall divide the adjusted trust estate (defined below) into as many equal shares as there are children of mine then living and children of mine then deceased with then-living issue. Each share set aside for a child of mine then deceased with then-living issue shall be further divided into shares for such issue by right of representation.**

The "adjusted trust estate" is equal to the trust estate at the time of termination of the trust plus:

(1) The outstanding balance of any loans made by the trust to any child of mine to any issue of a deceased child; and

(2) The total preliminary distributions made to all my children and any preliminary distributions made to any issue of a deceased child.

Each preliminary distribution shall be charged at its value when the distribution was made.

To compute the actual amount distributable to each beneficiary and without making a charge for interest, the trustee shall charge to each living child's share of the adjusted trust estate (1) the outstanding balance of any loans made by the trust to that child and (2) the preliminary distributions made to that child. The trustee shall similarly charge the equal share set aside for the then-living issue of a deceased child with any outstanding loans and preliminary distributions made to that deceased child or such issue. Each preliminary distribution shall be charged at its value when the distribution was made.

Each share for a beneficiary who has reached age 18 shall be distributed to that beneficiary free of trust. Each share for a minor beneficiary shall be distributed to _ _[*name of custodian*]_ _ as custodian for this minor beneficiary until age _ _[*number*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925).

If all my children die before all of my then-living children have reached age _ _[*number*]_ _, the trustee shall distribute the trust assets on the death of the last child of mine to die to my then-living issue by right of representation. If at that time I have no living issue, the trustee shall distribute the trust assets as follows: _ _[*Distribution*]_ _.

Comment: The drafter should modify this clause if the testator does not want to condition trust termination on the age of his or her youngest child. See §22.46 for discussion of different ways a trust may terminate. The wording of the clause assumes that the testator wants each child's ultimate share to be adjusted for preliminary distributions. If this assumption is incorrect, the drafter should amend the clause to call for no adjustments. On preliminary distributions, see §22.47.

This clause calls for distributions to issue by right of representation. For discussion of "issue" and "right of representation," see §§12.29, 12.32, 12.34.

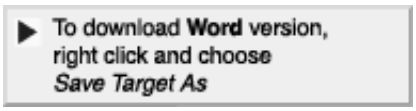
Under this clause, distribution is made outright to each adult beneficiary and to a custodian for each minor beneficiary. The testator can vary this distribution scheme (*e.g.,* distribution to separate trusts for each beneficiary, outright distribution to adult beneficiaries and distribution to trusts for each minor beneficiary).

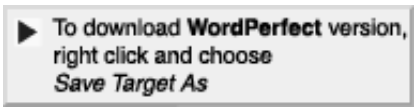
For discussion of the California Uniform Transfers to Minors Act, see §§22.13-22.15. On separate trusts for children, see §§22.53-22.58. For discussion of the generation-skipping transfer tax consequences of distributions to the issue of a deceased child, see chap 15.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.52A 4. Form: Alternative Family Pot Trust

§22.52A 4. Form: Alternative Family Pot Trust





22.52A-1 Alternative family pot trust

The trustee shall hold, administer, and distribute all property allocated to the children's trust as follows:

1. *Name of Trust*. The trust created by this paragraph may be referred to as _ _[*e.g., The John Doe Family Trust*]_ _.

2. *Additions to Trust*. Other property acceptable to the trustee may be added to this trust by any person.

3. *Discretionary Distributions*. Income of the trust estate shall be added to and become principal, and the trustee shall from time to time pay to or apply for the benefit of my issue and their spouses, including surviving spouses whether or not remarried, or any of them, such amounts as the trustee determines to be appropriate for their health, education (including study at an institution of higher education and vocational training), support, and maintenance, taking into account such factors as the trustee deems relevant, including the generation-skipping transfer tax exemption status of the trust. It is my desire to provide the beneficiaries with a safety net, but the trustee is also cautioned to avoid subsidizing or encouraging lack of initiative.

4. *Termination of Trust*. The trust shall terminate when all grandchildren of mine living at my death are deceased. On termination, the trust estate shall be distributed to my then-living issue, per capita at each generation.

5. *Distribution to Charity if No Issue*. If at any time before full distribution of the trust estate all my issue are deceased and no other disposition of the property is directed by this instrument, then the remaining portion of the trust shall then be distributed to _ _[*legal name and address of charitable entity*]_ _.

6. *Trustee.* The trustee of this trust shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The provisions of my will concerning trustees shall continue to apply to this trust to the extent not inconsistent with exercises of the powers of the trustee granted in this paragraph.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.53 VI. SEPARATE TRUST FOR EACH CHILD

§22.53 VI. SEPARATE TRUST FOR EACH CHILD

For the attorney whose client prefers a separate trust for each child beneficiary (see §§22.18, 22.20), a sample clause of the main terms of such a trust is provided in form 22.58-1, calling for:

- Distributions of principal and income to or for the child, at the trustee's discretion, until the child reaches age 21;
- Payment of the entire net income, and as much of the principal as the trustee considers necessary, to or for the child when the child reaches age 21;
- Partial distributions of principal to the beneficiary when the beneficiary reaches certain specified ages; and
- Distribution of the trust to persons appointed by the primary beneficiary if he or she dies before the trust terminates.

Particularly important planning and drafting considerations are discussed in §§22.54-22.57.

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A. Separate Trust Planning and Drafting Considerations

§22.54 1. Division of Assets Into Separate Trusts

Separate trusts are problematic if the testator wishes to treat several children equally but does not have an estate that is easily divisible into equal shares. An example of such an estate is one consisting primarily of a family business or farm. The problem of equal treatment of children may be further compounded by the desire of a client with a family business or farm to leave the business or farm to those of his or her children who have taken or are likely to take an active interest in it.

Rather than automatically urging the client to abandon separate trusts in favor of a family pot trust, the attorney should first explore ways to conform the nature of the client's assets to the client's desires. These are some of the methods to consider:

- *Different assets to different children.* The testator could leave the problematic asset (*e.g.,* stock in a family business) to the trust of the child most appropriate to receive it and assets of an equivalent value, if available, to the trusts of the other children. The primary difficulty presented by this plan is the necessity for frequent review of the testator's estate plan because (a) the testator may sell or otherwise dispose of some of the assets designated to particular trusts after execution of the will, and (b) the values of the testator's assets are likely to change over time, making the division of assets unequal.
- *Gift of minority interest; redemption agreement.* If the problematic asset is the testator's business and one child has already been involved in its operations, the testator might consider:
- Giving that child some stock in the business, as recognition of the value added to the business by the child's efforts.
- Devising the remaining stock equally to the trusts of all the children.
- Entering into an agreement with the business and the child who is given the minority interest, calling for the business to redeem the shares of the testator at his or her death. (Life insurance could be used to fund this redemption.)
- The final result would thus be cash, not illiquid stock, in each child's trust and ownership of the business by the child who is already involved in its operations.
- *Option to purchase.* An alternative to the plan described above for making a gift of a minority interest involves devising to the child who is already involved in the business the option to purchase it from the testator's estate. Careful drafting of this option is essential (particularly the method for determining the sale price). An option to purchase is inappropriate, however, if it will always be financially infeasible for the child to exercise it. To avoid problems with the availability of the marital deduction, the option price should always be at fair market value if it is exercisable after the first spouse's death and exercisable against shares held in a qualified terminable interest property (QTIP) trust. See IRS Letter Ruling 9139001. For further discussion of QTIP trusts, see chap 19.
- *Life insurance.* The testator should consider buying life insurance to equalize the treatment of his or her children. If the testator is able to value the problematic asset, it can be given intact to the trust of one child, with the trusts of the other children being named beneficiaries of life insurance proceeds of equivalent amounts. This alternative may be unattractive to the testator if determining the value of the problematic asset at the time of inheritance is difficult or if the insurance is expensive. In addition, a married testator must take care to pay the policy premiums only from the testator's separate property. Case law recognizes that the insured's surviving spouse or former spouse has a community property interest in life insurance proceeds, including proceeds of term insurance, when the premiums were paid partly or entirely with community property funds and the named beneficiary is someone other than the spouse or former spouse. See, *e.g.*, *Biltoft v Wootten* (1979) 96 CA3d 58, 157 CR 581.

The alternatives for dealing with this problem are limited only by the imaginations of the testator and the attorney. The attorney should carefully scrutinize any chosen alternative, however, for potentially adverse tax consequences.

NOTE: The attorney should be alert for possible tax problems if the separate trusts are funded by distributions from a trust whose life beneficiary is the surviving spouse. If those distributions include trust income accumulated during the life of the surviving spouse, the income distributed to the separate trusts at the spouse's death is an "accumulation distribution" to the new trusts. For the income tax effects of an accumulation distribution, see Lane & Zaritsky, Federal Income Taxation of Estates and Trusts (3d ed 2001).

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§22.55 2. Discretionary Distributions

Under form 22.58-1, the trustee has discretion to determine how much of the principal and income will be distributed to the beneficiary. On the need for "ascertainable standards" to guide the trustee, see §§16.19, 21.29.

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§22.56 3. Trust Termination

There are a variety of ways to distribute trust principal and thereby terminate a trust. Many separate trusts for children give the trustee discretion to invade principal to meet the child's needs until the child reaches a specified age. At that time, the entire trust corpus is distributed to the child. Other separate trusts require the trustee to distribute portions of the trust principal to the beneficiary at specified ages. In such cases, the final distribution that terminates the trust is relatively small and usually takes place at an age when the testator expects the beneficiary to be fully mature. Form 22.58-1 calls for distribution of a percentage of principal to the beneficiary at specified ages.

A separate trust for a child need not terminate during the child's lifetime. The testator may prefer to give the child a life interest and have the remainder pass directly to the child's children. If trust assets are distributed to the testator's grandchildren, however, a generation-skipping transfer tax may be assessed when the child dies (see chap 15), and the California rule against perpetuities may be violated (see chap 34).

On planning for termination of a trust for a particularly irresponsible and immature child, see §22.41.

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Source: Estate Planning/California Will Drafting/22 Trusts for Children/§22.57 4. Death of Child Beneficiary Before Trust Terminates

§22.57 4. Death of Child Beneficiary Before Trust Terminates

A child's separate trust that is designed to terminate during the child's lifetime should provide for contingent beneficiaries in case the child dies before trust termination. Form 22.58-1 gives the beneficiary a special power to select the contingent beneficiaries within specified limits.

In certain situations, it may be desirable to subject the trust estate to taxation in the beneficiary's estate. To avoid imposition of a generation-skipping transfer (GST) tax, some clients prefer to authorize the trustee to decide, or appoint a special trustee who will have the power to decide, whether to:

- Subject the trust assets to taxation in a child's estate if he or she dies before receiving complete distribution of the trust; or
- Allow the trust assets to be distributed as the trust directs without control or taxation in the child's estate and possibly allow the assets of the trust to be subject to the GST tax.

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§22.58 B. Form: Separate Trust for Each Child

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22.58-1 Separate trust for each child

***Distribution of Principal and Income*. The trustee shall divide all trust assets into as many equal shares as there are children of mine who survive me. Each share shall be retained and administered by the trustee as a separate trust on the following terms:**

(1) As long as a child for whom a trust is set aside is under age 21, the trustee shall pay to or for the child as much of the principal and net income of the child's trust as the trustee, in the trustee's discretion, considers necessary for the child's health, education, support, or maintenance. Any undistributed net income shall be accumulated and added to principal.

(2) When a child reaches age 21, the trustee shall pay to or for the child the entire net income of the child's trust. In addition, the trustee shall pay to or for the child as much of the principal of the child's trust as the trustee, in the trustee's discretion, considers necessary for the child's health, education, support, or maintenance.

(3) In exercising the trustee's discretion, the trustee shall take into account the tax consequences of any distribution or failure to distribute and any other factors that the trustee considers relevant.

(4) When the child reaches age 30, or on creation of the trust if the child is already that age, the trustee shall distribute to the child _ _[*number*]_ _ percent of the principal of the child's trust as then constituted. When the child reaches age 35, the trustee shall distribute to the child the undistributed balance of his or her trust.

(5) If the child dies before becoming entitled to distribution of the entire trust, the trustee shall distribute the balance of that child's trust (including accrued or undistributed income) in the manner appointed by the child by will or inter vivos document executed after my death. When exercising this special power of appointment in the will or inter vivos document, the child must specifically refer to it. The child may not appoint as beneficiaries his or her estate or creditors or the creditors of his or her estate. Any property not effectively appointed by the child shall be distributed, free of trust, to the child's then-living issue by right of representation. If no issue is then living, this property shall be distributed to my then-living issue by right of representation. If, however, the trustee must distribute any part of this property to one of my issue who is a beneficiary of any other trust under my will, the trustee shall add that part to that trust, except that any addition to a partially distributed trust shall augment proportionately the distributed and undistributed portions of that trust.

Comment: The drafter should discuss this clause carefully with the client. The client may want to vary its provisions considerably by, *e.g.*:

- Changing the ages at which distributions of a particular nature are authorized;
- Declining to give the child the power to determine contingent beneficiaries;
- Authorizing discretionary preliminary distributions (see §22.47) or prohibiting preliminary distributions of principal altogether; or
- Refraining from conditioning trust termination on the child's reaching a particular age (see §22.56).

This clause sets out an "ascertainable standard." See §§16.19, 21.29. The wording of the clause assumes that, after the testator's spouse or partner, the trust is the primary or contingent beneficiary of the testator's residuary gift.

For elaborations on the meaning of "support," see §§22.24-22.28. For broad and narrow definitions of "education," see §§22.29-22.30. On a beneficiary's housing needs, see §§22.31-22.33. On "issue" and "right of representation," see §§12.29, 12.32, 12.34.

In addition to form 22.58-1, the drafter should include a clause expressing the testator's intent about whether the

trustee should consider a beneficiary's other resources when making distributions. For suggested clauses, see form 22.36-1. The attorney should also draft a clause expressing the testator's intent about the frequency of payments. See §§21.9-21.10.

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23

Special Needs Trusts

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I. PURPOSE OF SPECIAL NEEDS TRUST

§23.1 A. Trust Preserves Public Benefits

Testators sometimes must plan for beneficiaries who are unable to provide for or care for themselves because of a physical or mental disability. A trust is almost invariably the preferred vehicle for providing financial aid to such a beneficiary. By providing asset and income management and protecting the beneficiary from exploitation by others, a trust can eliminate the need for a guardian or conservator of the estate. If the testator wishes, a trust can provide continued control of trust assets for other beneficiaries when the disabled beneficiary dies.

Using a trust to provide for a beneficiary with a disability can also enable the beneficiary to take advantage of both public benefits and the inherited property. A variety of state and federal benefits are available for persons who may need skilled nursing care or who are unable to support themselves. Such benefits are meant to provide the recipient with adequate food, shelter, or essential medical services. Without supplementation of these minimal public benefits, however, beneficiaries may be left without, *e.g.,* adequate dental care, special therapy, equipment to provide extra comfort or mobility, or resources for recreation. If the government reduces program benefits or if benefits fail to keep up with inflation, then the individual may be left without adequate food, shelter, or essential medical services.

A properly designed and administered trust can provide funds to supplement the disabled beneficiary's public benefits while causing little or no interference with government aid. In contrast, an outright devise to a disabled beneficiary may:

- Disqualify the beneficiary from receiving federal or state benefits until the inherited property has been consumed. This will have two results:
- The beneficiary's receipt of funds and social services will be disrupted for months. Because an individual must apply for Supplemental Security Income, Medi-Cal, and other public benefits, an outright gift making him or her ineligible may require extensive effort to reestablish his or her qualifications for aid. For disabled persons who require consistent medical care and physical or educational therapy, interference with the flow of benefits may be extremely serious.
- The gift will be depleted prematurely. Trust assets that could otherwise be used to supplement public benefits will be rapidly consumed by the cost of, *e.g.,* treatment, therapy, special equipment, health and home care aides, or nursing home care.
- Obligate the beneficiary to pay from the devise a share of the costs of benefits received or to reimburse a public agency for services already provided to the beneficiary if the receipt of the funds was not promptly reported and benefits were improperly paid.
- Cause assets to be expended prematurely and wasted, and to be unavailable to supplement the benefits that are later obtained.
- Leave the beneficiary at risk for exploitation by unscrupulous professionals when he or she has little to no experience at evaluating and hiring accountants, financial advisors/planners, attorneys, or other professionals.

A "supplemental needs trust" or "special needs trust" is a specialized kind of "spendthrift" trust designed to supplement public benefits when those benefits are available and, when they are not, make the trust funds available for the beneficiary's welfare. The trust provisions give the trustee broad discretion in making trust distributions to or for the beneficiary, to avoid jeopardizing the beneficiary's eligibility for public benefits. See chap 27 on spendthrift trusts.

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§23.1A B. Litigation Special Needs Trust Compared With Testamentary Trust

Probate Code §§3602-3612 authorize the management of litigation proceeds for a disabled plaintiff in a court-approved special needs trust, frequently referred to as a litigation special needs trust. The term "special needs trust" is not defined in the statute. The legislative history, however, makes clear that the term refers to the form of supplemental trust commonly used in estate planning for families with a disabled child.

Litigation special needs trusts (LSNTs) are not testamentary but are established as inter vivos irrevocable trusts. They are nevertheless important for practitioners who draft testamentary special needs trusts because they confirm and further establish legislative policy in California that favors the use of supplemental trusts for disabled persons.

For complete discussion of LSNTs and sample forms, see Drafting California Irrevocable Trusts §§13.36-13.67 (3d ed Cal CEB 1997). See also Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008).

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§23.2 C. Testamentary Trust Preferred to Protect Medi-Cal Eligibility for Surviving Spouse

A special needs trust (SNT) may be created as either a testamentary or an inter vivos instrument. The estate planner must determine which vehicle will better serve the client.

A nominally funded living SNT is useful in will or living trust planning for parents of a disabled child. If bequests are anticipated from several sources, a single living SNT may receive pourover distributions from the will or living trust of parents, grandparents, siblings, and others.

Frequently parents will establish such a trust for a disabled child and then notify grandparents of its existence. If the grandparent wishes to bequeath assets to the disabled child, the living SNT (1) provides an effective management device, (2) may preserve public benefits of the beneficiary, and (3) alleviates the need for the other friends or relatives to establish a testamentary trust in their will or living trust.

NOTE: If deceased parents or grandparents have already created a regular trust benefiting a disabled child, it may be possible to reform the trust into a third-party SNT or—if the child has received an outright inheritance—to establish a first-party SNT meeting the requirements of 42 USC §1396p(d)(4)(A). At least one court has held that the probate court has jurisdiction under Prob C §2580(b)(5) to create a special needs trust for an inheritance. *Conservatorship of Kane* (2006) 137 CA4th 400, 40 CR3d 378. However, it would have been preferable for the conservatee's parent to create a third party SNT to receive the funds after the parent's death. The court order might not satisfy the requirements of 42 USC §1396p(d)(4)(A), because a trust approved by substituted judgment is arguably established by the conservatee (or by the conservator) rather than the court. If the trust is established to receive an inheritance, a petition to distribute property from the decedent's estate to the trust also might be filed under Prob C §11640 or §11700, but the trust might still be treated as established by the beneficiary. It also appears that a parent of a minor child or a conservator for an adult child may petition the court for modification of a testamentary trust under Prob C §15403 (consent of all beneficiaries) as guardian ad litem under Prob C §15405 or under Prob C §15409 (changed circumstances) consistent with the requirements of 42 USC §1396p(d)(4)(A).

Courts have held in a charitable context that a trust can be modified with the agreement of all current beneficiaries when the modification accomplishes the settlor's primary purpose, as might be true in the case of a special needs trust that benefits a disabled child, even if the trustee has the power to name additional beneficiaries. *Boys & Girls Club v Walsh* (2008) 169 CA4th 1049, 87 CR3d 413.

Special considerations apply when the client wishes to establish a special needs trust to protect a beneficiary's eligibility for Medi-Cal benefits for nursing home care. If such a trust is a living trust, and is "established" by the applicant (or the applicant's spouse), it is subject to highly restrictive rules under which trust assets will usually be considered an available resource or income to the applicant if payments are made to or for the beneficiary. See 42 USC §1396p. Testamentary trusts established by the applicant's spouse, on the other hand, are expressly exempt from these restrictive rules. See 42 USC §1396p(d)(2)(A). For further discussion of federal and state law applicable to special needs trusts for Medi-Cal beneficiaries, see §23.8D.

In other cases, the decision whether to establish a special needs trust by a transfer during life or after death will be decided on other grounds, *e.g.,* whether the client wishes to make the gift of the trust corpus during life, the beneficiary's needs and eligibility for public benefits during the client's lifetime, and the extent of client obligations for beneficiary support.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.2A D. Preferred Methods in Making Annual Exclusion Gifts to Special Needs Trust

§23.2A D. Preferred Methods in Making Annual Exclusion Gifts to Special Needs Trust

Individuals who wish to make gifts to an SNT for the benefit of a disabled beneficiary will run into problems qualifying the gift for the IRC §2503(b) annual gift tax exclusion. To qualify for the annual exclusion, a trust must give a beneficiary certain withdrawal rights (the so-called *Crummey* powers); otherwise, the gift will not constitute the transfer of a present interest. The problem that arises is that giving a disabled beneficiary a *Crummey* withdrawal right will disqualify him or her from SSI and Medi-Cal benefits if the assets subject to the withdrawal right exceed the applicable resource limitations under SSI, typically $2000. See §23.7B. This problem arises because the assets subject to the withdrawal power are counted as a resource of the beneficiary. See §23.10. Two solutions to this gifting dilemma are to establish a *Cristofani* type trust with withdrawal rights for additional, nondisabled beneficiaries (see §23.2B) or to have the SNT own a 529 Plan (see §23.2C).

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.2B 1. Establish Cristofani Special Needs Trust

§23.2B 1. Establish *Cristofani* Special Needs Trust

The benefit of a *Cristofani* type trust, as described in *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1, is that the disabled beneficiary will not have a *Crummey* withdrawal right as required to receive annual exclusion gifts. Instead, the *Crummey* withdrawal rights will be authorized for beneficiaries other than the disabled beneficiary in a similar fashion as set forth in the *Cristofani* case. This technique is particularly helpful if the gifts are being used to pay the premiums on a life insurance policy. Practically speaking, the SNT will have multiple beneficiaries, the primary disabled beneficiary and other beneficiaries. The nondisabled beneficiaries will be provided *Crummey* withdrawal rights for the annual gifts, and any amount not distributed to the withdrawal right beneficiaries may be distributed to or accumulated for the disabled beneficiary under the terms of the SNT.

It is important to remember that a *Cristofani* withdrawal right beneficiary must have a non-contingent remainder interest in the SNT. The IRS acquiesced to *Cristofani* in result only and continues to challenge naked *Crummey* powers when the power holders have no other property interests or hold only contingent remainder interests. AOD 1996-010; IRS Letter Ruling 9628004.

There are important tax considerations in establishing and administering a *Cristofani* trust. Giving the nondisabled beneficiaries the power to withdraw assets for their own benefit is granting a general power of appointment over the assets subject to withdrawal. IRC §2514(c). If the withdrawal is not made, the lapse of the power of appointment is considered a gift by the beneficiary who held the power of appointment, if the value of the power of appointment exceeds the greater of $5000 or 5 percent of the value of the assets out of which the power of appointment could be satisfied. IRC §§2041(b)(2), 2514(e). According to IRC §2041, the "gift" of the excess over the $5000 and 5 percent created by the beneficiary's choice not to exercise the right of withdrawal will cause the proportion of the value of the asset on the date of the beneficiary's death attributable to this "gift" to be included in the beneficiary's estate for federal estate tax purposes. IRC §2041(b)(2). The release of a withdrawal power may also be considered a completed transfer subject to gift taxes. IRC §2514(b).

In cases in which it is important to avoid the possibility of a lapse of a withdrawal power that exceeds the $5000 or 5 percent safe harbor under IRC §2514(e), the withdrawal rights should be limited to the lesser of $5000 or 5 percent or the donor's available annual exclusion, and because an individual donee is allowed only one "five or five" amount to lapse each year (Rev Rul 85-88, 1985-2 Cum Bull 202), the trust should provide that the withdrawal amounts allowed to a powerholder be reduced for all other annual exclusion gifts made to the powerholder earlier in the same year. The problem with this approach is that the full amount of the annual exclusion may not be utilized. Also, because the "five or five" exception does not apply for income tax purposes, this may have the consequence that the holders of the lapsed *Crummey* powers become the owners of the lapse portion of the trust for IRC §671 purposes and are thereafter taxed on the income from that portion of the trust. IRS Letter Rulings 200022035, 9745010. Note that the donor may also need to allocate GST exemption to the gifts to the trust, if the trust has skip-person beneficiaries (*e.g.*, the donor's grandchildren) and the trust is intended to be GST-tax exempt, because the trust does not qualify for the IRC §2642(f) GST tax annual exclusion for transfers to a trust with one individual lifetime beneficiary. See §15.49.

If full annual exclusion gifts are contemplated, there are several general approaches to the problem of avoiding withdrawal power lapses in excess of the "five or five" amount when this is necessary. One is to provide that withdrawal powers do not lapse except on the last day of the calendar year, at which time they lapse only to the extent of the "five or five" amount (a "hanging power"). There are several disadvantages of hanging powers. The law regarding such powers is uncertain, and unwanted lapses may occur anyway, either because of the death of the powerholder or because of distribution of the trust. A second approach is to provide that the holder of a lapsed power retains a power of appointment over the lapse amount to the extent it exceeds the "five or five" amount. This prevents the gift caused by the excess lapse from being a completed gift. This approach presents problems similar to those posed by a hanging power. The gift will become complete if the trust is distributed or the beneficiary dies. For a thorough discussion of the tax consequences of a *Cristofani* trust and a variety of forms for establishment of a *Cristofani* trust, see Drafting California Irrevocable Trusts §§12.87-12.104 (3d ed Cal CEB 1997).

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.2C 2. Have Special Needs Trust Own 529 Plan

§23.2C 2. Have Special Needs Trust Own 529 Plan

Another way to authorize annual exclusion gifts for the benefit of a disabled individual is to have the SNT own a 529 Plan and direct individuals to gift into the 529 Plan. By statute, a gift to a 529 Plan qualifies as an annual exclusion gift (IRC §529(c)(2)(A)(i)) and once made, earnings grow tax-free until they are withdrawn. IRC §529(c)(1). A 529 Plan is designed to pay for a plan beneficiary's qualified educational expenses; however, in planning for a disabled individual, a gift is typically not being made to fund higher education, but rather to pay for the future noneducational "special needs" of the beneficiary. A 529 Plan is still an effective tool. To maintain the educational purpose of the 529 Plan, the statute requires that a penalty be assessed against non-qualified educational distributions. IRC §529(c)(6). The penalty, however, does not apply to disabled individuals. Prop Treas Reg §1.529-2(e)(4)(ii)(B)(1)-(2)). Thus, an SNT-owned 529 Plan serves a disabled beneficiary much like an IRA for non-qualified educational distributions and as a Roth IRA for qualified higher education distributions.

The funding of a 529 Plan must be made with cash. IRC §529(b)(2); Prop Treas Reg §1.529-2(d). Donors may also do 5 years of stacked gifting, meaning that if the annual exclusion is $12,000, then each donor could fund a 529 Plan owned by an SNT with $60,000 (for an individual) or $120,000 (for a married couple). IRC §529(c)(2)(B). The individual donors must survive for the next 5 years or the pro rata value of the remaining annual exclusion amounts is required to be included in the contributor's gross estate. IRC §529(c)(4)(C).

Not all 529 Plans are the same. Each state that offers 529 Plans creates and maintains its own program within the federal parameters. IRC §529(b)(1). All 50 states and the District of Columbia have established 529 Plans. In selecting the right states plan for an SNT beneficiary, it is important that the 529 Plan will:

- Authorize a trust to be owner of the 529 Plan. Some states do not allow a trust to be the owner of a 529 Plan. Federal law does not require that the account owner be an individual. Section 529(b)(1)(A) refers to the account owner only as a "person," and Prop Treas Reg §1.529-1(c) provides that "person" has the same meaning as under IRC §7701(a)(1). Section 7701(a)(1) defines "person" to include "an individual, a trust, estate, partnership, association, company or corporation." The term also includes a guardian, executor, administrator, conservator, or any person acting in a fiduciary capacity. Treas Reg §301.7701-6(a). Therefore, any of these individuals or entities could be an account owner, if permitted by state law and the governing account agreement.
- Maximize the contribution amount in the 529 Plan. Federal law requires states to establish procedures preventing contributions beyond the amount that is necessary to pay the beneficiary's qualified higher education expenses. IRC §529(b)(6); Prop Treas Reg §1.529-2(i)(1). Most states have established their own maximum contribution amounts, which currently range from roughly $200,000 to $400,000, with many states standing at about $250,000. It may also be possible for an individual to be the beneficiary of multiple 529 Plans.

The trustee also must determine whether the SNT beneficiary meets the definition of disability under the state's plan. Distributions from a 529 Plan for qualified higher education educational expenses are excluded from the distributee's gross income. IRC §529(c)(3)(B)(i). However, distributions made for nonqualified expenses (*e.g.*, future "special needs") are subject to income tax on the earnings portion of the distribution. IRC §529(c)(3)(A). Note that any benefit furnished to the designated beneficiary of a 529 Plan is treated as a distribution to the beneficiary. IRC §529(c)(3)(B)(iv). (Unlike the SNT named as the account owner, the designated beneficiary of the account must be an individual. Prop Treas Reg §1.529-1(c).) Moreover, distributions for nonqualified expenses are also subject to a 10-percent penalty on the earnings portion of the distribution. IRC §529(c)(6). A beneficiary who is disabled, however, will be refunded the 10-percent penalty upon third party confirmation of the disability. Prop Treas Reg §1.529-2(e)(4)(ii)(B)(1)-(2).

If the 529 Plan is intended for the disabled person's educational expenses, the distribution from the plan will be fully exempt from income tax when distributions are used to meet the beneficiary's qualified higher education expenses at an eligible institution of higher education. IRC §529(e)(3); Prop Treas Reg §1.529-1(c). "Qualified higher education expenses" are limited to the following:

- Tuition, fees, and the costs of books, supplies, and equipment required for the enrollment or attendance at an

eligible educational institution;

- Costs of room and board, provided that the student is carrying at least half of the course load required for full-time enrollment; and
- Expenses for special-needs services for special-needs beneficiaries incurred in connection with attendance or enrollment at an eligible educational institution.

For state-by-state comparisons of 529 Plans, see the websites at http://www.collegesavings.org and http://www.savingforcollege.com. Another useful website is http://www.kiplinger.com. For other considerations in selecting an appropriate 529 Plan, see California Estate Planning, chap 21A (Cal CEB 2002).

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.3 E. Eligibility and Recovery Rules

§23.3 E. Eligibility and Recovery Rules

After briefly describing coverage and eligibility rules for Supplemental Security Income and Medi-Cal benefits available to elderly or disabled persons, this chapter discusses the possible effects of a trust on eligibility and benefit amounts under federal and California law. The chapter also covers the trust's vulnerability to claims for payment for services or reimbursement for benefits provided. The chapter concludes with suggested clauses for special needs trusts with both single and multiple beneficiaries.

Because this treatment of special needs trusts is in the context of a will drafting book, the trusts discussed in this chapter are all testamentary trusts.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.4 F. Public Benefits in General

§23.4 F. Public Benefits in General

Attorneys experienced in the government benefit area warn that it is dangerous to dabble in the field. Not only are the statutes, regulations, and policies rife with contradictory directives and guidelines, but local program administrators cannot be relied on for authoritative advice. In addition, because the law in this field is so fluid, the drafting attorney cannot confidently predict that anything like today's law will govern when the testator dies.

The trust clauses suggested in this chapter are designed to preserve the trust assets as much as possible despite any changes that might occur in the law and the beneficiary's condition. The attorney planning a special needs trust should be generally familiar, however, with public benefits that may be available to the trust beneficiary. The attorney should also be alert to developments in public benefits regulation, which could affect the design and utility of the special needs trust.

Periodicals can provide current information. See, *e.g.,* CEB Estate Planning and California Probate Reporter; The ElderLaw Report, Harry S. Margolis, Ed. Organization newsletters may provide information on Medi-Cal eligibility and Medi-Cal provider issues. See Legal Network News (California Advocates for Nursing Home Reform, San Francisco).

The Internet is a fertile source of information on public benefits. See, *e.g.,* the following addresses:

- http://www.nosscr.org (National Organization of Social Security Claimants' Representatives; provides direct access to law, regulations and memoranda regarding Social Security Disability benefits, SSI, Medicare, and extensive links to all related agencies and programs);
- http://www.dhcs.ca.gov (Department of Health Care Services (formerly Department of Health Services; see §23.6); access to Medi-Cal All-County Welfare Directors (ACWD) Letters);
- http://www.canhr.org (California Advocates for Nursing Home Reform; current analysis and advice on Medi-Cal benefit strategies);
- http://www.ssa.gov (Social Security Administration; access to SSI Program Operations Manual System (POMS));
- http://cms.hhs.gov (Centers for Medicare and Medicaid Services; Medicaid policies, manuals, and letters);
- http://www.gpoaccess.gov (U.S. Government Printing Office; portions of Federal Register, access to congressional bills, the United States Code, a Congressional Record Index; and the Code of Federal Regulations);
- http://www.disabilitybenefits101.org (collaboration between several nonprofit organizations serving the disability community, with excellent summaries of the public benefits available to the working disabled community).

NOTE: Detailed familiarity with public benefits law may be required when the testator dies. The estate attorney may need to advise the trustee on whether the trust should operate or a "backstop" trust termination should go into effect. See form 23.44-1 for a backstop trust termination clause. It is important to distinguish who is the attorney's client prior to advising a trustee. It is common that a personal representative of the estate will also be a trustee of the special needs trust, but prior to advice being provided, the attorney should be clear on whether he or she is undertaking to represent the trustee in his or her capacity as trustee of the SNT. If so, and the trust will be used, its trustee may require advice on when (and whether) to make distributions, what to distribute, and to whom distributions should be made, in order not to jeopardize the beneficiary's eligibility for benefits.

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II. OVERVIEW OF SSI AND MEDI-CAL

§23.5 A. Social Security and Medicare: Benefits Without Asset and Income Eligibility Tests

Potential beneficiaries may be eligible for some public benefits regardless of their assets and other income. Chief among these benefits are Social Security benefits (including Social Security Disability Income) and Medicare insurance coverage. Eligibility for these benefits depends on such criteria as years worked within the Social Security system by the applicant or his or her spouse or parent; age or other physical condition; and whether the applicant is employed, unemployed due to disability, or retired. Although the amount of Social Security benefits payable may be affected by receipt of other public benefits or earned income, the benefits do not pose any special problems for the special needs trust drafter because they will not be affected by gifts from third persons. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 5 (Cal CEB 2003).

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B. SSI and Medi-Cal: Need-Based Benefits

§23.6 1. Overview and Sources of Public Benefits Law

Supplemental Security Income (SSI) and Medi-Cal are the most important "needs-based" public benefits available to the disabled, the blind, and the aged. The client who is concerned about the future of a disabled beneficiary will want to mitigate the impact of the trust on SSI benefits eligibility. The client who is concerned about the welfare of an elderly spouse, relative, or friend will want to preserve the beneficiary's eligibility for Medi-Cal payments for long-term nursing home care.

SSI provides a monthly cash subsistence grant for food and shelter to disabled, blind, or aged (65 or older) persons. Medi-Cal (California's version of the Medicaid program) pays for a broad array of medical (but not most dental) treatments and is the only government program that pays for long-term nursing home care. Both programs are need-based and available only to those with minimal financial resources. Persons who are eligible for SSI benefits are categorically eligible for Medi-Cal. Persons not eligible for SSI benefits may still be eligible for Medi-Cal if they are "medically needy." See §23.8 for Medi-Cal eligibility categories.

Both SSI and Medi-Cal are based on federal legislation providing the basic program requirements. SSI is administered by the Social Security Administration, although the state supplements the basic SSI grants. See Welf & I C §§12000-12700, governing the State Supplementary Program (SSP). Because Medi-Cal is state administered and partly state funded, the attorney must consult both state and federal statutes and regulations regarding these programs. For SSI, the basic sources are 42 USC §§1381-1383c and 20 CFR §§416.101-416.2227. For Medi-Cal, the sources are 42 USC §§1396-1396w-2 and 42 CFR §§430-456.657 (federal Medicaid); Welf & I C §§14000-14196 and 22 Cal Code Regs §§50000-58082 (state Medi-Cal). On eligibility for Medi-Cal, see 42 CFR §§435.1-435.845; 22 Cal Code Regs §§50011-50955.

Public benefits law undergoes constant revision. For example, Medi-Cal is dramatically affected by the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA) (Pub L 108-173, 117 Stat 2066). For certain low-income beneficiaries, MMA provides for subsidies to help pay for Medicare Part D prescription drug costs, including reduced or waived premiums and cost-sharing. See 42 USC §1395w-114. These beneficiaries include full-benefit dual eligibles (individuals eligible for both Medicare and Medi-Cal).

Beginning in January 2006, full-benefit dual eligibles do not have prescription drug coverage through Medi-Cal. To access drug coverage, they must enroll in privately offered Medicare Part D plans. Although dual eligibles are automatically enrolled into both the low-income subsidy and randomly selected Part D plans, many advocates are concerned that some dual eligibles will fall through the cracks of this automatic enrollment and many more will not understand and not be able to effectively use their new drug coverage. For a detailed discussion of Medicare Part D, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 7 (Cal CEB 2003).

Administration of SSI and Medi-Cal is subject to federal and state guidelines:

- The Social Security Administration's Program Operations Manual System (POMS) governs administration of SSI. POMS guidelines are available for inspection at Social Security Administration (SSA) offices. They can also be ordered from the Governing Printing Office on CD-ROM. While POMS are not the product of formal rule making, the United States Supreme Court has held that POMS rules "warrant respect" and are of persuasive authority. *Washington State Dep't of Soc. & Health Servs. v Guardianship of Keffeler* (2003) 537 US 371, 385, 154 L Ed 2d 972, 985, 123 S Ct 1017. The POMS can be found on the SSA website at https://secure.ssa.gov/apps10/poms.nsf/aboutpoms.
- Medi-Cal is governed by the California Department of Health Care Services (DHCS) All-County Welfare Directors (ACWD) Letters, which are sent to county welfare directors and administrative offices. The letters can be found on the DHCS website at http://www.dhcs.ca.gov/services/medi-cal/eligibility. Medi-Cal is also governed by the California guidelines of the federal Centers for Medicare & Medicaid Services (CMS), which administers the Medicaid program, found in the department's State Medicaid Manual. The State Medicaid Manual is

available on the CMS website at http://www.cms.hhs.gov/manuals.

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§23.7 2. SSI Benefits

SSI provides a monthly stipend to supplement the recipient's income to a maximum amount defined by regulation. The amount of the benefits is determined by guidelines in 20 CFR §§416.401-416.435 (see 20 CFR §416.410 (individual rate); 20 CFR §416.412 (eligible couple rate)). These payments are increased by a state supplement administered by the Social Security Administration. For federal regulations governing state supplements, see 20 CFR §§416.2001-416.2099. The federal SSI benefit amount is adjusted annually and published in the Federal Register each February, effective April 1. Beginning July 1, 2009, the maximum monthly benefit for an individual living in his or her own home is $850.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.7A a. Eligibility for Disabled and Aged Poor

§23.7A a. Eligibility for Disabled and Aged Poor

SSI eligibility requirements are described in 20 CFR §§416.200-416.269. The first requirement is that the applicant be disabled, blind, or over age 65. 20 CFR §416.202(a). The second requirement is that the applicant not have more than the permitted income and resources to pay for food and shelter. 20 CFR §416.202(c)-(d). Excess income and resources coming to an SSI recipient can cause the SSI monthly benefits to be reduced dollar for dollar. 20 CFR §416.420. Therefore, retaining SSI eligibility and payments for a special needs trust beneficiary requires familiarity with the program's eligibility requirements and system for counting income and resources. For resource limits, see §23.7B. For income rules, see §§23.7C-23.7D.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.7B b. Limitation on Resources

§23.7B b. Limitation on Resources

Eligibility for SSI depends on the value of the applicant's assets. An otherwise eligible married person is not entitled to SSI if the applicant's own countable resources and those of his or her spouse exceeds $3000. 42 USC §1382(a)(2)(B), (3)(A). For an otherwise eligible single person, the resource limit is $2000. 42 USC §1382(a)(1)(B), (3)(B). See also 20 CFR §416.1205.

Certain assets are excluded by statute or regulation from counting as resources:

- The most significant excluded asset is a personal residence, regardless of its value, in which the beneficiary resides. 42 USC §1382b(a)(1); 20 CFR §§416.1210(a), 416.1212. (There are special rules for income-producing real property even when it is also residential real property. See 20 CFR §§416.1220-416.1224.)
- Furniture, clothing and personal care items are excluded. 42 USC §1382b(a)(2)(A); 20 CFR §§416.1210(b), 416.1216.
- An automobile of any value is excluded. 42 USC §1382b(a)(2)(A); 20 CFR §416.1218.
- Certain property that is essential for "self-support" or necessary to fulfill a "self-support plan" approved by the Social Security Administration is excluded. This can range from a plot of land used to raise vegetables for home consumption to a computer with which the applicant earns an income. 20 CFR §416.1210(d)-(f) (list of excluded properties); 42 USC §1382b(a)(3) and 20 CFR §§416.1220, 416.1222, 416.1224 (property essential for self-support); 42 USC §1382b(a)(4) and 20 CFR §§416.1225-416.1227 (self-support plan). For other excluded assets, see 42 USC §1382b(a) and 20 CFR §416.1210.
- Assets valued at less than a given dollar limit that are designed to pay for funeral and burial or cremation expenses are excluded. Welf & I C §12152(e).

Certain property, although not excluded, is not counted as a resource. To be countable, property must be owned by the applicant (without restriction on his or her right to deal with it) and convertible to cash that can be used for the applicant's food or shelter. 20 CFR §416.1201.

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§23.7C c. SSI Benefits Reduced by Income

Income is either "earned" (see 42 USC §1382a(a)(1); 20 CFR §416.1110) or "unearned" (see 42 USC §1382a(a)(2); 20 CFR §§416.1120-416.1121). Both types of income count against benefits. Gifts, inheritances, and additions to trusts are categories of unearned income. 42 USC §1382a(a)(2)(E), (G); 20 CFR §416.1121(g).

Not all income is counted, however. Some items are specifically excluded from income for policy reasons. The first $20 per month of general unearned income is not counted, nor is the first $60 per calendar quarter of "infrequent" and "irregular" unearned income. 20 CFR §§416.1124(c)(6), (12). Likewise, the first $65 per month of general earned income is not counted, nor is the first $30 per calendar quarter of "infrequent" and "irregular" earned income and one-half of remaining earned income. 20 CFR §416.1112(c)(2), (5), (7). There are exclusions designed to encourage training (*e.g.,* grants and scholarships for educational expenses; see 20 CFR §§416.1124(c)(3)) and to enable the recipient to become self-supporting (*e.g.,* income earned under a qualifying "self-support plan"; see 20 CFR §416.1224(c)(13)). For other rules on counting income and income exclusions, see 20 CFR §§416.1111-416.1112 (what counts as earned income), 416.1123-416.1124 (what counts as unearned income). For the federal statutory exclusions from income, see 42 USC §1382a(b). In addition, Welf & I C §12152 provides certain other exclusions (*e.g.,* funds used for readers for the blind, educational scholarships).

Some income received by persons other than the benefits applicant may be counted as income to the applicant. Known as "deemed" income, it is deemed to be available to the applicant. Sources of deemed income include spouses or parents not themselves eligible for SSI benefits. There are special rules for determining what income of the other person is counted and the effect of this income on the applicant's eligibility or benefits amount. See 20 CFR §§416.1160-416.1169.

Income is either "cash" or "in-kind" income. Cash income is always counted as income unless it is specifically excluded, because it can be converted into food or shelter. Noncash income does not count as income unless it is, or can be converted into, food or shelter. Examples of noncountable in-kind unearned income are medical care and services from a provider who is paid directly by a third party. (These items are specifically excluded from countable income in 20 CFR §416.1103(a)(1).) Another item, also excluded, is an airplane ticket for domestic travel that cannot be converted into cash. 42 USC §1382a(b)(15).

Noncash income that is not counted as in-kind income for SSI eligibility purposes can be in the form of a wide variety of service and property items. Conversely, any service or property connected with food or shelter can constitute countable in-kind income. See §23.7D.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.7D d. Reduction for In-Kind Support and Maintenance

§23.7D d. Reduction for In-Kind Support and Maintenance

A special category of in-kind income, called "in-kind support and maintenance" (ISM), is attributed to the benefits applicant who receives food or shelter from a third party, including a special needs trust. In-kind support and maintenance may be food or shelter directly furnished to a beneficiary via payments to third parties. See 20 CFR §§416.1121 (types of unearned income), 416.1121(h) (support and maintenance in kind), 416.1123-416.1124 (counting rules), 416.1130-416.1148 (rules for valuing "in-kind support and maintenance"). In-kind support and maintenance can result in a reduction of federal benefits by the presumed maximum value (PMV) or by one-third the amount that the applicant could otherwise receive. Under the PMV rule, ISM is valued at the lesser of its actual value or its "presumed" value of one-third of the federal benefit portion ($637 in 2008), plus the $20 general income exception described in §23.7C. For example, if the trustee directly pays the beneficiary's rent, the beneficiary's SSI will be reduced by $232.33, even if the rent is $1500. Usually, the trust is drafted to allow the trustee to pay the rent and accept the reduction in these circumstances. See §23.32. For in-kind support and maintenance rules, see 20 CFR §§416.1130-416.1148. For the one-third reduction rule, see 20 CFR §416.1131.

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§23.7E e. SSI Transfer Rules

The purpose of the SSI transfer rules is to disqualify individuals who have made gifts of their assets so as to qualify for SSI benefits.

If a person disposes of resources for less than fair market value on or after a certain "look-back" date, the person is ineligible for SSI for a number of months determined by dividing the value of all gift transfers by the SSI benefit rate. The period of ineligibility, however, shall not exceed 36 months. 42 USC §1382b(c).

The SSI transfer rules are similar to the Medi-Cal transfer rules (see §23.9), but with several differences. An important distinction is that the SSI rules apply to transfers of "resources" but not "income." The Medi-Cal rules apply to both resources and income.

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§23.8 3. Medi-Cal Benefits

Medi-Cal provides payment for hospitalization, treatment in medical clinics, doctors' services, lab tests, X rays, home health care, nursing home care, and a host of related medical services. The program also pays for community mental health and drug abuse services and intermediate care facilities for the developmentally disabled. 42 USC §1396a(a)(10) (requisite provision of "medical assistance" by state plan implementing Medicaid); 42 USC §1396d(a)(1)-(5), (17), (21) (services for which state plan must provide assistance); Welf & I C §§14131.15, 14132, 14132.95, 14133.10, and 14133.22; 22 Cal Code Regs §§51301-51349 (descriptions of covered services).

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§23.8A a. Eligibility for Medi-Cal Benefits

Two main categories of persons are eligible for Medi-Cal benefits. First, subject to certain limited exceptions, if an individual receives Temporary Aid to Needy Families (TANF), CalWorks, SSI, or other public cash grant assistance, he or she automatically qualifies for Medi-Cal. Such an individual is "categorically needy." 42 CFR §435.4 (definition); Welf & I C §14005.1 and 22 Cal Code Regs §50201 (eligibility). See §§23.7 and 23.10 on eligibility for SSI benefits.

Second, an individual whose income level is too high to meet SSI eligibility requirements may nevertheless be eligible for Medi-Cal if medical expenses will deplete the applicant's income to below a "maintenance need" level. Such a person is "medically needy." 42 CFR §435.4 (definition); Welf & I C §§14005.7, 14005.12 (eligibility and maintenance need income level); 22 Cal Code Regs §§50201(4) (eligibility of medically needy for Medi-Cal), 50203 (who is medically needy). A substantial number of the medically needy are nursing home residents.

The maintenance need level is a percentage of the TANF grant payable to a person without income or resources. Computation rules are found in Welf & I C §14005.12 and 22 Cal Code Regs §§50601-50605. See Welf & I C §§14005.12(b) (single persons), 14005.12(c)-(f) (adult couples, families, and persons in institutions and nursing facilities).

Income over the maintenance need level is applied to payment for medical services as the medically needy person's "share of cost" much like a deductible or co-pay of private health insurance. Welf & I C §14005.7; 22 Cal Code Regs §50090. See 22 Cal Code Regs §§50651-50660 on determining the share-of-cost amount.

There are special property and income limits for applicants seeking Medi-Cal as medically needy persons. These rules are found in 22 Cal Code Regs §§50401-50489.9 (property inclusion and valuation) and 50501-50571 (income determination). The resource limits for purposes of Medi-Cal eligibility are similar to the rules for SSI eligibility. See §23.7B. (The California Medi-Cal regulations use the term "property," while the SSI rules refer to "resources.")

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§23.8B b. Medi-Cal Property Rules

The dollar value limits for eligible applicants' countable assets are the same as for SSI, with different amounts for single persons, spousal units, and larger family units. 22 Cal Code Regs §50420. Special resource rules apply in determining the Medi-Cal eligibility of a spouse in a nursing home. See §23.9.

Particular items of exempt property are listed in 22 Cal Code Regs §§50425-50487. Exempt items include the personal residence (22 Cal Code Regs §50425), furniture (22 Cal Code Regs §50465), and personal effects such as clothing and certain items of jewelry (22 Cal Code Regs §50467). A car of any value is exempt if it is needed to transport a disabled person. 22 Cal Code Regs §50461.

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§23.8C c. Medi-Cal Income Rules

Income does not count unless it is actually owned by and available to the applicant. For example, because income owed to a licensed board and care facility for the applicant's care is considered to be unavailable, it is not counted as part of the applicant's income. Community property is subject to special rules regarding its ownership. See 22 Cal Code Regs §§50513 and 50515 (availability), 50512 (ownership). See also §23.9 on spousal income and property rights. Certain items of income, listed in 22 Cal Code Regs §§50523-50544, are exempt from being counted. Most are public benefits and grants, but also included are small amounts of irregular or infrequent income. 22 Cal Code Regs §50542.

It is not only the Medi-Cal applicant's property and income that are counted for determining eligibility and share of cost. The property and income of the applicant and his or her family members living together (and of parents of minor children even when not living together) must be added together according to detailed regulations. The family group whose assets are counted together is called the Medi-Cal Family Budget Unit. 22 Cal Code Regs §§50351-50381, 50060.

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§23.8D d. Medi-Cal Trust Rules

Extremely restrictive rules apply to trusts created on or after August 10, 1993, that were "established" by the applicant. See 42 USC §1396p(d).

If the trust deemed "established" by the applicant is revocable, the corpus is considered an available resource; payments to or for the beneficiary are considered income, and payments to anyone else are considered transfers. 42 USC §1396p(c)(1)(B)(i). If the trust is irrevocable, complex rules apply under which corpus and/or income may be considered available if the trust could benefit the Medi-Cal applicant. If the irrevocable trust is one from which the applicant could not benefit, any portion of the corpus or income from which no payment could be made to the applicant is considered to be a transfer as of the date the trust is established. See 42 USC §1396p(d)(3)(B)(ii).

The following kinds of trusts are exempt from the restrictive rules (see 42 USC §1396p(d)(4)):

- A trust containing the assets of a disabled individual under 65 established for his or her benefit by a parent, grandparent, "legal guardian," or court—provided the state will receive all amounts remaining in the trust up to the amount of Medi-Cal benefits paid;
- Certain trusts in a state that does not allow income "spend down" (not California); and
- A trust containing the assets of a disabled individual if the trust is established and managed by a nonprofit corporation and meets other specified conditions.

Under 22 Cal Code Regs §50489.9(a), a trust for a disabled person that is established when the person is under 65 retains its special status if the beneficiary is currently disabled, whether or not he or she is age 65 or over. After age 65, however, assets may not be funded into the trust without affecting benefits.

The rules also impose a 60-month look-back period on transfers from certain trusts (42 USC §1396p(c)(1)(B)(i)) and expansive estate recovery rights (42 USC §1396p(b)(1)). See §23.15 for further discussion of Medi-Cal estate recovery rules.

PRACTICE TIP: It is important to note that the new rules apply only to trusts established "other than by will" (42 USC §1396p(d)(2)(A)) and to trusts established by the applicant, the applicant's spouse, a person with legal authority to act on behalf of the applicant, or a person acting at the direction or on the request of the applicant or the applicant's spouse. 42 USC §1396p(d)(2), (h)(1). Testamentary special needs trusts established by a parent or other family member or any third party for a disabled person are not affected by the trust rules. Under state regulations, testamentary trusts are expressly excluded from the restrictions applicable to Medicaid qualifying trusts (see 22 Cal Code Regs §50489.1) and restrictions applicable to trusts established on or after August 11, 1993 (22 Cal Code Regs §50489.5(a)(1)). It is a common misconception that a testamentary special needs trust must include a "(d)(4)(A) provision" directing reimbursement to the Department of Health Care Services for all benefits paid during the existence of the trust. Such a provision in a testamentary trust is not required under the statute.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.9 e. Special Rules for Spouse in Long-Term Care

§23.9 e. Special Rules for Spouse in Long-Term Care

Because Medi-Cal pays for long-term nursing home care, Medi-Cal eligibility has become an important issue in estate planning for the elderly. With nursing home costs averaging several thousand dollars per month, obtaining Medi-Cal coverage for a spouse in a nursing home can make the difference between penury and some measure of comfort for the spouse at home. (Medicare will only pay for limited posthospitalization nursing home care.)

Married couples have long been the subject of special state property and income rules designed to enable the "at home" spouse to avoid spending all the community resources on care for the institutionalized spouse as a prerequisite to Medi-Cal eligibility. In 1988, the Medicare Catastrophic Coverage Act (MCCA) (Pub L 100-360, 102 Stat 683) created a new system governing Medi-Cal eligibility with the same purpose. These eligibility rules were amended by the Omnibus Budget Reconciliation Act of 1989 (Pub L 101-239, 103 Stat 2106), Omnibus Budget Reconciliation Act of 1993 (Pub L 103-66, 107 Stat 312) and the Deficit Reduction Act of 2005 (DRA-2005) (Pub L 109-171, 120 Stat 4). The statutes changed Medi-Cal income, asset, and transfer rules, primarily as they affect married persons. The rules were further amended by the DRA. California has not yet implemented many of these changes.

In addition, penalty periods of ineligibility are imposed on any institutionalized individual who transfers assets within a specified "look-back" period (60 months under DRA-2005) before being both institutionalized and applying for medical assistance under the state plan. See 42 USC §1396p(c)(1)(A)-(B).

WARNING: Under former law, this period of ineligibility began on the first day of the month of the asset transfer. Under DRA-2005, the ineligibility period apparently will begin when the applicant is institutionalized and already otherwise eligible. 42 USC §1396p(c)(1)(D)(ii). As a result of this change, any applicant who makes a transfer less than 5 years before otherwise eligible for benefits will confront a penalty period that begins when the applicant has virtually no remaining assets and is probably already receiving long-term care.

It is unusual for a nursing home resident with a spouse at home to be the beneficiary of a special needs trust. The trust beneficiary is more likely to be widowed, with the predeceased spouse as the testator. However, the attorney should at least be aware that in order for a nursing home resident to be eligible for Medi-Cal, special more generous resource limits apply to the at-home spouse, and that periods of ineligibility result if transfer of assets is made within the "look-back" period. For a full discussion of rules applicable to institutionalized elders, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chaps 10-12 (Cal CEB 2003).

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III. DRAFTING TO PREVENT TRUST FROM COUNTING AS BENEFICIARY RESOURCE

§23.10 A. SSI Recipients: Restricted Access to Principal

If a trust is established by an individual, the portion of the trust from which payments can be made to or for the benefit of the individual or the individual's spouse is a resource of that individual who is the beneficiary. POMS §01120.201D.2. If the trust is established with the assets of a third party, these provisions do not apply and the trust is governed by POMS §01120.200. See POMS §01120.201C.1.

Under POMS §01120.200D.2:

> If an individual does not have the legal authority to revoke the trust or direct the use of the trust assets for his/her own support and maintenance, the trust principal *is not* the individual's resource for SSI purposes. The revocability of a trust and the ability to direct the use of the trust principal depends on the terms of the trust agreement and/or on State law. If a trust is irrevocable by its terms and under State law and cannot be used by an individual for support and maintenance, it *is not* a resource.

The trust will be counted as a resource if the beneficiary has "unrestricted access to the principal;" if, under California law, the beneficiary can direct the use of funds for his or her "support" or "maintenance"; or if mandatory outright distributions can be made to the beneficiary.

POMS is only a set of administrative guidelines, but this rule is consistent with the basic standards in 20 CFR §416.1201 for determining whether resources are available to the beneficiary. Those regulations require the SSI applicant to have control over an asset for it to be considered a resource. See §23.7B.

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§23.11 B. Medi-Cal Recipients

A beneficiary who is eligible for SSI is also eligible for Medi-Cal. 42 USC §1396a(a)(10); 42 CFR §435.120. The "medically needy" who do not qualify for other public assistance, however, must independently qualify for Medi-Cal benefits. See §23.8. The attorney must determine whether the special needs trust assets will be counted as part of their property.

As noted in §23.8, under 42 USC §1396p(d)(2)(A), testamentary special needs trusts established on or after August 11, 1993, are not affected by the OBRA 1993 restrictive trust rules.

Under 22 Cal Code Regs §§50489, 50489.1, 50489.5, and 50489.9, testamentary trusts are expressly not subject to the restrictions applicable to Medicaid Qualifying Trusts (see 22 Cal Code Regs §50489.1) or to the restrictions applicable to trusts established on or after August 11, 1993 (22 Cal Code Regs §50489.5(a)(1)). However, it is not necessary to use a testamentary trust to preserve Medi-Cal eligibility in most cases because these restrictions generally do not apply to other third party SNTs as well. See §23.10.

Testamentary special needs trusts may be construed to be included under 22 Cal Code Regs §50489.9(a)(1), applicable to trusts that are not described in §50489.1 or §50489.5. Under 22 Cal Code Regs §50489.9(b)(2), if a §50489.9(a)(1) trust is irrevocable, the trust assets are not available until distributed. Of course, as with other benefits, the issue for the Medi-Cal recipient is whether the distribution causes the recipient's available assets to exceed the amount necessary for eligibility for the benefit. The cautious drafter will proceed as if the same restrictions on distributions that apply for SSI recipients also apply for Medi-Cal recipients. See §§23.7, 23.12.

NOTE: It is usually important to provide the trustee with as much flexibility as possible to meet the beneficiary's needs in case they increase significantly or benefits are either not available or greatly reduced.

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IV. DRAFTING TO PREVENT BENEFITS REDUCTION CAUSED BY TRUST DISTRIBUTIONS

§23.12 A. Distributions That Reduce Benefits

Even if the trust principal is considered "exempt," "excluded," or "not available" to the beneficiary when eligibility for public benefits is determined (see §§23.7-23.8 on resource counting rules), distributions from the trust may count as unearned income to the beneficiary resulting in a reduction of SSI benefits (see §23.12A) or Medi-Cal benefits for the "medically needy" (see §23.12B).

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§23.12A 1. Reduction of SSI Benefits

If trust distributions count as income, they may reduce the beneficiary's SSI benefits dollar for dollar. 20 CFR §416.1104 (definition of "countable income"), §416.420 (reduction of benefits). Further, by making the beneficiary's income level too high, distributions over a certain amount can lead to termination of eligibility for SSI benefits altogether. The unearned income will fall into one of three categories; (1) cash; (2) "in-kind" income that can be converted into cash or otherwise used to obtain food and shelter; or (3) "in-kind support and maintenance" (*i.e.,* food or shelter directly furnished to a beneficiary via payments to third parties). See 20 CFR §416.1121 (types of unearned income), §416.1121(h) (support and maintenance in kind), §§416.1123-416.1124 (counting rules), §§416.1130-416.1148 (rules for valuing "in-kind support and maintenance").

When distributions are large enough and carried over into the next month so as to bring the beneficiary's countable resources above the permissible level, they can lead to disqualification from benefits eligibility altogether. See §23.7A on income and resource limits.

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§23.12B 2. Reduction of Medi-Cal Benefits

For "medically needy" individuals whose Medi-Cal eligibility is not dependent on SSI eligibility, excess income will be applied to payment for the services that Medi-Cal would otherwise provide. See §23.8 on the medically needy and their "share of cost." If the gift of cash or in-kind materials or services is large enough and is retained into the next month so that a portion of the gift is treated as a resource as well as income, then the beneficiary may become ineligible for Medi-Cal until the assets have been "spent down" again to bring the recipient within the Medi-Cal resource limits. See §23.7B.

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§23.13 B. Distributions That Will Not Affect Receipt of Public Benefits

In addition to providing information on gifts that should not be made to public benefits recipients, the regulations also specify what types of distributions may safely be made and how gifts may be conveyed without counting as income or resources.

EXAMPLE: For purposes of determining SSI eligibility, some receipts are specifically not counted as "income" because they are paid to third party vendors for services rendered; are not intended for food or shelter for the beneficiary; and cannot be applied to obtain these items. POMS §00815.400. These receipts include payments for medical services made directly to the provider and the value of support during a hospital stay. 20 CFR §416.1103(a)(1)-(2). They can also include payments for the beneficiary's travel and recreation, *e.g.,* a nontransferable, nonrefundable domestic airplane ticket or movie pass. On "income" rules for SSI eligibility, see §23.7C.

EXAMPLE: Similarly, significant noncash assets are not countable as a beneficiary "resource" for purposes of determining eligibility. A personal residence owned and occupied by a beneficiary is an exempt asset under both SSI (20 CFR §§416.1210(a), 416.1212) and Medi-Cal (22 Cal Code Regs §50425) rules. Other items may safely be given to the beneficiary without the donee's risking ineligibility for government assistance. See the property lists in 20 CFR §§416.1210-416.1220, 416.1230-416.1232 (SSI rules for "excluded" property) and 22 Cal Code Regs §§50423-50487 (Medi-Cal rules for "exempt" property).

Some of the planning for qualification for Medi-Cal benefits involves converting otherwise nonexempt resources (*e.g.,* money) into exempt resources. For instance, this may be done by repairing or improving the beneficiary's residence with money that would otherwise disqualify him or her from receiving Medi-Cal. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003). In addition, some otherwise countable property may fit under a special exemption. For example, a second delivery automobile might be approved for use in employment under a "self-support plan" permitted by SSI regulations. 20 CFR §§416.1220-416.1227.

Property of whatever nature that is countable as a resource (*e.g.,* jewelry that is not worn or held for family significance, collectibles, equipment for a hobby or sport) may be owned by the beneficiary if the aggregate value is below the applicable resource limit. 20 CFR §416.1216. See §§23.7-23.8 on resource limits for SSI and Medi-Cal recipients.

Even when distributions will be counted as unearned income and reduce public benefits, the trustee may be able to calculate to what extent and for how long the public benefits will be affected. SSI monthly payments, for example, will be reduced dollar for dollar by excess income, up to the benefits amount. 20 CFR §416.420. Unless the income exceeds the beneficiary's entire SSI monthly payment amount, however, the applicant will not be disqualified from receiving SSI entirely and therefore will not have to reapply for eligibility. See 20 CFR §§416.1323, 416.1324 (suspension of benefits due to excess income and resources); 20 CFR §416.1335 (termination of benefits due to continuous suspension for ineligibility).

Similarly, excess income coming in any month to a "medically needy" person will be applied to medical costs otherwise paid by Medi-Cal, but the beneficiary may continue to receive benefits once the excess is "spent down."

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§23.14 C. Conservative Drafting to Protect Benefits

The drafting implications of the distribution opportunities described in §23.13 are minimal. The drafting attorney must assume that the rules governing benefits eligibility when the trust is drafted will change by the time the trust goes into effect or that the beneficiary may move to another state where regulations are different. Even if they remain the same, the rules are so complex and subject to such disparate interpretations by local agencies that the drafter may not be able to create provisions to cover specific types of distributions. Instead, it will be the trustee's responsibility to take advantage of the resource and income rules when making distributions.

To protect benefits as much as possible, the clauses in this chapter direct that distributions not interfere with public benefits and include savings clauses that go into effect when a distribution may terminate the beneficiary's eligibility for public benefits. See forms 23.31-1, 23.38-1, 23.44-1.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/ V. DRAFTING TO PROTECT TRUST FROM GOVERNMENT CLAIMS FOR PAYMENT AND REIMBURSEMENT/§23.15 A. Beneficiary Payment or Reimbursement Obligations Depend on Program

V. DRAFTING TO PROTECT TRUST FROM GOVERNMENT CLAIMS FOR PAYMENT AND REIMBURSEMENT

§23.15 A. Beneficiary Payment or Reimbursement Obligations Depend on Program

Although receipt of property or income may result in a beneficiary's becoming ineligible for public benefits or in reducing available benefits, testamentary trust assets are rarely exposed to liability for reimbursement of benefits already conferred. The following discussion covers the major potential sources of reimbursement obligations relevant to special needs trusts.

Benefits overpayments

If a person receives Medi-Cal or SSI benefits while he or she is ineligible for the benefits, the cost of the benefits received must be repaid during the beneficiary's lifetime. Welf & I C §14009(c), (e) (repayment of Medi-Cal when overpayment caused by recipient's failure to provide requisite information truthfully and fully); 20 CFR §416.560 (refund of SSI overpayments; reduction of future benefits used as adjustment; see 20 CFR §416.543).

Recovery for payments to Medi-Cal recipient

Medi-Cal recovery rules may apply with respect to estates of recipients of Medi-Cal benefits who were institutionalized or over age 55 when receiving nonmedical services and certain medical services (mandatory recovery) or over age 55 when receiving other medical services (permissive recovery). On property subject to recovery, see §23.15A. If the recipient is the beneficiary of a first party SNT with the mandatory payback provision, the recovery rules may apply if the SNT assets remaining after the recipient's death are insufficient to reimburse DHCS for the Medi-Cal benefits and the recipient has other exempt assets, such as a home, that were not included in countable resources during the recipient's lifetime.

- *Mandatory recoveries.* All states *must* implement recovery programs as follows (42 USC §1396p(b)(1)):
- In the case of an institutionalized individual, from the individual's estate or on sale of the property subject to a lien imposed on account of medical assistance paid on his or her behalf.
- In the case of an individual 55 years of age or older when he or she received medical assistance for nursing facility services, or home and community-based nonmedical services (or for other medical assistance at the option of the state), from the individual's estate.
- *Permissive recoveries.* The state may enact recovery programs for persons over age 55 for any items or services under a state plan but not including medical assistance for Medicare cost-sharing. 42 USC §1396p(b)(1)(B)(ii). California has opted to include permissive recoveries. 22 Cal Code Regs §50961(b).
- *Prohibited recoveries.* States may not enact recovery programs against the estates of persons who were under age 55 when the services were received and were not residing in a "nursing facility, intermediate care facility for the mentally retarded, or other medical institution." 42 USC §1396p(a)(1)(B).

Although the general rule is that DHCS may not claim if the decedent was under 55 when services were received, a claim must be made against such an individual if he or she had been a nursing home patient. Welf & I C §14009.5(b)(1). However, in its Fiscal Analysis of Regulation R-32-00 (*i.e.*, the revised estate recovery regulations filed May 10, 2006), dated February 6, 2006 (available on the DHCS website at http://www.applications.dhs.ca.gov/regulations), DHCS made the surprising revelation that "there are currently no plans to implement this provision," referring to the provision for recovery of skilled care provided to persons under age 55. DHCS cited various administrative and economic reasons for abandoning such claims.

In addition, recovery is barred if there is a surviving spouse or a child who is under the age of 21, or is blind or permanently and totally disabled. 42 USC §1396p(b)(2). See §23.15B.

Institutionalized mentally ill

Welfare and Institutions Code §7275 requires payment for services from the property of a person living in a state

hospital for the mentally ill. Welfare and Institutions Code §7279 permits the state to obtain a court order for sale of the person's property, reserving only $500. Likewise, Welf & I C §7513 obligates a person living in a state hospital for the developmentally disabled to pay for his or her costs of care, less sums paid by the county. (The county may, in turn, seek reimbursement for any sums paid.)

Public aid recipients

Welfare and Institutions Code §17000 requires each county to extend aid and relief to indigents, but the "standards of aid and care" are left to each county's board of supervisors. Welfare and Institutions Code §17403 creates a qualified obligation to repay general assistance that may be enforced in the limited way specified in this section.

Persons who have received cash grants or medical aid as indigents, including hospitalization in a county hospital, are subject to this repayment obligation. If a person acquires property after having been a recipient of "public moneys," the county has a claim against the recipient "to the amount of a reasonable charge for moneys so expended." Welf & I C §17403.

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§23.15A 1. Estate Property Subject to Medi-Cal Recovery Claims

For purposes of Medi-Cal recovery, decedent's "estate" may include not only probate estate assets, but assets conveyed to another "through joint tenancy, tenancy in common, survivorship, life estate, living trust, or other arrangement"). 42 USC §1396p(b)(4).

State law provides that the Department of Health Care Services (DHCS) *must* claim against the estate of a deceased beneficiary, or against any recipient of the property of that beneficiary by distribution or survival, an amount equal to the payment for the health care services received (unless recovery for those services is prohibited by federal law as described in §23.15) or the value of the property received by any recipient from the decedent by distribution or survival, whichever is less. Welf & I C §14009.5(a).

Effective May 10, 2006, the DHCS adopted estate recovery regulations intended to comply with the statutory requirements. The regulations generally provide that the DHCS must claim against the estate of a decedent, or against any recipient of the decedent's property, for all Medi-Cal payments made on behalf of the decedent. 22 Cal Code Regs §50961(a)-(b). However, the recovery rules generally do not apply to third party SNTs established for the benefit of the decedent. For further discussion of the rules and proposed regulations regarding life estates, see Drafting California Irrevocable Trusts §13.18 (3d ed Cal CEB 1997).

WARNING: Because the rules in this area have been in flux, questions arise about the transition rules. Even though the effective date of the new rules is clear, it may not be clear which transactions and other events they apply to. Despite the obvious unfairness of applying a new recovery rule to all later deaths when the planning arrangements were made in reliance on an earlier rule, the DHCS probably has the legal authority to do so. See *Kizer v Hanna* (1989) 48 C3d 1, 255 CR 412. In that case, the California Supreme Court decided that application of the Medi-Cal estate recovery statute to payments made before the enactment of the rules was not "retroactive," because the statute applied only to deaths after the date of enactment. Before advising their clients, practitioners are warned to seek updates from groups and attorneys active in Medi-Cal planning. One such source of information is the website of California Advocates for Nursing Home Reform (CANHR) at http://www.canhr.org.

Although the general rule is that DHCS may not claim if the decedent was under 55 when services were received, a claim must be made against such an individual if he or she had been a nursing home patient. Welf & I C §14009.5(b)(1); 22 Cal Code Regs §50961(c)(1).

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§23.15B 2. Delayed Recovery From Estate of Surviving Spouse or Child

The Department of Health Care Services (DHCS) may not claim during the lifetime of a surviving spouse. Welf & I C §14009.5(b)(2)(A); 22 Cal Code Regs §50961(c)(2). However, on the death of the surviving spouse, DHCS must make a claim against his or her estate, or against any recipient of property from the surviving spouse obtained by distribution or survival, for the lesser of either the amount paid for the medical assistance given to the decedent or the value of any of the decedent's property received by the surviving spouse through distribution. Welf & I C §14009.5(b)(2)(A).

NOTE: Federal law limits claims to "the individual's estate, or upon sale of the property subject to a lien" (42 USC §1396p(b)(1)(A)) and does not mention claims against the estate of the beneficiary's spouse, but claims against the estate of the surviving spouse based on the value of property received from the decedent are common.

DHCS may not make a claim if there is a surviving child of the deceased beneficiary who is under 21, or who is blind or permanently and totally disabled. Welf & I C §14009.5(b)(2)(B)-(C); 22 Cal Code Regs §50961(d)(3)-(4); *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488. Federal law appears to prevent *any* state recovery in these cases. 42 USC §1396p(b)(2). California follows federal law, *i.e.,* the state is barred from making a claim for recovery—no matter who actually receives the decedent's property. See *Dalzin v Belshé* (ND Cal 1997) 993 F Supp 732 (proportionate share rule in Welf & I C §14009.5(b)(3) held to violate federal law). Even if a deceased Medi-Cal beneficiary leaves a home to several children, *e.g.,* only one of whom is disabled, all recovery is barred. The same reasoning can be expected to apply if there is a surviving child under age 21. The state's regulations now comply with the *Dalzin* case. 22 Cal Code Regs §50961(d)(3)-(4).

Property passing to the blind or disabled child may continue to be exempt from recovery after the child's death if the child in turn has a surviving disabled child. In *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488, for example, the court held that DHCS had no right of reimbursement for health care provided to the beneficiary of a first party special needs trust when the trust property passed to the beneficiary's child who was permanently and totally disabled and received Social Security disability benefits.

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§23.15C 3. Limitations Period for Medi-Cal Recovery Claims

The limitations period for a DHCS action to recover Medi-Cal payments is 3 years as an action on a liability created by statute under CCP §338(a) and begins to run when DHCS is given written notice under Prob C §215. The notice requirements and claim-filing deadlines are contained in Prob C §§9200-9205 (claim must be filed within 4 months after notice is given). The CCP §366.2 1-year period does not apply and DHCS is entitled to recover prejudgment interest. *Shewry v Wooten* (2009) 172 CA4th 741, 91 CR3d 199; *Shewry v Begil* (2005) 128 CA4th 639, 27 CR3d 209.

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§23.16 B. Prior Case Law Protected Nonsupport Trusts From Claims for Payment for Services to Institutionalized Mentally Ill

In three California cases, the courts specifically addressed the right of the state to be reimbursed for the costs of the beneficiary's institutionalization for mental illness from the assets of a trust established for the disabled beneficiary by a third party. See *Estate of Johnson* (1961) 198 CA2d 503, 17 CR 909 (no right to reimbursement when language of trust construed to authorize trustee to pay "in the neighborhood" of $25 per month for beneficiary's support in state hospital); *Estate of Hinckley* (1961) 195 CA2d 164, 15 CR 570 (no right to reimbursement when trust gave trustee discretion to pay amounts of principal necessary to provide for emergencies). But see *Estate of Lackmann* (1958) 156 CA2d 674, 320 P2d 186 (state entitled to reimbursement from trust established for beneficiary's "proper care, support and maintenance" despite spendthrift clause).

In each case, the court's paramount consideration was whether the settlor intended to provide a *support* trust. The courts also considered whether the testator was obligated under state law to support the beneficiary. These cases emphasize the importance of explicit statements of intent in the trust instrument. The clauses in this chapter clearly state that the trust (1) may not be used for support of the beneficiary, (2) may be used for supplemental funds only, and (3) may not have a negative impact on the beneficiary's eligibility for public benefits. See, *e.g.,* forms 23.27-1, 23.31-1, 23.38-1.

See §23.20 on the possible effect of a testator's legal support obligations on the trust's vulnerability to claims for reimbursement. On statutory "spendthrift" protection, see §§23.17-23.19.

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C. Statutory "Spendthrift" Protection

§23.17 1. Liability of Trust for Reimbursement When Required by Statute

If a public benefits recipient is the beneficiary of a trust (even a trust with a "spendthrift" clause) and a California statute makes the beneficiary liable for reimbursement for services received by the beneficiary, the beneficiary's spouse (or registered domestic partner), or minor child, then the appropriate state or county representative may bring a petition under CC §709.010 for reimbursement from the trust. Prob C §15306(a); Fam C §297.5(a). See chap 27 on spendthrift clauses. However, the public support reimbursement obligation does not apply to most special needs trust beneficiaries. Prob C §15306(b). See §23.18.

Probate Code §15306(a) provides for reimbursement in three situations:

(1) If the trust beneficiary/benefits recipient has the right to compel the trustee to make payments, then the court may order the trustee to make reimbursements from the trust "as [*the payments*] become due."

(2) If the beneficiary has no right to compel the trustee to make payments, then the court may order reimbursements out of any discretionary payments that the trustee does make.

(3) If the beneficiary is the spouse or minor child of the settlor (testator) and does not have the right to compel distributions from the trust, the court can compel the trustee to make reimbursements from trust funds to the extent that the trustee has the discretionary power to make payments to or for the beneficiary.

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§23.18 2. Exemption From Reimbursement Liability of Most Special Needs Trusts for Disabled

Probate Code §15306(b) substantially limits the court's authority under Prob C §15306(a) to order reimbursements when the trust beneficiary is disabled. Probate Code §15306(a) does not apply

> to any trust that is 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.

According to Cal L Rev'n Comm'n Comment to Prob C §15306, this limitation is intended to encourage potential settlors to provide in trust for the care or support of a disabled person without the risk that the property of the trust will be taken to reimburse a public agency for the support it provided. But see §23.19 on an important limitation on this exemption of trust property.

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§23.19 3. Protection for Trust for Institutionalized Mentally Ill or Developmentally Disabled Depends on Retained Medi-Cal Eligibility

The second sentence of Prob C §15306(b) provides that if a trust results in an individual's ineligibility for public social services under Welf & I C §§10000-18996, then the first sentence of Prob C §15306(b), which exempts trusts for disabled persons from reimbursement obligations, does not apply. The cited Welfare and Institutions Code sections provide for benefits under the State Supplementary Program (the state supplement to SSI) and Medi-Cal, among other programs.

No state laws currently require beneficiary *lifetime* reimbursements of funds received under SSI or Medi-Cal (except for overpayments). See §23.15. Probate Code §15306(a) should not, therefore, pose any threat of reimbursement to trusts for the aged or disabled who receive only those benefits; the provisions of Prob C §15306(b) appear to be irrelevant to special needs trusts for those beneficiaries.

Probate Code §15306(b) does create the risk of special needs trust liability, however, for reimbursement for care for the mentally ill and developmentally disabled who are in state institutions. These recipients *are* liable during their lifetimes for reimbursement of funds expended on their institutionalization. Welf & I C §§7275 and 7279 (liability of institutionalized mentally ill), 7513 (liability of institutionalized developmentally disabled). See also §23.15. Many of these patients receive Medi-Cal in addition to their institutional care. If, under Prob C §15306(b), such a beneficiary is disqualified for Medi-Cal benefits as a result of the trust, the trust may be liable to reimburse the cost of the beneficiary's care in the institution. If, however, the trust is carefully drawn to avoid loss of Medi-Cal eligibility, it should be protected against reimbursement liability by the exception provided in Prob C §15306(b). See §23.11 on drafting to avoid loss of Medi-Cal eligibility.

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§23.19A 4. Liability of Trust for Child Support

If there is a child support judgment against the trust beneficiary, at least one court has held that the appropriate agency may make a claim against the trust under Prob C §15305, notwithstanding a spendthrift clause or full discretionary authority of the trustee. *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489 (trustee's refusal to pay beneficiary's child support obligations from trust funds was found to be in bad faith and with improper motive; court looked at beneficiary's patent disregard of his child support obligations for his six children, and statutory and public policy objectives in favor of payment of child support as important factors).

Unlike a public support reimbursement obligation, there is no exception to the child support obligation for disabled individuals under Prob C §15305. Thus, the court may, to the extent that the court determines it is equitable and reasonable under the circumstances of the particular case, order the trustee of a third party SNT to satisfy all or part of a support judgment against the SNT beneficiary. Arguably, however, the trustee's obligation to provide for the needs of the beneficiary would be a proper motive for refusing to pay child support. See *Young v McCoy* (2007) 147 CA4th 1078, 54 CR3d 847 (trustee did not abuse her discretion in determining that no distributions should be made to a beneficiary who was serving a life sentence in prison for attempted murder; therefore, the court could not compel distributions to the beneficiary's victim who was seeking to enforce a judgment awarding personal injury damages).

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.20 D. Potential Liability of Parental or Spousal Estate for Beneficiary Support

§23.20 D. Potential Liability of Parental or Spousal Estate for Beneficiary Support

A variety of state statutes make relatives of a disabled person responsible to reimburse the state for costs expended for that person's care. Some of these statutes simply impose reimbursement liabilities; others specifically empower the state to collect from the estate of a deceased relative of the disabled person. These statutes may make the assets of a special needs trust created under the will of a responsible relative of the disabled person vulnerable to reimbursement liabilities.

Statutes that refer directly to the state's right to recoupment from a responsible relative's *estate* include:

- Fam C §3952, which provides for recoupment to the state or county from the estate of the parent of a child who is left "chargeable to the county, or confined in a state institution …"
- Welf & I C §7275, which imposes liability for the cost of care on the spouse, parents, and children of a person institutionalized for mental illness, and their estates. (This section does not impose liability for costs of care for a "mentally retarded" person in a state hospital. Welf & I C §7275.)

Statutes that impose liability, but do not refer specifically to collection from estates, include:

- Welf & I C §4782, which imposes fees on parents for 24-hour out-of-home services for a developmentally disabled child under age 18 (not to exceed the costs of caring for the child at home or actual costs of care, and according to ability to pay);
- Welf & I C §14008, which makes a parent of a child under age 18 responsible for almost all health care or related services provided under Medi-Cal; and
- Welf & I C §17300, which makes "responsible relatives" (spouses, and parents of minor children receiving benefits) liable for payments made by a county under the general relief provisions of Welf & I C §§17000-17501.

Family Code §§3910(a), 4400, and 4401, which impose generally a duty on the part of parents and adult children to maintain, to the extent of their ability, respectively, the child or parent who is unable to maintain himself or herself, have been held not to provide a basis for reimbursement to a county, which must rely on Welfare and Institutions Code sections instead. *County of San Bernardino v Simmons* (1956) 46 C2d 394, 296 P2d 329. On the general obligation of adult children to support parents under Fam C §4400, see *Marriage of Leni* (2006) 144 CA4th 1087, 50 CR3d 886 (no reimbursement of community on dissolution for amount used to support parent).

NOTE: With regard to parents who receive SSI, Welf & I C §12350 provides that "[n]o relative shall be held legally liable to support or to contribute to the support of any applicant for or recipient of aid" notwithstanding Fam C §§4400-4401. However, there does not appear to be any similar protection for adult children whose parents are recipients of Medi-Cal. Therefore, it is unclear whether the government could enforce an obligation on adult children to pay for the nursing home expenses of their parents.

These payment obligations may expose the estate of the parent, child, or spouse of a disabled person to collection (via creditor's claim) for cash grants received, housing provided, physical or mental health care, or developmental services. If these statutes are applied to seek support from an estate that would otherwise be distributed directly to a special needs trust, the estate may be lost before the trust can be established. There have been no reported cases, however, of a parent's estate being sued for reimbursement under Welfare and Institutions Code provisions.

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VI. TRUSTEE OF SPECIAL NEEDS TRUST

§23.21 A. Duty to Oversee Caregiving Arrangements

The testator who is a primary support for the beneficiary of the special needs trust will want to ensure that someone will be personally involved with the beneficiary's living and caregiving arrangements after the testator dies.

Even though the trust beneficiary may already have a network of caregivers (*e.g.,* social workers, medical personnel, physical or psychological therapists, in-home nurses), a readily available person committed to overseeing the beneficiary's care may be invaluable to:

- Determine which services are available;
- Ensure that the beneficiary receives the highest level of care;
- Visit the beneficiary to inspect living conditions;
- Consult with doctors and staff at residential facilities or nursing homes;
- Ensure that all available public benefits are requested and received by the beneficiary;
- Make recommendations to the trustee regarding the special needs of the beneficiary;
- Interface between the beneficiary and the trustee; and
- Apply for therapeutic, educational, and employment training programs for the beneficiary.

If the disabled beneficiary is a minor or conservatee, then the guardian or conservator is a logical person to fill this role. See chaps 24-25 on testamentary nominations of guardians of the person and estate. On guardianships generally, see California Guardianship Practice (Cal CEB Annual). On conservatorships, see California Conservatorship Practice (Cal CEB 2005). If the beneficiary is not a minor and does not require a conservator, the trustee of the special needs trust may be the appropriate person to provide the necessary oversight.

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§23.22 B. Candidate Must Comprehend Extraordinary Duties

Because the duties of the trustee of a special needs trust will be more demanding than those of a trustee who is expected only to manage and administer trust assets, it is imperative that the testator discuss the proposed nomination with the candidate. After fully disclosing to the candidate the range of the trustee's future duties, the testator should emphasize the importance of familiarity with the rules governing the public benefits for which the beneficiary may be eligible. The testator should also make sure, to the best of his or her ability, that the candidate will accept the nomination.

The testator must also try to arrange for successors to the primary nominated trustee. The importance of naming successors grows in proportion to the amount of personal involvement required of the trustee. The testator may wish to include a provision authorizing the trustee to nominate his or her own successor. The ultimate successor trustee of a trust is usually a corporate trustee, but a corporate trustee probably will not provide services that require personal involvement with the beneficiary (*e.g.,* visiting the beneficiary, calculating public benefits). Some corporate trustees will also require language mandating the hiring of a geriatric care manager and some have preferred language to use in such instances. Depending on the size of the trust, corporate trustee fees may quickly reduce the trust assets. Therefore, the testator must carefully consider individuals who may be able to take over the trustee position if the first nominee cannot serve. Because of the time and effort that will be demanded of the trustee, it may be wise for the testator to nominate cotrustees with separate responsibilities (*e.g.,* property management and review of beneficiary needs). A special family trust committee may be set up to perform the more personal functions in an advisory or cotrustee capacity.

PRACTICE TIP: Nonprofit corporate trustees are sometimes a viable alternative to other corporate trustees. Some nonprofit programs provide only trustee services and some provide both trustee services and caseworker services. For beneficiaries who are developmentally disabled, check with the local Aid for Retarded Citizens (ARC) affiliate for information on nonprofit trustees. For beneficiaries who are mentally ill, check with the local National Alliance for the Mentally Ill (NAMI) affiliate or the local mental health association chapter.

If a prospective trustee has no knowledge of public benefits, consider the establishment of a trustee advisory committee or special cotrustees to advise the trustee regarding distributions. See form 23.30-1.

The testator may consider naming a special cotrustee, or cotrustees, whom the trustee would be required to consult with and obtain consent from prior to making a distribution to the beneficiary. The form set out in §28.16 (designation of special trustee) may be adapted for this purpose. However, this provision should only be used after it is clearly understood how to resolve disagreements between trustees. Disagreements can open a trustee to personal liability and harm a beneficiary when a distribution is not made due to disagreements between a trustee and cotrustee.

The testator should consider providing for increased compensation to the trustee, in view of the greater demands that administration of a special needs trust imposes.

On selection and appointment of trustees, successor trustees, cotrustees, and special trustees, see chap 28. The trust will typically operate more smoothly if successor trustees are designated by the testator or the successor trustees themselves rather than relying on court petition.

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C. Specific Instructions

§23.23 1. Review of Beneficiary's Situation

When a guardian or conservator of the person or estate will be appointed, the trustee's duties should be coordinated with those of each other fiduciary. When there is no other fiduciary, the trustee's duties will be more extensive.

The will or living trust should provide the trustee with specific instructions on duties that exceed those ordinarily required of a testamentary trustee (*e.g.,* visits, consultations with caregivers). The will or living trust should also specify that the trustee is not responsible for tasks that the testator expects to be performed by other fiduciaries, *e.g.,* guardian of the person of a minor child. Accordingly, the drafting attorney must consult with the client to learn what the beneficiary's residential, medical, and therapeutic situation is likely to be in order to draft the appropriate specific directions.

Because the trustee has no legal powers over the beneficiary's person (unless the trustee is also the beneficiary's conservator or guardian), special instructions to the trustee must be made in the context of beneficiary needs for supplemental funds, services, or property (*e.g.,* therapeutic equipment) that the trustee can provide by means of trust assets.

The trustee of the special needs trust almost always should be required to review the beneficiary's financial condition, including available public benefits, to determine the beneficiary's needs and the effect of distributions from the trust on the beneficiary's eligibility for public assistance. See §§23.34-23.35 for form instructions. See also form 23.36-1, which requires the trustee to seek public benefits for the beneficiary (although some trustees may not want this responsibility). In implementing these requirements, a trustee may run into a situation in which the beneficiary will not cooperate in the application for public benefits.

PRACTICE TIP: Often, a signature and information is needed from the public benefits applicant, and a trust beneficiary may sabotage the application by refusing to cooperate. It is important to provide language that will exonerate the trustee in this situation.

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§23.24 2. Special Property Management Instructions

It may be helpful or necessary to provide the trustee with powers regarding property management. Following are three situations in which the drafter should include such powers in the will:

(1) *Retaining or acquiring nonproductive property.* For example, an expensive musical instrument held in trust for the beneficiary's occasional use is considered to be nonproductive property. Normally, the trustee has a duty to convert such property into property productive of income. If the testator wants the trustee to retain the instrument, the drafter should include in the will a special clause empowering the trustee to do so. See §§29.15, 29.19 (issues presented by retention of and investment in nonproductive property), 29.16, 29.20 (clause permitting retention of and investment in nonproductive property). (Musical instruments are exempt from inclusion in a beneficiary's property under Medi-Cal regulations. See 22 Cal Code Regs §50471. They are counted as resources under SSI eligibility regulations (see 20 CFR §§416.1210-416.1238) unless the instruments fit within a special category (*e.g.,* as a business property used for self-support) (see 20 CFR §416.1210(d)).)

(2) *Investing for low income.* The trustee may periodically withhold income to avoid reducing the beneficiary's public assistance benefits. Unless the trustee invests in assets that produce minimal income (*e.g.*, growth stocks) or nontaxable income (*e.g.,* municipal bonds), the trust may suffer the high rates of income tax imposed on irrevocable trusts under IRC §1(e). Because of this, the testator may wish to direct the trustee to invest in assets that will reduce the impact of those provisions.

(3) *Keeping public benefits separate.* Public benefits should never be funded into a third party SNT. Commingling may make the benefits attachable, which they would otherwise not be. See form 23.36-1, which provides a noncommingling instruction.

Other directions to the trustee regarding asset management may be required. See chap 29 for discussion of the trustee's management powers under statute and case law and a variety of specific clauses that may be appropriate when particular assets are likely to be held in trust.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.24A 3. Memorandum of Intent

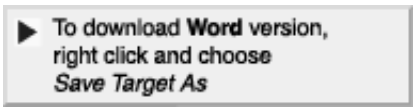
§23.24A 3. Memorandum of Intent

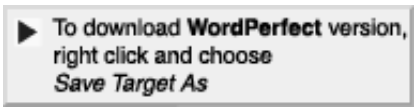
The parents of a disabled child are often his or her greatest advocates. When the parents die or become unable to advocate for the disabled child, the child's care will suffer. A Memorandum of Intent is an effective way to allow the parents to communicate their preferences regarding the advocacy and care of their disabled child to successor caregivers. It may be as simple as listing favorite activities or it may be as elaborate as naming every doctor, care manager, and individual assisting the disabled child with a daily, monthly, and yearly schedule for the disabled beneficiary. Many parents find it difficult to write this letter, and this is where the attorney's role as counselor is so important.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.24B 4. Form: Guidelines for Parents Writing Memorandum of Intent

§23.24B 4. Form: Guidelines for Parents Writing Memorandum of Intent





23.24B-1 Guidelines for parents writing memorandum of intent

A Memorandum (or Letter) of Intent communicates and documents your preferences regarding the care of the person for whom you have created a special needs trust, "the beneficiary." It provides a guideline for those people who may become responsible for decisions about the beneficiary of the special needs trust.

The Memorandum of Intent is a personal letter drafted by you, which is intended to give your successor trustees insight and information regarding services, supports, and other personal matters affecting the trust beneficiary. This letter differs from the trust because it does not convey legally binding directions like those in a trust. Rather, it is a personal letter to those people who will have responsibility for your family member or friend with a disability when they must make important decisions.

Important Points to Remember When Writing Your Letter

Parents, brothers, sisters, other family members, and especially the trust beneficiary should contribute to the letter.

The contents of the letter should reflect your expectations. Future circumstances may make it difficult for others to carry out strict demands. You must trust that those carrying out your plan will try to adhere to your expectations.

You should gear the preferences in the letter toward enhancing the trust beneficiary's independence and growth. Your requests should not accommodate the convenience of other family members or service providers.

The letter should be written in nontechnical language by you. It should communicate to the reader your heartfelt desires.

A letter of intent is not legally binding like your trust. However, its contents should not contradict your trust.

Periodically review, and if necessary, update your letter. Make sure that it still reflects not only your expectations, but also the preferences of other family members and your trust beneficiary. Age and circumstances may alter what you want in your letter.

The Content of Your Letter Should Include the Following Items

The letter should begin by stating the individual's full name, date of birth, place of birth, name of the trust, date of trust, and the beneficiary's Social Security Number.

You should then name the agencies that relatives, trustees, and guardians should contact for advice and help (*e.g.,* Regional Center, local chapter of The Arc, case manager, care providers, physicians, therapists, close family members, and friends).

Financial and Other Support for Your Trust Beneficiary

List all public benefits that the trust beneficiary receives or may be eligible to receive.

List any arrangements with a corporate trustee, care manager, or other entity for the trust beneficiary's continued care. Include the name(s) and address(es) plus any special instructions.

If appropriate, list the trust beneficiary's current employment or the type of employment you think he or she

would like.

Current Living Arrangements

Describe the type of living situation you anticipate for the trust beneficiary (*e.g.,* live with particular relative, small group home, apartment with support).

Location of the living situation you anticipate for your trust beneficiary (*e.g.,* the geographic locale you prefer, and type of physical and natural environment, if that is important).

Qualities of the living arrangement (*e.g.,* nonsmoking home, adhere to a certain religion, dietary restrictions, only allows certain types of disabilities, age of other residents).

Regular routines in the person's schedule (*e.g.,* daily schedule of getting ready for school, weekly appointments).

Programs/Services

Name the type of school or day program setting expected.

List the name and address of day programs, sports programs, habilitation programs, or other programs and activities in which the trust beneficiary regularly participates.

List the type of services, therapies, or medical interventions that are needed, or may be needed (*e.g.,* basic skills training, speech therapy, behavioral evaluations).

Describe the trust beneficiary's routine medical care (*e.g.,* regular check-up schedule, dental appointments, annual eye examination) and the names and locations of preferred medical professionals.

Name any health insurance that should be maintained, including addresses, phone numbers, insurance number. Make a copy of the insurance card and attach it to the letter.

Personal Preferences

Describe the trust beneficiary's grooming preferences (*e.g.,* type and color of clothes, hair style, preferred toilet articles).

Describe his or her likes and dislikes about food, allergies, chores, and other routine daily activities.

List his or her favorite personal items (*e.g.,* personal radio, certain furniture, personal pet).

Describe personal habits that it would be important for someone else to know about.

List all friends and relatives, their addresses, and how often the trust beneficiary likes to visit these people.

List the trust beneficiary's favorite recreation and other leisure activities and the level of independence in these activities. Include how often he or she likes to participate in these activities.

Describe any religious preferences and how often he or she participates in religious activities. The type of religious activities (*e.g.,* attends youth group but not church).

Abilities

Describe the trust beneficiary's level of independence for getting around the community (*e.g.,* ability to ride public transportation, independence in shopping, ability to go out alone).

Describe the trust beneficiary's ability to handle money (*e.g.,* change-making, independence in purchasing items).

Describe his or her abilities in reading, writing, communicating, and understanding what others may tell him or her. If he or she does not use verbal communications, note how he or she communicates desires or replies to others.

Describe any aspects of the trust beneficiary's disability that you feel are particularly important to be aware of (*e.g.,* needs a structured environment, must be kept from food, does not like loud noises).

Completing the Letter

Some clients find it easier to write the letter if they keep a daily journal for several weeks that records the daily, weekly, and monthly activities of both the trust beneficiary and those people who provide him or her support and care. The journal can then be condensed into a letter.

List any other information you feel is particularly important.

Both parents should sign and date the letter. Keep a copy for yourself and a copy with your trust. Distribute the letter to those who may be responsible for decisions about the trust beneficiary and invite their comments.

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VII. SPECIAL NEEDS TRUST CLAUSES

A. Introductory Clause

§23.25 1. Statement of Trust Purpose

The unusual nature of the special needs trust calls for a description of the trust's specific purpose in an introductory section. To clarify the testator's purpose and intent, some drafters provide a detailed description of the circumstances leading to the trust's creation.

The introduction to a trust for a disabled child:

- Begins with language that tracks Prob C §15306(b) in describing the child's disability (see Note below);
- States the intent that the trust provide aid in addition to the public assistance available to the child;
- Describes the needs that the trust can meet when the public benefits will not;
- Describes the adverse effects if creditors are able to reach the trust assets or the trust results in termination of public benefits; and
- States that the trust should be interpreted in view of the foregoing statements.

Although briefer and coupled with a beneficiary identification, form 23.27-1 is intended to achieve the same goals as the introduction described above. Because of the variation in different clients' situations, the form obviously cannot serve in every case. The drafter should create a specific description tailored to each client.

NOTE: The first sentence of form 23.27-1, which bolsters "spendthrift" protection, tracks the language of Prob C §15306(b). See §§23.17-23.19.

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§23.26 2. Sole Beneficiary or Multiple Beneficiaries

Although the testator usually prefers the beneficiary of a third party special needs trust to be the sole beneficiary of the trust, some testators may want to provide for other beneficiaries as well.

An important motive for naming multiple beneficiaries is to protect the trust from government reimbursement claims or to allow gifting under a *Cristofani* SNT. See §23.2B. If the trustee is given broad discretionary power to "sprinkle" trust benefits among several parties, the interest of the public benefits recipient in the trust assets is that much less clear. Further, if satisfaction of a government reimbursement claim would invade the interests of innocent third parties, an agency may be less eager to pursue the trust assets.

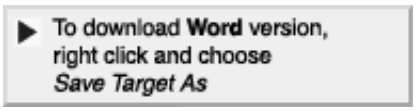
NOTE: A third party SNT may have multiple beneficiaries. A first party SNT (or trust established with the funds of the disabled beneficiary) may only be for the "sole benefit" of the disabled beneficiary.

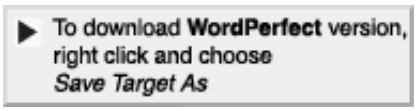
Forms in §§23.25-23.52 provide clauses for trusts with one primary beneficiary. Forms in §§23.54-23.59 provide clauses designed for a multiple income beneficiary trust with a trustee sprinkling power. See §§21.18-21.19 on sprinkling clauses; chap 22 on family pot trusts.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.27 3. Form: Trust Purpose

§23.27 3. Form: Trust Purpose





23.27-1 Trust purpose

***Purpose of Trust*. The primary beneficiary of this trust has a disability that substantially impairs the beneficiary's ability to provide for the beneficiary's own care or custody and constitutes a substantial handicap. The primary beneficiary has been diagnosed with _ _[*name disability*]_ _, which is characterized by the following symptoms: _ _[*describe symptoms*]_ _. The purpose of this trust is to provide financial aid that is supplemental to, rather than a replacement for, public benefits provided to the beneficiary, without disturbing public benefits that would be available to the beneficiary if the trust did not exist. The trustee shall hold, administer, and distribute all property allocated to the trust for the benefit of the following beneficiary during the beneficiary's lifetime, unless this trust is earlier terminated: _ _[*Name of primary beneficiary*]_ _.**

Comment: The first sentence of this clause tracks the language of Prob C §15306(b) to establish that the trust should be exempt from any reimbursement claims under Prob C §15306(a). See §§23.17-23.19 on Prob C §15306. The drafter who wishes to specifically describe the beneficiary's condition should probably add to this material rather than replace it. A database of disabilities, located at http://www.rarediseases.org/search/rdblist.html, is helpful in describing the symptoms of a disability.

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B. Distribution Provisions

§23.28 1. Special Needs Standard

The distribution standard of an SNT is often the most important provision in the entire SNT. The distribution standard will affect whether the trust "works" for the disabled beneficiary in two ways:

- Too broad a distribution standard will, in some jurisdictions, cause the trust to be considered an available resource for some needs-based public benefit programs and disqualify the beneficiary simply by the trust's existence, whether or not distributions are actually made.
- Too narrow a distribution standard restricts the trustee from enhancing the dignity and quality of life of the disabled beneficiary in the most effective manner.

Typically, the main purpose of an SNT is to supplement needs-based public benefits, without supplanting them. Trust assets should not be used to provide food or shelter for the beneficiary, unless the practitioner is aware of the consequences of doing so: If the trustee pays for food or shelter, it will reduce or eliminate some needs-based public benefits. See §23.12.

However, much greater flexibility (especially in the area of housing) makes a fully discretionary distribution standard desirable in most circumstances. There is some concern that a government agency (or new regulations) may, in the future, deem the more flexible discretionary distribution standard exercised and cause a reduction or elimination in benefits, even if the trust assets are not used for food or shelter. The SNT, however, at that point could be modified to comply with changes in the law to reduce the discretion available to the trustee. See discretionary distribution form provision in §23.31. See discussion in §23.32.

Distributions for medical expenses should not be permissible if the beneficiary is otherwise eligible for Medi-Cal unless they are to pay for items not covered by Medi-Cal. However, clothing can be supplied by the trust without penalty because clothing is excluded from the in-kind support and maintenance income reduction. 20 CFR §416.1102.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.29 2. Public Benefits Determine Selection of Income and Principal Distribution Clause

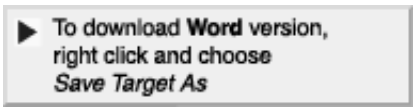
§23.29 2. Public Benefits Determine Selection of Income and Principal Distribution Clause

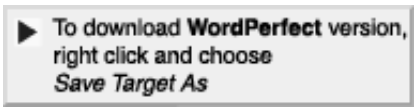
A trustee who *must* distribute either income or principal, at specified intervals or subject to an ascertainable standard, may be compelled by a government agency to pay for the beneficiary's care. See §§23.10-23.11, 23.17-23.19A. Or, a poorly informed beneficiary may petition a court to compel distributions, thus causing a loss or reduction of benefits.

The suggested clauses in §23.31 are for discretionary payments of both principal and income.

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§23.30 3. Form: Trustee Advisory Committee





23.30-1 Trustee advisory committee

***Trustee Advisory Committee*. Before making a distribution for the benefit of the beneficiary under the provisions of Paragraph _ _[*number*]_ _ of this trust, the trustee may first consult with the trustee advisory committee, composed of the persons named below, and shall consider the committee's advice and recommendations; provided, however, that, when it is impossible or impractical to contact and solicit the advice of any member of the committee, the trustee may make a distribution without such contact.**

Although the trustee may solicit the advice and recommendation of members of the trustee advisory committee, the trustee shall have sole authority for making distributions under the terms of this trust.

If a member of the trustee advisory committee is unwilling or unable, for any reason, to act or to continue to act as a member of the committee, the trustee shall appoint a successor member so that there shall be two members serving at all times.

A member of the committee shall have a familiarity with Medi-Cal and other programs of public benefits in addition to the needs of the beneficiary. Each member shall be entitled to reasonable compensation for services rendered in this capacity as the trustee in his or her sole discretion shall determine.

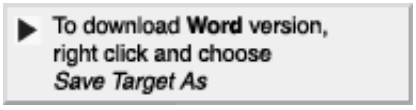
The names of the trustee advisory committee members are as follows: _ _[*names of advisory committee members*]**_ _**

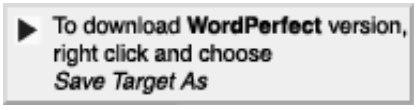
Comment: See discussion in §23.22.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.31 4. Form: Distributions of Income and Principal (SSI; 'Categorically Needy' Medi-Cal Recipient)

§23.31 4. Form: Distributions of Income and Principal (SSI; "Categorically Needy" Medi-Cal Recipient)





23.31-1 Distributions of income and principal

***Distribution of Income and Principal*. In accordance with the purpose of this trust and subject to the guidelines provided below, the trustee may pay to or apply for the benefit of the beneficiary as much of the trust net income and, if that income is insufficient, the trust principal, as the trustee determines, in the trustee's sole discretion, to be necessary or desirable to meet the beneficiary's special needs. "Special needs" are items or services that the trustee considers necessary for the beneficiary's health, protection, and welfare and that cannot, in the trustee's opinion, be provided by grants, services, and supplies available through any public agency, office, or department of California, any other state, or the United States. "Special needs" may include funds, items, or services that enhance the beneficiary's quality of life. Examples of funds, items, or services meeting special needs are personal items such as radios and televisions, modest gifts on the beneficiary's behalf to friends and relatives, a paid companion, health care services, supplies, and special equipment, training programs, and rehabilitation supplemental to those that the beneficiary is entitled to receive under a government assistance program. The trustee is neither obligated nor compelled to make any distribution. Any undistributed income shall be accumulated and added to principal.**

[*If appropriate, add*]

Although a primary intent of this trust is to preserve the beneficiary's eligibility for public benefits, the overriding goal of the trust is to ensure that the beneficiary's standard of living will be comfortable and enjoyable. Consequently, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority, in the trustee's sole and absolute discretion, to make distributions of trust assets for the specific need, even if the distributions cause the reduction or loss of public benefits.

Comment: This clause with the appropriate additional clause gives the trustee the most discretion to make distributions of principal as well as income. See §21.22 on directions to add accumulated income to principal. The examples of special needs should illustrate specific needs of the beneficiary that are generally unavailable from public resources. These examples should be tailored to the anticipated supplemental needs of the beneficiary.

The optional addition is often called a "discretionary" distribution standard, while the primary distribution standard is often called a "supplementary" distribution standard. Under a discretionary distribution standard, the trustee has more explicit flexibility in providing distributions although the trustee has discretion under the supplementary standard to make distributions as needed to enhance the beneficiary's quality of life. See discussion in §23.32.

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§23.32 5. Discretionary Distribution Standard

To provide the trustee greater flexibility to decide to forgo or reduce public benefits, if reliance solely on needs-based public benefits would not be in the beneficiary's best interests, the drafter should use form 23.31-1 with the additional clause. For generally similar alternative distribution provisions, see Special Needs Trusts: Planning, Drafting, and Administration §§6.18-6.23 (Cal CEB 2008).

A trustee may wish to a provide a safe and clean place to live for the disabled beneficiary of an SNT. SSI provides a modest cash stipend ($870 in 2008) to pay for all of the SNT beneficiary's monthly food and shelter needs. If the SSI recipient receives food or shelter, his or her SSI amount is reduced by the presumed maximum value of these benefits. See §§23.7D, 23.13. Rent (especially in large urban areas) for a decent apartment in a safe neighborhood is often well in excess of $1500 per month. Under the supplemental distribution standard, the SNT can never pay rent from the trust because it would cause a reduction in SSI benefits. See §23.28. This standard severely limits the availability of housing for the disabled individual.

If the discretionary distribution standard is used, the trustee may pay the $1500 monthly rent. Social Security would be notified and the payment of rent would cause a total reduction in the monthly SSI payment of around $232 per month in 2008. The result is, however, that the beneficiary lives in a decent home and loses only $232 of monthly payments. Counsel must be aware that if the beneficiary is receiving less than $232 per month of SSI prior to the trustee paying the rent, the beneficiary would lose all of his or her SSI payment and presumably the beneficiary's Medi-Cal benefits as well. It is important that the practitioner have a clear understanding of the public benefit rules before utilizing these strategies.

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C. Distribution Guidelines

§23.33 1. Guidelines Based on Beneficiary Situation

If the trust provides the trustee with maximum discretion to make distributions, guidelines for carrying out the testator's intent are important both for trustee direction and to convince government entities that, despite the trustee's discretion, funds are not available to pay for items covered by public benefits for the trust beneficiary. Form 23.34-1 provides a key guideline, requiring that the trustee not duplicate payments and benefits for the beneficiary available from nontrust sources.

Although form 23.36-1 implies that the trustee must be familiar with the beneficiary's needs and resources, the trust should explicitly direct the trustee to consider the beneficiary's other resources, both to guide the trustee and to reemphasize the supplemental nature of the payments that the trustee may make. For such a clause, see form 23.35-1.

See §23.21 on the trustee's duties and on selecting an appropriate trustee. The drafter may need to describe the trustee's duties in relation to the work of another fiduciary, *e.g.,* a guardian or conservator. See §23.22 regarding the role of a trustee advisory committee or special cotrustees in determining whether distributions should be made to the beneficiary. See §23.30 for form for trustee advisory committee.

Form 23.35-1, which suggests matters for the trustee to consider when evaluating the beneficiary's needs, can easily be amended to reduce, extend, or further define the trustee's review. For an example of such an amendment, see form 23.36-1. The clause is appropriate if the beneficiary is unable to seek public benefits for himself or herself and there is no guardian or conservator to perform this task. The trustee may be the logical person to assume this duty.

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§23.34 2. Form: Trustee to Consider Beneficiary's Other Resources

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23.34-1 Trustee to consider beneficiary's other resources

In determining whether to make a distribution, how a distribution will be made, and the amount to distribute, the trustee shall consider (1) any other income or resources of the beneficiary known to the trustee and readily available to the beneficiary and (2) all benefits available to the beneficiary from any government agency. Such benefits include but are not limited to Social Security and Supplemental Security Income; Medicare, Medicaid, Medi-Cal, and any other payments for medical, nursing, or custodial care; food stamps; and direct cash grants.

Comment: This clause is the minimal directive to the trustee of a special needs trust. Forms 23.35-1 and 23.36-1 require more active participation by the trustee in overseeing the beneficiary's care and benefits. This clause may be added to form 23.31-1.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.35 3. Form: Trustee to Evaluate Beneficiary's Needs

§23.35 3. Form: Trustee to Evaluate Beneficiary's Needs

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23.35-1 Trustee to evaluate beneficiary's needs

***Trustee Duties*. With reasonable frequency, the trustee shall:**

(1) Visit the beneficiary to evaluate the beneficiary's living conditions and medical care;

(2) Review the beneficiary's needs for physical and dental examinations by independent physicians and dentists, education or training programs, work opportunities and earnings, recreation, leisure time, and social activities; and

(3) Review the beneficiary's public benefits and eligibility for other benefits, including, *e.g.,* free public education and rehabilitation programs.

[*If applicable, add the following option*]

[*Option: Trustee to seek public support*]

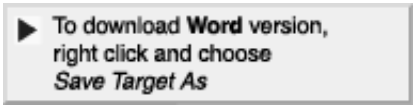
To the extent possible, the trustee is encouraged to aid the beneficiary in receiving in a timely manner all public benefits for which the beneficiary may be eligible.

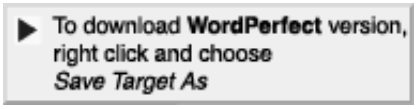
Comment: This clause may be used without the optional addition in conjunction with form 23.36-1.

The duties to evaluate the beneficiary's needs may be shared with a trustee advisory committee (see form 23.30-1) or special cotrustees. See §23.22.

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§23.36 4. Form: Trustee to Seek Public Agency Support





23.36-1 Trustee to seek public agency support

The trustee shall use best efforts to seek support and maintenance for the beneficiary from all available public resources, including but not limited to Social Security payments, Supplemental Security Income, Social Security Disability Insurance, Veterans Administration benefits of every kind, Medicare, and Medi-Cal or other Medicaid payments.

[*If applicable, add the following option*]

[*Option: Management of benefits received*]

If the trustee receives public benefits on the beneficiary's behalf, the trustee shall collect, expend, and account for those benefits separately from, and not commingle them with, all other assets of this trust. The separate account shall be used for distributions prior to any other assets in the trust.

Comment: This clause may be used separately or added to form 23.35-1. The drafter should use this clause when the trustee will take an active role in obtaining benefits for the beneficiary. The optional addition is important if the trustee will receive benefits for the beneficiary (*e.g.,* as the beneficiary's "representative payee" for SSI benefits). See §23.24 for suggested special instructions on managing the trust.

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5. Will Should Direct Trustee to Avoid Interference With Public Benefits

§23.37 a. Restriction of Trustee Powers to Preserve Trust Assets

To avoid having the trust assets counted as income or a resource to the beneficiary, or a source of reimbursement to a government agency for benefits rendered, the will or living trust must explicitly direct the trustee to use the trust assets as a supplement to, rather than a replacement for, public benefits. See §§23.7-23.11 on the effect of beneficiary income and resources on eligibility for SSI and Medi-Cal; §§23.15-23.20 on government reimbursement claims.

The testator may want to permit the trustee to make occasional payments that will *temporarily* reduce the amount of certain benefits or disrupt eligibility. If disruption of eligibility will be permitted, the optional language provided in form 23.31-1 must be used. On calculation of benefit amount reductions and periods of ineligibility, see §23.13.

NOTE: It may be preferable to terminate the trust when the beneficiary's benefits are cut off or the trust assets are jeopardized by government claims, and then give the funds over to third parties with a request that the funds be used for the former primary beneficiary. See §23.43 on emergency trust termination; §23.46 on the precatory trustee as distributee.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.38 b. Form: No Distributions That Interfere With Public Benefits [Deleted]

§23.38 b. Form: No Distributions That Interfere With Public Benefits [Deleted]

This form is no longer recommended for use. See §23.32 on discretionary distributions.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.39 c. Form: No Release of Funds on Beneficiary's Request; No Seeking Order to Distribute [Deleted]

§23.39 c. Form: No Release of Funds on Beneficiary's Request; No Seeking Order to Distribute [Deleted]

This form is no longer necessary. See §23.31 for a form providing for discretionary distributions.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.40 d. Form: Third Party Direction of Distribution Despite Trustee Determinations [Deleted]

§23.40 d. Form: Third Party Direction of Distribution Despite Trustee Determinations [Deleted]

This form is no longer recommended for use. See §23.30 for a form providing for a trustee advisory committee. See also §23.66 for a form providing for a trust protector.

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D. "Spendthrift" Clause

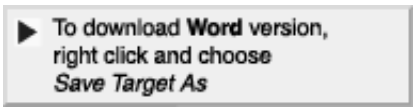
§23.41 1. Function of "Spendthrift" Clause in Special Needs Trust

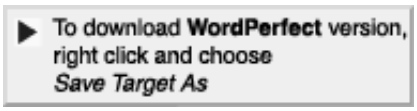
A "spendthrift" clause is vital in the special needs trust to limit the right of government entities to apply principal or undistributed income to the beneficiary's costs or as reimbursement for benefits already provided by a government agency.

Unless otherwise provided by statute, a restriction in a trust instrument on voluntary or involuntary transfers by the beneficiary will be honored for undistributed income (Prob C §15300) and principal (Prob C §15301). But see §§23.17-23.19 on Prob C §15306(a)-(b), which subjects trust assets to certain reimbursement claims and exempts the assets of certain trusts for disabled individuals from those claims. Form 23.42-1 is intended to place the trust under the protection of Prob C §15306(b). See chap 27 on spendthrift trusts generally.

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§23.42 2. Form: "Spendthrift" Clause





23.42-1 "Spendthrift" clause

***Spendthrift Clause*. No interest in the principal or income of this trust may be anticipated, assigned, encumbered, or subject to any creditor's claim or to legal process before actual receipt by the beneficiary. Because this trust is intended to be conserved and maintained for the beneficiary's special needs, no part of the trust principal or income may be subject to the claims of voluntary or involuntary creditors for any costs incurred or sums expended by any public agency, office, or department of California, any other state, or the United States, for the provision of care and services (including residential care) to or for the beneficiary (whether prospectively or in reimbursement). The beneficiary of the trust has a disability that substantially impairs the beneficiary's ability to provide for the beneficiary's own care or custody and constitutes a substantial handicap.**

Comment: The last sentence in this clause tracks the language in Prob C §15306(b), which exempts trusts for the described beneficiaries from the reimbursement obligations of Prob C §15306(a).

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E. Emergency Trust Termination

§23.43 1. Termination to Preserve Trust Assets

The drafter should include a clause in the trust describing what the trustee should do if the trust can no longer function as originally planned. Because a beneficiary may move to another state with different rules or the statutes, regulations, and case law governing eligibility for public benefits change often, even the most vigilant and skilled trustee may be unable to prevent the trust from rendering the beneficiary ineligible for public benefits. In addition, trust assets that become subject to government contribution or reimbursement claims will be quickly consumed. If the trustee redirects the use of the assets, the original beneficiary may still be able to benefit from them.

Forms 23.44-1 and 23.45-1 offer trust termination as a solution to these problems. Form 23.44-1 calls for termination of the trust if it renders the beneficiary ineligible for public benefits and the trustee decides that benefits eligibility is more helpful to the beneficiary than continued trust operation. If the testator believes that the beneficiary will not be adequately provided for without trust payments, and the trust is sufficiently large to be able to provide (at least temporarily) the services and goods that the beneficiary would receive from government programs, the trust can be used until its assets are exhausted. At that time, the beneficiary will requalify for benefits.

NOTE: Before using this clause, it should be determined how difficult it was for the beneficiary to obtain public benefits. There may be a problem requalifying if the beneficiary does not cooperate, if his or her disability is marginal, or as a result of bureaucratic red tape. Once lost, public benefits may be almost impossible to obtain again.

The clause does not authorize termination when trust distributions merely *reduce* particular benefits; trustee administrative adjustments can resolve this problem, which may even be the planned effect of certain distributions. See §23.13 on benefit reduction or interruption resulting from some distributions.

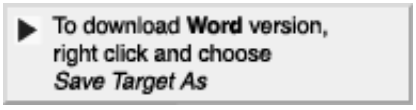
The drafter can use form 23.45-1 when the testator prefers that the trust terminate rather than serve as a source to *reimburse* a public benefits agency. The drafter can soften the drastic effect of this clause by also including form 23.47-1, which directs distribution of the corpus to third parties with a request that they aid the former beneficiary.

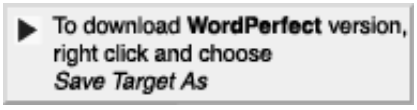
See §§23.46-23.48 on distributions after emergency trust termination.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.44 2. Form: Power to Terminate Trust if Trust Interferes With Beneficiary's Public Benefits

§23.44 2. Form: Power to Terminate Trust if Trust Interferes With Beneficiary's Public Benefits





23.44-1 Power to terminate trust if trust interferes with beneficiary's public benefits

***Termination of Trust*. If a court or government agency determines that the trust renders the beneficiary ineligible for public benefits for which the beneficiary would be eligible if the trust did not exist, the trustee shall evaluate the financial loss caused to the beneficiary by the beneficiary's ineligibility for public benefits as compared to the financial gain to the beneficiary resulting from the trust's continued operation, to determine whether to maintain the trust in operation or to terminate the trust. If the trustee determines that the benefits conferred by the trust do not outweigh the detriment caused by the loss of public benefits, the trustee may, in the trustee's sole discretion, terminate the trust and distribute the trust assets according to the provisions below.**

Comment: This clause is designed to give the trustee maximum discretion to decide on the termination. First, the trustee may disagree with (contest or appeal) an agency or court decision denying the beneficiary's eligibility. Second, the trustee will decide whether a determination of ineligibility should lead to termination. A third party SNT should not include postdeath authority to pay reimbursement claims of state agencies. This is required only for first party SNTs when the trust is considered to be established by the beneficiary (42 USC §1396p(d)(1)) (*e.g.,* a litigation SNT). See §23.8.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.45 3. Form: Automatic Trust Termination if Court Orders Reimbursement

§23.45 3. Form: Automatic Trust Termination if Court Orders Reimbursement

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23.45-1 Automatic trust termination if court orders reimbursement

***Termination of Trust*. The trustee shall terminate this trust and distribute its assets as provided in paragraph _ _[*number*]_ _ if:**

(1) A court of competent jurisdiction issues an order compelling the trustee to reimburse a government agency for payments made, services rendered, or materials supplied to or for the beneficiary by that agency; or

(2) The trustee determines, in the trustee's sole discretion, that the trust may be subject to garnishment, attachment, or execution by any creditor (including a government agency) and that no appeal or any other legal remedy can defeat the order for reimbursement or anticipated garnishment, attachment, or execution, or that legal challenge to that order, garnishment, attachment, or execution would be excessively costly to the trust in view of the then-remaining trust assets and the needs of any other beneficiary.

Comment: On providing instructions for distribution of trust assets when the trust terminates, see §§23.46-23.48.

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4. Description of Remainder Distribution on Emergency Trust Termination

§23.46 a. "Backstop" Distribution to Precatory Trustee

If the testator fears that an emergency trust termination may leave the beneficiary destitute, the drafter may include in the will a "backstop" clause as a last-ditch attempt to preserve the trust assets for the beneficiary's use. This type of clause provides that, if the trust terminates during the beneficiary's lifetime, the trust assets will be distributed to named parties (*e.g.,* relatives of the beneficiary) with a request that the recipients use the assets in the way that the testator intended the trustee to use them.

As long as the property is moved into the hands of one or more third parties who have no legal obligation to support the beneficiary or to provide payment for the services that the beneficiary receives from government programs, the assets are insulated from application by government agencies either as a share of benefit costs or as reimbursement for services rendered.

See form 23.47-1 for a suggested backstop clause. Before using this clause, the drafter should be certain that the testator either (1) would naturally name the third parties as successor beneficiaries on termination of the trust at the beneficiary's death or (2) has grounds to believe that the third parties will apply the assets as requested. The drafter should inform the testator that, because the intent of this clause will be defeated if it creates a legal obligation for the recipient, its benefit for the beneficiary with special needs cannot be guaranteed. The successor beneficiaries should be apprised of their moral responsibility in the event of an emergency trust termination.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.47 b. Form: Distribution on Trust Emergency Termination ('Precatory Trustee')

§23.47 b. Form: Distribution on Trust Emergency Termination ("Precatory Trustee")

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23.47-1 Distribution on trust emergency termination

***Distribution of Remainder*. If the trust terminates during the beneficiary's lifetime, the trustee shall, after paying the expenses of trust administration and termination, distribute the remaining trust principal, together with any undistributed income, to the person named below. That remainder beneficiary is requested, but not directed, to conserve, manage, and distribute the proceeds of the former trust estate for the benefit of the original beneficiary of the trust, in accordance with the provisions set forth in this trust for administration and distribution of the trust assets while the original beneficiary was beneficiary of this trust. The trustee shall distribute the trust remainder to** _ _[*name of remainder beneficiary*]_ _.

Comment: This clause should be amended if more than one beneficiary is named, both to conform articles and to describe the shares intended. See §23.46 on requirements for use of this clause.

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§23.48 c. Other Distribution on Trust Emergency Termination

Successor beneficiaries may not be available to act as precatory trustees. If that is the case, the drafter should simply provide for an outright distribution to whichever residuary beneficiary the testator wishes. See §23.46 on using a precatory trustee; chap 21 for sample clauses for distributions on trust termination.

NOTE: If an emergency termination might result from creditors' claims or claims for reimbursement (despite a "spendthrift" clause in the trust), the drafter may wish to include a charitable residuary beneficiary in the trust. A government agency and even an ordinary creditor might find it distasteful to collect on trust assets that would otherwise be going to charity.

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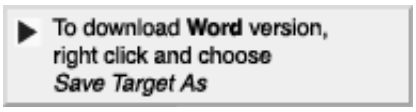
F. Protection of Trust When Beneficiary Dies

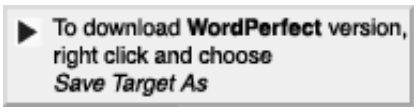
§23.49 1. Postdeath Asset Protection

Although the trust should include the usual clause for payment of death taxes, last-illness and funeral expenses, and trust administrative expenses at the beneficiary's death or other trust termination, the testator should express a preference for paying these expenses from outside monies (*e.g.,* Social Security death benefit) before resorting to trust funds. Expenses that are the obligation of government agencies should be excluded from payable expenses to preserve the trust from claims for reimbursement. For a suggested clause, see form 23.50-1.

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§23.50 2. Form: Expense Payments After Beneficiary's Death





23.50-1 Expense payments after beneficiary's death

***Payment of Expenses*. The trustee may, in the trustee's discretion, pay last-illness and funeral expenses, any death taxes attributable to any part of the trust estate, and expenses from the administration or distribution of the trust estate. "Death taxes" includes all estate and inheritance taxes, generation-skipping transfer taxes, and interest and penalties on such taxes. The trustee shall not pay expenses for which, in the trustee's opinion, there is an adequate source of payment outside the trust. The trustee shall also not pay expenses incurred by or on behalf of the beneficiary during the beneficiary's life if a public benefits program was obligated to meet those expenses while the beneficiary was alive.**

Comment: See chap 26 on tax payment clauses.

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§23.51 3. Ultimate Disposition of Trust Residue by Power of Appointment or Testator Gift

The trust must contain a clause directing the distribution of trust assets should the beneficiary die while the trust is still in operation. Distribution of the remainder to named individuals, heirs, or charitable organizations depends on the testator's estate plan. The drafter can find appropriate distribution clauses in sections of this book discussing trust distributions (see chap 21) and outright gifts to persons (see chap 12) and to charity (see chap 13).

The testator may also want to consider giving the beneficiary some control over the trust property's ultimate disposition. The remainder distribution can be made according to the beneficiary's exercise of a special power of appointment, directing distribution to members of a set or class of persons nominated by the testator. Because the special power of appointment will not permit the gift to be appointed to the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate it avoids both a challenge that the trust assets belong to the beneficiary during life and a claim for reimbursement from the beneficiary's estate after death (*e.g.,* Medi-Cal reimbursement under Welf & I C §14009.5). The device provides the beneficiary some power over the assets' disposition and assures the testator that the trust corpus will go to appropriate recipients. See Prob C §681 on the limitation of creditors' rights to property subject to a special power of appointment.

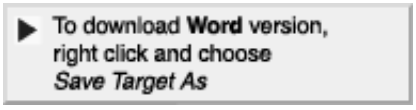
PRACTICE TIP: Before including a special power of appointment, determine whether the beneficiary may be subject to undue influence or mere pressure by potential recipients to exercise the power in their favor. The beneficiary's capabilities should be understood before including this provision. The testator may wish to require that the trustee consent to the exercise of the power.

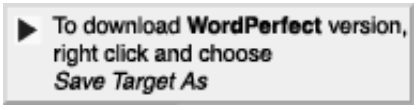
See §23.52 for a suggested clause for a gift of the residue by special power of appointment in the beneficiary. See chap 16 on powers of appointment.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.52 4. Form: Beneficiary's Testamentary Special Power of Appointment

§23.52 4. Form: Beneficiary's Testamentary Special Power of Appointment





23.52-1 Beneficiary's testamentary special power of appointment

***Special Power of Appointment*. At the death of the beneficiary, the trustee shall distribute any remaining balance of the trust property (including accrued income and undistributed income) to one or more members of the class specified below, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document executed by the beneficiary _ _[*and signed by the trustee*]_ _ after my death, specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in paragraph _ _[*number*]_ _.**

Class: _ _[*Name of class*]_ _

Comment: The blank paragraph number refers to a paragraph directing the destination of trust assets in the event of an emergency trust termination. If the beneficiaries in that paragraph were precatory trustees (see §§23.46-23.47), then the reference to the paragraph should be replaced by an alternative distribution clause such as the clause providing for residuary gifts.

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G. Clause Adaptations for Multiple-Beneficiary Special Needs Trust

§23.53 1. "Sprinkling" and Other Clauses

An alternative to the special needs trust with a sole beneficiary is a trust with a number of trust beneficiaries and a trustee with the power to make distributions to or for any one or more of them (*i.e.,* to "sprinkle" the income among the beneficiaries). The disabled or aged beneficiary is one of the beneficiaries; distributions to that beneficiary are made according to special needs trust guidelines.

A multiple-beneficiary trust may be desirable both because the testator wants to establish a trust for individuals other than the disabled or aged beneficiary and because that form can offer added protection for the assets from agency creditors.

Certain clauses of a multiple-beneficiary special needs trust must vary from those suggested in §§23.25-23.52:

- The beneficiaries will all be named initially, and the purpose of the trust as a special needs trust will be with regard to the identified disabled or aged beneficiary only;
- The distribution clause will be a "sprinkling" clause that does not require distributions to the disabled or aged (or any other) beneficiary;
- The special controls on distributions to or for the disabled or aged beneficiary will be directed particularly to that beneficiary;
- The distribution clause may permit a certain percentage of trust assets to be distributed to nondisabled beneficiaries and a certain percentage that is subject to special needs trust distribution requirements for disabled and aged beneficiaries; and
- Any emergency termination clause (effective if the trust renders the disabled or aged beneficiary ineligible for public benefits or if trust assets are ruled available for service payments or reimbursements) will not terminate the trust itself but only the trustee's power to distribute to the disabled or aged beneficiary.

For sample clauses for use in a sprinkling special needs trust, see forms in §§23.54-23.59. For a model clause for use in a non-special-needs children's trust, see §22.49.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/ 2. Sample Sprinkling Special Needs Trust Clauses/§23.54 a. Form: Trust Beneficiaries

2. Sample Sprinkling Special Needs Trust Clauses

§23.54 a. Form: Trust Beneficiaries

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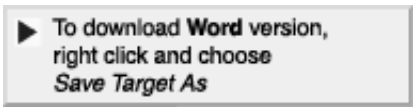
23.54-1 Trust beneficiaries

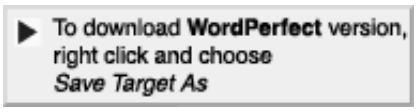
***Beneficiaries*. The beneficiaries of this trust are those of the following persons who survive me: _ _**[*Names of beneficiaries*]**_ _.**

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.55 b. Form: Trust Purpose for Disabled Beneficiary

§23.55 b. Form: Trust Purpose for Disabled Beneficiary





23.55-1 Trust purpose for disabled beneficiary

***Purpose of Trust*. The beneficiary named below has a disability that substantially impairs that beneficiary's ability to provide for that beneficiary's own care or custody and constitutes a substantial handicap. The purpose of any distributions from this trust to or for that beneficiary is to provide financial aid that is supplemental to, rather than a replacement for, public benefits provided to that beneficiary, without disturbing public benefits that would be available to that beneficiary if this trust did not exist. The beneficiary is _ _**[*name of disabled beneficiary*]**_ _.**

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.56 c. Form: Payments Sprinkled Among Beneficiaries

§23.56 c. Form: Payments Sprinkled Among Beneficiaries

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23.56-1 Payments sprinkled among beneficiaries

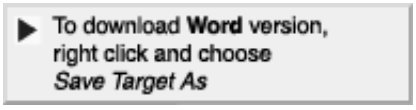
***Distribution of Principal and Income*. The trustee shall pay to or for the then-living, above-named beneficiaries as much of the principal and net income as the trustee, in the trustee's discretion, considers necessary for their _ _[*describe distribution standards, e.g., health, education, support*]_ _, except for _ _[*name of disabled beneficiary*]_ _, for whom distributions shall be according to the standards set forth below. Before making any distribution, the trustee shall consider (1) the value of the trust assets, (2) the relative present and future needs of each beneficiary, (3) other income and resources known to the trustee and reasonably available to the beneficiaries, and (4) the tax consequences to the trust and to any beneficiary. Further, before making any distribution to or for _ _[*name of disabled beneficiary*]_ _, the trustee shall consider the additional factors described below. The trustee, in the trustee's discretion, may make distributions that benefit one or more beneficiaries more than the others or that exclude one or more beneficiaries. Any undistributed income will be accumulated and added to principal.**

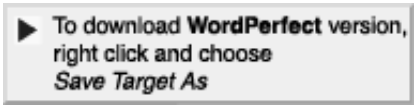
Comment: This clause must be followed by directions for distributions to the disabled beneficiary. See form 23.31-1 for suggested clauses. Those directions may be followed by additional limitations on distributions to the disabled beneficiary. See forms 23.57-1, 23.58-1, and 23.59-1. On clauses for distributions to nondisabled children, see §§22.21-22.33.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.57 d. Form: Consideration of Other Resources Available to Disabled Beneficiary

§23.57 d. Form: Consideration of Other Resources Available to Disabled Beneficiary





23.57-1 Consideration of other resources available to disabled beneficiary

In determining whether to make a distribution, how a distribution will be made, and the amount to distribute to or for _ _[*name of disabled beneficiary*]_ _, the trustee shall consider all benefits available to that beneficiary from any government agency. Such benefits include but are not limited to Social Security, Supplemental Security Income, and Social Security Disability Insurance payments; Medicare, Medicaid, Medi-Cal, and any other payments for medical, nursing, or custodial care; food stamps; and direct cash grants. The trustee shall not use or distribute trust assets that will:

(1) Make that beneficiary ineligible for public benefits otherwise available to the beneficiary from any public agency, office, or department of California, any other state, or the United States; or

(2) Pay for services (including residential care) rendered to that beneficiary by any government agency or unit.

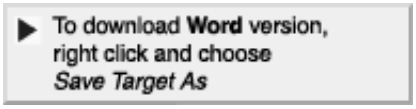
The trustee shall not reimburse from trust assets any amounts claimed by any government agency for material goods, services, or funds provided to that beneficiary.

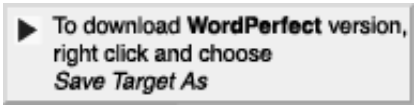
Comment: The drafter may want to include special instructions to the trustee to evaluate the beneficiary's needs or seek public benefits for that beneficiary. See §§23.35-23.36 for clauses. See §23.22 for discussion of giving certain powers regarding distributions to a trustee advisory committee or special cotrustees.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.58 e. Form: No Distributions to Disabled Beneficiary if Trust Interferes With Public Benefits

§23.58 e. Form: No Distributions to Disabled Beneficiary if Trust Interferes With Public Benefits





23.58-1 Cessation of distributions to disabled beneficiary if trust interferes with public benefits

If a court or government agency determines that the trust renders _ _[*name of disabled beneficiary*]_ _ ineligible for public benefits for which that beneficiary would be eligible if the trust did not exist, the trustee shall evaluate the financial loss caused to that beneficiary by the beneficiary's ineligibility for public benefits as compared to the financial gain to that beneficiary resulting from continued trust distributions. If the trustee determines that the power to make distributions does not outweigh the detriment caused by the loss of public benefits, the trustee may, in the trustee's sole and absolute discretion, (1) notify that beneficiary that the trustee will cease making distributions to or for that beneficiary and (2) make no distributions to or for that beneficiary.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.59 f. Form: No Power to Distribute to Disabled Beneficiary if Court Orders Reimbursement

§23.59 f. Form: No Power to Distribute to Disabled Beneficiary if Court Orders Reimbursement

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23.59-1 No power to distribute to disabled beneficiary if court orders reimbursement

The trustee's power to make distributions to or for _ _[*name of disabled beneficiary*]_ _ shall terminate, and the trustee shall make distributions to or for the other beneficiaries of this trust exclusively, if:

(1) A court of competent jurisdiction issues an order compelling the trustee to reimburse a government agency for payments made, services rendered, or materials supplied to or for _ _[*name of disabled beneficiary*]_ _ by that agency; or

(2) The trustee determines, in the trustee's sole and absolute discretion, that the trust may be subject to garnishment, attachment, or execution by any creditor, including a government agency, and that no appeal or any other legal remedy can defeat the order for reimbursement or anticipated garnishment, attachment, or execution, or that legal challenge to that order would be excessively costly to the trust in view of the then-remaining trust assets and the needs of the other beneficiaries.

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H. Trust Protector Clause

§23.60 1. Function of Trust Protector

A trust protector is a helpful tool in special needs trust planning as a check and balance against a poorly performing trustee. Because a trustee has so much control over the performance of a special needs trust, a trustee who (1) is negligent, (2) does not work well with the beneficiary, or (3) is merely slow to respond may cause a disabled beneficiary incredible harm. As protection against such a trustee, a trust protector may be provided with the authority to remove and replace a trustee with or without cause. The trust protector may be authorized to review investments and disbursements from the trust to ensure that the trust is operating as the settlors had intended. As an additional benefit, a trust protector may authorize modifications to a special needs trust to keep it current with the ever-changing law controlling special needs trusts and public benefits.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.61 a. Considering Trust Protector

§23.61 a. Considering Trust Protector

In considering how much power to give to a trust protector, the settlor (and the settlor's attorney) should consider the following situations in which a trust protector can be of great assistance:

- The law changes on public benefits so that the current trust is no longer considered an exempt resource;
- The trustee fails to discharge his or her duties to the beneficiary properly or to administer the trust in an efficient manner;
- The investment performance is unsatisfactory;
- The settlor's wishes with regard to discretionary powers are not observed;
- Misunderstandings and disputes between the trustee and beneficiaries arise; or
- The costs of administration are unreasonable.

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§23.62 b. Defining Role of Trust Protector

Some testators believe the role of the trust protector should be informal. Testators often do not think that the trust protector should be subject to any risks or held accountable for the performance or nonperformance of his or her duties. To avoid problems, it is best to clearly define the role of the trust protector and set forth appropriate limits on his or her role. There is not much legal authority in this area; however, in one California case, a person with similar responsibilities to a trust protector has been held to the same fiduciary standard of care as a trustee. *Crocker-Citizens Nat'l Bank v Younger* (1971) 4 C3d 202, 211, 93 CR 214 ("The few courts that have dealt with trust protectors have generally recognized their fiduciary nature by comparing them with cotrustees").

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.63 c. Powers of Trust Protector

§23.63 c. Powers of Trust Protector

A trust protector may be provided with a variety of powers:

- The trustee can be required to keep the trust protector informed about his or her actions;
- The trust protector can demand an accounting and the right to review all accountings;
- The trustee can be required to consult with the trust protector;
- Under certain circumstances, the trust protector may have the power to direct the trustee, in which case the trust protector would have the power to initiate an action against the trustee; or
- Any combination of the above.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.64 d. Selection of Trust Protector

§23.64 d. Selection of Trust Protector

In selecting a trust protector, the settlor should consider:

- The person's suitability and competence;
- Whether the person will accept enforceable duties and accept accountability for his or her acts and omissions;
- Whether the person is able to detect, keep up with, and understand changes in public benefit laws and the laws concerning special needs trusts;
- Where the person resides so he or she may provide appropriate oversight over the trustee and the beneficiary; and
- Whether there will be a cost associated with the trust protector's services and, if so, how much it will be.

Generally, the trust protector is an individual acquainted with the settlor's family and the needs of the beneficiary. The trust document should name a successor trust protector and, if desired, clearly set forth a procedure to ensure that there will always be a trust protector. For instance, the initially nominated trust protector may be empowered to designate his or her own successor.

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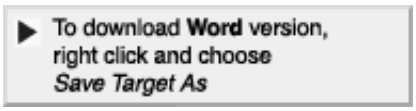
§23.65 e. Additional Trust Protector Provisions

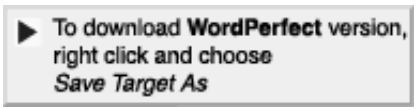
The trust agreement should specify how successor protectors are named and how they may be removed. If there is more than one trust protector or a protective committee, the trust agreement should indicate how they are to operate. For example, the trust document should specify (1) whether decisions are to be made by a majority vote or otherwise, (2) how many members constitute a quorum, (3) how often meetings are to be called and who calls them, (4) how decisions are to be recorded, (5) whether or not proxies can be given and to whom, (6) how to deal with the incapacity of a trust protector, and (7) that the trust protector's powers are not required to be exercised and may not be exercised for the trust protector's personal benefit.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.66 2. Form: Trust Protector

§23.66 2. Form: Trust Protector





23.66-1 Trust protector

***Trust Protector*. The function of the Trust Protector is to assist, if needed, in protecting the interests of _ _[*trust beneficiary*]_ _ and in achieving our objectives as manifested by the other provisions of this trust.**

A. Designation of Trust Protector

We appoint _ _[*name of initial trust protector*]_ _ to serve as Trust Protector of this trust.

B. Resignation of Trust Protector

A Trust Protector may resign by giving notice to us or to the survivor of us. If both of us are deceased, a resigning Trust Protector shall give notice to _ _[*name of beneficiary*]_ _ and the Trustee then serving _ _[*and to the Trust Advisory Committee*]_ _.

Such resignation shall take effect on the date set forth in the notice, which shall not be earlier than 30 days after the date of delivery of the notice of resignation, unless an earlier effective date shall be agreed to by us or the survivor of us or by _ _[*name of beneficiary's*]_ _ legal representative _ _[*and the Trustee/Trust Advisory Committee*]_ _. A resigning Trust Protector shall not be liable or responsible for the act of any successor Trust Protector.

C. Removal and Replacement of Trust Protector

While both of us are alive, we may remove any Trust Protector with or without cause at any time. If one of us is alive and the other is incapacitated or deceased, the nonincapacitated or surviving one may remove any Trust Protector with or without cause at any time, provided the nonincapacitated or surviving one appoints a successor Trust Protector that commences service simultaneously.

If a Trust Protector is removed, resigns, or cannot continue to serve for any reason while both of us are alive, we may appoint a successor Trust Protector.

D. Authority of Trust Protector to Appoint a Successor Trust Protector

Any Trust Protector (including successors) shall have the right to appoint a successor Trust Protector in writing. Such appointment shall take effect on the death, resignation, or incapacity of the appointing Trust Protector. If we or the nonincapacitated or surviving one of us have named a successor Trust Protector, the appointment of a successor Trust Protector under this subsection shall take effect only if and when all Trust Protectors that we or the nonincapacitated or surviving one of us have named fail to qualify or cease to act.

E. Default of a Designated Trust Protector

If the office of Trust Protector for a trust is vacant and there is no effectively named successor Trust Protector, the _ _[*Trustee/Trust Advisory Committee*]_ _ may appoint a successor Trust Protector for the trust. If the _ _[*Trustee/Trust Advisory Committee*]_ _ is unable or unwilling to appoint a successor Trust Protector, any interested party may petition a court of competent jurisdiction to appoint a successor Trust Protector.

F. Rights of Successor Trust Protectors

Any successor Trust Protector shall have all of the authority of the Trust Protector by original appointment, but will not be responsible for the acts or omissions to act of his or her predecessor.

G. Power to Remove and Appoint Trustees

The Trust Protector shall have the authority to remove any Trustee under this trust only if neither of us is serving as Trustee _ _[*and there is no then-serving Trust Advisory Committee*]_ _. Whenever the office of Trustee of a trust is vacant and no successor Trustee is effectively named, the Trust Protector shall appoint an individual or a corporate fiduciary to serve as Trustee.

The Trust Protector may not appoint himself or herself as a Trustee and a Trust Protector may not simultaneously serve as both Trust Protector and Trustee. This is in keeping with the intent and purpose that the Trust Protector's only interest will be to protect the financial resources governed by this agreement and our intent that the assets of this trust agreement not be considered income or resources for all entitlement benefits from any government agency, such as Regional Center services, Social Security Disability payments, Medicare, Medi-Cal, Supplemental Security Income (SSI), In-Home Support Service (IHSS), and any other special purpose benefits for which _ _[*trust beneficiary*]_ _ is eligible.

H. Good Faith Standard Imposed

The Trust Protector shall not be liable for any act or omission to act and shall be reimbursed promptly for any costs incurred in defending or settling any claim brought against that person in his or her capacity as Trust Protector unless it is conclusively established that the act or omission to act was motivated by an actual intent to harm the beneficiaries of the trust or was an act of self-dealing for personal pecuniary benefit.

I. Power to Amend Trust Agreement

The Trust Protector may amend any provision of this agreement as it applies to any trust to which the Trust Protector is serving as Trust Protector to:

(1) Add or modify terms of the trust so that the trust will protect the financial resources governed by this agreement and to comply with the settlor's intent that the assets of this trust agreement not be considered income or resources for all entitlement benefits from any government agency, such as Regional Center services, Social Security Disability payments, Medicare, Medi-Cal, Supplemental Security Income (SSI), In-Home Support Service (IHSS) and any other special purpose benefits for which _ _[*trust beneficiary*]_ _ is eligible.

(2) Alter the administrative and investment powers of the Trustee;

(3) Reflect tax or other legal changes that affect trust administration; and

(4) Correct ambiguities, including scrivener errors, that might otherwise require court construction or reformation.

Notwithstanding the foregoing, the Trust Protector shall not amend this agreement in any manner that would limit or alter the rights of a beneficiary in any trust assets held by the trust before the amendment, unless the purpose of the amendment is to modify an existing provision in the trust that defeats the settlor's intent of preserving public benefits.

An amendment made by the Trust Protector in good faith shall be conclusive on all persons interested in the trust and the Trust Protector shall not be liable for the consequences of any amendment or for not having amended the trust. An amendment to this agreement shall be made in a written instrument signed by the Trust Protector. The Trust Protector shall deliver a copy of the amendment to _ _[*name of beneficiary*]_ _, _ _[*name of beneficiary's*]_ _ legal representative, the Advisory Committee (if one is then serving), and the currently serving Trustee.

J. Not a General Power of Appointment

Notwithstanding any other provision in this agreement to the contrary, the Trust Protector shall not participate in the exercise of a power or a discretion conferred under this agreement that would cause the Trust Protector to possess a general power of appointment within the meaning of Internal Revenue Code §§2041 and 2514. Specifically, the Trust Protector may not use such powers for his or her personal benefit, or for the discharge of his or her financial or legal obligations.

K. Release of Powers

The Trust Protector, acting on his or her own behalf and on behalf of all successor Trust Protectors, may at any time, by a written instrument delivered to the Trustee, irrevocably release, renounce, suspend, or reduce any or all powers and discretions conferred on the Trust Protector by this agreement.

L. No Duty to Monitor

The Trust Protector shall have no duty to monitor any trust created under this agreement in order to determine whether any of the powers and discretions conferred by this agreement on the Trust Protector should be exercised. Further, the Trust Protector shall have no duty to keep informed as to the acts or omissions of others or to take any action to prevent or minimize loss. Any exercise or nonexercise of the powers and discretions granted to the Trust Protector shall be in the sole and absolute discretion of the Trust Protector, and shall be binding and conclusive on all persons. The Trust Protector is not required to exercise any power or discretion granted under this agreement.

M. Compensation

Any Trust Protector serving hereunder shall be entitled to receive (but not required to accept) reasonable compensation for services as determined by our Trustee. The Trust Protector shall be entitled to reimbursement for all expenses incurred in the performance of its duties as Trust Protector, including travel expenses.

Serving as Trust Protector shall not prevent the Trust Protector from also providing legal, investment, or accounting services on behalf of the trust or the trust beneficiaries. If the Trust Protector is providing professional services, the Trust Protector is entitled to charge his or her normal and customary fees for legal services rendered or to be rendered and in addition is entitled to be compensated for his or her services as Trust Protector.

N. Right to Examine

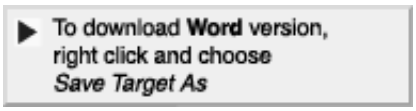
The books and records of each trust created under this agreement, including all documentation, inventories, and accountings, shall be open and available for inspection by the Trust Protector at all reasonable times.

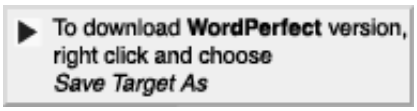
Comment: The references to "we" and "us" in this form suggest that it may be used in a joint will or (with modifications) in a funded revocable trust. If the trust is to be created by will, powers reserved to the testators such as the power to appoint a new trust protector should be modified to refer only to "the survivor of us" rather than "we or the surviving or nonincapacitated one of us" because the trust will be created only when one of the testators has died. Those reserved powers should be eliminated as redundant if the form is used in a will to be executed by a single testator. For an optional form providing for appointment of a trust advisory committee, see §23.67.

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Source: Estate Planning/California Will Drafting/23 Special Needs Trusts/§23.67 3. Form: Trust Advisory Committee

§23.67 3. Form: Trust Advisory Committee





23.67-1 Trust advisory committee

***Trust Advisory Committee*. The Trust Advisory Committee (TAC) is responsible to advise the trustee as to distributions that would be in the best interests of the beneficiary. The TAC serves in an advisory capacity only and its role is to make recommendations to the trustee. The trustee has sole and absolute discretion with regard to trust distributions.**

The TAC members, named below, were chosen because of their knowledge and experience in assisting persons with disabilities and/or their personal interest in the beneficiary. The TAC shall consist of a minimum of three and a maximum of five members. The initial members of the TAC are:

1. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

2. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

3. _ _[*name*]_ _, _ _[*address*]_ _, _ _[*relationship*]_ _

The trustee shall consider the TAC's advice concerning distributions. If it is impossible or impractical for the trustee to obtain the TAC's advice before a distribution, the trustee may make a distribution without such advice.

No trustee or TAC member shall be personally liable to any beneficiary for the trustee's or TAC member's acts or failure to act, except for willful misconduct, gross negligence, or reckless indifference to the interests of any beneficiary.

The TAC shall be entitled to inspect, review, and receive copies of all trust accountings, trust financial records, and trustee records.

The TAC shall have the right to remove and replace any then-serving trustee, with or without cause.

If a TAC member is unwilling or unable, for any reason, to serve or to continue to serve as a TAC member, then the remaining TAC members shall appoint a successor member so that there will be at least three members serving at all times.

Each TAC member shall be entitled to reasonable compensation for services rendered in this capacity as determined in the trustee's discretion.

Comment: A trust advisory committee (TAC) is often used in SNT planning, either alone or with a trust protector. Because the trustee has such broad discretion on distributions, it is often a good idea to have a check and balance system of management for an SNT. Moreover, due to the highly complex area of SNT administration, a trustee of an SNT is often a corporate fiduciary or private, professional fiduciary. A TAC can be a safeguard against any professional trustee failing to perform its duties.

The TAC may also assist the trustee with decisions on distributions for the disabled beneficiary. TAC members are typically family and friends of the beneficiary and sometimes professional members. The family and friends may assist the trustee in understanding the needs of the beneficiary and provide a voice for the disabled beneficiary. The professional members can be licensed clinical social workers who can provide expert care management of a disabled beneficiary, consultants familiar with Social Security and Department of Health Service regulations to make sure distributions do not run afoul of income and resource public benefit rules, or financial professionals who can design an investment strategy for the disabled beneficiary.

The trustee will typically be solely responsible for any surcharge on an improper distribution by the trustee, as provided in this form. If the SNT is established in compliance with the requirements of Cal Rules of Ct 7.903 (as will be true in the case of a litigation special needs trust (LSNT)), a bond may be required for TAC members. Further, all compensation of TAC members will have to be approved by a court prior to payment.

For alternative provisions and additional discussion of the respective roles of TAC members and the trust protector, see Special Needs Trusts: Planning, Drafting, and Administration §§6.29-6.42 (Cal CEB 2008).

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Source: Estate Planning/California Will Drafting/23A Taxation of Trust Distributions/Chapter Outline

23A

Taxation of Trust Distributions

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§23A.1 I. WHEN DISTRIBUTIONS TAXABLE

This chapter discusses income taxation of testamentary trusts. For these purposes, a testamentary trust is a separate trust created by the will of a decedent, but the same principles apply to a continuing trust created by a revocable trust that becomes irrevocable on the death of the settlor. All testamentary trusts and irrevocable trusts created by decedents are treated as nongrantor trusts.

Nongrantor trusts governed by Subchapter J of Chapter 1 of the Internal Revenue Code (IRC §§641-692) are irrevocable trusts that are treated as separate taxpayers. Income of a nongrantor trust may be taxed to the trust or its beneficiaries. Basic rules of trust income taxation are discussed in §§23A.2-23A.18. Additional rules are discussed in §§23A.19-23A.25. On tax consequences of trust termination, see §§23A.26-23A.28.

The basic rules may be summarized as follows:

- The income of a simple trust is taxed to the beneficiaries who are entitled to distributions from the trust, regardless of whether they actually receive distributions.
- The income of a complex trust is taxed to the beneficiaries who receive distributions from the trust or to the trust itself. Most testamentary trusts are complex trusts.

Special rules of trust income taxation apply to charitable trusts (see §§23A.29-23A.33) and trusts holding S corporation stock (see §§23A.34-23A.43). In addition, some inter vivos trusts created by the testator may be treated as part of the estate of the testator for a period of time following the death of the testator, in which case the separate existence of the trust is essentially ignored. IRC §645. See also California Trust Administration, chap 11 (2d ed Cal CEB 2001).

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II. TRUST INCOME TAXATION RULES

A. Determining Distributable Net Income (DNI)

§23A.2 1. Adjustments to Distributable Net Income

Distributable net income (DNI) is the amount of the trust's taxable and tax-exempt income that will flow out to the beneficiaries with distributions. Determination of a trust's DNI begins with finding the trust's taxable income, to which special adjustments are made as set forth in IRC §643(a). On allocation of DNI, see §23A.3.

The most common adjustments include the following:

- Adding back the distribution deduction and the personal exemption applied in determining the trust's taxable income. IRC §643(a)(1)-(2).
- Including net tax-exempt income in DNI. Net tax-exempt income is the total tax-exempt income earned by the trust, reduced by expenses allocable to the tax-exempt income (including a prorata share of general expenses like trustee fees and attorney fees) and by the amount of tax-exempt income paid to a charity. IRC §643(a)(5). Because DNI consists of a prorata portion of each class of income included in DNI, the net tax-exempt income retains its tax-exempt character when distributed to the beneficiaries.
- Subtracting net long-term capital gain unless the gain has been (1) allocated to income, either under the terms of the trust or under local law; (2) allocated to corpus and actually paid to the beneficiary during the taxable year; (3) used to determine the amount that must be distributed to the beneficiary; or (4) paid to a charity. IRC §643(a)(3); Treas Reg §§1.643(a)-3(a), 1.643(b)-1.
- For simple trusts only, subtracting extraordinary dividends and taxable stock dividends that the trustee, in good faith, allocates to corpus. IRC §643(a)(4).

The adjustment for capital gain allocated to income under local law may include gain allocated to income under a reasonable and impartial exercise of discretion by the trustee in accordance with a power granted by local law, such as the trustee power to adjust between principal and income under Prob C §16336, or the trustee power to convert the trust to a unitrust under Prob C §§16336.4-16336.7, as provided in Prob C §16328. The DNI of a simple trust that is not being administered as a total return trust as provided in Prob C §16336 or as a unitrust under the trustee conversion power or the terms of the trust usually will not include capital gains.

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§23A.3 2. Allocation of Distributable Net Income

Distributions of DNI are deemed to consist of a prorata portion of each class of income included in the DNI of the trust unless the trust agreement provides otherwise. See IRC §652(b). On adjustments to DNI, see §23A.2. A trust provision calling for the allocation, however, of a specific class of income to a specific beneficiary (*e.g.,* taxable income to a beneficiary in a lower income tax bracket and tax-exempt income to a beneficiary in a higher tax bracket) is recognized for tax purposes only if the allocation has an economic effect independent of its income tax consequences. Treas Reg §1.652(b)-2(b).

EXAMPLE: The following trust provision would not have an economic effect: One-half of all trust accounting income shall be paid to *B,* to be paid first from tax-exempt income and to be paid from taxable income only if tax-exempt income is insufficient to fully satisfy the amount to be distributed. Because there is no economic effect to the allocation, it would not be recognized, and the amount distributed to *B* would be considered a prorata share of the tax-exempt and taxable income included in DNI.

Thus, the amount of the distribution that the beneficiary is entitled to receive must be directly affected by the amount of income actually earned by the class of income to which the special allocation relates. In IRS Letter Ruling 200648025, the IRS ruled that an income ordering rule in a proposed charitable lead annuity trust (CLAT) would not be given effect because it had no economic effect on the distributions independent of tax consequences. See also IRC §662(b); Treas Reg §§1.642(c)-3(b)(2), 1.643(a)-5(b); Prop Treas Reg §§1.642(c)-3(b)(2), 1.643(a)-5(b); REG-101258-08, 2008-28 Int Rev Bull 111. The ordering rule would have provided that payments would be made in the opposite order from the rule prescribed by the IRS. See §23A.32.

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B. Simple Trusts

§23A.4 1. Definition of Simple Trust

Under IRC §651, a simple trust is one that:

- Requires all trust accounting income to be distributed at least annually;
- Makes no distributions of principal during the taxable year; and
- Makes no distributions to charity.

A trust can be a simple trust in some taxable years and a complex trust in others. For example, a qualified terminable interest property (QTIP) trust (see chap 19) is a complex trust in taxable years when corpus is distributed to the spouse (such as a distribution of corpus for the spouse's support), and a simple trust in all other years. A trust will be considered a simple trust even if the required income distribution is not made. Treas Reg §1.651(a)-1. Furthermore, the amount of income to be distributed to a particular beneficiary does not need to be specified. Treas Reg §1.651(a)-2(b).

All net trust accounting income earned by a simple trust during the taxable year is deemed distributed to the beneficiaries, on or before the last day of that taxable year, whether or not the net income is actually distributed.

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§23A.5 2. Taxation of Simple Trust and Its Beneficiaries

The term "income" as used in IRC §651(a)(1) means trust accounting income as determined under the terms of the trust and governing law. See IRC §643(b); Treas Reg §1.643(b)-1.

PRACTICE TIP: Trust accounting income frequently is not the same as taxable income. When determining what constitutes trust accounting income, the practitioner should pay close attention to the default rules provided by the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) and relevant provisions in the trust instrument.

California law provides for three alternative definitions of trust accounting income ("net income"): (1) the traditional definition of net income (total receipts minus total disbursements) determined under Prob C §16335; (2) net income as determined under Prob C §16336 (the "power to adjust"); and (3) a unitrust amount that is not less than 3 percent and not more than 5 percent of the fair market value of trust assets. Prob C §16328.

The trust receives a distribution deduction equal to the lesser of the trust accounting income distributed or the DNI, reduced in each case by the amount of net tax-exempt income. IRC §651. The DNI of a simple trust usually does not include net long-term capital gain, extraordinary dividends, or taxable stock dividends, even though those items may be included in the trust's taxable income. See Treas Reg §1.643(a)-3(a). However, capital gains are included in DNI if the trust document allocates the gains to the distribution or if they are allocated to income under a reasonable and consistent exercise of discretion by the trustee in accordance with a power granted by local law, *e.g.,* through exercise of the adjustment power under Prob C §16336 or through administration of the trust as a unitrust under the conversion power in Prob C §16336.4. Treas Reg §1.643(a)-3(b).

If a distribution in kind is made in satisfaction of a right to income, as defined in IRC §643(b), then the trust will be treated as having sold the property for its fair market value on the date of distribution. Treas Reg §1.651(a)-2(d). This rule incorporates the Treas Reg §1.643(b)-1 definition of income, with the consequence that the rule also applies to any portion of principal allocated to income under the Prob C §16336 trustee power to adjust, including the principal portion of unitrust payments made in satisfaction of a right to income under the Prob C §16336.4 trustee conversion power or the terms of the trust.

Each beneficiary must report the lesser of (1) the trust accounting income he or she is entitled to receive, whether or not it is actually received; or (2) a share of DNI, consisting of a prorata portion of each class of income. IRC §652. To the extent that a portion of the distribution made to the beneficiary includes net tax-exempt income, the portion retains its tax-exempt character in determining the tax payable by the beneficiary. If there is more than one beneficiary, DNI is shared by all the beneficiaries on a prorata basis.

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§23A.6 3. Estimated Tax Payments for Simple Trusts

In general, nongrantor trusts must make estimated tax payments. See IRC §6654(*l*)(1). As a practical matter, however, a simple trust will typically not have significant income each year (unless the trust has capital gain) because most of the income will be taxed to the beneficiaries. Each beneficiary of a simple trust must report any DNI deemed distributed to him or her as of each reporting period for purposes of determining the beneficiary's estimated tax payments.

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C. Complex Trusts

§23A.7 1. Definition of Complex Trust

A complex trust is any trust that is not a simple trust. IRC §661. Thus, a complex trust is:

- Any trust in which all of the 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.

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§23A.8 2. Taxation of Complex Trusts

The distribution deduction for a complex trust equals the lesser of distributable net income (DNI) (excluding any net tax-exempt income included in DNI) or the amount actually distributed by the trust, determined as follows (IRC §661(a)):

- For any net trust accounting income required by the terms of the trust to be distributed currently, the amount required to be distributed, whether it is actually distributed on or before December 31 of the current taxable year; and
- For all other distributions from the trust, income and corpus actually distributed on or before December 31 of the current taxable year or, if the trustee elects under IRC §663(b), within the next 65 days thereafter.

NOTE: If the trustee elects under IRC §663(b) to treat distributions made during the first 65 days of a year as having been made in the previous year, those distributions will not be considered distributions in the current taxable year. IRC §663(b).

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3. Estimated Tax Payments for Complex Trusts

§23A.9 a. Determining Estimated Tax

Complex trusts must make estimated tax payments. See IRC §6654(*l*)(1). When the tax liability of a complex trust for the current taxable year is less than $1000, the trust is not required to make any estimated payments. IRC §6654(e)(1). Revocable trusts that become irrevocable as a result of the settlor's death are subject to special rules beyond the scope of this chapter. See IRC §6654(*l*)(2).

When the tax liability of the trust exceeds $1000, there are two methods for determining estimated taxes (Notice 87-32, 1987-1 Cum Bull *477*):

- The first method uses the taxable income earned by the trust in the preceding taxable year. A nongrantor trust cannot use this method in its first taxable year, because there is no preceding taxable year; nor can a nongrantor trust with a short first taxable year use this method in its second taxable year, because the preceding taxable year must be a full 12 months.

- The second method uses annualized income. To determine the income on which estimated taxes must be paid net of the distribution deduction, the trustee may consider only distributions that are actually made through the end of the taxable period preceding the date that the estimated payment is due or, if greater, distributions that are required under the trust instrument. This limitation may create problems. See §23A.10.

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§23A.10 b. Problems in Determining Estimated Tax Using Annualized Income Method

Use of the annualized income method to determine estimated tax payments may be difficult for both the trustee (see §23A.11) and the beneficiary (see §23A.12) in certain situations, especially when the trust is a discretionary pot trust.

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§23A.11 (1) Trustee Problems

Before deciding what amount to distribute from such a trust to each beneficiary for the year, the trustee must first analyze each beneficiary's tax situation as compared with the trust's tax liability and future cash needs. The methods prescribed in Notice 87-32, 1987-1 Cum Bull 477, require a quarterly review of trust income and expenses, a quarterly determination of amounts to be distributed, and an actual distribution on or before the last day of each taxable period. To avoid estimated tax payments, trustees of complex trusts, and their advisors, must closely and carefully monitor taxable income and DNI of these trusts so that they can, as much as possible, distribute a rough estimate of the taxable income earned by the trust (other than long-term capital gain) to the beneficiaries on or before the last day of each quarterly period.

PRACTICE TIP: Although annual payments are permissible for some trusts (*e.g.*, qualified terminable interest property trusts), to facilitate estimated payments, the practitioner should consider including a provision for quarterly distributions in the trust instrument.

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§23A.12 (2) Beneficiary Problems

To determine income for each applicable period, a beneficiary who uses the annualized income method to determine estimated tax payments must consider distributions actually made through the end of the appropriate period and distributions required under the terms of the trust instrument.

EXAMPLE: The trust requires that one half of all net income be distributed to *B* currently and that the rest be paid or accumulated in the trustee's discretion. The trustee makes no distributions before March 31. When *B* makes the estimated payment due April 15, *B* must report one half of all the net trust accounting income earned by the trust through March 31, for purposes of determining annual income, even though no payment has actually been made.

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§23A.13 4. Taxation of Beneficiaries of Complex Trusts

Beneficiaries of complex trusts are taxed on the basis of tiers. See IRC §662(a). The first tier usually consists of beneficiaries entitled to receive trust accounting income that must be distributed currently. Thus, if the trust directs the distribution of a fixed amount each year, payable from income or principal, or both, and if trust accounting income is sufficient to make the payment, then the beneficiaries entitled to the distribution are assigned to the first tier. See §23A.14. The second tier includes all other beneficiaries of the trust. See §23A.15. Beneficiaries in the first tier receive no benefit from any charitable deduction available to the trust. See IRC §662(a)(1).

The DNI of a complex trust is allocated among the separate tiers and among the beneficiaries within each tier as follows:

- Each beneficiary in the first tier must report the lesser of the DNI or net trust accounting income he or she is entitled to receive, whether or not it is actually received by December 31 of the current taxable year. If the amount distributed to the first-tier beneficiaries exceeds DNI, however, the amount taxed to each beneficiary is his or her prorata share of DNI calculated without regard to the deductions allowable under IRC §642(c) (modified DNI). IRC §662(a)(1).

- If, after allocating DNI among members of the first tier, any DNI remains (residual DNI), the residual DNI is allocated among members of the second tier on a prorata basis. IRC §662(a)(2). Each beneficiary in the second tier must report the lesser of residual DNI or distributions actually made to him or her on or before December 31 of the current taxable year, or within the next 65 days thereafter if the trustee elects to deduct those distributions in the prior taxable year under IRC §663(b).

To the extent that the beneficiaries in the first tier must report modified DNI, there will be no residual DNI to be reported by the beneficiaries in the second tier.

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§23A.14 a. First-Tier Distributions

Fiduciary accounting income that is required to be distributed currently constitutes the first tier of distributions. IRC §662(a)(1); Treas Reg §§1.661(a)-2(a)(1), 1.662(a)-2(a). It is included in a beneficiary's gross income, to the extent of DNI, whether or not it is actually distributed. IRC §662(a)(1); Treas Reg §1.662(a)-2(a). If the amount required to be distributed exceeds DNI (without taking into account any charitable deduction), each beneficiary includes a ratable amount of DNI in his or her gross income. IRC §662(a)(1); Treas Reg §1.662(a)-2(b). Income required to be distributed currently includes income *or principal* (such as an annuity) to the extent that it is actually paid out of current trust accounting income. IRC §662(a)(1); Treas Reg §1.661(a)-2(b). See §23A.17. First-tier distributions also include amounts required to be paid by court order, such as a family allowance, to the extent such amounts are paid from trust accounting income. IRC §662(a)(1); Treas Reg §1.661(a)-2(c). On separate shares treated as separate trusts, see §23A.18.

If an estate or trust distributes appreciated assets in satisfaction of a mandatory right to income, the distribution is treated as a sale or exchange and the estate or trust recognizes gain on the distribution. See Treas Reg §1.661(a)-2(f). This rule incorporates the Treas Reg §1.643(b)-1 definition of income (see §23A.5), with the consequence that the rule also applies to any portion of principal allocated to income under the Prob C §16336 trustee power to adjust, or the principal portion of unitrust payments made in satisfaction of a right to income under the trustee conversion power in Prob C §§16336.4-16336.7 or the terms of the trust. Distributions of depreciated assets generally do not result in recognition of losses by reason of IRC §267. See §23A.8.

A first-tier distribution that qualifies for the charitable deduction does not qualify for the distribution deduction. IRC §663(a)(2); Treas Reg §1.663(a)-2. A charitable distribution may, however, have an effect on noncharitable first-tier distributions. If the amount required to be distributed, including any charitable distribution, is less than the DNI (computed without taking the charitable deduction into account), then the noncharitable first-tier distributees simply take into account the amounts distributed to them. See Treas Reg §1.662(a)-2(e), Example (1). If, however, the amounts required to be distributed *exceed* the amount of DNI (once again, computed without taking the charitable deduction into account), then first-tier beneficiaries must include in gross income a ratable portion of DNI, the end result being that the charitable deduction is of no benefit to those beneficiaries. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (2). For this reason, the charitable deduction is sometimes referred to as the "intermediate tier." See §23A.16.

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§23A.15 b. Second-Tier Distributions

All distributions properly paid, credited, or otherwise required to be distributed, other than amounts "required to be distributed currently," fall into the second tier. Second-tier beneficiaries are taxable only to the extent that DNI is not used up by first-tier beneficiaries, and then only as to their proportionate share (based on amounts received) of the remaining DNI. IRC §662(a)(2); Treas Reg §1.662(a)-3(a). "Other amounts distributed" do not, however, include specific gifts payable in three or fewer installments, or distributions that qualify for the charitable deduction. IRC §663(a); Treas Reg §§1.663(a)-1(b)(2), 1.663(a)-2.

A complex trust or estate receives a deduction for, and a second-tier beneficiary takes into account, only amounts "properly paid or credited." Thus, beneficiaries do not take into account the amount overpaid by mistake of fact or law, but only the amount properly payable. See *Freuler v Helvering* (1934) 291 US 35, 78 L Ed 634, 54 S Ct 308. Similarly, payments by an executor to the beneficiary of a testamentary trust not yet established by court order are not properly paid or credited. *Hopper v Government of V.I.* (3d Cir 1977) 550 F2d 844. But see *Buckmaster v U.S.* (10th Cir 1993) 984 F2d 379 (distributions made without court order at executor's peril were properly paid by subsequent court approval).

The statute requires actual payment or crediting. IRC §§661(a), 662(a). Nothing in the statute implies that distributions may be accrued. The payment of a debt to a creditor who is also a beneficiary of an estate or trust is not a distribution that is properly paid or credited. See *Alfred I. duPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332. A distribution to a beneficiary who immediately lends the distributed funds back to the trust or estate, however, qualifies as paid if not part of a prearranged plan. See, *e.g., Tobin Trust,* TC Memo 1951-35. Payment is, of course, a factual question. If the executor is a beneficiary and commingles personal and estate funds, the result depends on the facts of administration. See *McCauley v U.S.* (ED Ark 1961) 193 F Supp 938 (doctrine of constructive receipt not applicable unless administration unduly prolonged). In contrast, payments to a third party for a beneficiary's benefit, such as taxes, qualify as payment. See Treas Reg §1.662(a)-4; *Grant v Nicholas* (D Colo 1955) 127 F Supp 236 (beneficiary's income taxes).

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§23A.16 c. The Intermediate Tier

As discussed in §23A.14, first-tier beneficiaries get no benefit from a trust's or estate's charitable deduction, but because DNI takes the charitable deduction into account, it limits the amounts taxable to second-tier beneficiaries. Thus, the charitable deduction is sometimes referred to as the "intermediate tier." If second-tier distributions are equal to or less than DNI (computed without taking the charitable deduction into account) minus first-tier distributions, then the trust or estate gets the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (1). If second-tier distributions exceed DNI (once again, computed without taking the charitable deduction into account) minus first-tier distributions, then second-tier beneficiaries get some or all of the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (2).

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§23A.17 d. The Variable Tier

Annuities may be first-tier or second-tier distributions. If the annuity amount may be paid only from trust accounting income, it is first-tier. Treas Reg §1.662(a)-2(c). If the annuity amount may only be paid from principal, it is second-tier. Treas Reg §1.662(a)-3(b). If the annuity amount may be paid from either income or principal, it is variable-tier and its treatment will depend on the actions of the fiduciary and the existence of trust income. An annuity that may be paid from income or principal is deemed to come from income to the extent that there is fiduciary accounting income that has not been paid, credited, or required to be distributed to other beneficiaries during the taxable year. Treas Reg §1.662(a)-2(c). See Treas Reg §1.662(a)-2(e), Example (1). As with first-tier or second-tier distributions, annuity recipients are taxable to the extent of the allocable DNI, but the tier rules determine, as between the various beneficiaries, the taxable priorities. Moreover, charitable distributions may affect an annuity recipient's tier status, because the annuity recipient's status depends on the amount of fiduciary accounting income available for distribution. See Treas Reg §1.662(a)-2(e), Examples (1)-(2).

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§23A.18 5. Separate Share Rule

For purposes of computing distributable net income (DNI) for complex trusts under IRC §§661-662, if a single trust has multiple beneficiaries 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 DNI 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).

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)).

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D. Additional Trust Income Taxation Rules

§23A.19 1. Determining Trust Taxable Income

The taxable income of an irrevocable trust is computed in much the same manner as the taxable income of individuals. There are specific differences, however, with respect to computing the taxable income of trusts:

- Certain deductions may be claimed as estate tax deductions or income tax deductions, but not both (IRC §§213(c), 642(g));
- Special rules apply to the allocation of the depreciation deduction (IRC §167(d));
- The personal exemption is reduced to $300 for a simple trust (see §§23A.4-23A.6) or $100 for a complex trust (see §§23A.7-23A.18) but the regular personal exemption applies if the trust is a "qualified disability trust" (IRC §642(b)); and
- Expenses that would be miscellaneous itemized deductions for an individual taxpayer but that would not have been incurred in the absence of the trust (*i.e.,* trustee fees and attorney fees related to trust tax matters) are not subject to the 2-percent adjusted gross income floor. IRC §67(e). In contrast, trust investment advisor fees are generally considered miscellaneous itemized deductions subject to the 2-percent floor because investment advisor fees are commonly incurred in the absence of a trust. See *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782. The IRS issued proposed regulations shortly before the decision and has issued further temporary guidance in response to the decision. Prop Treas Reg §1.67-4; Notice 2008-116, 2008-52 Int Rev Bull 1372.

A trust may take a deduction for distributions and amounts required to be distributed to beneficiaries. IRC §§651, 661. In general, the distribution deduction is equal to the lesser of the amount distributed or required to be distributed or the trust's distributable net income (DNI). See §23A.2 for a discussion of adjustments to DNI.

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§23A.20 2. Charitable Deduction for Trust Income

A trust is entitled to a charitable deduction for trust accounting income (other than tax-exempt income) paid to a qualified charity under the terms of the trust. IRC §642(c). However, the requirements for obtaining the deduction can be fairly restrictive. See *Brownstone v U.S.* (2d Cir 2006) 465 F3d 525; *United States Trust Co. v IRS* (5th Cir 1986) 803 F2d 1363; *Mott v U.S.* (Ct Cl 1972) 462 F2d 512, cert denied (1973) 409 US 1108 (trust instrument must both mandate or authorize distributions to charity and provide that distributions are to be made from gross income). A trust can also claim a charitable deduction for the trust's distributive share of charitable contributions by a partnership in which the trust has an interest (or an S corporation in the case of an electing small business trust (ESBT)), even though the trust instrument has not authorized the charitable contributions. Treas Reg §1.641(c)-1(d)(2)(ii); IRS Letter Ruling 200140080.

The trust may take the charitable income tax deduction:

- For income it pays to a charity during the taxable year in which the trust receives the income (IRC §642(c)(1)); or
- For income it pays to a charity before the close of the taxable year after the year in which the trust receives the income, if it makes an appropriate election not later than the time, including extensions, for filing a return for the succeeding year (Treas Reg §1.642(c)-1(b)).

In Rev Rul 2004-5, 2004-1 Cum Bull 295, the IRS ruled that a trust could take a charitable deduction for the trust's distributive share of a charitable contribution made by a partnership from gross income, even though the trust's governing instrument did not authorize the trustee to make charitable contributions.

Unlike the charitable deduction for individuals, the charitable deduction for trusts is not limited to a fraction of the trust's adjusted gross income. Special rules applicable to the creation and taxation of charitable remainder trusts (CRTs) and charitable lead trusts (CLTs) are discussed in §§23A.29-23A.33.

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§23A.21 3. Taxable Year of Trust

All nongrantor trusts except charitable trusts must use a calendar year as their taxable year. IRC §644. For tax purposes, a trust begins on the date on which property is first transferred to the trustee in trust. This is true whether the trust is testamentary or inter vivos. The trust usually terminates on the date of the final distribution of trust corpus. If the distribution of trust corpus is unreasonably delayed, however, the trust is considered terminated after the expiration of a reasonable period of time required for the trustee to complete administration of the trust. Treas Reg §1.641(b)-3(b).

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§23A.22 4. Income Tax Rates Applicable to Trusts

The income tax rates for nongrantor trusts are substantially higher than those for individuals at the same income levels. The rates are adjusted annually for inflation; the 2009 rates are as follows (IRC §1(e)):

Taxable Income	**Rate of Tax**
0-$2,300	15%
$2,300-$5,350	$345 plus 25% of excess over $2,300
$5,350-$8,200	$1,107.50 plus 28% of excess over $5,350
$8,200-$11,150	$1,905.50 plus 33% of excess over $8,200
Over $11,150	$2,879 plus 35% of excess over $11,150

The maximum rate for adjusted net long-term capital gain is 15 percent, regardless of whether the taxpayer is a trust or an individual. Thus, there is little difference between retaining capital gains or qualified dividends in the trust and distributing them to the beneficiaries, except in very unusual circumstances (*e.g.,* when the marginal tax rate applicable to the beneficiary—before adding adjusted net capital gains to his or her other income—is 15 percent, then the tax rate on the portion of gain that would be taxed at the 15-percent rate is 0 percent. IRC §1(h).

For California income tax purposes, a trust is taxed at the same rate as an individual taxpayer. Rev & T C §17041(e). For example, the state income tax rate on a trust with a taxable income of $10,000 is only 2.25 percent. Thus, the combined state and federal tax rate of a trust may be less than the combined rate of an individual beneficiary even if the trust is taxed at a higher marginal federal tax rate. However, capital gains and qualified dividends are taxed at the same rate as ordinary income for California income tax purposes.

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§23A.23 5. Disallowance of Certain Capital Losses

Capital losses that occur as a result of transactions between related parties are disallowed. IRC §267(a)(1). Under IRC §267(b)(4)-(8), (13), related parties include:

- An estate and its beneficiaries;
- The trustee of one trust and the trustee of another trust if both trusts have the same settlor;
- The trustee of the trust and any of its beneficiaries; and
- The trustee of one trust and the beneficiaries of another trust if both trusts have the same settlor. (For these purposes, the settlor of a testamentary trust is the testator.)

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§23A.24 6. Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) applies to trusts. IRC §55. The rate of tax is 26 percent of the first $175,000 of alternative minimum taxable income (AMTI) and 28 percent of the excess. The regular tax rate (15 percent) under IRC §1(h) applies to capital gains and qualified dividends. The exemption amount for trusts is $22,500. If the trust has AMTI over $75,000, however, then the amount of AMTI subject to the AMT is increased by the lesser of (a) 25 percent of the excess AMTI over $75,000 or (b) $22,500.

PRACTICE TIP: Although the planner should be aware that AMT applies to trusts, in most cases trusts are unlikely to be subject to the tax. This is particularly true for simple trusts and for complex trusts that distribute all or most of their income in the current taxable year.

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§23A.25 7. California and Other State Income Tax

Taxation of estates, trusts, and beneficiaries in California is determined according to Subchapter J of Chapter 1 of the Internal Revenue Code (IRC §§641-692), except as provided otherwise in the Revenue and Taxation Code. Rev & T C §17731. California law conforms to IRC provisions as enacted January 1, 2005. Rev & T C §17024.5(a)(1). Uncodified provisions enacted on or after January 1, 1987, and on or before January 1, 2005, relating to incorporated IRC provisions also are incorporated. Rev & T C §17024.5(a)(2).

Although federal and California fiduciary income taxation of trusts are parallel, the rules are not entirely the same for out-of-state trusts. California treats the California residency of any trustee or noncontingent beneficiary as sufficient nexus to impose a tax. See Drafting California Revocable Trusts, chap 23 (4th ed Cal CEB 2003). See also California Estate Planning, chap 13 (Cal CEB 2002).

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§23A.26 E. Tax Consequences of Trust Termination

For income tax purposes, a trust does not necessarily terminate when the event measuring the duration of the trust occurs. Rather, it terminates after a reasonable period during which the trustee performs the duties necessary to complete the administration of the trust. Treas Reg §1.641(b)-3(b). The trust will be considered terminated after a reasonable period if the administration of the trust is unduly prolonged. Treas Reg §1.641(b)-3(d). After the trust is terminated for income tax purposes, all items of income, gain, loss, deduction, and credit are taxed to the beneficiaries entitled to receive the trust assets, in proportion to their undivided shares of the trust, as if the trust did not exist. Treas Reg §1.641(b)-3(d). See §23A.27. However, the beneficiaries cannot deduct excess deductions of the trust from taxable years before the year of termination. See §23A.28.

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§23A.27 1. Pass-Through of Unused Deductions and Losses to Beneficiaries

In the year in which the trust terminates, the trustee can pass through the trust's unused deductions and losses to the beneficiaries. See IRC §642(h). Only three categories of deduction and loss may be passed through. These are:

- Net operating loss (NOL) carryovers (Treas Reg §1.642(h)-1(a));
- Capital loss carryovers (Treas Reg §1.642(h)-1(b)); and
- Deductions, other than the personal exemption and charitable deduction, incurred in the last taxable year of the trust that exceed taxable income (excess deductions) (Treas Reg §1.642(h)-2).

The beneficiary may not carry back any unused NOL passed through to him or her from the trust and may carry over any unused NOL only for the balance of the 20-year carryover period. For California income tax purposes, the carryover period is only 10 years. Rev & T C §17276(b), (d). California does not allow NOL carrybacks by the trustee or the beneficiary. Rev & T C §17276(c). If the NOL was not incurred in the year of termination, two carryover years are used up in the year the trust terminates, one for last year of the trust and one for the first year of the beneficiary. If the trust incurs a NOL in the year of termination, however, the full 20-year carryover period (10-year California period) is available to the beneficiary receiving the passed-through NOL. IRC §172(b). Finally, if a NOL is in its 20th carryover year, it passes through to the beneficiary as an excess deduction rather than as a NOL. See Treas Reg §1.642(h)-1(b).

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§23A.28 2. No Pass-Through of Excess Deductions

Only deductible expenses incurred in the year of termination pass through to the beneficiaries. To the extent that the trust's deductible expenses exceeded taxable income in taxable years before the year of termination, the excess deductions are unavailable as a pass-through deduction to the beneficiaries. In addition, an excess deduction is passed through to the beneficiaries as a miscellaneous itemized deduction with respect to each beneficiary. Thus, it is deductible only to the extent that it exceeds 2 percent of a beneficiary's adjusted gross income. IRC §67. See §23A.19.

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III. CHARITABLE TRUSTS

§23A.29 A. Charitable Remainder Trusts (CRTs)

Two types of trusts qualify as charitable remainder trusts (CRTs): charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). See IRC §664. The requirements for qualifying a trust as a CRT are discussed in chap 14. For further discussion of CRTs, see California Estate Planning, chap 24 (Cal CEB 2002).

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§23A.30 1. Taxation of CRTs

A CRT is exempt from income tax. However, a CRT is subject to a 100-percent excise tax on unrelated business taxable income (UBTI). IRC §664(c)(2); Treas Reg §1.664-1(c).

Furthermore, if a CRT distributes property in kind to satisfy an annuity or unitrust payment, it is deemed to have engaged in a taxable sale or exchange. Treas Reg §1.661(a)-2(f). Although this treatment has no tax consequence to the trust, a taxable sale or exchange creates capital gain, which may affect the tax consequences of distributions to noncharitable beneficiaries. See §23A.31.

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§23A.31 2. Taxation of Noncharitable Beneficiaries

A noncharitable beneficiary of a CRT is taxed according to a special tier system (IRC §664(b)):

- A distribution is deemed to come first from current and accumulated ordinary income, which is determined without regard to any net operating losses (NOLs). Other ordinary losses first offset current income, next are carried back to offset income earned in the earliest years of the CRT, and then are carried forward indefinitely to determine the amount of accumulated ordinary income.

- A distribution is deemed to come next from current and accumulated gains from sales of capital assets, and next from current and accumulated tax-exempt income. Consistent with this general "worst in—first out" approach, short-term capital gains are deemed distributed before long-term gains. However, qualified dividends taxed at the same rate as long-term gains are considered ordinary income and are deemed distributed before short-term gains. If long-term gains are taxed at different rates, the gains subject to tax at the higher rates are deemed distributed first. Treas Reg §1.664-1(d).

- A distribution in excess of the foregoing classes of income is deemed to come from principal.

Income is deemed to be distributed to the beneficiary on the last day of the taxable year of the CRT even though the beneficiary may not receive the distribution until the next taxable year.

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§23A.32 3. Taxation of Charitable Beneficiaries

Charitable beneficiaries of CRTs (as well as charitable lead trusts (CLTs), discussed in §23A.33) are taxed on the basis of a special tier system that is the reverse of the noncharitable beneficiary tier system. See §23A.31. That is, a distribution to a charitable beneficiary comes first from principal, then tax-exempt income, then capital gain, and then, finally, ordinary income. Treas Reg §1.664-1(e).

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§23A.33 B. Charitable Lead Trusts (CLTs)

A charitable lead trust (CLT) is a trust that provides for payment of the income interest to a qualified charity for a specified period of time, after which the remainder passes to the grantor, his or her spouse, or his or her heirs. There are two types of CLTs: charitable lead annuity trusts (CLATs) and charitable lead unitrusts (CLUTs). A CLAT is a trust that pays a guaranteed annuity to a qualified charity. It can be used to permit the actuarial value of the lead interest to qualify for the gift or estate tax charitable deduction, and also an income tax deduction. See Treas Reg §1.170A-6(c)(2)(i). In a CLUT, on the other hand, the charity receives an annual payment equal to a fixed percentage of the fair market value of the property held in trust, determined annually. CLUTs are seldom used because the transfer tax benefits of CLATs are superior. For further discussion of CLTs, see California Estate Planning, chap 23A (Cal CEB 2002).

Because the testator cannot claim an income tax deduction for the lead interest, the only benefit to the testator from the creation of a nongrantor CLAT is the reduction of the value of the testator's taxable estate and removal of the income from the taxable income of the estate or noncharitable beneficiaries of the trust.

PRACTICE TIP: Despite the unavailability of an income tax deduction for the testator, the drafter should not overlook the possibility that the IRC §7520 valuation tables may have the effect of overvaluing the lead interest passing to the charity. If that is the case, the testator can pass a substantial after-tax amount to his or her heirs by using a CLAT. See §§14.81-14.99. See chap 13 for a discussion of valuation of charitable interests.

The income earned by a nongrantor CLAT is not taxed to the noncharitable beneficiaries when it is received by the CLAT. Rather, the CLAT gets a charitable deduction for amounts that are actually paid to a charity, either in the current year or the next year. IRC §642(c). See §14.82.

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IV. TRUSTS HOLDING S CORPORATION STOCK

§23A.34 A. Qualified Subchapter S Trusts (QSSTs)

Special rules apply to testamentary trusts that receive and hold S corporation stock. See IRC §§1361-1379. Generally, two kinds of trusts are eligible stockholders of an S corporation. First, a trust can satisfy the requirements for a qualified subchapter S trust (QSST). IRC §1361(d). See §§23A.35-23A.39. Second, a trust can satisfy the requirements for an electing small business trust (ESBT). IRC §1361(c)(2)(A)(v). See §§23A.40-23A.43.

NOTE: Trusts that receive assets by will from a deceased shareholder's estate may hold S corporation stock for a 2-year period after the decedent's death. IRC §1361(c)(2)(A)(iii). This may occur, for example, if the testator has a pourover will providing for distribution of estate assets to the testator's revocable trust. See chap 9. Revocable trusts may continue to hold S corporation stock for a similar 2-year period after the settlor's death. IRC §1361(c)(2)(A)(ii). The discussion in this chapter assumes that the trust holding S corporation stock is intended to continue beyond this 2-year period.

Generally, the requirements for a QSST are less flexible than those for an ESBT, but an ESBT typically pays higher taxes. Subject to certain limitations, a QSST can be converted to an ESBT and vice versa. See Treas Reg §1.1361-1(j)(12), (m)(7).

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§23A.35 1. Basic Requirements for QSST

A qualified subchapter S trust (QSST) must meet six requirements:

(1) There may be only one income beneficiary of the trust. IRC §1361(d)(3)(A)(i).

(2) The trust may not distribute principal to anyone other than the income beneficiary. IRC §1361(d)(3)(A)(ii).

(3) The income beneficiary's interest must terminate at the earlier of (a) his or her death or (b) the termination of the trust. IRC §1361(d)(3)(A)(iii).

(4) If the trust terminates while the income beneficiary is alive, the assets held in the trust may be distributed only to the income beneficiary. IRC §1361(d)(3)(A)(iv).

(5) The trust must be required to distribute or must actually distribute all income to one individual who is a United States citizen or resident. IRC §1361(d)(3)(B).

(6) The income beneficiary, or his or her legal representative, must elect to be treated as the deemed owner (IRC §678(a)) of the portion of the trust consisting of the S corporation stock. IRC §1361(d)(1)(B), (d)(2).

The IRS has ruled that the first four requirements listed must be set forth in the trust instrument and must be met even after the trust ceases to hold S corporation stock. Rev Rul 89-55, 1989-1 Cum Bull 268. This is not true of the fifth requirement. See IRS Letter Ruling 9014008.

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§23A.36 a. Requirement to Distribute All Income

All income earned by the trust must be required to be distributed or must actually be distributed to the beneficiary currently (*i.e.,* at least annually) for the trust to qualify as a QSST. IRC §1361(d)(3)(B). The trust may also qualify if the beneficiary has the power to withdraw any gifts to the trust for a limited period. The IRS has ruled that the withdrawal power causes the trust income to be taxed to the beneficiary under IRC §678 even after lapse of the power. IRS Letter Ruling 200147044. Income for these purposes means trust accounting income. See IRC §643(b).

PRACTICE TIP: The attorney should be aware of the tax problems for the income beneficiary of a QSST when the beneficiary is also taxed on capital gains realized by the S corporation (of which he or she would be treated as the deemed owner under IRC §678) that are not paid to him or her. Capital gains are not trust accounting income under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), but the UPAIA permits the trustee to make an adjustment between principal and income to offset the income tax imposed on the income beneficiary of a QSST attributable to capital gains. Prob C §16375(a)(2).

For the trust to qualify as a QSST, the beneficiary must receive all the income under all circumstances. The IRS has found that trusts *are* QSSTs under the following circumstances:

- The trust permits the payment of income to the custodian of a minor beneficiary under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). IRS Letter Ruling 8831020.
- The trust permits the trustee to accumulate income, as long as the trustee currently distributes all income to the beneficiary while the trust holds S corporation stock. IRS Letter Ruling 8921056.
- The trustee is permitted to accumulate income, as long as the trust does not hold S corporation stock. IRS Letter Ruling 9014008.
- The trust holds only a life tenant interest in S corporation stock. IRS Letter Ruling 200404037.

The IRS has found that trusts *are not* QSSTs in these situations:

- The trust requires the trustee to accumulate income until the beneficiary has attained age 21. IRS Letter Ruling 8921013.
- The trustee makes distributions to a grantor trust that is wholly owned by the income beneficiary of the QSST, rather than directly to the income beneficiary. IRS Letter Ruling 9014008.
- The trust is a charitable remainder trust (see §§23A.29-23A.32). IRS Letter Ruling 8922014.

PRACTICE TIP: When drafting a QSST, the planner should pay special attention to trusts that include spendthrift provisions. For a discussion of spendthrift clauses that may prevent the trust from becoming a QSST, see IRS Letter Ruling 8952014.

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§23A.37 b. One-Beneficiary Requirement

There may be only one beneficiary of a QSST. IRC §1361(d)(3)(A)(i), (d)(3)(B). A QSST may have successive income beneficiaries, however, if there is no more than one income beneficiary at any one time. Treas Reg §1.1361-1(j)(1)(iii), (j)(9). If a single trust has more than one beneficiary, and if the beneficiaries have substantially separate and independent shares of the trust, then the separate shares are treated as separate trusts for purposes of meeting this requirement. Treas Reg §1.1361-1(j)(3).

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§23A.38 2. QSST Election

The income beneficiary of the QSST must make an affirmative election to be treated as the deemed owner of the QSST under IRC §678, in the manner and form prescribed by the regulations. IRC §1361(d)(1)(B), (d)(2). The beneficiary must make a separate election for each S corporation whose stock is held in the QSST. Treasury Regulation §1.1361-1(j)(6) sets forth the manner and form of the election. After the QSST election has been made, it is irrevocable without the consent of the Secretary of the Treasury. See IRC §1361(d)(2)(C).

The election should be made by the current income beneficiary of the QSST, or his or her legal representative. Treas Reg §1.1361-1(j)(6)(ii). If the income beneficiary who made the election dies, each successive income beneficiary is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. Treas Reg §1.1361-1(j)(9). In addition, because the current income beneficiary of the QSST is treated as a shareholder of the S corporation (Treas Reg §§1.1361-1(h)(3)(i)(C), 1.1361-1(j)(7)), the individual must consent to the election to treat the corporation as an S corporation. IRC §1362(a)(2); Treas Reg §1.1362-6(b)(2)(iv). Failure to have all persons who are shareholders of the S corporation (in this case, the current income beneficiary of the QSST) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election. See IRC §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.

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§23A.39 3. Taxation of QSSTs

All items of income, gain, loss, deduction, and credit directly attributable to the activities of the S corporation are taxable to the income beneficiary. IRC §678(a). The income beneficiary will be taxed on this income regardless of the trust accounting income that the beneficiary is entitled to receive, which typically will only be dividends paid by the corporation.

The sale of the S corporation stock terminates the income beneficiary's deemed ownership under IRC §678; therefore, the gain or loss realized on the sale is subject to taxation under the normal rules applicable to trusts. It is not automatically taxed to the income beneficiary of the QSST. Treas Reg §1.1361-1(j)(8).

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§23A.40 B. Electing Small Business Trusts (ESBTs)

Under IRC §§1361(b)(2)(A)(v) and 1361(e), an electing small business trust (ESBT) may hold S corporation stock. If the trust meets the statute's requirements for ESBT status, the trustee of the trust makes the required election (see §23A.41), and the trust ownership does not cause the S corporation to exceed the maximum number of shareholders (see §23A.42), then the portion of the trust consisting of stock of one or more S corporations is subject to special rules that modify the customary rules for taxation of trusts. See §23A.43 for discussion of the special taxation rules applicable to ESBTs. Subject to certain limitations, a QSST (see §§23A.34-23A.39) can be converted to an ESBT and vice versa. See Treas Reg §1.1361-1(j)(12), (m)(7).

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§23A.41 1. Basic Requirements for ESBTs

A trust must fulfill four requirements to qualify as an ESBT:

- The trust may not have beneficiaries other than individuals, estates, or certain specified charities, including public charities (IRC §170(c)(2)), war veterans' organizations (IRC §170(c)(3)), fraternal societies, orders, or associations (IRC §170(c)(4)), and cemetery organizations (IRC §170(c)(5)).

- No interest in the trust may be acquired by purchase. IRC §1361(e)(1)(A)(ii). An interest is considered to have been purchased if its basis is determined under IRC §1012. IRC §1361(e)(1)(C).

- The trustee must make the election to be treated as an ESBT. IRC §1361(e)(3). See Treas Reg §1.1361-1(m)(2). In addition, because each potential current beneficiary of the ESBT is treated as a shareholder of the S corporation (Treas Reg §§1.1361-1(h)(3)(i)(F), 1.1361-1(m)(4)), each individual must consent to the election to treat the corporation as an S corporation. IRC §1362(a)(2); Treas Reg §1.1362-6(b)(2)(iv). Failure to have all persons who are shareholders of the S corporation (in this case, all potential current beneficiaries of the ESBT) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election. See IRC §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.

- The trust may not be a qualified subchapter S trust (QSST), a tax-exempt trust, or a charitable remainder trust (CRT). IRC §1361(e)(1)(B)(ii)-(iii).

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§23A.42 2. Determining Number of S Corporation Shareholders

The maximum number of permitted shareholders for an S corporation is 100. IRC §1361(b)(1)(A). A husband and wife are counted as one shareholder. Generally, each potential current beneficiary of a trust is treated as a separate shareholder. IRC §1361(c)(2)(B)(v). A potential current beneficiary is any person who, at any time during the period in question, is entitled to, or at the discretion of any person may receive, a distribution of income or principal. IRC §1361(e)(2). This does not include persons whose contingent interests are so remote as to be negligible, persons who may become beneficiaries in the future as a result of an exercise of a power of appointment, or persons whose rights to distributions are subject to a condition that has not occurred. Treas Reg §1.1361-1(m); Notice 97-49, 1997-2 Cum Bull 304.

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§23A.43 3. Taxation of ESBTs

Special rules apply to the income taxation of ESBTs. The portion of an ESBT that consists of S corporation stock is treated as a separate trust. IRC §641(d)(1)(A). The separate trust computes its taxable income taking into account only the following items:

- Items of income, deduction, loss, or credit that each S corporation shareholder must account for under the typical S corporation rules of IRC §1366 (IRC §641(d)(2)(C)(i));
- Gain or loss from the disposition of S corporation stock (IRC §641(d)(2)(C)(ii)); and
- State or local income taxes and administrative expenses allocable to either or both of the above two items (IRC §641(d)(2)(C)(iii)).

Taxable income is determined and taxed at the trust level and is not apportioned among the beneficiaries, even though distributions have been made to them. IRC §641(d)(2)(C). In addition, capital losses may be claimed only to the extent of capital gains (IRC §641(d)(2)(D)), and there is no exemption for purposes of determining alternative minimum taxable income of the separate share of the trust attributable to the S corporation stock (IRC §641(d)(2)(B)). See §23A.24 for discussion of the alternative minimum tax.

Tax is paid on the net income of the separate trust at the highest marginal tax rate applicable to trusts. IRC §641(d)(2)(A). The highest marginal tax rate is currently 35 percent (plus California tax of 9.3 percent under Rev & T C §17731.5) for ordinary income under IRC §1(e) and 15 percent for capital gains and qualified dividends under IRC §1(h). In determining the tax treatment of the trust for assets other than the S corporation stock, the items attributable to taxation of the separate trust for the S corporation stock are excluded from distributable net income (DNI), and the normal rules for taxation of trusts apply. IRC §641(d)(3). Finally, when all or a portion of the separate S corporation stock trust terminates, unused loss carryovers and excess deductions may be taken into account by the entire trust subject to the normal rules for taxation of trusts. IRC §641(d)(4).

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Guardianships of Person

Robert A. Schlesinger

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III. NOMINATING GUARDIAN OF PERSON
- A. Form: Nomination of Guardian of Person §24.20
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I. ROLE OF GUARDIAN OF PERSON

§24.1 A. Providing for Minor Beneficiary

Providing for a minor beneficiary presents special problems for the testator and the will drafter. A parent, who is the natural guardian of his or her child (see 10 Witkin, Summary of California Law, *Parent and Child* §194 (10th ed 2005)), usually wants to ensure that the minor's needs for personal care, education, and supervision will be met. Because of a minor's legal disabilities (see §§22.2-22.3) and lack of experience, some individual or institution must manage and conserve the minor's property and handle the minor's other legal and practical affairs.

Providing for the personal care of minors raises different questions than those arising from giving minors property. This chapter covers only testamentary guardianship of the person, first reviewing the California statutes pertinent to testamentary guardianship (see §§24.4-24.5) and then discussing guardianship of the person (see §§24.7-24.19). See §§24.20-24.23 for nomination clauses. Gifts of property to minors and guardianships of the estate are covered in chap 25.

For discussion of the law and practice of guardianship generally, see California Guardianship Practice (Cal CEB Annual).

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§24.2 B. Two Types of Testamentary Guardianship

Among the tools testators may use when providing for their minor children are nomination of a guardian of the minor's *person* and nomination of a guardian of the minor's *estate*. Prob C §§1500, 2108.

The guardian of the person generally has responsibility for the care, custody, control, and education of the minor. See Prob C §2351. See also §24.6. The guardian of the estate (see chap 25) is responsible for the management and control of the minor's property.

Testamentary and inter vivos nominations of guardians of a minor's person are authorized by Prob C §§1500 and 1502. There is no legal substitute for guardianship of the person. If the parents are deceased or otherwise unavailable, a guardian must be appointed by the court to take custody of the minor and provide for the child's needs. See §24.4. The two most common events triggering the unavoidable need for formal appointment of a guardian are school enrollment and the need for medical treatment requiring parental consent. For discussion of parental consent in matters affecting a minor's person, see California Guardianship Practice §§2.13-2.26 (Cal CEB Annual).

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.3 C. Coordination of Guardianship With Other Provisions for Minor

§24.3 C. Coordination of Guardianship With Other Provisions for Minor

A minor's needs typically cover a wide spectrum, ranging from companionship and personal care to financial support and skilled management of property. Whenever a will nominates a guardian, the guardianship should be properly coordinated with provisions made for the minor in the will or outside it. In particular, the appointment of a guardian should be tied in carefully with the financial arrangements the testator makes for the minor. See §24.19.

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D. Statutory Guardianship Provisions

§24.4 1. Summary of Provisions

Under the basic statutory scheme relating to guardians for minors, a parent may *nominate* someone for appointment as guardian of the person, the estate, or both. Prob C §1500. The nominee's actual appointment as guardian, however, may be made only by the court. Prob C §1514. For discussion of the rules governing the priority given to a parent's nominee and the limitations on the court's power to appoint someone else, see California Guardianship Practice §§1.18-1.21, 5.56-5.60 (Cal CEB Annual).

Probate Code §1500 provides that either parent may by will nominate a guardian of the person, the estate, or both, for the testator's child, to take effect on the nominating parent's death. The other parent's written consent is required unless that parent is dead or incapable of consent or unless that parent's consent would not be required for an adoption of the child.

In appointing a guardian of the person, the court is governed by Fam C §§3020, 3040, relating to custody of a child. Prob C §1514(b).

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§24.5 2. Definition of "Minor" for Purposes of Guardianship

The general rule is that a minor is "an individual who is under 18 years of age." Fam C §6500. A guardian of the person may not be appointed for a minor who is married or divorced, but a guardian of the person may be appointed for a minor whose marriage has been annulled. Prob C §1515. A guardianship of the person terminates when the minor marries or is adopted. Prob C §1600(b).

Marriage is one way a minor becomes emancipated (see Fam C §7002), which means that a guardianship of the person is not necessary for a married minor. The changes in the parent-child relationship resulting from emancipation are discussed in California Guardianship Practice §§2.7-2.10 (Cal CEB Annual).

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§24.6 E. Nature of Office; Duties and Powers

The statutes, so abundant in detail on the powers and duties of guardians of the estate (see §25.6), are much less explicit about guardians of the person. The brief statutory provisions described below, read in light of the minor's dependent relationship with the guardian, generally indicate the function of a guardian of the person:

- Probate Code §2351(a) provides that the guardian of the person "has the care, custody, and control of [the minor] and has charge of [his or her] education."
- Under Prob C §2352(a), the guardian of the person may fix the minor's residence at any place in California without court permission and at a place outside California with prior court permission. When fixing the minor's residence in California, however, the guardian must select the least restrictive appropriate residence that is (1) available and necessary to meet the minor's needs and (2) in the minor's best interests.
- Probate Code §§2353 and 2357 cover the guardian's authority to consent to medical treatment for the minor.

The guardian's basic duties are to supervise the minor's daily living, including schooling, medical care, clothing, shelter, and food. Equally important, but harder to prescribe or define, are the welcome, attention, love, and other psychological benefits the guardian should provide to the minor.

With the guardian's consent at the time of appointment, the court may impose on him or her conditions providing for the minor's care, treatment, education, and welfare. Prob C §2358. In nominating a guardian of the person for a minor child, presumably the testator may set forth in the will any nonobligatory conditions that he or she may wish the court to consider imposing on the guardian. On a similar provision relating to guardians of a minor's estate, see §25.5.

A parent can expand the guardian's authority to act without court approval by the terms of the nomination by will. To the extent provided in the will, a guardian of the person has the same authority over the minor's person as a parent with legal custody of the child. Prob C §2108(a).

Both a natural person and a nonprofit charitable corporation that qualifies under Prob C §2104 are eligible for appointment as guardian of the person, the estate, or both. Although certain nonprofit corporations may act as guardians of the person, a bank or trust company cannot serve as guardian of the person. Prob C §300.

No bond need be filed by a guardian of the person unless required by the court. Prob C §2322. See also Prob C §2324 (waiver of bond by nominator).

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II. SELECTING GUARDIAN OF PERSON

A. When Testamentary Nomination Is Desirable

§24.7 1. Benefits of Parental Nomination

A parent has power to nominate a guardian of the person for minor children within the limits prescribed by Prob C §1500. See §24.4. Because the nomination of a guardian for minor children may be the most important function of a parent's will, the will drafter should discuss the question of nominating a guardian if the client has minor children, even if the client does not raise this issue. On when a guardian of the estate is needed, see §§22.3, 25.3.

A deceased parent's clear-cut expression of choice of guardian in the will, together with the naming of alternates, serves the following purposes:

- It reduces the delay in providing a guardian of the person of a minor after the parent's death;
- It spares the minor the agony of a family dispute over the appointment; and
- It allows the parent to expand or limit the guardian's authority to care for the minor.

If both parents agree on the proposed nomination before the will is executed, the surviving parent is more likely to consent to the nomination of a third person. See §24.4 on the need for the surviving parent's consent. In addition, their agreement may ensure that, if both parents die in a common disaster, their wills will not contain conflicting nominations.

Testamentary nomination is always preferable when the testator believes that an undesirable individual is likely to seek appointment as guardian at the testator's death. If the testator substantiates the reasons for the appointment in the will or other written instructions, this explanation may persuade the court to follow the testator's intent, assuming that circumstances do not radically change between the time of will preparation and the date of death.

In some situations (*e.g.,* when the client is seriously ill), it may be wise for the testator to inform the minor of the contemplated guardianship. If not too disturbing to the minor, this information may provide a reassuring sense of continuity and help the minor accept the guardianship after the testator's death.

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§24.8 2. Both Parents' Deaths

Nomination of a guardian of a minor's person protects the child in case both parents die while the child is still a minor. Although the death of both parents may seem a remote possibility to the clients, the number of automobile accidents and airplane crashes in which both husband and wife die is sufficient to warrant the nomination. Because the surviving parent is the legal guardian of the minor's person (see §24.9), the will typically provides that the nomination will take effect only if the other parent does not survive. Usually, the same person or persons are nominated in each spouse's will. For a clause designed for this situation, see §24.20.

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§24.9 3. One Parent's Death

When one parent dies, the surviving parent normally has the right to the custody of any minor children. Thus, there is no need to name the surviving spouse as guardian of the person in the will. An attempt by the predeceasing parent to name a third person guardian of the person of the children will not be effective if the surviving parent does not consent (unless the surviving parent is incapable of consenting or consent would not be required for an adoption of the child; see Prob C §1500, discussed in §24.4), although the deceased parent's nomination of another person allows the nominee to bring a petition before the court.

Even if the parents' marriage has been dissolved and the judgment gave custody to the deceased spouse, a surviving parent who is otherwise competent and qualified has the right to custody. *Bell v Krauss* (1915) 169 C 387, 146 P 874. See 10 Witkin, Summary of California Law, *Parent and Child* §194 (10th ed 2005).

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§24.10 4. Nonparent Cannot Nominate

Under Prob C §1500, only a "parent" of the minor has the authority to nominate a guardian of the minor's person. See §24.4. Presumably, an adoptive parent would come within the purview of §1500. See Fam C §8616. Apparently, no other person has this authority.

Thus, the guardian of the person of an orphan could not nominate in his or her will a guardian for the child unless the guardian had legally adopted the child. A court might honor such a nomination, however, even though it is not authorized under the Probate Code.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.11 5. Appointment of Same Individual as Guardian of Person and of Estate

§24.11 5. Appointment of Same Individual as Guardian of Person and of Estate

The question often arises whether the guardian of the person of a minor should be appointed guardian of the estate as well. Because their functions and qualifications are entirely different, a clear separation between guardians allows each to carry out his or her duties more effectively. If the bulk of the estate is in the hands of a trustee, however, the guardian of the person may be appointed guardian of the estate for small amounts of property that may come into the minor's possession.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/ B. Choice of Guardian/§24.12 1. Choice Often Limited

B. Choice of Guardian

§24.12 1. Choice Often Limited

Ideally, the parent selecting a guardian of a minor child should be able to choose from a wide range of desirable persons. In practice, however, the parent usually considers no more than two or three persons as suitable possibilities. The range of choice may be further limited by the fact that some potential nominees may be unwilling to accept the responsibility.

The testator must balance complex factors to match the needs of minors and the qualifications of prospective guardians. Some of these factors are discussed below:

- Both the minor and the testator should have confidence in the selected individual, who should exhibit a genuine interest in the minor's welfare through a family relationship or personal friendship with the minor.
- Although age does not determine a person's fitness to be a guardian, the testator should consider whether a particular candidate has the necessary maturity, experience, temperament, patience, and stamina to undertake the responsibilities of guardian. Nominating grandparents as guardians of a minor's person is generally inadvisable because (a) they may be too old to handle the responsibility of young children and (b) selecting one set of grandparents may upset the other grandparents and create difficulty for the minor. Potential problems between the minor and the nominee's children should also be considered.
- The nominee should have some understanding of the emotional problems of children who have lost one or both parents, or the nominee should be willing and able to obtain skilled guidance.
- Integrity and stability are essential qualities in a guardian of the person because the individual selected will have close contact with and great influence over the minor.
- A married person is usually nominated as guardian of the person of a minor. Because a nominee's stable marriage can help create a peaceful and secure environment for the minor, some clients require that the nominee be married and living with his or her spouse at the time of the testator's death. See Comment to form 24.20-1. A change in marital status, however, does not always make the person unacceptable to the client; a widowed or divorced nominee may still be a satisfactory guardian. On the need for periodic review of the choice of guardian, see §24.18. On the nomination of husband and wife as coguardians, see §24.16.
- Children deprived of their parents may derive a sense of security from remaining with their brothers and sisters. If the testator has more than one child, the guardian should be capable of assuming the care of all, if possible.
- The nominee should be willing and able to give the minor a financial, social, moral, and religious upbringing similar to that which the testator would have provided. On making financial provisions, see §24.19.
- If the testator will not be able to provide sufficient funds to cover the minor's care throughout the period of guardianship, the nominee should be in a financial position to meet the increased expenses of the addition of the minor to his or her household. See §24.19.
- The nominee should have no conflicts of interest with the minor. See §25.9.
- If the testator wants the guardian to adopt the minor, the nominee should be someone who is willing to do so. But see §22.5 on the possible effects of adoption on the availability of guardianship funds for the minor's support.
- The testator should consult the nominee in advance to ascertain whether he or she is willing to serve as guardian. Alternates or successors (see §24.15) should also be consulted. If reciprocal arrangements are made between siblings and in-laws, the parties should consult with one another to confirm the arrangements.

Many of the factors listed above are of less importance in the selection of a guardian of the estate than a guardian of the person. For example, the testator may want one of his or her siblings to be the guardian of the person because of age and the presence of other children in the home but prefer to name one of the child's grandparents as guardian of the estate because of the grandparent's ability and authority to make financial decisions. In that case, age and stamina are less important than experience and family respect.

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§24.13 2. Nomination of Nonresident

Because many Californians have moved to the state relatively recently, nominees for guardian are often nonresidents of California. Nothing in statute or case law requires a guardian of a minor to be a resident of California. In many instances, placing the minor with close relatives in another state may serve the minor's interests better than placing him or her with strangers in California.

If the nominated guardian does not reside in California, the testator may suggest that the nominee petition for appointment in his or her resident state and petition in California only if this procedure is "necessary and convenient" (which is the standard for appointment of a guardian under Prob C §1514(a)). In most cases, California appointment is neither necessary nor convenient for nonresident nominees. Because California courts should give effect to foreign letters of guardianship in cases without unusual circumstances, the guardian can avoid the potential cost and delay of separate California guardianship proceedings. In cases with unusual circumstances, however, the nominee should petition for appointment in California. The superior court is likely to appoint the guardian nominated by the minor's parent or parents if the court's requirements have been satisfied. See *Guardianship of Levy* (1955) 137 CA2d 237, 290 P2d 320; *Guardianship of Boutz* (1938) 24 CA2d 644, 76 P2d 154. See also California Guardianship Practice, chap 5 (Cal CEB Annual).

Form 24.21-1 provides for both circumstances. Because the testator's suggestions are not binding on the nominee, this clause will not prevent a nonresident nominee from petitioning for appointment first in California.

For discussion of the law on nomination of nonresident guardians of the person, see 14 Witkin, Summary of California Law, *Wills and Probate* §918(b) (10th ed 2005).

Problems relating to nonresident guardians of the estate are discussed in §25.12.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.14 3. Compatibility With Guardian of Estate or Trustee

§24.14 3. Compatibility With Guardian of Estate or Trustee

A different individual or an institution may be appointed guardian of the minor's estate or may be established as trustee of a trust for the minor's benefit. When such arrangements are made, the guardian of the person should be able to cooperate with the financial or property managers.

On appointing the same person as guardian of both the person and the estate, see §25.10.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.15 4. Alternates and Successors

§24.15 4. Alternates and Successors

Alternate and successor guardians should be nominated in case:

- The first-named nominee dies or becomes unable or unwilling to serve before appointment; or
- The first appointee, after qualifying and beginning to serve, dies or becomes unable or unwilling to serve.

Usually the same persons are nominated as both alternate and successor guardians. See form 24.20-1. The term "successor guardian" is often used to refer to both alternates and successors.

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§24.16 5. Use of Coguardians

More than one person can be named as guardian of the person of a minor. Prob C §2105. The most common example is the nomination of a husband and wife to serve as coguardians. Because of the possibility of disputes between coguardians resulting from, *e.g.,* dissolution of marriage or separation, some attorneys prefer to name only sole guardians. Others believe that the spouse who is unrelated to the minor (or if neither spouse is related to the minor, the one who is less close to the minor) will react more warmly and cooperatively if named coguardian.

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§24.17 6. Special Instructions

In addition to choosing the guardian with care, the attorney and client should instruct the guardian about problems that might arise during the guardianship. For example, if the will includes specialized instructions for the minor's religious, institutional, medical, or hospital care, the attorney and client should explain the instructions during a personal conference with the guardian to ensure that the client's wishes are understood and followed. Written instructions agreed on and prepared at the conference are preferable to later memoranda that may differ from the instructions discussed by the parties.

See §24.7 for discussion of expansion of the guardian's powers under Prob C §2108(a).

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§24.18 7. Need for Frequent Review of Choice

The testator should review the choice of guardian of the minor's person frequently, perhaps as often as every two or three years. The testator may conclude that another guardian is more appropriate after assessing changes in the minor's needs and problems; the nominee's personal, financial, and marital situation; and the degree of friendship among the testator, the nominee, and their respective families.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.19 C. Financial Provisions for Guardianship of Person

§24.19 C. Financial Provisions for Guardianship of Person

When nominating a prospective guardian, the testator must consider the financial impact of the guardianship on the minor, the guardian, and his or her family. There are three possible financial arrangements:

(1) The testator provides adequate financial resources for the guardian to care for the minor;

(2) The guardian, although under no legal duty to do so, uses personal resources to support the minor; or

(3) The minor relies on public benefits for support, *e.g.,* Temporary Assistance to Needy Families (TANF).

The testator should attempt to provide sufficient funds to cover the costs of the minor's care throughout the guardianship and the costs of administering the guardianship, including court costs, attorney fees, and guardian fees and expenses. See Prob C §2623. If the testator's estate is not adequate to pay these expenses, the drafter should discuss with the testator the advisability of increasing the funds that will be available for the minor's support. The drafter may wish to consult competent life insurance advisers at this point in the planning. If the testator cannot or will not purchase enough insurance to cover the expenses of guardianship, the guardian of the minor's person may have to take financial responsibility for the minor.

In addition to providing funds for expenses directly or indirectly attributable to the guardianship, the testator is well advised to authorize payments to assist the guardian and his or her family. If the guardian is less affluent than the testator, the testator's provision for the minor may result in unequal treatment of the minor and the guardian's children. Even if the guardian's financial resources are the same or greater than the testator's, a reversal in the guardian's finances could create a similar economic disparity during the guardianship. For an illustrative clause, see §22.26.

Unless the guardian has an independent duty of support as the minor's parent or adoptive parent, the guardian of the minor's person has no legal duty to pay for the minor's care or education out of the guardian's own property. See California Guardianship Practice §11.1 (Cal CEB Annual). Nevertheless, as a practical matter, a guardian sometimes finds it necessary to use his or her own resources if the minor's resources are insufficient. This could stimulate resentment against the minor's presence in the family if it results in economic deprivation for the guardian and his or her family.

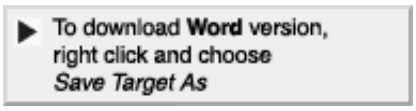
The financial impact on the guardian of taking responsibility for the minor may exceed the direct expense of caring for the minor and his or her estate. For instance, the addition of two or more small children to a family may require the remodeling of the family residence or the hiring of household help. If funds are available, the will drafter may wish to discuss with the testator the advisability of permitting payments to the guardian for these purposes. See form 24.23-1.

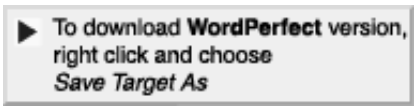
If the testator has placed the minor's financial matters in the hands of a trustee, it may be advisable to instruct the trustee to accept all statements of the guardian of the person regarding the beneficiary's needs, thus relieving the trustee of the responsibility of verifying the guardian's statement or the application of the funds.

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III. NOMINATING GUARDIAN OF PERSON

§24.20 A. Form: Nomination of Guardian of Person





24.20-1 Nomination of guardian of person

If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

Comment: The testator may condition the guardian's appointment on factors that the testator considers important, *e.g.,* that the nominee is living with the spouse to whom the nominee was married when the will was executed.

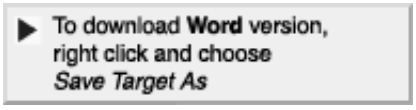
This clause can be adapted for the nomination of coguardians (see §24.16). See §24.15 for discussion of alternate and successor nominees. For a clause nominating a guardian of the estate only, see form 25.15-1.

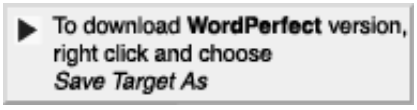
See §24.6 for discussion of bond.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.21 B. Form: Nomination of Nonresident Guardian of Person

§24.21 B. Form: Nomination of Nonresident Guardian of Person





24.21-1 Nomination of nonresident guardian of person

If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

I request that the nominee petition for appointment by the Court of competent jurisdiction in the State of _ _[*name of state*]_ _, or in any other state in which the nominee then resides, and that letters of guardianship and any other necessary documents be filed with the Superior Court of the State of California in which the administration of my estate may be pending. I request that the Court, on petition of the nominee, grant the nominee custody of my minor children and permit the guardian to change the residence and domicile of the children to the state where the guardian may then reside.

If it is necessary or convenient for the guardian of my minor children to be appointed by the Superior Court of the State of California, I nominate the individual identified above for appointment as guardian and request the Court to appoint the nominee, grant the guardian custody of the children, and permit the guardian to change the residence and domicile of the children to the state where the guardian may then reside.

Comment: See §24.13.

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Source: Estate Planning/California Will Drafting/24 Guardianships of Person/§24.22 C. Form: Authorization of Parental Authority Under Prob C §2108(a)

§24.22 C. Form: Authorization of Parental Authority Under Prob C §2108(a)

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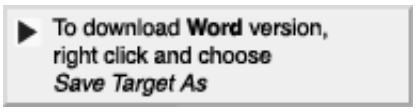
24.22-1 Authorization of parental authority under Prob C §2108(a)

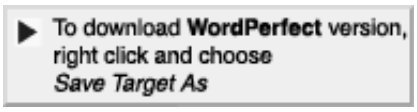
I give the guardian of the person of my children the same authority over the person of my child as a parent having legal custody of a child and authorize the guardian to exercise the power without the need for notice, hearing, Court authorization, instructions, approval, or confirmation in the same manner as if the authority were exercised by a parent having legal custody of a child. I request that no additional bond be required because of the grant of these independent powers.

Comment: See §24.7 for discussion of authorization of parental authority under Prob C §2108(a).

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§24.23 D. Form: Special Estate Distributions





24.23-1 Special estate distributions

I desire that the care and responsibility of my minor children not create any financial or physical burden on the guardian of the person and the guardian's family. Accordingly, I authorize and encourage the guardian to request expenditure of funds from the guardianship estate established for my minor children for such purposes as remodeling and additions to the guardian's residence, additional household help, nurses, and child day care. The guardian of the estate shall liberally distribute such funds as support and maintenance for the children, subject to any necessary Court approval.

Comment: See §24.19.

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25

Guardianships of Estate

Robert A. Schlesinger

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I. ROLE OF GUARDIAN OF ESTATE

§25.1 A. Management of Minor's Estate

As discussed in chap 22, a testator who intends to leave property by will to a minor should arrange for distribution of the property to a trustee, custodian, or guardian of the estate. See §22.4. This chapter discusses (1) third party management of a minor's estate through guardianship of the estate and (2) nomination of the guardians of the estate and of the property. See §§25.4-25.14.

For clauses for the nomination of guardians, see §§25.15-25.18.

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§25.2 B. Nature of Guardianship

A guardianship of the estate allows a parent to nominate someone to manage and control the minor's property until the minor reaches age 18. See Prob C §2401. Closely related is a guardianship for property that a minor receives from or by designating a third person, including property received by testamentary gift. Prob C §§1501, 2108(b). Because a guardian of the property has powers and duties similar to those of a guardian of a minor's estate (see Prob C §2109(a)), this chapter often uses these terms interchangeably. Although there is no legal alternative to guardianship of the person (see §24.2), which is an essential and useful tool, a guardianship of the estate has many unsatisfactory aspects. Most drafters consider the alternatives to guardianship of the estate, particularly trusts and custodianships, to be superior vehicles for handling a minor's property.

For a comparative discussion of testamentary trusts, custodianships, and guardianships as methods of managing a minor's property, see chap 22.

As discussed in §24.3, the drafter must coordinate the financial arrangements made for the minor with other provisions in the will that affect the minor.

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Source: Estate Planning/California Will Drafting/25 Guardianships of Estate/§25.3 C. When Nomination of Guardian Is Desirable

§25.3 C. When Nomination of Guardian Is Desirable

Because a guardianship of the estate is subject to the ongoing supervision of the probate court and terminates when the child reaches age 18 (Prob C §1600), it is a cumbersome device with many disadvantages. Whenever provision will be made for a minor in the will, the thoughtful drafter should discuss with the testator the use of a testamentary trust or custodianship as an alternative to guardianship of the estate. For a comparison of trusts, custodianships, and guardianships, see §§22.5-22.15.

Nevertheless, the client may insist on a guardianship because, *e.g.,* he or she does not understand the trust provisions, objects to the length of a trust, or prefers the comparative rigidity and court supervision demanded of guardianships. In addition, no satisfactory substitute for a guardianship may be available. For example, the estate may be too small to be accepted by corporate fiduciaries (see §22.12), and the only individuals willing to act as trustees may be reluctant to assume trust obligations because they do not understand the trust form or are unwilling to exercise discretionary powers. In such situations, if the minor is a person for whom the testator is entitled to nominate a guardian by will (see §25.4), testamentary nomination is usually preferable to leaving the choice of guardian to the survivors after the testator's death.

Even if a trust or custodianship is established, a guardianship of the estate may also be necessary if:

- The minor will receive property in the future. For instance, the testator may be the life tenant under a testamentary trust that will be distributed outright at death to his or her issue regardless of the issue's age. In this circumstance, there may be no alternative to a guardianship, because the arrangement has taken form irrevocably.
- A gift by a third person is made directly to the minor, rather than in trust or under the California Uniform Transfers to Minors Act (Prob C §§3900-3925).
- A claim by or against the minor exists or can be foreseen. See Prob C §§2405-2406, 2430-2431, 2500.
- A minor is designated as a beneficiary under an insurance policy. Most insurance companies require appointment of a guardian of the estate before payment of benefits.
- Property has been placed in a minor's name under a property settlement, and a sale of the property or other action relating to it becomes necessary.

Even if no need for a guardian of the minor's estate is presently foreseeable, a prudent drafter will include a nomination in the will to provide for unforeseen contingencies. See §25.15.

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II. SELECTING GUARDIAN OF ESTATE

A. Statutory Provisions for Nomination

§25.4 1. Parent May Nominate Guardian of Estate; Nonparent May Nominate Guardian of Property

The statutory scheme for guardians of the estate is essentially the same as that for guardians of the person, as discussed in §24.4: A parent may *nominate* a person or other entity for appointment as guardian of the estate (Prob C §§1500-1501), but the nominee's actual *appointment* as guardian may be made only by the court (Prob C §1514).

Either parent may nominate by will for the testator's child a guardian of the person, the estate, or both, to take effect on the nominating parent's death. Prob C §1500. The other parent's written consent is required unless that parent is dead or incapable of consent, or unless that parent's consent would not be required for an adoption of the child.

A parent or any other person may nominate a guardian for property that a minor receives from or by designation of the nominator by will, succession, or any other arrangement. Prob C §1501. This guardian is known as a "guardian of the property," to distinguish him or her from a guardian of the general estate nominated under Prob C §1500. Like the §1500 nomination, a nomination under §1501 may be made by will. Unlike the §1500 nomination, a nomination under §1501 will be effective even if the nonappointing parent is living and has not consented to it. See *Guardianship of Joaquin* (1959) 168 CA2d 99, 335 P2d 507.

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§25.5 2. Guardian Appointed by Court; Authority May Be Expanded

The court must appoint a guardian of the estate or a guardian of the property nominated under Prob C §1500 or §1501, unless the court determines that the nominee is unsuitable. Prob C §1514(c)-(d). The court must be guided by what appears to be in the minor's best interest, taking into account the proposed guardian's ability to manage and preserve the estate as well as the proposed guardian's concern for and interest in the minor's welfare. In addition, if the minor is old enough to form an intelligent preference about the person to be appointed, the court "shall give consideration to that preference in determining the person to be so appointed." Prob C §1514(e)(2).

NOTE: The drafter must be familiar with Prob C §2108(b), which requires the court to grant a guardian nominated by will under Prob C §1500 or §1501 the right to exercise any one or more of the Prob C §2591 powers provided in the will "[e]xcept to the extent the court for good cause determines otherwise." The powers enumerated in Prob C §2591, referred to as "independent powers," include many of the standard powers typically granted to trustees. Local probate rules in many counties discourage the court's routinely granting independent powers. By including in the nomination an authorization for the guardian to exercise independent powers, the testator has considerable influence in determining to what extent independent powers will be granted.

When a guardian of a minor's estate is appointed, the court may, with the guardian's consent, impose conditions not otherwise obligatory providing for the care and custody of the minor's property. Prob C §2402. In nominating a guardian for a minor's estate, the testator presumably may set forth in the will any nonobligatory conditions that he or she may wish the court to consider imposing on the guardian. Probate Code §2358 contains a similar provision relating to guardians of the person for minors. See §24.7.

See California Guardianship Practice, chap 5 (Cal CEB Annual) for discussion of appointment of a guardian.

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§25.6 B. Nature of Office; Duties and Powers

In contrast to the lack of rules governing guardianship of the person (see §24.6), a number of statutory provisions govern the powers and duties of a guardian of the estate. See Prob C §§2400-2595.

The guardian of a minor's estate "has the management and control of the estate." Prob C §2401(a). The guardian must file an inventory and appraisement and make periodic accountings to the court. Prob C §§2610, 2620. The guardian must use the powers conferred to the extent that ordinary care and diligence require their exercise. Prob C §2401(b). See also Prob C §2401.1 (use of ordinary care and diligence to determine whether the minor owns property in a foreign jurisdiction). In exercising his or her powers, the guardian may not hire or refer any business to an entity in which he or she has a financial interest. Prob C §2401(c).

Probate Code §§2450-2467 set forth the estate management powers of guardians of estates. Certain powers dealing with routine transactions may be exercised without court authorization; others relating to somewhat more unusual transactions require court authorization. See Prob C §2450(a). On petition of the minor, a creditor, or any other interested person, or on the court's own motion, the court may limit one or more of the guardian's powers or duties. Prob C §2450(b). In nominating a guardian for a minor's estate, the testator presumably may request that the court be petitioned to restrict the guardian's duties and powers in a manner designated in the will.

Unless a third party is obligated to support the minor, the guardian must use as much of the income (and, if the income is insufficient, the principal) of the estate that is necessary for "the comfortable and suitable support, maintenance, or education of the minor." Prob C §2420(a)-(b). The guardian of the estate has no legal duty, however, to provide for the minor out of the guardian's own property unless the guardian has an independent duty of support as spouse, parent, or adoptive parent of the minor. Compare these financial arrangements with those required for guardianships of the person, discussed in §24.19.

For further discussion of the powers and duties of guardians of the estate, see California Guardianship Practice, chap 12 (Cal CEB Annual).

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Source: Estate Planning/California Will Drafting/25 Guardianships of Estate/§25.7 C. General Considerations in Selecting Nominee

§25.7 C. General Considerations in Selecting Nominee

In many respects, the criteria for choosing the guardian of the estate are different from those for choosing the guardian of the person (see §§24.12-24.18).

A corporation authorized to conduct trust business in California may be appointed guardian of the estate (Prob C §300) but may not be appointed guardian of the person, although a qualified nonprofit charitable corporation is eligible for appointment as guardian of the person under Prob C §2104. See §24.7; California Guardianship Practice §5.16 (Cal CEB Annual).

The same person may be appointed guardian of both the person and the estate. See §25.10. Coguardians (joint guardians) of the estate may be appointed if the testator desires. Prob C §2105. Form 25.15-1 may be adapted for nominating coguardians of the estate. If bond will be waived, this should be stated in the will. See form 25.18-1.

The testator should consult prospective appointees for guardians of the estate in advance to ascertain their willingness to serve. Corporate appointees should be consulted whenever the guardianship will present special problems. The testator should review the selection periodically to determine whether the nominees are still appropriate and whether each is currently able and willing to undertake the responsibility.

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§25.8 1. Experience; Corporation Versus Individual

The guardian of the estate should have a comprehensive knowledge of business and a past record of success in managing the affairs of others. The guardian must be familiar with good accounting practices and be able to keep accurate and adequate records. Most losses in guardianship estates result from honest but inexperienced or unbusinesslike relatives acting as guardians. With such guardians, even a surety bond will not be entirely satisfactory. Although the bond may protect the guardianship estate against losses attributable to the guardian, the liability for loss will remain within the same family unit because the guardian, as principal, is bound to reimburse the surety under the subrogation rule of CC §§2847-2848. An experienced corporate fiduciary is ordinarily in a far better position than an inexperienced friend or relative to anticipate problems and take advantage of benefits, including knowing when to seek legal advice and other professional help. On the selection of a fiduciary, see California Estate Planning, chap 6 (Cal CEB 2002).

In certain circumstances, a corporate fiduciary may be less successful than the testator's business partner in managing an enterprise that requires specialized knowledge. Similarly, a family member experienced in trading securities may be more capable of achieving capital appreciation for the estate than a professional trustee.

Sometimes the size of the estate determines the kind of experience necessary for the guardian of the estate. An individual may be the appropriate guardian to manage the small estate of a minor, especially because corporate fiduciaries may decline to handle small estates. Larger estates, which present more complex problems, usually require more experienced management, though guardianship of the estate is usually far less effective than a trust. See §§22.5-22.12.

The cost of administering the guardianship may be a factor in selecting a guardian. In California, corporate fiduciaries usually charge an annual fee determined by the market value of the principal or the estate's annual gross income. Individuals, especially family members, often do not charge for their work and request only reimbursement for expenses and fees of accountants, tax return preparers, and investment advisers.

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§25.9 2. No Conflict of Interest With Minor

If an individual is selected as guardian of the estate, there should be no conflict of interest between the business affairs of the prospective guardian and the minor.

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§25.10 3. Appointment of Same Individual as Guardian of Person and of Estate

In considering whether to appoint the same person as guardian of the minor's person and guardian of the minor's estate, the attorney should keep in mind not only that their functions and qualifications are entirely different but also that a clear separation of duties allows each guardian to carry out his or her duties more effectively. Nevertheless, it is a common practice for one person to serve in both capacities. Although certain nonprofit corporations may act as both guardians of the person and of the estate, separate appointments are essential if the testator will appoint a bank or trust company as guardian of the estate, because a bank or trust company cannot serve as guardian of the person. See §24.7.

If the bulk of the estate is in a trustee's hands, the guardian of the person may be appointed guardian of the estate for small amounts of property that may come into the minor's possession.

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Source: Estate Planning/California Will Drafting/25 Guardianships of Estate/§25.11 4. Compatibility With Guardian of Person and Trustee

§25.11 4. Compatibility With Guardian of Person and Trustee

If different persons will be appointed as guardian of the person and guardian of the estate, they should be able to work together harmoniously. The same is true if a trust for the minor's benefit is set up in addition to a guardianship of the estate and a person different from the guardian of the estate is appointed as trustee.

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§25.12 5. Nomination of Nonresident

Normally, a California testator will nominate a California resident or a California corporate fiduciary as guardian of the estate. Nevertheless, it appears that testamentary nomination of a nonresident person as guardian of the estate will be given effect by California courts. A nonresident guardian will probably be required to post bond, even if bond is waived in the will, and may be required to appear in California to take the prescribed oath. However, a foreign corporation (other than a national banking association authorized to conduct a trust business in California) cannot act as a guardian of the estate in California. Fin C §§1502-1503.

On nomination of a nonresident as guardian of the person, see §24.13.

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§25.13 6. Alternates and Successors

If the will nominates an individual as guardian of the estate, one or more alternates should be designated in case the first nominee dies or becomes unable or unwilling to serve before qualification. Likewise, one or more successors should be named in case the first appointee, after qualifying and beginning to serve, dies or becomes unable or unwilling to serve. Usually the same person is nominated as both alternate and successor guardian. A frequent practice is to name a corporate fiduciary as alternate and successor.

When the will nominates a corporate fiduciary as guardian of the estate, it is not necessary to nominate alternates unless there is reason to believe that the institution named may decline appointment. Likewise, it is not necessary to provide for successors in the event the selected corporate fiduciary merges or is consolidated with another entity, because successors in interest to both state and national banks become successor fiduciaries by operation of law in California. See Fin C §§2073, 2095.

Forms 25.15-1 and 25.16-1 include nominations of alternates and successors. The single term "successor guardian" is often used to refer to both successors and alternates.

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§25.14 D. Should Bond Be Required?

A corporate fiduciary acting as guardian is not required to post bond. Prob C §301. If bond has been waived by the nominator, other guardians nominated under Prob C §§1500 and 1501 need not give bond unless bond is required by the court from which the letters issue. Prob C §2324. In practice, however, courts are reluctant to dispense with bond for individual guardians of the estate.

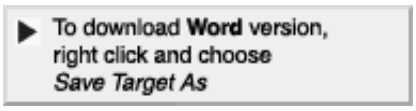
The testator may make a bond mandatory by not waiving it. More commonly, however, testators prefer to direct that no bond be required. Although it is commonly assumed that the honesty of the guardian makes a bond unnecessary and that the bond premium is an unjustified expense, neither of these assumptions may be justified. Completely honest guardians may cause losses by using poor judgment, and bond premiums are inexpensive in comparison with the insurance they provide.

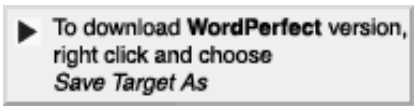
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III. NOMINATING GUARDIAN OF ESTATE

§25.15 A. Form: Nomination of Guardian of Estate





25.15-1 Nomination of guardian of estate

If my spouse does not survive me and if at my death any of my children are minors, I nominate as guardian and successor guardian of any estate of my minor child or children, in the order and priority indicated, the following:

First: _ _[*Name of guardian of estate*]_ _
Second: _ _[*Name of successor guardian of estate*]_ _

Comment: The drafter may modify this clause for an unmarried testator by deleting the first phrase concerning survival by a spouse.

The testator may condition the guardian's appointment on factors that the testator considers important, *e.g.,* that the nominee and spouse to whom the nominee is married when the will is executed are married and living together when the appointment of the guardian would otherwise be effective.

Coguardians may be nominated (see §24.16); the drafter may adapt this clause for that purpose. See §25.13 for discussion of successor and alternate nominees. For a clause nominating a guardian of the person only, see §24.20.

If the financial provisions for a testator's minor children are set up in the form of a trust, and if the trustee is empowered in the trust instrument to make payments for the minor's benefit, a guardianship of the minor's estate will probably be unnecessary. In case the need for a guardian of the estate may later arise (*e.g.,* the minor inherits property from some other source; see §25.3), the clause may be modified to address this possibility by changing the words "I nominate as guardian and successor guardian of any estate of my minor child or children" to "I nominate as guardian and successor guardian of any estate of my minor child or children for which a guardian may be required."

For a clause nominating a "guardian of the property," see form 25.16-1. For discussion of bond, see §25.14. For a clause waiving bond, see form 25.18-1.

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Source: Estate Planning/California Will Drafting/25 Guardianships of Estate/§25.16 B. Form: Nomination of Guardian of Property

§25.16 B. Form: Nomination of Guardian of Property

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25.16-1 Nomination of guardian of property

If at my death anyone who takes property from me by will or by succession is a minor, I nominate as guardian and successor guardian of any of the property the minor takes from me, in the order and priority indicated, the following:

First: _ _[*Name of guardian of property*]_ _
Second: _ _[*Name of successor guardian of property*]_ _

Comment: This clause nominates a "guardian of the property." It can be modified to apply to a parent-child situation. Unlike an appointment of a general guardian of the estate under Prob C §1500, a nomination under Prob C §1501 does not require the consent of the testator's surviving spouse. For further discussion, see §25.4.

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Source: Estate Planning/California Will Drafting/25 Guardianships of Estate/§25.17 C. Form: Authorization of Independent Powers Under Prob C §2108(b)

§25.17 C. Form: Authorization of Independent Powers Under Prob C §2108(b)

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25.17-1 Authorization of independent powers under Prob C §2108(b)

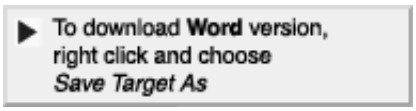
I request that the guardian of my child's estate be permitted to exercise _ _[*all the powers listed/the power to _ _*[*specify*]*_ _ as provided*]*_ _* **under Probate Code §2591 independently and without the need for notice, hearing, Court authorization, instructions, approval, or confirmation. I further request that no additional bond be required because of the grant of these independent powers.**

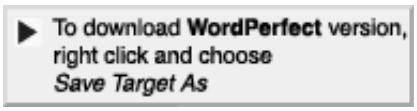
Comment: This clause is appropriate if the testator wishes the court to grant the guardian, under Prob C §2108(b), specified Prob C §2591 powers. The clause can be modified for the testator who wants the court to consider imposing on the guardian nonobligatory conditions under Prob C §2402 or to restrict, under Prob C §2450(b), one or more of the guardian's estate management duties and powers set forth in Prob C §§2450-2467. See §25.5 for further discussion.

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§25.18 D. Form: Waiver of Bond





25.18-1 Waiver of bond

I request that no bond be required of any nominee mentioned in this paragraph.

Comment: For pros and cons of waiving bond, see §25.14.

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26

Tax Payment Clauses

Clare H. Springs
Michael A. Roosevelt

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§26.1 I. ALLOCATION OF TRANSFER TAXES

Preparing the provisions of a will that allocate the payment of transfer taxes is one of the most important, technically complicated, and demanding aspects of will drafting. First, the attorney must understand all death-related transfer taxes and the statutes that apportion their burdens. Second, the attorney must apply this knowledge to help the client decide how the taxes generated by his or her death should be paid. The will of a client whose taxable estate is likely to exceed the available IRC §2010 estate tax applicable exclusion amount must address, in one form or another, how the tax burden should be apportioned among the beneficiaries of his or her estate. A will provision allocating the tax burden is unnecessary only if it is certain that there will be no tax liability (*e.g.*, all assets will pass to the client's spouse or a qualified charity) or all probate and nonprobate assets will pass to one beneficiary.

This chapter covers California and federal statutes that apportion the burden of transfer taxes, factors to consider when planning how to apportion the tax burden, and sample tax payment clauses that address the concerns and wishes of most testators. The chapter also discusses the authors' view that statutory apportionment is usually the arrangement that is most equitable and consistent with the client's wishes. The authors believe that the attorney should recommend variations from statutory apportionment only after carefully considering the client's situation.

A comprehensive treatment of tax payment clauses is beyond the scope of this chapter. Thus, for example, this chapter does not discuss the Canadian capital gains tax imposed on United States citizens or residents who die owning "capital property" located in Canada. For an extensive discussion of tax payment clauses, see Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990, chap 4 (Cal CEB 1991).

This chapter does not address the perplexing conflict-of-laws issues that may arise in relation to tax apportionment for the client with assets in several states. For discussion of those issues, see §37.26.

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§26.2 II. STATUTORY APPORTIONMENT FRAMEWORK

A number of California and federal laws determine how the various transfer taxes will be apportioned at death when the will contains no direction from the testator on this matter. For discussion of these laws, see §§26.3-26.13.

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A. Estate Taxes

1. California Statutes

§26.3 a. General Rule: Equitable Proration

California law requires "any estate tax" to be "equitably prorated among the persons interested in the estate." Prob C §20110. By "estate tax," the statute means state and federal estate taxes and interest and penalties on any deficiency. Prob C §20100(a). A "person interested in the estate" is defined as "any person … entitled to receive, or who has received, from a decedent while alive or by reason of the death of the decedent any property or interest therein." Prob C §20100(b).

For taxes to be "equitably prorated," the law requires that their burden be apportioned in the proportion that the net value of the property received by each person interested in the estate bears to the total net value of all property received by all persons interested in the estate. Prob C §§20111-20112. There is an exception for split interest devises. If a person is given an income or other temporary interest in any property (*e.g.,* in a trust), the estate tax attributable to the entire property is charged against the corpus of the property without apportionment between the temporary or income and remainder interests. Prob C §20113. This exception is not as unfair as it may appear at first. For example, the reduction of the corpus for the payment of estate taxes correspondingly reduces the income, thereby effectively amortizing any tax attributable to the income interest. Further, the exception means that an income beneficiary would not need to contribute toward payment of taxes that might exceed any income received at the time of tax payment. See Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990 §4.40 (Cal CEB 1991).

Although in many states an annuity is considered to be a temporary interest, this is not the case in California. An annuity is not a nonchargeable interest exempted from apportionment under Prob C §20113. *Estate of Steele* (1980) 113 CA3d 106, 169 CR 635. See also *Estate of Malpas* (1992) 7 CA4th 1901, 9 CR2d 806.

The values of property to be used when equitably apportioning estate taxes are the fair market values as determined for federal estate tax purposes. Prob C §20100(e). Consequently, when an alternate valuation is elected under IRC §2032, the value used is the fair market value on the alternate valuation date. Cal L Rev'n Comm'n Comment to Prob C §20100.

The California statutory concept of equitable proration means not only that tax burdens are equitably apportioned but also that tax benefits are credited to the recipients of the particular dispositions that generated them. Thus, in making a proration of estate taxes, allowances must be made for federal estate tax deductions and credits. Prob C §20112. Recipients of dispositions that generate credits or tax deductions benefit from them.

These allowances particularly benefit spouses and charities. A disposition that qualifies for the marital deduction or for a charitable deduction does not bear any portion of the taxes imposed on the estate. These allowances, however, arise in many other contexts. For example, if an election is made under IRC §2032A to qualify certain real property for a reduction in value for federal estate tax purposes, the proration will first be determined as though the election had not been made. Then the tax attributable to the IRC §2032A property will be reduced by the amount that the tax is reduced by the election. Thus, the recipient of the qualified real property will receive the benefit of the tax reduction. Prob C §20114(b). Similarly, the beneficiaries of a closely held business receive the benefit of the family-owned business deduction under IRC §2057 (repealed in 2004) and the deferral of taxes available under IRC §6166. Prob C §20115; Cal L Rev'n Comm'n Comment to Prob C §20115. On the similar treatment of distributions in satisfaction of contractual entitlements (*e.g.,* those under prenuptial agreements), see Pennell, Estate Planning 1990 §4.32.

NOTE: Not everything passing to a surviving spouse qualifies for the marital deduction. See chap 17. For example, a support allowance payable to the surviving spouse is deductible only under certain circumstances. See Reg §§20.2056(b)-1, 20.2056(c)-2. Thus, if the surviving spouse receives a large family allowance for an extended period, a substantial tax may be generated. The attorney and client should consider how they would like that tax

to be paid. See §26.34.

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§26.4 b. Effect of Express Directions of Decedent

California apportionment statutes (Prob C §§20100-20117) do not apply under Prob C §20110(b)(1) if the decedent

> in a written inter vivos or testamentary instrument disposing of property specifically directs that the property be applied to the satisfaction of an estate tax or that an estate tax be prorated to the property in the manner provided in the instrument.

In short, the decedent's express written directions about how taxes should be apportioned control. An "instrument disposing of property" includes an instrument creating an interest in property or an amendment to such an instrument. Prob C §20110(b)(1).

NOTE: Although Prob C §20110(b)(1) is less than a model of clarity, it does not appear to permit an estate tax burden higher than that imposed by the apportionment statutes to be imposed by an instrument disposing of property on property not subject to disposition by that instrument. See *Estate of Reno v Commissioner* (4th Cir 1991) 945 F2d 733 (testator may not impose estate tax on entireties property under Virginia law).

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.5 c. Enforcement

§26.5 c. Enforcement

The executor has the duty to recover from all beneficiaries of nonprobate property their proportionate shares of the estate tax. Prob C §20116(a). To avoid exposing the executor unfairly to personal liability if he or she is unable to collect from a beneficiary his or her share of the estate tax, Prob C §20116(b) permits the executor to equitably prorate among the other beneficiaries the amount not recoverable. Those beneficiaries gain a right of reimbursement against the uncooperative beneficiary, which may be enforced through the executor or by a lawsuit directly against that beneficiary. Prob C §20117.

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§26.6 d. Apportionment of IRC §2032A Recapture Tax

Internal Revenue Code §2032A(c) imposes an additional tax if, within ten years after the decedent's death and before the death of the qualified heirs, the latter dispose of an interest in qualified real property or cease the qualified use of the qualified real property. Under Prob C §20114(c), this tax

> shall be a charge against the portion of the qualified real property to which the additional tax is attributable, and shall be equitably prorated among the persons interested in that portion of the qualified real property in proportion to their interests.

For a good example of how this tax is handled, see Cal L Rev'n Comm'n Comment to Prob C §20114.

If at the time of recapture the qualified real property is in trust, the additional tax cannot simply be charged to the corpus of the trust under Prob C §20113. *Estate of Libeu* (1988) 205 CA3d 1436, 253 CR 456.

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§26.7 e. Apportionment of IRC §2057 Recapture Tax

Internal Revenue Code §2057(f) imposes an additional tax if, within ten years after the decedent's death, the qualified heirs dispose of the qualifying family-owned business, cease to participate materially in the business, lose United States citizenship, or move the principal operation of the business outside of the United States. The recapture tax continues to apply, although the deduction does not apply to estates of decedents dying after December 31, 2003. IRC §2057(j). Unlike Prob C §20114(c), however, which deals with the proration of the similar additional tax under IRC §2032A, no such California apportionment statute has been enacted relating to the IRC §2057 additional tax. See §26.6.

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§26.8 2. Federal Rights of Reimbursement

Technically speaking, there are no federal apportionment laws. The estate and its personal representative are always initially liable to pay all estate taxes. IRC §2205. In four specific situations, however, federal law grants certain individuals or the estate the right to be reimbursed for a portion of the taxes paid. See §§26.9-26.12.

California law defers to these reimbursement rights. See Prob C §20110(b)(2). For the most part, the federal rights are consistent with California's preference for equitable apportionment.

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§26.9 a. Reimbursement for Tax on Insurance Proceeds

Internal Revenue Code §2206 provides:

> Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate. If there is more than one such beneficiary, the executor shall be entitled to recover from such beneficiaries in the same ratio.

This statute gives the personal representative the right to collect from every beneficiary of life insurance proceeds his or her proportionate share of the estate taxes attributable to these proceeds.

A specific exception is made for a surviving spouse. No reimbursement right is created to the extent that the life insurance proceeds qualify for the marital deduction. IRC §2206. This exception is consistent with California's concept of equitable proration. Prob C §20112. See §26.3. No similar exception is carved out for proceeds that qualify for a charitable deduction, but none is necessary because insurance proceeds payable to a qualified charity do not generate any tax liability.

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§26.10 b. Reimbursement for Tax on Power of Appointment Property

Using language virtually identical to IRC §2206, IRC §2207 gives the personal representative the right to recover from the beneficiary of property included in the gross estate under IRC §2041 (*i.e.,* property over which the decedent had a general power of appointment) that portion of the estate tax attributable to this property. If there is more than one beneficiary, the personal representative is authorized to recover from each his or her proportionate share of the taxes attributable to the power of appointment property. IRC §2207. Internal Revenue Code §2207 also provides an exception for the surviving spouse. No right of reimbursement is available to the extent that the property subject to the general power of appointment qualifies for the marital deduction. Internal Revenue Code §2207 presumes that life insurance proceeds receivable by the surviving spouse first qualify for any available marital deduction, with the power of appointment property consuming any excess of the amount of the marital deduction over the amount of qualifying insurance proceeds. Like IRC §2206, IRC §2207 does not create a similar exception for charities, although no exception is necessary.

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§26.11 c. Reimbursement for Tax on Qualified Terminable Interest Property (QTIP)

The most significant of the federal reimbursement rights is codified in IRC §2207A. Under this provision, the increase in estate tax attributable to the inclusion of qualified terminable interest property (QTIP) in the surviving spouse's estate may be recovered by the surviving spouse's personal representative from the person receiving the property. IRC §2207A(a)(1). For discussion of qualified terminable interest property and trusts, see chap 19.

This reimbursement right is significant because it often results in a greater than prorata share of the surviving spouse's estate taxes being imposed on recipients of the qualified terminable interest property. Because the executor is entitled to recover the incremental tax caused by inclusion of the qualified terminable interest property, IRC §2207A requires reimbursement from the QTIP trust at the highest marginal estate tax rates. Further, IRC §2207A permits recovery of incremental taxes without benefit of deductions or credits available to the estate as a whole. This is in contrast to IRC §§2206 and 2207, which effectively prorate all deductions and credits among all takers. Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990 §4.19 (Cal CEB 1991).

Interest and penalties attributable to the qualified terminable interest property are subject to the incremental right of reimbursement. IRC §2207A(d). This has no counterpart in IRC §§2206 and 2207.

Internal Revenue Code §2207A does not provide for prorata recovery from multiple recipients of qualified terminable interest property. Instead, it provides that the personal representative may recover part or all of the incremental tax from any recipient. IRC §2207A(c).

The dictates of IRC §2207A(a)(1) may be modified if the surviving spouse directs otherwise in his or her will or revocable trust. IRC §2207A(a)(2). See §26.19. The person who established the QTIP trust, however, is not authorized by IRC §2207A(a) to modify its recovery language, and in any event such language may be considered part of the revocable trust, and not binding on the surviving spouse. Nevertheless, if only as a directive to the surviving spouse, the QTIP trust might provide for a more equitable proration. For example, it could specify that if the surviving spouse's gross estate includes QTIP property, for which the predeceased spouse received a marital deduction, a share of the federal estate tax on the surviving spouse's estate must be apportioned against the QTIP property (or its distributees) on a prorata basis, computed without allocation of the surviving spouse's applicable credit amount. The full benefit of the surviving spouse's applicable credit amount would be allocated ratably among the other assets of the surviving spouse's gross estate that are subject to the apportioned tax burden.

PITFALL: The failure to assert the IRC §2207A right of reimbursement constitutes a gift from the beneficiaries of the spouse's estate to the beneficiaries of the qualified terminable interest property. Treas Reg §20.2207A-1(a)(2). This failure does not result in gift tax liability, however, if the surviving spouse's will waives the right of reimbursement. Treas Reg §20.2207A-1(a)(3).

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.12 d. Reimbursement for Tax on IRC §2036 Property

§26.12 d. Reimbursement for Tax on IRC §2036 Property

If property is included in a decedent's gross estate under IRC §2036 (relating to transfers with retained life estates), the decedent's estate is entitled to recover from the recipient of the property the share of the estate tax attributable to this property. IRC §2207B(a)(1). This right of reimbursement constitutes a proportionate entitlement like that under either IRC §2206 or IRC §2207 and not an incremental entitlement like that under IRC §2207A.

Like IRC §2207A, IRC §2207B includes penalties and interest attributable to the tax in the amount subject to reimbursement (see IRC §2207B(c)) and entitles the estate to be reimbursed partly or wholly from any one of the recipients of IRC §2036 property (see IRC §2207B(b)).

As with the other federal rights of reimbursement, the decedent may alter the dictates of this statute by provisions in his or her will. Unlike IRC §§2206 and 2207, but like IRC §2207A, IRC §2207B permits the decedent to express contrary wishes in a revocable trust document instead of a will. IRC §2207B(a)(2). It is not yet clear whether a failure to waive and assert this right of reimbursement will result in a gift of the type imposed under IRC §2207A.

NOTE: This right of reimbursement makes no exception for surviving spouses with respect to the marital deduction. No general exception is created for property qualifying for a charitable deduction either, but IRC §2207B(d) does provide that no right of reimbursement lies against any qualified charitable remainder trust.

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§26.13 B. Generation-Skipping Transfer Tax

Federal law controlling apportionment of the generation-skipping transfer (GST) tax is contained in IRC §2603. First, IRC §2603(a) specifies who is liable for the tax:

- In the case of a taxable distribution, the transferee is liable. IRC §2603(a)(1).
- In the case of a taxable termination or direct skip from a trust, the trustee is liable. IRC §2603(a)(2).
- In the case of a direct skip other than one from a trust, the transferor is liable. IRC §2603(a)(3).

Second, IRC §2603(b) provides that, regardless of who is liable for the tax, it will be charged to the property constituting the generation-skipping transfer. This provision does not apply, however, if other directions are made in the governing instrument. IRC §2603(b). These directions must include a "specific reference" to the GST tax. IRC §2603(b). Thus, a general tax apportionment clause charging "all death taxes" against the residue will not change the statutory scheme of apportionment of the GST tax.

For a number of interpretive questions likely to arise under IRC §2603, see Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990 §4.23 (Cal CEB 1991). See chap 15 for complete discussion of the GST tax.

Probate Code §§20200-20215 codify California law on apportionment of the GST tax. This law does not preempt federal law on the subject. Prob C §20210(b)(2). Because the California provisions apportioning the GST tax essentially adopt the concept of equitable proration, they are very similar to the California provisions apportioning estate taxes. Compare Prob C §§20200-20215 with Prob C §§20100-20117. In general, proration is made in the proportion that the value of the property received by each transferee bears to the total value of all property received by all transferees. Prob C §20211. Under Prob C §20210(b)(1), these proration provisions do not apply if the transferor specifically directs that the GST tax be prorated in the manner provided in the written instrument transferring the property. See §26.3 on equitable proration of estate tax.

This chapter does not discuss apportionment issues specifically related to the GST tax. For discussion of those issues, see §15.58.

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III. FACTORS TO CONSIDER IN PLANNING FOR APPROPRIATE TAX PAYMENT PROVISIONS

§26.14 A. Fairness of Statutory Apportionment Rules

The most reasonable way to apportion transfer tax burdens usually is the manner dictated by existing California and federal law. See §§26.3-26.13. Statutory apportionment assigns to each beneficiary the responsibility to pay that portion of the taxes generated by the property received by the beneficiary. The fairness of such an apportionment scheme is apparent. Statutory apportionment should not be recommended or selected, however, without considering the problems it might engender for the client's estate. See §§26.15-26.21, 26.29-26.30.

This chapter does not discuss apportionment issues specifically related to the generation-skipping transfer tax. For discussion of those issues, see §15.58.

If the attorney and client select statutory apportionment as the method of tax allocation to be used, it is good drafting practice for the will to make this clear. See §26.34. A statement in the will to that effect will eliminate any ambiguity about the testator's intent concerning the allocation of tax burdens.

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§26.15 B. Gifts of Illiquid Assets

The statutory apportionment scheme of equitable proration may cause problems for a beneficiary of illiquid assets. Unless the beneficiary has personal funds with which to pay his or her share of the taxes, the assets will have to be sold. The testator may not have desired this result. If the testator gave the illiquid assets (*e.g.,* family heirlooms) to the beneficiary for sentimental reasons, selling the assets for tax purposes will defeat the testator's intent. In addition, assets that are difficult to sell (*e.g.,* limited partnership shares) may increase administrative problems for the executor or beneficiary.

To alleviate these problems, some testators give a cash gift (either from the probate estate or through nonprobate means) to the beneficiary of the illiquid assets to cover that beneficiary's share of the taxes. This solution raises problems of its own because the testator must make fairly accurate projections not only of the cash available in his or her estate at the time of death but also of the extent of the tax burden on the illiquid assets and on the additional cash gift. A reasonable forecast of tax liability is particularly elusive when younger clients and assets that may fluctuate widely in value (*e.g.,* retirement plans) are involved.

Other testators exempt the illiquid assets from any responsibility for transfer taxes, letting the full tax burden fall on the estate's liquid assets. For the testator who wishes to make small gifts of personal items to several beneficiaries with the residue being distributed to one or more primary beneficiaries, this is often the best tack to take. The liquid assets in the residue are charged with all the taxes attributable to the probate estate so that the recipients of the personal items can receive them intact and at no tax cost. But see §§26.22-26.28 on risks to consider before charging the residue with the responsibility for payment of all transfer taxes.

On illiquidity and federal reimbursement rights, see §§26.8-26.12. On collection problems that may arise when illiquid assets generate taxes, see §26.16.

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§26.16 C. Collection Problems

Statutory apportionment of transfer taxes sometimes leads to collection problems for the executor. If there are beneficiaries of nonprobate property, the executor must rely on them to provide the funds to the estate for their share of the taxes. Uncooperative beneficiaries must be compelled to pay. See §26.5. The executor's problems may be compounded if the uncooperative beneficiaries reside in other states. Further, if the probate estate is not able to pay the taxes when they are due, the executor will have to try and borrow the needed funds to avoid the imposition of interest and penalties.

These problems should be particularly considered by the client who has reason to believe that a nonprobate beneficiary will not cooperate with the executor. A good example of such a client is one designating life insurance proceeds to a former spouse under a marital property settlement.

Even if there are no nonprobate beneficiaries, collection problems may not be completely avoided. An audit of the estate tax returns after the estate has made final distributions may result in additional tax liability over what the executor has retained as a reserve. If an audit does not result in additional tax liability, it may nevertheless trigger a readjustment of the apportionment of the taxes paid (*e.g.,* if some of the estate assets are revalued). In either case, the executor is faced with the unenviable task of getting funds from beneficiaries. Of course, these collection problems may be avoided only in an apportionment scheme that allocates all tax burdens to one beneficiary who happens to be the executor. Statutory apportionment tends to exacerbate such problems, however, because it often results in many beneficiaries being collectively responsible for the tax liability.

The client who wishes to help the executor avoid these collection problems can do one of the following:

- Waive statutory apportionment and assign payment of the taxes to the residue (but see §§26.22-26.28);
- Waive apportionment only for the property being distributed to the potentially troublesome beneficiary; or
- Waive apportionment with respect to changes produced by an audit and assign any additional tax liability to the residue.

These options, however, have significant drawbacks. All of them result in an apportionment scheme less fair than the statutory one. See §26.14. Unless the taxes charged to other beneficiaries reduce the devise to the troublesome beneficiary, the second option even rewards the beneficiary for being troublesome. The third option will influence every exercise of discretion the executor must make about the state and federal estate tax returns. Because of these drawbacks, many attorneys rely instead on the executor to maintain an adequate reserve for taxes.

NOTE: Under IRC §§2206, 2207, 2207A, and 2207B, the estate first pays the tax liability and then is entitled to reimbursement. See §§26.8-26.12. This frequently means a significant risk of collection problems for the estate. This risk is higher if multiple beneficiaries receive illiquid property.

The attorney should consider ways to relieve the estate from its responsibility to advance the taxes attributable to property subject to these reimbursement rights. For example, if IRC §2207A is involved, the attorney may be in a position to draft into the qualified terminable interest property (QTIP) trust document a clause requiring the trustee to pay the trust's incremental share of taxes to the executor of the surviving spouse's estate on demand or directly to the taxing authorities. See, *e.g.*, form 26.36-1. Fashioning a way around the reimbursement problem is especially important if the probate estate is likely to have liquidity problems that will make advancing taxes difficult or if the probate estate is simply too small to pay the taxes first.

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§26.17 D. Tax-Free General or Specific Gifts

Clients frequently wish certain general or specific gifts to be made free of any tax liability. A gift of $50,000 to a grandchild and a gift of a birthstone necklace to a favorite niece are familiar examples of such gifts. The client desires to exempt such gifts from taxes either because they comprise just a small portion of the estate, the bulk of which is given to the client's primary beneficiaries, or because they are illiquid and of sentimental value. See §26.15. Exempting such gifts from tax liability is particularly appropriate when, by statutory apportionment, they are likely to incur both estate and generation-skipping transfer (GST) taxes. In that case, not making the gifts tax free is likely to reduce them significantly. See IRC §§2001, 2641.

The tax payment provision of the will should be used to exempt these gifts from tax liability. This provision should also indicate from what source the tax attributable to these gifts should be paid. See §26.34 for a sample clause. Exempting property from imposition of the GST tax can be accomplished either in the tax payment clause of the will or in a clause dealing with allocation of the GST exemption.

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§26.18 E. Temporal (Split) Interests

The attorney and client should consider deviating from the dictates of Prob C §§20113 and 20213 when the estate plan calls for a nondeductible temporal interest with a remainder interest that qualifies for a charitable deduction. In this situation, the effect of application of statutory apportionment is to charge transfer taxes attributable to the temporal interest to the trust remainder, thereby reducing the charitable deduction and increasing the taxes for the estate as a whole. See §26.24. Although statutory apportionment usually exempts gifts that qualify for the charitable deduction from any portion of the tax burden (see §26.3), this does not occur when nondeductible temporal and charitable remainder interests are involved. Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990 §4.55 (Cal CEB 1991).

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.19 F. Right of Reimbursement From QTIP Trust

§26.19 F. Right of Reimbursement From QTIP Trust

If an estate includes a qualified terminable interest property (QTIP) trust, IRC §2207A gives the probate estate the right to recover from the remainder beneficiary of the QTIP trust the increase in estate tax liability attributable to the inclusion of the QTIP trust in the gross estate. IRC §2207A(a). Because the QTIP trust must reimburse the estate at the highest marginal estate tax rate and without the benefit of deductions or credits available to the estate as a whole, this right of reimbursement results in the QTIP trust's bearing more than its proportionate share of estate taxes. See §26.11. If the beneficiaries of the probate estate are the same as the beneficiaries of the QTIP trust, this does not pose a problem. If the beneficiaries are different, however, the client may prefer to override the statute and have the QTIP trust and the other assets comprising the gross estate each bear a proportionate share of the estate taxes.

EXAMPLE: A husband leaves $600,000 in a QTIP trust, with the income to his wife and the remainder to their child. The wife dies in 2008, leaving her own estate (after deductions) of $2,200,000 partly to their grandchild ($2,000,000) and partly to her sister ($200,000). If all the wife's unified tax credit amount is available, the total estate tax due on her death is $360,000, computed as follows:

Wife's taxable estate	$2,200,000
Value of QTIP trust	600,000
Total taxable estate	2,800,000
Tentative tax ($780,800 + 45% of $800,000; IRC §2001(c)(1))	1,140,800
Unified credit (IRC §2010(a))	(780,800)
Total tax due on wife's death	$360,000

Under IRC §2207A, the wife's estate is entitled to recover $270,000 of this tax liability from the child, computed as follows:

Wife's taxable estate	$2,200,000
Tentative tax ($780,800 + 45% of $200,000; IRC §2001(c)(1))	870,800
Unified credit (IRC §2010(a))	(780,800)
Tax due without adding QTIP trust	90,000
Total tax due	360,000
Tax without QTIP trust	(90,000)
Difference	$270,000

Thus, unless the wife's will provides otherwise, the child, who receives $600,000, will pay $270,000 in taxes and the grandchild, who receives $2,000,000, together with the sister, who receives $200,000, will pay only $90,000 in taxes. A provision in the wife's will that allocates the tax burden differently may be called for. See §26.34.

If the client wishes to shift part or all of the QTIP trust tax burden to the probate estate, the attorney should make this desire explicit in the will even though the client may prefer to trust the executor not to assert the estate's right of reimbursement. To accomplish this result, the will or revocable trust must specifically indicate the survivor's intent to waive the right of recovery (*e.g.*, by specific reference to QTIP, the QTIP trust, or IRC §2044 or §2207A). A provision directing that estate taxes be allocated pro rata between the QTIP trust and the survivor's trust may be sufficient.

Eisenbach v Schneider (Wash App 2007) 166 P3d 858. To greatly reduce the risk of any litigation regarding an estate tax apportionment issue, however, prudent practitioners should expressly mention IRC §2207A. A mere statement that taxes shall be allocated as provided "with no right of reimbursement" is not sufficient to waive the right of recovery. *Blauhorn Revocable Trust* (Neb 2008) 746 NW2d 136. If the executor does not assert the right of reimbursement and the will does not waive this right, a gift tax liability is incurred. See §26.11.

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§26.20 G. IRC §§2032A and 2057 Recapture Taxes

If an estate qualifies for IRC §2032A special use valuation, the benefit of the reduction in tax due to the reduction in value of the estate inures to the benefit of the recipient of the qualified property. Prob C §20114(b). If any disqualifying sale or act causes recapture of the tax benefit, that additional tax is apportioned against the qualified property. Prob C §20114(c). This is consistent with California's preference for equitable proration. See §§26.3, 26.6. No similar statute has been enacted, however, relating to the IRC §2057 family-owned business interest deduction. See §26.7.

The apportionment provisions under Prob C §20114 may themselves produce inequities, however. For example, assume that the qualified beneficiary's prorata share of the estate tax amounts to $76,500 and the reduction in tax due to IRC §2032A is $97,500. Under Prob C §20114(b), the entire tax liability apportioned to the qualified beneficiary is wiped out. The amount of the tax reduction unable to be enjoyed by the qualified beneficiary ($21,000) is allocated to other estate beneficiaries to avoid wasting it. If a later recapture event occurs, however, the entire recapture tax of $97,500 is apportioned to the qualified beneficiary even though other estate beneficiaries benefited from the IRC §2032A election. See Cal L Rev'n Comm'n Comment to Prob C §20114. The attorney may wish to fashion a clause that adjusts for this possible inequity.

One way to make such an adjustment is to give the qualified beneficiary the right to recover from other estate beneficiaries the amount of tax reduction not enjoyed by the qualified beneficiary. This right may be difficult to enforce, however, if the other estate beneficiaries just receive outright devises instead of interests in trust. For a sample clause, see §26.34. Another method for making such an adjustment is to give to the qualified beneficiary an amount equal to the tax savings in excess of this beneficiary's allocable share of the tax savings. The planner should consider the equities of such an additional devise if a recapture event does not occur.

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§26.21 H. Excludable Funds Under Former IRC §2039(c)

Under former IRC §2039(c), death benefits paid from an employee's retirement plan were excluded from the gross estate for estate tax purposes if certain requirements were met. One of these was the requirement that the funds would not be used to benefit the estate. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (Pub L 97-248, §245, 96 Stat 524) established $100,000 as the maximum amount excludable under former IRC §2039(c) for persons dying after December 31, 1982. Former IRC §2039(g).

Even though former IRC §2039(c) was repealed by the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, §1852(e)(1)(A), 100 Stat 2868), liberal grandfather provisions compel the attorney to consider the exclusion afforded by this statute in some cases. TRA 1986 §1852(e)(3) restored the full estate tax exclusion for qualified employee benefit plan distributions to decedents who separated from service before January 1, 1983, and who did not change the form of benefit under the plan. That section also restored the $100,000 estate tax exclusion for qualified employee benefit plan distributions to decedents who separated from service before January 1, 1985, and who did not change the form of benefit under the plan. Therefore, clients who can still take advantage of former IRC §2039(c) benefits because of the grandfather provisions should seriously consider a clause in their wills prohibiting use of qualified funds for payment of estate taxes.

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.22 I. Risks of Assigning Responsibility for Tax Liability to Residue

§26.22 I. Risks of Assigning Responsibility for Tax Liability to Residue

Many attorneys routinely insert into wills a provision directing that all transfer taxes be paid from the residue of the probate estate. This is an unwise practice. The dangers of this type of tax payment clause are described in §§26.23-26.28.

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§26.23 1. Risk of Unintended Windfall to Nonprobate Beneficiaries

In part because more people are aware of the drawbacks of probate administration, more people are holding more of their assets in nonprobate form. It is no longer uncommon for a client's nonprobate assets to consist of a life insurance policy, pension benefits, tax-deferred savings plans, deposit accounts, and a residence in joint tenancy and for a client's probate assets to include primarily personal effects and some cash assets. If the tax payment clause in the will directs the residue of the probate estate to pay all transfer taxes, whether attributable to probate or nonprobate assets, the recipients of the nonprobate assets will receive a windfall and there will be a distorted effect on the client's probate estate. Further, such a clause may direct the source of payment for taxes away from the client's most liquid assets.

Whenever a tax clause that charges taxes to the residue of the probate estate is contemplated, both the attorney and client should seriously consider whether to include the taxes generated by nonprobate property. The authors recommend that the attorney illustrate to the client the effect of a tax clause that charges all taxes to the residue of the probate estate. If the tax payment clause is finally drawn to charge taxes attributable to nonprobate assets to the residue, the attorney should inform the client of the impact for tax apportionment purposes of his or her acquisition of additional nonprobate assets after execution of the will.

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§26.24 2. Risk of Reduction of Marital or Charitable Deduction

Wills often include a residuary devise intended to qualify, in whole or in part, for the marital deduction. If the will calls for transfer taxes to be paid from the residue, the deduction will be reduced under IRC §2056(b)(4)(A). A reduction of the deduction will increase the overall tax liability of the estate. In *Estate of Lurie v Commissioner* (7th Cir 2005) 425 F3d 1021, for example, a marital deduction trust that received the residue of the decedent's revocable trust became liable for substantial estate taxes when $40 million worth of irrevocable trust assets were included in the decedent's taxable estate, reducing the marital deduction and resulting in additional tax. See also *Estate of Betty Pace Miller*, TC Memo 1998-416, aff'd (5th Cir 2000) 2000-1 USTC ¶60,370, 85 AFTR2d 1047 (decided under Texas law). For a more favorable decision based on Utah law, see *Estate of John David McCoy*, TC Memo 2009-61. However, cautious practitioners should not rely on the *McCoy* decision.

A similar risk of an increase in the estate's tax liability exists if the residue includes gifts intended to qualify for the charitable deduction. If taxes are payable out of such gifts, only the net amount received by the charities is deductible by the decedent's estate. IRC §2055(c). In *Estate of Mildred Green*, TC Memo 2003-348, for example, the generation-skipping transfer (GST) tax on a direct skip to a trust for the decedent's grandchildren was charged to the share of the residue passing to a family foundation, reducing the charitable deduction and resulting in additional estate tax. See also *Estate of Silveira* (1983) 149 CA3d 604, 197 CR 121 (prorating taxes and expenses among all devisees and legatees, including charitable organizations). But see *Estate of Dionigi Brunetti*, TC Memo 1988-517 (applying California equitable apportionment statute even though the testator's will provided that estate taxes were to be paid out of the residue of the testator's estate "without apportionment" because of the presumption that equitable apportionment applies). For an unusual example of the potential danger involving state inheritance taxes on pecuniary formula gifts after the settlor of a California revocable trust moved to another state, see *In re Menchhofer Family Trust* (Iowa App, Feb. 19, 2009, No. 8-464/07-1702) 2009 Iowa App Lexis 123.

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§26.25 3. "Equalizing" Lifetime and Testamentary Gifts

If a client wants to make a testamentary gift to an individual equivalent in value to a lifetime gift to another individual, the effect of taxes must be taken into account. To achieve this result, the will or revocable trust must either (1) specifically direct that the taxes attributable to the "equalizing" gift are paid from other sources, such as the residue of the probate estate, or (2) make a larger than intended gift so that, net of tax, the devisee will receive the intended sum. Because the estate's tax liability may vary depending on the IRC §2010 applicable exclusion amount in the year of death, the former solution is generally preferred.

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§26.26 4. Risk of Unintentional Results From Failure to Consider Effect of Credits

If taxes are payable from the residue, a tax credit might lead to unexpected consequences. For example, the failure to follow equitable proration rules can work an unintended inequity with respect to the IRC §2013 prior transfer property (PTP) credit, available to the estate of a beneficiary who dies within 10 years after the testator. At the beneficiary's death, taxes paid by the testator's estate on property later included in the beneficiary's estate qualify as an IRC §2013 credit against the beneficiary's estate taxes. If in the testator's estate the taxes attributable to the property devised to the beneficiary were not charged against that beneficiary, the beneficiary's estate would enjoy a benefit generated by the payment of taxes by other individuals.

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§26.27 5. Risk of Loss of Section 303 Benefits

The dividend-avoidance benefits of IRC §303 are available only to the extent that the owner of the redeemed stock bears the burden of estate taxes and administration expenses. IRC §303(b)(3); Reg §1.303-2(g)(1). Thus, if the will directs the residue to pay "all death taxes" and stock qualifying for redemption under IRC §303 is specifically devised to a beneficiary, IRC §303 benefits will be lost.

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.28 6. Risk of Unavailability of Summary Administration

§26.28 6. Risk of Unavailability of Summary Administration

Property passing outright to a surviving spouse or registered domestic partner may do so without probate administration. Prob C §§13650-13660; Fam C §297.5(c). A problem may arise if the will (1) contains specific and general gifts to others with the residue passing to the surviving spouse and (2) directs estate taxes to be paid from the residue. If estate taxes are due, use of the summary procedures under Prob C §§13650-13660 would be restricted because it would be the executor's obligation to take possession of the residuary assets to pay such taxes before these assets could be transferred to the spouse.

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§26.29 J. Partial QTIP Election Problems

When drafting a will that includes a qualified terminable interest property (QTIP) trust, the attorney should anticipate that only a partial QTIP election may be made at the time of the testator's death. If taxes are generated by a partial QTIP election, special attention must be paid to the source designated in the will for payment of such taxes to avoid certain pitfalls.

If the taxes incurred because of a partial QTIP election are charged against the QTIP trust, the marital deduction will be reduced under IRC §2056(b)(4)(A), thereby increasing the overall tax liability of the estate. One solution to this problem may be to include in the will a direction that two identical but separate trusts be created representing the qualified and nonqualified portions of the trust in the event of a partial QTIP election. The taxes generated by the partial election could then be allocated directly to the nonqualified separate trust.

If (1) the will allocates all taxes to the bypass trust and (2) the beneficiaries of this trust are not the beneficiaries of the QTIP trust, a partial QTIP election may significantly alter the relative interests of the estate's beneficiaries in a manner inconsistent with the testator's intent. A statutory tax apportionment clause would circumvent this problem by allocating any taxes attributable to the partial QTIP election to the QTIP trust. In this event, however, the pitfall discussed in the preceding paragraph must be considered.

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§26.30 K. Disclaimer Trust Problem

The attorney should be aware that the tax result of a partial QTIP election can also be achieved by a disclaimer by the surviving spouse of part of the spouse's interest in the QTIP trust. The attorney may wish to anticipate such a disclaimer with a provision giving any disclaimed interest in the QTIP trust either to the bypass trust or to a separate trust for the surviving spouse for which the QTIP election would not be made. See §26.29. A statutory tax apportionment clause would then allocate the taxes attributable to the disclaimed assets to the assets themselves without affecting the remaining marital deduction or distorting the testator's overall dispositive plan.

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IV. TAX PAYMENT DRAFTING CONSIDERATIONS

§26.31 A. Need for Clarity in Tax Payment Clauses

The attorney must draft the tax apportionment provisions of a will clearly and unambiguously. Failure to do so may lead not only to costly litigation but also to a result inconsistent with the testator's wishes.

EXAMPLE: In *In re McKinney* (App Div 1984) 477 NYS2d 367, 369, the tax payment clause in the will provided that all taxes

> upon or with respect to property passing under this my Will, and any property passing outside of my Will, which is required to be included in the taxable estate, including that property passing by the terms of a trust created by me this date, be paid out of my testamentary residuary estate herein and that no portion thereof shall be apportioned to or collected from the specific bequests contained in this Will or from distributions made from said trust.

The will gave 30 percent of the residue to an individual and the rest to a charity "[a]fter payment of all expenses, taxes and specific bequests as aforesaid." 477 NYS2d at 369. Under New York law, unless the will directs otherwise, a charitable devise should be exonerated from any tax liability. The issue in this case was whether the will did direct otherwise, thereby permitting the estate to pay the taxes from the residue "off the top." After examining the tax apportionment clause and the residuary clause, the court found that there was no unambiguous direction from the testator and held in favor of the charitable residuary beneficiary.

For cases exemplifying the dangers of careless boilerplate tax clauses that provide that all taxes are charged to the residue without apportionment when a portion of the residue passes to charity or to the surviving spouse, which results in a lower net amount passing to the charity or spouse, a lower charitable or marital deduction, and an increase in estate tax, see §26.24.

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§26.32 B. Specifying Taxes to Be Covered by Tax Payment Clause

Particularly if the client chooses to deviate from statutory apportionment of transfer taxes, the attorney must ensure that the will clause apportioning the estate's tax burden clearly states which taxes are subject to its provisions. The clause should specify whether it is intended to include, *e.g.,* federal estate taxes, California and other state death taxes, federal and state generation-skipping transfer (GST) taxes, and the recapture taxes under IRC §§2032A and 2057.

A general reference to "all taxes due as a result of my death" is not adequate. For example, IRC §2603(b) permits a will to direct apportionment of the GST tax in a manner other than that called for by statute as long as the will makes "specific reference" to the GST tax. See §26.13.

NOTE: If the gross estate of a surviving spouse includes a qualified terminable interest property (QTIP) trust, IRC §2207A entitles the probate estate to recover from the recipients of the QTIP trust assets the incremental estate tax attributable to these assets. See §26.11. When drafting a tax payment clause for a client whose gross estate may include a QTIP trust, the attorney should be careful to avoid a clause so all-inclusive that it inadvertently exonerates the QTIP trust from any tax liability.

EXAMPLE: A decedent dies with a QTIP trust included in her gross estate. The QTIP trust was established by the decedent's predeceased husband. The decedent's marriage to that husband, which was childless, was the second for both of them. The remainder beneficiaries of the QTIP trust are the children of the first marriage of the predeceased husband. The beneficiaries of the decedent's will are her children by her first marriage. If the decedent's will includes a tax payment clause making her probate estate responsible for all death taxes, the result will be the allocation of the QTIP trust tax burden to the decedent's probate estate. The children of the predeceased husband's first marriage will benefit at the expense of the decedent's own children, a result which is probably inconsistent with the decedent's wishes.

This is not to suggest that a tax payment clause in a surviving spouse's will should never shift the QTIP trust tax burden to the estate. If, for instance, the estate and the trust have identical beneficiaries and the trust contains illiquid assets, failing to reassign the tax burden imposed by IRC §2207A may cause serious administrative burdens. Such a shift in the tax burden, however, should never be the inadvertent result of a poorly drafted tax clause. On shifting at least part of the QTIP trust tax burden to the probate estate, see §26.19.

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§26.33 C. Coordination of Tax Payment Clauses in Estate Plan Documents

Many clients' estate plans now include a will and a revocable trust. The attorney drafting a tax payment clause of a will for a client who also has a revocable trust must ensure that the tax payment clauses of both documents are consistent. Inconsistent clauses combined with different beneficiaries are an invitation to litigation.

Precisely how the attorney achieves this consistency depends on the particulars of each case. One common situation is that of a client most of whose assets are in trust. In this case, many attorneys draft the will to "pour over" probate estate assets into the trust (see chap 8) and design the trust to contain the basic tax payment instructions. These attorneys draft the will's tax payment clause simply to direct (1) that the trustee pay the taxes according to the terms of the trust and (2) that, if the trust cannot pay some or all of the taxes, the executor pay them according to the trust's terms. See form 26.35-1.

Another common situation is that of a client with one or two assets in trust and the rest subject to distribution by the will. If statutory apportionment is desirable and liquidity is not a problem, both the trust and the will should contain parallel provisions directing apportionment according to law. To minimize the risk of a collection problem (see §26.16), the trust instrument should also direct the trustee to pay the trust's share of the taxes to the executor or directly to the taxing authorities.

If a deviation from the federal reimbursement rules under IRC §2206 or §2207 is contemplated, the attorney should bear in mind that a deviation will be enforced only if it is provided for in the testator's will. See §§26.9-26.11. A direction in the testator's living trust is not sufficient. If a deviation from IRC §2207A or §2207B is intended, the attorney should remember that, although a direction in a will or living trust is permissible, to be effective it must specifically indicate an intent to waive any right of recovery and not merely direct that all taxes be paid by the estate. See §26.12.

The need to coordinate tax clauses applies not only to the client who has established a will and trust but also to the client who is a beneficiary of a trust created by another person. The client may possess interests in or powers over such a trust that cause some or all of its assets to be taxable in the client's estate. All trust instruments affecting the client should be carefully reviewed by the attorney to eliminate the possibility of unexpected tax surprises.

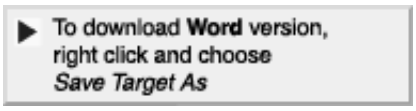
For further discussion of coordination of multiple tax clauses, see Drafting California Revocable Trusts, chap 15 (4th ed Cal CEB 2003).

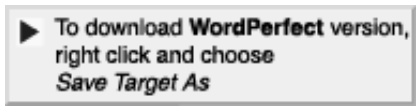
NOTE: For trusts that are intended to escape taxation (*e.g.,* irrevocable life insurance trusts), the attorney should include a safety valve tax clause specifying that, if any part of the trust is includable in the grantor's estate for reasons independent of the provision, the taxes attributable to this inclusion should be paid from the trust. For this clause to be effective, the grantor's will expressly should not waive apportionment with respect to the trust. Additionally, the tax clause might authorize the trustee to buy assets from or lend money to the grantor's estate. This would ease any liquidity problems encountered by the estate.

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V. SAMPLE TAX PAYMENT CLAUSES

§26.34 A. Form: Statutory Apportionment With Specific Exceptions





26.34-1 Statutory apportionment with exceptions

I direct that all death taxes attributable to assets passing under or outside my will be apportioned among the persons interested in my estate in the manner provided by California and federal law in effect at the time of my death. "Death taxes" includes all estate and inheritance taxes, generation-skipping transfer taxes, Internal Revenue Code §2032A recapture taxes, taxes attributable to excess retirement accumulations, and interest and penalties on such taxes. I direct my executor to seek reimbursement for such taxes paid by my executor from the recipients of property subject to any such tax to the fullest extent permitted by law. The exceptions to these general directions follow:

(1) All death taxes attributable to the gifts made under paragraphs _ _[*numbers*]_ _ of my will shall be paid by my executor from the residue of my estate without apportionment among the residuary beneficiaries;

(2) All death taxes attributable to any family allowance shall be paid by my executor from the residue of my estate without apportionment among the residuary beneficiaries; and

(3) If my gross estate for federal estate tax purposes includes property to which Internal Revenue Code §2044 applies, my executor shall recover from the persons receiving that property that prorata portion of the estate taxes attributable to such property, determined without giving effect to Internal Revenue Code §2207A.

[*If applicable, add the following option*]

(4) Notwithstanding any other provision of California and federal law, Internal Revenue Code §2032A recapture taxes shall be apportioned among the persons interested in my estate in proportion to the reduction in estate tax otherwise payable with respect to the qualified real property that is the subject of the election under that section and with respect to the other property as provided in Probate Code §20114 or successor provision.

Comment: Statutory apportionment is often the most appropriate method of allocating the burden of transfer taxes. See §26.14. This clause calls for statutory apportionment.

It is important to specify clearly which taxes are subject to the terms of this clause. See §26.32. On allocation issues involving the generation-skipping transfer (GST) tax, see §15.58. The drafter should remember that the reimbursement rights under IRC §§2206 and 2207 make no mention of interest and penalties. See §26.11.

The clause includes exceptions to statutory apportionment that many clients find appropriate. For discussion of factors that may lead to deviations from statutory apportionment, see §§26.15-26.21, 26.29-26.30. If the clause includes an exception to the statutory apportionment scheme for the GST tax, specific reference to the tax is required. See §26.13.

Exception (1) exempts certain devises from liability for taxes. See §§26.15-26.17. The exception directs that the taxes attributable to such gifts should be paid from the residue. Other sources for payment of such taxes, such as a bypass trust, may be substituted for the residue if appropriate. This is the exception most commonly desired by clients with respect to specific and general pecuniary requests. The attorney should carefully consider and possibly modify this exception if the residue includes a gift intended to qualify for the marital or charitable deduction. See §26.24.

On the rationale behind exception (2), see §26.3. If the exception is excluded from the clause, the court can increase the allowance to include the amount of the additional taxes if they create a hardship.

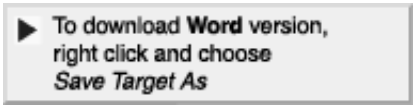
The purpose of exception (3) is to limit the tax liability of the qualified terminable interest property (QTIP) trust to its

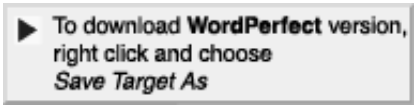
prorata share of the estate taxes. See §26.19. Note that the exception refers to IRC §2044 instead of describing the property to which that section applies. This reference is an efficient way to include property that qualifies for an unlimited marital deduction under either the estate tax provision (IRC §2056(b)(7)) or the gift tax provision (IRC §2523(f)).

The purpose of exception (4) is to apportion a share of IRC §2032A recapture taxes among persons who received an allocation of an excess amount of estate tax reduction on property other than qualified real property under Prob C §20114(b). See §26.20.

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§26.35 B. Form: Death Taxes Paid From Revocable Trust





26.35-1 Death taxes paid from revocable trust

The trustee of the _ _[*name and date of revocable trust*]_ _ is directed by its terms to pay from the trust all death taxes attributable to assets passing under my will or the trust. "Death taxes" includes all estate and inheritance taxes, generation-skipping transfer taxes, Internal Revenue Code §2032A recapture taxes, taxes attributable to excess retirement accumulations, and interest and penalties on such taxes. If at my death that trust does not exist or is insufficient to pay all the death taxes, I direct my executor to pay the taxes that cannot be paid from the trust, according to the terms of that trust on the date on which my will is executed. Those terms are incorporated in this paragraph by reference. Death taxes attributable to assets not passing under my will or the trust shall be paid as provided in Division 10 of the California Probate Code and applicable provisions of the Internal Revenue Code.

Comment: The drafter should use this clause when the will "pours over" the assets of the probate estate into a living trust and the trust is intended to pay all the taxes. See §26.33. The clause assumes that, if the trust does not exist at the testator's death, the probate assets will be disposed of in accordance with the terms of the trust instrument. The trust should direct how the burden of taxes should be allocated among beneficiaries. If the tax payment provisions of the trust are conveniently grouped in one or two sections, the clause should specifically incorporate them by reference. On incorporation by reference, see §5.3.

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Source: Estate Planning/California Will Drafting/26 Tax Payment Clauses/§26.36 C. Form: Payment of Taxes on Qualified Terminable Interest Property

§26.36 C. Form: Payment of Taxes on Qualified Terminable Interest Property

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

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

26.36-1 Payment of taxes on qualified terminable interest property

***Payment of Taxes on Trust*. On written demand of the executor of my spouse's estate, the trustee shall distribute to this executor from the principal of this trust that portion of the estate tax due from my spouse's estate that is attributable to this trust, as determined under Internal Revenue Code §2207A. If my spouse directs by will that a lesser amount be demanded toward payment of my spouse's estate tax, the trustee shall distribute to my spouse's executor only that lesser amount.**

Comment: This clause is intended to be used in an instrument creating a qualified terminable interest property (QTIP) trust. The purpose of the clause is to coordinate payment of taxes attributable to the QTIP trust with the surviving spouse's estate. See §26.16.

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27

Spendthrift Clauses

CEB Staff

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I. DEFINITION AND PURPOSES OF SPENDTHRIFT CLAUSES

§27.1 A. Restriction on Assignment of Interest and Protection From Creditors

A "spendthrift" clause in a trust has a dual purpose: (1) to prevent a beneficiary from assigning his or her interest and (2) to protect trust assets from claims of the beneficiary's creditors. See Prob C §§15300-15309. In this context, the word "spendthrift" is a term of art and does not necessarily refer to the beneficiary's monetary habits. Even if the beneficiary is extremely circumspect, the testator may desire to protect the beneficiary's interest (as far as possible) from creditors' claims or judgments, which could arise from the beneficiary's misfortune or accident. In addition, the testator may want to prohibit the beneficiary from giving away his or her interest in the trust or from putting the trust at risk by assigning or pledging the interest as security for a loan. Such protection is termed "spendthrift" protection whether or not the beneficiary is financially responsible.

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§27.2 1. Limitations on Beneficiary's Voluntary Assignment

A spendthrift clause in the trust instrument can be used to restrain the beneficiary from assigning and thereby anticipating his or her interest in the trust. Prob C §§15300-15301.

In a sense, however, Prob C §15301 does not prevent a beneficiary who is entitled to trust principal at a future date from assigning his or her expectancy for a consideration. A valid contract to assign (as opposed to a present assignment) can be enforced against a beneficiary, and distributed trust assets are subject to execution on a judgment against the beneficiary. *Kelly v Kelly* (1938) 11 C2d 356, 79 P2d 1059.

In *DeMille v Ramsey* (1989) 207 CA3d 116, 254 CR 573, two sisters had agreed in writing to share equally in the property their mother might leave them. The mother died, leaving a testamentary trust under which the bulk of her assets passed to one of her daughters. This daughter argued that the boilerplate spendthrift clauses in the trust superseded the agreement. The court of appeal affirmed a trial court holding that the trust was not a spendthrift trust, finding that the decedent had intended to protect her daughter from creditors of the daughter's husband and had not intended to keep the assets out of her daughter's hands. The court specifically held that the agreement would not violate Prob C §§15300-15301. See §27.4.

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§27.3 2. Limitations on Involuntary Assignment

A spendthrift clause affords limited protection from claims of the beneficiary's creditors. The clause will protect trust distributions, before the beneficiary receives them, against the beneficiary's creditors but only up to the amount needed for the beneficiary's support and education; all excess amounts not required for the beneficiary's support and education are subject to the claims of creditors. Prob C §15307. The beneficiary's "needs" are determined on the basis of a station-in-life test. See Cal L Rev'n Comm'n Comment to Prob C §15307.

When the trust directs the accumulation of surplus income, a creditor may only reach mandatory payments beyond the beneficiary's needs for education and support. *Estate of Lawrence* (1968) 267 CA2d 77, 72 CR 851. The mere presence of a spendthrift clause may not protect trust funds in bankruptcy, however, if other provisions of the trust give the beneficiary excessive control over the trust. See *Ehrenberg v Southern Cal. Permanente Med. Group (In re Moses)* (9th Cir 1999) 167 F3d 470. In *McCoy v Johnson* (ND Ill, July 22, 2002, No. 02 C 3258) 2002 US Dist Lexis 13239, the court held that the surviving spouse's interest in a deceased spouse's testamentary trust was an asset of the survivor's bankruptcy estate, because the trust provisions as a whole did not place any limits on the amounts the survivor could distribute as trustee for the survivor's health, support, and maintenance.

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§27.4 B. Effectiveness of Spendthrift Clauses; When Creditor Can Reach Beneficiary's Interest

If the trust instrument contains a spendthrift clause providing that a beneficiary's interest is not subject to voluntary or involuntary transfer, the general rule is that 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 paid to the beneficiary. In *Birdsell v Coumbe* (BAP 9th Cir 2003) 304 BR 378, the court held that monies distributed from a spendthrift trust to a bankruptcy debtor within 180 days after filing the petition were included in the bankruptcy estate to the extent distributions were made from income. If a trust instrument gives the trustee discretion to make payments of income or principal, a creditor or transferee of the beneficiary may not compel the trustee to pay any discretionary amount. Prob C §15303. If the trust provides that the trustee must pay income or principal or both for the beneficiary's education or support, amounts necessary for these purposes cannot be transferred and are not subject to enforcement of a money judgment until paid to the beneficiary. Prob C §15302.

There are significant exceptions to this general rule:

- *Improper payment by the trustee may create personal liability*. A trustee of a discretionary trust who has personal knowledge of a transfer of a beneficiary's interest or who has been served with process by a judgment creditor under CCP §709.010, and then pays income or principal to the beneficiary, may be personally liable to the transferee or creditor. Prob C §15303(b). See *Cassell v Globerson (In re Kolb)* (Bankr CD Cal, May 29, 2007, No. 97-32321) 2007 Bankr Lexis 1896 (trustees liable for distributions to sons of trust beneficiary who purportedly disclaimed his interest in trust property and then filed bankruptcy petition).
- *The trustor cannot create the trust to impair the rights of creditors*. A trustor who is also a beneficiary of a trust that he or she created cannot use a spendthrift clause to impair the rights of creditors or transferees. Prob C §15304.
- *A spendthrift clause may not bar the legal obligation of support*. If a trust beneficiary has a legal obligation to support a former spouse or registered domestic partner or child, and the beneficiary has the right to compel the trustee to distribute income or principal, the court may order the trustee to satisfy the beneficiary's support obligation as payments from the trust become due. Prob C §15305; Fam C §297.5(b). The court may order the trustee to satisfy the beneficiary's support obligation out of all or part of future payments for the beneficiary. Prob C §15305(c). At least one court has held that trust assets may be reached to satisfy the beneficiary's child support obligations, despite a trust provision allowing the trustee to make no distributions. *Ventura County Dep't of Child Support Servs. v Brown* (2004) 117 CA4th 144, 11 CR3d 489.
- *A spendthrift clause does not bar reimbursement for public support*. Trust assets may be reached to reimburse a state or local public entity for public support of the beneficiary or his or her spouse or domestic partner or minor child. Prob C §15306. See chap 23.
- *A spendthrift clause may not prevent payment of a judgment creditor*. The court may direct the trustee to pay 25 percent of a payment that would otherwise be made to or for the beneficiary to satisfy judgment payable to a judgment creditor. Prob C §15306.5. This assumes that the beneficiary is entitled to any distributions. 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 in prison for attempted murder.
- A judgment creditor may reach amounts in excess of amounts needed for a beneficiary's education or support. Prob C §15307. The relationship of this section to Prob C §15306.5 is unclear.

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C. Spendthrift Clauses Are Not Always Desirable

§27.5 1. Spendthrift Clause May Prevent Income Shifting

A spendthrift clause should not automatically be used in a will. Such a clause may, for example, prevent a trust beneficiary in a high tax bracket from transferring his or her income interest. For example, a surviving spouse sometimes reaches a point in life when the spouse concludes that he or she no longer needs the benefits of a bypass trust, that it is no longer necessary to continue to incur the costs of the trust, and that immediate termination of the trust with distribution of trust assets to the children is desirable so that the income on trust assets will now be taxed to the children. If a trust contains a spendthrift clause, it may be necessary to incur the expense of a court proceeding in order to terminate the trust.

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§27.6 2. Ordinary Spendthrift Clause Should Not Disqualify Marital Deduction

A protective provision that limits income payments to the beneficiary or that directs accumulation of income should not be used in a trust intended to qualify for a marital deduction under either IRC §2056(b)(5) or IRC §2056(b)(7), because the surviving spouse must be entitled for life to all income from the trust property. Ordinary spendthrift clauses, however, can safely be used in marital deduction trusts. Treas Reg §20.2056(b)-5(f)(7). See form 27.8-1 for this type of clause. An income interest is not disqualified merely because it is not subject to assignment, alienation, pledge, attachment, or creditors' claims. Treas Reg §§20.2056(b)-5(f)(7), 20.2056(b)-7(c)(2). The marital deduction would be defeated, however, by a clause stating that the beneficiary's interest will cease and terminate if any attempt is made to violate the spendthrift clause. See *Virginia Nat'l Bank v U.S.* (4th Cir 1971) 443 F2d 1030.

A devise containing a poorly drafted spendthrift clause may still be held to qualify for the marital deduction under Prob C §21522, which permits admission of parol evidence to save the marital deduction when the will is ambiguous. Careful drafting of the spendthrift clause will eliminate the necessity to prove that the marital deduction was intended by the testator.

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Source: Estate Planning/California Will Drafting/27 Spendthrift Clauses/§27.7 3. Spendthrift Clause Will Not Bar Disclaimer

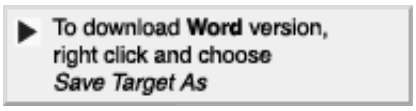
§27.7 3. Spendthrift Clause Will Not Bar Disclaimer

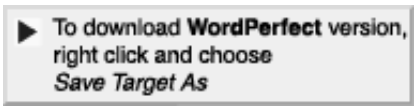
A spendthrift clause will not bar a beneficiary from disclaiming his or her interest under Prob C §§260-295. Prob C §286. The disclaimer must be made within the period specified in Prob C §279.

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II. SAMPLE SPENDTHRIFT CLAUSES

§27.8 A. Form: Short-Form Spendthrift Clause





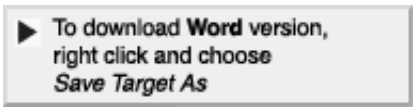
27.8-1 Short-form spendthrift clause

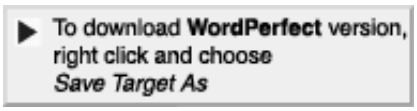
***Spendthrift Clause*. No interest in the principal or income of any trust created under this will may be anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.**

Comment: This short-form spendthrift clause applies both to voluntary alienation by the beneficiary and to involuntary alienation at the hands of a creditor of the beneficiary.

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§27.9 B. Form: Long-Form Spendthrift Clause





27.9-1 Long-form spendthrift clause

***Spendthrift Clause*. If the creditor of any beneficiary who is entitled to any distributions from a trust established under this will (other than from any marital deduction trust requiring the distribution of all income or any qualified subchapter S trust) attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, notwithstanding any other provision in this instrument, the distribution set aside for that beneficiary shall be disposed of, until the release of the writ of attachment or garnishment or other process, as follows:**

(1) The trustee shall pay to or apply for the benefit of that beneficiary all sums that the trustee, in the trustee's discretion, determines to be necessary for the reasonable health, education (including study at an institution of higher learning or vocational school), and support of the beneficiary according to his or her accustomed mode of life; and

(2) The portion of the distribution that the trustee determines to exceed the amount necessary for the health, education (including study at an institution of higher learning or vocational school), and support shall, in the trustee's discretion, either be added to and become principal in whole or in part, or be paid to or applied for the benefit of the other beneficiaries then entitled to receive payments from any trust established under my will, in proportion to their respective interests in the trust estate; or, if there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person or persons presumptively entitled to the next eventual interest, in proportion to their respective interests in the trust.

Comment: This option permits only distributions protected from creditors by a spendthrift clause, when creditors seek to attach trust assets. See §23.17 on the limited protection afforded by a spendthrift clause. The clause therefore offers greater protection to trust assets than does form 27.8-1.

Because this option directs accumulation of income, it is specifically made inapplicable to any marital deduction trust (other than an estate-type marital deduction trust) and any qualified subchapter S trust, both of which depend on the annual distribution of income for their qualification.

Instead of giving the trustee the discretion to add excess distributions to principal or to distribute the amounts to other beneficiaries, the testator may direct that the amounts may be added to principal. The drafter should use that option if a beneficiary may serve as trustee. See discussion of trustee-beneficiaries in §28.8.

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28

Office of Trustee

George R. Dirkes

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I. ROLE OF TRUSTEE IN TESTAMENTARY TRUST

§28.1 A. Limited Scope of Chapter

This chapter discusses the law and suggests will provisions relating to the office of trustee of a testamentary trust. Among the topics covered are the selection, appointment, succession, bonding, compensation, and exculpation of trustees, and the trustee's personal responsibility and relationship to the trust. Chapters 29-31 cover trustee management, accounting, and administrative powers provided by law or by will provision.

The material in this chapter is intended to be applied to testamentary trusts only. The drafter's use in a revocable trust of provisions appropriate to a testamentary trust can result in adverse income and estate tax consequences. For discussion of unwanted tax consequences that might result from the use of certain administrative provisions in irrevocable trusts, see Drafting California Irrevocable Trusts, chap 10 (3d ed Cal CEB 1997).

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§28.2 B. Nature of Trustee's Duties

One of the most important decisions an estate planning client can make is the selection of the trustee of the client's testamentary trust. The selection is particularly significant when broad discretionary powers will be given to the trustee. The trustee of a trust holds legal title to the trust assets and has a duty to deal with trust property for the benefit of the trust beneficiaries. Prob C §16000; Restatement (Second) of Trusts §2 (1959). Thus, the trustee of a testamentary trust is the manager of the trust property for the benefit of the persons whom the testator has named in the will to be the trust beneficiaries. Basically, the testamentary trustee's duty is to fulfill the testator's purposes in creating the trust as expressed in the will.

Many of the trustee's fiduciary obligations have been codified in Prob C §§16000-16015. For example, a trustee has a duty to (1) administer the trust solely in the interest of the beneficiaries (Prob C §16002), (2) deal impartially with multiple beneficiaries (Prob C §16003), (3) avoid conflicts of interest (Prob C §§16004-16005), (4) take control of and preserve the trust property (Prob C §16006), and (5) make the trust property productive (Prob C §16007). Furthermore, whether the trustee receives compensation does not offset the trustee's standard of care or performance in the administration of the trust. Prob C §16041.

The trustee's management duties vary according to the nature of the trust property. For example, the management skills required of a trustee holding a single parcel of real property under a long-term, net-net lease to a responsible tenant are minimal compared to those required of a trustee holding a diversified investment portfolio or a substantial interest in a closely held business or farm. Therefore, the selection of the trustee should be made only after careful examination of the problems likely to be faced in the management of the trust assets.

Regardless of the nature of the trust property, certain general duties are common to all testamentary trustees. Initially, the trustee should review and become familiar with the provisions of the will relating to the trust. Next, if appropriate in light of the trust provisions, the trustee should interview the trust beneficiaries so that the trust administration can accommodate their needs, objectives, and personal circumstances to the extent feasible and permissible. At the same time, the trustee must review the trust assets to determine whether they are proper trust investments, taking into account any directions in the will, the rights and needs of the income and remainder beneficiaries, and sound investment principles. See Prob C §16049.

During the term of the trust, the trustee must continue to manage the trust assets, periodically review the quality of the trust investments, keep records of all trust transactions, file appropriate tax returns, and distribute principal or income as directed by the will. If the trustee has discretion in matters involving distributions of principal and income, the trustee must exercise that discretion, as well as other skills involved in the trust administration, according to the "prudent person" standard of care set forth in Prob C §§16040 and 16047.

On termination of the trust, the trustee must determine who is entitled to the remaining trust assets and distribute them accordingly. Because the trustee may be personally liable for the trust's unpaid debts, the trustee should ensure that all taxes and other trust obligations have been paid or provided for before this distribution. 4 Scott & Ascher on Trusts §§26.1-26.2 (5th ed 2007). The trustee, however, may have a right of indemnification against the beneficiaries to the extent of the estate assets. See *Johnston v Long* (1947) 30 C2d 54, 181 P2d 645; 4 Scott on Trusts §26.4.5. See also IRC §2204(b) (fiduciary's personal liability for estate taxes).

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II. SELECTING TRUSTEE

§28.3 A. Trustee's Qualifications

Although the client often assumes that the person selected to be executor or guardian of the person of the testator's minor children is the ideal choice for trustee of the testamentary trust, this is not necessarily true. An executor's responsibilities are generally short term and demand fewer investment and management skills than those required for a trustee. A guardian of the person should be willing to assume responsibility for the personal welfare of the children but need not be concerned with property management. The testamentary trustee must be able to manage property (or at least to supervise property management), respond to the trust beneficiaries' personal and financial needs, and assume long-term responsibility for the administration of the trust. Of course, in many instances the person named as executor is competent to serve as trustee, thereby ensuring continuity of management between the estate and the testamentary trust.

In general, any individual who has the capacity to acquire title to property and to enter into contracts may be a trustee. See *Wallace v Riley* (1937) 23 CA2d 654, 74 P2d 807, disapproved on other grounds in *Estate of Propst* (1990) 50 C3d 448, 462, 268 CR 114; 13 Witkin, Summary of California Law, *Trusts* §44 (10th ed 2005). Although a minor may acquire title to property, a minor is generally an inappropriate choice for trustee because his or her contracts are voidable. See Restatement (Second) of Trusts §91 (1959).

A beneficiary of a trust may be its sole trustee or one of two or more cotrustees. *Williams v Miranda* (1958) 159 CA2d 143, 323 P2d 794 (inter vivos trusts); Restatement §99. However, if the sole beneficiary of all present and future interests in a trust is also its sole trustee, the trust ceases because no one has an interest in enforcing the trust. See Restatement §99(5). In addition, having a beneficiary serve as trustee may result in serious adverse income and estate tax consequences. See §§28.8-28.8C.

If the sole trustee is a disqualified person for purposes of being a transferee of a donative transfer under Prob C §21350 (see §1.35), he or she may be removed. See Prob C §15642(b)(6); see also §28.4.

Apparently, an alien may act as trustee in California. See CC §671. A nonresident individual may also be a trustee. If continuing court jurisdiction over the trust is sought under Prob C §17300(b) (see §28.51), however, the court might require the nonresident to post bond as a condition of appointment to avoid losing effective jurisdiction over the trust. See also §28.22 on the trustee's bond. Using a nonresident trustee also may subject a trust to the foreign trust reporting requirements of IRC §6048. Under IRC §7701(a)(30)(E)(ii), a trust is a foreign trust unless one or more United States persons have the authority to control all substantial decisions related to the trust. For these purposes, a "United Sates person" includes a citizen or resident of the United States. IRC §7701(a)(30)(A). The foreign trust reporting requirements can be quite burdensome. Therefore, the selection of a resident individual trustee is strongly recommended. For a complete discussion of foreign trusts, see Drafting California Irrevocable Trusts §§3.68-3.75 (3d ed Cal CEB 1997).

Any corporate entity authorized to conduct a trust business in California may act as trustee. Prob C §83. This includes state-chartered corporations, industrial banks, or commercial banks (Fin C §§107, 1500.1), national banking associations (Fin C §§1502-1503), and state and federal savings and loan associations (Fin C §§5102, 6515). However, no foreign (other state) corporation or association, other than a national bank or a foreign state bank authorized to conduct a trust business in California, may act as a trustee in this state. Fin C §1503. A nonprofit corporation may act as a trustee only when the trust is incidental to the principal objectives of the corporation. Corp C §5140(k).

A person named trustee of a testamentary trust is not merely a nominee, like a named executor, but is a devisee under the will and thus may not readily be deprived of the right to act as trustee. *Estate of Wellings* (1925) 197 C 189, 240 P 21. Presumably, a court could refuse to decree distribution of trust property to a person who could be removed as trustee under Prob C §15642. On §15642, see §28.20. Unless grounds for removal exist, however, the trustee named in the will is entitled to act as a matter of right.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.4 B. Attorney as Trustee

§28.4 B. Attorney as Trustee

If the attorney drafted the will, he or she is a "disqualified person" for purposes of donative transfers under Prob C §21350 (see discussion in §1.35).

If the attorney who drafted the will and testamentary trust (or any other disqualified person) is named sole trustee, he or she may be removed, regardless of whether he or she actually is the transferee of a donative transfer by the testator, unless, based on any evidence of the intent of the executor and all other facts and circumstances, the court finds it consistent with the executor's intent that the trustee continue to serve, and that this intent was not the product of fraud, menace, duress, or undue influence. Any waiver of this provision by the testator is void. The provision does not apply if (a) the testator is related by blood or marriage to, or is a cohabitant with, any of the trustees, the person who drafted or transcribed the will and testamentary trust, or the person who caused the instrument to be transcribed; or (b) the instrument is reviewed by an independent attorney who counsels the executor and signs and delivers to the executor and the designated trustee a certification of independent review in substantially the form set out in Prob C §15642(b)(6).

An attorney who also serves as the trustee may receive either the trustee's compensation or compensation for legal services performed for the trustee, but not both, unless the trustee obtains approval for the right to dual compensation by court order or there is no objection from persons entitled to notice, as provided under Prob C §15687(d). Prob C §15687(a). The restriction against compensation for legal services also applies to persons with specified relationships or associations with a trustee, unless the trustee waives trustee compensation or obtains approval as provided under Prob C §15687(d).

NOTE: If the trustee is not an attorney, the trustee will need to retain an attorney to represent the trust in court proceedings. A trustee who is not an attorney may not represent the trust in propria persona in proceedings involving third parties. *Ziegler v Nickel* (1998) 64 CA4th 545, 75 CR2d 312. However, a trustee who petitions the court for orders terminating a trust, settling an account, or awarding trustee fees is not required to be represented by counsel. *Finkbeiner v Gavid* (2006) 136 CA4th 1417, 39 CR3d 871.

In addition to restrictions under Prob C §§15687 and 21350, significant ethical issues confront an attorney who is considering taking on the role of trustee. Because the attorney owes a duty of fidelity to the client, "all business dealings between an attorney and client whereby the attorney benefits are closely scrutinized for any unfairness on the attorney's part." *Magee v State Bar* (1962) 58 C2d 423, 430, 24 CR 839. This scrutiny is justified by the attorney's dual obligations to avoid taking advantage of the client and to provide the client with services that are in the client's best interests, regardless of the attorney's involvement. Although accepting a trusteeship may appear to benefit the client, the position actually benefits the attorney, who has an opportunity to earn compensation. Because the attorney's self-interest is involved once he or she is named trustee, the attorney may not be able to give the disinterested advice that the client deserves.

The attorney must also determine whether, in holding the position, he or she can comply with the requirement of Cal Rules of Prof Cond 3-300 to avoid adverse interests. The attorney's acceptance of the role of trustee is explicitly covered by that rule because to agree to serve as trustee of a client's trust is to "enter into a business transaction" with the client.

The client's execution of the trust instrument is not sufficient written consent to the terms of the transaction to meet the requirements of Cal Rules of Prof Cond 3-300(C). See *Schneider v State Bar* (1987) 43 C3d 784, 239 CR 111, discussed in §28.43. This case makes clear that exculpatory language in the trust instrument will not excuse an attorney from fulfilling the separate requirements of the California Rules of Professional Conduct.

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C. Considerations in Selecting Trustee

§28.5 1. Institutional Trustee

The advantages of an institutional (corporate) trustee include:

- *Permanence*. An institutional trustee is normally able to act as trustee during the entire duration of the trust and thus can provide continuity of administration. Moreover, an institutional trustee, unlike an individual trustee, is not subject to illness or disability.
- *Professional management*. An institutional trustee typically employs personnel experienced in a wide variety of fields (*e.g.,* securities investment, real property management). The institution's support staff and computerized accounting resources cannot be matched by most individual trustees. In addition, institutional trustees usually maintain various common trust funds that enable small trusts to diversify their investments easily.
- *Impartiality*. An institutional trustee is more likely to treat successive or concurrent beneficiaries equitably. Although this may not matter when the beneficiaries are in the same family, it may become important when the beneficiaries are members of different families, *e.g.,* the testator's spouse or domestic partner and children by a prior marriage or partnership.
- *Financial accountability*. Because the financial accountability of an institutional trustee is normally beyond question, the beneficiaries are assured of an effective remedy for breach of trust. Moreover, the fact that institutional fiduciaries are periodically examined by various government agencies gives additional assurance that the trust will be properly managed.
- *Tax advantages*. Under the tax laws (especially the generation-skipping transfer tax laws (see chap 15)), use of an independent trustee such as an institutional trustee may permit greater latitude in administering the trust without jeopardy to planned marital or charitable deductions or income tax savings. For discussion of these tax considerations, see §§28.8-28.8C.
- *Bond*. A trust company is not required to furnish a bond, even if the governing instrument requires it. Prob C §15602(e). In some instances, this exemption will save the trust the expense of a bond. On when a bond is required of a testamentary trustee, see §28.22.

The disadvantages of an institutional trustee include:

- *Cost of administration*. Many clients believe that the cost of an institutional trustee is too great, especially if they intend the trustee to consult with an investment adviser rather than to use the institutional trustee's own investment expertise. To make an accurate assessment of charges, however, the client must compare the institutional trustee fees with the total cost of professional accountants, investment advisers, and custodial services that an individual trustee might be required to use.
- *Conservative investment approach*. Many clients consider the investment approach of an institution to be more conservative than necessary. For example, even though real property values have either kept pace with or outpaced an inflationary economy, an institutional trustee will not ordinarily make investments in real property. Some clients, however, favor a conservative investment approach.
- *Institutional problems*. The selection of an institutional trustee does not always guarantee stable management of trust assets. Like all large organizations, institutional trustees may experience department mergers and personnel turnover and may exhibit indecision and an inability to respect the needs and desires of beneficiaries. A bank that merges with or acquires a bank serving as trustee will automatically succeed to the trustee position (see §28.11), but the successor may not be as appropriate for the role of trustee as the original institution.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.6 2. Individual Trustee

§28.6 2. Individual Trustee

The advantages of an individual trustee include:

- *Personal relationship*. If the testator chooses a close friend or member of the family as trustee, that individual is more likely to be aware of the testator's desires and the beneficiaries' personal needs. Choosing an individual trustee may be particularly desirable when the testator wishes the trustee to function as a family adviser.
- Beneficiary participation in management. Some clients wish to permit a young beneficiary to participate in managing the trust assets as trustee or cotrustee, especially if the trust will terminate during the beneficiary's lifetime. If the trustee-beneficiary's powers are too broad, however, serious tax problems may result. See §§28.8-28.8C.
- *Administration costs*. Clients often assume that the cost of administering a testamentary trust can be completely eliminated by appointment of a family member or close friend as trustee. This may be true, but the cost of such a trustee can be accurately determined only by considering the charges of investment counsel, accountants, asset custodians, and others whom the individual trustee may need to consult or employ to discharge his or her duties adequately. Depending on the value and nature of the trust assets and the trustee's ability and available time, an individual trustee may cost more or less than an institutional trustee.
- Speed. Decisions can usually be reached more quickly by an individual than by an institution, because institutions usually act through committees and observe other formal procedures.
- *Investment approach*. Although directions in the trust will significantly affect the trustee's investment approach, an individual trustee may be less conservative in managing a trust than an institutional trustee. The testator should evaluate the testator's goals to determine whether such an approach is an advantage or a disadvantage.
- *Familiarity with management of closely held business*. Although a representative of an institutional trustee may sit on the board of directors of a closely held corporation in which the trust holds a controlling interest, this representative will not ordinarily be as effective in that capacity as an individual chosen by the testator who is familiar with the testator's business.

The disadvantages of an individual trustee include:

- *Lack of professional management*. Because individual trustees are often inadequately compensated for their services, many trustees view their duties as favors rendered to the deceased. The quality of management may suffer as a result. Further, for a trust to be properly administered, the individual trustee must either be well qualified to perform all duties of trust management or be willing to seek competent advice. Individual trustees often are unprepared in either respect. In addition, individual trustees tend to neglect record keeping, which can make costly accounting and attorney services necessary later.
- *Difficulty of finding competent individual*. An individual who accepts a trusteeship must make a major commitment of time and responsibility. It is often difficult to find an individual (other than a beneficiary or family member) who is willing and able to act as trustee.
- *Death or incapacity of trustee*. Loss of continuity may result from changes in individual trustees over time due to death or incapacity.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.7 3. Multiple Trustees

§28.7 3. Multiple Trustees

The selection of two or more individuals, or one or more individuals and an institution, as cotrustees offers the advantage of combining the different skills of each trustee. Moreover, a testator who does not wish to give a beneficiary complete control over trust property management may be able to give the beneficiary some participation and responsibility as cotrustee. It may be useful to name a cotrustee to manage property that the trust's primary trustee is unwilling or unable to manage (*e.g.,* real property in another state).

Tax considerations often favor the use of cotrustees. A cotrustee who is not a beneficiary or who is a beneficiary with an adverse interest may exercise or be vested with a veto power over powers that would result in adverse tax consequences for the trustee if exercised alone by a trustee-beneficiary. On income, estate, or gift tax issues raised by appointment of a trustee who is or could be a beneficiary of the trust, see §§28.8-28.8C. For further discussion of grants of powers to cotrustees or special trustees, see §§28.9, 28.36.

If a national bank acts as a cotrustee, bank regulations require that the bank keep the trust records. See, *e.g.*, 12 CFR Parts 9 and 19. A corporate fiduciary will generally expect to receive the bulk of the trustee fees.

Most of the disadvantages of using multiple fiduciaries can be minimized by special clauses in the will. One major disadvantage is that decisions by cotrustees generally must be unanimous to bind the trust, unless the will specifies otherwise. Prob C §15620. See §§28.34-28.35 for sample clauses authorizing action by fewer than all trustees. Note that such clauses can be tailored to the skills or judgment of the various cotrustees.

NOTE: Certain trustee powers may be exercised by cotrustees without unanimous consent. In *Edwards v Edwards* (1998) 61 CA4th 599, 71 CR2d 653, the court held that a majority of successor trustees of a revocable trust may vote the stock of a family corporation under Corp C §704. If multiple trustees are used, trustee voting requirements for corporation stock intended to become property of a testamentary trust should be dealt with in the will. Different voting requirements may be appropriate for different acts. Both Corp C §704 and Prob C §15620 defer to trust voting requirements specified in the will.

Other potential disadvantages result from the requirements in Prob C §16013 that each cotrustee participate in administering the trust and take reasonable steps either to prevent a cotrustee from breaching the trust or to compel a cotrustee to redress a breach of trust. Probate Code §16402 limits a trustee's liability to a beneficiary for a cotrustee's acts. The trustee is liable only if the trustee (Prob C §16402(b)):

(1) Participates in the cotrustee's breach of trust;

(2) Improperly delegates administration of the trust to the cotrustee;

(3) Approves, knowingly acquiesces in, or conceals the cotrustee's breach of trust;

(4) Negligently enables the cotrustee to breach the trust; or

(5) Neglects to take reasonable steps to compel the cotrustee to redress a breach of trust that the trustee knows about or reasonably should have known about.

Even these rules, however, can lead to draconian results.

EXAMPLE: In *Blackmon v Hale* (1970) 1 C3d 548, 83 CR 194, the results of which were codified in Prob C §16402(b)(2), (4), the court held liable the partner of an attorney who wrongfully appropriated funds from the law firm's trust account. Another partner, who had withdrawn from the firm before deposit of the misappropriated funds but whose name remained on the firm's trust account, was also held to have breached his duty as a cotrustee.

If a trustee is aware of a cotrustee's breach of trust, resignation by the innocent trustee may be deemed acquiescence in the breach, for which he or she may be liable. Under Prob C §16402(b)(3), such acquiescence would be an independent breach of trust. Further, because Prob C §16402(b)(5) requires the innocent but aware trustee to take steps to compel the other trustee to redress his or her breach of trust, resignation alone will not assure freedom from liability for the other trustee's acts.

The provisions of Prob C §16402 can create unwanted potential liability in many situations. For example, the testator may wish to appoint a surviving partner and a bank as cotrustees, intending that the partner should be able to rely on

the bank and not be liable for any breach of trust committed by the institution. To meet the testator's goals, the drafter must use an exculpatory clause to relieve the individual trustee from liability for acts of the institutional cotrustee. See §28.48 for a clause adaptable to particular situations.

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§28.8 4. Tax Perils in Selecting Beneficiary or Related Party as Trustee

If a trustee will be or may become a beneficiary of the trust, or if a trustee is related to the beneficiary, the trustee's fiduciary powers may have adverse income, estate, or gift tax consequences for the trustee. Before naming a beneficiary or beneficiary's relative as trustee, the attorney must carefully consider the trustee's distribution and management powers. The following is a brief survey of estate tax (see §28.8A), gift tax (see §28.8B), and income tax (see §28.8C) issues raised by naming a beneficiary or beneficiary's relative as trustee of a testamentary trust.

On the tax problems of naming a beneficiary as trustee, see Drafting California Irrevocable Trusts §10.6 (3d ed Cal CEB 1997). On the tax consequences of various trustee powers, see Acker, *Administrative Powers*, Tax Management Portfolios 820-2d (2005).

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§28.8A a. Estate Tax Considerations

If a trustee-beneficiary dies holding the equivalent of a general power of appointment over the trust corpus, the entire value of that corpus is includable in the trustee's gross estate and therefore is subject to federal estate tax. IRC §2041. A general power of appointment is a power exercisable in favor of its holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. IRC §2041(b)(1). The Internal Revenue Service considers certain powers held by trustee-beneficiaries, exercisable in favor of themselves or their dependents, to be general powers of appointment. On powers of appointment generally, see chap 16.

Ordinary management and accounting powers of a trustee-beneficiary do not normally amount to a general power of appointment. The federal estate tax regulations provide that the following do not constitute powers of appointment (Treas Reg §20.2041-1(b)(1)):

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties.

Nevertheless, an income trustee-beneficiary with very broad powers (*e.g.,* broad power to determine what receipts constitute principal or income, broad power to invest in wasting assets) may be found to have a general power of appointment. See §29.7 for further discussion of "tax-sensitive" powers.

Powers to distribute trust assets present the greatest risk of the inadvertently created general power of appointment. The most common example is the power in a trustee-beneficiary, not limited by an "ascertainable standard," to invade principal for his or her own benefit. The ascertainable standard prevents principal invasions that are not for specific purposes listed by the IRS. Treasury Regulation §20.2041-1(c)(2) provides examples of powers limited and not limited by an ascertainable standard. Payments made for the beneficiary's "health, education, support and maintenance" are limited by an ascertainable standard. IRC §2041(b)(1)(A). See §§16.19, 21.29-21.30 for further discussion of the standard and the consequences of giving the trustee a "broad" (not ascertainable) standard for making distributions.

A parent-trustee may be considered to hold a general power of appointment if the trustee has the power to make distributions to children whom the trustee is legally obligated to support. Although a trustee's power to use principal for his or her own support according to an ascertainable standard is not a general power of appointment (IRC §2041(b)(1)(A)), a power to apply trust principal for the support of the trustee's dependents according to an ascertainable standard will be deemed a general power. Such a power is considered to be equivalent to a power to appoint for the trustee's own benefit. See Treas Reg §20.2041-1(c)(1); Rev Rul 79-154, 1979-1 Cum Bull 301.

Probate Code §16082 is designed to prevent a finding of any implied general power of appointment simply because a trustee has the power to make distributions to others. The statute provides that a trustee or beneficiary who holds a power to appoint or distribute income to others may not use the power to discharge his or her legal obligations, unless the trust instrument specifically authorizes this use. Nevertheless, the drafting attorney who wishes to avoid creating a general power of appointment should not give a parent-trustee the power to make distributions in satisfaction of his or her legal obligations of support. If the testator wants gifts to be made to a beneficiary's children, the gift-making power should be put in the hands of a third party cotrustee or special trustee. On cotrustees, see §28.7; on special trustees, see §28.9.

There are also tax risks in naming related individuals as trustees of trusts for the benefit of each other or each other's natural beneficiaries ("reciprocal trusts"). When the powers of each trustee would constitute a general power of appointment over the trust assets if held by the other trustee, the IRS will "uncross" the trusts and treat each trustee as though he or she had a general power of appointment over the assets of the other trust.

EXAMPLE: In IRS Letter Ruling 8029001, a father created trusts for his two daughters, naming each daughter as trustee for her sister. Each daughter subsequently assigned interests in the trust she administered to short-term trusts for her sister's children. The IRS "uncrossed" the trusts, treated each daughter as the trustee of the trust of which she was beneficiary, and found incomplete gifts of the assigned property. Essentially, the IRS held that

each daughter controlled the stock in her own trust as well as in her sister's trust.

The relationship of the parties need not be familial for the reciprocal trust doctrine to apply. Partners created the trusts giving rise to *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730, in which the reciprocal trust doctrine was applied to challenge annual gift tax exemptions claimed for gifts made from the trusts. In addition, the assets in the trusts need not be exactly equivalent for the reciprocal trust doctrine to apply. IRS Letter Ruling 8717003. See Hader, *Planning to Avoid the Reciprocal Trust Doctrine*, 26 Est Plan 358 (Oct. 1999).

The power in a trustee-beneficiary to terminate at any time a trust in favor of himself or herself can also constitute a general power of appointment and result in the trust's inclusion in the beneficiary's estate. *Maytag v U.S.* (10th Cir 1974) 493 F2d 995. This result can be avoided by use of a cotrustee who is an "adverse party" with interests that would be adversely affected by exercise of the power under IRC §2041(b)(1)(C)(ii). See *Estate of Richard C. Maxant*, TC Memo 1980-414, nonacq AOD 1981-97.

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§28.8B b. Gift Tax Considerations

When a trustee-beneficiary holds a general power of appointment, the power's inter vivos exercise, lapse, or release may be a transfer subject to federal gift taxes. IRC §2514(b). For example, the IRS found that, by appointing cotrustees, a trustee-beneficiary relinquished a discretionary power to appoint trust income to himself. See Rev Rul 79-421, 1979-2 Cum Bull 347. Because the power had amounted to a general power of appointment over trust income, the relinquishment constituted a taxable gift.

A trustee-beneficiary's exercise of a power of appointment to transfer trust property to others may also have adverse gift tax consequences.

EXAMPLE: In *Estate of Ruth B. Regester* (1984) 83 TC 1, an income beneficiary of a trust exercised a special power of appointment permitting distributions to the testator's descendants. The court held that this constituted a taxable gift of the value of the income that would have been generated on the appointed property had the power not been exercised. See also Reg §25.2514-1(b)(2); Rev Rul 79-327, 1979-2 Cum Bull 342.

But see *Self v U.S.* (Ct Cl 1956) 142 F Supp 939. The *Regester* court distinguished the decision in *Self,* and the IRS indicated in Rev Rul 79-327 that it would not follow *Self*. There will be no gift tax, however, if the trustee-beneficiary acts under a fiduciary power limited by a reasonably fixed or ascertainable standard. Reg §25.2511-1(g)(2).

The reciprocal trust doctrine discussed above in an estate tax context has been applied to disqualify reciprocal withdrawal powers from the gift tax annual exclusion. See Rev Rul 85-24, 1985-1 Cum Bull 329, in which the IRS did not allow an exclusion for amounts withdrawn when (a) a first trustor created a trust for his child and gave second and third trustors rights of withdrawal, and (b) the second and third trustors at the same time created similar trusts for their children and the first trustor. See also *Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575, in which the IRS disallowed exclusions for transfers to family members of the donor's brother in apparent exchange for transfers from the brother and his family to members of the donor's family, and *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168, in which the IRS disallowed exclusions for gifts made by each of three brothers to trusts benefiting children of the other brothers. The IRS only allowed exclusions for gifts that each brother made to the trust for his own children.

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§28.8C c. Income Tax Considerations

Powers in the beneficiary as trustee may also have adverse income tax consequences. If the trustee has the power "exercisable solely by himself" to vest the principal or income of the trust in himself or herself, trust income will be included in the trustee's gross income for federal income tax purposes. IRC §678(a). Use of a cotrustee, however, should prevent this problem; the cotrustee need not be an adverse party. See §28.39A on using cotrustees and special trustees to prevent adverse tax consequences to the trustee. Some attorneys believe that using an ascertainable standard to limit income distributions to the trustee-income beneficiary provides sufficient protection against adverse income tax effects of the beneficiary's serving as trustee. They therefore conclude that use of a cotrustee, which may be unacceptable to a surviving spouse or domestic partner who is serving as trustee, is unnecessary. See §16.19.

Under IRC §678(c), a bare power in a trustee to apply trust income for the support of someone whom the trustee is legally obligated to support will not cause the income to be taxed to the trustee. The income will be taxed to the trustee when, and only to the extent that, the income is used for this purpose. On income tax problems arising from a power that may be used to satisfy the trustee's legal obligation of support, see §28.39B.

The potential tax problems posed by use of a trustee-beneficiary can be avoided by replacing the trustee with a nonbeneficiary trustee to exercise the powers that may generate tax problems. This can be done in two ways:

(1) Placing the tax-sensitive powers in the hands of a cotrustee or special trustee. See §§28.9, 28.39A, 29.7, 30.9, 31.14.

(2) Enabling the trustee-beneficiary to disclaim any power that will create tax problems. (The power can then be exercised by a cotrustee or special trustee.) For a disclaimer to be effective in limiting the trustee's tax liability, it must be exercised within a certain period of time. This period is different for income tax purposes (see IRC §678(d)) than for gift tax purposes (see IRC §2518(b)). See §31.15 for a clause authorizing disclaimer of trustee administrative powers, which can be adapted for other types of powers. For a sample clause describing the duties of a special trustee who steps in to exercise disclaimed powers, see form 28.40-1.

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§28.9 D. Using Special Trustee

The testator may wish to give a third party "special trustee" one or more of the trustee's powers without shifting the burden of the trustee's other duties and without permitting the third party to influence other aspects of trust administration. For example, a testator may appoint an institutional trustee to carry out the day-to-day management of the trust but authorize a designated individual to exercise a power to invade principal, to determine the investment policies of the trust, or to give prior approval to investments recommended by the institutional trustee, without appointing that individual as a cotrustee.

A special trustee is most commonly needed when the trustee is also the trust's sole income beneficiary. Giving a third person the power to invade principal can prevent the inclusion of trust assets in the trustee-beneficiary's estate if he or she dies while serving as trustee.

For tax issues presented by a trustee-beneficiary or a trustee related to a beneficiary, see §§28.8-28.8C. On invasion powers, see §28.39A. See also §28.41 for a sample clause giving the special trustee distribution and invasion powers.

Instead of transferring a power from the general trustee to a special trustee, the testator may want to give the special trustee a veto over exercise of the power. The general trustee can be required to notify the special trustee of any proposed action (*e.g.,* securities sale). The special trustee is given a specified period within which to veto the proposed action, after which the general trustee, if not notified of a veto, is free to proceed. This mechanism has the advantage of allowing the person with greatest proximity to trust operations, the general trustee, to initiate action and the disadvantage of delaying the trustee's action in an emergency. See Alternative 2 in form 28.38-1, which gives a special trustee veto power over trustee investments. The form contains a deadline within which the special trustee must respond to proposals from the general trustee.

The tax consequences of giving a veto power to a special trustee are unclear. Holding a veto power may be considered to be equivalent to holding the power subject to the veto because the veto can be exercised until the special trustee's wishes are complied with. Compare *Warren H. Corning* (1955) 24 TC 907, 915, aff'd (6th Cir 1956) 239 F2d 646, superseded by statute on other grounds as stated in *Estate of Helen S. Wall* (1993) 101 TC 300 (control over trustee appointment) with *Estate of Frederick M. Kasch* (1958) 30 TC 102, acq 1958-2 Cum Bull 6 (power to invade principal).

In *Kasch,* the court rejected the Internal Revenue Commissioner's argument that the veto power was equivalent to possession of a power of appointment. The veto power had not yet been exercised in that case, however, because a condition precedent to the existence of the power had not occurred. See also Rev Rul 79-46, 1979-1 Cum Bull 303, in which the Internal Revenue Service ruled that a right to prevent cancellation of a life insurance policy by purchasing it for its cash surrender value was sufficient to cause the holder of the power to be taxed on the proceeds of the policies (less the cash surrender value) under IRC §2042.

If a special trustee arrangement is used, whether the special trustee has full power with respect to specified matters or a veto power, successor special trustees should be named in the will. A less desirable alternative is to give the general trustee the right to exercise the power if the office of special trustee is vacant. See §28.11 on whether a power given to a trustee is personal or descends to a successor.

See also forms 28.16-1 (naming special trustee and successor special trustee); 28.38-1 (giving special trustee investment advisory and investment veto powers).

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§28.10 E. Prior Review of Trust by Trustee

A trust will not fail for lack of a trustee. Prob C §15660. Thus, if the trustee appointed in the will is unable or unwilling to act, the trust will nevertheless be given effect and the court will appoint a trustee. Prob C §15660. Steps should be taken before the will is executed, however, to ensure that the named trustee will serve.

The testator should confirm that the proposed trustee is willing to act. To minimize questions about the trust administration and ensure the trustee's future cooperation, the drafting attorney may permit the proposed trustee to read the will and discuss the trust provisions. For the same reason, representatives of a proposed institutional trustee should review the will before execution, especially if the assets will be difficult to manage (*e.g.,* rental property, an interest in a closely held business), the trust has any unusual provisions (*e.g.,* granting a third person the right to vote the stock of a close corporation or to direct investments), or the institution may be unwilling to act as trustee for any other reason (*e.g.,* the small size of the trust corpus).

In addition to providing the opportunity to eliminate potential administrative difficulties, the proposed trustee's preliminary examination of the trust provisions and estate assets substantially reduces the likelihood that the institution will later decline to act as fiduciary. Incidentally, most institutions will review wills in which they are named as trustee at no charge.

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III. TRUSTEE APPOINTMENT, RESIGNATION, AND REMOVAL

A. Trustee Appointment

§28.11 1. Naming Trustees and Their Successors

The term "name" is used in forms 28.12-1 and 28.16-1 because Prob C §§15600-15601 refer to the "person named as trustee." Compare the term "nominate" regarding the selection of guardians and executors (whose appointment is subject to court approval) in §§24.20-24.21, 25.15-25.16, and 32.10-32.12.

A vacancy occurring in the office of trustee (or cotrustee) is filled according to the instructions of the will, whether it names a successor or provides a mechanism for choosing a successor. Prob C §15660(a)-(b). If the will neither names the successor trustee nor provides for a way to appoint one, a vacancy may be filled in one of two ways: (1) A trust company may become trustee on the agreement of all adult income and potential remainder beneficiaries (Prob C §15660(c)), or (2) the court will appoint a successor on the petition of a cotrustee or any interested person (Prob C §15660(d)). Under §15660(d), the court hearing the petition must consider the wishes of beneficiaries who are age 14 or older.

Despite the existence of these "backstop" provisions, one or more successor trustees should always be named in the will to avoid use of an institutional trustee when one is not desired (see §28.5 on corporate trustees) or the inconvenience and expense of a court proceeding. Naming successor trustees also ensures that the testator's objectives are carried out. Even if a corporate trustee is named as the original trustee, a successor should also be named because the named corporate trustee might decline to accept the office or might later resign. See §28.17 on beneficiary designation of the successor trustee.

Language referring to successors in interest is unnecessary when naming a bank as fiduciary in California, because successors in interest to both state and national banks become successor trustees by operation of law. Fin C §§2073, 2095.

Unless otherwise indicated in the will, a successor trustee is endowed with all the powers of the initial trustee by operation of law. Restatement (Second) of Trusts §196 (1959). The powers of the trustee are considered to vest in the office of the trustee rather than in any particular individual. See *Estate of Canfield* (1947) 80 CA2d 443, 181 P2d 732. Similarly, unless the will provides otherwise, if a vacancy occurs in the office of a cotrustee, the remaining cotrustee or cotrustees may act with all the departed cotrustee's powers, without a successor cotrustee's taking office. Prob C §15621; Restatement §195.

To avoid any dispute over successor-trustee powers, however, the will should expressly state that successor trustees may exercise all powers given to the initial trustee or specify which powers successor trustees may not exercise. If the testator wants to limit certain powers to trustees and their successors who are specifically named in the will, the clause nominating successor trustees should state this.

See §28.49 on successor-trustee liability for acts of predecessor trustee and §28.50 for a form limiting such liability.

Trustee appointment is often made part of the clause making the gift to the trust. See §28.13 for a form clause. Successor trustees are either named when the original trustee is named (see form 28.12-1) or named in a separate clause (see form 28.14-1). Because a trustee can take over for a departed cotrustee, successor cotrustees are usually not named in the will.

Nominations of special trustees are generally made in a clause that is separate from the nomination of the general trustee, because the duties of the special trustee must be particularly described. Form 28.16-1 contains the nomination portion of the special trustee clause. Forms providing special trustee duties in §§28.40-28.41 follow the discussion in §§28.39-28.39C of circumstances in which powers are typically given to a special trustee. The discussion in §§28.39-28.39C also refers to forms in other chapters that grant, or can be adapted to grant, powers to special trustees.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/ 2. Forms Naming Trustees and Their Successors/ §28.12 a. Form: Nomination of Trustee and Successors for All Trusts

2. Forms Naming Trustees and Their Successors

§28.12 a. Form: Nomination of Trustee and Successors for All Trusts

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28.12-1 Nomination of trustee and successors for all trusts

***Nomination of Trustee*. I name as trustee and successor trustee of any trust created in my will, in the order and priority indicated, the following:**

First: _ _[*Name of trustee*]_ _
Second: _ _[*Name of successor trustee*]_ _

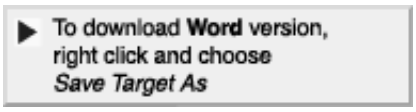
All powers vested in the original trustee shall be exercisable by any successor trustee.

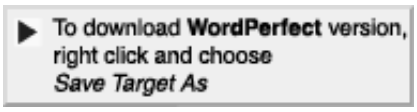
Comment: This clause may be adapted to apply to a single trust, to the appointment of different trustees and successor trustees for different trusts, or to cotrustees. If the testator does not want to give to successor trustees all the powers given to the first-named trustee, the last sentence in the clause should be replaced with a description of successor trustee powers or how those powers will differ from the powers given to the initial trustee.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.13 b. Form: Nomination of Trustee Within Clause Creating Trust

§28.13 b. Form: Nomination of Trustee Within Clause Creating Trust





28.13-1 Creation of trust; nomination of trustee

***Gift of Residue*. I give the residue of my estate, in trust, to _ _[*name of trustee*]_ _. If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The trustee shall hold, administer, and distribute all property allocated to the trust as follows:**

Comment: Drafters who prefer to name the trustee and alternate trustee in the clause establishing the gift may use this clause, which will then precede all the provisions of the testamentary trust. If the drafter prefers not to permit the named trustee to nominate a successor as provided by this clause, successor trustees may be named in a separate clause. See §28.14.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.14 c. Form: Separate Clause Naming Successor Trustee

§28.14 c. Form: Separate Clause Naming Successor Trustee

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28.14-1 Nomination of successor trustee

***Nomination of Successor Trustee*. If the person named as trustee is unable to serve in that office, then the persons listed below shall serve as successor trustees. The order in which their names are given is the order in which succession shall take place. All powers vested in the first-named trustee will be exercisable by any successor trustee. The successor trustees are:**

First: _ _[*Name of successor trustee*]_ _
Second: _ _[*Name of second successor trustee*]_ _

Comment: This clause should be used with form 28.13-1 if the successor trustees are not named in that clause. Normally, the original trustee and successor trustees will be named in the same clause. If the powers of a successor trustee should be more limited than those of the original trustee, the last sentence of this clause before the nomination will not apply, and the powers of the successor must be described.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.15 d. Form: Court Appointment of Successor Trustee

§28.15 d. Form: Court Appointment of Successor Trustee

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28.15-1 Court appointment of successor trustee

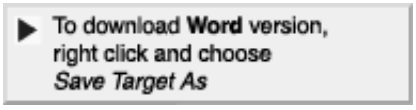
Appointment of Successor Trustee. **If no trustee or successor trustee named in my will can serve, then a court of competent jurisdiction shall appoint a trustee or cotrustees, individual or corporate, after considering the preferences of the current income beneficiaries of the trust.**

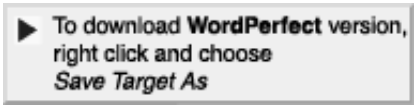
Comment: This clause may be adapted to provide for appointment by, *e.g.,* a beneficiary or the last-serving trustee. For suggested language, see the optional addition to form 28.19-1.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.16 e. Form: Nomination of Special Trustee and Successors

§28.16 e. Form: Nomination of Special Trustee and Successors





28.16-1 Nomination of special trustee

***Nomination of Special Trustee*. For any trust created under my will, I name as special trustee and successor special trustee, in the order and priority indicated, the persons listed below. The special trustee's duties shall be limited to the exercise of discretion under this paragraph, and the special trustee shall not be concerned with other aspects of trust administration. The special trustee shall receive reasonable compensation. Each successor special trustee shall serve if the prior-named special trustee fails to qualify or ceases to act. Any special trustee may resign and name a successor. This appointment shall supersede nomination of the designated successor. If all special trustees fail to qualify or cease to act, a court of competent jurisdiction shall appoint a special trustee or cotrustees, individual or corporate, after considering the preferences of the current income beneficiaries of the trust.**

First: _ _[*Name of special trustee*]_ _
Second: _ _[*Name of successor special trustee*]_ _

The special trustee's duties are as follows:

Comment: The drafter should amend this clause if the will creates only one trust. If the special trustee's compensation should be described more specifically, one of the fee structures suggested in form 28.25-1 (trustee compensation) may be appropriate. On special trustee's duties, see §§28.9, 28.36, 28.38-28.41. Other special trustee duties (*e.g.,* the power to invade principal for the benefit of the trustee-beneficiary) may be adapted from clauses describing duties of the general trustee. See chap 29.

This clause permits the special trustee to replace the successor special trustees named in the will. If the testator wishes to name successor special trustees who cannot be replaced by the special trustee, the drafter should delete the sentence giving nomination power to the special trustee.

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§28.17 3. Appointment of Successor Trustee by Trustee or Beneficiary

There are two primary reasons why a testator may want to give his or her survivors the power to name a successor trustee to act after all the successors named in the instrument have failed to qualify or ceased to act:

(1) If the trusts created in the testator's will are likely to last for several generations, it may be impossible for the testator to name a succession of individual trustees who are able to act for the entire term of all the trusts.

(2) The testator may wish to leave the succession of trustees open to provide greater flexibility than would be possible if every successor were named.

Allowing a trustee or beneficiary to name a successor trustee is a useful alternative to the traditional practice of naming an institutional trustee as the ultimate successor trustee. Although the tradition was based on the assumption that the institution would outlive any individual nominee, there is no guaranty that a named institution will serve. Not only may the institution decline to act, it may also resign if, *e.g.,* the value of the trust does not meet or later falls below its minimum asset requirements. Moreover, merger and acquisition activities may create a situation in which the successor in interest to a bank's trust business is not as suitable a trustee as the originally named institution. See §28.5 on institutional trustees. Therefore, unless the testator adamantly wishes to have a particular institutional trustee act, a better approach may be to give adult beneficiaries the power to name a successor to serve after the last of the named trustees. The beneficiaries can decide whether to name an individual or an institutional trustee.

The power to name successor trustees can be given to trust beneficiaries, to the trustee then in office, or to a third person or persons. The testator should be cautious in giving a beneficiary the power to name a successor trustee. If the beneficiary also has the unrestricted right to remove the trustee and appoint a successor (including himself or herself), and if the trustee has powers that constitute a general power of appointment, the nominating beneficiary will be considered to hold a general power of appointment for death tax purposes. See Treas Reg §20.2041-1(b)(1). See also §§28.8-28.8C, 28.39-28.39C on trustee-beneficiary powers that constitute a general power of appointment. To avoid adverse tax consequences, the beneficiary should be prohibited from appointing himself or herself as successor trustee. For discussion of trustee removal and forms describing removal powers, see §§28.20-28.21.

Provisions for designation of successor trustees by a beneficiary, trustee, or third party must be carefully drafted to state:

- How the successor's appointment is made. A formal procedure for making the appointment (*e.g.,* in writing, delivered to income beneficiaries and appointee) will eliminate confusion.
- Whether the person making the appointment or another person may modify or revoke the appointment.
- Whether the power to appoint overrides any succession of trustees provided in the will.
- Whether the power to appoint includes the power to remove an already-serving trustee.
- Whether the beneficiary or any other person should be excluded from the class of permissible appointees for income, estate, gift, or generation-skipping transfer tax reasons.

See the optional addition to form 28.19-1 (trustee designation of successor after resignation) and form 28.21-1 (trustee designation by beneficiary after removal) for clauses giving trustee appointment power to trustees and beneficiaries. The drafter can adapt these forms if the testator wishes a court to select a successor trustee.

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B. Trustee Resignation

§28.18 1. Giving Trustee Right to Resign

Under Prob C §15640, a trustee of a testamentary trust may resign only as provided in the will (Prob C §15640(a)), with the consent of all adult beneficiaries who are receiving or are entitled to receive income or who would be entitled to receive principal if the trust were then terminated (Prob C §15640(c)), or under court order (Prob C §15640(d)). On petition by a trustee, the court is required to accept the trustee's resignation; it may appoint a receiver or temporary trustee pending appointment of a permanent successor. Prob C §15640(d).

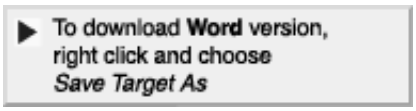
To eliminate the need for the trustee to petition the court at the trust's expense for permission to resign, the will may provide expressly for trustee resignation.

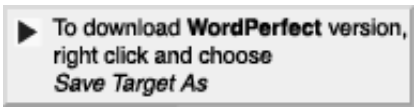
See form 28.19-1 for provisions for succession after trustee resignation: one for succession by the successor trustee named in the will, and an optional addition providing for succession by a fiduciary selected by the departing trustee or a successor trustee appointed by a majority of adult beneficiaries.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.19 2. Form: Trustee Resignation; Succession

§28.19 2. Form: Trustee Resignation; Succession





28.19-1 Trustee resignation and succession

***Resignation of Trustee*. Any trustee may resign at any time from any trust created under my will. The resigning trustee shall give written notice of the resignation by personal delivery or registered mail to all current income beneficiaries. The resignation shall be effective on the acceptance of office by a designated successor trustee.**

[*If appropriate, add one of the following options*]

[*Option 1: Trustee appointment supersedes designation in will*]

The resigning trustee may appoint a successor trustee. This appointment shall supersede the designation of any successor trustee in my will.

[*Option 2: Beneficiary power to appoint successor trustee*]

If no trustee named in my will can serve, a successor trustee shall be appointed by a majority of adult beneficiaries currently entitled to trust income or, if none, a majority of adult beneficiaries who are entitled to distribution of income or principal in the discretion of the trustee.

Comment: Form 28.19-1 provides for a successor designated in the will to take office, unless superseded by a successor appointed by the resigning trustee as provided by Option 1 (or the designated successor is not available as contemplated by Option 2). If a beneficiary or any other person may not act as trustee for tax reasons, this clause should specifically exclude that person from candidacy to avoid his or her inadvertent appointment.

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C. Trustee Removal by Beneficiary

§28.20 1. Using Trustee Removal Clauses

A trustee may be removed as provided in the will, by the probate court on the court's own motion, or on petition by a cotrustee or beneficiary. Prob C §15642(a). The court can suspend a trustee on its own motion without a petition being filed by an interested party under Prob C §17200. *Schwartz v Labow* (2008) 164 CA4th 417, 78 CR3d 838. Removal may occur either before or after any property has been distributed to the trustee. The statutory grounds for removal are (1) breach of trust, (2) insolvency or unfitness to administer the trust, (3) hostility or lack of cooperation among cotrustees, (4) failure to act, (5) excessive trustee compensation under the circumstances, (6) the trustee is a disqualified person under Prob C §21350(b) (see discussions in §§1.35, 28.4) unless the court finds that it is consistent with the settlor's intent that the trustee continue to serve and that this intent was not the product of fraud, menace, duress, or undue influence, (7) substantially inability to manage the trust's financial resources or otherwise execute properly the duties of the office, (8) substantial inability to resist fraud or undue influence, or (9) other good cause. Prob C §15642(b).

These grounds do not specifically include conflict of interest, but a conflict of interest can constitute "other good cause." In *Getty v Getty* (1988) 205 CA3d 134, 252 CR 342, the court held that when a legally proper ground for removal exists (*e.g.,* conflict of interest), there need be no evidence of actual past wrongdoing by the trustee to justify the removal. But see *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842, in which the court held that a trustee will be removed only for demonstrated abuse of power if the settlor selected the trustee with full knowledge of possible conflicts of interest.

Will provisions for trustee removal, including grounds for removal in appropriate cases, avoid the need for a court proceeding to remove a trustee. Also, the explicit power to remove a trustee can give beneficiaries a means of obtaining better service from the trustee. A nominated trustee may refuse to accept the office, however, if removal is entirely at the discretion of a beneficiary or third party.

A removal power may have adverse estate tax consequences. When the trustee has powers that would constitute a general power of appointment if held by a beneficiary, and the beneficiary has the power to remove the trustee and appoint a successor including himself or herself, then the trust property will be taxed in the beneficiary's estate. See Treas Reg §20.2041-1(b)(1). See also §28.17.

However, a retained power to substitute another independent trustee for the existing trustee is not the type of power that would constitute a general power of appointment. See discussion in §16.26.

The drafter must consider whether granting a beneficiary the power to remove a trustee will give the beneficiary more control over trust management than the testator intends. This is particularly important when the trust is a marital deduction qualified terminable interest property trust, designed to give the surviving spouse lifetime income but to reserve to the testator control over the disposition of the corpus. See chaps 17-20 on marital deduction trusts.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.21 2. Form: Trustee Removal by Beneficiary

§28.21 2. Form: Trustee Removal by Beneficiary

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28.21-1 Trustee's removal by beneficiary

[*Add one of the following alternatives*]

[*Alternative 1: Removal without cause*]

***Removal of Trustee*. For any trust in which _ _[*name of beneficiary*]_ _ is a beneficiary, _ _[*name of beneficiary*]_ _ may by written instrument delivered to the trustee remove any trustee and appoint any _ _[*person/corporation*]_ _ _ _[*except _ _[himself/herself]_ _ or any related or subordinate party (within the meaning of Internal Revenue Code §672(c))*]_ _ as successor trustee or cotrustee, with this designation superseding any appointment made under the trust instrument. After written acceptance by the appointed successor trustee, the removed trustee shall promptly deliver all trust assets in _ _[*his/her/its*]_ _ possession to the successor trustee _ _[*together with an accounting for all acts affecting the trust since the date of any prior accounting*]_ _.**

[*Alternative 2: Removal for cause*]

***Removal of Trustee*. For any trust created under my will in which _ _[*name of beneficiary*]_ _ is a beneficiary, _ _[*name of beneficiary*]_ _ may by written instrument delivered to the trustee and all current income beneficiaries remove for cause any trustee in office and appoint any person or corporate trustee as successor trustee or cotrustee, with this designation superseding any appointment under my will. After written acceptance by the appointed successor trustee, the removed trustee shall promptly deliver all trust assets in _ _[*his/her/its*]_ _ possession to the successor trustee and account for all acts since any prior accounting. This power shall also apply if the trustee resigns or ceases to act. "Cause" shall include without limitation:**

(1) Lack of attention to trust administration matters;

(2) Incompatibility or personality conflict with one or more beneficiaries;

(3) Residence of all current income beneficiaries of the trust outside the state in which the corporate trustee being removed maintains its principal place of business or in which the individual trustee being removed resides; or

(4) Any other grounds that, if alleged and proved, would justify Court removal of the trustee.

The power of removal shall be exercisable only in the interests of all trust beneficiaries.

Comment: The drafter should use form 28.21-1 when the testator wishes to give a beneficiary the right to remove a serving trustee. The drafter should adapt this clause if the testator wishes (1) to restrict removal power to removal of, *e.g.,* corporate trustees or (2) to limit the types of successor trustees to, *e.g.,* corporate trustees.

The clause must also be adapted if the testator intends the beneficiary to have the power to remove a trustee, but not to replace the trustee with anyone other than a named successor. If the trust is intended to outlive the beneficiary with the removal power, the clause should state whether succeeding beneficiaries will have the same, more limited, or expanded removal power.

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D. Trustee Replacement Owing to Incapacity

§28.21A 1. Need for New Trustee When Appointed Trustee Becomes Incapacitated

Clauses for designating a successor trustee on the inability or unwillingness of a trustee to serve (see §§28.12-28.16) implicitly extend to situations in which the trustee becomes physically or mentally incapacitated. The testator may wish to include a separate clause, however, requiring that a physician or other trusted person certify the trustee's incapacity. If the opinion of a physician is required, it is important to address the issue of whether the physician can provide the needed opinion without violating the doctor-patient privilege and relevant privacy laws.

One approach for dealing with this problem is to require trustees to execute waivers of their confidentiality rights. Any such waiver by the trustee would need to comply with the requirements of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191, 110 Stat 1936) (particularly the HIPAA privacy provisions in 42 USC §1320d-2 and the resulting HIPAA Privacy Rule in 45 CFR pts 160, 164) and California's Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37). If the waiver is included in a document specifically authorizing the release of medical information executed at the time of assuming the office, there is some question whether that waiver or authorization will be effective years later when the question of incapacity arises. It is also unclear whether a broad authorization for release of medical information will satisfy the requirements.

Planners generally want to avoid the need for a successor trustee to seek a court order either to obtain the release of medical information or to remove the trustee. The need for a court order would defeat the purpose of including an incapacity clause in the trust document. One commentator argues that the trust document should require trustees and successor trustees to execute an authorization for release of health information as a prerequisite to appointment or to continuation of service. See Soskin, *How to Be a HIPAA Lawyer*, 26 CEB Est Plan Rep 125 (Apr. 2005). For a form of trustee replacement clause containing alternative provisions, see §28.21B. For a form of trust provision requiring successor trustees to authorize release of health information, see §28.21C. For a form of authorization by successor trustees for use and disclosure of health information, see §28.21D.

Replacing a trustee because of incapacity may present problems with transferring property to the successor trustee unless the substituted trustee is willing and competent to arrange for the transfer. It may be advisable not to limit court jurisdiction if that becomes necessary to resolve problems of transfer. See Prob C §17200(b)(10) (petition for appointing or removing trustee).

Because some corporate trustees are reluctant to petition the court to act as successor trustee, the trust document should allow a beneficiary to petition for appointment of the institution as successor trustee. Note, however, that this clause is not absolutely necessary, because §17200(b)(10) authorizes any trustee or beneficiary to petition for removal of a trustee. The statute gives no standard for removal. A clause may also be included authorizing the corporate trustee, at the request of a named person (including an interested person, a friend of the settlor, or a beneficiary), to petition the court for appointment as successor trustee.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.21B 2. Form: Replacement of Incapacitated Trustee

§28.21B 2. Form: Replacement of Incapacitated Trustee

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28.21B-1 Replacement of incapacitated trustee

[*Add one of the following alternatives*]

[*Alternative 1: Determination by physicians*]

Replacement of Incapacitated Trustee. **If the trustee of any trust created under my will cannot administer the trust because of physical or mental incapacity, the successor trustees provided for in this trust in the order named shall act as trustee, having all rights and powers granted to the trustee by this document. Physical or mental incapacity shall be conclusively established if two physicians authorized to practice medicine in the State of California or any other place in which the trustee resides, who are unrelated to the settlor and the trustee by blood or marriage, issue written declarations under penalty of perjury to that effect _ _[***and*** _ _[*name(s) of particular physician and/or trusted friend*]_ _ ***concur(s) that the trustee is incapacitated***]_ _.**

[*If applicable, add the following option*]

[*Option: Successor trustee may petition for court removal of incapacitated trustee*]

Court Removal of Incapacitated Trustee. **In the absence of declarations of incapacity, the successor trustee designated in this trust or one or more of the beneficiaries may petition the court having jurisdiction over this trust to remove the trustee and replace _ _[*him/her*]_ _ with the designated successor trustee. The successor trustee or beneficiary who petitions the court shall incur no liability to any beneficiary of the trust or to the substituted trustee as a result of this petition as long as the petition is filed in good faith and in the reasonable belief that the substituted trustee is physically or mentally incapacitated or otherwise cannot act.**

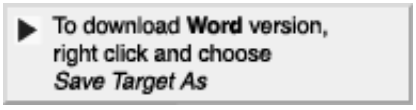
[*Alternative 2: Determination by committee*]

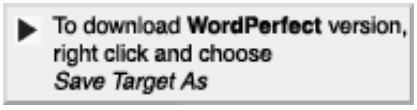
Replacement of Trustee. **If the trustee is no longer able to effectively manage the affairs of the trust, the successor trustees provided for in this trust in the order named shall act as trustee, having all rights and powers granted to the trustee by this document. The trustee's inability to effectively manage the affairs of the trust shall be conclusively established if at least _ _[*two/three*]_ _ of the following concur in that opinion: _ _[*name(s) of three to five individuals, e.g., family members, trusted friends, successor trustee, primary physician*]_ _.**

Comment: The disadvantage of the optional clause in Alternative 1 for court removal of an incapacitated trustee is that an obstreperous beneficiary who cannot convince physicians of the trustee's incapacity may embarrass and upset the trustee without cause. Alternative 2 may be customized to permit determination by a single individual.

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§28.21C 3. Form: Trustee Required to Authorize Release of Health Information





28.21C-1 Trustee required to authorize release of health information

1. *Agreement to Execute Authorization.* A specific condition precedent to the appointment and acceptance of, or continuation in, the position of trustee, co-trustee, or successor trustee of any trust created under my will is the execution of the Authorization for Use and Disclosure of Protected Health Information in the form set forth in Exhibit _ _[*letter*]_ _ (except for such changes as may be required to comply with subsequent changes in the law and regulations), attached hereto and incorporated herein by this reference, for purposes of determining whether the trustee, co-trustee, or successor trustee is capable of managing the affairs of the trust.

2. *Revocation of Authorization.* Any trustee, co-trustee, or successor trustee may revoke an authorization for disclosure of health information previously executed by such person, but revocation shall be deemed to constitute the immediate resignation of the trustee, co-trustee, or successor trustee.

3. *Determination of Capacity.* Any individual holding or accepting the office of trustee or co-trustee of this trust agrees to be examined by a physician selected by such person to determine whether such person has the capacity to serve or continue serving as trustee or co-trustee, as defined in this trust document _ _[*to determine whether such person is substantially incapable or capable of managing this trust*]_ _, within thirty (30) days of being reasonably requested to do so by a successor trustee or co-trustee, if any, and otherwise by the next successor trustee or co-trustee, or if there is none, by any beneficiary who is currently entitled to receive income or principal distributions from this trust. A trustee, co-trustee, or successor trustee who refuses to be examined within thirty (30) days after being requested to do so in writing, as provided above, shall be deemed to have immediately resigned.

Comment: For a form of authorization for use and disclosure of protected health information that may be attached to the trust document, see §28.21D.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.21D 4. Form: Authorization for Use and Disclosure of Health Information

§28.21D 4. Form: Authorization for Use and Disclosure of Health Information

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28.21D-1 Authorization for use and disclosure of health information

AUTHORIZATION FOR USE AND DISCLOSURE OF PROTECTED HEALTH INFORMATION

1. Pursuant to the Health Insurance Portability and Accountability Act of 1996 (HIPAA), 42 USC §1320d and 45 CFR parts 160, 164, and the California Confidentiality of Medical Information Act, Civil Code §§56-56.37, I authorize all health care providers and covered entities to disclose my protected health information and medical information:

A. To a successor agent or co-agent nominated under a durable power of attorney signed by _ _[*name of settlor*]**_ _ of which I am then acting or then eligible to act as an agent, at the request of a successor agent or co-agent, in the form of a written and signed opinion that I do or do not have capacity as defined in the power of attorney _ _**[, *along with a statement containing the minimum health information necessary to support and explain the opinion*]**_ _.**

B. To a successor trustee or co-trustee _ _[*or beneficiary*]**_ _ of any trust of which _ _**[*name of settlor*]**_ _ is the settlor and of which I am nominated as a trustee _ _**[*or a beneficiary of such trust*]**_ _, at the request of such co-trustee or successor trustee, in the form of a written opinion that I do or do not have capacity to serve as trustee as defined in the trust _ _**[, *along with a statement containing the minimum health information necessary to explain and support the opinion*]**_ _.**

C. To the attorney for _ _[*name of settlor*]**_ _, at his or her request, for the purpose of determining my capacity to serve as trustee, and I authorize _ _**[*name of attorney*]**_ _ to redisclose such information in the minimum amount required to implement or not implement such actions, as the case may be.**

2. Any person authorized above to receive my protected health information may bring a legal action against any covered entity or health care provider that refuses to provide my protected health information for the purposes described above, and shall be reimbursed from the trust for all costs pertaining to such legal action.

3. I understand that:

A. I have a right to receive a copy of this authorization.

B. I may revoke or modify this authorization at any time by written notice delivered to and received by the health care provider.

C. This authorization shall expire on the date of my death unless validly revoked prior to that date.

D. Under California law, all recipients of protected health care information may not redisclose it except as required or permitted by law.

E. The covered entity may not condition treatment, payment, enrollment, or eligibility for benefits on whether I sign an authorization unless the law allows conditions.

F. There is the potential for information disclosed pursuant to this authorization to be subject to redisclosure by the recipient and no longer protected by HIPAA regulations.

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

_ _[*Typed name*]_ _

Comment: This form is to be produced in a typeface not smaller than 14-point type pursuant to CC §56.11(a).

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IV. TRUSTEE'S BOND

§28.22 A. When Bond Is Required; Advisability of Waiver

Unless the will provides otherwise, no bond is required of a testamentary trustee who is named in the will. Prob C §15602. A trust company is not required to give a bond, even if the will requires it. Prob C §15602(e). The Probate Code, however, requires a bond of an individual trustee who is not named in the instrument and who is appointed by the court. Prob C §15602(a)(3). The statute also permits the court to require a bond of a trustee if one is necessary to protect the interests of the beneficiaries or other persons having an interest in the trust. Prob C §15602(a)(2).

Even if a bond is required in the will, the court may nevertheless waive or reduce bond, although the court may not excuse the requirement of bond for an individual trustee who is not named in the instrument except under compelling circumstances, including a request by all adult beneficiaries that bond be waived. Prob C §15602(b). Because the bond requirement is for the beneficiaries' benefit, bond may also be waived if there are no creditors of the trust and all beneficiaries consent to the waiver. *Estate of Shapiro* (1947) 79 CA2d 731, 181 P2d 117.

A bond is ordinarily an unnecessary expense. A testator who insists on bond for a trustee named in the will should consider nominating others in whom he or she has more confidence. When a trust lasts for many years, however, named trustees may no longer be available to serve. The identity of every trustee of a trust is impossible to establish in advance, unless the trust terminates at the original trustee's death. A bond does provide some measure of financial protection for the beneficiaries in case of breach of trust or losses caused by poor judgment. Even so, after weighing the costs against the protection afforded by a bond, many practitioners use a will clause that waives bond for all trustees in all testamentary trusts. Should the waiver of bond become unwise, those concerned may petition under Prob C §15602(a)(2) to require a bond notwithstanding the express waiver.

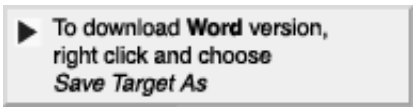
Although a bond is not required of a trustee named in the will, the court might require bond of a nonresident trustee or a successor trustee selected by the trustee or another person. If the terms of the will may lead to those circumstances, the drafter who wants to avoid the imposition of bond should specify that no bond is required. A clause waiving bond may also be effective (especially if the beneficiaries support the waiver) when a trustee not named in the will is appointed by the court, despite the apparent requirement of bond in Prob C §15602(a)(3).

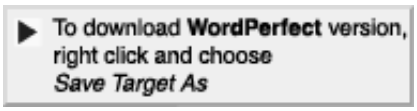
If a bond may be required of a named trustee, the testator may want to provide for a successor trustee so that the original nominee can resign and be replaced if the bond is required of him or her.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.23 B. Form: Waiver of Bond

§28.23 B. Form: Waiver of Bond





28.23-1 Waiver of bond

No named or unnamed, resident or nonresident trustee of this trust shall be required to post bond or security to serve.

Comment: The drafter may want to require bond for a trustee who is neither named in the will nor appointed under a procedure set forth in the will. This clause may be integrated with the nomination clauses in forms 28.12-1, 28.13-1, 28.16-1.

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V. TRUSTEE COMPENSATION AND REIMBURSEMENT

§28.24 A. Using Clause for Trustee Compensation

In the absence of a provision in the will governing compensation, the trustee is entitled to reasonable compensation. Prob C §15681. Quoting from Bogert, The Law of Trusts and Trustees §966 (1977), the court in *Estate of McLaughlin* (1954) 43 C2d 462, 467, 274 P2d 868, emphasized that, in addition to trust income, the following factors must be considered in determining reasonable trustee compensation:

> [T]he success or failure of the administration of the trustee; any unusual skill or experience which the trustee in question may have brought to his work; the fidelity or disloyalty displayed by the trustee; the amount of risk and responsibility assumed; the time consumed in carrying out the trust; the custom in the community as to allowances to trustees by settlors or courts and as to charges exacted by trust companies and banks; the character of the work done in the course of administration, whether routine or involving skill and judgment; any estimate which the trustee has given of the value of his own services.

See also *Estate of Nazro* (1971) 15 CA3d 218, 93 CR 116, in which the court approved the *McLaughlin* court's award of reduced trustee and attorney fees.

If there is more than one trustee in office, the compensation must be apportioned between or among the trustees in proportion to their individual services, unless the will provides otherwise or the trustees otherwise agree. Prob C §15683. (The compensation of a special trustee is probably governed by the same standard, although the statute refers only to "cotrustees.") Institutional trustees generally expect to receive the bulk of the trustee fees.

When the will specifies the amount of the trustee compensation, the court has authority to increase or decrease the fees if (Prob C §15680(b)):

- The duties of the trustee are substantially different from those contemplated when the trust was created;
- Compensation in accordance with the terms of the trust would be inequitable or unreasonably low or high; or
- Extraordinary circumstances call for equitable relief.

According to Cal L Rev'n Comm'n Comment to Prob C §15681, the trustee may receive compensation without a court order. See 18 Cal L Rev'n Comm'n Reports 1363 (1986). On petition, however, the court may fix the amount of compensation prospectively under Prob C §15682. See Prob C §17200(b)(9).

To avoid the need for periodic court intervention if the trustee and the beneficiaries do not agree on the amount of the trustee fees, the testator should set the rate of compensation or at least include a clause in the will permitting "reasonable compensation" without court approval. Specifying the compensation in the will provides certainty for both the testator and the trustee.

NOTE: Trustee fees under local court rules may range from 0.75 percent to 1 percent of the net value of the trust principal annually, plus additional fees for extraordinary services. Extraordinary services include services rendered in connection with the establishment and termination of the trust as well as litigation and tax matters. Local rules may also provide for fee awards to trustee counsel.

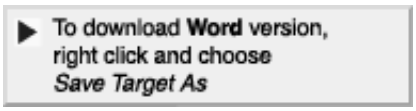
Trustee compensation is virtually always set on an annual basis, stated either as a flat sum or as a percentage of the net value of the trust principal. The latter method tends to keep the trustee fees commensurate with the responsibility involved (to the extent that this can be measured by the size of the trust principal) and with cost of living increases. In the usual case, the specified fee covers only the trustee's ordinary services. Under the circumstances specified in Prob C §15680(a), (b)(1)-(3), the trustee could petition for compensation for extraordinary services even if the will stated that the specified fee is intended to cover both ordinary and extraordinary services.

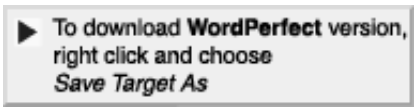
If the trustee is expected to delegate a considerable portion of his or her duties (*e.g.,* accounting responsibilities), it may be advisable to reduce the trustee's compensation in proportion to the work-load reduction or by the amount paid to the agents.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.25 B. Form: Trustee Compensation

§28.25 B. Form: Trustee Compensation





28.25-1 Trustee compensation

[*Add one of the following alternatives*]

[*Alternative 1: Reasonable compensation*]

***Trustee Compensation*. Trustees are entitled to reasonable compensation.**

[*Alternative 2: Specified compensation*]

***Trustee Compensation*. Without Court order, the trustee shall be entitled to (1) annual compensation for all ordinary services rendered to the trust, computed as follows: _ _[*formula*]_ _, and (2) reasonable compensation for any extraordinary services rendered. If the trustee serves for only part of a calendar year, the annual compensation shall be prorated to reflect the actual period of service.**

Comment: A trustee is entitled to reasonable compensation if the trust is silent. Prob C §15681. If the trust document specifies compensation, the trustee is entitled to the compensation specified. A court can increase or decrease the amount specified if appropriate. Prob C §15680. Specifying a compensation that is too low may result in the desired trustee declining to serve.

To use Alternative 2, the drafter must provide a formula for calculating the annual compensation. A typical percentage fee formula is: "_ _[*Number*]_ _ percent of the average net value of the principal of the trust estate during each year."

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C. Devise to Trustee

§28.26 1. Devise in Lieu of Compensation

Unless the will states otherwise, a specific devise to the person named as trustee of a testamentary trust is considered to be made in addition to the trustee fees rather than in place of them. Restatement (Second) of Trusts §242, Comment f (1959).

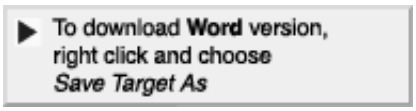
The testator should consider the tax implications of a devise in lieu of compensation for services. A devise is not usually includable in the recipient's gross income for income tax purposes (IRC §102), but trustee fees, like other compensation for personal services, are taxable income to the recipient. The tax consequences of a devise to the trustee, however, may depend on the terms of the will. If the devise is made on the condition that the recipient act as trustee, the devise will be subject to income tax and the trust will obtain an income tax deduction for the payment. *Ream v Bowers* (2d Cir 1927) 22 F2d 465. If the will specifies that the devise is made in lieu of other compensation but will be paid whether or not the trustee assumes office, the devise is not compensation for services and will probably not be includable in the recipient's gross income. *U.S. v Merriam* (1923) 263 US 179, 68 L Ed 240, 44 S Ct 69. See Rev Rul 57-398, 1957-2 Cum Bull 93; *J. Edward Murray* (1938) 38 BTA 26, acq 1938-2 Cum Bull 22.

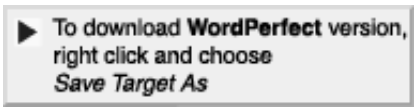
But see *Bank of New York v Helvering* (2d Cir 1943) 132 F2d 773, in which the court treated a devise of a percentage of trust income in lieu of commissions as a devise to the extent that the amount exceeded the statutory compensation for trustees. This case indicates that the tax consequences of a devise may depend on facts and circumstances rather than on particular language in the will.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.27 2. Form: Devise in Lieu of Compensation

§28.27 2. Form: Devise in Lieu of Compensation





28.27-1 Devise to trustee in lieu of compensation

The devise to _ _[*name of trustee*]_ _ in this clause is made to the person named as trustee of my testamentary trust. This devise is made in lieu of all compensation to which the beneficiary would otherwise be entitled as trustee but shall be payable whether or not the beneficiary serves as trustee.

Comment: This clause accompanies a devise in the will's gift-giving section; it is not a "trust clause" included in the will's testamentary trust section. For discussion of general pecuniary gifts, see §§12.70-12.71. The clause is designed to provide the trustee with compensation that is free from income tax. The advisability of such a clause depends on the relative income tax brackets of the trust and the trustee and whether the testator intends to make a gift even if the recipient does not serve as trustee. If the drafter wants the devise to serve in lieu of ordinary compensation, but not to limit extraordinary compensation, the clause should be amended accordingly. To do so, the drafter may wish to use the portion of form 28.25-1 that provides for extraordinary compensation.

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§28.28 D. Trustee Expense Reimbursement

The trustee is entitled to be reimbursed out of the trust assets for the payment of all proper expenses of the trust as well as for expenses that were not properly incurred but that benefited the trust. Prob C §15684.

Although no will provision is necessary to give the trustee the right to reimbursement for proper expenses, it may be desirable to give the trustee some protection against allegations that the trustee has incurred unauthorized expenses. Otherwise, the trustee may have to establish that the payments were proper or benefited the trust. See §28.30 for a clause authorizing the trustee to employ and pay agents to perform duties that should ordinarily be performed by the trustee. See also Restatement (Third) of Trusts §88 (2007). Additional protection may be provided by permitting the trustee to charge the trust with all expenses incurred in good faith. See Restatement (Second) of Trusts §245, Comment c (1959). Such a clause could be a separate clause or an addition to the provision for trustee compensation.

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VI. TRUSTEE DELEGATION OF DUTIES

A. Trustee Power to Delegate

§28.29 1. Delegation of Trust Administration Duties Generally

The trustee has a duty "not to delegate to others the performance of acts that the trustee can reasonably be expected to perform personally." Prob C §16012(a). An express provision in the trust will authorize an otherwise impermissible delegation, however. 3 Scott & Ascher on Trusts §17.3 (5th ed 2007).

Although the trustee may not delegate to a cotrustee or anyone else the entire administration of the trust (Prob C §16012(a)), the trustee may delegate acts that a person would ordinarily delegate in the management of his or her own affairs. Restatement (Third) of Trusts §80 (2007). See 3 Scott on Trusts §§17.3.2-17.3.4. Probate Code §16247 explicitly authorizes the trustee to hire accountants, attorneys, investment advisers, appraisers (including probate referees appointed under Prob C §400), or other agents (even if associated or affiliated with the trustee) to advise or assist the trustee in the performance of administrative duties. Under the circumstances, when employing agents and advisers in administration of the trust, the trustee is still subject to the "prudent person" standard of conduct described in Prob C §16040.

When employing agents associated or affiliated with the trustee, the trustee must comply with the Prob C §16002 duty of loyalty and the Prob C §16004 duty to avoid conflicts of interest.

Moreover, a trustee who delegates responsibilities to an agent, a cotrustee, or another person still has a duty to exercise general supervision over the person's performance. Prob C §16012(b). Absent a contrary provision in the will, the trustee must still make an independent judgment after consulting with an adviser. See *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848; *Estate of Dodge* (Sur Ct 1943) 39 NYS2d 186, aff'd (App Div 1943) 43 NYS2d 512.

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§28.29A 2. Delegation of Investment and Management Functions

The proscription against delegation does not apply to investment and management functions governed by the Uniform Prudent Investor Act (Prob C §§16045-16054). See Prob C §16012(c). A trustee may delegate investment and management functions as prudent under the circumstances. Prudence must be exercised in such functions as selecting the agent, establishing the scope and terms of the delegation, and periodically reviewing the agent's overall performance and compliance with the terms of the delegation. See Prob C §16052(a). A trustee who complies with the requirements of Prob C §16052(a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated, other than as specified in Prob C §16401, discussed in §28.29C.

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§28.29B 3. Compensation When Duties Are Delegated

The petition for approval of the account or a report accompanying the petition must contain a statement disclosing any family or affiliate relationship between the fiduciary and any agent hired by the fiduciary during the accounting period. Prob C §1064(a)(4).

If an individual is named trustee, the testator should consider authorizing the trustee to employ a corporate fiduciary to perform routine administrative and investment advisory services. The trustee will retain final authority in matters involving the exercise of judgment.

The testator may also merely request that the trustee consult with a particular individual on investment or other matters. This solution is particularly appropriate when the testator respects the judgment of a particular individual but does not wish to burden him or her with any specific duties. A more formal arrangement is suggested by Alternative 2 in form 28.38-1, a clause requiring the general trustee to obtain a special trustee's prior approval of investments.

The testator may encourage the trustee's use of advisers through a will clause that specifically authorizes the trustee both to employ such experts and to charge the trust with the cost of their services. The difficulty of later proving that the trustee made the ultimate decision after consultation (see *Estate of Talbot* (1956) 141 CA2d 309, 296 P2d 848) suggests that it may also be desirable to authorize the trustee to rely on the advice of experts in the trust's employ. The testator may name one or more advisers or persons to designate them. See §28.30 for a form permitting trustee retention of advisers.

Probate Code §16243 authorizes payment of reasonable compensation to employees and agents of the trust. In *Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494, the appellate court held that a trial court may award fees to the trustee's attorney for services rendered in connection with objections to the trustee's accounts even though the court has not yet ruled on the objections.

The will should specify whether the trustee's compensation must be reduced by the amount paid to agents and consultants. If an individual trustee delegates all custodial and record-keeping tasks to a corporate fiduciary, for example, it may be inappropriate for the individual to receive fees as though he or she were performing the delegated work. See §28.24 on trustee compensation.

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§28.29C 4. Trustee Liability for Agent's Acts

When creating clauses that permit the trustee to delegate major responsibilities the drafter should bear in mind the provisions of Prob C §16401. Under this statute, the trustee is liable to a beneficiary for acts or omissions by an agent that would constitute a breach of trust if committed by the trustee, when one or more of the following circumstances exist:

(1) The trustee directs the agent's acts;
(2) The trustee delegates to the agent the performance of a nondelegable act;
(3) The trustee fails to use reasonable prudence in the selection or retention of the agent;
(4) The trustee does not periodically review the agent's overall performance and compliance;
(5) The trustee conceals the agent's acts; or
(6) The trustee fails to take reasonable steps to compel the agent to redress a known wrong.

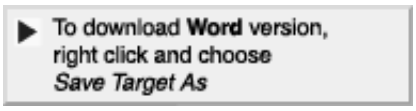
Whether a trustee acts reasonably under items (3) or (6) is determined according to the trustee's standard of care described in Prob C §16040, when the duties delegated are other than investment or management functions. Cal L Rev'n Comm'n Comment to Prob C §16401(b).

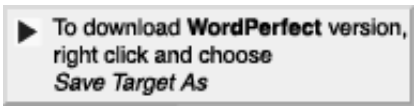
When the duties delegated are investment or management functions, special standards of trustee prudence apply. See Prob C §16052, discussed in §28.29A.

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B. Forms Giving Trustee Power to Delegate

§28.30 1. Form: Power to Employ Agents and Advisers





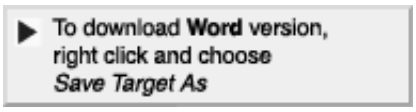
28.30-1 Power to employ agents and advisers

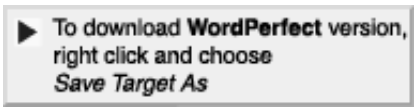
***Power to Employ Agents and Advisers*. The trustee may, in the trustee's discretion, employ and rely on the advice given by any custodian, attorney, accountant, investment adviser, corporate fiduciary, or other agents or advisers to assist the trustee in the administration of this trust. Reasonable compensation for services performed by any agent or adviser shall be paid from either principal or income of the trust estate and shall not decrease the compensation to which the trustee is entitled.**

Comment: The clause providing for the agents' compensation should be used with care, because it enables the trustee to delegate the performance of most of his or her duties while still receiving the entire trustee fee. The drafter should amend this clause or the trustee compensation clause (see form 28.25-1) when payment to an agent should reduce the fee. Note that, under current California law, a trustee has the power to delegate investment and management functions under Prob C §16052. If the trustee may be a beneficiary, the optional language giving the trustee discretion to charge agent fees against either principal or income should be used with caution; the power may be viewed as giving the trustee-beneficiary a general power of appointment. See §§28.8, 30.9.

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§28.31 2. Form: Beneficiary Selection of Investment Adviser; Trustee Exculpation





28.31-1 Investment adviser selection by beneficiary; trustee exculpation

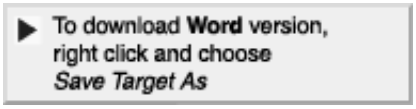
***Investment Adviser Selected by Beneficiary*. For any trust in which _ _[*name of beneficiary*]_ _ is a beneficiary, _ _[*name of beneficiary*]_ _ may select an investment adviser. The trustee shall abide by the decision of the investment adviser and will not be liable or surcharged for losses directly attributable to investments made on the adviser's advice. The trustee shall not take independent action on specific trust investments unless the trustee receives written instructions from the investment adviser.**

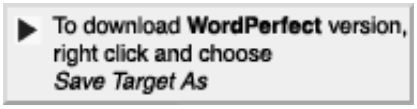
Comment: This clause enables a named beneficiary to select an investment adviser. The clause can be adapted to any kind of consultant, adviser, or broker. If the testator wants other beneficiaries to have this power at the death of the first beneficiary (*e.g.,* children after the death of the surviving spouse or domestic partner), the clause should provide this. In lieu of this clause, the testator can name an adviser to provide either consultation or mandatory instruction. See form 28.32-1. See also §§28.36, 28.38 on using special trustees to guide investments.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.32 3. Form: Trustee Requested to Consult With Third Party Adviser

§28.32 3. Form: Trustee Requested to Consult With Third Party Adviser





28.32-1 Trustee consultation with third party adviser

***Nomination of Investment Adviser*. The trustee is requested, but not required, to consult with and consider the recommendations of the following person regarding the retention, sale, exchange, lease, and investment of trust assets:** _ _[*Name of third party adviser*]_ _.

Comment: This clause provides for consultation only on investment matters. To avoid delay if the trustee must act quickly, the consultation is not made mandatory. Under this clause, the consultant will not be treated as a trustee. The testator may also wish to provide for consultation on other matters, *e.g.,* beneficiary needs.

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C. Delegation of Duties Among Cotrustees

§28.33 1. Reasons for Delegating Among Cotrustees

When cotrustees are used, it is often impractical for each trustee to be involved in all aspects of trust administration. See §28.7 on statutory requirements affecting cotrustee performance. The requirement that all cotrustees act jointly (see Prob C §15620) may make it difficult for the trust to transact business if one or more of the trustees is out of the country, in another state, physically incapacitated, or simply uninterested in the day-to-day aspects of administering the trust. In such circumstances, it may be wise for less-active trustees to delegate powers to a trustee who manages the trust on a daily basis. The testator may effect this delegation in advance through a clause eliminating the usual requirement for unanimous cotrustee consent or providing that only some of the trustees' signatures are required to bind the trust in certain respects.

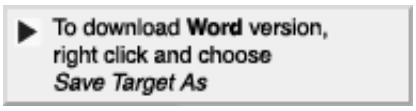
A will provision giving a cotrustee the right to delegate powers does not eliminate his or her duties to the trust; the delegation must be consonant with the good judgment otherwise required for fiduciary acts. Further, the right to delegate does not reduce the delegating cotrustee's exposure to liability for the other cotrustee's acts unless the will provides exculpation. See §§28.29 (nondelegability of trustee's entire responsibility), 28.7 (trustee's liability for cotrustee's acts).

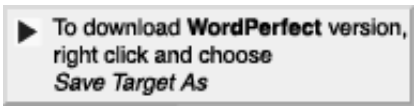
Form 28.34-1 suggests only one situation in which delegation of powers among cotrustees may be appropriate. The attorney can provide for powers delegation in other circumstances with special drafting.

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2. Forms Delegating Powers Among Cotrustees

§28.34 a. Form: Individual Cotrustee's Delegation of Powers to Cotrustee During Absence





28.34-1 Power to delegate powers to cotrustee during absence

A cotrustee may, in the trustee's discretion, delegate any of the cotrustee's powers to another cotrustee during temporary vacation periods or other absences from California. This power of delegation may be exercised only by written notice to the other cotrustee specifying the delegated powers. The delegation of powers shall terminate on delivery of written notice to the cotrustee of termination of the delegation. The delegating cotrustee shall incur no liability to any beneficiary of the trust estate as a result of any actions taken or not taken within the scope of delegation during the period of delegation.

Comment: This clause is likely to be useful in a majority of trusts administered by cotrustees. It may be adapted to, *e.g.,* substitute the term "corporate cotrustee" for "cotrustee" in the appropriate case or describe other conditions under which a cotrustee may delegate powers. The clause may be integrated with the nomination clauses in forms 28.12-1, 28.13-1, 28.16-1, if multiple trustees are named.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.35 b. Form: Action by Majority of Cotrustees Binds Trust

§28.35 b. Form: Action by Majority of Cotrustees Binds Trust

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

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28.35-1 Majority trustee action binding

Any action taken by a majority of the trustees in office shall be binding on this trust, and third parties may rely on this action. The nonconsenting trustees shall not be liable for actions of the majority.

Comment: This clause is designed for trusts with more than two cotrustees. It may be adapted to limit the majority's power to take specific actions, such as restricting monetary obligations to those below a certain amount. The clause may be integrated with the nomination clauses in forms 28.12-1, 28.13-1, 28.16-1, if multiple trustees are named.

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VII. DIVISION OF DUTIES AMONG TRUSTEES

A. Nontax Reasons to Allocate Duties

§28.36 1. Allocating Duties to Use Trustees' Special Skills or Resources

The testator's objectives may indicate that certain duties should be vested exclusively in one trustee. For example, the testator may disagree with the investment policies of an institutional trustee but want to take advantage of its permanence and record-keeping facilities, or the testator may have confidence in an individual trustee's judgment regarding beneficiary needs but want all investment decisions to be made by an institution that is expert in managing funds.

Because there are many arrangements for delegating duties between and among cotrustees, the drafter's skill and knowledge of typical arrangements can truly benefit the client. The alternative clauses in §28.37 provide for division of investment duties between or among cotrustees.

Any clause restricting a proposed institutional trustee's duties should be reviewed by a representative of the institution before the will's completion. See §28.5 (institutional trustees).

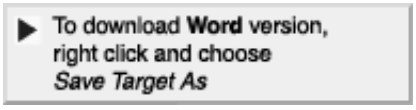
An alternative approach to splitting investment duties between or among cotrustees is to use a special trustee whose only duties and powers relate to investments. See §§28.9 (using special trustees), 28.38 (clauses giving special trustee control or veto power over investments). For general discussion of trustee investment powers, see §§29.10-29.22.

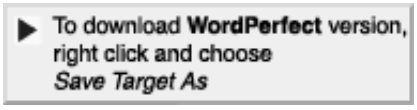
See §31.15 for a clause permitting a trustee to disclaim *administrative* powers, either entirely or in favor of another trustee.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.37 2. Form: Division of Investment Duties Between Cotrustees

§28.37 2. Form: Division of Investment Duties Between Cotrustees





28.37-1 Division of investment duties between cotrustees

[*Add one of the following alternatives*]

[*Alternative 1: One cotrustee to direct investments*]

The cotrustee named below shall have the sole power to direct investments of the trust estate. The other cotrustee shall comply with all written directions for trust investments, have no responsibility to review trust investments, and incur no liability to any interested party for following these written directions or for failing to act in the absence of any written directions.

Trustee: _ _[*Name of trustee*]_ _

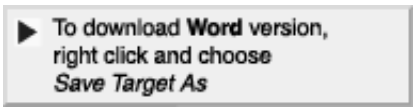
[*Alternative 2: Proposals by corporate trustee to individual trustee*]

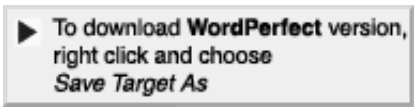
The corporate trustee shall make periodic reviews of the investments held by the trust estate and, based on these reviews, make written proposals to the individual trustee regarding purchases and sales of trust assets. If the individual trustee fails to notify the corporate trustee in writing of the disapproval of any proposed sale or investment within ten days after mailed notice, the corporate trustee may consider such inaction as approval. The corporate trustee shall not be liable for any loss resulting from retention or investment of any property when the individual trustee disapproved of the proposed action.

Comment: By substituting appropriate terms, the drafter may adapt either alternative clause for a trust with either individual or corporate cotrustees. For instance, a clause based on Alternative 1 could state: "The individual trustee alone will have the power to direct the corporate trustee." Alternative 2 could be amended to name an individual cotrustee in place of the corporate trustee. The clause may be integrated with the nomination clauses in forms 28.12-1, 28.13-1, 28.16-1, if multiple trustees are named.

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§28.38 3. Form: Special Trustee Powers Over Investments





28.38-1 Special trustee powers over investments

[*Add one of the following alternatives*]

[*Alternative 1: Special trustee to direct investments*]

The special trustee may, in the trustee's discretion, direct the trustee to retain, sell, exchange, or lease any property of the trust estate and to invest funds of the trust estate in property that the special trustee may specify. The trustee shall comply with all written directions of the special trustee and shall incur no liability to any interested party for following these written directions.

[*If applicable, add the following option*]

[*Option: Exculpation of trustee from liability for inaction*]

The trustee shall incur no liability to any interested party for failing to act in the absence of written directions from the special trustee, as long as a special trustee is in office and the trustee has no knowledge of the special trustee's inability to act.

[*Alternative 2: Special trustee veto power over investments*]

The trustee shall not exercise any investment power unless the trustee first gives written notice to the special trustee of each proposed exercise of that power, except that the trustee may, in the trustee's discretion, invest any funds awaiting investment in savings accounts or money market funds without the special trustee's consent. On receipt of this notice, the special trustee shall promptly notify the trustee in writing of the special trustee's approval or disapproval of the proposed action. If the trustee has notified the special trustee of any proposed action by certified mail at the special trustee's last-known address and has not received notice of approval or disapproval from the special trustee within _ _[*number*]_ _ days from the date of mailing, the special trustee shall be deemed to have approved the action. If for any reason no special trustee is serving, the trustee shall exercise investment powers without the special trustee's consent. The trustee shall not be liable to any interested party for failure to take action disapproved by the special trustee.

Comment: Alternative 1 is useful when the testator wants to use the special trustee's investment skills without burdening the special trustee with other trust administration duties. This clause enables, but does not require, the special trustee to act. If the optional addition is used, the trustee is not liable for inaction when not directed to act by the special trustee. Therefore, the drafter should not use that additional clause unless it is clear that the special trustee will serve as investment director; otherwise, the trust may suffer from inaction on the part of both the special and general trustees.

Alternative 2 can be used either to take advantage of a special trustee's investment skills or to provide third party (special trustee) control over investments when the testator wishes to restrict the general trustee's investment powers. The testator may want this restriction because, *e.g.,* the trustee is inexperienced or is also a beneficiary. See §28.8 on tax issues raised by a trustee-beneficiary.

If the trust does not contain a clause describing how a trustee's inability to act is determined (often by a physician's certificate), the drafter should add that provision to this clause or to form 28.16-1 (naming initial and successor special trustees and providing for special trustee compensation). The clause may be integrated with the nomination clauses in form 28.16-1.

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B. Tax Reasons for Delegating Powers and Duties Among Trustees

§28.39 1. Tax Issues Presented by Trustee Powers

Granting some types of powers to certain trustees can create unwanted tax problems. Following are descriptions of the most common tax-sensitive situations and ways to avoid them: trustee-beneficiary invasion power (see §28.39A); trustee power to apply trust property to a dependent's support (see §28.39B); and trustee power over insurance on the trustee's life (see §28.39C).

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§28.39A a. Trustee-Beneficiary Invasion Power

As discussed in §28.8, vesting a trustee who is also a beneficiary with the sole power to invade principal for his or her own benefit may cause that person to be taxed on the income generated by the assets over which he or she exercises the power. Because requiring joint exercise of the power by the beneficiary and another party will prevent the beneficiary's taxation on the trust income (IRC §678(a)(1)), using a cotrustee will eliminate the adverse income tax consequences of the beneficiary's invasion powers.

The potential estate tax problems raised by vesting an invasion power in a trustee-beneficiary may not be solved as easily. The Internal Revenue Service considers a trustee-beneficiary's unlimited power to invade principal for his or her own benefit to be the equivalent of a general power of appointment. If the trustee-beneficiary dies holding the power, the entire trust corpus over which the trustee has power will be includable in his or her estate for federal estate tax purposes. IRC §2041(b)(1)(A). California has attempted to solve these two problems by limiting the powers of a trustee-beneficiary to an ascertainable standard in most situations. Prob C §16081(c). Another solution is to give the invasion power to both the trustee-beneficiary and a cotrustee who has an interest substantially "adverse" to that of the trustee-beneficiary. See IRC §2041(b)(1)(C); Treas Reg §20.2041-1(c)(1).

In several revenue rulings, the IRS considered whether a cotrustee had an adverse interest in the property substantial enough to relieve the trustee-beneficiary from having a power of appointment over the property under IRC §2041. See Rev Rul 82-156, 1982-2 Cum Bull 216 (income beneficiary's power to appoint corpus subject to consent of trustee or remaindermen was general power because trustee did not have adverse interest); Rev Rul 79-63, 1979-1 Cum Bull 302 (joint powerholder's interest as permissible appointee under special testamentary power of appointment limited to decedent's children was not substantial adverse interest); Rev Rul 77-158, 1977-1 Cum Bull 285 (each of three trustees, also beneficiaries, had general power of appointment, resulting in inclusion of one third of trust corpus in estate of each trustee); Rev Rul 76-503, 1976-2 Cum Bull 275 (permissible appointee did not have adverse interest).

In Rev Rul 77-158 and Rev Rul 76-503, the IRS concluded that the interests of coholders of an appointment power were not adverse for gift tax purposes under Treas Reg §25.2514-3(b)(2) when a deceased power holder was replaced by a successor other than the remaining power holders with the consequence that they did not gain anything by surviving the other power holders and, therefore, had no incentive to delay withdrawing trust property in equal shares. In IRS Letter Rulings 200502014 and 200647001, the IRS concluded to the contrary that members of a distribution committee who could appoint trust property to themselves by unanimous consent did not hold general powers of appointment over equal shares of the property as provided in Treas Reg §25.2514-3(b)(3) when the grantor of the trust retained a testamentary power of appointment and the remaining trust estate was to be distributed to the members, or the survivor of them, on the grantor's death if the retained power was not exercised. However, the IRS has issued a news release in which it indicates that those letter rulings may be inconsistent with these revenue rulings. See IR-2007-127, discussed in 29 CEB Est Plan Rep 51 (Oct. 2007).

As these revenue rulings show, despite the testator's attempt to select a cotrustee with a substantial adverse interest, the IRS may still find that the beneficiary cotrustee has a power of appointment. To avoid possible inclusion of the trust property in the estate of a cotrustee-beneficiary, a testator who does not want to limit principal invasions by an ascertainable standard should simply relieve the beneficiary trustee of any powers over principal distributions. Instead, the testator can vest all powers over principal distributions in a special trustee with no interest in the trust other than the fiduciary office in which the special trustee serves.

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§28.39B b. Trustee Power to Apply Trust Property to Dependent's Support

The power of a trustee to use trust property to satisfy the trustee's legal obligation of support constitutes a general power of appointment. Treas Reg §20.2041-1(c)(1). In addition, to the extent that trust income is used to discharge the trustee's legal obligation of support, it is includable in the trustee's gross income. IRC §678(c); Treas Reg §1.678(c)-1(b). If the testator does not want to prohibit the trustee from using trust property to satisfy the trustee's legal obligations of support, this power should be given to a cotrustee or a third party special trustee.

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§28.39C c. Trustee Power Over Insurance on Trustee's Life

A trustee's exercise of "incidents of ownership" over a life insurance policy on the trustee's life that is held by the trust may lead to inclusion of the policy proceeds in the trustee's gross estate under IRC §2042. This result can be avoided by giving these powers to a cotrustee or a special trustee rather than to the insured. See Rev Rul 84-179, 1984-2 Cum Bull 195, in which the IRS ruled that a decedent does not have incidents of ownership over a policy of insurance on the decedent's life that would cause the policy proceeds to be included in the decedent's gross estate, if the powers may be exercised in a fiduciary capacity only and cannot be exercised for the decedent's own benefit. In Rev Rul 84-179, the decedent-trustee did not pay the policy premiums. Relying on *Estate of Skifter v Commissioner* (2d Cir 1972) 468 F2d 699, the IRS rejected *Rose v U.S.* (5th Cir 1975) 511 F2d 259, in which the court had disapproved the decision in *Skifter*. See also *Hunter v U.S.* (WD Mo 1979) 474 F Supp 763, aff'd (8th Cir 1980) 624 F2d 833 (policies excluded from trustee's estate when trustee had no beneficial interest in trust). Note that transferring the powers over the policy may be ineffective if the new trustee is also a beneficiary having broad powers of invasion or holding a special power of appointment over the trust property.

The drafter can give the trustee the right to disclaim powers that may present tax problems, if the testator does not wish to give these powers to a cotrustee or special trustee in the will. Form 28.40-1 can be used in conjunction with a clause that enables the trustee to disclaim unwanted powers. For a sample clause enabling the trustee to disclaim unwanted administrative powers, see form 31.15-1, which may be adapted to permit disclaimer of other kinds of powers (*e.g.,* investment or income allocation powers).

Form 28.41-1 can be used to give a special trustee discretionary power to make distributions for a trustee-beneficiary or a trustee's dependent. See chap 21 for other distribution and principal invasion clauses that may be adapted to describe a special trustee's powers.

For a clause giving a special trustee power over insurance on the general trustee's life, see form 29.53-1.

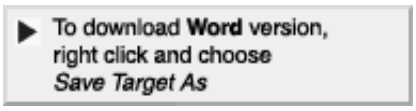
For further discussion of special trustees, see §28.9. For a clause naming initial and successor special trustees and providing for special trustee compensation, see form 28.16-1.

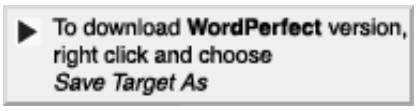
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Source: Estate Planning/California Will Drafting/28 Office of Trustee/ 2. Special Trustee to Act in Place of General Trustee/§28.40 a. Form: Special Trustee to Act if Trustee Disclaims Powers

2. Special Trustee to Act in Place of General Trustee

§28.40 a. Form: Special Trustee to Act if Trustee Disclaims Powers





28.40-1 Special trustee to act if trustee disclaims powers

The special trustee's duties shall include only exercise of powers and duties permanently or temporarily disclaimed or released by the general trustee for such reasons as conflict of interest or adverse tax consequences to the trustee personally.

Comment: This clause provides a "backstop" special trustee who will serve if the general trustee finds that his or her own exercise of given powers will jeopardize a desired marital deduction or create a power of appointment. The clause enables the general trustee to disclaim powers in favor of the special trustee. For a clause naming initial and successor special trustees and providing for special trustee compensation, see form 28.16-1.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.41 b. Form: Special Trustee to Exercise Sprinkling Power

§28.41 b. Form: Special Trustee to Exercise Sprinkling Power

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

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28.41-1 Special trustee to exercise sprinkling power

The special trustee shall add income of the trust estate to principal and pay to, or apply for the benefit of, _ _[*names*]_ _ (the beneficiaries) sums that the special trustee, in the special trustee's discretion, determines to be necessary or proper for the beneficiaries' health, education (including study at an institution of higher education and vocational training), support, and maintenance. The special trustee shall exercise this power from time to time in trust and by a written instrument delivered to the trustee. The special trustee shall receive reasonable compensation.

Comment: This clause gives the special trustee the discretionary power to distribute ("sprinkle") income among a group of beneficiaries. The provision may be used to avoid adverse tax consequences when the general trustee is also a beneficiary. The clause may be integrated with the nomination clause in form 28.16-1.

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VIII. TRUSTEE'S DEALINGS WITH TRUST

§28.42 A. Trustee's Duty to Avoid Conflicts of Interest

Ordinarily, a trustee may not sell assets to the trust, buy assets from the trust, lend funds to the trust, or otherwise deal as an individual with the trust. See Prob C §16004(a); *Estate of McLellan* (1936) 8 C2d 49, 63 P2d 1120; *Estate of Howard* (1955) 133 CA2d 535, 284 P2d 966. In many instances, however, it may be desirable to permit the trustee to "self-deal" in one of these ways. The trustee's special competence, knowledge, or relation to the trust property may make him or her an appropriate purchaser of trust assets or source of borrowed capital.

For example, a trustee who was the testator's business associate may be the most likely prospect to buy the testator's interest in the business. If the trustee is the decedent's surviving spouse or domestic partner, the trustee's purchase of the decedent's interest in community property may provide needed liquidity to the trust. A form is provided in §28.44 to permit the trustee to purchase or lease trust assets, sell or lease property to the trust, lend to the trust, or borrow from the trust.

Another situation with potential for "self-dealing" occurs when the trust holds the stock of a corporation that employs the trustee. Of course, an officer or director of a trust-owned corporation should be selected as a trustee only after careful consideration of possible conflicts of interest between the corporation and the trust. Nevertheless, many testators wish to name business associates as trustees. Form 28.45-1 is designed to permit such a trustee to act despite conflicts of interest. See also §§29.43-29.46 (power to manage securities) for powers that may be added to the clause.

A provision in the trust instrument empowering the trustee to engage in self-dealing overrides the policy expressed in the statutory duty of loyalty and prohibitions against self-dealing. *Copley v Copley* (1981) 126 CA3d 248, 278, 178 CR 842. *Copley* arose out of the conflicting interests of a cotrustee of a trust that held a controlling interest in a corporation. The trustees had obligations both to minimize overall federal estate taxes (by claiming the lowest possible value for the stock) and to provide for the payment of such taxes by causing the corporation to redeem stock under IRC §303 at a price consistent with the stock's federal estate tax value. One of the cotrustees was the surviving spouse. The stock's low value for purposes of the IRC §303 redemption benefited her by producing a larger marital share. The court found that the trustor had knowingly placed the cotrustees in a position of conflict and that the usual duty of loyalty (see Prob C 16002) and the prohibitions against self-dealing (see Prob C §§16004(a), 16002) were overridden by specific directions in the trust instrument. The court also held that the trial court abused its discretion in removing cotrustees named by a trustor who was fully aware of the potential conflicts. For further discussion, see §28.20. On the decision in *Copley,* see *Getty v Getty* (1988) 205 CA3d 134, 252 CR 342.

For discussion of the duty of loyalty, see *Van de Kamp v Bank of America* (1988) 204 CA3d 819, 834, 251 CR 530. In this case, the plaintiffs challenged some of the defendant bank's practices as trustee, including the self-depositing of trust funds. The court held that the bank's statutory right to self-deposit (see Prob C §§16225, 9705; Fin C §1562) permits the trustee to profit from the self-deposited funds when the self-deposit itself is not a breach of trust (*e.g.,* if the funds are necessary for administration of the trust or are awaiting distribution).

If the testator wants to name an institutional trustee, the drafting attorney should review *Estate of Pitzer* (1984) 155 CA3d 979, 202 CR 855, which involved a bank that served as trustee of a testamentary trust. The court upheld the general principle that an institutional trustee can make a loan for the purchase of trust property without violating its fiduciary duty; the circumstances of each transaction must be examined to determine whether the dealings are acceptable conduct. The court held that the bank in *Pitzer* was self-dealing and in breach of trust when it permitted its commercial department to finance a purchase of property from the trust, because the transaction had been undertaken primarily for the bank's own benefit. The bank had earned interest as a result of the transactions and secured its loan by a deed of trust on the property purchased from the trust.

Under Prob C §16015, the provision of services for compensation by a regulated financial institution to a trust for which it is trustee is not a violation of the duty of loyalty described in Prob C §16002 or the duty to avoid a conflict of

interest described in Prob C §16004. Section 16015 is intended to be consistent with the rule in *Estate of Pitzer, supra*. 18 Cal L Rev'n Comm'n Reports 1377 (1986). Thus, despite §16015, if the testator intends to nominate an institutional trustee and the trustee may want to use the services of its various divisions, the drafting attorney should consult the testator about including specific authorizations to the trustee to involve its nontrust departments in trust transactions.

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§28.43 B. Self-Dealing by Attorney-Trustee

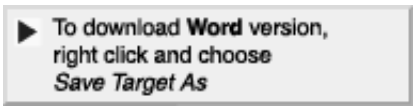
Attorney-trustees are subject to stricter standards of self-dealing than nonattorney fiduciaries under Cal Rules of Prof Cond 3-300. Rule 3-300 imposes independent requirements of disclosure, advice, and informed consent on attorney-trustees who transact business with clients. See *Schneider v State Bar* (1987) 43 C3d 784, 239 CR 111 (decided under former Cal Rules of Prof Cond 5-101). The court noted the general rule stated in *Copley v Copley* (1981) 126 CA3d 248, 278, 178 CR 842, that specific directions in the trust instrument authorizing self-dealing or placing the trustee in a position of conflict of interest may exempt a lay trustee from the statutory duty of loyalty and prohibitions against self-dealing (now found in Prob C §§16002, 16004(a)). The *Schneider* court held, however, that the rule in *Copley* did not exempt an attorney-trustee from complying with former Cal Rules of Prof Cond 5-101, because the terms of a trust agreement authorizing self-dealing came within the rule rather than superseded it.

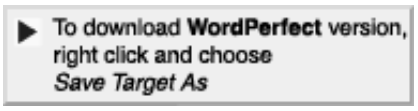
The fact that the trust instrument in *Schneider* gave the attorney-trustee broad discretion (including the power to make unsecured loans to himself) did not eliminate his duty, before accepting the nomination and office as trustee, to explain to his clients the effect of the broad discretionary powers in the trust agreement, to disclose his intention to make unsecured loans to himself, and to advise the clients to seek independent counsel.

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C. Forms Permitting Trustee Self-Dealing

§28.44 1. Form: Trustee Self-Dealing Permitted (Power to Loan, Buy, and Sell)





28.44-1 Trustee power to lend, buy, and sell as individual (self-dealing)

***Power to Transact With Trust as Individual*. The trustee may, in the trustee's discretion:**

(1) Loan or advance the trustee's own funds to the trust for any trust purpose, with interest at current rates;

(2) Receive security for such loans in the form of a mortgage, pledge, deed of trust, or other encumbrance of any assets of the trust;

(3) Purchase or exchange assets of the trust at their fair market value as determined by an independent appraiser;

(4) Sell property to the trust at a price not in excess of its fair market value as determined by an independent appraiser;

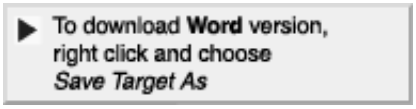
(5) Lease assets to or from the trust for fair rental value as determined by an independent appraiser; and

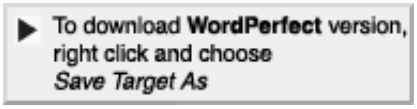
(6) Make unsecured or secured loans at reasonable rates of interest to the trustee, any beneficiary of any trust created under my will, or the estate of any such beneficiary.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.45 2. Form: Trustee Self-Dealing Permitted (Corporate Employee)

§28.45 2. Form: Trustee Self-Dealing Permitted (Corporate Employee)





28.45-1 Trustee power to self-deal as corporate employee

***Power to Transact With Trust as Corporate Officer*. Any person acting as trustee may hold office in any corporation in which a trust under this instrument holds securities and may receive compensation from this corporation for services performed as director, officer, or employee of the corporation. The trustee may also purchase, sell, or otherwise deal with the stock of this corporation for the trustee's individual account and may vote the stock of the corporation held by the trust, including voting shares in favor of the trustee or any other person.**

Comment: This clause is useful when the trust is expected to hold shares in a close corporation of which the trustee is an officer and a shareholder. The drafter should amend the clause if the will creates only one testamentary trust.

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§28.46 D. Prohibition Against Commingling Assets

The trustee has a duty to keep the trust property separate from other property and to ensure that it is designated as trust property. Prob C §16009. See 3 Scott & Ascher on Trusts §17.11 (5th ed 2007). It is a breach of trust for the trustee to commingle trust funds with those belonging to other trusts, the trustee, or anyone else. It is also a breach of trust to fail to earmark trust funds. This rule applies to banks and trust companies as well as to individuals, except that the trust department of a bank may deposit funds in the commercial department of the same bank while awaiting investment (Fin C §§1562, 1591), and trust companies may invest in their own common trust funds (Fin C §1564) and mortgage participations (Fin C §1565).

See §§30.5-30.7 for discussion of when similar trusts may be jointly administered, and a form permitting the trustee to administer similar trusts jointly.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/ E. Exculpatory Clauses/§28.47 1. Trustee Standards of Conduct and Exculpatory Clauses

E. Exculpatory Clauses

§28.47 1. Trustee Standards of Conduct and Exculpatory Clauses

In administering the trust, the trustee has the duty to (Prob C §16040(a)):

> administer the trust 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.

The "prudent person rule" is inapplicable to investment and management functions (see Prob C §16040(c)). These functions are governed by the "prudent investor" rules set out in the Uniform Prudent Investor Act (Prob C §§16045-16054).

Probate Code §16047(a) states the parameters of the prudent investor standard:

> 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.

The trustee has the statutory power to employ agents (*e.g.,* accountants, attorneys, auditors, investment advisers, or other agents), even if they are associated or affiliated with the trustee, to advise and assist the trustee in the performance of administrative duties. Prob C §16247. Special rules govern a trustee's liability for the decisions or actions of an agent to whom investment or management functions are delegated. Prob C §16052; see §28.49.

A trustee is liable to the beneficiaries for losses caused by his or her own acts, except for mere errors in judgment (simple negligence). See *Estate of Cousins* (1896) 111 C 441, 44 P 182; *Estate of Baird* (1955) 135 CA2d 343, 287 P2d 372, disapproved on other grounds in *Estate of Schloss* (1961) 56 C2d 248, 256, 14 CR 643 (reversed on another issue). See also 4 Scott & Ascher on Trusts §24.27 (5th ed 2007). Under certain circumstances, the trustee is also liable for the acts of the trustee's agents (Prob C §16401; see §28.29) and the acts of cotrustees (Prob C §16402; see §28.7) or a predecessor trustee (Prob C §16403(b); see §28.49).

The prudent person standard (governing trust administration) and the prudent investor standard (governing investment and management functions) may be expanded or restricted by the testator. See Prob C §§16040(b) and 16045(b), respectively. Moreover, it is possible to exempt a trustee from certain liabilities. For example, a testator may want to relieve a family member or friend who is willing to serve as trustee from liability for ordinary negligence. However, an exculpatory clause will not be given effect with respect to liability for (a) a breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the beneficiary's interest; or (b) any profit derived from a breach of trust. Prob C §16461. See also Restatement (Second) of Trusts §222 (1959) (codified in part by Prob C §16461); *Corbett v Benioff* (1932) 126 CA 772, 14 P2d 1028.

NOTE: By the same token, an exculpatory clause should not be given effect with respect to liability for tortious acts committed by the trustee as might arise, for example, under CC §51.9 (sexual harassment of the plaintiff by a person in a business, service, or professional relationship with the plaintiff, including an executor, trustee, or administrator). See *Hughes v Pair* (2009) 46 C4th 1035, 95 CR3d 636 (offensive conduct directed at mother of beneficiary was not sufficiently pervasive or severe to support cause of action against trustee for sexual harassment or intentional infliction of emotional distress).

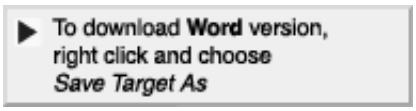
Exculpatory clauses for attorneys acting as trustees may be construed even more narrowly than exculpatory clauses for trustees who are not attorneys. Restatement §222(3) (which was not enacted as part of Prob C §16461) provides that an exculpatory clause resulting from a drafter-trustee's abuse of a fiduciary or confidential relationship will not be given effect, although the fact that the person benefiting from the clause drafted the instrument does not in itself render the clause ineffective. Restatement §222, Comment d. See also 3 Scott on Trusts §222.4. (Note that under California law the drafter of an instrument or a person who has a fiduciary relationship with the transferor (and certain affiliated persons) may not be a beneficiary under the instrument unless he or she is related to the principal in specified ways.

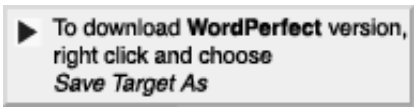
See Prob C §21350(a), discussed in §1.35.)

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.48 2. Form: Trustee Exculpation

§28.48 2. Form: Trustee Exculpation





28.48-1 Trustee exculpation

Exculpation of Trustee. **The trustee shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in the business of acting as a trustee.**

Comment: The drafter may want to limit the exculpation provided in this clause to trustees actually named in the trust or to certain of the named trustees, *e.g.,* a surviving spouse or partner.

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F. Liability for Acts of Predecessor Trustee

§28.49 1. Successor Trustee's Liability

A trustee may be liable for the acts of a predecessor trustee. The circumstances under which a successor trustee may be liable for a breach of trust committed by a predecessor trustee are set forth in Prob C §16403(b):

- When the successor trustee knows or should have known of the breach of trust and allows it to continue;
- When the successor trustee neglects to take reasonable steps to compel the predecessor to deliver the trust property; or
- When the successor trustee neglects to take reasonable steps to redress the predecessor's breach of trust about which the successor knows or should have known.

See *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716; *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317 (successor trustee has right and duty to compel former trustee to transfer trust records to him, including privileged communications related to matters of day-to-day trust administration). See also *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487 (attorney for two trustees waived any protection regarding work product sought by the successor trustee when he disclosed files to another attorney representing one of those trustees). In *HCL Props. Ltd. v Superior Court* (2005) 35 C4th 54, 24 CR3d 199, the court held that a company that operated the decedent's business was not the holder of the Evid C §954 attorney-client privilege formerly held by the decedent. According to the court, the personal representative was the holder of the privilege under Evid C §953(c), and the privilege ceased to exist when the personal representative was discharged. The statute has since been amended to make clear that the holder of the privilege may include a personal representative appointed after closing of the estate for purposes of subsequent administration under Prob C §12252.

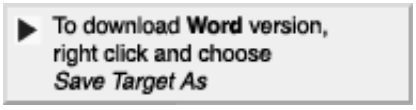
In *Borisoff v Taylor & Faust* (2004) 33 C4th 523, 15 CR3d 735, the court held that a successor personal representative had standing to sue the former personal representative's attorneys, who allegedly failed to preserve the right to claim an estate tax refund. The court noted that a successor personal representative has all the powers and duties that the former personal representative would have had under the Probate Code, including the power to sue and defend and the power to retain and compensate counsel.

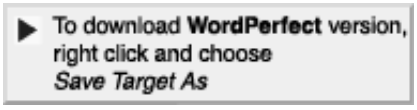
To avoid exposing a successor trustee to liability under Prob C §16403(b) and to avoid the risk that a successor trustee (in particular an institutional trustee) will not be willing to act, it is generally advisable to include a clause that limits this liability.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.50 2. Form: Waiver of Liability for Acts of Predecessor Trustee

§28.50 2. Form: Waiver of Liability for Acts of Predecessor Trustee





28.50-1 Limitation on successor trustee liability

***Limitation on Successor Trustee Liability*. Any successor trustee may, in the trustee's discretion, accept as correct any accounting of trust assets made by any predecessor trustee. No successor trustee shall be under any obligation to institute any action or proceeding for the settlement of the accounts of any predecessor trustee or for any actions or omissions of any predecessor trustee.**

Comment: The drafter may want to add a clause specifically empowering the trustee to institute an action to settle the predecessor's accounts. The clause should suggest that the successor trustee "may institute," *e.g.,* any action or proceeding.

A clause providing for nonliability for a cotrustee's acts may also be desirable.

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G. Providing for Court Supervision of Trust

§28.51 1. Court Supervision Generally Inadvisable

Unless the will directs otherwise, no trust created under a will executed on or after July 1, 1977, is subject to the continuing jurisdiction of the superior court. Prob C §17300. See also Prob C §17209 (administration of trusts intended to be "free of judicial intervention"). Because of the considerable effort and expense entailed in rendering accounts to the court and in obtaining court approval, the will should not require continuing court supervision in most cases. (If continuing court supervision is not required, many institutional trustees will charge the lower fees applicable to inter vivos trusts.)

The testator should be informed that, without contrary instruction in the will, the court will not supervise the trust. The question of court supervision should be discussed in depth if circumstances suggest that supervision might be prudent. The client should understand that, even if the will does not require court supervision, a trustee or beneficiary may invoke court supervision at any time, for any one of the variety of reasons set forth in Prob C §17200. In *Estate of Bowles* (2008) 169 CA4th 684, 87 CR3d 122, the court held that, when a surviving spouse trustee of a testamentary QTIP trust and third parties were alleged to have participated in a breach of trust, a trust remainder beneficiary had standing to sue either the trustee or the third parties or both, even after a successor trustee was appointed.

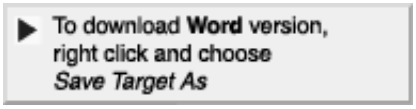
A trust that is subject to the continuing jurisdiction of the superior court may be removed from the court's jurisdiction if the trustee is either a trust company (see Prob C §17351) or not a trust company (see Prob C §17352). Removal under §17351 is effected by notice to the beneficiaries; removal under §17352 requires court approval obtained according to procedures outlined in the section.

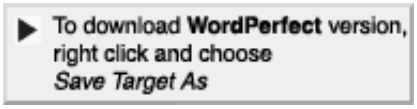
For a clause requiring continued trustee accounting to the court, see form 30.4-1, which generally applies to trusts for minors.

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Source: Estate Planning/California Will Drafting/28 Office of Trustee/§28.52 2. Form: Trusts Subject to Continuing Court Jurisdiction

§28.52 2. Form: Trusts Subject to Continuing Court Jurisdiction





28.52-1 Trusts subject to continuing court jurisdiction

***Court Supervision*. All trusts created under my will are subject to the continuing jurisdiction of the superior court.**

Comment: This clause must be amended if the testator wishes only one trust to be supervised by the court. In most cases, the will should not require continuing court supervision. See §28.51.

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29

Trustee Management Powers

M. Kimball Hettena

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I. POWERS OF TESTAMENTARY TRUSTEE

§29.1 A. Planning Trustee Powers

This chapter covers grants of powers to testamentary trustees for asset investment and management. The chapter first discusses the sources of trustee management powers and why the powers should usually be made explicit in the will. The chapter then reviews factors affecting powers selection, dangers of limiting trustee powers, trustee discretion, and tax traps presented by certain trustee powers. The bulk of the chapter contains descriptions of and suggested clauses for specific management powers.

Because trustee management powers must be planned in conjunction with trustee accounting and administrative powers, the drafter must also consult chaps 30 (trustee accounting powers) and 31 (trustee administrative powers). The accounting powers, which principally involve allocation of assets to principal or income accounts, can affect asset management (*e.g.,* rules for allocating depreciation can seriously affect a business's apparent financial condition; see §30.13). Similarly, management powers can affect trustee accounting (*e.g.,* the power to invest in discount bonds, with or without the duty to allocate principal receipts to income, can affect a business's accounting practices; see §29.49). Administrative powers, which relate to payments of trust expenses and taxes and how property is allocated in distributions, also affect and are affected by investments and asset management. See chap 31 on these powers.

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B. Sources of Trustee Management Powers

§29.2 1. Statutory Trustee Powers

Under Prob C §16200, trustee powers that are exercisable without prior court authorization include all powers conferred by the will and, except as limited by the will, all powers conferred by statute. The statutory powers are found primarily in Prob C §§16220-16249 and in Prob C §§16320-16375. They are extensive, providing virtually every power usually required by trustees. If the statutory powers are insufficient, Prob C §16200(c) appears to give to the trustee whatever powers are necessary for performance, according to the "prudent person" standard of care under Prob C §16040 for trust administration, or according to the "prudent investor" standard under Prob C §16047 for investment and management functions. Probate Code §16052 confers a limited power to delegate investment and management functions.

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§29.3 2. Powers Conferred by Will

Most drafters enumerate trustee powers in the will, at least to the extent of incorporating statutory powers by reference—even though the current importance of expressly stating powers is minimized (at least in California) by:

- The opportunity to simply list the statutory powers in the decree of distribution after the testator's death; and
- The ability of trustees to use Prob C §18100 trust certifications when dealing with third parties.

The need for greater specificity may be more important when the trust may hold out-of-state real property, the testator may die domiciled in another state, or the principal place of trust administration will be outside California.

Powers clauses in trusts of modest size that are intended to operate for a short time (*e.g.,* during the minority of children) and that contain easy-to-administer trust assets and trusts that may never come into existence (*e.g.,* a young parent's trust for minor children) can be provided in either of two ways:

(1) Incorporating by reference the powers listed in Prob C §§16220-16249. See §29.3A.

(2) Setting out a short list of trustee powers. Clauses providing minimal descriptions of trustee powers have traditionally been used in this circumstance. See form 29.60-1 for a "short-form" trustee management powers clause. The clause provides a list of management powers, which should reassure third parties (*e.g.,* transfer agents, title companies), who may be reluctant to honor powers not explicitly stated in the trust, that the trustee has been empowered to act. It also incorporates statutory powers by reference.

Trusts intended to continue for more than 20 years, to hold assets of major value or to hold assets that are difficult to administer, usually require a longer and more elaborate set of management powers fully set out in the trust. In particular, the attorney should pay special attention to management powers when the trust will hold real property, business interests, farms, or wasting assets. The clauses in this chapter compose a set of management powers often needed for a large trust.

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§29.3A 3. Powers Incorporated by Reference

The court having jurisdiction of the probate proceedings can set forth the incorporated powers listed in Prob C §§16220-16249 in full in the decree of distribution establishing the trust, thus providing third parties with a full description of the trustee's powers. See form 29.8-1 for a clause incorporating statutory powers by reference. The last sentence of this clause is intended to avoid the following limitations on trustee investment powers:

Under Prob C §16224, a trust that permits investment in obligations of the United States is deemed to permit investment in mutual funds and common trusts funds "the portfolios of which are limited to United States government obligations maturing not later than five years from the date of investment or reinvestment and to repurchase agreements fully collateralized by United States government obligations." Although this provision does not literally prevent investment in mutual funds investing in longer-term government bonds, it can be argued that it implies such a prohibition. As such, the provision seems to conflict with the later-enacted trustee power to invest in any kind of asset under Prob C §16047(e).

Under Prob C §16225, a court order is required to deposit trust funds in an amount greater than the maximum FDIC insured or collateralized amount. This limitation on portfolio content seems to conflict with the trustee power to invest in any kind of assets under Prob C §16047(e).

As an alternative, the drafter may incorporate the administrative power provisions of Uniform Trust Code §§815-816. For various reasons, these provisions are generally better organized and more clearly stated than those of the California Probate Code. See Drafting California Revocable Trusts §17.19 (4th ed Cal CEB 2003).

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C. Selecting and Limiting Trustee Powers

§29.4 1. Determining Needed Powers

Choosing and drafting appropriate trustee powers require the drafter's careful analysis of a variety of factors affecting the trust. While implementing the testator's wishes, the drafter must, *e.g.,* avoid unwise restrictions on the trustee's powers (see §29.5), provide appropriate discretion to the trustee (see §29.6), and avoid creating unwanted tax consequences (see §29.7).

The drafter's first task, however, is to determine which powers the testamentary trustee may need (or should not have) to carry out the trust's terms. To do so, the drafting attorney must review the characteristics of the proposed trust, including:

- *Nature of trust assets.* Is the trust expected to hold assets with particular management problems, *e.g.,* a partnership interest or ranch? Are the assets a portfolio of equity and debt issues, which the testator expects the trustee to sell and trade from time to time, or assets that the trustee may manage but must retain (*e.g.,* a family business or residence)?
- *Amount and timing of required distributions.* Will the trustee need to invest assets to generate a set income? Invest to maximize the trust principal's growth? Sell assets to raise cash for distributions?
- *Special trust objectives.* Does the testator want the trustee to preserve the family farm, residence, or business? Is the trust designed to be a marital deduction power of appointment or qualified terminable interest property trust? Is the trust intended to protect and increase assets to pay for a child's education? Are there other special trust objectives?
- *Trustee-beneficiary relationships.* Will the named trustee be a beneficiary of the trust or be personally responsible for the support of a beneficiary? To avoid undesirable tax consequences in either case, some powers may need to be restricted or given only to other trustees. See §29.7.
- *Trust duration.* Is the trust designed to exist only during the life of a surviving spouse or partner? If so, the drafter may wish to select powers based on conditions existing when the will is drafted. If the trust is designed to be of longer duration, the drafter may need to include more extensive powers and to rely on the trustee to determine how to manage the trust assets.

Analysis of these particular aspects of the trust, along with a review of management powers clauses (from this book as well as other sources), will ensure that the drafter includes all required powers and powers restrictions in the will.

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§29.5 2. Avoiding Undue Restrictions on Powers

Although the drafter's primary aim is to create a trust that will attain the testator's goals, acceding to specific testator demands concerning trustee powers may be unwise. Clients may ask that the trustee be directed to take or not take certain actions (*e.g.,* to sell or not sell all the trust property), but they usually have not examined the consequences of these demands in light of future changed circumstances such as possible market fluctuations, sales costs, and changes in beneficiary needs.

The attorney should avoid trust language that mandates or restricts the exercise of certain powers in ways that can later prevent the trustee from effective trust administration. The trustee will not be able to deviate from specific directives in the will without court permission (*e.g.,* under a Prob C §16201 petition for relief from restrictions on powers) unless following the directives would be illegal, impossible, or defeat or impair the trust's purposes. 3 Scott & Ascher on Trusts §16.4.1 (5th ed 2007). Because a trustee who acts contrary to the powers provided in the will is vulnerable to suit from injured beneficiaries, a trustee confronted by an overly restrictive, impractical, or harmful directive should probably seek court approval before taking liberties with the will's instructions. This procedure is usually expensive and time-consuming. On trustee deviation from trust restrictions, see 13 Witkin, Summary of California Law, *Trusts* §§93-94 (10th ed 2005).

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§29.6 3. Giving Trustee Appropriate Discretion

The drafting attorney must decide what degree of discretion to give the trustee in relation to the various powers.

A grant of a power to a trustee does not, by itself, either require or permit exercise of the power. Prob C §16202. The mere grant of a power, unless made with specific direction regarding its exercise, only allows the trustee to use discretion in deciding whether, when, and how to exercise the power.

Trustee discretionary powers must be exercised reasonably, unless they are stated to be "sole," "absolute," or "uncontrolled" powers. Prob C §16080. Powers granted in the trustee's sole, absolute, or uncontrolled discretion give the trustee the greatest possible freedom in exercising the powers. Absolute discretion relieves the trustee of the requirement of exercising the powers "reasonably." Even so, the discretion must be exercised in accordance with fiduciary principles, not in bad faith, and with regard to the trust's purposes. Prob C §16081(a). As a practical matter, the exercise of discretionary trustee powers is always subject to court review on petition of a beneficiary or trustee. Prob C §17200(b)(5).

Unless the testator reposes the highest confidence in the named trustee's management and investment skills, reliability, and honesty, it is generally unwise to provide the trustee with absolute discretion. When this expanded discretion is granted, it should apply only to particular powers—not to an entire set of powers. Nor should the drafter rely on a grant of absolute discretion instead of clear drafting. When the testator anticipates that disputes will arise regarding the trustee's administration of the trust, explicit statements of the testator's preferences and goals may serve the trustee better than expanded trustee discretion.

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§29.7 D. Avoiding Unintended Tax Consequences

Unintended tax problems for the trust or persons interested in it may be created by conferring certain management powers on a trustee in "tax-sensitive" situations. These problems arise most often (1) in connection with a trust intended to qualify for the estate tax marital deduction, or (2) when the trustee or a dependent of the trustee is a beneficiary of the bypass trust. In the first situation, inappropriate trustee powers may lead to denial of the expected deduction for property held in the marital deduction trust. See §29.7A. In the second situation, the trustee may be considered to hold a general power of appointment, and trust property may be treated as the trustee's for estate, gift, and income tax purposes. See §29.7B.

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§29.7A 1. Loss or Reduction of Marital Deduction

For a marital deduction power of appointment trust, qualified terminable interest property trust, or qualified domestic trust to achieve its tax purposes, the surviving spouse must be assured the right to the trust income during his or her lifetime. See chap 17 for an overview of rules applying to marital deduction trusts; chaps 18-19 on specific types of marital deduction trusts.

The trustee must not be permitted to interfere with this right by, *e.g.,* holding an overly broad investment power that permits the trustee to invest in non-income-producing assets. See §§29.15, 29.19 on the powers to retain and invest in unproductive property. This issue is further discussed in §29.11.

For the same reason, investing in or retaining particular types of assets may jeopardize the marital deduction. The tax hazards are noted in the relevant sections in this chapter that address powers to invest in particular assets, *e.g.,* discount bonds (see §29.49) and insurance policies (see §29.51). See also §§17.84-17.89 on the effect of holding a closely held business, subchapter S stock, a partnership, special use property, and income in respect of a decedent in a marital deduction trust. See California Decedent Estate Practice §33.62 (2d ed Cal CEB 2009) for the definition of income in respect of a decedent.

"Savings clauses," governed by Prob C §§21500-21526, require the trustee of a trust intended to qualify for the marital deduction to exercise powers so as to comply with the marital deduction statute and applicable regulations. The attorney should not rely on those statutes instead of properly drafted marital deduction trust clauses. The clauses may not work as the drafter intends, or the client may die a nonresident of California and the statutes may not apply. The drafter should consult the statutes as a checklist, however, to determine whether the will includes and restricts each power as necessary. In addition, the attorney should decide whether to make any of the clauses expressly *inapplicable* to a particular will. For a sample savings clause to be used in marital deduction trusts, see §17.33.

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§29.7B 2. Inadvertent Creation of General Power

The drafting attorney must also pay special attention to trustee management powers clauses when an income or remainder beneficiary, or a person responsible for a beneficiary's support, will be or may become the trustee of a testamentary trust.

The power of a trustee to invest in non-income-producing or wasting assets can benefit the remainder beneficiary at the expense of the income beneficiary or vice versa. See §§29.15, 29.19 on retention of, and investment in, underproductive assets; §§29.47, 29.49 on acquiring bonds at a premium and at a discount. When a trustee has such powers and could therefore personally benefit through their exercise, the Internal Revenue Service may contend that the trustee enjoys the equivalent of a general power of appointment over the trust principal. If the trustee does have a general power of appointment over the principal, that property will count as part of the trustee's federally taxable estate if he or she dies in office. Further, a trustee's powers to manage the trust estate for himself or herself as beneficiary may lead to inclusion of trust income in the trustee's gross income for income tax purposes. Giving up the problem power may constitute a taxable gift. See chap 16 on powers of appointment; §§16.13-16.16, 28.8 on tax consequences of powers of appointment.

Fairly broad, though standard, investment and management powers do not constitute a general power of appointment if they must be exercised according to a fiduciary's standard of conduct. *Estate of Genevieve Rolin* (1977) 68 TC 919, aff'd (2d Cir 1978) 588 F2d 368. Nevertheless, it is usually wise to provide carefully restricted trustee powers if the beneficiary of a trust may act as the trustee. See §§16.17-16.19 on limiting powers to avoid creating a power of appointment. A clause permitting the trustee to disclaim certain powers can be an additional safeguard. See §31.14 on trustee disclaimer of administrative powers to avoid adverse tax consequences. Appointment of a cotrustee or special trustee to take over the suspect powers or join in their exercise is a third method to avoid creating a power of appointment and the only way to avoid income tax problems in certain situations. See §§28.9, 28.17 on use of cotrustees and special trustees.

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E. Clauses Granting Statutory Powers to Trustee and Introducing Itemized Powers

§29.8 1. Form: Trustee to Have Statutory Powers

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29.8-1 Trustee may exercise statutory powers

***Trustee Powers*. The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.**

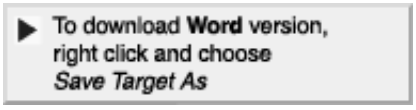
Comment: Usually it is not necessary to include a lengthy list of trustee powers in will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are incorporated only by reference in the will. Cal Rules Ct 7.650. California law confers a wide range of trustee powers. See Prob C §§16047(e), 16052, 16200, 16220-16249.

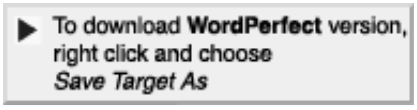
If the testator wants the trustee powers to be more limited in any respect than those available by statute when the will is prepared, the drafter should not use this clause. If the testator is concerned that the legislature may expand trustee powers beyond those considered desirable, the drafter can omit the words "or hereafter." This clause should be amended if the will includes only one trust.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.9 2. Form: Introduction to Trustee Powers

§29.9 2. Form: Introduction to Trustee Powers





29.9-1 Introductory clause granting trustee powers

For all trusts under my will, except when my will specifically provides otherwise, _ _[*in addition to powers now or hereafter conferred by law,*]_ _ **the trustee** _ _[*or any successor trustee then in office*]_ _ **shall have the powers described below:**

Comment: Form 29.9-1 is used as an introduction to the description of trustee powers. It can be used to introduce either a short or a long set of trustee powers. (See form 29.60-1 for the short set of powers.) The optional phrase "in addition to powers now or hereafter conferred by law" provides for statutory powers as well as powers explicitly stated in the will. If the trust does not elsewhere include a definition of "trustee" as including successor trustees, and the testator intends successor trustees to have the same powers as trustees first in office, the drafter should include the optional phrase "or any successor trustee then in office."

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II. INVESTMENT POWERS

§29.10 A. Prudent Investor Rule

Probate Code §16007 imposes a duty on the trustee to make the trust property productive "under the circumstances and in furtherance of the purposes of the trust." Thus, the trustee generally has a duty to keep the money of the trust estate invested, and the trustee is subject to a penalty for failure to invest. *Lynch v John M. Redfield Found.* (1970) 9 CA3d 293, 88 CR 86 (nonprofit foundation directors held to same standard as trustees).

Under the California Uniform Prudent Investor Act (UPIA) (Prob C §§16002-16003, 16045-16054), the trustee has liberal powers of investment unless contrary instructions appear in the will. The trustee is required to invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other limitations of the trust. Prob C §16047(a). The emphasis in former CC §2261 on avoiding "speculation" is eschewed in favor of a direction to the trustee to consider individual investments as part of an overall investment strategy having risk and return objectives reasonably suited to the trust. Prob C §16047(b). The trustee now has a *duty* to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so. Prob C §16048.

The California prudent investor rule is consistent with modern portfolio theory, according to which an optimal portfolio is structured to achieve the lowest level of risk for a given level of return. According to this theory, diversifying a portfolio by adding different types of assets reduces the overall risk (variability) of the portfolio if the new investments, when compared to the existing investments, react differently to events influencing the markets.

Under the prudent investor rule, individual fiduciaries are held to the same standard of care when investing as corporate trustees. Therefore, ordinary individuals who lack the requisite expertise and knowledge to set and carry out appropriate investment policies must obtain the needed professional help. Under the Uniform Prudent Investor Act, the trustee is now permitted to *delegate* the investment and management of assets, as long as the trustee exercises prudence in selecting an agent, defining the scope and terms of the delegation, and reviewing the agent's overall compliance. Prob C §16052. See §28.29.

For example, in *In re Stuart Cochran Irrevocable Trust* (Ind App 2009) 901 NE2d 1128, the court held that the trustee of an irrevocable life insurance trust had not violated the Indiana version of the Uniform Prudent Investor Act when it surrendered the trust's life insurance policies and acquired a new policy with a much lower death benefit. Due to poor investment conditions, coverage under the surrendered policies might have lapsed within a short period of time. The court found that the trustee had not improperly delegated investment decisions to the settlor's insurance advisor. The fact that the advisor had formulated and submitted the proposal to change policies did not establish delegation. Further, within limits, delegation is permitted under the UPIA. The court noted that the trustee also obtained an opinion from an independent insurance advisor.

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B. General Investment Powers

§29.11 1. "Prudent Investor" Clause

The terms of the will may expand or restrict the prudent investor rule. Prob C §16046(b).

Form 29.12-1 defines the trustee's investment powers in terms of the Uniform Prudent Investor Act discussed in §29.10. This clause may be used even in "tax-sensitive" situations, when the trustee must be careful to equalize the impact of investment and tax decisions among the beneficiaries (see §29.9).

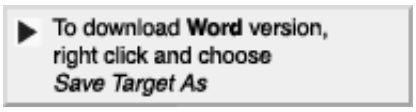
Various options may be added to form 29.12-1 to broaden the power of investment, as discussed in §29.13. A clause granting unqualified broad powers to the trustee ordinarily should not be used when a trustee is a beneficiary. Such powers authorize investments that can easily be used to improve the situation of current beneficiaries over remainder beneficiaries and vice versa. Such an investment strategy would be in violation of the trustee's duty to deal impartially with multiple beneficiaries, and to act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries. Prob C §16003. Unrestricted investment powers can also lead to imputation of asset ownership to a trustee, creating income tax liability in the trustee (see IRC §678). Care must also be taken to ensure that a trustee who is a remainder beneficiary is not given investment powers equivalent to a power of appointment over trust assets, which would create the possibility that the assets are considered part of the trustee's estate at death under IRC §2041. See chap 16 on powers of appointment; §§16.13-16.16 on the tax consequences of creating a power of appointment; §28.8 on the tax perils in selecting a beneficiary or other related party as trustee.

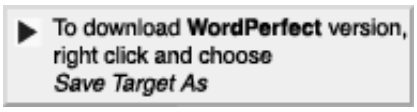
When the testator wishes to control trustee investment policy, the drafter may use form 29.14-1, which provides a format for describing particular assets in which the trustee may invest. Because restricted investment powers are normally inadvisable, form 29.14-1 should not often be used. See §29.10.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.12 2. Form: Investment According to Prudent Investor Rule

§29.12 2. Form: Investment According to Prudent Investor Rule





29.12-1 Investment according to prudent investor rule

***Investment According to Prudent Investor Rule*. The trustee may, in the trustee's discretion, invest and reinvest trust funds in every kind of property (real, personal, or mixed) and every kind of investment, specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trust, mortgage participations, market funds and index funds appropriate under the then-prevailing circumstances (specifically including, but not limited to, the factors set out in Probate Code §16047(c)):**

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.

In so doing, the trustee shall exercise care, skill, and caution to attain the settlor's goals under this instrument. The trustee shall consider individual investments as part of an overall investment strategy having risk and return objectives reasonably suited to the purposes of the trust. The trustee's investments may include stock in, or any common trust fund administered by, the trustee or stock in any entity owned by the trustee or that owns the trustee.

[*If applicable, add one or more of the following options*]

[*Option 1: Power to purchase on margin and buy options*]

The trustee may buy stocks or other securities on margin; invest in index funds; and buy or sell options, puts, and calls.

[*Option 2: Institutional trustee's investment in controlled stock*]

The trustee's investments may include stock in, or any common trust fund administered by, the trustee or stock in any entity owned by the trustee or that owns the trustee.

[*Option 3: Power to invest aggressively*]

The trustee may invest in an aggressive manner, assuming greater than customary risks of loss to principal, in order to achieve a higher total rate of return.

[*Option 4: Investments need not be diversified*]

The investments need not be diversified.

Comment: See §29.11 on using the prudent investor standard. If a trustee is a corporate trustee, it is advisable to add Option 2. The drafter may not want to give the trustee the power to purchase insurance on the beneficiary's life. See §29.51 on issues presented by life insurance as a trust investment.

The optional additions offer the drafter an opportunity to provide the trustee with greater than ordinary latitude in investing. See §29.13. For restriction on investment power when the trust is a marital deduction trust, see Option 2 in form 29.16-1.

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§29.13 3. "Broad Powers" Options

Among the "broad powers" options in form 29.12-1 is a clause (Option 4) authorizing the trustee not to diversify trust investments. Normally, the trustee is required to diversify trust assets. See Prob C §16048. See also Restatement (Third) of Trusts §90 (2007); 4 Scott & Ascher on Trusts §19.3.2 (5th ed 2007). Diversification is also usually desirable as a practical matter. The diversification rule should be tempered, however, when the testator wants the trustee to retain a specific asset that constitutes a large portion of the trust estate (*e.g.,* the family residence or an interest in a closely held business).

Option 2 is a suitable addition when the trustee is a corporate trustee. Express authorization for a corporate trustee to invest trust funds in its own common trust fund is unnecessary in California because Fin C §1564 specifically authorizes such investments (if funds are composed of property permitted by law for investment of trust funds) unless prohibited by the terms of the will. The clause is included in this chapter, however, because some corporate fiduciaries prefer to have the power stated in the will and the trust may be administered in a state that may not authorize such investments. One disadvantage of investing in a common trust fund is that, on the termination of the trust, this fund must be liquidated (because individuals cannot hold interests in these funds), and the sale may create a gain or loss for income tax purposes.

Option 3 should be used when the testator wants to allow the trustee to follow an "aggressive" investment strategy. Although the drafter is unlikely to use the clause often, it may be useful when, *e.g.,* the trust is designed for growth and is not intended to be the source of current income for the primary beneficiary. Both Option 3 and Option 4 require special testator confidence in the trustee's investment skills and judgment. The drafter may want to limit these powers to a particular named trustee, and not give them to successor trustees.

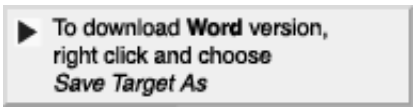
NOTE: Margin accounts, mentioned in Option 1, permit credit purchases. Margin accounts are discussed in §29.27 and included in the "power to borrow" clause in form 29.28-1.

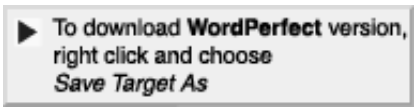
If Option 1 is intended for use in connection with a marital deduction trust that is not an estate trust, it is advisable for the drafter to include Option 2 in form 29.16-1, relating to the reasonable production of income. See §29.15 on the dangers of a marital deduction power of appointment or qualified terminable interest property trust holding unproductive property. For further discussion of the marital deduction, see chap 17. On marital deduction trusts, see chaps 18-19.

Alternatively, the testator can put the burden on the spouse to demand that the trustee make the trust property productive. See form 29.22-1 for a clause empowering the spouse to direct the trustee to convert unproductive property to property productive of income. This method, which may benefit the trust in some circumstances, relieves the trustee from the requirement to invest in or hold only income-producing assets. For instance, if the spouse decides that closely held stock that pays no dividends should be retained in the trust to avoid a forced sale, then he or she can simply refrain from directing the trustee to convert the stock in question to income-producing property.

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§29.14 C. Form: Restricted Investment Powers





29.14-1 Trustee to have restricted investment powers

***Limited Investment Powers*. The trustee may, in the trustee's discretion, invest and reinvest trust funds only in the following kinds of property:** _ _[*Describe investments*]_ _

Comment: This clause should be completed with a description of the types of investments to be permitted, *e.g.,* bank deposits, United States government bonds, common stocks listed on any national securities exchange, improved real estate, certificates of deposit at federally insured banks or savings and loan associations in denominations no greater than insurable amounts.

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D. Power to Retain Any Property

§29.15 1. Granting Power to Retain Unproductive Property

If the trustee holds property that was received from the decedent's estate, the trustee has a duty under Prob C §16049 to review the trust assets to decide whether retaining the property will bring the trust portfolio into compliance with the Uniform Prudent Investor Act and the purposes, terms and circumstances of the trust. Prob C §16049.

Form 29.16-1 gives broader powers than those included in the statute. The drafter should use the clause with care because of the special issues presented by retention of unproductive property. These derive from (a) the trustee's duty to make trust property productive, (b) the harmful effect that holding unproductive property can have on the interests of income beneficiaries, and (c) the hazards that these property holdings pose for the marital deduction power of appointment and qualified terminable interest property trusts. See §29.19 for extensive discussion of these issues and an explanation of the terms "unproductive" (used in the Internal Revenue Code) and "underproductive" (used in the Probate Code). The term "unproductive," which is used in this chapter, is meant to include "underproductive" property. Because the meanings of these terms are not always congruent, however, form 29.20-1 refers to "underproductive" property. See also Drafting California Irrevocable Trusts §19.37 (3d ed Cal CEB 1997).

If the testator wants to include a clause specifically permitting retention of unproductive property and a marital deduction trust is part of the estate plan, the drafter should also use either Option 2 in form 29.16-1 (aggregate return of investments must be reasonable) or form 29.22-1 (surviving spouse has power to require conversion of unproductive property to productive property).

See §31.23 on retention of the spouse-occupied residence despite its character as unproductive property. Special rules exempt this residence and personal property retained for the surviving spouse's personal use from the proscriptions against holding unproductive property in the marital deduction trust. Treas Reg §§20.2056(b)-5(f)(4), 20.2056(b)-7(h), Example (1).

The power to retain assets may be inconsistent with the requirement for diversification of trust investments. See §§29.10-29.11. Therefore, use of any clause permitting asset retention must be coordinated with other clauses regarding the trustee's investment powers. In *Americans for the Arts v Ruth Lilly Charitable Remainder Annuity Trust* (Ind App 2006) 855 NE2d 592, the court held that a trustee did not have a duty to diversify trust assets, because the trust document expressly conferred a power to retain indefinitely any property received by the trustee and further declared that property could be retained regardless of whether retention of the property prevented the diversification of trust investments, as provided in form 29.16-1. The court noted that a general authorization to retain investments "does not ordinarily abrogate the trustee's duty" with respect to diversification, because the grant of a power does not in itself require or permit the exercise of the power, but rather the exercise of a power is subject to the trustee's fiduciary duties. See Prob C §16202. The *Lilly* court distinguished *Wood v U.S. Bank* (Ohio App 2005) 828 NE2d 1072, in which the court held that a general power to retain investments did not override the duty to diversify. The *Wood* court noted that the settlor could have eliminated the duty to diversify—he simply did not do so.

If the testator wants the trustee to retain a particular asset, such as stock in a closely held business, the drafter should include a clause directing this. In *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473, the court denied a petition compelling trustees of a testamentary trust who were also directors of a family corporation to pay increased dividends to income beneficiaries, because the will expressly allowed the trustees to retain the corporation stock and to determine what was income and what was principal. The drafter should not only empower the trustee to retain the property but also describe circumstances under which it may be sold. Even if retention of the property is mandated by the will, the court may later authorize a sale if circumstances change after the testator's death so that the trust's purposes would be defeated by retention of the asset. See 3 Scott & Ascher on Trusts §18.1.4.2 (5th ed 2007).

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§29.16 2. Form: Power to Retain Any Property

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29.16-1 Power to retain any property

***Power to Retain Trust Property*. The trustee may, in the trustee's discretion, continue to hold any property that the trustee receives or acquires for as long as the trustee considers advisable, regardless of whether retention of the property prevents the diversification of trust investments.**

[*If applicable, add one or more of the following options*]

[*Option 1: Retention by corporate trustee or decedent's partner*]

The trustee may, in the trustee's discretion, retain property in which the trustee is individually interested, such as shares of the trustee's own stock.

[*Option 2: Investments in marital deduction trust must provide reasonable return*]

Notwithstanding the foregoing powers, the aggregate return from all investments from time to time must be reasonable under the prevailing circumstances.

Comment: The drafter should use Option 1 when the trustee should be permitted to retain stock, investment in which might otherwise appear to be self-dealing. See §§28.42-28.43 on trustee dealings with the trust in general and self-dealing in particular. Option 2 should be used when the trust property is held in a marital deduction trust, in which the provisions must entitle the beneficiary spouse to all income. The addition ensures that the surviving spouse will not be deprived of income through retention of low-income assets.

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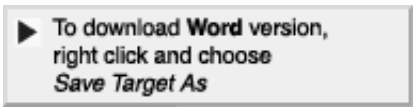
E. Power to Abandon Property

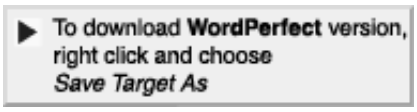
§29.17 1. Asset Abandonment

On occasion, the expenses of maintaining and preserving a trust asset may exceed the item's value. In addition, retention of an asset located in a foreign jurisdiction could be used by that jurisdiction as the basis for imposition of taxes or control over the trust. The trustee may need to be able to abandon property that would result in trustee liability under environmental laws or regulations for cleanup or removal of contaminated property. In such instances, giving the trustee explicit power to abandon a trust asset is an important aid to trust administration.

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§29.18 2. Form: Power to Abandon Property





29.18-1 Power to abandon property

***Power to Abandon Trust Property*. The trustee may, in the trustee's discretion, abandon any property or interest in property belonging to the trust if the trustee determines, in the trustee's discretion, that the abandonment is in the best interests of the trust and its beneficiaries.**

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F. Power to Invest in Underproductive Property

§29.19 1. Issues Presented by Investing in Unproductive Property

Because of the substantial potential for appreciation presented by unproductive assets such as unimproved real estate and growth stocks, the testator may want to give the trustee a broad grant of discretion to acquire such assets. Assets that are unproductive of income present special issues, however, which the drafter must consider before providing the trustee with the power to acquire them.

First, the trustee is ordinarily under a duty to "make the trust property productive." Prob C §16007. The Cal L Rev'n Comm'n Comment to Prob C §16007, however, recognizes that property may be made productive by appreciation in value as well as by production of income. Further, the Uniform Prudent Investor Act (UPIA) (Prob C §§16002, 16003, 16045-16054) gives trustees broad discretionary power and provides for evaluating trust investments based on the portfolio as a whole. Prob C §16047(a), (b). The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) also facilitates investments in property not producing immediate income by permitting the trustee to make adjustments between principal and income, although the trustee may not make adjustments if the trustee is also a beneficiary. Prob C §16336.

The drafter must bear in mind that although trustee acquisition of non-income-producing assets may be appropriate when asset growth is an important trust objective, it can favor remainder beneficiaries over income beneficiaries in the absence of Prob C §16336 adjustments. A trustee who is able to invest in unproductive assets thereby has the power to shift the beneficial enjoyment of the trust assets. If the trustee is also a beneficiary, or has a duty individually to support one of the beneficiaries, this power could lead to undesirable tax consequences, including a finding that the trustee has a general power of appointment over trust assets. See chap 16 on creation of a power of appointment; §§16.13-16.16 on the tax consequences of creating a power of appointment; §28.8 on the perils of a beneficiary's serving as trustee.

Further, the marital deduction may be jeopardized in a general power of appointment marital deduction trust if the trustee is authorized to retain unproductive property (with certain exceptions, *e.g.,* a residence or other property for the surviving spouse's personal use). Reg §20.2056(b)-5(f)(4)-(5). The same danger exists with respect to a qualified terminable interest property trust. See IRC §2056(b)(7)(B)(ii)(I). To protect the marital deduction, the spouse must be empowered to require the trustee to make trust property productive or to convert it into productive property within a reasonable period of time. Reg §20.2056(b)-5(f)(4).

Probate Code §21524(c) gives the income beneficiary of a trust intended to qualify for the marital deduction the right to require the trustee to make any unproductive property productive or to convert it to productive property within a reasonable time. However, a clause explicitly giving the spouse this power should nonetheless be included in the will, because the testator may die a nonresident of California. See form 29.22-1. On when statutory powers should be spelled out in the will, see §29.3.

When a trust is not a marital deduction trust, it is permissible to authorize or direct the trustee to hold unproductive property. When it is contemplated that a trust will hold a specific asset that is not productive (*e.g.,* stock of a closely held corporation that does not pay dividends), the trust instrument should expressly provide that the trustee is authorized to retain the asset and that such retention is not a violation of any duty of the trustee. Mere authorization is not sufficient because the mere fact that a trustee holds a power does not mean that exercise of the power is proper in a particular situation. Prob C §16202.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.20 2. Form: Power to Retain or Acquire Underproductive Property

§29.20 2. Form: Power to Retain or Acquire Underproductive Property

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29.20-1 Power to retain or acquire underproductive property

Power to Retain or Acquire Underproductive Property*. The trustee may, in the trustee's discretion, retain or acquire underproductive property_ _[, subject to my spouse's power to compel the trustee to make marital trust property productive***]_ _. No such retention or acquisition shall constitute a violation of any duty of the trustee.**

Comment: The optional language refers to form 29.22-1 and may be used when the will provides for a marital deduction trust.

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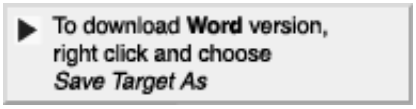
§29.21 3. Spouse's Power to Direct Trustee to Convert Unproductive Property to Productive Property

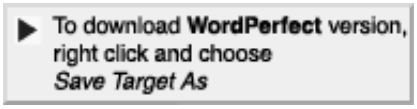
If unproductive property will be held in a marital deduction trust, the spouse must be empowered to require the trustee either to make the property productive or to convert it to productive property within a reasonable time to safeguard the deduction. See §§17.30, 29.19. See form 29.22-1 for a clause giving the spouse this power.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.22 4. Form: Trustee Compliance With Spouse's Direction to Convert Unproductive Property to Income Property

§29.22 4. Form: Trustee Compliance With Spouse's Direction to Convert Unproductive Property to Income Property





29.22-1 Trustee compliance with spouse's direction to convert unproductive property

***Conversion of Unproductive Property*. My spouse shall have the right to direct the trustee in writing to convert any unproductive property held in the marital trust to productive property within a reasonable time, and the trustee shall comply with this direction within a reasonable time after receipt of the directive.**

Comment: The drafter should use form 29.22-1 when the will provides for a marital deduction trust and contains a clause authorizing the trustee to retain or acquire unproductive property.

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III. MISCELLANEOUS MANAGEMENT POWERS

A. Sale, Exchange, and Repair of Trust Property

§29.23 1. Explicit Granting of Powers

The trustee has a duty to the beneficiary to assume, retain control of, and preserve trust property. Prob C §16006. In addition, the prudent investor rule (see §29.10) applies to the power to sell, exchange, and manage trust property. Prob C §16046(a).

The trustee has the powers to sell (for cash or credit) and exchange trust property (Prob C §16226); manage, improve, and partition trust property (Prob C §16227); repair, improve, and demolish trust property (Prob C §16229); and grant options on trust property (Prob C §16233). The trustee also has the power to develop land. Prob C §16230. Although express authorization in the will for these activities is unnecessary, explicit inclusion of certain of these specific powers is advisable to ease negotiations with potential purchasers and other third parties (*e.g.,* title companies) and to avoid question if the property is administered outside California. Form 29.24-1 provides most of these powers.

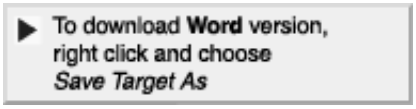
Regardless of the powers provided by statute or in the will, the trustee is bound by fiduciary duty not to use trust property for any purpose unconnected with the trust, or to take part in any transaction in which the trustee has an interest adverse to the beneficiary. Prob C §16004(a). Furthermore, if a trustee purchases trust property after or in contemplation of appointment as trustee, the trustee may not enforce a resulting claim against the trust property, although a court may permit reimbursement from trust property for the amount that the trustee paid in good faith for the claim. Prob C §16004(b).

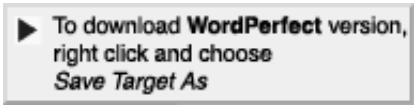
Although a trustee may not sell trust property to himself or herself without express authorization, it is not improper for the trustee to sell trust property to one of the beneficiaries of the trust. See 3 Scott & Ascher on Trusts §18.1.4.4 (5th ed 2007). See also §28.42 on trustee dealings with the trust; form 28.44-1 (permitting a trustee as an individual to lend to the trust or buy from and sell assets to it); form 28.45-1 (authorizing the trustee to "self-deal").

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.24 2. Form: Power to Sell, Exchange, and Repair Trust Property

§29.24 2. Form: Power to Sell, Exchange, and Repair Trust Property





29.24-1 Power to sell, exchange and repair trust property

***Power to Sell, Exchange, and Repair Trust Property*. The trustee may, in the trustee's discretion, manage, control, grant options on, sell (for cash or on deferred payments, with or without security), convey, exchange, partition, divide, maintain, improve, and repair trust property.**

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B. Power to Lease

§29.25 1. Stated Power Enhances Trustee Credibility

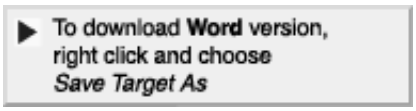
If the trust estate includes land, the trustee has a duty to make it productive, *e.g.,* by leasing it. On the trustee's duty to make trust property productive, see Prob C §16007. See also §29.11. Probate Code §16231 authorizes the trustee to enter into a lease for terms within or beyond the term of the trust, and Prob C §16232 gives the trustee similar powers to enter into leases and arrangements to explore for and remove oil, gas, minerals, and geothermal energy. An explicit power to lease, however, gives the trustee added credibility when dealing with third parties.

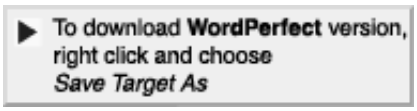
Form 29.26-1 includes some powers relating to mineral rights. If the trust will include substantial interests in mineral rights, the more detailed provisions of form 29.58-1 may be appropriate.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.26 2. Form: Power to Lease, Including Mineral Rights

§29.26 2. Form: Power to Lease, Including Mineral Rights





29.26-1 Power to lease, including mineral rights

***Power to Lease Trust Property*. The trustee may, in the trustee's discretion, lease trust property for terms within or beyond the term of the trust and for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases, pooling, and unitization agreements.**

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/ C. Power to Borrow/§29.27 1. Explicit Grant of Power May Be Required for Trustee to Borrow

C. Power to Borrow

§29.27 1. Explicit Grant of Power May Be Required for Trustee to Borrow

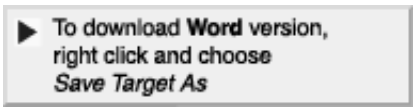
Probate Code §16241 authorizes the trustee to borrow money to be repaid from trust property for any trust purpose. An institutional trustee may borrow from a bank holding company, affiliate, or subsidiary of the trustee. (See also Prob C §16015, discussed in §28.42, which permits a bank to provide and receive compensation for services to a trust of which it acts as trustee.) Probate Code §16228 also grants the trustee the power to encumber, mortgage, or pledge trust property in connection with the exercise of any other power that the trustee has, including borrowing. Like other powers, the trustee's power to borrow is subject to the trustee's obligations as a fiduciary. Prob C §16202.

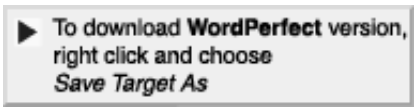
Banks frequently refuse to lend money to a trust unless the trustee is explicitly empowered to borrow in the trust instrument. Consequently, the powers to borrow money and to encumber both real and personal property should be expressly granted. The reference to joint indebtedness in form 29.28-1 is included because some title companies may otherwise refuse to issue a policy covering a loan secured by property owned in common with another person.

The optional addition to form 29.28-1 empowers the trustee to maintain margin accounts with securities brokers. This will enable the trustee to make purchases for less than full price, with the balance payable on sale of the securities. The power should not be provided unless the trustee is, or has delegated the investment function to, a sophisticated and careful investor; if the value of a stock purchased on margin declines, the trust will owe the remainder of the purchase price.

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§29.28 2. Form: Power to Borrow





29.28-1 Power to borrow

***Power to Borrow*. The trustee may, in the trustee's discretion, borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner of the property in which the trust has an interest.**

[*If applicable, add the following option*]

[*Option: Power to establish margin account*]

The trustee may also, without limitation, establish and maintain any margin account or accounts with securities dealers or brokers.

Comment: The testator should not give the trustee the power to establish a margin account, provided in the optional addition, unless the trustee is a sophisticated and careful investor.

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D. Power to Initiate and Defend Litigation

§29.29 1. Duty to Initiate and Defend Litigation

The trustee has the duty to enforce claims that are part of the trust property (*e.g.,* rents, accounts payable (Prob C §16010)) and to defend actions that could cause trust losses (Prob C §16011). Probate Code §16249 also gives the trustee the power to prosecute or defend actions, claims, or proceedings for the protection of trust property. Probate Code §859 imposes liability for twice the value of the property on any person who in bad faith wrongfully takes, conceals, or disposes of property in or belonging to the trust recovered by the trustee in an action under Prob C §§850-859. See *Estate of Young* (2008) 160 CA4th 62, 72 CR3d 520 (decedent's estate entitled to double damages because trial court determined that decedent's transfers of property to "land trusts" were caused by fraud and undue influence).

Failure to take any such action when reasonably required may cause the trustee to be personally liable for the resulting loss. See 3 Scott & Ascher on Trusts §17.9 (5th ed 2007); *Purdy v Johnson* (1917) 174 C 521, 163 P 893; *Estate of Prior* (1952) 111 CA2d 464, 244 P2d 697 (dictum). On the trustee's duty to defend claims, see *Metzenbaum v Metzenbaum* (1953) 115 CA2d 395, 252 P2d 31; Restatement (Second) of Trusts §178 (1959). On the executor's power to maintain and defend actions for and against the decedent's estate, see §33.6.

Even though the power authorized by form 29.30-1 is implied in the trustee's duty to protect the trust, it should be explicitly stated for the benefit of the nonprofessional trustee and interested third parties. See Restatement (Third) of Trusts §76(2) (2007).

Even when the power is set forth in the will, the trustee is well advised to petition the court for instructions under Prob C §17200 before embarking on uncommon types of litigation (*e.g.,* a minority stockholder's suit) if the will does not expressly authorize that type of lawsuit.

NOTE: Form 29.30-1 clearly states that the trustee's powers to litigate and defend actions continue after the trust terminates. This is important because, although under California law the power to litigate continues beyond the life of the trust, the power terminates in other states. See *Botsford v Haskins & Sells* (1978) 81 CA3d 780, 146 CR 752 (under California law, complaint could be filed after trust termination); *Harold Patz Trust* (1977) 69 TC 497 (under Wisconsin law, because trustee unable to litigate trust matters after distribution of trust assets, trustee also unable to litigate tax deficiency); *Ranghild Elton*, TC Memo 2000-9 (under Texas law, trustee unable to continue as party petitioner after trust voided ab initio by state court judgment).

Without specific empowering language in the will, costs may be recovered in actions brought by or against the trustee. CCP §1026.

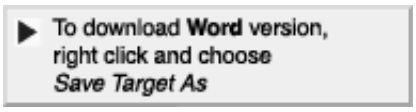
In many cases, it may be more prudent for the trustee to compromise a claim or submit the claim to arbitration than to litigate the matter. Under Prob C §16242(a)-(c), the trustee may pay, arbitrate, compromise, or release the claim. See generally Restatement (Second) §192. A clause empowering the trustee to take these courses of action is provided in form 29.31-1.

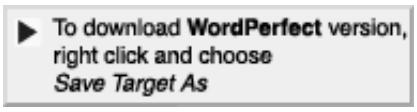
NOTE: A trustee may petition a court concerning the internal affairs of the trust. See Prob C §17200. The trustee or any interested person may also file a petition for a court order when the trustee possesses or holds property that is claimed to belong to another, or when the property of the trust is claimed to be subject to a settlor's creditor. Prob C §850(a)(3). See also Prob C §856.5 (court must not grant petition if it determines that matter should be determined by civil action).

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.30 2. Form: Power to Initiate and Defend Litigation

§29.30 2. Form: Power to Initiate and Defend Litigation



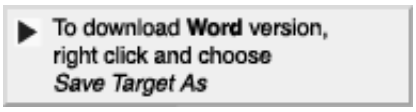


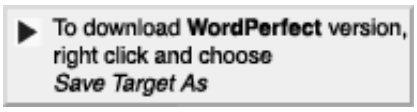
29.30-1 Power to initiate and defend litigation

***Power to Initiate and Defend Litigation*. The trustee may, in the trustee's discretion, initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate that the trustee considers advisable. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.**

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§29.31 3. Form: Power to Compromise Claims





29.31-1 Power to compromise claims

***Power to Compromise Claims*. The trustee may, in the trustee's discretion, compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust. The trustee's decision in this regard shall be conclusive. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.**

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E. Power to Insure

§29.32 1. Stated Power Reinforces Trustee Duty

Probate Code §16240 gives the trustee the power to insure the trust's assets as well as to insure the trustee against liability to third persons.

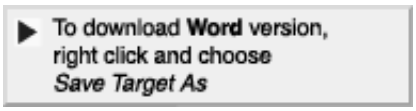
Implicit in the trustee's fiduciary duty is the requirement to carry insurance on trust property that would customarily be carried by a prudent person who owned the property. Restatement (Second) of Trusts §176 (1959); Restatement (Third) of Trusts §76, Comment d (2007). See Prob C §16040 for the "prudent person" standard of conduct. Further, the trustee may carry additional insurance to the extent sanctioned by standards of "good business judgment." 1A Nossaman & Wyatt, Trust Administration and Taxation §27.01[3] (rev 2d ed 1966).

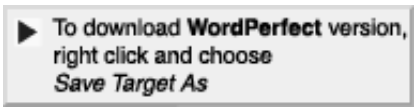
The trustee may also charge the trust for insurance against the trustee's liability; such insurance is of particular importance when the trustee will be responsible for operating a business. See *Johnston v Long* (1947) 30 C2d 54, 181 P2d 645, in which the court held that an executor was personally liable for a tort committed in the course of the operation of the decedent's business.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.33 2. Form: Power to Insure

§29.33 2. Form: Power to Insure





29.33-1 Power to insure

***Power to Insure*. The trustee may, in the trustee's discretion, carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.**

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F. Powers to Address Environmental Concerns

§29.34 1. Minimizing Risk of Fiduciary Environmental Liability

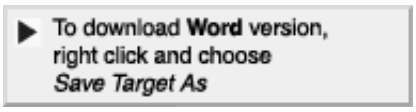
Environmental laws generally impose strict liability for failure to comply with rules for management of hazardous or toxic substances. Ownership and operation of contaminated property may expose fiduciaries that hold the property to liability, resulting in civil and criminal penalties, and substantial cleanup costs, although the liability of an "innocent fiduciary" is generally limited to the value of assets held in a fiduciary capacity. 42 USC §§6991b(h)(9), 9607(n). See *Canadyne-Georgia Corp. v NationsBank* (11th Cir 1999) 183 F3d 1269. To minimize the risk and extent of environmental liability, it may be advisable to give the trustee specific authority to monitor trust property and undertake cleanup of trust property. The drafter may also want to consider whether the trustee should be permitted either (1) to refuse to accept contaminated property, to abandon it, or to appoint a special trustee to handle it; or (2) to distribute such property, if to do so would be in the trust's best interests. Some institutional trustees may demand the right to resign for self-protection if the trust receives contaminated property. For discussion of trustee resignation, see §§28.18-28.19. The trustee may be further protected by an indemnification clause that would be effective if the trustee is held personally liable for cleanup costs of contaminated property.

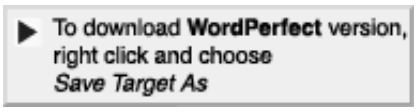
For a brief review of the fiduciary's responsibilities with regard to environmental laws, see California Trust Administration, chap 6 (2d ed Cal CEB 2001).

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.35 2. Form: Power to Monitor Property

§29.35 2. Form: Power to Monitor Property



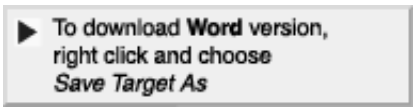


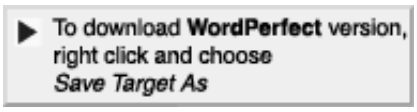
29.35-1 Power to monitor property for regulatory compliance

***Power to Monitor Trust Property*. The trustee may, in the trustee's discretion, inspect from time to time or monitor any property held in any trust created under my will in order to determine compliance with any law, regulation, or ordinance that may or does affect the property. This power specifically includes the power to inspect assets controlled by any business enterprise held by the trustee.**

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§29.36 3. Form: Powers to Comply With Environmental Laws





29.36-1 Powers to comply with environmental laws

***Power to Comply With Environmental Laws*. The trustee may, in the trustee's discretion:**

(1) Take any action to prevent, abate, clean up, or otherwise remedy any actual or threatened violation of any environmental law arising from the existence, condition, maintenance, or use of any property held in any trust created under my will. Action may be taken before or after the initiation of enforcement action by any government agency. The trustee may, in the trustee's discretion, charge the cost of any inspection, monitoring, reporting, preventive activity, abatement, cleanup, or other remedial action against trust income or principal.

(2) Settle or compromise any claim against the trust asserted by any government body or private party involving the violation of any environmental law alleged to result from the existence, condition, maintenance, or use of any trust property.

(3) Decline to accept any property in trust if the trustee determines, in the trustee's sole discretion, that the property's existence, condition, maintenance, or use (before or after its acceptance into the trust) does or could violate any environmental law, resulting in liability to the trustee or detriment to the value of other trust assets. Acceptance of any property into the trust shall not create any inference regarding the existence of any liability under environmental law affecting the property.

(4) Disclaim any power if the trustee determines, in the trustee's sole discretion, that the power may cause the trustee to incur personal liability under any environmental law.

(5) Decline to serve as trustee or resign as trustee if the trustee determines, in the trustee's sole discretion, that there may be or is a conflict of interest between the trustee in a fiduciary capacity and as an individual because of claims or liabilities that could be asserted against the trustee arising from the existence, condition, maintenance, or use of any trust property.

"Environmental law" as used in this trust means any federal, state, or local law, regulation, rule, or ordinance relating to protection of the environment or human health.

The trustee will not be liable to any beneficiary for any detriment to trust property values due to the trustee's compliance with any environmental law.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/ G. General Business Interest Powers/ §29.37 1. Authority to Continue Business Operation

G. General Business Interest Powers

§29.37 1. Authority to Continue Business Operation

Business operation presents many special concerns for a trustee, which the testator can address with powers in the will:

(a) *Should the business operation continue past the testator's death?* Probate Code §16222(c) gives the trustee the power to continue to operate a business that is part of the trust property for "a reasonable time," pending sale of the business. Moreover, Prob C §16222(a) permits the trustee to incorporate, dissolve, or change the form of the business. The business cannot be operated indefinitely, however, unless indefinite operation is authorized in the will or by court order. Prob C §16222(b). If the trust will include an interest in a closely held business, a clause identifying an existing business and authorizing the operation of the business must be included. Usually, these businesses have value only if they continue to operate.

(b) *Should the trustee be empowered to conduct a business?* Because a trust may hold a business ownership interest, a general clause empowering the trustee to conduct a business is usually advisable, even if the testator does not hold a particular business interest when the drafter prepares the estate plan. This is particularly important for relatively young testators, whose financial circumstances may change substantially over time.

(c) *Should the trustee be authorized to sell the estate's interest in a closely held business?* Many closely held businesses are subject to buy-sell agreements, which require the decedent owner's estate to sell its interest in the business to surviving owners. On estate planning considerations for owners of small businesses and sample buy-out agreements for owners of shares in close corporations and partnerships, see Business Buy-Sell Agreements, chaps 2-4 (Cal CEB 1991). If the testator's business is affected by such an agreement, the drafter should review the document to see whether it calls for trustee action that should be authorized or approved in a will provision.

(d) *To enable the business to prosper, what trust management rules should govern?* If the trust is likely to hold a controlling interest in an incorporated or unincorporated closely held business, the attorney should ensure that the principal and income rules applicable to a trust (in particular the rules on allocation of depreciation between income and principal) do not suffocate the business. See §§30.8-30.12 on allocating expense items to principal and income accounts; §30.13 on depreciation reserves. For example, must the trustee use its position as a majority shareholder of a closely held corporation to cause the corporation to pay dividends that will ultimately go to the income beneficiaries of the trust?

(e) *Does the testator want to influence the future management of the business?* If the testator has particular wishes regarding the conduct of the business, they must be stated both to give the trustee direction and to assure the trustee of the powers and indemnity he or she will need to include out those wishes. The optional directions clause in form 29.38-1 may be adapted to include specific directives regarding, *e.g.,* hiring, supervision, and compensation.

(f) *Does the testator want to minimize the risk to the trustee of managing the business?* Because the risk of managing a business is generally greater than the risk of managing conventional investments, the testator may wish to protect the trustee from employee misconduct and to authorize the trustee to rely on financial and business statements. The optional trustee protection clause in form 29.38-1 may accomplish this purpose. The testator will probably want to encourage the trustee to take out insurance against liabilities incurred by business operations. See §29.51 on insurance. If the business is a partnership and the trust will succeed to a general partner's interest, the drafting attorney should determine whether it is wise and possible to convert the interest to that of a limited partner. If the answer to both inquiries is affirmative, the specific power should be included. See form 29.42-1.

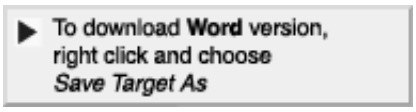
NOTE: The lease of four or fewer residential units is not considered to be the operation of a business or other enterprise. Prob C §16222(b).

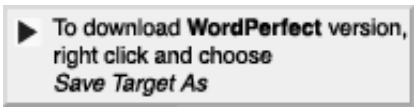
For further discussion of trust business holdings, see Drafting California Irrevocable Trusts §§19.74-19.108 (3d ed Cal CEB 1997). See also §28.42 on trustee conflicts of interest; §28.29 on trustee delegation of trustee duties and compensation of agents; §28.47 on exculpatory clauses generally.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.38 2. Form: Overall Powers for Business Interests

§29.38 2. Form: Overall Powers for Business Interests





29.38-1 Powers for business interests

***Power to Operate a Business*. The trustee may, in the trustee's discretion, continue to hold and operate, sell, or liquidate, at the risk of the trust estate, any business or investment activity in whatever form (including a sole proprietorship, general or limited partnership interest, trust, corporation (including a closely held corporation), or other entity) that the trustee receives or acquires under this trust. The trustee may, in the trustee's discretion, do all things that the trustee considers advisable in connection with this business or investment activity, including the following:**

(1) Incorporate or make other changes in the form of the organization of the business or investment activity;

(2) Lend or contribute other trust funds to the business or investment activity;

(3) Serve as an officer or director of any corporation;

(4) Consent to the retention of all or any portion of the distributable share of net income of the business or investment activity to meet its reasonable needs;

(5) Rely on the written statement of the managing partner or other chief executive of the business or investment activity, setting forth the reasons for withholding distributable net income;

(6) Dissolve, liquidate, sell, or otherwise dispose of the business or investment activity or any interest in it;

(7) Without independent investigation, accept as correct and rely on financial or other statements rendered by an accountant, an officer, or a principal of the business, for any business or investment activity or any interest in it; and

(8) For accounting and reporting purposes, regard the business or investment activity as an entity separate from the trust, and account for money and property received from and paid to the business or investment activity.

[*If applicable, add one or more of the following options*]

[*Option 1: Directions on management and compensation*]

The trustee shall perform all acts and employ all personnel that the trustee may, in the trustee's discretion, consider necessary or desirable for the management and operation of any business interest held in the trust estate, without liability for any loss resulting from the acts or omissions of any of the employees, provided that the trustee uses reasonable care in selecting and supervising them. The trustee shall pay the employees from the trust estate compensation that the trustee considers to be reasonable.

[*Option 2: Trustee protection*]

The trustee shall incur no liability for misconduct, mismanagement, or negligence on the part of any employee of a business, any employee or partner of a partnership, or any employee, officer, or director of a corporation in which trust funds are invested. The trustee shall be held harmless against and be indemnified out of the trust estate for any claims, liability, losses, or damages chargeable against the trustee arising out of or connected with the trustee's possession, management, or ownership as trustee of any interest in a business or an investment activity.

Comment: The drafter may want to limit the character of businesses that the trust can hold and, if a specific

business will certainly become part of the trust, name that business in the authorizing clause. If the trustee as an individual owns a business interest in which it also holds an interest as trustee of the testamentary trust, specific authorization to continue the trust interest in that business entity should be provided. The optional additions are particularly useful when the trustee will be directly involved in the business management. If the trustee is a corporate trustee, the indemnification against liability for acts of a business employee in Option 2 should be limited by the phrase "who is not an officer or employee of the trustee."

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H. Corporate Business Interest Powers

§29.39 1. Authority to Participate in Corporate Organizational Matters

Without a specific power to do so, the trustee may lack the authority to exchange trust property for corporation shares, *i.e.,* to incorporate a business. See 3 Scott & Ascher on Trusts §18.1.4.7 (5th ed 2007), noting the traditional view that the mere power to sell trust assets may be insufficient authorization for the trustee to exchange trust property for corporation shares. Further, the trustee should be given explicit powers to delegate management, which in the corporate context may involve giving proxies or entering into voting trusts. See §28.29 on the trustee's duty not to delegate his or her duties. Form 29.40-1 is intended to provide a full range of these and other powers for the trustee who is expected to participate in managing a corporate enterprise.

Testators who are business owners sometimes name their business associates as trustees. When this arrangement is in the estate plan, the drafter should include an optional clause permitting the trustee to serve even though he or she personally owns shares in the corporation, to avoid any charge of trustee self-dealing. This clause is provided in Option 1 to form 29.40-1. See §28.42 on trustee self-dealing.

A clause permitting (but not mandating) the election of officers to maintain consistent management is offered in Option 2 to form 29.40-1, as an example of one way that a testator can provide guidance to the trustee.

On managing securities held in trust, see §29.43.

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§29.40 2. Form: Corporate Business Management

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29.40-1 Authority for corporate business management

***Corporate Management Powers*. The trustee may, in the trustee's discretion:**

(1) Acquire and hold shares in any corporation and incorporate any business in any state or possession of the United States of America, in the District of Columbia, or in any foreign country;

(2) Transfer to any corporation any real or personal assets of the trust estate and receive in exchange shares of stock or other securities of the corporation;

(3) Serve as an officer or a director of any corporation;

(4) Vote in person or by proxy the shares of any corporation;

(5) Participate in voting trusts and pooling agreements and deposit any shares with and transfer title to any committee, assignee, or trustee under terms that the trustee considers advisable; and

(6) Participate in reorganizations, consolidations, and mergers concerning any corporation; exchange shares or securities for other shares or securities or other assets; liquidate or join in the liquidation of any corporation; and retain and operate (alone or in conjunction with any others) any interest in any business so received.

[*If applicable, add one or more of the following options*]

[*Option 1: Authorization despite trustee's personal ownership of shares*]

The trustee may exercise these powers even though the trustee may also own shares or securities in the corporation for the trustee's own account.

[*Option 2: Management and delegation (closely held corporation)*]

I request but do not require that the trustee vote the stock of this corporation to elect as directors and officers the persons actively participating in the corporation's management when I die. The corporation's management and the conduct of its operations may be delegated to persons chosen by the corporation's board of directors.

Comment: Form 29.40-1 provides an extensive array of powers. If the testator wants to restrict the trustee's powers at all, the clause must be amended.

Option 1 authorizes the trustee to trade in shares of a corporation even though the trustee also owns shares in the corporation.

Option 2 is for use with a clause naming the corporation in which the testator will leave an interest. If such a clause is not included in the will, the name of the corporation should be inserted. If the drafter uses Option 2, a clause protecting the trustee from liability for delegating powers should be included among the management clauses.

The drafter may adapt any of these clauses for use in connection with a partnership by substituting partnership terms for the corporate terms provided in the clauses. For instance, the trustee can be given the authority to transfer to any partnership any real or personal assets of the trust estate and receive in exchange an interest in the partnership (adapting item (2) of form 29.40-1).

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I. Partnership Interest Powers

§29.41 1. Authority to Hold Partnership Interest

When the trust will hold a general partnership interest, the drafting attorney and client should consider the potential liability to which that holding may expose the trust. The trust could become directly liable on partnership obligations; there is no protective shield for the partnership business owner like that available when the ownership is in corporate form. On partnership liabilities, see Advising California Partnerships §3.64 (3d ed Cal CEB 1999). (The same concern for liability exists for the trustee holding a sole proprietorship.)

If the testator owns a partnership interest that is expected to be maintained in the trust, the will should specifically refer to that interest and the trustee's expected management of the interest. When one or more partnerships will be important trust investments, an empowering clause like form 29.42-1 shows that the trustee is not improperly exposing the trust to liability and that the testator intended the trustee to hold the partnerships in the trust. If the trustee individually owns an interest in the asset, the drafter should include an optional clause like Option 1 to form 29.42-1 to avoid issues of trustee self-dealing. See §28.42 on trustee's dealings with trust assets in which he or she is personally interested.

To avoid the risks of trustee participation as a general partner, the testator may want the trustee's investment in the business to be as a limited partner, with the protections afforded by that status. See Advising Partners §3.65. However, the testator must also consider the loss of control over the investment, which the conversion from general to limited partner status will cause. Whatever the testator's wishes, the partnership agreement may prove to be the most important factor in the decision about whether to require the trustee to change the status: It may not permit the conversion or may require the other partners' concurrence for any change to the partnership structure. Option 2 to form 29.42-1 is designed to require conversion of the interest to a limited partnership interest when possible.

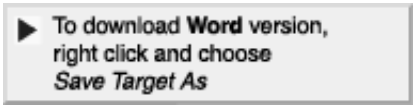
The drafting attorney should consider adapting one or more of the general business clauses provided in §29.38 for use in connection with a partnership interest. For instance, the trustee exculpation provided in Option 2 to form 29.38-1 is advisable in most instances. The attorney may also want to adapt Option 2 to form 29.40-1, recommending trustee retention of the corporate management team in place when the testator dies.

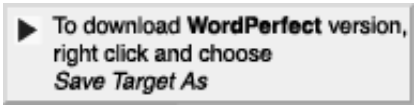
See §29.37 for general observations regarding trust investment and participation in businesses.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.42 2. Form: Power to Engage in Partnership Business

§29.42 2. Form: Power to Engage in Partnership Business





29.42-1 Power to engage in partnership business

***Partnership Interest Powers*. The trustee may, in the trustee's discretion:**

(1) Enter into any general or limited partnership agreement;

(2) Become and remain a partner under the agreement;

(3) Transfer to the partnership any real or personal assets of the trust estate, in exchange for an interest in the partnership;

(4) Carry out all the terms and conditions of any partnership agreement; and

(5) When possible, convert any general partnership interest to a limited partnership interest.

[*If applicable, add one or more of the following options*]

[*Option 1: Trustee-partner may serve as partner for trust*]

The trustee shall have these powers even if the trustee is also a partner of the partnership for the trustee's own account.

[*Option 2: Trustee must convert general partnership interest to limited partnership interest*]

Notwithstanding the foregoing, the trustee shall, if possible, convert any general partnership interest that I may have at the time of my death to a limited partnership interest.

Comment: See §29.41 on the trust's engaging in a partnership business. Option 2 can be used with either the power to engage in a partnership business provided in form 29.42-1 or the general grant of power to engage in business provided in form 29.38-1. Option 2 can be adapted for use when neither of those clauses is used. If used with form 29.42-1, the drafter should delete from form 29.42-1 the discretionary power to convert a general partnership interest into a limited partnership interest.

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J. Securities Ownership

§29.43 1. Managing Securities Held in Trust

The trustee, as legal owner of shares held by the trust, may exercise the powers of a shareholder, but must do so prudently and in a manner that promotes the interest of the beneficiaries. See 3 Scott & Ascher on Trusts §18.1.8 (5th ed 2007). The trustee ordinarily may give proxies to vote any shares of stock held in the trust. Prob C §16234(a); Corp C §§702(a), 705(a). The trustee may also deposit shares with a protective committee, which may be established when the corporation is in financial difficulty, and may participate in voting trusts and corporate reorganizations. Prob C §16237.

In view of the statutes cited above, the trust instrument need not include the powers to vote stock, give proxies, deposit shares with protective committees, or participate in voting trusts or corporate reorganizations. Form 29.44-1 provides those powers, however, because their inclusion may help the trustee in transactions with third parties (*e.g.,* transfer agents) and may persuade a foreign court that the trustee has such powers if the will is probated, or the trustee's acts are challenged, outside California.

Specific authority to enter into shareholders' agreements may be useful if the trust will hold stock of a statutory "close corporation." Form 29.44-1 provides the authority to enter into S corporation shareholder agreements.

When the trust owns a controlling interest in a corporation, the trustee should attend shareholders' meetings and personally vote the stock held in the trust. On the responsibilities of the trustee who holds a controlling interest in a business, see 3 Scott on Trusts §18.1.8.2.

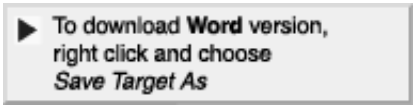
The testator may direct that shares of stock held in a testamentary trust be voted according to the directions of a third person or persons other than the trustee, or that such shares be voted in a particular manner. See 3 Scott on Trusts §18.1.8.1. The extent to which these directions are enforceable is not clear. Directions to vote stock have been held unenforceable in some cases on the ground that the decedent cannot attempt to prescribe management policies after death. See *Estate of Hirshon* (1963) 242 NYS2d 218, 192 NE2d 174, in which the court invalidated testamentary directions that the trustees elect themselves as directors and operate the company in a certain fashion. Although vesting the voting rights in a third person generally appears to be permissible, it is unclear whether such an arrangement constitutes a voting trust subject to the ten-year limitation of Corp C §706 or otherwise violates some public policy of separating the right to vote from legal ownership of the stock. See *Estate of Colyear* (1964) 230 CA2d 558, 41 CR 88.

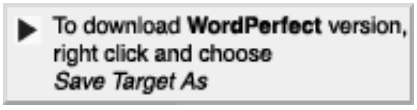
A trustee is subject to the same rules in connection with securities ownership as other securities holders. For example, a trustee who sells a company's majority interest to a buyer who loots the corporation is liable to the corporation for losses incurred through the stock sale if the trustee was aware of facts indicating that the buyer intended to loot the corporation. *DeBaun v First W. Bank & Trust Co.* (1975) 46 CA3d 686, 120 CR 354.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.44 2. Form: Power to Manage Securities

§29.44 2. Form: Power to Manage Securities





29.44-1 Power to manage securities

***Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including but not limited to the powers to:**

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements (whether or not extending beyond the term of the trust) and enter into shareholders' agreements, including but not limited to buy-sell agreements and close corporation and S corporation shareholders' agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, in the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

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§29.45 3. Holding Securities in Nominee's or Broker's Name

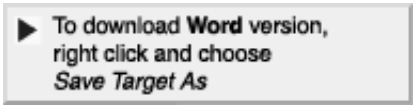
To facilitate the transfer of stocks and other securities, trustees often place trust shares in the name of a third person as nominee, or maintain the shares in the name of the securities broker who managed the asset purchase ("street name"). (Securities can be and often are also held in "bearer" form, which enables the shares to pass by delivery.) These methods make possible quicker and easier transfer of securities on sale, eliminating the need to obtain the trustee's signature on actual share certificates. In California, Fin C §1563 authorizes institutional trustees to hold shares in the names of nominees and to aggregate groups of the same securities owned by different trusts all in the name of one nominee. The institutional trustee, however, is liable for any loss incurred on stocks or other securities so registered arising from the nominee's acts. Probate Code §16238 gives noninstitutional trustees the power to hold shares in nominee or bearer form.

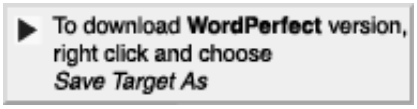
Form 29.46-1 makes explicit the power to hold securities in the nominee's name or street name. Some brokerage firms require an explicit clause like this to hold securities in street name in an account for a trust.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.46 4. Form: Power to Hold Securities in Nominee's Name or in 'Street Name'

§29.46 4. Form: Power to Hold Securities in Nominee's Name or in "Street Name"





29.46-1 Power to hold securities in nominee's name or in "street name"

***Power to Hold Securities in Alternative Forms*. The trustee may, in the trustee's discretion:**

(1) Hold securities or other property in the trustee's name as trustee under this trust, in the trustee's own name, or in the name of a nominee, including what is commonly called a "street name"; or

(2) Hold securities unregistered in such condition that ownership will pass by delivery.

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K. Purchasing Bonds at Premium

§29.47 1. Premium Bonds

Some debt securities are so structured that a premium amount over the bond's face value is paid at the time of purchase, in exchange for interest over the bond's lifetime at a rate higher than the current market rates otherwise available. When the bonds mature, they are redeemed only for the face value.

If a trust instrument provides for different distributions of principal and income, these bonds favor a trust's income beneficiaries. The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) does not provide for amortization over the securities' lifetimes of the principal paid for the premiums. Prob C §16357(a). Thus, absent a discretionary use of the Prob C §16336 principal and income adjustment power, there is no source of funds from which to reimburse the principal that paid the premium when the bonds mature and are redeemed at face value (which is less than the purchase price including the premium). The adjustment power is not available in cases in which the trustee is a beneficiary. Prob C §16336(b)(7). Accordingly, if a trustee invests heavily in high premium bonds, the remainder beneficiaries may have grounds to object, although this usually depends on evaluation of the portfolio as a whole. See Prob C §16047. To avoid any question of the trustee's authority to purchase bonds at a premium, it is advisable to include in the will a clause expressly authorizing their purchase and providing that such purchases are not a violation of any duty of the trustee.

If the trustee is authorized to purchase premium bonds, it is ordinarily advisable to require that the premiums be amortized in order to eliminate the inequity to the remainder beneficiaries. Form 29.48-1 provides a sample amortization clause. Some limits on the amortization requirement can be set for administrative convenience, so that the trustee need not amortize when the premium is minimal. Option 1 to form 29.48-1 provides such limits. This optional clause should not, however, be used when the trustee is in a "tax-sensitive" situation, because it might provide the trustee with discretionary powers that can be used to his or her personal advantage, leading to the imputation of personal ownership of the bonds for tax purposes. See §28.8 on the tax perils of selecting a beneficiary or person responsible for a beneficiary's support as trustee; §29.7 on tax issues raised by giving such a trustee certain discretionary powers.

Alternatively, the testator may authorize the trustee to buy premium bonds without any amortization requirement, despite the inequity. Because such a clause would effectively give the trustee a power, not subject to any ascertainable standard, to invade principal for the income beneficiaries' benefit, it should not be used when an income beneficiary is trustee. See §28.8. See also Option 2 to form 29.48-1 for a clause that does not require the trustee to amortize the premium.

Internal Revenue Code §171 provides for an election to take an amortization deduction for bond premiums. Assuming that the trustee is not in a tax-sensitive situation and that the trustee has discretionary power to amortize bond premiums, the trustee can take into consideration the respective income tax brackets of the income beneficiaries, the trust, and the remaindermen in determining whether to amortize. Generally, if the income beneficiaries are in a higher income tax bracket than the trust or the remainder beneficiaries, it is better to amortize the premium because the deduction will be taken against current income.

On the trustee's duty not to favor one beneficiary or group of beneficiaries over another, see §28.2.

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§29.48 2. Form: Power to Purchase Bonds at Premium

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29.48-1 Alternative: Power to purchase bonds at premium (amortization of premiums)

***Power to Purchase Bonds at Premium*. The trustee may, in the trustee's discretion, purchase bonds and pay any premiums connected with the purchase that the trustee, in the trustee's discretion, considers advisable, provided, however, that each premium is repaid periodically to principal from the interest on the bond in a reasonable manner and, to the extent necessary, from the proceeds on the sale or other disposition of the bond.**

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

[*Option 1: No bond premium repayment required*]

The trustee need not repay any portion of the premiums on bonds purchased at, or for less than, _ _[*specify, e.g., 103*]**_ _ percent of their par value.**

[*Option 2: Power to purchase bonds at premium (no amortization of premiums)*]

The trustee may, in the trustee's discretion, purchase bonds and pay any premiums connected with the purchase that the trustee considers advisable, without the obligation to repay premiums to principal despite any loss or gain on the bonds that falls on or inures to principal on their respective maturities or on their sale or other disposition.

Comment: Form 29.48-1 is for use when the bond premiums are to be amortized. Option 1 is provided to limit the trustee's repayment obligation when the premium is small. The clause should not be used in a "tax-sensitive" situation (*i.e.,* when the trustee is also a beneficiary or is otherwise obligated to support a beneficiary). Option 2 dispenses altogether with any obligation to amortize the premiums. This clause also should not be used in tax-sensitive situations.

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L. Purchasing Bonds at Discount

§29.49 1. Discount Bonds

Some debt securities are structured so that the bonds are purchased for a sum less than face value; at maturity, the bonds are redeemed for the full face value. (The value of the bonds may increase at a fixed rate, with higher values payable at set intervals.) The proceeds of sale, redemption, or other disposition of bonds are generally principal. Prob C §16357(b). The proceeds therefore usually accrue to the remainder beneficiaries' account. A bond purchased at a discount also ordinarily offers a lower coupon (interest) rate than a comparable bond purchased at par. Unless such a bond is sold or redeemed within one year, the increase in value of the bond as time goes by will be allocated to principal. Prob C §16375(b). Unless an adjustment is made under Prob C §16336 or otherwise, an investment in discount bonds will benefit the remainder beneficiaries at the income beneficiaries' expense. Adjustments cannot be made under §16336 if the trustee is a beneficiary.

Because acquisition of these bonds can favor the remaindermen, the testator who wishes to authorize their purchase may choose to include a clause such as form 29.50-1.

Option 1 to form 29.50-1 permits the trustee to make current distributions to income of an amount representing the discount. Another approach is to require the trustee to allocate to income the amount of the discount that is treated as ordinary income (in the form of interest) for federal income tax purposes during the year. Option 2 to form 29.50-1 uses this approach.

Option 3 to form 29.50-1 is designed to relieve the trustee from the duty to make the allocations required by a clause such as Option 2 to form 29.50-1 when the discount is minimal. Option 3 to form 29.50-1, which is analogous to Option 1 to form 29.48-1 for premium bonds, should be made inapplicable (through use of Option 4 to form 29.50-1) to the income interest in a qualified terminable interest property or general power of appointment marital deduction trust to ensure that the surviving spouse receives all the income from the trust, a prerequisite for the marital deduction. See §17.22 on this requirement. It is unnecessary to include Optional 4 to form 29.50-1 when a marital deduction *estate* trust is used, because income from such a trust is not required to be paid annually. See chap 17 for an overview of the marital deduction and trusts designed to achieve it.

The forms are not needed in a trust that does not provide for different distributions of principal and income. Further, they are not needed for a trust that will be administered by an independent trustee under California law. Under Prob C §16047, a portfolio is to be evaluated based on the portfolio as a whole. Therefore, it may not be appropriate to make adjustments for any particular asset, even though that particular asset favors a particular beneficiary when viewed in isolation. Further, an independent trustee has the power to adjust between principal and income under Prob C §16336.

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§29.50 2. Form: Power to Purchase Bonds at Discount

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29.50-1 Form: Power to purchase bonds at discount

***Power to Purchase Bonds at Discount*. The trustee may, in the trustee's discretion, purchase bonds at any discount that the trustee, in the trustee's discretion, considers advisable.**

[*If applicable, add one or more of the following options*]

[*Option 1: Discount may be allocated to income*]

If, however, the trustee determines that the current yield on the bonds is materially less than the rate of return that the trust could otherwise obtain with equivalent safety, all or part of the discount may be credited periodically to trust income in a reasonable manner.

[*Option 2: Allocations of bond receipts consistent with income tax treatment*]

The trustee shall allocate to income any part of distributions made with respect to any bond or other obligation for the payment of money that is equal to the larger of (1) the amount constituting the payment of interest or (2) the amount taxable as ordinary income under the provisions of the Internal Revenue Code of 1986. The trustee shall allocate the remainder of this distribution to principal.

[*Option 3: When trustee need not allocate bond discount to income*]

The trustee need not allocate to income the discounts of bonds purchased at, or for less than, _ _[*specify, e.g., 90*]_ _ percent of their par value, and any loss or gain on the sale or other disposition of the bonds shall fall on or inure to principal.

[*Option 4: Discounts must be paid annually (marital deduction trust)*]

Notwithstanding the foregoing powers, all discounts with respect to bonds held in the marital deduction trust shall be accumulated and distributed at least annually as interest during the life of the surviving spouse.

Comment: To ensure that the income beneficiaries will ultimately receive income equivalent to that available from other investments with comparable risk, Option 1 allows a trustee who believes that the income beneficiaries would be shortchanged by the discount bond's return to periodically allocate a portion of the return to the income account.

Option 2 accomplishes the same goal, but rather than leave to the trustee's discretion the amount to be paid to the income beneficiaries, the clause requires the trustee to treat as income the amount allocable to income under income tax law. Note that this tax provision applies to assets other than bonds.

Option 3 can be used when the trustee will not be required to make any allocation to income to compensate for losses to the income beneficiaries resulting from the purchase of bonds at a discount. This clause should not be used when there is a trustee-beneficiary, because failure to allocate part of the discount value to income beneficiaries will result in favoring the remainder beneficiaries. Option 4 must be used with Option 3 if the trust is a qualified terminable interest property or general power of appointment marital deduction trust.

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IV. SPECIFIC ASSET INVESTMENT AND MANAGEMENT POWERS

A. Power to Invest in Life Insurance

§29.51 1. Issues Presented by Trust Ownership of Life Insurance

Trustee investment in life insurance policies raises three issues. The first two issues result from the fact that insurance policies usually do not produce income; the third issue results from the tax consequences of an insured's role as trustee:

- First, if the insurance policy does not pay dividends (and therefore does not produce income), the policy will be an unproductive asset. Investment in the policy will be an inappropriate action for the trustee to take unless the will gives the trustee specific authorization to make this investment, because a trustee's fiduciary duty is to make the trust assets productive. See §29.19 on trustee investment in unproductive property. Form 29.52-1 provides the power to invest in life insurance.
- Second, in a trust intended to qualify for a marital deduction, the investment's lack of productivity could jeopardize the deduction. For the trust to qualify for the marital deduction, the spouse must be "entitled to all the income from the property" held in the trust. IRC §2056(b)(7)(B)(ii)(I). See §17.22 on this requirement; chap 17 for discussion of the marital deduction in general; §29.19 on trustee investment in unproductive property. Because funds invested in life insurance do not generate income, the trust may not qualify for the marital deduction if it holds life insurance.

The safest way to avoid jeopardizing the marital deduction with life insurance holdings is to keep the marital deduction trust insulated from them. Wills for testators wanting to obtain the marital deduction for their estates frequently provide for one or more trusts other than a marital deduction trust; any of the non-marital-deduction trusts (*e.g.,* a bypass trust) can be designed to contain life insurance, but the marital deduction trust is forbidden from doing so. To remind the trustee that no life insurance should be held by the marital deduction trust, however, the optional addition to form 29.52-1 denies a trustee of a marital deduction trust the power to invest in life insurance policies without the surviving spouse's consent.

Additional protection can be obtained through form 29.22-1, which gives the spouse the power to require the trustee of the marital deduction trust to convert unproductive property to income property. In Rev Rul 75-440, 1975-2 Cum Bull 372, the Internal Revenue Service ruled that a savings clause prevented the loss of the marital deduction, even though the trustee had the power to purchase nonproductive life insurance policies, because the clause manifested the decedent's intent that the investment power apply only to the residuary trust and not to the marital deduction trust. This clause supplements the statutory savings clause in Prob C §21524(c), which gives the surviving spouse the same power. The clause should be included, both to remind the trustee and surviving spouse of the income-production issue and to provide the spousal right in case the will is probated outside California.

- Third, an insured's serving as trustee may cause policy proceeds to be included in the trustee's estate if the trustee dies while in office. Normally, when a trustee other than the insured holds all incidents of ownership in a policy of life insurance, the insurance proceeds that would otherwise be included in the insured's estate may escape estate tax by virtue of IRC §2042. On incidents of ownership, the retention of which by an insured can bring the policy proceeds into his or her taxable estate, see IRC §2042(2); California Estate Planning, chap 19 (Cal CEB 2002). If, however, the trustee of the trust holding the policy is also the insured and dies while in office, the value of the proceeds could be included in the trustee-insured's estate for purposes of determining estate tax liability, on the ground that the trustee-insured held incidents of ownership over the policy at death.

If a trust that owns life insurance is a generation-skipping trust, the life insurance proceeds may be subject to

generation-skipping transfer (GST) tax except to the extent that the GST tax exemption is available. The GST tax law may be found in IRC §§2601-2663. On the GST tax, see chap 15.

EXAMPLE: A husband assumes that he will predecease his wife and transfers all incidents of ownership in insurance policies on his life to his wife. When she dies first, all her property, including the policies, passes into a testamentary trust of which her husband is trustee. See *Estate of Skifter v Commissioner* (2d Cir 1972) 468 F2d 699. In *Skifter,* the court held that the husband-trustee's powers of management, which included paying the premiums, did not amount to incidents of ownership, because he acted only in a fiduciary capacity and could not exercise his powers for his own economic benefit. The IRS has since similarly held that a trustee who *purchases* a policy of insurance on the trustee's life does not have incidents of ownership if only trust proceeds (not the trustee's personal funds) are applied to premiums, the trustee can exercise powers over the policy only in a fiduciary capacity, and the trustee cannot personally benefit from the investment. See Rev Rul 84-179, 1984-2 Cum Bull 195.

Form 29.53-1 is designed to prevent imputation of incidents of ownership to a trustee-insured (often the surviving spouse), by giving the suspect powers (including the power to change beneficial ownership of the policy) to a third party special trustee or to a cotrustee. See §§28.7-28.8, 28.12-28.13, 28.16 on using special trustees and cotrustees and for clauses naming cotrustees and special trustees. Form 29.53-1 can be adapted for use in connection with trusts that may hold insurance on the life of a trustee other than the testator's spouse.

Form 29.53-1 may not prevent the policy proceeds from being taxed in the insured-trustee's estate if he or she has beneficial interests in the trust, such as an invasion power or a special power of appointment, which are likely to be found in qualified terminable interest property or general power of appointment marital deduction trusts. Although there is no authority on this point, it may be advisable in such a case to include a clause stating that any beneficiary invasion power or special power of appointment does not apply to policies of insurance on the insured's life. Whether only an income interest in the trust constitutes an incident of ownership is an open question.

A trustee who is not also a trust beneficiary should usually be given the power to pay insurance premiums from either income or principal, so that the trustee can select tax effects of the payments that are appropriate to the beneficiaries' circumstances. The payment of insurance premiums from income will reduce the amount of income taxed to the beneficiary (assuming that all income is required to be distributed to the beneficiary and that no corpus is distributed). See IRC §§643(b), 652(a), 662(a)(1). Note that a trustee who is also a beneficiary should not hold the power to pay premiums from either income or principal, because the power may be treated as a general power of appointment. See §30.9. Form 29.53-1, which gives a special trustee control of life insurance on the general trustee's life, includes this power.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.52 2. Form: Power to Invest in Life Insurance

§29.52 2. Form: Power to Invest in Life Insurance

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29.52-1 Power to invest in life insurance

***Power to Invest in Life Insurance*. The trustee may, in the trustee's discretion, acquire and maintain life insurance, annuity, or endowment policies on the life of any person, and exercise all rights of ownership granted in such policies.**

[*If applicable, add the following option*]

[*Option: No insurance policies to be held in marital deduction trust*]

Notwithstanding the foregoing powers, no policies of life insurance may be held in the marital deduction trust without my spouse's consent.

Comment: The drafter should use form 29.52-1 with care. See §29.19 on required trust asset productivity and tax issues that this power may present. The drafter need not use the optional addition if the spouse is also given the power to convert unproductive property to productive property. See §§29.21-29.22.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.53 3. Form: Special Trustee to Control Insurance on Trustee's Life

§29.53 3. Form: Special Trustee to Control Insurance on Trustee's Life

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29.53-1 Special trustee to control insurance on trustee's life

***Special Trustee to Hold Life Insurance*. While _ _[*trustee's name*]_ _ is acting as trustee, all incidents of ownership in any policies of insurance on that trustee's life shall be vested in and exercisable solely by the special trustee, who shall designate the trust as beneficiary of all the policies. In addition, the trustee shall, on the request of the insurer under any of the policies, execute any documents required to implement the actions taken by the special trustee. The trustee shall pay all premiums on the policies only as directed by the special trustee. The premiums shall be paid from either the income or the principal of the trust, or in part from each, as the special trustee may, in the special trustee's sole and absolute discretion, determine.**

Comment: Form 29.53-1 is for use in a trust holding insurance on the trustee's life. If the will provides for more than one trust, the drafter should designate the specific trust to which the clause applies. For example, the drafter may insert the phrase "that are held in the trust under paragraph _ _[*number of paragraph containing the trust*]_ _" after "insurance on the trustee's life." Form 29.53-1 should be amended to identify the special trustee if the special trustee has not previously been named. See form 28.16-1 for a clause naming a special trustee. If the trust has cotrustees, one of whom is not a "sensitive trustee" (see §28.8), this clause may be adapted to provide, *e.g.,* that the cotrustee undertake the incidents of ownership and order premium payments.

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§29.54 B. Bank and Savings and Loan Accounts

Probate Code §16225 authorizes a trustee to make deposits at reasonable interest rates in an insured account in a financial institution or in a collateralized account in a bank, insured savings and loan association, or insured credit union, including deposits in any such institution operated by the trustee. Consequently, a clause specifically giving the trustee power to place cash in such an account is unnecessary.

A deposit with an insured savings and loan association reduces the amount of bond that might otherwise be required of a trustee. Fin C §7001(b). On trustee's bond generally, see §28.22.

The trustee's authority to invest in savings accounts or to leave money in commercial accounts is subject to the trustee's duty to make cash productive. See §29.19.

EXAMPLE: In *Lynch v John M. Redfield Found.* (1970) 9 CA3d 293, 88 CR 86, the court held that the trustees breached their duty to make foundation funds productive under the prudent investor rule by leaving the money in a non-interest-bearing bank account for five years. In *Conservatorship of Pelton* (1982) 132 CA3d 496, 183 CR 188, an institutional trustee acting as conservator had deposited more than $264,000 in one of its 5¼ percent passbook accounts for 17 months when 30-day accounts paying 9½ percent were available at other banks. Against a surcharge action, the bank argued that former CC §2261(3) (replaced by Prob C §16225) expressly sanctioned an investment in its own interest-bearing account. The court held that this statute merely authorized the type of investment and did not supersede a trustee's general duty to maximize the trust assets, particularly in view of the inherent conflict of interest. In remanding the case for further findings, the court held that the bank trustee bore the burden of proving that the lower interest rate was justified under the circumstances.

The United States Controller of the Currency requires that trust funds awaiting investment or distribution in an account in a national bank must not be held uninvested or undistributed any longer than is reasonable for the proper management of the account. 12 CFR §9.10(a).

For discussion of investment by a bank trustee and the fiduciary duty of loyalty, see *Van de Kamp v Bank of America* (1988) 204 CA3d 819, 251 CR 530. On institutional trustees generally, see §28.5. On a bank trustee's investment in the bank's own funds, see §28.46.

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C. Farming and Ranching Interests

§29.55 1. Detailed Trustee Powers Necessary

Without express authority in the will, it may be improper for the trustee to invest trust funds in a farm or ranch or even to retain a farm or ranch among the assets of the trust. Accordingly, if the trust estate is likely to contain an interest in a farm or ranch, the will should specifically authorize the trustee to retain and operate the farm or ranch and give the trustee all powers necessary for proper management of the asset.

For discussion of the difficulties presented by these kinds of property, see Kelley, Ludtke & Steinmeyer, Estate Planning for Farmers and Ranchers: A Guide to Family Businesses with Agricultural Holdings (3d ed 1995).

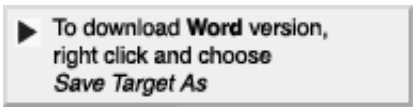
In addition to the powers in form 29.56-1, the drafter should consider including some of the clauses in §§29.38, 29.40, and 29.42 concerning the operation of a business. Further, a detailed interview with the testator-owner of farm or ranch property may suggest specific powers that should be given to the trustee in addition to or in place of form 29.56-1.

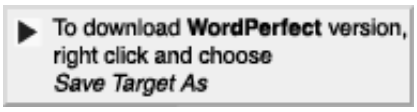
Farm or ranch property passing from the testator may present special tax issues, such as those associated with installment payment of taxes under IRC §6166. See form 31.13-1 for a clause permitting the trustee to defer distribution of property that, if distributed all at once, would trigger acceleration of estate tax installment payments.

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.56 2. Form: Powers for Farming Interests

§29.56 2. Form: Powers for Farming Interests





29.56-1 Powers to retain and to operate farm or ranch

***Power to Hold Farm or Ranch Property*. The trustee may, in the trustee's discretion, continue to hold, operate, and participate in the operation of any farming or ranching property or interest that the trustee receives under this trust, at the risk of the trust estate. In addition to the general powers set forth in my will, the trustee shall have the following powers with respect to any farming or ranching property or interest:**

(1) To operate the property or interest with hired labor, tenants, labor contractors, or sharecroppers;

(2) To hire a farm manager or professional farm management service to supervise the farming operations;

(3) To lease or rent land, equipment, or livestock for cash or on shares;

(4) To sell, purchase, exchange, or otherwise acquire or dispose of farm machinery, livestock, farm products, timber, supplies, and services used in connection with the property;

(5) To remove, construct, repair, and improve fences, structures, pipelines, wells, ditches, and improvements and buildings of all kinds on the premises;

(6) To fertilize, terrace, clear, ditch, and drain lands and install irrigation systems; to follow soil conservation and other practices designed to conserve, improve, and maintain soil fertility and productivity; and to carry on reforestation;

(7) To remove existing improvements (including trees, vines, and other sources of production) and to plant new improvements either as replacements or as additions;

(8) To carry on both a crop program and a livestock program (including the raising, purchase, and sale of livestock and any ranch or farm products);

(9) To borrow money, to encumber improvements and grant Uniform Commercial Code interests in the improvements, and to pledge harvested or growing crops, timber, and livestock;

(10) To execute contracts, notes, chattel mortgages, and other agreements relating to agriculture with any officer or agency of the federal or state governments or of any corporation organized under them;

(11) To enter into acreage-reduction and crop diversion agreements;

(12) To make soil conservation commitments;

(13) To perform all acts necessary to cooperate with any government agricultural program and to participate in and receive all payments and other benefits and proceeds under such programs; and

(14) To take any other action necessary to operate a farm or ranch for the benefit of the beneficiaries of this trust.

[*If applicable, add the following option*]

[*Option: Power to invest in farm or ranch*]

The trustee may, in the trustee's discretion, invest and reinvest all or part of the trust estate in, and operate or participate in the operation of, any farming or ranch property or interest, at the risk of the trust estate.

Comment: Form 29.56-1 gives the trustee the power to hold on to farm or ranch property received from the testator's estate. The clause also provides related powers for the property's proper operation. The optional addition gives the trustee the power to acquire farm or ranch interests. Because of the special problems presented by farm and ranch properties, the testator may not want to grant the trustee this power.

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D. Mineral Rights

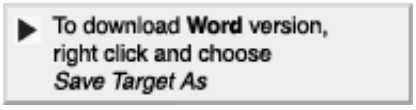
§29.57 1. Powers Ease Trustee Negotiations

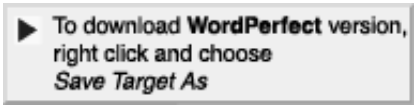
Probate Code §16232 authorizes the trustee to enter into mineral leases, including community oil leases and pooling agreements, for terms within or beyond the term of the trust. A clause expressly permitting leases is therefore not required but may be advisable if it is likely that trust land will be used for oil and gas exploration or production. Such a clause will facilitate negotiations with potential lessees and other third parties. Form 29.58-1 gives the power to lease as well as many other powers typically exercised by owners of mineral rights.

On allocating the proceeds from natural resources located on trust-owned land to income or principal, see §30.15. See also Comment, *The Oil and Gas Lease as a Trust Asset*, 7 UCLA L Rev 358 (1960).

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§29.58 2. Form: Powers for Managing Oil, Gas, and Mineral Properties





29.58-1 Power to manage oil, gas, mineral properties

***Power to Manage Oil, Gas, and Mineral Properties*. In addition to the general powers set forth in my will, the trustee shall have the following powers with respect to oil, gas, or mineral properties:**

(1) To retain, acquire, develop, operate, and otherwise manage mineral lands (i.e., lands actually or potentially bearing oil, gas, or other minerals), mineral rights, royalties, shares in joint ventures, oil or gas payments, and tangible property used in, or intended for use in connection with, exploratory or productive activity, whether such assets are held outright, as a tenant-in-common, in joint ventures through undivided shares, by participation in syndicates, through general or limited partnerships, or through stock interests in listed or unlisted corporations;

(2) To join in the reorganization of any group or venture that, either by agreement or under pertinent laws, is required to dissolve or liquidate because of the death, incompetency, bankruptcy, or withdrawal of any participant, and to acquire whatever share in the reorganized group or venture that the trustee determines, in the trustee's discretion, is appropriate (whether it is larger or smaller than the corresponding share in the predecessor group or venture);

(3) To negotiate and enter into (as lessor, lessee, sublessor, sublessee, assignor, or assignee) oil, gas, and other mineral leases, "farm-outs," subleases, and assignments, and to make reservations of interests whenever the trustee, in the trustee's discretion, considers it appropriate to do so; to enter into "dry-hole contribution" and similar agreements; and to conduct (alone or with others) exploratory and development operations (including geological and geophysical work and drilling and equipping oil and gas wells);

(4) To pool, consolidate, or unitize trust properties for exploration, development, management, or administration; to enter into pooling and unitization agreements with others; to conduct (alone or with others) reworking, repressurization, and other secondary recovery operations (by gas injection, water flooding, or other means); to exchange undivided interests in mineral properties of any type for interests in other properties; and to exchange mineral rights for drilling or other services or for material and equipment; and

(5) To employ engineers, geologists, appraisers, geophysicists, lease brokers, and other trained individuals or organizations to assist with the management of the trust assets.

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§29.59 E. Tax Shelter Properties

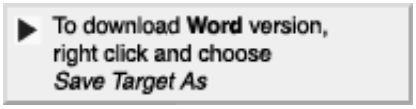
Declining income tax rates and passive loss rules have resulted in decreased popularity of tax shelters as investments. When a trust will include tax shelter properties, however, the attorney must consider the distinctive aspects of these investments. The trustee should be given special directions regarding:

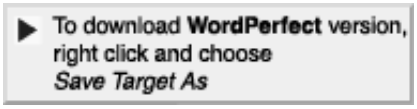
- Retention of tax shelters (see §29.15 on the power to retain unproductive property);
- Nondiversification of investments (see §29.11 on the "broad" power of investment);
- Handling the "crossover" problem (*i.e.,* whether to invest in additional tax shelters generating passive losses to offset taxable income from shelters that have begun to produce passive income);
- Allocating income and deductions between principal and income and allocating depreciation and depletion deductions among the beneficiaries and the trust (see chap 30); and
- Distributing corpus on termination of the trust (see chap 31).

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Source: Estate Planning/California Will Drafting/29 Trustee Management Powers/§29.60 V. FORM: SHORT FORM OF TRUSTEE'S POWERS

§29.60 V. FORM: SHORT FORM OF TRUSTEE'S POWERS





29.60-1 Short form of trustee's powers

***Trustee Powers*. The trustee shall have the full power to sell, borrow, encumber, convey, exchange, invest, reinvest, partition, divide, improve, and repair the property constituting the trust estate from time to time. The trustee shall also have all powers now or hereafter conferred on the trustee by California law. _ _**[*These powers may be exercised without regard to any current or future statutory limitations or insurance or collateralization requirements that would apply in the absence of an express authorization in the trust instrument.*]**_ _ The enumeration of certain powers in this instrument shall not limit the trustee's powers. The trustee shall have all the rights, powers, and privileges that an absolute owner of the same property would have, subject to the trustee's fiduciary obligations and to any limitations stated elsewhere in this instrument.**

Comment: The optional language is intended to avoid certain limitations on trustee investment powers that may apply under Prob C §§16244-16255. See §29.3 on this clause.

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30

Trustee Accounting Powers

Julia P. Wald

I. TRUSTEE ALLOCATIONS AND ACCOUNTING §30.1

II. DUTY TO RENDER ACCOUNT
- A. Purpose and Contents of Account §30.2
- B. Preliminary Trustee Accounting Power Forms
  - 1. Form: Duty to Account Privately §30.3
  - 2. Form: Duty to Account to Court §30.4

III. ACCOUNTING FOR MULTIPLE TRUSTS
- A. Power to Consolidate or Divide Trusts §30.5
- B. Form: Physical Segregation of Separate Trusts Not Required; Division Into Separate Trusts Permitted §30.6
- C. Form: Consolidated Administration of Testamentary Trusts With Trusts Otherwise Created §30.7

IV. ALLOCATION OF INCOME AND EXPENSE ITEMS TO PRINCIPAL AND INCOME ACCOUNTS
- A. Purpose of Provisions for Allocation to Principal or Income §30.8
- B. Tax Considerations in Allocating Items to Principal or Income Accounts §30.9
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  - 1. Encumbered Property §30.11
  - 2. Underproductive Property §30.12

V. CREATING DEPRECIATION AND DEPLETION RESERVES
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  - 1. Trustee's Discretion to Establish Depreciation Reserve; Effects on Beneficiaries §30.13
  - 2. Form: Power to Establish Depreciation Reserve §30.14
- B. Allocation of Principal and Income From Natural Resources (Depletion Reserves)
  - 1. Allocation Issues Presented §30.15
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- C. Allocation of Deferred Compensation
  - 1. Deferred Compensation Allocation Issues §30.17
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- D. Amortization of Intangibles
  - 1. Intangible "Liquidating Assets" §30.19
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VI. ALLOCATION OF INCOME AND EXPENSE ITEMS AMONG CLASSES OF SUCCESSIVE BENEFICIARIES
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  - 3. Form: Undistributed Income Payable to Succeeding Beneficiaries §30.24
- C. Allocating Items of Expense Among Succeeding Beneficiary Classes
  - 1. Expense Allocation Rules §30.25
  - 2. Form: Allocation of Expenses Among Successive Beneficiaries §30.26
- D. Making Adjustments for Allocation Decisions §30.27

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§30.1 I. TRUSTEE ALLOCATIONS AND ACCOUNTING

This chapter first describes the testamentary trustee's statutory duty to render an account when there is no specific direction from the testator, and then describes the latitude permitted to the testator in directing the trustee to provide an account or in relieving the trustee from doing so. Forms are provided for directing "private" and court-supervised accountings. See §§30.3-30.4. This portion of the chapter also covers accounting for multiple trusts. See §§30.5-30.7.

The remainder of the chapter addresses the allocation of expense and income items to principal and income accounts. The topics treated are (a) allocation of ordinary items of income and expense (see §§30.8-30.12); (b) depreciation, depletion, and amortization reserves (see §§30.13-30.20); and (c) allocation of items of income and expense among successive classes of beneficiaries (see §§30.21-30.27). The chapter discusses the practical and tax implications of the allocations as well as reliance on provisions of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), or on specific clauses in the will, to direct how allocations should be made. Relevant forms are provided.

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II. DUTY TO RENDER ACCOUNT

§30.2 A. Purpose and Contents of Account

Accountings serve two primary purposes. First, they protect the beneficiaries by disclosing errors in the trust administration so that corrective steps can be taken before the cumulative effect of the mistakes becomes disastrous. Second, they protect the trustee by providing a mechanism through which, by having the court approve an accounting, the trustee can be discharged from liability for previous actions.

For testamentary trusts, accountings are not subject to court approval (Prob C §16062(c)), although the testator may provide for "court accountings" (see form 30.4-1). Further, a beneficiary may petition for court review of an accounting (Prob C §17200(a), (b)(5)) and object to the accounting if the objection is filed within 3 years after the date on which the beneficiary received the accounting. Prob C §16063(a)(6). See *Estate of Howard* (1976) 58 CA3d 250, 129 CR 836, and *Estate of Hensel* (1956) 144 CA2d 429, 301 P2d 105, on the effect of the probate court's approval of the accounting. Ordinarily, a person who is not a trustee and has no rights to receive distributions does not have standing to object to trust accountings because the opening language of Prob C §17200 refers to petitions by trustees and beneficiaries. However, the settlor of a charitable trust and perhaps other persons in the case of a testamentary trust may have standing to object to trust accountings if the trust instrument gives that person the power to compel accounts, because the Prob C §24 definition of "beneficiary" includes any person entitled to enforce a charitable trust. See *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289. Note that the settlor in *Patton* also reserved the right to change remainder beneficiaries. Arguably, the reserved appointment power also makes the settlor or other person holding the power a beneficiary of the trust because the Prob C §24 definition of "beneficiary" includes a "person who has any present or future interest" in the trust.

Generally, a trustee of a testamentary trust is required to account at least (1) annually, (2) at the termination of the trust, and (3) at a change of trustees. The account must be rendered to each beneficiary who must or may receive current distributions of principal or income. Prob C §16062(a).

The rules governing accountings are set forth in Prob C §§1060-1064: Prob C §1061 sets out the elements of an account summary and its proper format; Prob C §1062 describes the required supporting documentation for the summary; Prob C §1063 describes additional required schedules; and Prob C §1064 sets out the required contents of a petition for approval of the account. The first account must reconcile the initial assets on hand with the decree of distribution of the estate. Cal Rules of Ct 7.901(b).

The detailed account requirements in Prob C §§1060-1064 replace the many different local court rules governing contents of accounts. See Prob C §1060 (accounts exclusively governed by Prob C §§1060-1064 except as specifically provided elsewhere in the Probate Code or unless good cause is shown). However, local courts may well continue to have their own accounting rules.

The trustee is not required to account if:

- The will waives the requirement of an accounting unless it is shown that a material breach of the trust is reasonably likely to have occurred (Prob C §16064(a));
- All the beneficiaries entitled to an accounting waive the right to an accounting in writing (Prob C §16064(c)); or
- The beneficiary is the trustee (Prob C §16064(d)).

Counsel should be aware, however, that a waiver is unenforceable as to any sole trustee who is a disqualified person under Prob C §21350.5. Prob C §§16062(e), 16064(a). See §1.35 for discussion of disqualified persons.

The testator may require an accounting but change the elements of the accounting from those set out by the governing statutes.

Note that the trustee must provide to any beneficiary requesting it a "report of information" containing some of the same information that is provided in a formal account. Prob C §16061.

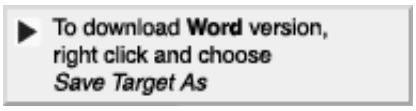
The trustee's duty to file accounts in the format required under Prob C §§1060-1064 apparently applies to all accounts whether or not the trust is court-supervised. See Prob C §§1060, 16064(a). Exceptions to the accounting

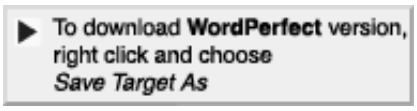
requirement, including waiver by the trustee, are set forth in Prob C §16064. The statutory accounting requirements may prove to be unduly burdensome for families administering trusts of modest size. There is no apparent penalty for not following the statute if the trust is not supervised. See 18 CEB Est Plan Rep 70 (Dec. 1996).

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B. Preliminary Trustee Accounting Power Forms

§30.3 1. Form: Duty to Account Privately





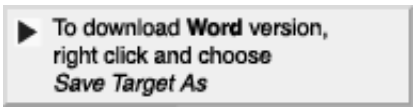
30.3-1 Private accounting

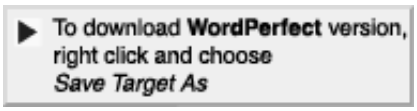
***Trustee Accounts*. The trustee shall periodically, but not less often than annually, render an account of its administration of the trust to the current principal and income beneficiaries. This accounting must comply with the provisions of Probate Code §§16063 and 1060 through 1064. A beneficiary's written approval of the accounting will be a complete protection of the trustee from a claim by that beneficiary regarding all matters and transactions stated or shown by the accounting. In addition to actual written approval by a beneficiary or the beneficiary's parent, guardian, or conservator, the following will also constitute written approval of the accounting: a beneficiary's failure, within 90 days after a written request has been mailed by the trustee to the beneficiary at his or her last known address, to deliver to the trustee either (1) written approval of the accounting or (2) written objection to the accounting with reasons specified.**

Comment: This clause requires an annual accounting that complies with the statutory requirements for a court-filed accounting. It also requires prompt attention by the beneficiaries so that the trustee can obtain approval or comment quickly. The drafting attorney should use this clause only after careful consideration, because the duty to account is time-consuming and burdensome. The drafter who wants to limit the duty to account can amend the clause to waive or modify the requirements of Prob C §§1060-1064, *e.g.,* to require submission of accounts to only those beneficiaries "who deliver a written request for such accountings to the trustee." (Only if no beneficiary asks for an accounting will the trustee be relieved of the duty to prepare the account; otherwise the restrictive language only limits the number of beneficiaries to whom the accounting will be sent.) If there is more than one trust, this clause can be amended to limit its application to one or more of the trusts. The drafter may also want to reduce or expand the time during which approval or objection must be given.

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§30.4 2. Form: Duty to Account to Court





30.4-1 Court accounting required

This trust shall be subject to the continuing jurisdiction of the superior court, as defined in Probate Code §17301, and the trustee shall file annual accountings with the Court having jurisdiction over the trust until all current principal or income beneficiaries attain majority. When these minors attain majority, the trustee shall provide private accountings to the beneficiaries annually, if the trustee wishes to continue to submit accountings to the appropriate Court at the expense of the trust estate. All accountings must otherwise comply with Probate Code §§16063 and 1060 through 1064.

Comment: This clause requires submission of the annual accounting to the court while there are minor beneficiaries. The drafter may wish to delete the second sentence, requiring private accountings once the duty to account to the court ends. See Comment to form 30.3-1. The drafter may also wish to delete the last sentence, giving the trustee the option of continuing to account to the court, if the testator believes its use will persuade the trustee to account to the court when continued court accounting is unnecessary. This clause may be used in addition to form 30.3-1 if the will contains trusts for both adult and minor beneficiaries. It may be amended to require accountings to continue as long as a beneficiary is under any form of disability, including minority.

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III. ACCOUNTING FOR MULTIPLE TRUSTS

§30.5 A. Power to Consolidate or Divide Trusts

Unless otherwise provided by the trust instrument, a trustee who holds property under separate trusts has a duty to segregate the property of the trusts. 3 Scott & Ascher on Trusts §17.11.2 (5th ed 2007). The Probate Code, however, permits trusts with substantially similar terms to be consolidated and treated as a single trust as long as the trust's purposes or the beneficiaries' interests will not be compromised. Prob C §15411.

The clauses in §§30.6-30.7 provide for joint administration of the assets of (1) trusts created under the same will that meet the criteria described in the form or (2) one or more trusts created under the same will and one or more trusts created by any other testamentary or nontestamentary instrument that meet the criteria described in the clause. The trustee must consider whether this administration will truly benefit the beneficiaries. In any event, care must be taken to maintain the separate tax status of the separate trusts.

Probate Code §15412 permits a court to achieve the contrary result, *i.e.,* to divide a trust into two or more separate trusts, subject to the same limitations of achieving trust aims and protecting beneficiary interests. One reason for dividing a trust is to maximize use of the testator's generation-skipping transfer (GST) tax exemption (see IRC §2631) by splitting a trust into two trusts: one trust that is wholly exempt from GST tax and another trust that is subject to the tax. Any principal invasion could then be made from the trust that is subject to the GST tax, to preserve the assets in the other trust free of GST tax. For discussion of the GST tax, see chap 15.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.6 B. Form: Physical Segregation of Separate Trusts Not Required; Division Into Separate Trusts Permitted

§30.6 B. Form: Physical Segregation of Separate Trusts Not Required; Division Into Separate Trusts Permitted

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

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

30.6-1 Physical segregation of separate trusts not required; division into separate trusts permitted

[*Add one of the following alternatives*]

[*Alternative 1: Division not required for all trusts*]

***Segregation of Assets Not Required*. The trustee shall not be required to segregate physically or to divide assets among the various trusts created under my will, except on termination of any of the trusts. The trustee, however, shall be required to keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms.**

[*Alternative 2: Division required for marital deduction trusts*]

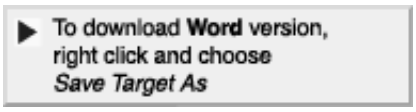
***Segregation of Assets Not Required*. Except with respect to trusts created under my will that qualify for the marital deduction, the trustee shall not be required to segregate physically or divide assets among the various trusts, except on termination of any of the trusts. The trustee, however, shall keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms.**

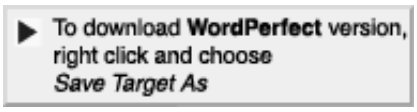
Comment: Form 30.6-1 relieves the trustee of the duty to segregate the assets of multiple trusts. When one or more of the trusts may be a marital deduction trust, the drafter should use Alternative 2.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.7 C. Form: Consolidated Administration of Testamentary Trusts With Trusts Otherwise Created

§30.7 C. Form: Consolidated Administration of Testamentary Trusts With Trusts Otherwise Created





30.7-1 Consolidated administration of trusts under will with trusts otherwise created

***Segregation of Assets Not Required*. The trustee may, in the trustee's discretion and without Court approval, administer the assets of any trust created under my will together with the assets of any other trust or trusts otherwise created, without physically segregating the assets of the various trusts (except on termination of any of the trusts), provided that (1) the trustee determines that administration as a single trust will be consistent with the intent of the persons who established the trusts, including the intent with respect to the tax consequences of the trusts, and will facilitate trust administration without defeating or impairing beneficial interests; and (2) the terms of the various trusts are substantially identical. The trustee, however, shall keep separate accounts for the separate undivided interests.**

Comment: The drafter should use form 30.7-1 when (1) the trustee will be the trustee of trusts other than those created under the will (with terms substantially similar to the testamentary trusts) and (2) the trusts can be administered more efficiently if the trustee is allowed to administer them together (*e.g.,* the trustee may make common investments and simultaneous distributions). For example, the surviving spouse or partner may create an inter vivos trust for the same beneficiaries served by a testamentary trust.

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IV. ALLOCATION OF INCOME AND EXPENSE ITEMS TO PRINCIPAL AND INCOME ACCOUNTS

§30.8 A. Purpose of Provisions for Allocation to Principal or Income

Wills frequently provide for payment of income to one or more beneficiaries for life or for a term of years, with a subsequent distribution of corpus to others, or a will may provide that distribution of income is mandatory, whereas distribution of principal is discretionary. Under such circumstances, it is particularly important for the trustee to determine whether particular receipts should be treated as principal or income and whether particular expenditures should be charged against principal or income.

Allocations of receipts and expenditures must be made in accordance with the terms of the will. Prob C §16335(a)(1). If the will contains no provision regarding a particular allocation and does not give the trustee discretion to make this allocation, the allocation must be made in accordance with the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). Prob C §16335(a)(3).

Because the UPAIA provides a reasonably comprehensive set of rules for allocation of receipts and disbursements between principal and income, many wills do not include extensive and specific provisions regarding such allocations and simply incorporate the statute by reference.

However, the UPAIA is noticeably biased in favor of allocations to principal. In this connection, the statute overly relies on the trustee's supposed power to make adjustments between income and principal under Prob C §16336, even though this adjustment power is not available when the trustee is a beneficiary. See, *e.g.*, Prob C §16350; *Hasso v Hasso* (2007) 148 CA4th 329, 55 CR3d 667 (money received in partial liquidation of an entity allocated 100 percent to principal whenever money or property received by all owners collectively is greater than 20 percent of the entity's gross assets).

Further, some of the UPAIA rules are based on considerations of trustee convenience that may not accurately reflect the expectations of a particular testator. For example, Prob C §16362 arbitrarily declares that receipts from "liquidating assets" are to be allocated 10 percent to income and 90 percent to principal. This applies to receipts from mineral rights, copyrights, and royalties. In years when there are only small receipts from a large asset, this scheme is seriously deficient in terms of implementation of likely settlor intentions. A similar rule applies to deferred compensation, annuities, and similar payments from an individual account or other "separate fund" not classified as interest or principal by the payor. For these payments, the trustee is directed to allocate to income 10 percent of the part of the payment required to be made during the accounting period and the balance to principal unless the trust is a marital deduction qualifying trust and the payor provides documentation to the trustee reflecting the internal income of each separate fund. Prob C §16361. See §30.17.

The importance of setting forth the testator's intention regarding principal and income provisions is illustrated by *Getty v Getty* (1972) 28 CA3d 996, 105 CR 259. In that case, the plaintiff sued to determine whether closely held corporation dividends in the form of additional stock should be (1) allocated to income (as required by rules then in effect), which would result in the stock's being distributed to income beneficiaries, or (2) allocated to corpus, which would result in the stock's being retained in trust. The court held that the latter treatment was proper because the settlor intended to maintain control of the corporation through trust ownership of the stock. A clause in the trust instrument could have made litigation unnecessary; a contrary ruling would have completely altered the structure of corporate control. See also *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473 (trustees of testamentary trust did not breach the duty of impartiality to income beneficiaries who received annual dividends equal to 1.25 percent of the value of closely held corporation stock, because the will expressly allowed the trustees to retain the trust property and to determine what is income and what is principal).

The testator may prefer to give the trustee discretion in making allocations to principal and income, free of the strictures of the UPAIA in those situations in which the Prob C §16336 adjustment power will not be available because the trustee is a beneficiary or the trust may not be administered under the laws of a state that has adopted the Uniform

Act. Even when the trustee is expected to follow the rules in the UPAIA, giving the trustee the freedom not to follow the statute may minimize controversy in a particular situation. The testator's power to confer this discretion is clear. Prob C §16335(a)(2). When the discretion is conferred, no inference of impropriety arises if the trustee exercises it contrary to provisions of the UPAIA. Prob C §16335(a)(2). Alternative 2 in form 30.10-1 explicitly confers discretion on the trustee to deviate from the rules provided in the UPAIA.

If the trustee is a beneficiary of a trust, care must be taken in giving the trustee the power to determine income and principal. It should be expressly stated that the power is subject to fiduciary standards and must be exercised fairly. Otherwise, the trustee may be considered to hold a general power of appointment under IRC §2041.

Further, unless a mandatory "income" interest is needed to assure that a trust will qualify for an IRC §2056 marital deduction, drafters should seriously consider methods of eliminating the need to distinguish between income and principal. This can be done by giving the lead beneficiary distribution rights other than "income." Appropriate alternatives include "unitrust" interests (the right to receive a percentage of the value of the trust) and cost-of-living adjusted annuity interests (the right to receive a stated amount plus an inflation adjustment). See §§20.6-20.8. In some cases, a unitrust interest may satisfy the income requirement. See §19.7.

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§30.9 B. Tax Considerations in Allocating Items to Principal or Income Accounts

The trustee's power to determine principal and income allocations can have estate tax implications when the trustee is also a beneficiary or the trust is intended to qualify for the estate tax marital deduction. The powers most vulnerable to attack relate to allocation of receipts and disbursements between principal and income and to investment in non-income-producing or wasting assets.

A trustee-beneficiary who possesses a broad power to allocate receipts or disbursements between principal and income could be viewed as having a general power of appointment over the trust corpus under IRC §2041 because the power can be used to affect beneficial enjoyment of the trust in favor of the income or remainder beneficiaries. This result would lead to inclusion of the trust principal in the trustee-beneficiary's own estate for estate tax purposes. See chap 16 on powers of appointment and their creation.

The regulations provide that a power to allocate receipts and disbursements, exercisable in a fiduciary capacity, is not in itself a power of appointment. See Treas Reg §20.2041-1(b)(1). In *Cherlyn C. Caldwell Martinez* (1976) 67 TC 60, acq 1977-2 Cum Bull 1, a gift tax case, the will explicitly stated that the trust must be governed by California law. The court found that California law regarding fiduciaries limited exercise of even a boilerplate "absolute discretion" given to a trustee to determine principal, gross income, or net distributable income.

For the trust to qualify for the estate tax marital deduction, the surviving spouse must have the lifetime right to receive all trust income generated by the assets held in the marital deduction trust. The will must make clear that the trustee's power to allocate receipts and disbursements to principal or income is subject to reasonable limitations enforceable by local courts, so that the trustee cannot use allocations to reduce income otherwise due the surviving spouse. Treas Reg §20.2056(b)-5(f)(4). See also §§29.19, 30.12 for discussion of analogous issues raised when the trust contains unproductive property. See chap 17 for an overview of the marital deduction and requirements for obtaining it; chaps 18-19 for description of marital deduction trusts.

Similar issues are presented by accounting powers with respect to particular assets, whose exercise can also affect beneficial enjoyment or income receipt. These include discretionary powers to create a depreciation or depletion reserve for an aging or wasting asset, amortize premium bonds (see §29.47), allocate income of discount bonds (§29.49), and (raising the power of appointment issue only) allocate income among successive beneficiaries.

There are a variety of ways to avoid raising tax issues with grants of allocation powers. The will can limit the trustee's discretion by requiring the trustee to use the allocation rules of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). For a clause imposing this requirement, see form 30.10-1.

If power of appointment issues are raised because the trustee is or may become a beneficiary, the testator may prefer to vest discretionary allocation powers in (1) a cotrustee with interests in the trust adverse to the trustee or (2) a special trustee. See §§16.18, 28.8 on using third party trustees to avoid power of appointment tax issues raised by trustee-beneficiaries. An independent special trustee can also be authorized to exercise the Prob C §16336 adjustment power.

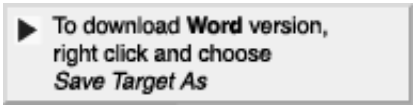
Another way of dealing with the tax problems raised by certain of these sensitive situations is to adjust the dispositive provisions rather than to restrict the administrative powers of the trustee. For example, if trust income is required to be accumulated, questions relating to allocation of receipts and disbursements become immaterial.

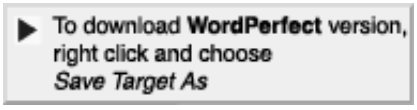
Further, there is a growing trend towards eliminating principal and income issues by giving the lead beneficiary rights that are not dependent on classical concepts of trust income. The beneficiary can be given a right to "unitrust" payments equal to a fixed percentage of the value of the trust assets at the start of each year. Another approach is to give the beneficiary the right to receive a fixed dollar amount that is adjusted annually by increases in the consumer price index.

Unfortunately, except in the case of the rarely used "estate trust," these alternatives are not available when the trust is intended to qualify for the marital deduction, because the surviving spouse must receive all "income" from such a trust.

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§30.10 C. Form: Power to Make Allocations Between Principal and Income





30.10-1 Power to make allocations between principal and income

[*Add one of the following alternatives*]

[*Alternative 1: Uniform Principal and Income Act to govern*]

***Allocation of Principal and Income*. Except when my will specifically provides otherwise, the trustee shall determine what is principal and income of the trust estate and apportion and allocate receipts, expenses, and other charges between those accounts according to the provisions of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375).**

[*Alternative 2: Broad power to determine principal and income*]

***Allocation of Principal and Income*. Except when my will specifically provides otherwise, the trustee may, in the trustee's discretion, determine what is principal and income of the trust estate and apportion and allocate receipts, expenses, and other charges between those accounts. The preceding powers include the power to charge in whole or in part against principal, or to amortize out of or charge to income, premiums paid on the purchase of bonds or other obligations. Although the trustee is not required to establish a reserve for depreciation or to make any charge for depreciation against income for that reserve, the trustee may, in the trustee's discretion, do so. The reserve and charges will be established on assumptions and in amounts determined by the trustee, in the trustee's discretion.**

If the trust is a member of a partnership, the trustee may, in the trustee's discretion, accept, with respect to that partnership interest, any accounting methods used by the partnership, despite the inclusion of depreciation reserves by the accounting methods and the assumptions on which any reserve is based and despite any inconsistencies with the accounting methods used by the trustee for other property of the trust estate.

No inference of imprudence or partiality will arise if the trustee, in exercising this discretion, allocates a receipt or an expenditure in a manner contrary to the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375) and it is contemplated that the trustee's allocations are likely to deviate from those in the UPAIA in those situations in which the UPAIA arbitrarily allocates fixed percentages of receipts to principal and income. In making allocations between principal and income, the trustee must act reasonably and treat the beneficiaries impartially.

Comment: Alternative 1 requires the use of the directions provided by the UPAIA, while Alternative 2 confers broad discretion on the trustee to make allocations to principal and income and create depreciation reserves. The drafter using Alternative 1 may wish to add provisions regarding depreciation and depletion reserves or other directives.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.10A D. Particular Issues in Allocating Expenses Between Principal and Income Accounts

§30.10A D. Particular Issues in Allocating Expenses Between Principal and Income Accounts

Most wills and trusts do not contain an express provision allocating expenses between principal and income. Without such a provision, ordinary trustee compensation will be charged one-half to income and one-half to principal. Prob C §16370(a). The same allocation is made for expenses for accountings, judicial proceedings, and other matters that involve both the income and remainder interests. Prob C §16370(b). Most other ordinary expenses are charged to income. Prob C §16370(c). Insurance premiums relating to trust property are charged to income. Prob C §16370(d). Expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust and its property, are allocated to principal. Prob C §16371(a)(4). In *Thomas v Gustafson* (2006) 141 CA4th 34, 45 CR3d 639, the court held that trustee legal fees incurred in a dispute concerning whether the trustee of a bypass trust could consider the surviving spouse's assets in deciding whether to invade principal for the spouse's support should be charged entirely to principal.

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§30.11 1. Encumbered Property

When encumbered property is transferred to a trust, the trustee is empowered to use trust funds to meet the indebtedness. In fact, the trustee has a duty to prevent loss of the property by sale at foreclosure and may sell or encumber trust assets or acquire a senior encumbrance, if necessary, to protect the trust estate from loss. 3 Scott & Ascher on Trusts §17.8 (5th ed 2007).

Should payments on the encumbrance be charged to principal or to income or be allocated between the two sources? Under Prob C §§16370(c) and 16371(a)(3), unless the will provides otherwise, the interest portion of each mortgage payment is charged to income, and the principal portion of each payment is charged to the principal of the trust.

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§30.12 2. Underproductive Property

Generally, in the absence of a court order, at least a portion of the expenses for administering underproductive property will be charged to income. Prob C §§16370-16373. There is no statutory provision to compensate the income beneficiary for a property's underproductivity. A testator anticipating that the trust will hold underproductive property (*e.g.,* family corporation stock paying low dividends) may want to give the trustee power to charge the expenses to principal, unless this discretion is already provided in a more general manner. See, *e.g.,* Alternative 2 in form 30.10-1.

In general, property not productive of income should not be included in a general power of appointment or qualified terminable interest marital deduction trust, because its retention could be interpreted as depriving the surviving spouse (*i.e.,* the income beneficiary) of the lifetime right to all trust income, thus disqualifying the trust corpus for the marital deduction. See chap 17 for requirements for the marital deduction; chaps 18-19 on marital deduction trusts.

For a trust that holds "unproductive" property to qualify for the marital deduction, the surviving spouse must have the right to require the trustee either to make that property productive or to convert the property to productive property "within a reasonable time." (The regulations refer to property not productive of income as "unproductive" property.) There is a special exception for a residence or other property held for the spouse's personal use. See Reg §20.2056(b)-5(f)(4). Under Prob C §21524(c), one of the California statutes designed to ensure that trust powers provisions comply with the technical provisions of the marital deduction law, the trustee of a marital deduction trust holding unproductive property is required to convert the property to productive property at the surviving spouse's insistence. It is obviously preferable to avoid the issue, however, by omitting inclusion of unproductive property (other than the specially exempt property) in the trust.

See §§29.15-29.22 for further discussion of the issues presented when the trust holds "unproductive" and "underproductive" property.

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V. CREATING DEPRECIATION AND DEPLETION RESERVES

A. Creating Reserves for Depreciation

§30.13 1. Trustee's Discretion to Establish Depreciation Reserve; Effects on Beneficiaries

In the absence of an express provision in the will or trust, the trustee is generally permitted to establish depreciation reserves in the trustee's discretion. Prob C §16372(b). It may be desirable to limit the trustee's discretion by requiring the trustee to establish a reserve for depreciation.

The form in §30.14 provides two alternatives. In Alternative 1, the trustee is empowered, but not required, to establish a depreciation reserve. This follows the statute.

Alternative 2, which requires the trustee to create a depreciation reserve, should be used when the trust involves any of the tax-sensitive situations described in §30.9. The testator may also want a reserve established in a situation without a "sensitive trustee" if a large part of the trust assets are wasting assets and the testator wants the remainder beneficiaries to share in the property's profits. Without the reserve, the income beneficiaries will receive the assets' income, while the remainder beneficiaries will be left with less-productive, worked-out assets. The reserve will compensate the remainder beneficiaries for the diminution in the assets' productive value.

In either case, the testator should consider the advisability of stating in the will which generally accepted accounting method of depreciation the trustee should use.

The rules for creating a depletion reserve are the same as for creating a depreciation reserve. See Treas Reg §1.642(e)-1.

Special income tax rules cover the allocation of depreciation and depletion deductions between the trustee and the trust income beneficiaries for income tax purposes. IRC §§167(d) (depreciation), 611(b) (depletion), 642(e). If the trustee does not establish a depreciation reserve, the depreciation deduction is apportioned between the trustee and the income beneficiaries on the basis of the trust income allocated to each. If the trustee does establish a depreciation reserve, the depreciation deduction must be allocated to the trustee to the extent that income is set aside for the reserve. To the extent that the depreciation deduction exceeds the income set aside for the reserve, the excess is allocated between the trustee and the beneficiaries on the basis of income allocable to each. Treas Reg §1.167(h)-1(b). Similar rules apply for depletion deductions. Treas Reg §1.611-1(c)(4).

Whether this result is desirable depends on the circumstances of each case. Therefore, it is generally advisable to provide the trustee as much flexibility as possible. Note that the depreciation deductions allocable to beneficiaries can be greater than their prorata share of trust income because the depreciation deduction is not limited by the amount of trust income. Rev Rul 74-530, 1974-2 Cum Bull 188.

The allocation of income to a depreciation or depletion reserve can have a substantial effect on the income beneficiary. The allocation of income to a depreciation reserve affects the actual amount of income that the income beneficiary receives (although not the amount of taxable income to be reported).

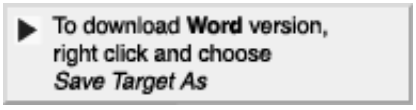
EXAMPLE: The trustee is required to distribute the trust net income to one income beneficiary. The trust net income is $10,000, and the depreciation deduction is $5000. If the trustee did not create a depreciation reserve, the income beneficiary would receive $10,000 and take the $5000 depreciation deduction. If the trustee created a depreciation reserve of $5000, however, this amount would be deducted from the $10,000 of income before distribution, so that the income beneficiary would receive only $5000. In either case, the beneficiary would pay taxes on only $5000, but the income received would be very different. See *Kearney v U.S.* (SD NY 1953) 116 F Supp 922, 925.

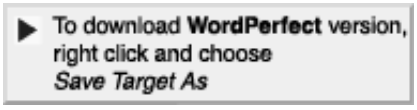
On apportionment of depreciation and depletion deductions between the income beneficiaries and the trust, see Rev Rul 74-530, 1974-2 Cum Bull 188.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.14 2. Form: Power to Establish to Depreciation Reserve

§30.14 2. Form: Power to Establish to Depreciation Reserve





30.14-1 Power to establish reserve for depreciation

[*Add one of the following alternatives*]

[*Alternative 1: Trustee not required to establish reserve*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee need not establish any reserve for depreciation or make any charge for depreciation against all or any part of the trust income (including income realized through use of any portion of the trust estate in the conduct of a business by the trust). The trustee may establish such a reserve, however, in the trustee's discretion, and may fund the reserve by appropriate charges against trust income. The reserve and charges will be established on assumptions and in amounts determined by the trustee in the trustee's discretion.

[*If desired, add the following option*]

[*Option: Considerations for trustee*]

In exercising this discretion, the trustee shall consider the following: _ _[*Considerations*]**_ _**

[*Alternative 2: Trustee required to establish reserve*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee shall establish a reserve for depreciation of all income-producing real and personal property, capital improvements, and extraordinary repairs.

[*Alternative 3: Trustee required to establish reserve; reasonable return required (marital deduction trust)*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee shall establish a reserve for depreciation of all income-producing real and personal property, capital improvements, and extraordinary repairs if the aggregate return of all investments of the marital trust from time to time is reasonable in light of existing circumstances.

Comment: This clause may be used with Alternative 1 in form 30.10-1. Note that Alternative 2 in form 30.10-1 gives the trustee discretion to establish a depreciation reserve. If that clause is used, form 30.14-1 is not needed. Alternative 1 in form 30.14-1 should be used, however, if the testator wishes the trustee to have discretion to establish a depreciation reserve without having the broad power to determine principal and income that is conferred under Alternative 2 in form 30.10-1. Depending on how the last sentence of Alternative 1 in form 30.14-1 is worded, the scope of the trustee's discretionary authority with regard to depreciation may be more circumscribed than that conferred by Alternative 2 in form 30.10-1. The optional addition to Alternative 1 in form 30.14-1 is completed by describing matters that the testator wants the trustee to consider in deciding whether to establish the reserve, such as an intent to benefit income beneficiaries primarily or to maximize principal for final distribution. Alternative 3 should be used for a marital deduction trust so that the surviving spouse's right to trust income will not be impaired by the depreciation reserve. See chaps 18-19.

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B. Allocation of Principal and Income From Natural Resources (Depletion Reserves)

§30.15 1. Allocation Issues Presented

A significant problem can arise when a sizable portion of the trust estate consists of natural resources governed by Prob C §§16363-16364. Under Prob C §16363, receipts from minerals, water, or other natural resources are generally allocated 10 percent to income and 90 percent to principal, except in the case of timber. Generally, receipts from timber are allocated to income to the extent that the rate of removal "during the accounting period" does not exceed the rate of growth. Prob C §16364. Under Prob C §16363, the amount allocated to income may be quite meager unless the rate of extraction is very high. The situation is complicated by the fact that income tax laws may allocate far greater amounts to income. The timber rule is somewhat more equitable, but only if the timber is harvested every year.

The testator may alter these results by using form 30.16-1, which provides for allocation of a particular amount of the depletable asset's receipts to income. Following are alternative means of accomplishing the same goal (*i.e.,* recognizing the asset's diminishing value while increasing trust income):

(1) Providing for accumulation of some of the trust's income;

(2) Directing the trustee to dispose of the wasting assets; or

(3) Giving the trustee discretion to establish a reserve for depletion or to refrain from doing so.

Because Alternative 1 in form 30.16-1 involves reserving some of the trust asset income from distribution to the beneficiary, it cannot be used if the trust is to qualify for the marital deduction as a marital deduction power of appointment or qualified terminable interest trust.

Ownership of natural resources often involves unusual tax considerations. Under conditions provided in IRC §631, that statute grants an election to the taxpayer to treat certain timber, coal, or domestic iron interests as IRC §1231 assets. The elections under IRC §631 must be made by an owner or a party with a contract right to take the asset, which must be held for more than one year before the property's disposal. The attorney is cautioned to consider the effect of this election on the allocation of income between income and remainder beneficiaries. For example, if an election under IRC §631 were made, a clause allocating all capital gain to principal might be construed to change the allocation of timber sales proceeds from income to principal because, for tax purposes, the election would cause the timber proceeds to be taxable at capital gains rates. Another possible distortion might occur if the proceeds were allocated to income under the will but the income tax burden were imposed on principal under a clause charging capital gains taxes to corpus.

Because form 30.16-1 fixes the amount of proceeds allocable to income, the drafter may use the clause even in tax-sensitive circumstances. Such circumstances may occur, for instance, when the trustee is also a beneficiary or is obligated to support a beneficiary, and the drafter must avoid creating powers that enable the trustee to shift income to favor certain beneficiaries. See §§16.13-16.26, 28.8, 28.39 on tax problems caused by broad powers. If there are substantial returns from the investment, however, they will go to the remainder beneficiaries. Before using this clause, the drafter should be certain that the testator wants this result.

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§30.16 2. Form: Allocation of Receipts to Account for Depletion

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

30.16-1 Allocation of receipts to account for depletion

[*Add one of the following alternatives*]

[*Alternative 1: Allocation to income to maximum percentage*]

The trustee shall allocate to income of the trust estate all proceeds from property subject to depletion or containing natural resources, to the extent that the annual proceeds do not exceed _ _[*number*]_ _ percent of the property's fair market value at the valuation date. The term "valuation date" means the date on which the last of the following events occurs: (1) the principal is established; (2) the property is acquired; or (3) the property is put into commercial use, if the resource is discovered after the events described in (1) and (2).

[*Alternative 2: Trustee to create reasonable reserve for depletion*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee shall establish a reasonable reserve for depletion of all depletable natural resources, including but not limited to oil, gas, and minerals, to be charged to income from time to time. Except for this charge, receipts from such sources shall be allocated to income.

[*Alternative 3: Trustee to create reasonable reserve for depletion; reasonable return required (marital deduction trust)*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee shall establish a reasonable reserve for depletion of all depletable natural resources, including but not limited to oil, gas, and mineral property, to be charged to income from time to time, provided the aggregate return of all investments of the marital trust from time to time is reasonable in light of existing circumstances. Except for this charge, receipts from such sources shall be allocated to income.

Comment: This clause may be used with Alternative 1 in form 30.10-1. Note that Alternative 2 in form 30.10-1 gives the trustee discretion to establish a depletion reserve. If that clause is used, form 30.16-1 is not needed.

If Alternative 1 in form 30.16-1 is used, the drafting attorney must first determine the appropriate limit to proceeds allocable to income and then insert the percentage. Either Alternative 1 or Alternative 2 may be used when there is a trustee-beneficiary. If the trust is a marital deduction trust, the drafter should use Alternative 3 so that the surviving spouse's right to trust income will not be impaired by the depletion reserve.

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C. Allocation of Deferred Compensation

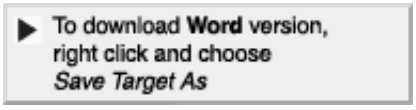
§30.17 1. Deferred Compensation Allocation Issues

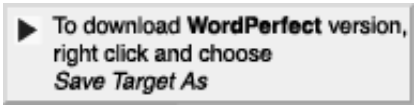
Under Prob C §16361(c), required payments from individual retirement accounts, profit-sharing plans, and similar arrangements not characterized by the payor as interest or dividends (as provided in Prob C §16361(b)) generally are allocated 10 percent to income and 90 percent to principal. This may result in allocations to income that are far smaller than anticipated by the testator. Indeed, because of the obvious possibility that the resulting allocation to income will not satisfy the requirements for the federal estate tax marital deduction under Rev Rul 2006-26, 2006-1 Cum Bull 939, the statute expressly authorizes allocating a greater amount to income if needed to obtain the deduction. Prob C §16361(d). For example, the statute provides that an amount equal to 4 percent of the account value per year may be allocated to income if the payor does not provide documentation to the trustee reflecting the internal income of each separate fund. Prob C §16361(g). This provision is intended to address the marital deduction concern by satisfying the alternative unitrust definition of "income" in Treas Reg §1.643(b)-1. See §19.7. The statute also creates a "trapping" problem in that the trust may receive significantly more taxable income than it is permitted to distribute to the beneficiary. This may be highly undesirable because trusts can receive only modest amounts of income before becoming subject to the highest income tax brackets. IRC §1(e). Generally, these issues should be addressed on a case-by-case basis, depending on the nature of particular assets, the testator's disposition wishes, the effect of the trapping problem, and the relevance of the marital deduction. The general clauses in §30.18 can be adapted as appropriate.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.18 2. Form: Power to Allocate Deferred Compensation to Principal

§30.18 2. Form: Power to Allocate Deferred Compensation to Principal





30.18-1 Power to allocate deferred compensation to principal

[*Add one of the following alternatives*]

[*Alternative 1: Power unlimited*]

The trustee may, in the trustee's discretion, allocate to income all or any portion of deferred compensation, including but not limited to benefits payable under a qualified pension, profit-sharing, or stock bonus plan described in Internal Revenue Code §401, and all other income in respect of a decedent as defined in Internal Revenue Code §691 and the applicable federal income tax regulations (or any successor to that statute or those regulations).

[*Alternative 2: Power limited (marital deduction trust)*]

The trustee may, in the trustee's discretion, allocate to income all or any portion of deferred compensation, including but not limited to benefits payable under a qualified pension, profit-sharing, or stock bonus plan described in Internal Revenue Code §401, and all other income in respect of a decedent as defined in Internal Revenue Code §691 and the applicable federal income tax regulations under this section (or any successor to that statute or those regulations). If any of these items do not yield a reasonable amount of income as required by Treasury Regulation §20.2056(b)-5(f), however, the trustee shall allocate a reasonable portion of that item to income. The trustee shall determine the amount of the allocation by taking into account the testator's desire to comply with Treasury Regulation §20.2056(b)-5(f) for all amounts allocated to the marital deduction trust.

Comment: This clause may be used with Alternative 1 in form 30.10-1. Note that Alternative 2 in form 30.10-1 gives the trustee discretion to allocate deferred compensation to principal. If that clause is used, form 30.18-1 is not needed.

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D. Amortization of Intangibles

§30.19 1. Intangible "Liquidating Assets"

Trusts may contain intangible property that will be a source of current income to the trust but the value of which will diminish over time because the property right is terminable. Examples of such intangible "liquidating assets" are copyrights, patents, royalty rights, and leaseholds. An allowance made to compensate the remainder beneficiaries for the loss in value of the assets during the trust administration is called an "amortization" allowance. It is the analogue to a "depreciation" allowance for tangible personal property or the "depletion" allowance for real-property-based property rights (*e.g.,* mineral rights).

Generally, Prob C §16362 applies to receipts from such assets and allocates them 10 percent to income and 90 percent to principal. The issues presented are substantially the same as described for deferred compensation in §30.17.

The deduction rules for intangible liquidating assets are the same as those for depletion and depreciation; the Internal Revenue Code encompasses amortization of intangible rights within the rules for depreciation. See Treas Reg §1.167(a)-3. See also §30.15 on tax issues in creating depletion and depreciation reserves.

On administration issues posed by some intangible property, see Crawford & Sare, *Estate Planning for Authors and Artists*, Tax Management Portfolios 815-2d (2004).

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.20 2. Form: Power to Establish Amortization Reserve for Intangible Property

§30.20 2. Form: Power to Establish Amortization Reserve for Intangible Property

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30.20-1 Power to establish amortization reserve for intangible property

[*Add one of the following alternatives*]

[*Alternative 1: Trustee to establish reserve*]

The trustee shall establish a reasonable reserve for amortization of all intangible property having a limited economic life, including but not limited to patents and copyrights, to be charged to income from time to time. Except for such reserves, receipts from these assets shall be allocated to income.

[*Alternative 2: Trustee to establish reserve; allocation of receipts to reserve to maximum percentage*]

The trustee shall establish a reserve for amortization of all intangible property having a limited economic life, including but not limited to patents and copyrights, to be charged to income from time to time. The trustee shall allocate to the reserve all proceeds from the property, to the extent that the annual proceeds do not exceed _ _[*number*]_ _ percent of the property's fair market value at the valuation date. The term "valuation date" means the date on which the principal is established or the property is acquired, whichever occurs later. Except for such reserves, receipts from these assets shall be allocated to income.

[*Alternative 3: Trustee to establish reserve; reasonable return required (marital deduction trust)*]

Notwithstanding any other provision of my will or of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375), the trustee shall establish a reasonable reserve for amortization of all intangible property having a limited economic life, including but not limited to patents and copyrights, to be charged to income from time to time, provided the aggregate return of all investments of the marital trust from time to time is reasonable in light of existing circumstances. Except for such reserves, receipts from these assets shall be allocated to income.

Comment: The clauses in form 30.20-1 are analogous to the suggested clauses for creating depreciation and depletion allowances. See §§30.14, 30.16.

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VI. ALLOCATION OF INCOME AND EXPENSE ITEMS AMONG CLASSES OF SUCCESSIVE BENEFICIARIES

§30.21 A. Allocation Issues Presented by Successive Beneficiary Classes

Successive interests present two questions regarding allocation of income and expense items:

(1) When do the rights of a beneficiary begin or end?

(2) Once this date is determined, how should accrued but unpaid items of income and expense be allocated?

The rights of successive beneficiaries on the creation of a trust or on the death of a beneficiary are largely governed by the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). The principles set forth in the statute, however, are subject to alteration in the governing instrument. See Prob C §16335(a)(1).

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B. Allocating Items of Income

§30.22 1. Commencement and Termination of Beneficiary's Right to Income

Unless the will provides otherwise, the income beneficiaries of a testamentary trust are entitled to the income from the assets of the trust estate from the date of the testator's death. The rules governing accrual of income on testamentary distributions in trust during an intervening period of estate administration are the same as the rules applicable to accrued income during estate administration generally. Prob C §16340.

For the period of administration, such income is calculated as a prorata portion of the net income of all property in the probate estate that is not specifically or demonstrably devised. Prob C §12006. The exception is that the income beneficiary of a general pecuniary devise in trust is entitled to interest during probate administration only after the first year of administration. Prob C §12003. Probate Code §16340(b) provides that the rate of interest payable on gifts distributable under a trust is the same as that payable on nontrust devises. The rate is provided in Prob C §12001. The will may vary these rules. Prob C §16335(a)(1).

The date on which an income beneficiary's interest in a trust terminates is usually the day before the event that causes termination of the interest. Prob C §16345(d). Generally, an income beneficiary is entitled to all income that was paid to the trust and legally due to be paid to the trust during that beneficiary's income interest. Income due but not paid to the trust is added to principal. Income that was accrued but not yet due is generally paid to the holder of the successive income interest. If the due date of the income receipt is not periodic, the income is treated as accruing day to day and accrued income is added to principal. Prob C §§16346-16347.

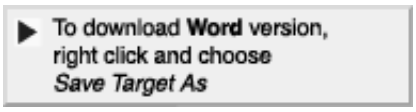
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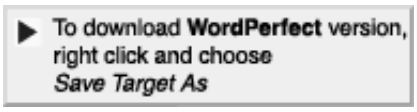
§30.23 2. Allocation of Accrued Income Unpaid Before Income Beneficiary's Death

Before the enactment of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), many trust instruments provided that trust income that was accrued but not yet distributed at the death of an income beneficiary was to be paid to the holders of the next successive interest. Although this is no longer necessary for the purpose of avoiding a distribution of income due (but not yet received by the trust) to the estate of the deceased income beneficiary, such a provision remains useful for purposes of clarifying testator intent and for permitting distribution of the income to the next income beneficiary rather than allowing the statute to add the income to principal. The provision also avoids distribution of income due and received by the trust (but not yet distributed) to the estate of the deceased income beneficiary. See form 30.24-1.

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§30.24 3. Form: Undistributed Income Payable to Succeeding Beneficiaries





30.24-1 Undistributed income payable to succeeding beneficiaries

Except when my will specifically provides otherwise, at the time of any trust termination, the trustee shall distribute income accrued and income held undistributed to the next succeeding beneficiaries in proportion to their interests. Except as otherwise expressly provided, such income shall retain its character as income.

Comment: This provision may be added to the distribution clauses in chap 31.

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C. Allocating Items of Expense Among Succeeding Beneficiary Classes

§30.25 1. Expense Allocation Rules

Expense items are allocated to principal or income accounts according to instructions provided in the will or the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). If the will is silent on the issue, expenses are allocated using the same "due date" rules applicable to receipts. Prob C §16346. In some cases in which there may be a very large accrual of a liability before payment (*e.g.,* an annual interest payment on a large debt obligation), it may be desirable to authorize allocation on an accrual basis. Form 30.26-1 may be used for this purpose.

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Source: Estate Planning/California Will Drafting/30 Trustee Accounting Powers/§30.26 2. Form: Allocation of Expenses Among Successive Beneficiaries

§30.26 2. Form: Allocation of Expenses Among Successive Beneficiaries

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30.26-1 Trustee must prorate expenses on daily basis

The trustee shall prorate all taxes and current expenses among successive beneficiaries on a daily basis over the period to which these expenses relate.

Comment: This provision may be added to the distribution clauses in chap 31.

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§30.27 D. Making Adjustments for Allocation Decisions

The drafter may want to give the trustee the power to compensate certain beneficiaries, groups of beneficiaries, or the income or principal account for any harm caused by, or imbalance in benefits conferred as a result of, the trustee's exercise of an accounting power.

Before creating such a clause, however, the drafter should give careful thought to the consequences of exercise of the power, because such a power enables the trustee to shift gift benefits and tax burdens. Potential consequences include creating a power of appointment in a trustee-beneficiary (see chap 16), interfering with the qualification of a qualified terminable interest property trust for the marital deduction if the spouse's income rights are impaired (see chap 17), and creating income tax burdens for beneficiaries the trustee had sought to protect by the initial accounting decisions. In addition, the existence of the power may imply to beneficiaries that the trustee should exercise the power and create pressure for adjustments with results that the testator would not have wished.

For the drafter who chooses to include a clause to make equitable adjustments, form 31.18-1 can provide a clause. A phrase should be added to require the trustee to consider the testator's intentions regarding tax consequences for the various beneficiaries (a similar phrase may be found in form 30.7-1). It may also be helpful to provide that the trustee's decisions in making adjustments will be final.

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31

Trustee Administrative Powers

CEB Staff

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- B. Nonprorata Distributions §31.3
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§31.1 I. PLANNING DISTRIBUTION POWERS

This chapter discusses:

- *Testamentary trustee powers relating to asset distribution*. The chapter provides clauses for trustees to make (a) in-kind and nonprorata distributions and (b) distributions to beneficiaries who are under disabilities that make direct distributions to them difficult. The chapter also provides clauses that guide and protect the trustee when events that affect trust distribution occur, *e.g.,* births, deaths, or conflicts among parties interested in the trust.
- *The effect of certain testamentary trustee powers on the taxability of the trust or distributees*. The chapter addresses the trustee's power to disclaim administrative powers, not to exercise discretionary powers, and to make adjustments in distributions to achieve desired tax results. The chapter also covers the trustee's power to accept additions of property to, or cease administration of, the trust.
- Powers *authorizing the trustee to pay for certain beneficiary expenses*. The chapter focuses on payment of a deceased beneficiary's last-illness and funeral expenses, death taxes attributable to trust property included in the beneficiary's estate, and living expenses of a beneficiary who is permitted to inhabit trust real property rent free.
- *Trustee powers affecting the trust corpus as a whole*. This topic includes powers to accept additions to the trust from third parties, to merge small trusts, and to terminate a small trust.
- *Continuation of trustee powers after trust termination until the trust business is wound up.* The chapter provides a clause to empower the trustee to finish up the trust's business after the occurrence of the terminating event.
- *Rules for interpretation of trust clauses.* The chapter focuses on trustee conduct as a fiduciary and the choice of the law to govern the trust.

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II. "IN-KIND" AND NONPRORATA DISTRIBUTIONS OF TRUST CORPUS

§31.2 A. Distributions "In Kind"

Either during administration of the testamentary trust or on termination of the trust, or both, the trustee must transfer part or all of the trust estate to persons entitled to it. It is good practice to provide the trustee with explicit authority to sell an asset and distribute the money or to distribute the property "in kind" (*i.e.,* as it is).

Distribution of appreciated property in satisfaction of a beneficiary's right to a specific dollar amount, to specific property other than that distributed, or to trust accounting income, causes the estate or trust to realize gain and gives the recipient of the appreciated property a cost basis under IRC §1012. See Treas Reg §1.661(a)-2(f); *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217 (right to receive $5 million on attaining age 40); *Suisman v Eaton* (D Conn 1935) 15 F Supp 113, aff'd (2d Cir 1936) 83 F2d 1019 (right to receive $50,000 on attaining age 25); Rev Rul 68-392, 1968-2 Cum Bull 284. If, however, the distribution satisfies a specific bequest under IRC §663(a)(1), the recipient has no income and only the estate or trust recognizes gain or loss. See Rev Rul 66-207, 1966-2 Cum Bull 243. Gain or loss is recognized on an item-by-item basis, not on an aggregate basis. See *Williams v McGowan* (2d Cir 1945) 152 F2d 570 (sale of partnership interest). Even a simple direction to equalize lifetime gifts made by the decedent can result in recognition of gain by the trust or estate, because it creates a right in the "shorted" beneficiary to a fixed amount. See Rev Rul 82-4, 1982-1 Cum Bull 99.

Making distributions in kind is often appropriate. If the will directs that assets must be liquidated, growth potential may be sacrificed, property may have to be sold in a bad market, and gain resulting from the sale may be taxable to the beneficiaries. Distributions made in kind, however, can delay realization of capital gain (see Rev Rul 54-503, 1954-2 Cum Bull 237), and the trustee may elect under IRC §643(e) to have the trust pay taxes on gain realized when the property is distributed (see California Trust Administration §11.50 (2d ed Cal CEB 2001)).

If a trust asset will be distributed in kind to more than one person, the trustee must decide whether to distribute it in divided or undivided interests and prorata or nonprorata. See §31.3 on nonprorata distributions, including a discussion of when a nonprorata distribution power is not appropriate. Form 31.4-1 gives the trustee the power to make distributions in kind and prorata or nonprorata.

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§31.3 B. Nonprorata Distributions

Prorata distribution is distribution of exactly the same asset or set of assets to each beneficiary of a gift. In contrast, nonprorata distributions are distributions of different properties or sets of properties to the recipient beneficiaries.

EXAMPLE: When two parcels of real property and three types of corporate securities will be divided equally among four beneficiaries, a prorata distribution will give each beneficiary an equal interest in the real properties and an equal number of shares of each of the companies. A nonprorata distributive plan will give each beneficiary a different mix of real property and corporate shares, with all beneficiaries receiving distributions of equal value. Some beneficiaries may receive shares and no real property; some may receive real property and no shares.

See §33.25 on prorata and nonprorata distributions by executors.

Probate Code §16246 gives the trustee the power to make nonprorata distributions and to "adjust resulting differences in valuation." The trustee has the authority to take unrealized gains and losses into account when making distributions. See 18 Cal L Rev'n Comm'n Reports 1401 (1986).

The income tax basis of a trust asset may be considerably lower than the asset's fair market value. A nonprorata distribution that does not take the tax bases of distributable assets into consideration may result in widely disparate economic benefits to beneficiaries who receive property with the same fair market value. For example, a beneficiary who receives $100,000 in cash will have no taxable gain on subsequent disposition, but a beneficiary who receives securities valued at $100,000 with a $20,000 basis will, on a subsequent sale, have a gain of $80,000.

The trustee who has the power to make nonprorata distributions should be given direction about whether to make those distributions with or without first taking the assets' income tax bases into account. Although the power to make nonprorata distributions without considering tax bases may result in varying economic benefits to beneficiaries, it may also allow the trustee to realize overall tax benefits or to achieve a better dispositive plan.

If the testator wants a more restrictive directive, Alternative 1 in form 31.5-1 should be added to the standard clause (see form 31.4-1). If the testator wishes the trustee to have maximum flexibility, the drafter should use Alternative 2 in form 31.5-1.

The language in form 31.4-1 permitting nonprorata distribution is intended to prevent the Internal Revenue Service from classifying a nonprorata distribution to multiple beneficiaries as a taxable exchange among the beneficiaries. See Rev Rul 69-486, 1969-2 Cum Bull 159; IRS Letter Ruling 199912040.

NOTE: A trustee-beneficiary should not ordinarily be given the right to make nonprorata divisions or distributions of assets, even though the trustee must use fair market value in making such divisions or distributions. A trustee who makes a favorable distribution of assets to himself or herself (*e.g.,* assets with a high income tax basis or high-yielding assets) may be held to have violated his or her fiduciary duties. See Prob C §16004(a) on trustee conflicts of interest. See also §§31.17 and 33.35 for discussion of *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 68, in which the court held that the trustee must deal in an impartial manner with the beneficiaries.

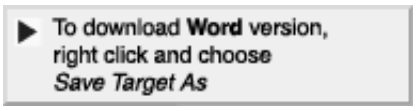
In addition, the IRS could take the position that a trustee holding such a power possesses a general power of appointment, because the trustee could use it to increase his or her share of trust income and corpus. See §§16.13-16.16, 28.8.

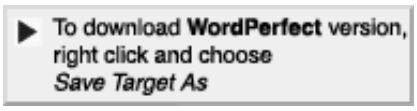
If the client wishes to give the trustee complete flexibility in making distributions with or without regard to income tax basis, the drafter should include form 31.18-1, giving the trustee discretion to allocate benefits and to make adjustments among the beneficiaries for tax consequences, in addition to form 31.4-1 (broad power of distribution) and Alternative 2 in form 31.5-1 (nonprorata distribution or allocation without regard to income tax basis).

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C. Powers Regarding Asset Distribution

§31.4 1. Form: Broad Powers of Distribution





31.4-1 Broad powers of distribution

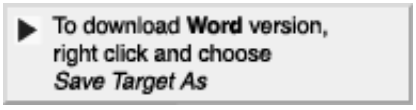
***Power to Divide Trust Property*. When the trustee must divide any trust property into parts or shares for the purpose of distribution or otherwise, the trustee may, in the trustee's discretion, make the division and distribution in identical interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.**

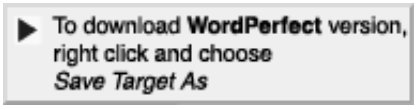
Comment: Form 31.4-1 gives the trustee broad power to decide how property should be distributed when the distribution is in several shares. See §31.3 on when a nonprorata distribution power is not appropriate.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.5 2. Form: Nonprorata Distributions and Income Tax Basis

§31.5 2. Form: Nonprorata Distributions and Income Tax Basis





31.5-1 Nonprorata distributions with or without regard to income tax basis

[*Add one of the following alternatives*]

[*Alternative 1: Nonprorata distributions with equivalent or proportionate income tax bases*]

In making nonprorata distributions to beneficiaries, the trustee shall consider and attempt to equalize as much as possible the aggregate income tax bases of assets distributed to the various beneficiaries. Any such determination by the trustee shall be binding on all parties in interest.

[*Alternative 2: Nonprorata distributions without regard to income tax basis*]

In making nonprorata distributions to the beneficiaries, the trustee need not consider the income tax bases of the various assets nor make any attempt to equalize the aggregate income tax bases of assets distributed or allocated. The decision of the trustee to consider or not to consider the income tax bases shall be binding on all parties in interest.

Comment: This clause may be added to form 31.4-1. Alternative 1 requires the trustee to consider tax bases when making distributions. Alternative 2 relieves the trustee from any responsibility to do so. See §31.3 on the impact of selecting one of these clauses.

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III. DISTRIBUTIONS TO MINORS OR DISABLED PERSONS

§31.6 A. Statutory Rules and Trust Clauses for Distributing Gifts to Minors and Disabled Beneficiaries

Probate Code §16245 permits the trustee to make distributions directly to a beneficiary or to "another person" for a beneficiary's use or benefit, even when the beneficiary is under a legal disability (*e.g.,* a minor). It is good practice, however, to give the trustee the explicit power to make distributions to a minor or disabled beneficiary by making payments:

- To any suitable person with whom the beneficiary resides or who provides for the beneficiary's needs; or
- For the benefit of, or directly to, the minor or disabled beneficiary if the trustee believes that the beneficiary is able to use the money appropriately.

By using this power, the trustee may be able to avoid requiring a guardianship of a minor beneficiary's estate or a conservatorship of an incapacitated beneficiary's estate as a precondition to distributions to the beneficiaries.

Statutes provide that gifts to minors may be distributed under certain conditions to a minor's parent, to be held for the minor, if the minor's total estate does not exceed $5000 (including the assets to be received and excluding custodial property held under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925)). Prob C §§3400-3402. See §22.16.

A simple method for distributing gifts that are too large to be distributed to the minor's parent is to make distributions to a custodian for the minor beneficiary under CUTMA. Prob C §6341. A standard clause directing a testamentary trustee to make such distributions under CUTMA (or the corresponding Act in the state where the minor resides) is a simple way to eliminate the need for a guardianship. For discussion of CUTMA and related clauses, see §§22.13-22.15, 22.38.

On testamentary guardianships, see chaps 24-25; 3 Scott & Ascher on Trusts §17.14.1 (5th ed 2007). See also §§33.33-33.35 on similar property distribution issues with respect to the executor. For a clause authorizing payments to minors or disabled beneficiaries, see form 31.7-1.

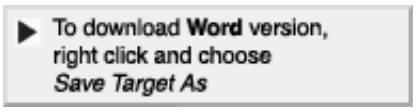
When a distribution must be made, the trustee's concern is likely to be the beneficiary's ability to manage the distributed property—not just whether (1) the beneficiary is under a legal disability or lacks legal capacity or (2) the distribution is permitted by statute. Form 31.7-1 provides the trustee with broad power to make distributions to third parties for the use and benefit of a beneficiary who is under a legal or an actual disability. Not only will the clause enable the trustee to select the most sensible and efficient method of distribution, but it will also eliminate problems that may arise if the trust comes under the jurisdiction of the court of a state with less liberal distribution rules.

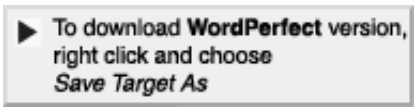
Form 31.7-1 allows the trustee to decide whether the beneficiary is capable of using and managing the distribution. If the testator does not wish the trustee to make that determination, the drafter must include the optional addition to make the meanings of "disability" and "disabled" clear in the will. Otherwise, the trustee may feel required to obtain a judicial determination of these terms, which will be time-consuming, costly, and emotionally harmful to the beneficiary. In addition, even though the beneficiary may be unable to use or manage the gift, he or she may not meet the criteria for a judicial finding of incapacity or disability.

If a distribution to a minor might consist of a large amount of property or property requiring active management, the drafter should consider including a clause that permits continuing administration of the assets in trust pending the minor's majority or some later time. See form 31.8-1. On trusts for minors generally, see chap 22. On special needs trusts for disabled beneficiaries who are eligible for government benefits, see chap 23.

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§31.7 B. Form: Facility of Payment; Definition of "Disability" and "Disabled"





31.7-1 Facility of payment

***Distribution of Property to Minors or Disabled Persons*. If the trustee is directed to distribute trust property to a minor, a person under any other legal disability, or a _ _[*person who, by reason of illness or physical condition is disabled/person not adjudicated to have limited legal capacity but who, by reason of illness or mental or physical disability, is in the trustee's judgment unable to manage the distributed property properly*]_ _, the trustee may, in the trustee's discretion, make the distribution to:**

(1) The beneficiary directly;

(2) A legally appointed guardian or conservator of the beneficiary's person or estate;

(3) A custodian for the minor beneficiary under any applicable Uniform Transfers or Gifts to Minors Act _ _[*to hold for the beneficiary until age _ _[number from 18 to 25*]_ _]_ _;

(4) A third party for the benefit of the beneficiary; or

(5) An adult relative or friend in reimbursement for amounts properly advanced for the beneficiary's benefit.

If no custodian exists for receipt of property under any applicable Uniform Transfers or Gifts to Minors Act, the trustee may designate a custodian to receive the property.

31.7-2 Definition of "disability" and "disabled"

The terms "disability" and "disabled" include any physical or mental condition that renders a person unable to conduct his or her financial affairs in a prudent and efficient manner and that is likely to extend for a period longer than _ _[*number*]_ _ months. The condition of disability _ _[*must/may*]_ _ be evidenced by a written statement of the disabled person's regularly attending physician, filed with the trustee.

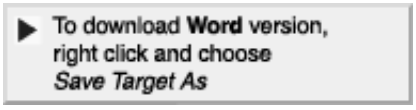
Comment: If the testator wants property distributed to and held by a custodian under the California Uniform Transfers to Minors Act (Prob C §§3900-3925) after the beneficiary reaches age 18, the drafter should use the optional phrase "to hold for the beneficiary until age _ _[*number from 18 to 25*]_ _" in subparagraph (3) of form 31.7-1. Note that the applicable Uniform Transfers or Gifts to Minors Act in a state outside California may limit this age to 18 or 21.

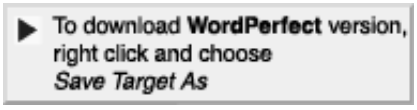
If form 31.7-2 is to be used in conjunction with form 31.7-1, the drafter should use the alternative phrase "person who, by reason of illness or physical condition is disabled" in form 31.7-1.

The drafter may want to amend form 31.7-2 by deleting the phrase "in a prudent and efficient manner" or by choosing other criteria for measuring disability. The time span provided should be of sufficient length to justify distribution to a third party for the beneficiary's benefit (*i.e.,* at least three months). If a party or professional other than a physician may be appropriate to state the beneficiary's disability, the drafter should amend the last sentence accordingly. In most cases, however, the drafter should not provide that the disability "must" rather than "may" be evidenced by a written statement of the attending physician, to avoid privacy concerns under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191, 110 Stat 1936), particularly the HIPAA privacy provisions in 42 USC §1320d-2 and the HIPAA Privacy Rule (45 CFR pts 160, 164), and California's Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37). See Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008).

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§31.8 C. Form: Back-Up Trust for Minor Beneficiary's Distribution





31.8-1 Back-up trust for distribution to minor beneficiary

***Power to Delay Distribution to Minor*. Except when my will specifically provides otherwise, the trustee shall delay outright distribution to any minor beneficiary by continuing to hold that minor's share in a separate trust. The trustee may, however, in the trustee's discretion, terminate the trust or obtain a Court order to terminate the trust. The trustee shall pay to or for the minor beneficiary as much of the trust estate as is necessary for the minor beneficiary's health, education, support, or maintenance, after taking into account the minor beneficiary's other income and resources known to the trustee and reasonably available for that purpose. The trustee shall add any undistributed income to principal. When the minor beneficiary attains majority, the trustee shall distribute the trust estate to the beneficiary outright. If the minor beneficiary dies before distribution, the trustee shall distribute the trust estate to the beneficiary's estate.**

Comment: If the testator wants to continue the trust past the minor's reaching age 18, the drafter should amend form 31.8-1 to change the trust's duration.

The drafter should consider including a "spendthrift" clause with this clause. See chap 27. The drafter should also make sure that the will contains a clause protecting the trust (as well as other trusts created under the will) against the rule against perpetuities. See chap 34.

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IV. EFFECT ON DISTRIBUTIONS OF EVENTS AFFECTING BENEFICIAL INTERESTS

A. Protecting Trustee From Liability

§31.9 1. Protecting Trustee From Liability for Distributions Affected by Events of Which Trustee Had No Knowledge

Although beneficial interests in a trust are frequently altered by birth, death, or marriage, the trustee may not receive timely notice of such events. To encourage regular distributions with a minimum of red tape, the drafter must protect the trustee from liability for distributions made in ignorance of these events. Form 31.10-1 provides such protection. (As discussed in §31.9A, under Prob C §16061.7(i) there may be no waiver of the trustee's duty to notify beneficiaries and heirs when a trust becomes irrevocable or when there is a change of trustee.)

If the will does not contain the optional language suggested in form 31.10-1, the exculpatory language in form 31.10-1 may relieve the trustee from liability for failure to pay any death or generation-skipping taxes that come due as a result of a beneficiary's death. The testator may want to omit the optional clause if a friend or family member will serve as trustee, but the clause may be appropriate if a professional fiduciary will serve instead.

A third party's exercise of a power of appointment is one event that may affect a trustee's distribution duties. If the trustee does not receive notice of the exercise of the power of appointment within a given period after the death of the reputed holder of the power, form 31.10-1 enables the trustee to make distributions as if the power had not been exercised. Without such a clause, a trustee who is concerned that distributions will be improperly made may refuse to distribute in a timely manner. On exercising powers of appointment, see chap 16. On the marital deduction power of appointment trust, see chap 18; California Estate Planning, chap 17 (Cal CEB 2002).

The clauses in this section of the will are usually placed in a trust paragraph with other "miscellaneous" provisions applicable to the trust, *e.g.,* definitions, perpetuities savings clause.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.9A 2. No Protection From Liability for Failing to Notify Beneficiaries and Heirs When Revocable Trust Becomes Irrevocable or When There Is Change of Trustees

§31.9A 2. No Protection From Liability for Failing to Notify Beneficiaries and Heirs When Revocable Trust Becomes Irrevocable or When There Is Change of Trustees

A "notification by trustee" must be served on beneficiaries, heirs, and specified other persons when (1) a revocable trust or any portion of it becomes irrevocable because of the death of one or more of the settlors, and (2) when there is a change of trustees of an irrevocable trust. Prob C §16061.7(a). The required contents of the notification are set forth in Prob C §16061.7(g). The notification must be served by mail not later than 60 days after the occurrence of the event, or after the trustee becomes aware of the existence of a person entitled to receive the notification. Prob C §16061.7(f).

The trustee must provide a copy of the terms of the irrevocable trust or irrevocable portion of it to any beneficiary or heir of a deceased settlor who requests it. Prob C §16061.5. The requirement of a statement in the notification concerning the recipient's right to request a copy of the trust also can be satisfied by providing the recipient a copy of the trust with the notice. See *Germino v Hillyer* (2003) 107 CA4th 951, 132 CR2d 478. "Terms of the trust" does not include documents that were intended to affect disposition only while the trust was revocable. Prob C §16060.5. No person who receives the notification by trustee may bring an action to contest the trust more than 120 days from the date the notification is served, or more than 60 days from the day on which a copy of the terms of the trust is mailed or personally delivered to that person during that 120-day period, whichever is later. Prob C §16061.8. If the notification is served because a revocable trust has become irrevocable, the notification must include a warning in boldfaced type regarding the 120-day contest period. Prob C §16061(h). See *Harustak v Wilkins* (2000) 84 CA4th 208, 100 CR2d 718.

A trustee who fails to serve the notification as required will be liable for all damages caused by the failure, unless the trustee has made a reasonably diligent effort to comply with the notification requirements. See Prob C §16061.9(a).

Any waiver by a settlor of the requirement of service of the notification by trustee is against public policy and therefore void. Prob C §16061.7(i).

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B. Exculpating Trustee for Action Before Notice of Events Affecting Beneficial Interests

§31.10 1. Form: Trustee Action Before Notice of Events Affecting Beneficial Interests

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31.10-1 Trustee action before notice of events affecting beneficial interests

***No Liability for Trustee Action Before Notice of Events*. Unless the trustee receives written notice of the occurrence of an event affecting the beneficial interests in _ _[*this trust/any trust created under my will*]_ _, the trustee shall not be liable to any beneficiary of the trust for distributions made or other actions taken by the trustee in good faith as though this event had not occurred.**

[*If applicable, add the following option*]

[*Option: No exculpation of trustee's liability for nonpayment of taxes*]

This paragraph shall not, however, exculpate the trustee from liability arising from nonpayment of death or generation-skipping taxes that may be due as a result of the occurrence of an event affecting the beneficial interests of _ _[*this trust/any trust held under my will*]_ _.

Comment: If the testator does not wish to require written notice of the event, the word "written" should be deleted or replaced with the word "actual." (Requiring that notice be in writing prevents any disagreement about whether notice was received.) If the drafter includes the trustee exculpation clause in form 28.48-1, the drafter should not use the optional nonexculpation clause in form 31.10-1.

There may be no exculpation in the case of a trustee's duty to notify beneficiaries and heirs when a revocable trust becomes irrevocable or when there is a change of trustees. See Prob C §16061.7(i). See discussion in §31.9A.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.11 2. Form: Trustee May Distribute if No Notice of Exercise of Power of Appointment

§31.11 2. Form: Trustee May Distribute if No Notice of Exercise of Power of Appointment

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31.11-1 Trustee may distribute if no notice of exercise of power of appointment

***Distribution of Property Subject to Power of Appointment*. The trustee may distribute assets held in trust and subject to a power of appointment as if the power had not been exercised, if the trustee has not received any document purporting to exercise the power by the earlier of:**

(1) Six months after the death of any person holding a power of appointment over the assets; or

(2) If the powerholder is purported to have a will, expiration of the statutory period in the decedent's domicile within which a will contest must be filed to contest the purported will.

If a document purporting to exercise the power is subsequently located, the trustee shall not be liable to the appointees under that exercise, and the rights of the appointees and the persons to whom the trustee distributed the assets shall be determined as provided by law.

Comment: Form 31.11-1 is needed only if the will provides for exercise of a power of appointment without requiring that the document exercising the power of appointment be delivered to the trustee during the holder's lifetime. See chap 16 on powers of appointment.

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C. Effect of Disputes on Distributions

§31.12 1. Trustee's Right to Withhold Payment While Disputes Are Resolved

When distributions are made from a trust, questions may arise about the identity of the persons entitled to trust property or the amounts that they are entitled to receive. On the termination of the trust, income taxes may be payable by the trustee that will affect the distributable amounts. See, *e.g.,* Treas Reg §1.661(a)-2(f)(1), under which gain may be recognized on distribution of "in-kind" property in satisfaction of a gift of a specific dollar amount or a gift of specific property other than the distributed property or in satisfaction of a right to trust accounting income. Further, the trustee is personally liable for any unpaid generation-skipping transfer taxes due by reason of a direct skip or taxable termination. IRC §2603(a). See chap 15.

Even without an express clause in the will, the trustee is probably justified in withholding from the beneficiaries whatever part of the trust corpus may be the subject of conflicting claims. See *Feldmeier v Superior Court* (1938) 12 C2d 302, 83 P2d 929. To ensure that the trustee is not surcharged because of an error in judgment, the drafter should include form 31.13-1 in the will.

Form 31.13-1 will also give the trustee the authority to delay asset distribution or division for at least 6 months after the testator's death. An informed decision on whether to adopt the date of death or an alternate valuation date (usually 6 months after the testator's death) under IRC §2032 often cannot be made until after the alternate valuation date occurs. Yet the distribution or other disposition of estate assets within 6 months after the testator's death will fix the alternate valuation date of that property for estate tax purposes. IRC §2032(a)(1); Treas Reg §20.2032-1(c)(1). See *Herbert H. Kohler*, TC Memo 2006-152, nonacq in AOD 2008-1 (valuation of estate property based on value of stock received in tax-free reorganization completed 2 months after decedent's death). But see Prop Treas Reg §20.2032-1(f) (postdeath changes in property other than changes in "market conditions" outside control of trustee disregarded in determining alternate valuation date values). In addition, division of estate property into shares may be interpreted as a distribution and thus inadvertently serve to fix those assets' valuation date. See Rev Rul 78-430, 1978-2 Cum Bull 230 (division of community property revocable trust into shares at death of one spouse was not a distribution); Rev Rul 73-97, 1973-1 Cum Bull 404 (division of revocable trust into separate trusts was a distribution for alternate valuation purposes). This clause should not affect the qualification for the marital deduction of a general power of appointment or a qualified terminable interest property marital deduction trust. Treas Reg §20.2056(b)-5(f)(9). See chaps 18-19.

Form 31.13-1 is usually included in the same trust division or paragraph as other distribution provisions. On trust distribution clauses in general, see chap 21.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.13 2. Form: Power to Withhold Distribution Pending Tax Payment and Conflict Resolution

§31.13 2. Form: Power to Withhold Distribution Pending Tax Payment and Conflict Resolution

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31.13-1 Power to withhold distribution pending tax payment and conflict resolution

***Power to Withhold Distribution*. When an event requires the trustee to divide, segregate, or distribute trust property, the trustee may delay the division, segregation, or distribution of all or part of the property for the period of time necessary to ascertain and provide for the payment of any tax, claim, or other liability against the property. During this period, the trustee may pay the net income of the trust property to the persons and entities entitled to it. The provisions of this paragraph shall not be deemed to postpone or defer the vesting of any interest created by the dispositive provisions of the trust.**

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V. EXERCISING ADMINISTRATIVE POWERS TO AVOID UNWANTED TAX EFFECTS

A. Trustee's Disclaimer of Administrative Powers

§31.14 1. Purpose of Disclaimer; Trustee's Right to Disclaim

A disclaimer is a refusal to accept an interest in property, including any power with respect to it, that necessarily will result in the property's passing to another. Prob C §265. Because certain administrative powers held by a trustee may have adverse tax consequences, it may be advisable to permit the trustee to disclaim such powers. Without explicit authority to do so, however, a trustee might not be permitted to modify the terms of the trust by disclaiming a fiduciary power.

Typically, a trustee may want to disclaim administrative (or other) powers for two reasons:

(1) *To abandon powers that will disqualify property for a marital or charitable deduction*. The goal is to enable the trustee to make a "qualified" disclaimer, *i.e.,* a disclaimer that satisfies Internal Revenue Service requirements so that the desired tax consequence, recognition of a marital or charitable deduction, will result. Examples of powers that the trustee may want to disclaim, in relation to trusts intended to qualify for the qualified terminable interest property (QTIP) marital deduction, include the power to withhold income from the surviving spouse and the power to invade principal for the remainder beneficiaries. Another example can occur when a surviving spouse is the trustee of a disclaimer bypass trust. A disclaimer by the spouse of property that, by reason of the disclaimer, will go into the bypass trust will be ineffective if the trustee spouse retains discretionary dispositive powers over the bypass trust property. The trustee spouse would then wish to disclaim the dispositive powers. See chap 17 on the marital deduction; chap 19 on QTIP trusts; chap 20 on bypass trusts. See the discussion below of IRC §2518, which defines and provides requirements for qualified disclaimers.

(2) *To disclaim a power that the IRS may view as a general power of appointment over trust property under IRC §2041*. This disclaimer power may be needed when the trustee or a dependent of the trustee is a beneficiary of the trust, and the trustee holds powers that may affect beneficial interests. See §28.8 on tax issues presented by a trustee-beneficiary; chap 16 on powers of appointment.

Neither California law nor the federal disclaimer statute explicitly permits the selective disclaimer or release by a trustee of any of his or her administrative powers under the trust. Although the California statutes broadly define "interests" that may be disclaimed to include "powers" (Prob C §267(a)), they do not specifically authorize the disclaimer of an administrative power. See Prob C §§260-295. The statutes address disclaimers of interests by beneficiaries (Prob C §275), persons executing disclaimers on the beneficiaries' behalf (Prob C §264), and guardians, conservators, or personal representatives executing disclaimers (Prob C §§276-277), but they do not directly mention disclaimers by a trustee. Because Prob C §267(b)(14) defines "interest" to include "[a]ny other interest created by any testamentary or inter vivos instrument," however, a trustee can probably disclaim an administrative power if the trust expressly permits it.

Under federal law, disclaimers of an interest in property are allowed under IRC §2518, and IRC §2518(c)(2) provides that a power with respect to property must be treated as an interest in that property. Therefore, a disclaimer probably encompasses the administrative powers of a trustee. Even if not technically a disclaimer under Prob C §260, the release of a trustee's administrative powers will almost certainly be effective if authorized in the trust instrument. See Prob C §16200(a); Rev Rul 90-110, 1990-2 Cum Bull 209 (disclaimer by trustee not effective because not authorized by governing instrument or state law).

In some circumstances, a trustee who is unable to disclaim, release, or restrict a power may wish to resign in order to divest himself or herself of the unwanted power. Alternatively, the beneficiary or beneficiaries may be able to execute disclaimers that will divest the trustee of the unwanted power. When the trustee is also the beneficiary, another possible solution is to direct in the trust instrument that a special trustee will hold any "tax-sensitive" powers.

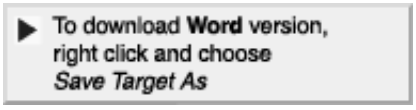
The California disclaimer statute (Prob C §§260-295) does not expressly provide for a refusal to act as a trustee or a refusal to accept any of the trustee's powers. Probate Code §§15600 (acceptance of trust by trustee) and 15601 (rejection of trust), however, set forth methods of acceptance and rejection of a trust (and modifications of a trust) by the trustee. See generally Prob C §§15200-15212 (creation of trusts), 16000 (duty to administer trust), 16420(a)(1) (beneficiary may compel trustee to perform duties).

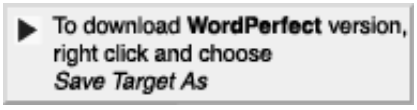
Although it is not clear whether a refusal to act as trustee may be treated as a qualified disclaimer, the authors recommend that a refusal to act as a trustee be made in conformity with California's specific procedure for declining to act as a trustee (Prob C §15601) and, if done to try to avoid adverse tax consequences, in a manner that satisfies state and federal disclaimer requirements (see IRC §2518; Prob C §§260-295).

For further discussion of disclaimer of powers by a trustee who is also a beneficiary of a trust, see California Estate Planning, chap 27 (Cal CEB 2002).

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§31.15 2. Form: Disclaimer of Administrative Powers





31.15-1 Disclaimer of administrative powers

***Disclaimer of Administrative Powers*. The trustee may, in the trustee's discretion, disclaim, release, or restrict the scope of any administrative power held in connection with any trust created under my will, whether the power is expressly granted in my will or implied by law, in a written instrument specifying the power to be disclaimed, released, or restricted and the nature of the restriction. Any power disclaimed or released shall be extinguished unless the trustee, in the trustee's discretion, appoints an independent special trustee to exercise the disclaimed or released power. In deciding whether to exercise the discretion to disclaim, release, or restrict a power described in this clause, the trustee shall consider the best interests of all the beneficiaries as a whole.**

Comment: This form is not for general use and should not be used to attempt to achieve tax objectives. A power to amend the trust to achieve a particular tax objective, *e.g.,* qualification of the trust as a charitable remainder trust, should be drafted specifically and in accord with Internal Revenue Code guidelines and provisions designed to achieve this goal.

Form 31.15-1 should be amended if the will creates only a single trust. If the trusts have cotrustees or a special trustee, the drafter should consider providing a clause to allow an appropriate cotrustee (*e.g.,* a corporate fiduciary) or a special trustee to take over any disclaimed or released powers.

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§31.16 B. Limiting Powers to Save Marital Deduction

Unless the will specifically provides otherwise, the rules of construction in Prob C §§21500-21526 will apply to wills probated in California and may prove effective to preserve the marital deduction for a trust when the will lacks certain limiting and clarifying provisions. Prob C §21502. See §17.32 on these rules of construction.

Form 17.33-1 states the testator's intention that a trust qualify for the marital deduction and directs that fiduciary powers respecting that trust and its assets not be exercised in any way that could jeopardize the deduction. This clause serves both to alert the trustee to take special care when administering the marital deduction assets and to provide direction in case the trust administration takes place in a jurisdiction without savings clauses like those discussed above.

Probate Code §§21500-21526 and form 17.33-1 are no substitute for careful drafting of the marital deduction trust provisions. Certain defects in drafting (*e.g.,* allowing the trust to terminate at the surviving spouse's remarriage) will prevent the trust from qualifying for a marital deduction.

On using a savings clause, see Rev Rul 75-440, 1975-2 Cum Bull 372, discussed in §29.51.

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C. Trustee Powers to Make Adjustments for Consequences of Tax Elections and Other Decisions

§31.17 1. Trustee Tax Elections

Elections made by the executor or trustee may have favorable tax consequences for some beneficiaries at the expense of the interests of others.

EXAMPLE: In *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 68, the executor had the option of deducting administrative expenses either on the federal estate tax return (which would benefit the remainder beneficiaries of the testamentary trust) or on the income tax return (which would benefit the life tenant). The court held that the tax benefit should be allocated among the beneficiaries in an equitable manner.

The attorney can avoid litigation like that in *Bixby* by giving the trustee the authority in the will to make the allocations required by the court in *Bixby*. See §33.21 for discussion of this issue as it affects executors.

The trustee's selection of trust investments may affect the beneficiaries' tax situations in varying ways. If an income beneficiary is in a high tax bracket, he or she may benefit by trustee investment in tax-exempt municipal bonds. This action by the trustee, however, may subject him or her to suit by the remainder beneficiaries for holding an investment that primarily benefits the income beneficiary. See *In re Dwight's Trust* (Sup Ct 1952) 128 NYS2d 23 (trustee surcharged for loss to remainder beneficiary from sale of federal bonds and purchase of municipal bonds). A clause such as form 31.18-1 will permit the trustee to make an equitable adjustment between the income beneficiaries and the remaindermen.

Other considerations than fairness may dictate whether a beneficiary adjustment clause is made discretionary or mandatory. A trustee who has discretion to make adjustments can affect the economic benefits from the trust. Consequently, a trustee who is a beneficiary, or has a dependent who is a beneficiary, and has the power to make adjustments among beneficiaries may be considered to have a general power of appointment under IRC §2041. To avoid the imputation of a power of appointment, therefore, the drafter should not give such a "sensitive" trustee discretionary adjustment powers. See chap 16 on powers of appointment; §28.8 on tax issues raised by a trustee-beneficiary.

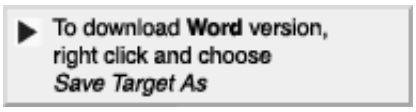
Instead of giving the trustee of a non-estate-type marital deduction trust the discretion to make adjustments among beneficiaries, the drafter should require the trustee to allocate the benefits and make adjustments among the beneficiaries. Otherwise, the trust may be disqualified for the marital deduction because the surviving spouse will not be entitled to all the trust income. See chap 17 on the marital deduction.

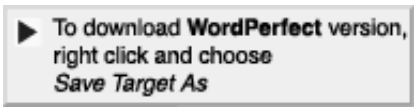
See also §§30.5, 30.11-30.12, 30.13-30.20, 31.2-31.3 on other allocations affecting beneficiary shares.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.18 2. Form: Power to Adjust for Tax Consequences

§31.18 2. Form: Power to Adjust for Tax Consequences





31.18-1 Power to adjust for tax consequences

***Power to Adjust for Tax Consequences*. The trustee may, in the trustee's discretion, take any action and make any election to minimize the tax liabilities of (1) any trust held under my will and (2) the trust's beneficiaries. The trustee may allocate the benefits among the various beneficiaries and make adjustments in the rights of any beneficiaries, or between the income and principal accounts, to compensate for the consequences of any tax election or investment or administrative decision that the trustee believes has directly or indirectly benefited one beneficiary or group of beneficiaries over others.**

Comment: On use of this clause and whether the trustee should be given discretion to make adjustments or be required to do so, see §31.17. If the power will not be discretionary, the drafter should replace the word "may" in the clause with "shall."

To avoid any conflict among clauses, the drafter should coordinate form 31.18-1 with any other "power to adjust" clause in the will, *e.g.,* any power to adjust for consequences of income or expense item allocations between income and remainder beneficiaries (see §30.27).

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VI. EXPENSE PAYMENTS ON TERMINATION OF BENEFICIARY INTERESTS; USE OF RESIDENCE

A. Payment of Beneficiary's Death Taxes

§31.19 1. Authorizing Death Tax Payment

At the death of a trust beneficiary, all or part of the trust corpus may be subject to death taxes as an asset of the trust beneficiary's gross estate under IRC §2031. Often, the trust property will pass to persons or entities different from those who receive the deceased trust beneficiary's own property. Under California law, the trust beneficiary's executor has a statutory right to proceed against the trust for a prorata share of the tax payment. Prob C §§20100-20225. To ensure that death taxes resulting from the inclusion of the trust property as an asset of the deceased trust beneficiary's gross estate are paid out of trust assets, a will can authorize the trustee to pay from the trust estate the portion of the deceased trust beneficiary's death taxes allocable to the trust assets. Form 31.20-1 provides this authorization.

The drafter should ensure that such tax payments are not made from property that might otherwise qualify for a marital or charitable deduction. The optional addition to form 31.20-1 should be used whenever the will creates a trust that the executor can elect to qualify as a qualified terminable interest property (QTIP) marital deduction trust. See IRC §2056(b)(7); chap 19. See also §§26.11, 26.19.

Clauses giving the trustee authority to pay death taxes for the estate of a deceased *beneficiary* should be distinguished from clauses relating to the executor's payment of death taxes arising from the *testator's* death. On drafting the latter type of clause, see chap 26.

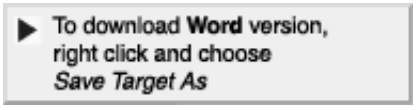
It is generally advisable to restrict the trustee from paying any additional estate tax imposed by IRC §2032A, because that tax should be borne by the beneficiaries of the §2032A property rather than by the estate as a whole or the remainder of the estate. See §§26.6, 26.20.

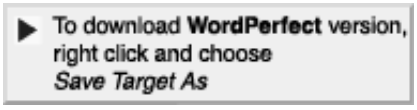
PITFALL: The drafting attorney must create any clause authorizing debt and tax payments with great care. When the surviving spouse (or partner)'s expenses and death taxes could be paid from one of several trusts, the selection of one trust to bear those costs may cause deductions to be lost from the appropriate trust or burden one trust with more than its share of debts. The drafter must also coordinate the clause authorizing death tax (and other debt) payments with other will clauses for payment of expenses and taxes. See §26.32. See also Drafting California Revocable Trusts, chap 15 (4th ed Cal CEB 2003).

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.20 2. Form: Trustee May Pay Beneficiary's Death Taxes

§31.20 2. Form: Trustee May Pay Beneficiary's Death Taxes





31.20-1 Trustee may pay beneficiary's death taxes

At the death of _ _[*name of beneficiary*]**_ _, the trustee may, in the trustee's discretion, pay from that beneficiary's trust estate any death taxes _ _**[*other than any additional tax imposed by Internal Revenue Code §2032A*]**_ _ attributable to all or part of the trust estate. "Death taxes" includes all estate and inheritance taxes, generation-skipping transfer taxes, and interest and penalties on such taxes. Any trust property that would otherwise qualify for deduction with respect to federal estate tax, however, shall not be used for the payment of any death taxes.**

[*If applicable, add the following option*]

[*Option: Payment of taxes on QTIP property in spouse's estate*]

On the demand of the executor of my spouse's estate, the trustee shall distribute to the executor:

(1) The amount of any federal estate tax that the executor is entitled to recover under Internal Revenue Code §2207A in respect of property held in the trust at the time of my spouse's death; and

(2) The increase in the California estate tax and any other estate, legacy, or succession tax that results from the inclusion of the property in my spouse's gross estate under Internal Revenue Code §2044.

If there is no executor of my spouse's estate at the time for payment of this tax, the trustee may pay the tax directly to the appropriate taxing authority.

Comment: This clause may be added to the clause providing for distribution of the trust remainder. In most cases, the drafter should use the optional phrase "other than any additional tax imposed by Internal Revenue Code §2032A." See discussion in §31.19.

The drafter should use the optional addition relating to the right of recovery under IRC §2207A whenever qualified terminable interest (QTIP) property may be included in the surviving spouse's gross estate for death tax purposes.

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B. Beneficiary's Last-Illness and Funeral Expenses

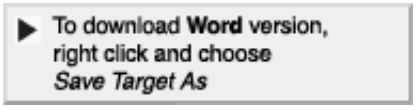
§31.21 1. Permitting Beneficiary Expense Payments

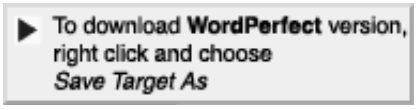
Uncertainty over the trustee's power to pay a deceased beneficiary's last-illness and funeral expenses has led to litigation in cases involving trusts for the beneficiary's support. See 2 Scott & Ascher on Trusts §13.2.4 (5th ed 2006). If the testator wants the trustee to have this power, the drafter should include a clause clearly giving it to the trustee. For further discussion and a general clause, see §§22.27-22.28. Form 31.22-1 permits payment of expenses incurred for a deceased surviving spouse or partner.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.22 2. Form: Trustee May Pay Spouse or Partner's Last-Illness and Funeral Expenses and Obligations Incurred for Support

§31.22 2. Form: Trustee May Pay Spouse or Partner's Last-Illness and Funeral Expenses and Obligations Incurred for Support





31.22-1 Trustee may pay spouse or partner's last-illness and funeral expenses and obligations incurred for support

***Payment of Expenses and Obligations*. At the death of my _ _[*spouse/partner*]_ _, if _ _[*he/she*]_ _ survives me, the trustee may, in the trustee's discretion, pay the _ _[*his/her*]_ _ last-illness and funeral expenses and obligations incurred for _ _[*his/her*]_ _ support, unless other adequate provisions for those payments exist.**

Comment: See form 22.28-1 for a clause permitting payment of last-illness and funeral expenses and obligations incurred for the support of a nonspouse or nonpartner beneficiary.

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C. Authorizing Surviving Spouse or Other Beneficiary to Occupy Residence

§31.23 1. Issues Presented by Residence Occupancy

The drafting issues raised by a testator's intent that a surviving spouse or partner reside in a home contained in a testamentary trust depend on which trust holds the home and the spouse or partner's distribution rights under the trust, and whether the spouse or partner is only a beneficiary or also a trustee.

Many practitioners try to avoid having an interest in a residence pass to a bypass trust or a QTIP trust. A major reason is that a trust that is not a grantor trust taxed under IRC §671 is not eligible to claim the IRC §121 exclusion of gain on the sale of a residence.

If the residence (or the testator's interest in it) may be held in a bypass trust for the surviving spouse or partner, the trust instrument should specify that the trustee is directed to retain the residence for use by the spouse or partner. This effectively overrides the trustee's normal obligation to diversity investments under Prob C §16048. In addition, the trust should provide the spouse or partner with distribution rights that are the economic equivalent of the right to use the property without paying rent. This may be done by providing that the spouse or partner is entitled to all trust income, or by providing that the trustee is to make the residence available for use by the spouse or partner for his or her support as long as he or she wishes without regard to his or her ability to provide for his or her support from other income or assets. Such a power is limited by an ascertainable standard for support and will not constitute a general power of appointment under IRC §2041 even if the spouse or partner is the trustee. This latter approach is generally preferable inasmuch as giving the spouse or partner a mandatory income interest in a bypass trust can force distributions of property out of the estate tax exempt bypass trust to the survivor, thereby increasing the value of property taxed on the death of the survivor. On the bypass trust, see chap 20.

If the residence will pass to a QTIP trust, the trust will already (and necessarily) provide for distribution of all income to the surviving spouse, so it is only necessary to provide the direction for the trustee to retain the use of the residence by the spouse.

The transfer of real property or an interest in it to a bypass trust or QTIP trust for the spouse's occupancy should not trigger a reassessment for property tax purposes under Proposition 13. Revenue and Taxation Code §63(a) exempts "[t]ransfers to a trustee for the beneficial use of a spouse, or the surviving spouse of a deceased transferor." See chap 20 on bypass trusts.

Occupancy of trust real property by the surviving spouse or a nonspouse beneficiary raises trust taxability issues. In *Commissioner v Plant* (2d Cir 1935) 76 F2d 8, acq 1976-2 Cum Bull 2, the court held that when a beneficiary is given the right to occupy real property held in trust and the trustee is obligated to maintain the property and pay taxes on it, trust income used for the expenditures does not constitute taxable income to the beneficiary (who was, in *Plant,* otherwise entitled to all the trust income) but is taxed to the trust. But see *Alfred I. duPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332, which contains dictum indicating that the tax court is uncomfortable with the decision in *Plant*.

Although the trust should be able to deduct property taxes, maintenance costs may not be deductible. See *Alfred I. duPont Testamentary Trust* (1974) 62 TC 36, aff'd (5th Cir 1975) 514 F2d 917, in which the tax court held that maintenance expenses were not deductible under IRC §212, because the residence was not held for the production of income. (On remand, the tax court held that the trust was also unable to deduct the maintenance expenses as a distribution to the surviving spouse as trust beneficiary under IRC §651 or §661. See *Alfred I. duPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332.) As a practical matter, there is no indication that the IRS remains interested in this issue and the revenue implications are nominal.

Although it should not be necessary, including form 31.24A-1 may be useful to establish that a residence held in a trust for a beneficiary's use is a "qualified residence" (*i.e.,* the beneficiary's principal residence). This clause will ensure the deductibility of interest paid on the mortgage. See IRC §§163(h)(4)(A), (D).

PITFALL: Form 31.24A-1 permits the trustee to determine which, if any, beneficiaries may occupy real property held in

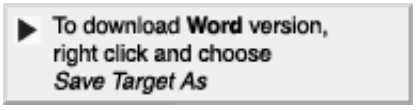
the trust. If the drafter uses this clause, and the trustee is also a trust beneficiary or has a dependent who is a beneficiary, the drafting attorney must limit the trustee's powers to ensure that the trustee does not have a general power of appointment over the trust property. See §28.8; chap 16. A boilerplate prohibition against a trustee making distributions that discharge the trustee's own support obligations should suffice. If California law applies, the prohibition is provided by Prob C §16082.

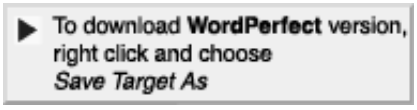
On providing for a residence for the testator's children, see §§22.31-22.33.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.24 2. Form: Surviving Spouse or Partner May Occupy Residence

§31.24 2. Form: Surviving Spouse or Partner May Occupy Residence





31.24-1 Surviving spouse or partner may occupy residence

As long as my _ _[*spouse/partner*]_ _ wishes and is able to benefit from the use of a residence, the trustee shall provide for the support of my _ _[*spouse/partner*]_ _ by owning and maintaining a residence, or a fractional interest in a residence of my _ _[*spouse/partner*]_ _'s choice, for use by my _ _[*spouse/partner*]_ _. The portion of the trust estate to be used for this purpose shall be determined by my _ _[*spouse/partner*]_ _. This support shall be provided without regard to other income and assets available for these purposes. At the request of my _ _[*spouse/partner*]_ _ the trustee shall sell the residence and acquire a different residence.

Comment: Form 31.24-1 may be used with a qualified terminable interest property (QTIP) trust for a spouse. See §31.23.

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§31.24A 3. Form: Power to Permit Life Beneficiary to Occupy Real Property

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31.24A-1 Power to permit life beneficiary to occupy real property

The trustee may, in the trustee's sole discretion, permit any person having an interest in the income of the trust to occupy any real property forming a part of the trust estate on terms that the trustee considers proper, whether rent free, in consideration of payment of taxes, insurance, maintenance, and ordinary repairs, or otherwise.

Comment: Form 31.24A-1 is designed to permit lifetime beneficiaries (the testator's children or others) with an income interest to occupy trust real property. See §31.23. It gives the trustee the power to choose the occupants of the property. The drafter should use this clause with caution because the full discretion it gives the trustee may create a power of appointment if the trustee or a dependent of the trustee is one of the beneficiaries. See chap 16. The concept that the discretion may create a power of appointment will not be a problem if the property is only a residential dwelling and can only be provided for use as a residence, because such a right is clearly a right of support limited by an ascertainable standard for purposes of IRC §2041. For a clause specifically designed to permit the testator's children to occupy the family residence, see form 22.33-1.

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VII. TRUSTEE POWERS AFFECTING TRUST CORPUS AS A WHOLE

A. Power to Accept Additions to Trust

§31.25 1. Power to Accept Additions; Tax Consequences

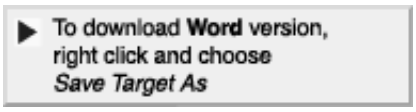
Probate Code §16221 provides that the trustee has the power to accept additions to the trust. In case the trust is administered outside California, however, the drafter should include a clause explicitly authorizing the trustee's acceptance of additions. For a form of power to accept additions, see §31.26.

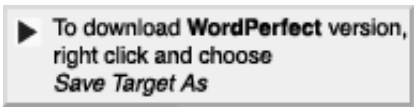
A gift to a testamentary trust raises special tax issues. The donor should be aware that the person adding the property may become the settlor for purposes of income, estate, and generation-skipping taxes, to the extent of the addition to the trust. See IRC §§671-677, 2035-2038; *State St. Trust Co. v U.S.* (1st Cir 1959) 263 F2d 635. See chap 15 on the generation-skipping transfer tax. The addition of property to a testamentary trust will constitute a gift; the donor must file appropriate gift tax returns. If the donor is a beneficiary of the testamentary trust, the transfer of property to the trust may be subject to tax in the donor's estate at the donor's death as a gift with a retained interest. IRC §2036; Treas Reg §20.2036-1(c); Prop Treas Reg §26.2632-1(c). Because of these tax considerations, gifts to testamentary trusts are generally not advisable.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.26 2. Form: Additions to Trust Authorized

§31.26 2. Form: Additions to Trust Authorized





31.26-1 Additions to trust authorized

***Additions to Trust Authorized*. With the trustee's written consent, additional property may be added at any time from any source to any trust held under my will.**

Comment: The phrase "with the trustee's written consent" should be deleted if the testator does not wish to require trustee consent to additions to the trust. The trustee has the option to resign if the trustee does not wish to administer the additional property. See §28.18.

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§31.27 B. Combined Administration of Trusts

See §§30.5-30.7 on trustee powers to manage without segregation (1) the assets of multiple trusts created under the will and (2) the assets of trusts created under the will with the assets of trusts created by another instrument.

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C. Small Trust Termination

§31.28 1. Trustee Powers to Terminate Trust

Probate Code §15408 permits a trustee to petition the court for an order to terminate a small trust that is uneconomical to administer. Under Prob C §15408(a)(2), the standard for determining whether a trust may be terminated is whether the fair market value of the corpus

> 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.

The trustee may also seek court permission to modify the terms of the trust. Prob C §15408(a)(2).

Probate Code §15408(b) provides that, without any determination of whether the standard described in Prob C §15408(a) is met and without court permission, a trustee can terminate the trust if the corpus has a value of $20,000 or less.

Form 31.29-1 gives the trustee the power to terminate the trust when the principal is a set amount or less, or whenever the trustee determines that the trust is uneconomical to administer. Form 31.29-1 describes how the assets may be distributed after trust termination. These clauses may be useful if the trust is administered outside California and the statutory remedy provided in Prob C §15408 is not available. They also alert the trustee to the possibility of terminating a trust when the corpus becomes too small for efficient administration.

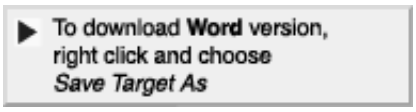
The list in form 31.29-1 of acceptable means to distribute the assets is important. Probate Code §15410 offers rules for distribution if the trust instrument is unclear, but the rules address the issue of proportions distributable to the various beneficiaries—not the facility to be used for payment.

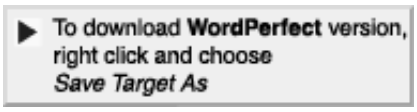
PITFALL: If the trustee might use the power granted in form 31.29-1 to terminate a qualified terminable interest property (QTIP) trust, the drafter must ensure that the trustee is directed to distribute the QTIP trust property to the surviving spouse. Otherwise, the property may not qualify for the marital deduction. See chap 17 on requisites for the marital deduction.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.29 2. Form: Small Trust Termination

§31.29 2. Form: Small Trust Termination





31.29-1 Small trust termination

***Small Trust Termination*. If the trustee determines, in the trustee's discretion, that the principal of any trust is uneconomical to administer,**

[*If applicable, add the following option*]

[*Option: Termination only when principal below specified amount*]

and the trustee determines that the principal of the trust is worth less than _ _[*dollar amount*]**_ _,**

[*Continue*]

the trustee shall:

(1) Distribute the trust assets to the beneficiaries in proportion to their interests in income; or

(2) Distribute the trust assets as provided in an order issued by a court of competent jurisdiction.

On the distribution and delivery, the trust shall terminate. The trustee shall not be liable or responsible to any person for its actions terminating the trust, nor for its failure or refusal at any time to terminate the trust as authorized in this paragraph.

Comment: See discussion in §31.28.

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VIII. CONTINUATION OF TRUSTEE POWERS AFTER TRUST TERMINATION

§31.30 A. Trustee Powers Must Continue Until Trust Business Is Wound Up

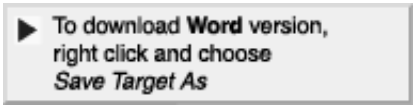
The powers of a trustee ordinarily continue until the affairs of the trust have been completely wound up. 5 Scott & Ascher on Trusts §36.1 (5th ed 2008). Form 31.31-1, however, gives the trustee express authority to act after the event triggering termination of the trust has occurred, to eliminate any possible doubt about the trustee's authority.

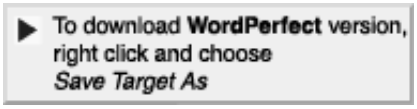
For discussion of powers while the trustee winds up administration of the trust, see *Estate of Nicholas* (1986) 177 CA3d 1071, 1082, 223 CR 410. See Treas Reg §1.641(b)-3(b), under which a trust is considered terminated for federal income tax purposes after the expiration of a "reasonable period" for the trustee to complete the trust administration.

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.31 B. Form: Trustee Powers Continue Until Trust Distribution

§31.31 B. Form: Trustee Powers Continue Until Trust Distribution





31.31-1 Trustee powers continue until trust distribution

***Powers Continue Until Distribution of Trust Property*. All powers, duties, and immunities of the trustee shall continue after termination of any trust created under my will for a reasonable period until actual distribution of the trust property.**

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IX. RULES OF CONSTRUCTION

§31.32 A. Trustee Powers Exercised in Fiduciary Capacity; Choice of Law

Will clauses can be used to provide rules of construction. By describing how trustee powers must be exercised, these rules can provide the trustee with additional direction and prevent disputes over how the trust should be administered. Following are several commonly used rules of construction:

- *A clause stating that the trustee's powers must be exercised in a fiduciary capacity*. Such a clause is designed to counter any argument by taxing authorities that a trustee's administrative powers are equivalent to a general power of appointment. See form 31.33-1, which is based in part on Treas Reg §20.2041-1(b)(1).
- *A clause identifying which jurisdiction's law will apply to interpretation of the trust provisions*. Questions about which state's law will apply to the trust can be avoided if the drafter specifies the law that governs. A court will probably honor such a provision if (1) the jurisdiction whose laws will govern the trust has some contact with it (*e.g.,* trust property is located there), and (2) application of the law will not violate public policy. See form 31.34-1.

NOTE: A choice-of-law clause that addresses issues other than construction may not be honored regarding administration of real property located outside California, because the law of the situs generally rules real property in trust. See CC §755. With respect to matters of construction, virtually all jurisdictions follow the "intent of the testator" rule and will concede that testator intent is best ascertained by honoring the choice-of-law clause if there is one.

Because one or more trusts established under a will might be more conveniently administered in another state in the future, the drafter should consider using Alternative 1 or the optional addition to Alternative 2 in form 31.34-1. Corporate fiduciaries often will only accept trusts governed by the law of state where they do business, because it is easy to make mistakes administering a trust governed by the law of another state. Likewise, an attorney in another state is likely to counsel a client not to accept trusteeship of a trust governed by state law with which the attorney is unfamiliar.

See Drafting California Revocable Trusts, chap 23 (4th ed Cal CEB 2003) for full discussion of choice-of-law issues. See also 5A Scott & Fratcher, The Law of Trusts §§553-666 (4th ed 1989).

- *A statement specifying whether the law that governs the will must be the law in effect when (1) the will is executed, (2) the testator dies, or (3) the will is being interpreted (i.e., the law including new statutory and decisional law).* On the one hand, selecting the law in effect when the testator dies (or when the will is executed) minimizes uncertainty about the interpretation of will provisions. On the other hand, providing that later changes in the law will determine how the will is interpreted makes administering the will easier for the fiduciary. He or she can apply current law and need not research the law as it existed before the will is probated and the trust goes into effect. See form 31.34-1.

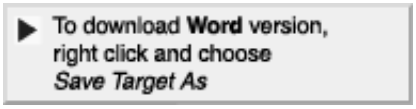
The will clauses suggested in §§31.31, 31.33, and 31.34 are usually included in one paragraph toward the end of the trust, along with many other miscellaneous clauses explaining the meaning of, *e.g.,* (1) references to gender, number, numbered articles, and statutes; and (2) definitions such as "issue" and "spouse" or "partner." For suggested clauses, see chap 35 and the sample trusts in Drafting California Revocable Trusts (4th ed Cal CEB 2003) and Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

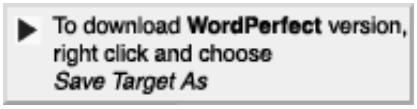
Three of the clauses generally found in the concluding paragraphs of testamentary trusts are thoroughly discussed in chaps 20 (clause governing beneficiary's disclaimer of gifts), 27 ("spendthrift" clause), and 34 (rule against perpetuities saving clause).

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.33 B. Form: All Powers Exercisable Solely in Fiduciary Capacity

§31.33 B. Form: All Powers Exercisable Solely in Fiduciary Capacity





31.33-1 All powers exercisable solely in fiduciary capacity

***Powers Exercisable Solely in Fiduciary Capacity*. The trustee shall exercise all powers in the trustee's fiduciary capacity. The trustee shall have no power under any provision of my will to enlarge or shift any of the beneficial interests under any trust created under my will except as an incidental consequence of the discharge of the trustee's fiduciary duties.**

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Source: Estate Planning/California Will Drafting/31 Trustee Administrative Powers/§31.34 C. Form: Choice-of-Law Clause

§31.34 C. Form: Choice-of-Law Clause

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

31.34-1 Choice of law

[*Add one of the following alternatives*]

[*Alternative 1: California law governs construction of trust*]

Any trust created under my will shall be construed in accordance with the laws of the State of California.

[*Alternative 2: California law governs construction and administration of trust*]

The laws of the State of California in force _ _[*when I execute my will/on the date of my death/from time to time*]**_ _ shall govern the validity, construction, interpretation, and administration of any trust created under my will.**

[*If applicable, add the following option*]

[*Option: When trust may be administered in another state*]

If, however, any trust under my will is administered outside California, a court with jurisdiction over the trustee of the trust may, after determining that the change of governing law will not affect the administration or taxation of the trust in a way adverse to the interests of the beneficiaries of that trust, order that the law of that state governs the trust.

Comment: It may be undesirable to provide that California law will govern administration of the trust, as provided by Alternative 2 without the optional addition, because a future trustee may decide that the trust should be relocated to another jurisdiction, and the administration of the trust will be governed by California law in any event if the trust is administered in California.

Alternative 1 is based on the choice-of-law provision in Drafting California Revocable Trusts §18.10 (4th ed Cal CEB 2003).

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32

Selection of Executor

Judith M. Copeland

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I. QUALIFICATIONS FOR AND NOMINATION OF EXECUTOR

§32.1 A. Definition and Appointment of "Executor"

An executor is a person nominated in a will to be appointed by the court to administer the estate at the testator's death. Thus, the executor is properly described as the "executor of the will of" the decedent or the "executor under the will of" the decedent (sometimes abbreviated as "executor u/w/o") rather than as the "executor of the estate of" the decedent. The term "executor" is included within the term "personal representative." Prob C §58.

For federal estate tax purposes, "executor" includes any person who has control or possession of the decedent's property. IRC §2203. If a person other than the probate executor is an executor for tax purposes (*e.g.,* the trustee of a revocable trust), the drafter may wish to clarify in the will which "executor" is empowered to make tax elections.

This chapter focuses on the criteria for selecting executors, drafting executor nomination clauses, and the standards for executor conduct and liabilities incurred when executors fail to meet those standards. Chapter 33 discusses the powers and duties of the executor.

For detailed discussion of the procedural aspects of estate administration by the executor, see California Decedent Estate Practice (2d ed Cal CEB 2009). On the executor's role in estate planning, see California Estate Planning (Cal CEB 2002).

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§32.2 B. Statutory Qualifications for Executor

A person nominated as executor in a will has the right to appointment unless he or she lacks the minimal qualifications required by statute. Prob C §§8402(a), 8420. Chief among these are majority and the physical and mental capacity to perform his or her duties; the nominee must not be "incapable" or "otherwise unfit" to serve. Prob C §8402(a)(1)-(2). Further, a nominee is disqualified from appointment if grounds would exist for his or her removal under Prob C §8502 were he or she already serving as executor. Prob C §8402(a)(3). Grounds for removal under Prob C §8502 include the executor's actual or imminent waste, embezzlement, mismanagement of the estate, or fraud on the estate; incapacity; and neglect of the estate. In addition, the executor may be removed if his or her removal is "necessary for protection of the estate or interested persons." Prob C §8502(d).

The grounds for executor disqualification enumerated in Prob C §8402 are substantially different from those listed in that section's predecessor, former Prob C §401, repealed operative July 1, 1989. Former Prob C §401 disqualified a nominee who was a minor, "convicted of an infamous crime," or judged by a court to be "incompetent" to serve "by reason of drunkenness, improvidence, or want of understanding or integrity." The grounds for disqualification were exclusive and were strictly construed. See *Estate of Backer* (1985) 164 CA3d 1159, 211 CR 163; *Estate of Shimun* (1977) 67 CA3d 436, 136 CR 668.

The additional grounds for disqualification incorporated by the reference to Prob C §8502 in Prob C §8402(a)(3) provide more grounds for challenging a nominated executor. Nevertheless, because successful contests to a testator's nominees are rare, careful selection of the nominees is crucial to proper estate management.

The executor need not be related to the testator or be a beneficiary under the will. Residence in California or the United States is not a condition of appointment. See Prob C §8402(a)(4), (b). Although an executor who moves out of state during estate administration may continue to serve, local rule or practice may require a nonresident nominee to obtain a bond even if the will waives such a bond. A nonresident of the United States may be unable to obtain a bond, which will effectively preclude his or her appointment as executor. County probate rules should be consulted.

A judge may be named executor of a will but may not preside in any proceeding relating to the will. See Prob C §7060.

A California corporation or association authorized to conduct the business of a trust company may be named and appointed as executor. Prob C §§83, 300. No foreign corporation, however, may qualify as executor except a national banking association authorized to conduct a trust business in California. Fin C §§1502-1503. If a trust company nominated as executor is succeeded by another trust company qualified to act, the court may authorize its successor to serve. Prob C §8423. If there is a merger or consolidation of a bank or trust company while it is serving as executor, the successor is considered to be a continuation of the corporate executor and succeeds to the powers of the named executor without further probate court approval. *Estate of Barreiro* (1932) 125 CA 153, 167, 13 P2d 1017.

If the testator owns property requiring administration outside California (*e.g.,* real property), he or she may wish to nominate an executor for the ancillary probate. In that case, the drafter should consult the law of the foreign jurisdiction to determine its qualifications for executors. On ancillary proceedings, see California Decedent Estate Practice, chap 11 (2d ed Cal CEB 2009). Alternatively, the testator may authorize an individual under Prob C §8422 to nominate an ancillary executor if necessary. See §32.6.

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C. Selecting Executor

§32.3 1. Selection Criteria

The position of executor involves substantial responsibilities and potential liabilities. See, *e.g.,* §§32.21-32.26. Although an executor usually employs an attorney to assist in gathering the estate assets, paying the decedent's obligations, and distributing the assets according to the testamentary plan, the executor is responsible for the proper administration of the estate. The executor's conduct determines the efficiency, integrity, and intelligence with which the estate administration proceeds. Therefore, the attorney and testator should thoroughly discuss potential nominees.

Among those a testator will consider for executor are a spouse or partner or other family member, friend, business associate, and (for a large estate) corporate fiduciary. During the selection process, the testator should consider (1) the value, nature, and location of estate assets; (2) whether the estate administration will be complex; and (3) family and business relationships.

The attorney can assist the testator in a dispassionate review of potential nominees to determine which have the necessary qualities and skills of an executor. In addition to being personally reliable and pragmatic, the nominee should have the capacity and temperament to:

- Cope physically and emotionally with the tasks of estate administration.
- Work with professionals such as attorneys, tax preparers, and investment counsel.
- Deal constructively with beneficiaries and family members. If there are intrafamily conflicts, certain nominees may not be appropriate.
- Maintain clear records of estate transactions, manage estate assets, or supervise others in doing so.

The attorney should discourage the testator from nominating someone merely because the nominee is likely to waive commissions. Conditioning nomination on a waiver of commissions will not be effective; the executor will still be able to take statutory commissions. See §32.19.

The attorney must point out to the testator potential conflicts of interest presented by certain nominations. For example, a surviving partner may be responsible both to wind up the business of the partnership and to account to the executor, or to exercise a buy-sell agreement between the surviving partner and the estate. If the nominee's interests are in potential conflict with those of the estate, the conflict should be acknowledged in the nomination paragraph to discourage a contest to the appointment.

It is good practice to coordinate the nomination of the executor with the selection of the trustee of the testator's revocable trust, if any. See Drafting California Revocable Trusts §§5.7-5.18 (4th ed Cal CEB 2003).

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§32.4 2. Corporate Fiduciaries

A corporate executor may be better equipped than any available individual to handle investment and record-keeping problems. The expertise of its corporate staff may eliminate the need to hire separate tax preparers, appraisers, or investment advisers (although the corporate executor usually will request extraordinary fees for some of these services, *e.g.,* tax work). Corporate fiduciaries, however, require that the estates they serve be over a minimum size. Therefore, they are not available to administer even some fairly large estates. When the size of the estate precludes a corporate fiduciary from serving as executor, the attorney may suggest that the testator select a private professional fiduciary. Private professional fiduciaries are individuals experienced in serving as personal representatives. They can often provide more personal service than that offered by a corporate fiduciary.

Because fees and commissions are set by statute, use of a corporate or private fiduciary does not ordinarily expose the estate to more expense than use of an individual. Although the professional executor will be more likely to request extraordinary fees, the savings that result from the professional's efficiency and experience often offset the extraordinary fees.

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§32.5 3. Nominating Coexecutors

A testator may name two or more persons to serve as coexecutors. Nomination of coexecutors may encourage more considered judgments and provide combined sources of information and skills. For example, nomination of a family member as coexecutor along with an institutional fiduciary combines both the family member's familiarity with the assets and the institutional executor's experience and expertise in estate administration.

There are disadvantages to multiple executors, however. When there are two coexecutors, both must concur to exercise a power; if there are three or more coexecutors, the concurrence of a majority is required. Prob C §9630. Consequently, multiple decisionmakers usually make administration less efficient. Disagreements can lead to stalemates that may damage the estate (*e.g.,* when tax elections are required). Additionally, a corporate fiduciary may decline to act as coexecutor with an individual.

If a named coexecutor is disqualified from serving, the court may appoint other named executors to administer the estate. If the ground for disqualification is the nominee's minority, the individual may petition for appointment on attaining majority. Prob C §8424(a). When the court appoints fewer than all nominated coexecutors, those actually appointed have the same authority as all would have had if they had been appointed. Prob C §8425.

When joint personal representatives have been appointed and one or more are unable to act (because of, *e.g.,* absence, legal disqualification), the remaining coexecutors may need to seek a court order under Prob C §9630(c) authorizing action without the absent representative.

The appointment of multiple executors does not increase the total statutory compensation payable, because the commissions allowed are apportioned among those serving. Prob C §10805.

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§32.6 4. Delegating Authority to Nominate

Under Prob C §8422, the testator may give one or more persons the power to designate an initial or successor executor or coexecutor. The designation must be made in a writing filed with the court. Prob C §8422(b). If more than one person is given the designation power, they must unanimously agree on a nominee unless the will provides otherwise. If any of the designators is unable or unwilling to act, the unanimous agreement of the remaining designators is necessary for the designation to be effective. Prob C §8422(b).

This power enables the testator to give a nominated executor the power to nominate a coexecutor or to give to a nominated executor or coexecutor the power to nominate a successor. Lacking express authority in the will, an executor does not have these powers. Prob C §8422(c). Also, if an ancillary probate is likely to be required for out-of-state property, the primary executor can be directed to designate an ancillary executor to administer the property. To ensure that the designation will be effective, however, the attorney should first consult the law of the foreign jurisdiction.

The broad language of Prob C §8422 permits the testator to give the power to nominate an executor, coexecutor, or successor to a third party who has not been named as executor. For example, the will could instruct a family member to choose a corporate fiduciary to serve as successor executor if the original executor is unable to serve.

The will may describe a group from whom nominees must be selected, such as family members or qualified professional fiduciaries. A testator can require, *e.g.,* that the designator select one family member and one private professional fiduciary to serve as coexecutors.

Delegating the power to nominate the executor provides flexibility in determining who will administer the estate. The designator can take into account a switch of banking affiliations, a change of residence, and other factors subject to change in making his or her selection. Further, this approach permits selection of the individual or institution most likely to be responsive to the needs of the surviving spouse or partner during the period after the testator's death. For example, the decedent's spouse might be nominated as executor, with the power to name another individual or a corporate fiduciary as coexecutor.

See form 32.13-1 (naming persons to designate the executor).

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.7 D. Contacting Nominated Executor

§32.7 D. Contacting Nominated Executor

To be reasonably sure that an individual nominee will serve as executor when the testator dies, the testator should discuss the matter with the candidate, explaining the time and responsibilities that the position will entail. It is just as important for the testator to consult a proposed corporate fiduciary. The testator should ascertain whether the size of the estate will be acceptable to the corporate fiduciary and whether the fiduciary may decline appointment for any other reason (*e.g.,* because the estate assets include an ongoing business requiring active participation).

Consultation is particularly important when the nominee is the sole nominee or the last alternate nominee. If that nominee declines to serve as executor, court appointment of an administrator with the will annexed will be necessary.

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E. Attorney as Executor

§32.8 1. Ethical and Practical Issues for Attorney

An attorney who is familiar with a testator's family and financial situation often appears to the testator to be an ideal choice for executor. Nomination of the drafting attorney as executor, however, presents special ethical and practical issues.

Because an appointment as executor can lead to substantial financial benefit for the drafting attorney, it may come within the purview of the California Rules of Professional Conduct.

Under these rules, a client's informed written consent is required for an attorney to "acquire … [a] pecuniary interest adverse to a client" (Cal Rules of Prof Cond 3-300) or to continue representation if the attorney "has an interest in … [the] subject matter" of the representation (Cal Rules of Prof Cond 3-310). In addition, an attorney may not induce a client to "make a substantial gift" to the attorney. Cal Rules of Prof Cond 4-400. See §1.35 on limitations on transfers to drafters.

If challenged, nomination of the drafter as executor will be closely scrutinized for undue influence by the attorney. On the attorney's duty to the testator and the close review of circumstances resulting in a legacy to the will drafter, see *Magee v State Bar* (1962) 58 C2d 423, 24 CR 839. On the impropriety of routine nomination of the drafter in clients' wills, see *State v Gulbankian* (Wis 1972) 196 NW2d 733.

Before accepting a nomination as executor, the drafter should first determine that the nomination is clearly in the testator's best interests. The roles of fiduciary's counsel and fiduciary are very different; experience as an attorney for executors does not ensure the attorney's reliable performance as executor. The attorney should be certain that no other able and willing candidate is better suited to administer the estate.

The drafter may wish to obtain a written statement from the testator that the attorney was specifically requested to accept the nomination as executor. In some cases it may be advisable to require that independent counsel (a) review any will in which the drafter is nominated as executor and (b) interview the testator to obtain evidence of capacity, independent judgment, and intent.

Note that the attorney will be held to an attorney standard of conduct while serving as executor, even though that role can be filled by a lay person. *Layton v State Bar* (1990) 50 C3d 889, 904, 268 CR 845, 853 (attorney-executor); *Libarian v State Bar* (1943) 21 C2d 862, 865, 136 P2d 321 (attorney must conform to professional standards regardless of capacity in which he or she serves). See also California Decedent Estate Practice, chap 29 (2d ed Cal CEB 2009). Before agreeing to serve as executor, the attorney should determine whether his or her professional errors and omissions insurance covers performance as a fiduciary. The attorney should also consult with law partners, who may be concerned about sharing liability with an attorney-executor.

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§32.9 2. Specific Will Clause Required for Dual Compensation

The testator may expect that the attorney who is nominated as executor will also serve as his or her own attorney when administering the estate. If that is not the attorney's intention, he or she should inform the testator. Many attorneys prefer not to serve in both capacities. In any event, a will provision denying the executor the power to retain counsel at the estate's expense will probably not be effective in light of the provisions for attorney compensation in Prob C §§10810-10811. Nor will the executor be bound by any direction in the will to retain a specific attorney. *Highfield v Bozio* (1922) 188 C 727, 207 P 242.

Regardless of any provision in the will, an attorney who serves as an executor may only receive compensation for services performed as executor. If the attorney provides legal services for the personal representative as well, he or she may also receive compensation for these services, but only if the court so approves in advance and finds that the fee arrangement serves the best interests of the decedent's estate. Prob C §10804.

Probate Code §10804 does not affect the common practice of an attorney/executor retaining the attorney's law firm to be the attorney for the estate under an agreement providing that the attorney/executor will not share in the firm's fee for services to the estate.

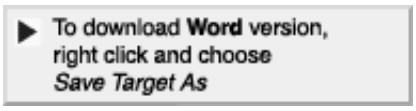
For general discussion of compensation issues, see §§32.19-32.20. See form 32.14-1 on nominating an attorney as executor.

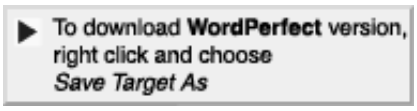
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Source: Estate Planning/California Will Drafting/32 Selection of Executor/ F. Executor Nomination Clauses/§32.10 1. Form: Individuals Nominated as Executor and Alternate or Successor Executors

F. Executor Nomination Clauses

§32.10 1. Form: Individuals Nominated as Executor and Alternate or Successor Executors





32.10-1 Nomination of executor and alternate or successor executors

***Nomination of Executor*. I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:**

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

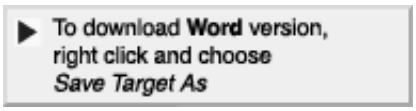
Comment: The will should specify the nominee's full legal name and the version of this name that the nominee uses (*e.g.,* "Allan Baker Doe, also known as A. Baker Doe"). This makes it possible to use the executor's commonly used name in the petition for probate and order for probate, eliminating the need for the executor to sign an unfamiliar version of his or her name during administration of the estate.

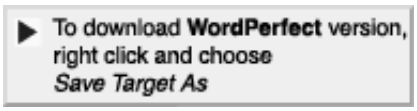
Although the law does not require that the nominee's address be included in the will, it is good practice to provide the town and state of the nominee's residence. As further identification of the nominee, the testator should indicate any relationship of the nominee to the testator, *e.g.,* "My sister _ _[*name*]_ _"

The testator should name (a) at least one additional person or institution to serve as alternate executor if the primary nominee fails to qualify for appointment and (b) a candidate for appointment as successor executor if the serving executor leaves office due to death, resignation, or removal. The same nominee is usually nominated to serve as either alternate or successor executor. See form 32.10-1. The designation of an alternate or successor executor must be clearly distinguished from the naming of coexecutors. See form 32.11-1 (nominating coexecutors); form 32.13-1 (appointing third person to nominate successor executor). See also form 32.12-1 (nominating corporate fiduciaries). The drafter can amend these forms to provide for more alternate or successor executors.

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§32.11 2. Form: Nomination of Coexecutors





32.11-1 Nomination of coexecutors

[*Add one of the following alternatives*]

[*Alternative 1: If one cannot serve, remaining nominee serves*]

***Nomination of Executors*. I nominate the persons listed below, in the order and priority indicated, to serve as coexecutors of my will:**

First: _ _[*Name of coexecutor nominee*]_ _
Second: _ _[*Name of coexecutor nominee*]_ _

If either of these nominees fails to qualify or ceases to act as executor, I nominate the following person to serve as sole executor: _ _[*Name of successor executor nominee*]_ _.

[*Alternative 2: If one cannot serve, new coexecutor succeeds*]

***Nomination of Executors*. I nominate the persons listed below, in the order and priority indicated, to serve as coexecutors of my will:**

First: _ _[*Name of coexecutor nominee*]_ _
Second: _ _[*Name of coexecutor nominee*]_ _

If either of these nominees fails to qualify or ceases to act as executor, I nominate the persons listed below to serve as successor coexecutors in the order and priority indicated. If only one of my nominees qualifies and is able to act, then that remaining nominee will serve as sole executor.

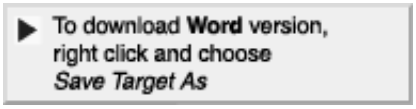
First: _ _[*Name of successor coexecutor nominee*]_ _
Second: _ _[*Name of successor coexecutor nominee*]_ _

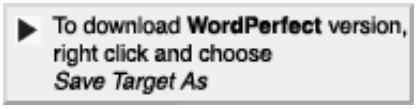
Comment: This clause provides for the appointment of multiple executors and for the replacement of nominees who fail to qualify or cease to act. The alternatives provide the options of allowing the remaining executor to serve alone or of requiring the substitution of another nominee as a coexecutor or as a sole executor if both primary nominees fail to qualify or cease to act.

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.12 3. Form: Nomination of Corporate or Private Professional Fiduciary

§32.12 3. Form: Nomination of Corporate or Private Professional Fiduciary





32.12-1 Nomination of professional fiduciary

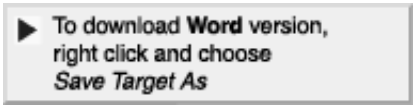
***Nomination of Executor*. I nominate the following _ _[*corporate/private professional*]_ _ fiduciary, or its successors and assigns, as executor of my will: _ _[*Name of corporate or private professional fiduciary, city where located*]_ _.**

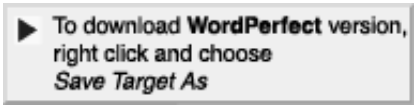
Comment: The drafter should use the fiduciary's full corporate name and specifically designate its location. If the testator does not want to include its successors and assigns in the nomination, a successor executor should be named. On corporate and private professional executors, see §32.4.

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.13 4. Form: Delegation of Authority to Designate Executor

§32.13 4. Form: Delegation of Authority to Designate Executor





32.13-1 Delegation of executor nomination

[*Add one of the following alternatives*]

[*Alternative 1: Power to designate executor*]

***Nomination of Executor*. I confer on the following person the power to designate the _ _[*position*]_ _ of my will: _ _[*Name*]_ _.**

[*Alternative 2: Backup executor designation*]

***Nomination of Executor*. I nominate as _ _[*position*]_ _ any trust company or private professional fiduciary designated by the following person: _ _[*Name*]_ _.**

Comment: The drafter can use Alternative 1 to give to a third party the power to select a sole executor or to give to the nominated executor or a third party the right to name one or more coexecutors or a successor or ancillary executor. The drafter can limit the conditions for the power's exercise by adding a prerequisite condition. For instance, the power to select an alternate executor can be limited by the following condition: "If none of the named executors nominated in my will can serve,...."

Exercise of the power can be required or permissive. For example, a named executor can be permitted, but not required, to designate a coexecutor. The drafter can also amend the clause by adding categories from which the designator may or must select the executor, *e.g.,* "The _ _[*executor/third party designator*]_ _ may exercise this power in favor of another individual or a qualifying bank or trust company," or "The _ _[*executor/third party designator*]_ _ must exercise this power in favor of one of the following named persons:...."

Alternative 1 is a "backstop" clause that provides a professional fiduciary successor when nominated individuals are unavailable to serve or there is unanticipated need for an executor (*e.g.,* when an ancillary probate is required).

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.14 5. Form: Nomination of Attorney as Executor

§32.14 5. Form: Nomination of Attorney as Executor

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

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

32.14-1 Nomination of attorney as executor

***Nomination of Executor*. I nominate the following attorney as executor of my will: _ _**[*Name*]**_ _.**

[*If applicable, add the following option*]

[*Option: Attorney may receive dual compensation*]

While serving as executor, my attorney may serve as _ _[*his/her*]**_ _ own attorney and may receive both executor's commissions and attorney fees in compensation.**

Comment: Even if the will contains the optional addition, the attorney who serves as his or her own counsel cannot receive compensation for serving as both executor and executor's attorney unless preauthorization is received from the court. See §32.9.

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6. Definition of "Executor"

§32.15 a. Effect of Clause Defining "Executor" to Include All Personal Representatives

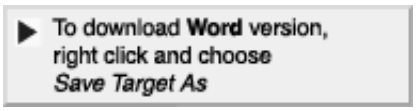
The term "personal representative" includes not only the executor but also an administrator with the will annexed and a special administrator. Prob C §58. Drafters frequently include a clause stating that the term "executor" includes other kinds of personal representatives. See form 32.16-1. This clause makes all will clauses that refer generically to "the executor" apply to other personal representatives. As a result, if (1) an ancillary executor must be appointed, (2) a special administrator must be appointed before appointment of an executor, or (3) an administrator with the will annexed must serve because none of the named executors can or will serve, each of those persons will have all the duties, powers, and discretions intended for the originally nominated executor.

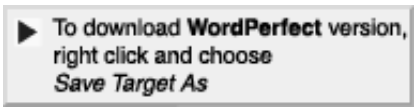
Such a clause should not be used, however, if the testator wants to reserve any powers or discretions to named candidates for executor (*e.g.,* the right to be appointed without posting bond, power of sale). See chap 33 for clauses giving powers to executors.

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.16 b. Form: Definition of 'Executor'

§32.16 b. Form: Definition of "Executor"





32.16-1 Definition of "executor"

The term "executor" includes any personal representative of my estate.

Comment: To simplify references throughout the will, this clause defines "executor" to include any personal representative of the estate, whether that person is the nominated executor, an administrator with the will annexed, or a special administrator. If the testator wishes to grant powers to alternate or successor executors or to other personal representatives that differ from those provided to the primary nominee, the will should state those differences, and this clause should not be used. The clause may be added to the nomination clauses in §§32.10-32.14.

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II. EXECUTOR'S BOND

§32.17 A. Bond Required Absent Waiver

The will can affirmatively require that a nominated executor obtain bond, or the will can waive this requirement. Absent a waiver in the will, or a written waiver by all the beneficiaries, the court will require the nominee to post bond as a condition to issuance of letters testamentary. Nominated coexecutors must obtain either individual or joint bonds, as determined by the court. Prob C §§8480, 8481(a).

Executors' bonds, which may be obtained from surety companies approved by the court, are fixed by the court at amounts based on estate inventory values, income, and sales proceeds. Prob C §8482. The bond premiums are charged to the estate, not to the individual executors. Prob C §8486. If bond is provided by personal sureties, the amount of the bond is doubled. Prob C §8482(c).

There are two exceptions to the bonding requirement. One is provided for qualified corporate fiduciaries that have funds or securities on deposit with the California State Treasurer as a guaranty of performance. Fin C §§1540-1547. Another is provided for public administrators, which act under official bond; however, estates administered by a public administrator are subject to a "bond fee," which varies with the size of the estate. Prob C §7621(d).

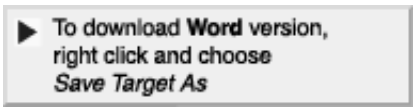
For further discussion of bonding requirements and procedures (including avoidance of bond by depositing estate funds into blocked accounts) and of the surety's liability, see California Decedent Estate Practice, chap 9 (2d ed Cal CEB 2009).

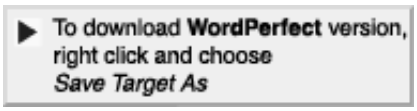
Most testators who believe that their nominated executors will handle the estate honestly and efficiently wish to avoid the expense of a bond. The drafter may include a provision in the will expressly dispensing with bond for some or all nominees. See form 32.18-1. The drafting attorney must ensure that the will does not waive bond inappropriately. If the will delegates nomination of the executor to a third party, for example, the testator may wish to retain the bonding requirement because he or she has little basis on which to judge the nominated executor's capacities. In addition, requiring bond may encourage hostile beneficiaries to accept a nominated executor.

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Source: Estate Planning/California Will Drafting/32 Selection of Executor/§32.18 B. Form: Waiving or Requiring Bond

§32.18 B. Form: Waiving or Requiring Bond





32.18-1 Alternative: General waiver of bond

[*Add one of the following alternatives*]

[*Alternative 1: Bond waived*]

I request that no bond be required of any executor nominated in my will.

[*Alternative 2: Bond required*]

I request that the Court require bond of any personal representative of my estate.

Comment: If the testator intends that there be coexecutors, the drafter might wish to refer in Alternative 1 to "any executor acting jointly or severally." If a nominee is given the power to designate an executor, "executor" can be replaced with "any executor designated under the power given in my will." See §32.6 on delegating nomination of an executor. Even if the will waives bond, the court may require bond if the proposed personal representative resides out of state or if there is other good cause. Cal Rules of Ct 7.201(b).

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III. COMPENSATION OF EXECUTOR AND EXECUTOR'S ATTORNEY

§32.19 A. Statutory Provisions for Compensation

An executor is entitled to reimbursement of expenses incurred in administering the estate as well as payment of commissions for ordinary services based on a fixed percentage of the probate estate. Prob C §§11004 (expenses), 10800 (ordinary commissions). In addition, the court may allow "just and reasonable" compensation for extraordinary services. Prob C §10801. The Cal L Rev'n Comm'n Comment to Prob C §10801 provides several examples of services that "may be considered as extraordinary," including sales or mortgages of estate property, defending the representative's account, and carrying on the decedent's business. See California Decedent Estate Practice, chap 30 (2d ed Cal CEB 2009).

The executor may not be entitled to reimbursement of litigation expenses incurred in an unsuccessful defense of a contested will. See *Estate of Higgins* (1910) 158 C 355, 111 P 8; *Estate of Miller* (1968) 259 CA2d 536, 66 CR 756. See also *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742 (attorney who represented trustee in unsuccessful defense of contested trust amendment is not entitled to have fees paid from the trust; the undue-influence contest was essentially a dispute between beneficiaries and it would be inequitable to effectively charge the prevailing party with the loser's expenses).

The will may direct different executor compensation than that provided by statute. See §32.20.

Any contract between the executor and an estate beneficiary for the executor to receive higher compensation than the statutory commission or compensation provided for in the will is void. Prob C §10803.

If there are coexecutors or successive executors, the executor's compensation must be apportioned by the court according to the services actually rendered or according to agreement among the executors. Prob C §10805. A single executor's commission also will be apportioned between a special administrator and the general personal representative. Prob C §8547(b).

Unless otherwise directed in the will, compensation of the executor's attorney for ordinary services is governed by the statutory schedule in Prob C §10810. The court may award extraordinary fees, including fees for services performed by a paralegal. Prob C §10811. However, the court cannot approve in advance an arrangement providing for variable fees that is not a contingent fee agreement within the meaning of Prob C §10811(c). For these purposes, a contingent fee is defined as a fee payable only in the event litigation is successful, and that is calculated as a percentage of the amount received, with the consequence that the estate will actually receive something after all fees and costs have been paid. See *Estate of Stevenson* (2006) 141 CA4th 1074, 46 CR3d 573 (court order approving agreement to pay variable fees for handling claims for and against insolvent estate was invalid when estate was left with negative net worth after litigation despite reduction in creditor claims and agreement of certain lenders to pay money to estate). Multiple attorneys share the statutory compensation, which is apportioned by the court according to services rendered or according to agreement among the attorneys. Prob C §10812. Any agreement between the personal representative and the attorney for higher compensation to the attorney is void. Prob C §10813. If the will provides for the attorney's compensation, however, that direction governs unless the attorney or personal representative successfully petitions the court for relief from the will provision. Prob C §10812.

On compensation issues concerning the attorney who serves as both executor and executor's attorney, see §32.9.

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§32.20 B. Testamentary Provisions for Compensation

Wills usually do not provide for executor compensation. The statutory scheme allows payment of an objectively determined amount and, on court approval, permits larger amounts when justified by the tasks that the executor performs. Prob C §§10800-10801. See §32.19 on statutory commissions. The testator may specify, however, the compensation that the executor will receive for his or her services. If the executor's compensation is specified in the will, that amount will be the executor's full compensation for all services, unless the executor successfully petitions for relief from this provision in the will. Prob C §10802. Consequently, the executor must choose between the amount provided by will and the statutory and extraordinary commissions allowable by statute.

Similarly, if the will provides for a legacy to the executor in lieu of statutory commissions, the executor must either accept the legacy as payment in full for services or renounce the legacy and accept statutory compensation. See *Estate of Van Every* (1944) 67 CA2d 164, 153 P2d 614 (attorney fees). If, however, the testator provides that the executor will serve without compensation, the executor may nevertheless elect to receive statutory commissions. *Estate of Fritz* (1933) 130 CA 725, 20 P2d 361.

When planning compensation provisions, the attorney should consider tax factors. A devise to an executor that is not conditioned on performance as executor is treated as a testamentary transfer and thus is not subject to income taxes. See *U.S. v Merriam* (1923) 263 US 179, 68 L Ed 240, 44 S Ct 69. Even though a transfer is described in the will as a devise, it will be treated as taxable compensation to the executor if it is made in exchange for executor services. *Ream v Bowers* (2d Cir 1927) 22 F2d 465.

NOTE: Executor's commissions, as part of administration expenses allowable under state law, may be taken as deductions in the calculation of federal estate taxes. IRC §2053. The attorney should draft the will provisions with an eye to permitting the amounts payable to be treated to the extent possible as deductible expenses. In *Estate of Howard Gilman,* TC Memo 2004-286, the court held that executors who were also officers of businesses owned by the estate could deduct only the compensation of those individuals and other expenses that were actually incurred for the benefit of the estate itself. The estate had attempted to deduct compensation of the executor for management services related to assets transferred by the estate to a limited liability company. The court noted that the will provided that the executor was not to receive commissions or other fees for acting as executor and that he was to continue to be compensated by the businesses for services rendered as he had been before the testator died. However, the court also stated that "[u]sing executors to run a commercial enterprise does not convert expenses of the enterprise to estate expenses."

For further discussion of waiver of compensation, see California Decedent Estate Practice, chap 30 (2d ed Cal CEB 2009).

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IV. EXECUTOR'S LIABILITY AND EXCULPATORY PROVISIONS

§32.21 A. Introduction

As legal representative of the decedent's estate, an executor can be held personally liable by those interested in the estate for failing to fulfill his or her fiduciary obligations. Although the Independent Administration of Estates Act (Prob C §§10400-10600) simplifies estate administration by allowing executors to administer estates with fewer required court authorizations, decreased court supervision may mean increased exposure to liability for the executor.

Executors who breach their fiduciary duties may (1) be required to reimburse the estate for losses caused by the breach, (2) be charged with interest on those losses, and (3) expose themselves to personal liability to creditors and beneficiaries.

On specific duties, powers, and potential liabilities of executors, see §§32.22-32.26, chap 33. For further discussion of executors' liabilities and actions against executors, see California Decedent Estate Practice, chap 29 (2d ed Cal CEB 2009).

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B. Executor's Liability

§32.22 1. Executor's Duties Generally

An executor is accountable for all the decedent's estate that comes into his or her possession and is chargeable with losses resulting from default or neglect. *Estate of Gerber* (1977) 73 CA3d 96, 140 CR 577. An executor is under a duty to manage and control the estate, using the ordinary care and diligence required by the circumstances of the estate. Prob C §9600(a).

Executors are under an affirmative duty to exercise a power, and to refrain from exercising a power, to the extent required by ordinary care and diligence. Prob C §9600(b). A professional fiduciary, such as a bank or trust company, is held to a higher standard and must exercise the skill and knowledge ordinarily possessed by professional fiduciaries. See *Estate of Beach* (1975) 15 C3d 623, 631, 125 CR 570, 574.

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§32.23 2. Surcharges for Breach

An executor breaching his or her fiduciary duty may be charged with losses, including (Prob C §9601(a)):

- Any loss or depreciation in value of the estate resulting from the breach, with interest;
- Any profit made by the executor through the breach, with interest; and
- Loss of any profit that would have accrued to the estate but for the breach.

Sums assessed against an executor for these losses are called surcharges. Any or all of these penalties may be excused if the court finds that the executor acted in good faith and reasonably under the circumstances known to the executor. Prob C §9601(b).

Failure to make tax elections beneficial to the estate or to collect assets or pursue claims of the decedent may result in a surcharge against the executor. The executor may also be surcharged for neglect in determining and paying applicable taxes (resulting in increased costs to the estate) and for failure to preserve and protect estate assets and investments. *Estate of Gerber* (1977) 73 CA3d 96, 140 CR 577. In addition, surcharges may be imposed for the executor's neglect or misconduct with respect to sales of estate property or in operating the decedent's business. See California Decedent Estate Practice §§29.118-29.125 (2d ed Cal CEB 2009).

An executor who uses estate funds for personal needs is liable for the amount used (with interest), even though he or she is the eventual beneficiary of these funds, unless he or she is the sole beneficiary. *Estate of Johnson* (1984) 162 CA3d 917, 208 CR 821 (sole beneficiary); *Estate of McSweeney* (1954) 123 CA2d 787, 268 P2d 107 (executors who were creditors as well as two of several beneficiaries).

An executor is not ordinarily personally liable for the decedent's liabilities or debts. (Such an obligation may, however, be created by a writing signed by the executor or his or her agent. See Prob C §9604.) An exception to this rule is created if the executor deals with creditors in bad faith or fails to provide notice to creditors as required by statute. See §32.25.

An executor is liable (and therefore may be surcharged) for a coexecutor's breach of fiduciary duty when the executor (Prob C §9631):

- Participates in the breach;
- Approves, acquiesces in, or conceals the breach;
- Improperly delegates responsibility to the coexecutor or otherwise enables the breach to occur through negligence; or
- Knows or should know of the breach and fails to compel the coexecutor to cure it.

Even if there are surcharges against the executor, the right to statutory commissions is not lost. *Estate of Roberts* (1945) 27 C2d 70, 162 P2d 461. The attorney's commission can be reduced by the court, however, if the executor causes delay in closing the estate. Prob C §12205; *Estate of Heller* (1992) 7 CA4th 862, 9 CR2d 274.

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C. Particular Sources of Liability

§32.24 1. Torts Committed During Administration; Unauthorized Contracts

An executor is personally liable for any torts committed by him or her or by his or her agents during administration of the estate. However, the representative has a right to reimbursement from the estate assets to set off any judgment if there was no personal fault. *Johnston v Long* (1947) 30 C2d 54, 181 P2d 645. On the executor's tort liability, see California Decedent Estate Practice §29.103 (2d ed Cal CEB 2009).

Only when authorized to do so by will or statute (including authorization by court order) may an executor enter into a contract with a third party obligating the estate for payment. Although the executor is personally liable for unauthorized contracts, he or she may be reimbursed from estate assets if the court later finds the contract to be necessary to the estate administration. *Nason v Granz* (1963) 223 CA2d 761, 35 CR 876.

In any action prosecuted or defended by a personal representative, costs will be assessed against the estate assets unless the court specifically directs that the costs be paid personally by the personal representative because of mismanagement or bad faith in the conduct of the action. CCP §1026. See also Prob C §1002. An executor may wish to obtain insurance to protect against such liabilities, as authorized by Prob C §9656.

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§32.25 2. Executor's Personal Liability to Creditors and Beneficiaries

After a creditor's claim has been approved and ordered paid by the court, the executor is liable personally and on the bond for failure to pay the claim. Prob C §11424.

An executor may also be liable for the bad faith failure to notify reasonably ascertainable creditors of the administration of the estate. See Prob C §9053(b)(1). Personal representatives may also be liable for failing to diligently try to identify creditors of the decedent. See Prob C §9053(d). See §32.26 on the executor's obligation to respect federal and state claims priorities.

Once an order for final distribution is issued, the executor is personally responsible to all estate beneficiaries to make the distribution as ordered. Prob C §11750(a)-(b). Division of estate property into distributive shares may raise complicated questions of valuation, and beneficiaries may have a cause of action against the executor if the property is not fairly divided. See *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 68. See also §§33.25-33.30.

An executor has no duty to defend a will contest until the will has been admitted into probate and the executor has been appointed. Prob C §8250(b).

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§32.26 3. Executor's Personal Liability for Taxes

The executor is responsible for filing returns and paying all federal income, estate, and gift taxes due from the decedent or the estate on a timely basis. The executor's liability is usually limited to the estate assets. See IRC §6903(a). However, the executor's failure to determine outstanding tax liabilities and to pay them on time may result in personal liability to the executor. *Estate of Lock* (1981) 122 CA3d 892, 176 CR 358 (gift taxes). The executor may be released from any potential personal liability for payment of estate tax due on timely (a) written application for Internal Revenue Service determination of tax owing and discharge from personal liability and (b) payment of taxes due. IRC §2204. Discharge for personal liability for the decedent's income or gift taxes may be similarly obtained under IRC §6905. The executor's liability for estate taxes, however, may not be dischargeable in bankruptcy. See *U.S. v Tomlin* (ND Tex 2001) 266 BR 350.

Internal Revenue Code §6501(d) provides a limitation on personal liability for estate income taxes by requiring that a tax be assessed, or proceedings for collection without assessment be commenced, within 18 months after a written request for the assessment or commencement of action. The written request, which may be made only after the return is filed, must be made within three years after the filing. On income tax return preparation responsibilities, see §33.5.

If an election has been made to pay the federal estate tax in installments, the executor may be required to post a bond to secure his or her discharge from personal liability. IRC §2204(a). In certain circumstances, IRC §6324A permits discharge without the posting of bond if a special lien on the estate property is agreed to by all persons with an interest in the property and filed with the IRS.

If an executor in good faith relies on the decedent's gift tax returns in determining the estate tax liability, the executor has no personal liability for any estate tax deficiency attributable to gifts made over three years before the decedent's death and not shown on the returns. IRC §2204(d).

Under the generation-skipping transfer (GST) tax, the executor is responsible for filing a tax return and paying any tax attributable to a direct skip. IRC §§2603(a)(3), 2662(a). (A direct skip includes any gift to a beneficiary who is two or more generations younger than the testator's generation. IRC §§2612(c), 2613.) For general discussion of the GST tax, see chap 15.

An executor may also incur personal liability to the United States if he or she pays a debt of the estate before paying the estate obligations to the federal government. 31 USC §3713(b). The executor is liable to the extent of the amount of the payment. Under IRC §6901(a), this liability is treated as a tax liability that accrues interest until payment. Field Service Advice Memorandum 199915002. In *U.S. v Bartlett* (CD Ill 2002) 186 F Supp 2d 875, the court held that an executor was personally liable for failure to satisfy the decedent's obligation as a transferee to pay gift tax on a gift from the decedent's father. On the California tax, see Rev & T C §19516. There are, however, certain exceptions for paying costs of administration and funeral expenses. See *U.S. v Weisburn* (ED Pa 1943) 48 F Supp 393. Probate Code §11420 sets forth the order in which claims must be paid from the probate estate. (Probate Code §11420(a) subordinates claims to preferred debts of the United States and the State of California.) In *William D. Little* (1999) 113 TC 474, the court held that the personal representative was not liable for paying lower-priority claims and making distributions to heirs instead of paying decedent's and the estate's income taxes. Although the personal representative had knowledge of facts that would cause a reasonable person to inquire about possible tax liabilities, the personal representative reasonably relied on the attorney's erroneous advice that no taxes were due.

On executors' liabilities, see California Decedent Estate Practice, chap 29 (2d ed Cal CEB 2009).

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§32.27 D. Limited Value of Exculpatory Clauses

A will provision attempting to relieve the executor from any of the types of personal liability described in §§32.22-32.26 may not be enforced by the California courts, because an executor has a statutorily imposed responsibility to those interested in the estate. It is likely that exculpatory clauses will be subject to strict construction, which is true for exculpatory clauses in trusts. *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644; Restatement (Second) of Trusts §222(2) (1959). To be excused by such a clause, a questionable act must be the specific act described by the provision. Restatement §222(2).

Under the rule of strict construction, a general exculpatory clause that attempts to relieve an executor from all personal liability connected with estate administration might be held to be void as either ambiguous or overbroad. In the case of egregious misconduct, the clause will be disregarded as a matter of public policy. See 4 Scott & Ascher on Trusts §24.27.3 (5th ed 2007).

Regardless of how inclusive (or specific) an exculpatory clause may be, it will not be held to excuse breaches of the fiduciary's duty committed (1) in bad faith, (2) with gross negligence, (3) with intentional or reckless disregard for the interests of those interested in the estate, or (4) for the representative's personal gain. Prob C §16461 (limitation of exculpatory terms in trust). See also *Corbett v Benioff* (1932) 126 CA 772, 14 P2d 1028 (general indemnification clause in trust did not protect trustees against own wrongful acts in violation of trust); Restatement (Second) of Trusts §222(2)-(3).

Provisions giving the executor particular powers and duties permit the testator to define which actions and decisions will be left to the executor's discretion without challenge by those interested in the estate. See, *e.g.,* §§33.21-33.22, 33.25-33.28 on tax powers and powers to divide property on distribution. Providing latitude in this way usually serves the purposes otherwise intended to be met by an exculpatory clause, making such a clause unnecessary.

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V. ACCOUNTING REQUIREMENTS AND WAIVERS OF ACCOUNTS

§32.28 A. Statutory Accounting Requirements

An executor is responsible for keeping proper and detailed accounts of his or her administration of the estate. See generally Prob C §§10900-10954. The executor (1) must account for receipts, disbursements, gains and losses on sales, and property on hand (Prob C §10900(b)) and (2) must render a final account and petition for settlement of estate administration as soon as the estate is in a condition to be closed (Prob C §10951). The account must include the items required in Prob C §§10900 and 1060-1064.

In addition, at any time during administration of the estate, the court may, on its own or any interested party's motion, require the executor to file a verified account showing the financial condition of the estate. Prob C §10950. Any interested person may then contest the account and require the executor to be examined on oath about the account and the disposition of the estate assets. Prob C §11002. On actions to compel accountings, see California Decedent Estate Practice §§29.105-29.117 (2d ed Cal CEB 2009).

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§32.29 B. Waiver of Accounting

A personal representative's duty to account may be waived when one of the following requirements has been met (Prob C §10954(a)):

- Each person entitled to distribution from the estate has executed and filed either a written waiver of account or a written acknowledgment that the person has received the share of the estate to which he or she is entitled; or
- Adequate provision has been made for the full satisfaction of each person's interest (except that adequate provision need not be made to satisfy the interests of residuary devisees or devisees whose interests are subject to abatement, payment of expenses, or accrual of interest or income).

In view of the statutory requirements imposed on the executor, it is unlikely that a will provision relieving the executor from filing an account will prevent a party interested in the estate from compelling an account, particularly if the estate is insolvent. See, *e.g., Bennalack v Richards* (1897) 116 C 405, 48 P 622, in which the court voided a will provision that attempted to waive the statutory requirement that a property sale must be approved by the court. See also *Elliott v Superior Court* (1968) 265 CA2d 825, 71 CR 807, in which the court, citing Restatement (Second) of Trusts §187, Comment k (1959), held that public policy prohibits allowing a testator to relieve a testamentary trustee of all accountability to the court. See Restatement (Third) of Trusts §87, Comment d (2007). Accordingly, this chapter does not include a form providing for a waiver of accounts.

Some testators wish to require that an accounting be filed by prohibiting a waiver, even by all interested persons. Although there is no judicial authority on this procedure, it appears that a court would abide by the testator's desire that the statutory requirements be observed, because the waiver of an account is subject to the court's discretion. See Prob C §10950(a).

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Powers and Duties of Executor

Judith M. Copeland

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I. PLANNING FOR EXERCISE OF POWERS AND DUTIES

§33.1 A. Powers and Duties Derived From Statute and Will

An executor derives both powers and duties from provisions in the will and from the Probate Code. See Prob C §§9600-9606 (fiduciary standard of care and executor's liability), 9650-10382 (management of estate property). The will drafter should review the statutory provisions to determine whether to restrict or withdraw some of the powers or to supplement them by adding other powers and duties in the will. The extent of an executor's powers and how they can be exercised also depend on whether he or she acts under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600). The drafter should become familiar with the IAEA's effects on estate administration.

The drafter should avoid restricting the executor's discretion by mandatory directions in the will unless the testator has fully considered their effects. A mandatory clause that appears to be sensible when the will is prepared may prove detrimental to the estate after the testator's death. A better approach is to authorize, but not direct, the executor to take a specific action. By doing so, the testator can express a preference in the will without unduly restricting the executor.

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§33.2 B. Powers and Duties Personal to Executor

The executor has a fiduciary duty to follow the requirements of the law and the will; failure to act with the requisite prudence and diligence may result in the executor's personal liability for any losses suffered by the estate. Prob C §§9600-9603. Because these are the executor's personal responsibilities, they cannot be surrendered to an attorney or agent. See §33.2A. Similarly, the executor is responsible for filing federal estate and income tax returns on time. See §33.2B.

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§33.2A 1. Possession of Estate Assets

Turning over possession or control of estate assets to the executor's attorney is a breach of the executor's duties, even if the selection of the attorney was made without negligence. *Estate of Guiol* (1972) 28 CA3d 818, 105 CR 35. However, the statute permits the executor to surrender estate property to the possession of the person who is presumptively entitled to it, *i.e.,* the beneficiary, unless or until the property is needed for the estate's administration. See Prob C §9650(c).

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§33.2B 2. Filing Federal Tax Returns

There is an addition to tax equal to 5 percent per month, up to a maximum of 25 percent, for failure to file a timely return unless it is shown that such failure was due to reasonable cause and not due to willful neglect. IRC §6651(a)(1). The executor's reliance on the attorney's incorrect advice about the filing date will not ordinarily constitute "reasonable cause" for late filing under IRC §6651(a)(1). *U.S. v Boyle* (1985) 469 US 241, 83 L Ed 2d 622, 105 S Ct 687. See also *Estate of Ethel Josephine Spowart Hinz*, TC Memo 2000-6 (erroneous advice was not given until the extended deadline for filing had already passed; it was not reasonable for the executor not to ask the attorney what extension had been granted).

Among the very narrow circumstances in which an executor may be excused for failure to timely file the return is the circumstance in which the executor has relied on the erroneous advice of counsel concerning a question of law, *e.g.,* "when a taxpayer shows he reasonably relied on the advice of an accountant or attorney that it was unnecessary to file a return, even when such advice turned out to have been mistaken." *Boyle*, 469 US at 250, 83 L Ed 2d at 631. See *Estate of Gertrude Zlotowski*, TC Memo 2007-203 (reliance on attorney to file estate tax return was not reasonable cause for failure of executors to file the return; executors failed to show that the attorney advised them, as a matter of law, that it was not necessary to file the return). The need for an appraisal also is not reasonable cause for failing to file a timely return. *Estate of Edward H. Eddy* (2000) 115 TC 135.

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II. POWERS AND DUTIES NOT REQUIRING SPECIFIC WILL CLAUSES

§33.3 A. Probate Code Powers and Duties

The many powers and duties provided in the statutes need not be expressly stated in the will; however, the testator may wish to recite certain powers to alert the executor to their availability or to emphasize or clarify particular intentions regarding them. Following is a discussion of powers and duties contained in the Probate Code.

For detailed discussion of the executor's responsibilities and authority, see California Decedent Estate Practice (2d ed Cal CEB 2009).

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§33.4 B. Collection and Care of Estate Assets

The executor has the duty to discover and take into his or her possession the decedent's entire probate estate (including all real and personal property) and to collect debts owed to the decedent or the decedent's estate. Prob C §9650(a)(1); *Lobro v Watson* (1974) 42 CA3d 180, 116 CR 533. The executor is entitled to receive rents, issues, and profits due to the estate until the property is distributed. Prob C §9650(a)(2). The executor may surrender possession of estate property, however, to the person presumptively entitled to it (*i.e.,* the beneficiary under the will) unless the executor requires its possession for estate administration. Prob C §9650(c). The executor has the power to abandon certain tangible personal property when the costs of collecting or maintaining it exceed its value to the estate. Prob C §§9780-9788. The executor may also release an uncollectible claim. Prob C §9830(a)(3).

Once the executor has taken charge of estate property, he or she must "take all steps reasonably necessary" to preserve it during administration. Prob C §9650(b). See *Estate of King* (1942) 19 C2d 354, 358, 121 P2d 716. Further, Prob C §9600(a) provides that the executor must use "ordinary care and diligence" in managing and controlling the estate. The statutes outline certain aspects of this basic responsibility. For example, unless provided otherwise in the will, the executor must invest all estate cash (except amounts that are reasonably necessary for orderly estate administration) in interest-bearing accounts. Prob C §9652. In addition, the executor must pay real and personal property taxes assessed on the assets. Prob C §9650(b).

Most of the executor's duties, however, require the executor to determine whether to use the discretionary powers provided by statute. The fiduciary's standard of care provided in Prob C §9600 may require the executor to exercise the Prob C §10259 power to sell, without court approval, personal property that would depreciate in value if not promptly sold. The executor may be obligated to maintain insurance on the property under Prob C §9656. To preserve estate property, the executor may need to continue a decedent's unincorporated, nonpartnership business for up to 6 months without specific court authorization. Prob C §9760(b). See §§33.42-33.43. (With a court order, the executor may continue as a partner in the decedent's partnership under Prob C §9762.) Preservation of assets may require litigation under Prob C §§9820-9823 or settlement of an action under Prob C §9830(a)(1). But see the limitations in Prob C §§9832(a) and 9833 on disputes involving real property valued over $25,000. See also §33.6.

The executor has no duty to complete pending construction, although the will may authorize him or her to do so. *Estate of Hincheon* (1911) 159 C 755, 116 P 47. Similarly, there is no duty to acquire property, even though the additional property might enhance the value of the estate property. See *Neet v Holmes* (1944) 25 C2d 447, 154 P2d 854. An executor will not be held liable for failure to rent residential property if he or she acts with due diligence and in good faith in attempting to secure an income from the property. See *Estate of Fraysher* (1956) 47 C2d 131, 301 P2d 848. In general, the executor is not liable for any depreciation in the value of estate assets attributable to actions taken in good faith and without negligence. See *Estate of Beach* (1975) 15 C3d 623, 125 CR 570.

Certain powers related to preservation of estate assets are also provided in the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600). For example, an executor with powers under the IAEA may make ordinary or extraordinary repairs or alterations to buildings or other property without court authorization (Prob C §10562) and pay taxes, assessments, and other expenses incurred in the collection, care, and administration of the estate (Prob C §10556). See §33.10 on IAEA powers.

Even if the executor is also a beneficiary under the will, he or she may deal with estate property only as a fiduciary until the property has been distributed and must account to the court for all assets in his or her possession. *Estate of Curry* (1969) 274 CA2d 502, 79 CR 125.

If an estate is insolvent, the executor must preserve as much of the estate as possible for the creditors' benefit. All claims must be paid on a prorata basis, subject to statutory priority and court approval. Prob C §11422. The executor does not have the power to prefer one creditor over another in disregard of the statutory priorities; any instruction or direction in the will to this effect will be ineffective.

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§33.5 C. Income Tax Return Preparation

The executor is responsible for the timely preparation and filing of the following:

- The decedent's personal income tax returns for unreported tax years or partial years (IRC §6012(b)(1); Rev & T C §18505(g));
- Estate income tax returns for each tax year until the estate is terminated (IRC §6012(b)(4); Rev & T C §18505(d), (f)); and
- Estate or inheritance tax returns (returns relating to large transfers at death in 2010) (IRC §6018(a); Rev & T C §§13403, 13501).

See §33.21; California Decedent Estate Practice, chaps 33-34 (2d ed Cal CEB 2009). Although the executor has the power and duty to file the returns, he or she may not personally prepare them. They must be prepared by a bonded tax preparer or a person exempt from bonding requirements, *e.g.,* an accountant or attorney. Bus & P C §22251(a)(1)(A) (definition of "tax preparer"), §22258 (exemptions). The executor may file a joint income tax return with the decedent's surviving spouse. IRC §6013. The executor should be cautious about filing a joint return, however, if there is some uncertainty about the survivor's tax problems. The IRS takes the position that the executor may not claim innocent-spouse relief from joint liability and allocation of tax liability under IRC §6015. Field Service Advice 200117005. In rare cases, an executor who is uncertain about the nature and extent of the survivor's earnings will choose to file a separate return. In such cases, innocent-spouse relief from liability or a share of community property income of the survivor also may be available under IRC §66 and Treas Reg §§1.66-1—1.66-5.

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§33.6 D. Power to Maintain Legal Actions on Estate's Behalf

The executor may (1) maintain on the estate's behalf an action that the decedent might have taken if living and (2) defend actions against the decedent or the estate. Prob C §9820; CCP §§368.5, 375, 377.20-377.42, 385. An estate cannot itself sue or be sued; the executor must bring suit or defend in a representative capacity on behalf of the estate's beneficiaries. *Estate of Bright* (1951) 104 CA2d 827, 232 P2d 523. The beneficiaries may be joined as parties in an action brought by the executor, but they are neither necessary nor indispensable parties. Prob C §9654; CCP §369. If there is no personal representative of the estate, an action may be brought by the decedent's successor in interest. CCP §377.32. See, *e.g., Exarhos v Exarhos* (2008) 159 CA4th 898, 72 CR3d 409 (successor may be liable for attorney fees in unsuccessful action on contract between decedent and defendant).

When necessary, an executor has not only the power but also the duty to institute actions for possession of property belonging to the decedent. *Estate of McCarthy* (1970) 5 CA3d 158, 85 CR 50. An executor may bring suit for the wrongful death of the decedent but is not required to do so. CCP §377.60. The executor must defend the estate against groundless creditors' claims (see, *e.g., Nathanson v Superior Court* (1974) 12 C3d 355, 115 CR 783) and must also defend the estate assets against other claims made on the assets (see, *e.g., Estate of Turino* (1970) 8 CA3d 642, 87 CR 581). These obligations derive from the executor's duty to collect, preserve, and protect the estate assets until distribution. *Estate of Turino, supra*.

The executor's powers and duties to litigate are for the benefit of all persons interested in the estate. Thus, if the estate is insufficient to meet creditors' claims because the decedent made lifetime conveyances of property to defraud creditors or avoid obligations, the executor may be forced by a creditor to commence and prosecute an action to recover the property for the creditor's benefit. Prob C §9653(a).

The power of the executor to settle actions is limited by Prob C §§9831-9835, relating to settlement of creditors' claims (before the claim period has ended), real property actions, actions in which the estate obligation would be over $25,000, claims and debts of the executor or his or her attorney, and personal injury or wrongful death actions. Settlement of all these actions requires court approval. Procedures for obtaining court authorization for compromise or settlement and for effecting the settlement are described in Prob C §§9836-9838.

Under the Independent Administration of Estates Act (Prob C §§10400-10600), an executor may institute, compromise, and defend actions and proceedings involving the estate without prior court authorization. Prob C §§10552-10553. See §33.10.

On actions by and against the executor generally, see California Decedent Estate Practice, chap 29 (2d ed Cal CEB 2009).

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.7 E. Powers Regarding Creditors' Claims

§33.7 E. Powers Regarding Creditors' Claims

The executor's duties regarding creditors' claims against the estate are governed by statutory rules on the presentation and payment of claims. Prob C §§9000-9304. The executor must make a reasonably diligent search for creditors and provide notice of the estate proceedings to all known and reasonably ascertainable creditors. Prob C §9053(d); *Tulsa Prof. Collection Servs. v Pope* (1988) 485 US 478, 99 L Ed 2d 565, 108 S Ct 1340. Notice must also be given to certain public entities, including the Franchise Tax Board for estates for which letters are first issued on or after July 1, 2008. Prob C §9202. On creditors' claims generally, see California Decedent Estate Practice, chap 14 (2d ed Cal CEB 2009). Payment or provision for payment of debts is a precondition for closing the estate. Prob C §11640(a).

This discussion assumes that the executor has opened a probate proceeding. If a probate proceeding is not commenced, CCP §366.2 appears to bar a claim against the estate after 1 year from the date of the decedent's death. See *Bradley v Breen* (1999) 73 CA4th 798, 86 CR2d 726. See also *Collection Bureau v Rumsey* (2000) 24 C4th 301, 99 CR2d 792 (action against surviving spouse for decedent's medical bills must be commenced within 1 year of death); *Wagner v Wagner* (2008) 162 CA4th 249, 75 CR3d 511 (successor trustee's cause of action for compensation for care of deceased settlor barred by 1-year statute of limitations). In *Farb v Superior Court* (2009) 174 CA4th 678, 94 CR3d 586, the court held that the 1-year limitations period for filing an action based on a liability of a decedent was not tolled during the minority of the claimant.

Because of the 1-year limit of CCP §366.2, some practitioners have concluded that it is unnecessary to use a formal probate proceeding when one is not required. Probate may not be required to transfer certain assets or for small estates. Probate is not required if all of the decedent's property passes to the surviving spouse or registered domestic partner. See Decedent Estate Prac, chap 4.

NOTE: The filing of a creditor's claim tolls the 1-year limitation period of CCP §366.2 until the claim is allowed, approved, or rejected by the executor under Prob C §9352. However, the filing of a claim does not toll the special 1-year limitation period of CCP §366.3 applicable to actions alleging breach of a contract to make a will. See *Stewart v Seward* (2007) 148 CA4th 1513, 56 CR3d 651. See also *Wilkison v Wiederkehr* (2002) 101 CA4th 822, 124 CR2d 631 (action for breach of contract to devise a home barred by failure to file a creditor's claim).

Some claims may not be subject to the 1-year limit of CCP §366.2. In *Estate of Yool* (2007) 151 CA4th 867, 60 CR3d 526, for example, the court held that an action to declare that a decedent held title to residential property under a resulting trust was not an action on the liability of a decedent. The decision essentially takes the view that the applicable statute of limitations on an action to establish a resulting trust is 4 years under CCP §343.

Because creditors' rights are provided by statute, the drafter need not include a clause in the will regarding payment of claims in general. A testator may wish to specify the source for payment of debts, however, if the statutory debt allocation provisions are not appropriate in a particular case. For example, if the testator wishes certain debts to be paid from particular funds or from the proceeds of the sale of named assets rather than from the residue of the estate, the will should contain specific directions to that effect. See Prob C §§21400-21405 on the order of abatement of gifts for payment of debts; Prob C §§20110-20117 on estate tax proration among beneficiaries. See also chap 26 on statutory apportionment of, and clauses for allocating, death tax burden; §§12.3-12.6 on abatement.

A general directive in the will that all debts must be paid does not require payment of any mortgage or other lien against property specifically devised. Prob C §21131. If the testator wants the encumbrance paid, the drafter should include a special clause directing payment.

An executor who has been granted authority under the Independent Administration of Estates Act (Prob C §§10400-10600) has broad powers regarding claims against the estate. Without prior court approval, the executor may allow, pay, reject, contest, or compromise any claim by or against the estate; institute, compromise, and defend actions and proceedings relating to such claims; and allow a claim to be filed after expiration of the time for filing. Prob C §§10552-10553. See §33.10.

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§33.8 F. Power to Contract and Perform Decedent's Contracts

As a general rule, an executor may not make any contract binding on the estate or incur any obligations not authorized by statute or the will. See, *e.g., Harm v Frasher* (1960) 181 CA2d 405, 5 CR 367. The executor is personally liable for contracts that he or she improperly entered. On the executor's liability, see §33.24. In a number of situations provided by statute, however, the executor has full authority to contract for the estate without prior court authorization. For example, the executor may enter into (1) final settlement of claims for or against the estate (see §33.7) or (2) a written contract to retain an agent or auctioneer to assist in the sale of real or personal property (Prob C §§10150-10151). Probate Code §10801(b) authorizes the executor to:

- Employ an attorney to represent him or her as executor;
- Employ tax counsel, tax auditors, accountants, or other tax experts to perform tax-related services for the estate; and
- Pay for these services with estate funds.

See *Estate of McMillin* (1956) 46 C2d 121, 292 P2d 881. Other powers to contract are available when the executor is given authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600).

Note that there is no statutory authority for the executor to retain investment counsel. If the will does not authorize the executor to employ investment counsel, he or she must seek court approval for the contract. For a clause permitting retention of investment advisers, see form 33.41-1.

In general, the executor must perform contracts entered into by the decedent during his or her lifetime, unless the acts to be performed are personal services appropriately rendered by the decedent only (which are discharged by death). *Didier v American Cas. Co.* (1968) 261 CA2d 742, 68 CR 217 (building contract found not to be personal to decedent). The executor ordinarily must seek court authorization before taking action to complete a contract. See *Estate of Burke* (1926) 198 C 163, 244 P 340. An executor acting under the IAEA need not seek court approval but must give "notice of proposed action" before taking action to complete a contract.

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§33.9 G. Power to Seek Court Authorization to Act

Because of the executor's overriding duty to protect estate assets, the executor may act without express statutory or testamentary authority or prior court authorization if the actions are just, reasonable, and in the best interests of the estate. See *Estate of Massena* (1933) 129 CA 255, 18 P2d 779. Without obtaining prior court authority, however, the executor acts at his or her own risk. The court will determine later (usually on petition for distribution) whether the executor's action was necessary and reasonable. *Estate of Massaglia* (1974) 38 CA3d 767, 113 CR 751 (continued operation of hotel business).

The executor may "assuage his perplexity" about the justice or legality of a proposed action by filing a petition for instructions with the court. See *Estate of Cross* (1975) 51 CA3d 80, 86, 123 CR 825. The executor has broad statutory authority to seek the probate court's instructions and directions concerning the disposition, management, operation, care, protection, or preservation of the estate or estate properties. Prob C §9611. The executor must give appropriate notice. See *Estate of Sigourney* (2001) 93 CA4th 593, 113 CR2d 274.

On seeking instructions, see California Decedent Estate Practice, chap 16 (2d ed Cal CEB 2009).

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III. INDEPENDENT ADMINISTRATION OF ESTATES ACT (IAEA)

§33.10 A. IAEA Reduces Need for Court Supervision

When an executor is granted authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600), certain actions can be taken without obtaining prior court approval, thus reducing the time and costs of probate administration.

The authority granted under the IAEA may be either "limited" or "full." Although an executor with limited authority may take all actions permitted to the executor with full authority, he or she may not sell or exchange real property, grant an option to purchase real property, or borrow funds giving real property as security without prior court approval. Prob C §10403. With full authority, an executor may do the foregoing without prior court order if he or she gives "notice of proposed action" to interested persons before taking the action. Prob C §§10510-10511, 10514-10515.

Independent authority cannot be granted to an executor if expressly prohibited in the will. Prob C §10404. Otherwise, an executor will be granted independent authority on noticed request if no objections show good cause to deny the authority. Prob C §§10404 (will provision), 10452 (objections).

The will can permit the executor only limited authority under the IAEA or permit the executor to obtain powers under the IAEA but limit the powers in specific ways, *e.g.,* requiring court supervision of creditor claims payments or of the continued operation of the testator's business. Prob C §10502(b). See suggested clauses in form 33.13-1 for these alternative powers.

Except in the circumstances provided in Prob C §10501(c) (when the heirs consent and creditors will not be harmed), even an executor with full authority under the IAEA must obtain court approval to take the following actions (Prob C §10501(a)):

- Pay executor's commissions and attorney fees;
- Settle accounts;
- Make preliminary and final distributions and obtain discharge;
- Sell or grant an option to purchase estate property to the executor or his or her attorney;
- Exchange estate property for property of the executor or his or her attorney;
- Allow, pay, or compromise a claim of the executor or his or her attorney against the estate or a claim of the estate against either of them; and
- Extend, renew, or modify the terms of a debt or other obligation of the executor or his or her attorney that is owed to or in favor of the decedent or the estate.

An executor with authority under the IAEA may take certain other actions without court approval after giving notice of the proposed action provided no objection to the action is presented. See Prob C §§10580-10585 (notice procedure), 10586-10589 (objections). An executor's reports, accounts, and petitions for distribution must list and describe all actions of the executor for which a notice of proposed action was required. Cal Rules of Ct 7.250(a). Those actions are:

- Selling or exchanging real property (only with "full" authority) (Prob C §10511; see §§33.15-33.16);
- Continuing the operation of a decedent's business for longer than 6 months (Prob C §10534(d)) or selling or incorporating the business (Prob C §10512; see §§33.42-33.43);
- Abandoning personal property if the costs of collecting, maintaining, and safeguarding it exceed its fair market value (Prob C §10513);
- Borrowing money and securing the loan with personal property or (only with "full" authority) executing a mortgage or deed of trust (Prob C §10514);
- Granting options to purchase real property (only with "full" authority) (Prob C §10515; see §33.17) and transferring property to an option holder who has complied with terms in the will (Prob C §10516);
- Completing a decedent's contract to convey real or personal property (Prob C §10517; see §33.8);

- Determining certain claims of the decedent or third parties to real and personal property (Prob C §10518; see §33.8);
- Making a disclaimer (Prob C §10519);
- Distributing income received during administration to persons entitled to it under Prob C §13000 (Prob C §10520(a));
- Distributing household furniture and furnishings, motor vehicles, clothing, jewelry, and other tangible articles of a personal nature to the persons entitled to the property under the decedent's will, not to exceed an aggregate fair market value (as determined on the basis of the inventory and appraisal) to all persons of $50,000, computed cumulatively through the date of distribution (Prob C §10520(b));
- Distributing cash to general pecuniary devisees entitled to it under the decedent's will, not to exceed $10,000 (Prob C §10520(c));
- Entering into a contract to be performed in more than 2 years, other than a lease of real property (Prob C §10532(b); see §33.8);
- Investing estate funds in any manner provided by the will or, if no investment power is provided, in securities eligible for investment of surplus state monies provided in Govt C §16430 (Prob C §10533; see discussion below of investments not requiring prior notice of proposed action);
- Making the first payment of a family allowance, the first payment of a family allowance beginning 1 year or more after the decedent's death, or the first payment increasing a family allowance (Prob C §10535(b));
- Leasing real property for longer than 1 year (Prob C §10536(b));
- Selling or exchanging personal property, except sales of listed securities and certain other described property (Prob C §10537; see §§33.15-33.16); and
- Granting a broker an exclusive right to sell estate property for a period of more than 270 days (Prob C §10538).

Unless otherwise provided by the will (Prob C §10502(b)), an executor with full or limited powers under the IAEA may do the following without either court authorization or giving notice of the proposed action:

- Invest estate assets in (1) insured California bank and savings and loan accounts, (2) United States and California direct obligations maturing in 1 year or less, (3) certain money market mutual funds and trust funds, or (4) any manner provided by the will (Prob C §10533(a); see §33.19);
- Sell certain personal property (Prob C §10537(b));
- Make repairs or alterations to buildings or other estate properties (Prob C §10562);
- Vote a security or selling or exercising stock subscription or conversion rights (Prob C §10561);
- Allow, compromise, or reject claims against the estate and allow claims to be filed against the estate after the 4-month claims-filing period under Prob C §9100 has expired (Prob C §10552(d); see §33.7);
- Institute, compromise, and defend actions by or against the estate (Prob C §10553; see §33.6);
- Pay taxes and other expenses in administration of the estate (Prob C §10556);
- Continue the operation of a decedent's business for less than 6 months (Prob C §10534; see §33.42);
- Pay a family allowance (Prob C §10535(a)), subject to the restrictions of Prob C §10535(b);
- Modify the terms of an obligation owed to the decedent or the estate (Prob C §10554);
- Grant an exclusive right to sell property for up to 90 days (Prob C §10538(a));
- Convey property to effectuate the exercise of another power (Prob C §10555);
- Purchase an annuity granted in the will (Prob C §10557);
- Exercise an option right (Prob C §10558);
- Purchase commodities or securities to complete a contract of sale entered into by the decedent (Prob C §10559);
- Hold securities in a nominee's name (Prob C §10560); or
- Accept a deed in lieu of foreclosure or giving partial satisfaction or reconveyance under a trust deed (Prob C §§10563-10564).

See California Decedent Estate Practice, chap 15 (2d ed Cal CEB 2009) for further discussion of the IAEA.

Although an express clause authorizing administration of the decedent's estate under the IAEA is not required for the court to permit IAEA administration under Prob C §10450, including such a clause seems advisable if the testator wants

his or her estate administered under the Act. A clause stating the testator's preferred method of administration may help overcome objections by those interested in the estate to the representative proceeding under the Act. The will should not require the executor to act under the IAEA, however. In some situations (*e.g.,* when beneficiaries are hostile to the executor or are divided over the advisability of an action the executor wishes to take), the executor may wish to seek court authorization before acting.

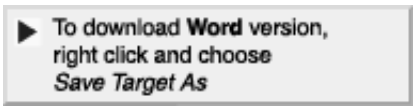
Occasionally, a testator may want to prevent the executor from obtaining powers under the IAEA. For example, he or she may foresee potential conflicts of interest between the executor and certain beneficiaries or may want to require court supervision to allow parties interested in the estate to review the executor's proposed actions. In these instances, the will drafter should include a clause specifying that the executor not be given powers under the IAEA. Otherwise, IAEA powers will ordinarily be granted to the executor on request. Prob C §10404. See form 33.12-1 for clauses prohibiting the executor from exercising IAEA powers.

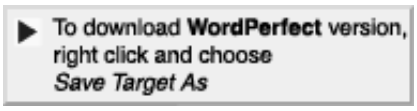
Unless another clause in the will provides that instructions to executors apply to any personal representative of the estate, the drafter should specify in the will whether the instruction granting powers under the IAEA covers any representative or only nominated executors.

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B. Will Clauses Regarding IAEA Powers

§33.11 1. Form: IAEA Applicable





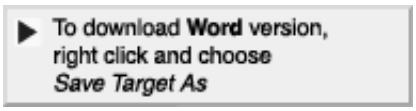
33.11-1 Executor to have IAEA powers

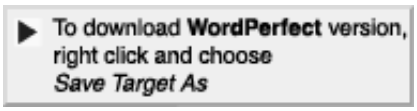
***Powers of Independent Administration*. My executor may administer my estate under the California Independent Administration of Estates Act (Probate Code §§10400-10600).**

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.12 2. Form: IAEA Not Applicable

§33.12 2. Form: IAEA Not Applicable





33.12-1 Personal representative shall not have IAEA powers

***No Powers of Independent Administration*. No personal representative of my estate shall administer my estate under the California Independent Administration of Estates Act (Probate Code §§10400-10600).**

Comment: If the will drafter does not include this clause in the will, the executor is free to seek authority under the IAEA. Including this clause in the will prevents any personal representative from obtaining IAEA powers. If the testator wishes to limit a particular nominee executor's IAEA powers, this clause should be adapted. For a clause providing limited authority or restricted powers, see §33.13.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.13 3. Form: Limited Authority or Restricted Powers Under IAEA

§33.13 3. Form: Limited Authority or Restricted Powers Under IAEA

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

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

33.13-1 Executor to have limited authority or restricted powers under IAEA

[*Add one of the following alternatives*]

[*Alternative 1: Limited authority*]

***Powers of Independent Administration*. My executor may administer my estate under the California Independent Administration of Estates Act (Probate Code §§10400-10600) but with limited authority only as the term "limited authority" is defined in Probate Code §10403.**

[*Alternative 2: Full authority (with certain powers restricted)*]

***Powers of Independent Administration*. My executor may administer my estate under the California Independent Administration of Estates Act (Probate Code §§10400-10600) but must obtain Court authorization for exercise of the following powers:** _ _[*Powers*]_ _.

Comment: The will drafter should include one of these alternatives when the testator wishes the estate to be administered under the IAEA but wants certain actions to be supervised by the court. In Alternative 2, the drafter should enumerate any powers in Prob C §§10510-10564 whose exercise the client wants to limit.

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IV. CLAUSES REGARDING SPECIFIC POWERS AND DUTIES

§33.14 A. Using Power-Granting Clauses

Because of the comprehensive statutory provisions authorizing a broad range of executor powers and duties (particularly as expanded by the Independent Administration of Estates Act; see §33.10), a will may require relatively few clauses regarding the executor's powers. Simple wills typically specify only a power of sale (see form 33.16-1), a power to lease estate property (see form 33.18-1), and other powers needed to administer the particular assets likely to be in the testator's estate.

Specific will clauses, however, can give the executor flexibility in administering the estate, *e.g.,* in investing estate funds (see form 33.20-1) or distributing estate property (see §§33.23-33.37). Furthermore, specific instructions to the executor reveal the testator's intentions, which may help avoid disputes over the executor's actions. For these reasons, many of the clauses discussed in §§33.15-33.50 contain executor powers already granted by statute. These clauses can be used or amended to expand or limit the statutory powers with respect to particular assets or situations. Other powers would not be available to the executor without court authorization if not granted in the will. See, *e.g.,* §§33.23-33.24, 33.40-33.41, 33.44-33.45.

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B. Drafting for Specific Powers

1. Sale of Estate Assets

§33.15 a. Reasons for Clause Granting Power to Sell

An executor may sell estate assets when necessary to pay debts, devises, family allowances, or expenses if (1) a sale is in the best interests of the estate and those interested in it or (2) the will directs or authorizes a sale of property. Prob C §10000. Directions in the will that particular property be sold, or that property be sold in a particular manner, must be followed. Prob C §10002(a). The court may order an executor who has refused to sell property to do so if (1) the will directs sale of the property; (2) a sale is necessary to raise cash to pay debts, devises, family allowance, taxes, or expenses of administration; or (3) a sale is to the advantage of the estate and in the best interests of the estate and those interested in it. Prob C §10001.

Despite the statutory powers allowing sales, it is generally advisable for the drafter to include an express power of sale in the will, often combined with a power to lease estate assets (see §33.16). When the executor does not have IAEA authority, such a provision allows him or her to dispense with the requirements of publishing or posting notice of the proposed sale. Prob C §§10252, 10303. See §33.10. Also, an authorization for sale in the will eliminates the need to demonstrate to the court the sale's necessity or advantage to the estate and benefit to interested persons—findings otherwise required for court confirmation. See §33.15A. When the will gives the executor independent administration powers, explicit sales authorization reinforces the statutory powers if beneficiaries question the executor's right or decision to sell. Finally, granting the executor discretion to sell property may help convince tax authorities that costs of sale are deductible from federal estate tax (IRC §2053) or fiduciary income tax (IRC §67(e)(1)). See §33.15B.

If the testator's estate is likely to contain real property suitable for use as pasture and grazing land, the testator should consider including in the will an authorization to sell the land to a grazing or pasture association under Prob C §10207.

The drafting attorney should discourage the client from including mandatory directions to the executor regarding property to be sold or the method of sale. It usually makes better financial sense to give the executor full discretion over sales decisions in view of postdeath circumstances. Moreover, a direction to sell may make sales expenses nondeductible from estate or income tax. However, if the testator wants particular property sold or properties sold in a particular order, the will should contain directions to do so.

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§33.15A (1) Power May Eliminate Need for Court Confirmation

Unless the executor has full authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600), his or her sale of estate property usually (personal property) or always (real property) must be returned to the court for confirmation. In most cases, third parties have the opportunity to offer to purchase the property at prices higher than the reported sale ("overbids") at the confirmation hearing, and the executor must demonstrate the sale's necessity or advantage to the estate and benefit to interested persons. Prob C §§10260(a), 10261(a), 10262 (personal property); Prob C §§10308(a), 10310(a), 10311 (real property). Title to the property does not pass to the new owner until court confirmation has been given, except for sales of securities or perishable or depreciating property. Prob C §10260 (personal property); Prob C §10308 (real property). If the purchaser fails to comply with the terms of sale after confirmation, the court may vacate the order of confirmation on the petition of the personal representative and award damages to the estate against the defaulting purchaser. Prob C §10350(a). In *Estate of Felder* (2008) 167 CA4th 518, 84 CR3d 220, the court held that an estate was entitled to retain the entire deposit of a defaulting purchaser of real property as damages under Prob C §10350(e)(1) even though the estate owned only a one-half interest in the property.

An executor with full authority under the IAEA can usually sell personal property without court confirmation after giving notice of the proposed action under Prob C §§10580-10592. Prob C §10537(a). Likewise, sales of real property by an executor with full authority do not require court confirmation, although notice of the proposed action must be given. Prob C §§10510-10511. See §33.10 on exercise of powers under the IAEA. Sales of listed securities or cash sales of perishable or depreciating property or stock subscription rights do not require court approval or prior notice to interested parties. Prob C §10537(b).

Some testators prefer to direct that sales of estate real property be subject to court confirmation for two reasons: (1) The real estate commission in a court-confirmed sale, which is subject to the court's commission schedule, may be lower than that charged in unconfirmed sales; and (2) competitive bidding at the confirmation hearing may result in an increased price. If court confirmation is desired, form 33.16-1 may be adapted for this purpose. Note that even if the will is silent on the issue, the executor still has the option of selling real property under court supervision. Prob C §10500(b). See California Decedent Estate Practice, chap 18 (2d ed Cal CEB 2009).

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§33.15B (2) Power May Facilitate Tax Deductions

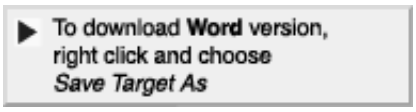
Under Treas Reg §20.2053-3(d)(2), the estate tax deduction for administration expenses is limited to costs of sales to raise money for payment of estate charges, preservation, or distribution.

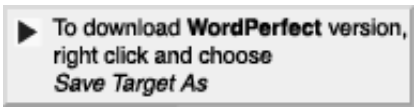
Under IRC §67(e), the 2-percent floor for miscellaneous itemized deductions does not apply to expenses incurred in connection with the administration of an estate or trust that would not have been incurred if the property were not held in the estate or trust. For example, the 2-percent floor does not apply to the executor's fees and commissions. Investment advisor fees are generally subject to the 2-percent floor because such fees are also paid by individual taxpayers. See *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782 (2-percent floor applies unless expense is "uncommon (or unusual or unlikely)" to be incurred by an individual). See also Prop Treas Reg §1.67-4; Notice 2008-116, 2008-52 Int Rev Bull 1372. While the disallowed deductions often have little impact on taxable income because expenses far exceed the 2-percent floor, the limitation may have significant alternative minimum tax (AMT) implications. Under IRC §56(b)(1)(A), miscellaneous itemized deductions generally are not allowed for AMT purposes, but expenses that are deductible under IRC §67(e) without regard to the 2-percent floor are not included in calculating the trust's alternative minimum taxable income. Suppose, for example, that a $20 million trust has gross income of $1 million, deductions of $100,000 that are allowed for AMT calculations, and deductions of $200,000 that are not allowed. Both DNI and net trust accounting income will probably be on the order of $700,000, but alternative minimum taxable income will be $900,000. If the trust distributes $700,000 to the beneficiaries, the trust's regular taxable income will be close to zero, but $200,000 of alternative minimum taxable income will be allocated to the trust.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.16 b. Form: Power to Sell or Lease Estate Assets

§33.16 b. Form: Power to Sell or Lease Estate Assets





33.16-1 Power to sell or lease estate assets

***Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.**

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2. Lease of Estate Assets

§33.17 a. Uses of Separate Clause Permitting Leases

A lease of estate property is governed by Prob C §§9940-9948. Because the term "lease" also includes an option to purchase real property (Prob C §9940), a lease of estate property is also governed by Prob C §§9960-9966, which describes the procedure for granting an option to purchase real property.

A court order is not a prerequisite for leasing estate real property if (1) the rent does not exceed $5000 a month and the lease term does not exceed 1 year, or (2) the term is from month to month, regardless of the amount of rent payable. Prob C §9941. An executor may petition for court authority to enter into a longer-term or higher-rent lease, but he or she must show that the lease is to the estate's advantage. Prob C §§9942(a), 9943(a). Unless the will authorizes or directs the executor to lease or sell property, notice of the petition must be given to all interested parties and published. Prob C §9944(a)-(b). If the lease term will extend for more than 10 years, notice requirements are increased, and the petition must show the lease's benefit to persons interested in the estate. Prob C §§9943(b), 9944(c).

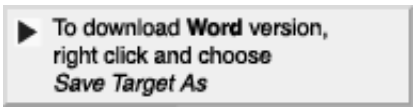
If the executor has authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600), he or she may lease estate property without prior court approval. See §33.10. Notice of the proposed action under Prob C §§10580-10592 must be given if real property will be leased for longer than 1 year. Prob C §10536(a)-(b). Notice of proposed action is not a prerequisite for personal property leases unless the lease is for more than 2 years. Prob C §10536(c).

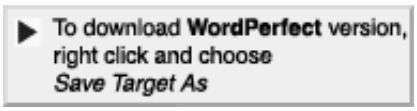
A clause authorizing leases is generally included in a decedent's will, often combined with a power of sale (see §§33.15-33.16), but a separate clause may be used if the testator for some reason does not wish to give the executor an unlimited power of sale. See §33.18. If no IAEA powers have been granted, the clause will at least eliminate the requirement to publish notice of a petition for court authority to lease. Even with IAEA powers, the provision informs interested parties that the executor has discretion to lease. On occasion, a testator may wish to direct the executor to lease a particular property on specified terms, *e.g.,* the lease of a residence to a family member. If terms favorable to the lessee are contemplated, the will should spell them out to protect the executor from a claim that he or she acted improperly in making the lease.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.18 b. Form: Power to Lease Estate Assets

§33.18 b. Form: Power to Lease Estate Assets





33.18-1 Power to lease estate assets

***Power to Lease Estate Assets*. My executor may lease all or any part of the real or personal property of my estate on terms that my executor considers proper.**

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/ 3. Power to Invest/§33.19 a. Will Can Expand Executor's Investment Powers

3. Power to Invest

§33.19 a. Will Can Expand Executor's Investment Powers

Although the executor's primary duty is to conserve estate assets rather than to invest them (see *Estate of McSweeney* (1954) 123 CA2d 787, 268 P2d 107), the Probate Code requires that all estate cash (except amounts reasonably necessary for the orderly administration of the estate) be kept in interest-bearing accounts unless the will provides otherwise. Prob C §9652. Moreover, the executor's statutory duty to manage the estate using ordinary care and diligence may require the exercise of a power, which in some circumstances could be the power to invest estate funds. On standard of care requiring exercise of power, see Prob C §9600(b); Cal L Rev'n Comm'n Comment to Prob C §9600.

Before expiration of the time for filing creditors' claims, the choice of investments for an executor without authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600; see §33.10) and without court authority is limited to the following:

(1) Depositing estate funds in an insured bank or savings and loan account in California (Prob C §9700);

(2) Purchasing direct California and federal obligations maturing no later than one year from the date of investment (Prob C §9730(a));

(3) Purchasing an interest in a money market mutual fund or other designated fund limited to investment in United States government obligations maturing in less than five years (Prob C §9730(b)); or

(4) Investing in a common trust fund for short-term fixed income obligations (Prob C §9730(c)).

Before expiration of the time for filing creditors' claims, with court authority the executor may invest in California or federal obligations without maturity date restrictions (Prob C §9731), purchase an annuity (Prob C §9733), exercise an option right (Prob C §9734) or a subscription right (Prob C §9737), and purchase shares or commodities that the decedent sold short (Prob C §9735).

After the time for filing claims has expired and all claims have been paid or secured, with court approval the executor may invest estate money "in any manner provided in the will." Prob C §9732.

Without a court order and without awaiting expiration of the creditors' claims period, an executor who has authority under the IAEA may:

- Deposit estate money in an insured bank or savings and loan account in California;
- Invest in the ways described in (1)-(4) above (Prob C §§9700 and 9730(a)-(c) are duplicated in the IAEA in Prob C §10533(a)(1), (a)(2)(A)-(C)); and
- Invest estate money in securities made eligible for the investment of surplus state funds by Govt C §16430.

More important, the executor may also invest estate assets "in any manner provided by the will." Prob C §10533(a)(2)(D), (3). (Notice of the proposed action is required for investments not described in (1)-(4) above, even if they are authorized in the will. Prob C §10533(b)-(c).)

Without giving notice, the executor with authority under the IAEA may vote a security (Prob C §10551), sell or exercise security subscription or conversion rights (Prob C §§10537, 10561), exercise an option (Prob C §10558), or purchase securities or commodities sold short by the decedent (Prob C §10559).

Because of the additional latitude in investing that the will can provide an executor with or without IAEA powers, the will drafter usually should include clauses specifying the forms of investments acceptable to the testator. For a suggested clause, see form 33.20-1.

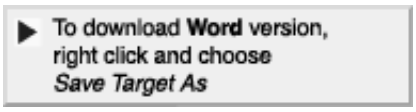
Although some testators may wish to restrict permissible investments in accordance with their own investment philosophies, most will drafters permit the executor broad discretion to select investments appropriate to the economic conditions during estate administration and to the needs of the estate and its beneficiaries. It is unwise to direct particular investments or investment strategies in the will because the testator can foresee neither the estate's financial needs nor future market conditions.

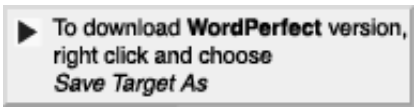
On executor's investment powers generally, see 2 California Decedent Estate Practice, chap 19 (2d ed Cal CEB 2009).

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.20 b. Form: Broad Power to Invest

§33.20 b. Form: Broad Power to Invest





33.20-1 Power to invest

***Investment Powers*. My executor may invest and reinvest surplus money of my estate in any kind of real, personal, or mixed property that my executor considers advisable, including but not limited to improved and unimproved real property; interest-bearing accounts; corporate and government obligations; preferred or common stocks; shares of mutual funds; investment trusts; and stocks, obligations, and shares or units of common trust funds of any corporate fiduciary. My executor shall not be liable for failure to exercise this power.**

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/ 4. Tax Powers and Duties/§33.21 a. Tax Clauses Highlight Issues and Clarify Duties

4. Tax Powers and Duties

§33.21 a. Tax Clauses Highlight Issues and Clarify Duties

Among the executor's most important duties is the responsibility to:

- Determine tax liabilities of the estate and the decedent; and
- Ensure that tax returns are prepared and timely filed, that tax elections are intelligently considered and made when necessary, and that taxes owed by the estate are fully satisfied.

The executor can be held personally liable for failure to perform this responsibility properly. See §32.26. For general discussion of an executor's tax responsibilities, see California Decedent Estate Practice, chaps 33-34 (2d ed Cal CEB 2009).

Even without specific will provisions, the executor has authority to make many tax decisions for the estate. For example, the executor may have to consider the following elections:

- Selection of the estate's fiscal year for income tax purposes (IRC §441(b)).
- Choice of the decedent's date of death or the alternate valuation date 6 months after the date of death, or the date on which the property is "disposed of" within that 6 months, to value estate assets for federal estate tax purposes (IRC §2032). The alternate valuation date election cannot be made on a return filed more than one year after the due date (including extensions). *Estate of Edward H. Eddy* (2000) 115 TC 135; Treas Reg §20.2032-1(b); IRS Letter Ruling 200419005.
- Discontinuation of S corporation election if the estate has an interest in an S ("tax-option") corporation. This election requires the vote of more than half the corporation's shares. See IRC §1362(d). An estate may be a qualifying shareholder for a reasonable period of administration. IRC §1361(b)(1)(B); *Old Va. Brick Co. v Commissioner* (4th Cir 1966) 367 F2d 276.
- Elections affecting any partnership interest in the estate, including the executor's election to treat the estate tax value of partnership property distributed within 2 years of death as its adjusted partnership basis under IRC §732(d). Under IRC §743(b), this election is available only if the partnership has made the election (on its partnership return) under IRC §754 to adjust the basis of transferred partnership assets to reflect the date-of-death value of the decedent's partnership interest. Because partners' interests in partnerships are generally subject to buy-sell agreements, the executor should also consider joining with the surviving partners to make two modifications to the partnership agreement: (1) to set a value on partnership goodwill (payment for which is capital gain rather than ordinary income, unlike payment for receivables and inventory (IRC §§735(a), 736(b)(2)(B)) and (2) to change the partnership's tax year (if permissible under IRC §706). See Advising California Partnerships §§9.17-9.19, 9.21 (3d ed Cal CEB 1999) on IRC §§743(b) and 754 elections. Regarding buy-sell agreements generally, see Business Buy-Sell Agreements (Cal CEB 1991). Revenue and Taxation Code §17851 adopts these provisions of the Internal Revenue Code (IRC §§732(d), 736, and 743(b)) for purposes of state taxation.
- Corporate redemption of estate stock under IRC §303 or Rev & T C §17321 to pay death taxes and expenses, if the estate's interest in a corporation exceeds 35 percent of the value of the gross estate less IRC §§2053-2054 deductions. This redemption can allow the proceeds to benefit from capital gains tax treatment, which will provide an offset for capital losses.
- Election of the payment method for death benefits from qualified plans (lump-sum payment or payments over 2 or more tax years). Income tax considerations must be weighed in making this election. See IRC §§402(e), 2039.
- Obtaining an extension of time to pay federal estate tax (for up to 10 years) based on reasonable cause. IRC §6161(a)(2).
- Obtaining an extension of time to pay federal estate tax on a reversionary or remainder interest. IRC §6163.

- Obtaining an extension of time to pay federal estate tax when the estate consists largely of interests in one or more qualified closely held businesses. IRC §6166.
- Election of special valuation for estate tax purposes of real property used as a farm or in a trade or business. IRC §2032A.
- Election to have the gross estate deduct all or a portion of the value of qualified family-owned business interests (not applicable to decedents dying after December 31, 2003, and before January 1, 2011). IRC §2057.
- Disclaimer on behalf of the decedent of interests that pass to the decedent at death, thus avoiding their taxation as part of the estate. See IRC §2518; Prob C §277(b). On disclaimers generally, see Prob C §§260-295; §§20.27-20.29, 31.14; California Estate Planning, chap 27 (Cal CEB 2002).
- Election under IRC §2056 to allow qualified terminable interest property to qualify for the marital deduction for federal estate tax purposes. See §§33.49-33.50 for further discussion and forms. See also chap 19.
- Election, for estate of second spouse to die, to treat qualified terminable interest property as if no election was made when the first spouse died. The purpose is to make the first estate the transferor for generation-skipping transfer tax purposes. IRC §2652(a)(3).
- Election to determine whether a distribution of property other than cash will be treated as a taxable event with the estate realizing a gain or loss, based on a change in value while the estate held the property. IRC §643(e). See Decedent Estate Prac §33.98.
- Exercise of the right under IRC §2207A to recover the estate taxes allocable to qualified terminable interest property includable in the gross taxable estate (although not includable in the probate estate) of the second spouse to die, from the recipient of the property (unless the second decedent's will or revocable trust provides otherwise). See §26.11. See also Decedent Estate Prac §§34.4, 34.35.
- Election to have revocable trust treated and taxed as part of the estate for federal income tax purposes. IRC §645.

Although the executor has full power to make the above elections without enabling will clauses, it may be wise to draft specific authorizations for particular elections to alert the executor to their existence.

The drafter should use other specific will clauses to clarify the testator's intent. For example, the will could contain language allocating the death tax burdens and clearly indicate whether the taxes are to be equitably prorated among the beneficiaries as provided in Prob C §§20100-20225, paid from the residuary estate, or allocated in some other manner. Such clauses must be drafted with caution. See chap 26 for discussion of making such allocations and suggested clauses for realizing the testator's plan.

If the executor has power to make tax decisions that may shift income, gift, or death tax burdens among persons interested in the estate, the drafter should include a will clause specifically stating that the testator does not intend the beneficiaries' shares to be reallocated to compensate for those decisions. Otherwise, reallocation may be required. This clause prevents potential disputes among beneficiaries as well as the additional accounting necessary when compensatory reallocations are made. See *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 68, in which the court held that an executor may not favor one beneficiary over another unless specifically authorized by the will. If an election benefits some beneficiaries to the detriment of others, the executor must equalize the estate shares. See Decedent Estate Prac §33.91 on the requirement that the executor act with impartiality.

The will drafter should also include a clause immunizing the executor from potential liability to beneficiaries for tax elections that may favor one beneficiary (or group) over another. The executor can then make decisions based on the best interests of the estate as a whole, without concern that certain decisions may result in tax consequences adverse to a particular beneficiary. See suggested clause in §33.22.

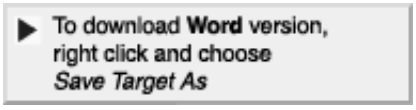
On the effect of tax decisions on the interests of beneficiaries, see *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842, in which the appellate court upheld trial court adjustments of the price for which the fiduciaries redeemed stock for payment of death taxes and expenses. For an analogous case in which the court held that a trustee who was given "absolute discretion" by the trust instrument must nonetheless uphold fiduciary standards, see *Estate of Collins* (1977) 72 CA3d 663, 139 CR 644.

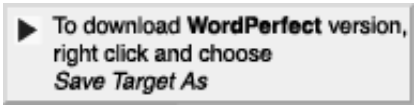
PITFALL: Waiving adjustments for tax elections or otherwise directing adjustments in the will may jeopardize allowance of a marital deduction or charitable deduction for estate tax purposes. See chap 17.

On similar reallocation issues resulting from the executor's discretion in selecting assets for distribution, see §33.25.

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§33.22 b. Form: Power to Take Actions Without Regard to Tax Consequences





33.22-1 Power to make tax decisions (no adjustments required)

***Power to Make Elections and Other Decisions Without Regard to Tax Consequences*. My executor may make the following choices or elections, regardless of the effect on other provisions of my will or on any person interested in my estate: (1) choose a valuation date for estate tax purposes; (2) choose the methods to pay estate or inheritance taxes; (3) elect to treat or use an item either as an income tax deduction or as a death tax deduction, for either federal or state tax purposes; (4) determine when a particular item will be treated as taken into income or used as a tax deduction, to the extent the law provides that choice; (5) disclaim all or any portion of any interest in property passing to my estate at or after my death; (6) join with the trustee of my revocable trust in filing income tax returns; and (7) join with my spouse or my spouse's estate in filing joint income or gift tax returns for any years for which I have not filed returns before my death and consent to any gifts made by my spouse as being made half by me for gift tax purposes, even though either of these actions may subject my estate to additional tax liabilities. No person adversely affected by any of these choices is entitled to any reimbursement or adjustment, and my executor is not required to make any adjustment between income and principal or in the amount of any property passing under my will as a result of any election under this provision.**

Comment: Note that executor's choice (7) in this clause applies only to estates of married decedents and must be deleted when this provision is used for the wills of unmarried clients. This clause makes clear that any adverse tax effects suffered by estate beneficiaries due to the executor's exercise of certain tax elections do not give rise to claims by beneficiaries against either the estate or the executor. As an alternative to this clause, the will can direct the executor to make adjustments among beneficiaries to compensate for adverse tax consequences. If the testator does intend to favor a particular beneficiary or class of beneficiaries, the will should state this.

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5. Distributing Estate Assets

a. Timing Distributions

§33.23 (1) Control Over Timing Is Limited

The executor has limited control over the timing of distributions from the estate or the length of its administration, regardless of the testator's wishes. The earliest a preliminary distribution can take place is 2 months after issuance of letters testamentary. Prob C §§11600-11602, 11620-11622, 12540 (ancillary probate); Prob C §11623 (procedure for representative with authority under the Independent Administration of Estates Act). Distributions may be delayed by the need to obtain an order providing for alternate distributees under Prob C §11603 or an order approving distributions to persons other than the beneficiary under Prob C §11604. See, *e.g., Estate of Molino* (2008) 165 CA4th 913, 81 CR3d 512 (agreement authorizing assignee heir hunter to select and pay attorney invalid as a matter of public policy). The latest time for distribution is controlled by the rules governing the length of the administration period. When the estate is ready to be closed, the executor must render a final account (unless waived; see §32.29) and petition for final distribution of the estate assets (Prob C §§10951, 11640). If a petition for final distribution has not been filed within 12 months after the executor's appointment when no federal estate tax return is due, or within 18 months when a return is due, the representative must file a status report explaining why the estate cannot be closed and requesting authority to continue administration. Prob C §12200. Any limitation on the time of administration contained in the will is directory only; the executor and the court may continue administration as long as necessary. Prob C §12206. Moreover, the Internal Revenue Service may independently determine when an estate's administration period has ended, regardless of local court action. IRC §641(a)(3); Treas Reg §1.641(b)-3(a); *Brown v U.S.* (5th Cir 1989) 890 F2d 1329.

A problem may arise concerning the length of administration when there is a dispute with the Internal Revenue Service about the value of an estate asset. It may be in the best interests of the estate to refrain from selling the asset until the estate tax audit is complete, because the sale might establish a value different from the date-of-death value. Beneficiaries, however, may pressure the executor to sell the asset and distribute the proceeds, using the status report requirement under Prob C §12200 to seek the probate court's direction for the executor to do so. A narrowly drawn clause in the will, authorizing the executor to hold assets and refrain from selling them pending the outcome of an estate tax audit, serves two purposes:

(1) It shows that the executor, by not distributing the estate within 18 months, is acting in accordance with the testator's desires; and

(2) It diminishes pressure on the executor from beneficiaries to sell and distribute assets.

See form 33.24-1 for a suggested clause.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.24 (2) Form: Power to Postpone Selling Assets Pending Outcome of Estate Tax Audit

§33.24 (2) Form: Power to Postpone Selling Assets Pending Outcome of Estate Tax Audit

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33.24-1 Power to postpone asset sale pending audit

***Power to Postpone Sale of Assets*. My executor may postpone selling any asset pending the outcome of an audit with the Internal Revenue Service or other taxing authority if the executor determines that it is in the best interests of the estate to do so.**

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b. Selecting Assets to Satisfy Shares

§33.25 (1) Clause Permitting Executor Asset Selection Gives Needed Protection

When the will directs gifts of fixed fractions of the estate to several beneficiaries, the executor must decide whether to distribute each asset pro rata or to distribute the assets in another manner to satisfy each beneficiary's share. Because a prorata distribution gives each beneficiary a proportionate share of each asset, each distributee is treated alike with respect to all characteristics of the asset, including liquidity and income tax basis. A nonprorata distribution, which gives beneficiaries different assets or selections of assets, may result in the beneficiaries' being treated in different ways even though the proportionate values of their gifts will be as directed in the will. For example, whether the distributed gift has a high or low income tax basis for capital gains treatment substantially affects the gift's ultimate value to the recipient. Because executors must treat all beneficiaries with impartiality and may not benefit some at the expense of others (*Roach v Coffey* (1887) 73 C 281, 14 P 840), an executor who is not protected by a specific will clause should obtain the beneficiaries' consent to a proposed nonprorata disposition.

To provide the executor with maximum flexibility in choosing assets to satisfy the will's dispositive plan, the testator may give the executor authority to select assets for distribution in his or her discretion, on a prorata basis or otherwise, and without regard to the tax basis of particular assets. This discretion allows the executor to consider asset characteristics other than value in making distributions so that he or she may, *e.g.,* distribute low-basis assets to low tax-bracket (or charitable) beneficiaries and vice versa without fear of challenge. *Estate of Bixby* (1956) 140 CA2d 326, 295 P2d 68, illustrates dangers inherent in tax decisions made without a protective clause. In *Bixby,* an executor's tax election favored income over remainder beneficiaries. The court required the executor to reallocate funds to equalize the beneficiaries' treatment. See also California Decedent Estate Practice §§4.14-4.17 (2d ed Cal CEB 2009). Of course, the executor must still exercise this discretion fairly for all beneficiaries.

PITFALL: An intended marital or charitable deduction may be reduced if the executor has discretionary adjustment powers that permit infringement on the gift interests of a distributee spouse or charity. See chaps 13 and 17 on charitable and marital deduction gifts, respectively, and requisites for successful deductible gifts. On using particular assets to fund marital deduction and bypass trusts, see California Trust Administration, chap 14 (2d ed Cal CEB 2001).

The clauses in §§33.26-33.28 provide powers routinely granted in combination.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.26 (2) Form: Power to Distribute Property Nonprorata

§33.26 (2) Form: Power to Distribute Property Nonprorata

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33.26-1 Power to distribute property nonprorata

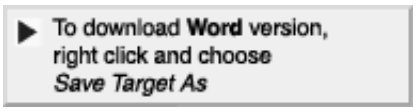
***Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata.**

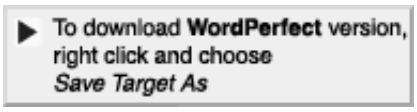
Comment: If this form is used, form 33.27-1 (power to allocate property to distributive shares) and form 33.30-1 (power to satisfy pecuniary devise in kind) are not needed. If the client wants the executor to use a valuation date different from that provided by statute in making a distribution in kind, this clause should be amended.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.27 (3) Form: Power to Allocate Property to Shares

§33.27 (3) Form: Power to Allocate Property to Shares





33.27-1 Power to allocate property to distributive shares

***Power to Allocate Property to Distributive Shares*. In selecting estate property to be distributed in fulfillment of any nonspecific devise made in my will, my executor may determine which property to allocate to the portions to be distributed.**

Comment: This clause is not needed if form 33.26-1 is used. If this clause or that clause is not used, the drafter should state in the will whether the executor may consider the assets' income tax bases when making the allocation decisions. For a form of broad power to consider basis and make adjustments, see §33.28.

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§33.28 (4) Form: Power to Consider Basis and Make Adjustments When Making Distributions

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33.28-1 Power to consider basis and make adjustments when making distributions

***Power to Make Adjustments for Tax Basis*. My executor may consider the income tax bases of estate assets when allocating property to fulfill devises. My executor may make adjustments to shares or gifts to compensate for the tax consequences of any distribution that my executor believes may directly or indirectly prefer one beneficiary or group over another; my executor's decisions in this regard shall be final. My executor may allocate property to fulfill devises without regard to the income tax bases of estate assets and shall not be liable for failure to exercise the powers to consider tax bases or to make compensatory adjustments provided above.**

[*If applicable, add the following option*]

[*Option: Limited discretion regarding gifts intended to qualify for marital or charitable deduction*]

My executor shall not exercise these powers, however, in a manner that will reduce, eliminate, or jeopardize any estate tax marital or charitable deduction otherwise available to my estate.

Comment: Form 33.28-1 provides maximum discretion to the executor. Note that the powers given are discretionary; if the testator wants to require any of these actions, the clause must be amended. If estate tax marital or charitable deductions are intended, the optional addition must be used as well; it is designed to prevent the discretion provided in form 33.28-1 from causing loss of the full deduction otherwise available.

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c. Using In-Kind Property to Satisfy Pecuniary Devises

§33.29 (1) Proper Asset Valuation Assures Fairness and Protects Deductions

The will may authorize the executor to satisfy a pecuniary devise in whole or in part by distribution of property other than money. Without such a clause, an executor may be forced to sell assets to raise cash when the market is bad or when the sales process is expensive or time-consuming.

To meet the terms of a gift, however, an executor satisfying a pecuniary devise with noncash assets must ensure that the assets are properly valued. Unless the will provides otherwise, the property selected must be valued as of the date of distribution. Prob C §21118(a). If the will provides that assets may be valued on another date, the property selected must fairly reflect appreciation and depreciation occurring between the valuation date and the date of distribution unless the will provides otherwise. Prob C §21118(a).

The Internal Revenue Service has ruled that the estate tax marital deduction or charitable deduction may be disallowed if the executor has the ability to favor the nonspousal or noncharitable beneficiaries in funding pecuniary devises; however, valuing the assets as of the date of distribution will preserve the deductions. Rev Proc 64-19, 1964-1 Cum Bull 682; Rev Rul 90-3, 1990-1 Cum Bull 175. Fairly representative funding provided by the second clause of Prob C §21118(a) also ensures compliance with Rev Proc 64-19. See §17.64. Note that minimum-worth funding ensures compliance with Rev Proc 64-19 when the marital gift is the pecuniary gift, but violates the mandate of Rev Proc 64-19 when the credit shelter gift is the pecuniary gift and the residue funds the marital gift. See §17.50. Consequently, the executor's powers should not overrule Prob C §21118(a) with regard to date-of-distribution or fairly representative funding of marital or charitable gifts.

Fortunately, Prob C §21522(c) operates with Prob C §21118(a) to ensure that an executor's discretion to value assets for distribution will not disqualify devises from the marital deduction. Probate Code §§21540-21541 perform the same function for charitable remainder and charitable lead trusts. Under these statutes, if a testator intends a devise to qualify for the marital deduction or as a charitable remainder trust or charitable lead trust, the terms of the will must be construed to comply with the relevant tax provisions; the fiduciary may not take any action that impairs the deduction. Prob C §§21522(c), 21540-21541.

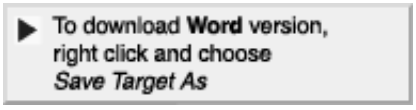
See California Estate Planning, chap 17 (Cal CEB 2002) on gifts qualifying for marital deduction, Estate Plan, chap 23 on gifts qualifying for charitable deduction.

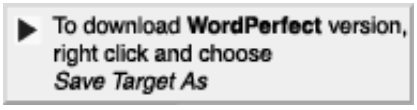
PITFALL: The executor's exercise of discretion in satisfying the devise can affect the estate's tax liability in another way. When appreciated assets are used to satisfy a pecuniary gift, the estate will realize a capital gain of the difference between the dollar amount of the gift and the basis of the property distributed. See Rev Rul 56-270, 1956-1 Cum Bull 325. See also Decedent Estate Practice §§33.98, 33.119, 33.127 (2d ed Cal CEB 2009).

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.30 (2) Form: Power to Use In-Kind Property to Satisfy Pecuniary Devise

§33.30 (2) Form: Power to Use In-Kind Property to Satisfy Pecuniary Devise





33.30-1 Power to satisfy pecuniary devise in kind

***Power to Satisfy Pecuniary Devise in Kind*. Except when my will specifically provides otherwise, my executor may satisfy any general pecuniary devise by cash, by in-kind property valued as of the date of distribution, or partially by each.**

Comment: This clause is not needed if form 33.26-1 is used. If the client wants the executor to use a valuation date different from that provided by statute, this clause should be amended. See §33.29 on Prob C §21118(a) and valuation issues.

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d. Dividing Community Property Nonprorata

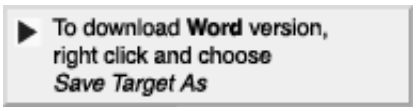
§33.31 (1) No Gain or Loss Recognition on Nonprorata Division

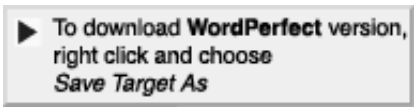
A decedent's estate includes an undivided 50-percent interest in each asset the decedent and his or her spouse owned as community property. The estate and the surviving spouse can agree to a nonprorata division of the community property without recognizing gain or loss. See Rev Rul 76-83, 1976-1 Cum Bull 213 (nonprorata division at marital dissolution); IRS Letter Ruling 199925033 (nonprorata division at death). See also IRC §1041, which provides that no gains or losses will be recognized on transactions between spouses. When an estate will contain community property, the will should include a clause permitting the executor to agree with the surviving spouse to divide the community property nonprorata, so that the estate need not own half of each community property asset.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.32 (2) Form: Power to Divide Community Property Nonprorata

§33.32 (2) Form: Power to Divide Community Property Nonprorata





33.32-1 Power to divide community property nonprorata

***Power to Divide Community Property Nonprorata*. My executor may agree with my surviving spouse or my spouse's legal representative to divide community property in cash, in divided or undivided interests in kind, or partly in cash and partly in kind, either prorata or nonprorata, at reasonable values as of the date(s) of division.**

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/ e. Distributing Devises for Benefit of Minors or Incompetents/§33.33 (1) Gifts to Minors or Persons With Disabilities May Require Special Distribution Clauses

e. Distributing Devises for Benefit of Minors or Incompetents

§33.33 (1) Gifts to Minors or Persons With Disabilities May Require Special Distribution Clauses

Gifts to minors or to adults with physical or emotional difficulties who cannot manage property present an executor with special problems.

The executor can distribute directly to the beneficiary any gift that the beneficiary can use appropriately and that does not require management. The executor will prefer not to distribute directly, however, any gift that the beneficiary cannot use or manage properly. Direct distribution in such a situation would deprive the recipient of the property's full benefit.

If the beneficiary is a minor or person with a disability with a fiduciary empowered to receive property on the beneficiary's behalf, the executor can distribute to that representative. When there is no fiduciary, however, the executor without instruction in the will must look to distribution methods sanctioned in the statutes.

The Probate Code provides a variety of ways to distribute gifts to minors even without specific authorization in the will:

- The executor can distribute property to a minor beneficiary's parent if the minor's total estate, including the distribution, totals $5000 or less. Prob C §3401. See Prob C §3400(b) for definition of "total estate." Probate Code §3413(d) reiterates this rule for money gifts.
- The executor may make an irrevocable transfer of the testamentary gift to a custodian under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925); the transfer must be authorized by the court if it exceeds $10,000 unless the custodian is a trust company. Prob C §3906(a), (c).
- With a court order under Prob C §3413(a)-(c), gifts of money to a minor can also be deposited in a "blocked" account (subject to withdrawal only on court order); distributed to an adult custodian for the benefit of the minor under CUTMA; or, if less than $20,000, held as the court directs.
- The executor can petition to have a guardian appointed to receive the money under Prob C §3413.
- If the executor holds money "for the benefit of a minor" as the result of a judgment in favor of the minor (*e.g.,* wrongful death award), the executor can obtain a court order for payment of the money in accordance with Prob C §3611, which offers alternatives similar to those described above. Prob C §§3600, 3610.

Even nonmonetary gifts can be distributed to an adult or trust company as custodian for the minor under CUTMA, if the executor considers the transfer to be in the minor's best interests, the transfer is not prohibited by or inconsistent with the will's provisions, and any transfer of property valued over $10,000 is authorized by the court. Prob C §3906. (Any distribution from the estate must be authorized by the court in any event. See Decedent Estate Practice, chaps 25, 30-32 (2d ed Cal CEB 2009) for discussion of procedure to obtain orders for distribution.)

Note that all these custodial arrangements will terminate, and the gift will be distributed directly to the beneficiary, when the beneficiary reaches age 18.

A testator making a sizable gift to a minor should consider using a testamentary trust to receive and administer the gift. See chap 22 regarding trusts for children and grandchildren. For smaller gifts that would present the minor beneficiary with use or management problems, the will should usually direct distribution to a custodian for the minor under CUTMA so that guardianship can be avoided. If possible, the will should name the custodian (and a successor candidate). The will should also state when the custodianship will terminate; a custodianship under CUTMA terminates when the beneficiary attains age 18, unless the will expressly specifies a later age up to age 25. Prob C §3920.5.

The only statutes that address the issue of distributions of property belonging to nonconservatee incompetent adults are Prob C §§3600-3612. These sections provide judicial authority to order the disposition of funds received from a court-approved settlement of a matter in which the person with a disability is a party or as a result of a judgment in the disabled party's favor. For the person with a disability who is not a conservatee, the funds may be deposited in a blocked account (to be withdrawn only by court order) or (if not over $20,000) held as the court "determines to be in the best interest" of the person with a disability. The remaining balance of any money may be paid to a special needs trust meeting the specific requirements of Prob C §§3611 and 3604 and established under Prob C §3604 for the benefit of

the minor or person with a disability. Prob C §3611(b)-(d). Money paid to the Prob C §3604 special needs trust may be limited. Prob C §3604(b)(3). See Drafting California Irrevocable Trusts, chap 13 (3d ed Cal CEB 1997).

If the testator anticipates that an adult beneficiary will be unable to handle an expected gift, the drafter should try to include directions to the executor for the gift's distribution. Providing these directions may be crucial for the gift to be of use at all, because otherwise the executor may distribute the gift without realizing that special arrangements need to be made.

It may be appropriate to provide for distribution of the gift to a testamentary trust. If the beneficiary is or may be the recipient of public benefits, then a "special needs" trust may be the appropriate form for that trust to take. See chap 21 on payment and distribution clauses in testamentary trusts; chap 23 on "special needs" trusts. If a trust is not required because the gift is not so large or complex that a trustee must manage it, yet the beneficiary would have difficulty using the gift appropriately without help, the testator may wish the gift to go to a conservator for the beneficiary. If so, the will should nominate primary and successor conservators. Whatever the gift or the beneficiary's condition, the drafter must make it possible for the executor to deliver the property to someone able to give a receipt, so that the executor can obtain discharge from his or her fiduciary obligations to the estate.

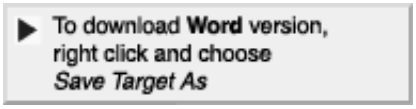
The clauses in §§33.34-33.35 are meant to be used only as "backstops" in case a minor or an adult with an incapacitating condition receives a gift not necessarily intended for him or her. Examples are a residuary gift to a family group or a gift passing via the antilapse provisions of Prob C §21110(a). As noted above, if the testator expects that the gift will pass to a minor or person with a disability, the drafter should provide specific directions for the gift's distribution.

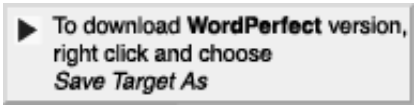
Form 33.34-1 covers distributions both to minors and to adults unable to manage extensive property. Form 33.35-1 provides direction only for distributions to minors.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.34 (2) Form: Distributing Gifts to Minors or Disabled Persons

§33.34 (2) Form: Distributing Gifts to Minors or Disabled Persons





33.34-1 Distributing gifts to minors or disabled persons

***Distribution of Gifts to Minors or Disabled Persons*. My executor may distribute a gift made in my will to any beneficiary who is a minor, who is under any legal disability, or who is unable in the executor's judgment to use or manage the property properly by reason of mental or physical illness or disability, to (1) the beneficiary's guardian or conservator of the estate, (2) a custodian for the minor beneficiary under the California Uniform Transfers to Minors Act, or (3) the minor beneficiary's parent. My executor may distribute the property to the beneficiary directly if, in the executor's judgment, the beneficiary has the capacity and maturity to use and manage the gift appropriately. The receipt of any of the above-described distributees shall suffice for the executor's discharge with regard to the property.**

Comment: This clause applies to both minors and adults. It is intended to serve only when a remainder gift or failed specific gift could pass to a minor or to an adult with an incapacitating condition. If the will makes an outright gift to a minor or adult with an incapacitating condition, this clause should not be used. Instead, the drafter should provide specific directions on whether the beneficiary should receive the gift directly and, if not, who should receive the gift for the beneficiary and in what capacity that distributee will serve (*e.g.,* guardian, conservator, custodian). Major gifts probably should be made in trust.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.35 (3) Form: Power to Distribute Gift to Minor

§33.35 (3) Form: Power to Distribute Gift to Minor

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

33.35-1 Power to distribute gift to minor

***Distribution of Gifts to Minors*. If the beneficiary of property from my estate is a minor when the property will be distributed, and my will names no custodian to receive the property for the minor under the applicable Uniform Transfers to Minors Act, then my executor may distribute the property to (1) a legally appointed guardian of the beneficiary's estate; (2) an adult selected by the executor as custodian for the minor beneficiary under the California Uniform Transfers to Minors Act until the minor reaches age _ _**[*number up to 25*]**_ _**; (3) the beneficiary's parent; or (4) the beneficiary directly if, in the executor's judgment, the beneficiary has the capacity and maturity to use the gift appropriately. The receipt of any of the above-described distributees shall suffice for the executor's discharge with regard to the property.**

Comment: This clause addresses distributions to or for a minor beneficiary. The drafter should consult the testator on whether a delayed (past age 18) distribution to the beneficiary is preferred if the distribution will be made to a custodian under the California Uniform Transfers to Minors Act.

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f. Authorizing Payment for Distribution Costs

§33.36 (1) Clause Prevents Beneficiary Disputes Over Distribution Costs

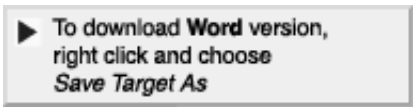
When the testator's gifts will require special care and handling to transfer, the will should contain instructions on the payment of expenses (*e.g.,* packing, shipping, and insurance) incurred in distributing the property to the beneficiaries. Such a clause helps avoid disputes among beneficiaries over whether the estate as a whole or the beneficiaries of the various gifts should pay these expenses. The clause may also help convince tax authorities that the distribution costs are necessary and therefore should be deductible as administration expenses. See Reg §20.2053-3(d)(1).

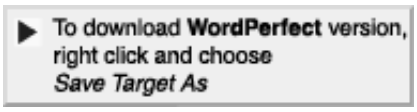
If the testator wishes a beneficiary to pay all distribution costs or some distribution costs but not others (*e.g.,* insurance but not packing), the will should state this.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.37 (2) Form: Power to Pay Costs of Distribution

§33.37 (2) Form: Power to Pay Costs of Distribution





33.37-1 Power to pay costs of distribution

***Costs of Distribution of Personal Property*. My executor shall pay from my estate any storage, packing, shipping, delivery, insurance, and other charges relating to the distribution of property from my estate, and treat these payments as an administration expense.**

Comment: To relieve the executor from the burden of having to decide which gift-related expenses to pay, this clause requires the executor to pay the distribution expenses. If the estate contains any gift items whose distribution will entail extraordinary expenses (*e.g.,* livestock), the drafter should specifically mention those items and any related distribution costs.

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6. Avoiding Interest on General Pecuniary Devises

§33.38 a. Clause Prevents Imposition of Statutory Interest

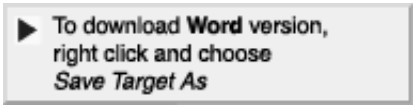
In the absence of a specific clause in the will, California law provides for interest on undistributed general pecuniary devises, beginning one year after the date of the decedent's death. Prob C §12003. The rate of interest is defined in Prob C 12001. The testator may want to include a provision to (1) relieve the executor from the need to calculate and pay accrued interest or (2) provide for interest at a different rate, perhaps beginning on a different date. Among other practical concerns, the practitioner should be aware that interest on devises may not be deductible for income tax purposes if the IRS determines that the delay in distribution was unnecessary. See *Schwan v U.S.* (D SD 2003) 264 F Supp 2d 887.

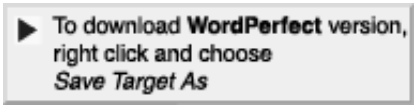
PITFALL: Such a clause should contain an exception for any gift meant to qualify for the marital deduction to avoid losing the deduction on the ground that a waiver of the interest provided by law prevents the spouse from receiving all income from the gift, a requirement for the deduction. IRC §2056(b)(5), (7). See chap 17. The clause also should contain an exception for any gift (other than a split-interest gift) meant to qualify for the charitable deduction to avoid losing the deduction on the ground that a waiver of the interest provided by law prevents the charity from receiving the exclusive use of the property as required by IRC §2055(a). See chap 13. The requirements for a split-interest gift ensure that the charitable interest will not be diminished by the failure to promptly fund the gift. IRC §2055(e). See chap 14.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.39 b. Form: General Pecuniary Devises Do Not Bear Interest

§33.39 b. Form: General Pecuniary Devises Do Not Bear Interest





33.39-1 No devise bears interest

***Devises Not to Bear Interest*. No devise in my will _ _**[*or in any codicil to it*]**_ _ shall bear interest even if the devise is not paid or satisfied within any period prescribed by law.**

[*If applicable, add the following option*]

[*Option: Exception for marital deduction gift and charitable deduction gift*]

This clause shall not apply to the marital deduction gift in paragraph _ _[*number*]**_ _ or the charitable deduction gift in paragraph _ _**[*number*]**_ _.**

Comment: This clause should be used with caution. In most cases, the phrase "or in any codicil to it" should not be used. The attorney has no way of knowing what gifts may be provided by a codicil, and the clause may be included in the codicil if desired. The attorney must make sure that the clause does not prevent the payment of statutory interest on gifts intended to qualify for the marital deduction or charitable deduction. See Pitfall in §33.38.

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7. Retaining Investment Counsel

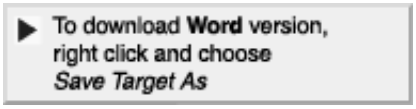
§33.40 a. Clause Is Prerequisite for Adviser's Employment

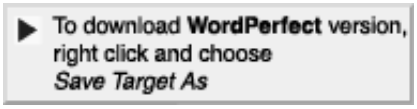
Because broad investment powers are available to most executors, many executors may need an investment adviser's assistance in properly investing the estate assets. A clause empowering the executor to retain investment counsel is particularly helpful for individual (as opposed to corporate or private professional) fiduciaries. Although an executor has a duty only to preserve the estate assets pending distribution and not to invest them for capital appreciation, the testator may nevertheless want the executor to retain an adviser to ensure proper investment of the assets, especially if estate administration may be prolonged.

Probate Code §10801(b) specifically authorizes an executor to employ tax experts to prepare tax returns and perform other tax responsibilities, but there is no analogous statute providing a similar power to retain investment counsel. If the testator wants the executor to be able to retain investment advisers, the employment should be specifically authorized in the will. See §33.41. The clause may also help characterize the adviser's fees as administration expenses deductible for estate tax purposes. See Treas Reg §20.2053-3(d)(1).

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§33.41 b. Form: Power to Retain Investment Adviser





33.41-1 Power to retain investment adviser

***Power to Retain Investment Adviser*. My executor may retain an investment adviser without Court approval and on terms that my executor considers proper. My executor may pay the adviser's fee as an administration expense.**

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/ 8. Continuing Decedent's Business/ §33.42 a. Clause Regarding Business Operation Must Work With Codes and Agreements

8. Continuing Decedent's Business

§33.42 a. Clause Regarding Business Operation Must Work With Codes and Agreements

If the testator owns a business, the will usually should contain a clause granting the executor authority to continue to operate the business. The clause should be drafted, however, with any controlling agreements in mind.

As a general rule, an executor may continue operation of an unincorporated nonpartnership business of the decedent for up to six months following issuance of letters, without prior court authorization and regardless of whether the executor is authorized to act under independent administration. Prob C §9760. An executor with authority under the Independent Administration of Estates Act (IAEA) (Prob C §§10400-10600) may operate a nonpartnership business for the same period without giving notice of the proposed action. Prob C §10534(b)-(d). An executor without IAEA authority may continue the business after the six months only under court order (Prob C §9760); with IAEA authority, an executor may continue the business without court order but only after giving "notice of proposed action" (Prob C §10534(b)).

An executor without IAEA authority may continue in the decedent's shoes as the general partner of a partnership business only under court order (Prob C §9762); the executor with IAEA authority may do so without court order (Prob C §10534(a)) but subject to the partnership agreement and the Uniform Partnership Act (Corp C §§16100-16962). The executor with IAEA authority must give "notice of proposed action" to continue as a general partner more than six months after letters are issued. Prob C §10534(d). See Prob C §§10580-10592 for the "notice of proposed action" procedure.

Under the standard of ordinary care and diligence applicable to personal representatives (see Prob C §9600), the executor may have an affirmative duty to continue the business at least for a limited period of time. For example, continued business activity may be necessary for the enterprise to retain its goodwill value. On the executor's business-enterprise duties, see Decedent Estate Practice, chap 23 (2d ed Cal CEB 2009).

Despite the statutory authority for continuing a decedent's business, the personal representative is well advised to obtain prior court authority under Prob C §9760. A court order authorizing the continuation of a business releases the executor from liability for claims based on an act or omission that was directly authorized, approved, or confirmed in the order. Prob C §7250(a). Without the order, the executor must later seek court approval based on a finding that his or her business operation has been in the best interests of the estate and persons interested in it. See Cal L Rev'n Comm'n Comment to Prob C §9760; *Estate of Burke* (1926) 198 C 163, 244 P 340.

When the testator owned an interest in a partnership that will be dissolved, the surviving partner has the right to continue in possession of the partnership assets for the purpose of winding up or continuing the business if appropriate. Corp C §15038(b). The executor has a right, however, to an accounting of the decedent's interest in the business. Prob C §9761; Corp C §§15043, 15510, 15634. The executor may seek a court order to require an accounting if necessary. Prob C §9761. If the partnership continues without settlement of accounts between the estate and the partnership, the executor may demand to receive the value of the decedent's partnership share with accrued interest from the date of death or, in lieu of interest, the profits attributable to use of the estate's share of the partnership property. Corp C §15042. If the surviving partner does not continue in possession of the partnership property, the executor may have the duty to take possession of the property to preserve the decedent's interest in the assets. See *Normart v Safer* (1924) 67 CA 507, 227 P 943.

The executor may seek a court order to continue as a general or limited partner on terms provided by the court as long as this action is consistent with any written partnership agreement. Prob C §9762. (Surviving partners may consent to inconsistent terms. Prob C §9762(a).) Probate Code §9763(b) appears to provide independent authority for the executor to exercise the decedent's rights as a limited partner.

NOTE: Corporations Code provisions supersede those of the Probate Code when the two conflict over rights and duties of the executor and the surviving partners. Corp C §15045.

When a client owns a partnership interest, the drafting attorney should determine (1) whether the partnership

agreement and amendments to it vary from the statutory pattern of operation, accounting, and payment described above, and (2) whether will provisions are necessary to address elections or options provided in the agreement. A court can enforce the terms of a partnership agreement to, *e.g.,* sell the partnership interest to the surviving partners. See *Estate of Foreman* (1969) 269 CA2d 180, 74 CR 699.

If the estate holds stock in a closely held corporation that was not the "alter ego" of the decedent, the executor may exercise only the voting rights represented by the stock and not become involved in running the business of the corporation, which had a separate legal existence from the decedent and is also separate from the estate. In exercising stock ownership rights, the executor must act with the same duty of care that a prudent shareholder would exhibit under similar circumstances. *Estate of Massaglia* (1974) 38 CA3d 767, 113 CR 751. On the alter-ego doctrine, see Counseling California Corporations §§3.78-3.86 (3d ed Cal CEB 2008).

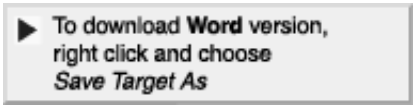
In most cases, a testator with an interest in a business should develop an estate plan designed to pass ownership and control of the interest to others without relying entirely on will provisions. Interests in partnerships or corporations frequently are subject to buy-out agreements. See generally California Estate Planning, chaps 18, 25 (Cal CEB 2002).

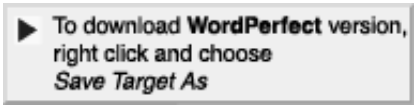
The drafter should inquire not only about existing agreements that may affect the executor's actions regarding a business but also about whether the testator wants particular policies to be followed. For example, if the executor is individually an owner of the business, a clause can describe his or her powers as executor in dealing with himself or herself as owner.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.43 b. Form: Power to Continue or Sell Decedent's Business

§33.43 b. Form: Power to Continue or Sell Decedent's Business





33.43-1 Power to continue or sell decedent's business

***Power to Continue Operation of a Business*. My executor may either (1) continue the operation of a business belonging to my estate for as long as the executor considers it to be in the best interests of the estate or (2) sell or liquidate the business on terms and conditions that the executor considers proper. My executor shall not be liable for any losses resulting from the operation, sale, or liquidation of the business, unless the executor acts in bad faith, is grossly negligent, or engages in willful misconduct.**

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9. Purchasing Property From Estate

§33.44 a. Statutes Limit Executor's Purchases

With the four exceptions noted below, the personal representative and his or her attorney may not directly or indirectly purchase property of the estate "or any claim against the estate." Prob C §9880. This rule is intended to protect the estate's beneficiaries from an executor or an executor's attorney who might otherwise acquire estate property for personal advantage to the detriment of the estate. The Cal L Rev'n Comm'n Comment to Prob C §9880 indicates that the term "personal representative's attorney" must be broadly construed to include associates and partners of, and attorneys of counsel with, the law firm of the executor's attorney and other law firms associated with that firm in any estate proceedings. The term "purchase" is also broadly construed. In *Estate of Martin* (1999) 72 CA4th 1438, 86 CR2d 37, the court held that a redemption of stock owned by the estate should be voided because the executor failed to disclose that she owned stock in the same company.

The statute's prohibition does not extend to the executor's relatives, although a sale of estate assets to such persons for less than full consideration may raise an inference of fraud. *Estate of Denlinger* (1950) 98 CA2d 130, 219 P2d 495. The rule, however, covers a "dummy" purchaser who immediately transfers title to the executor. See *Parkman v Savage* (1964) 227 CA2d 436, 38 CR 664.

There are four exceptions to the general prohibition against purchases of estate property by personal representatives and their attorneys. Representatives and their attorneys may purchase estate property if:

(1) The will authorizes the purchase (Prob C §9882);

(2) All affected beneficiaries or heirs consent to the purchase, and the transaction is shown to be of some advantage to the estate (Prob C §9881);

(3) The will provides an option to purchase (Prob C §9885); or

(4) The decedent and the representative or attorney had a contract for the purchase (Prob C §9884).

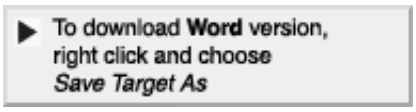
Even purchases made under these exceptions require prior court approval after a noticed hearing. A hearing and order are required even if the executor has full authority under the Independent Administration of Estates Act. Prob C §10501(a)(5)-(7).

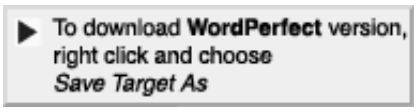
A testator may avoid the statutory prohibitions through will provisions authorizing purchase by, or giving options to purchase to, the executor or his or her attorney. Prob C §§9880, 9882-9883, 9885. Thus, if the named executor or any potential successor executor may want to purchase specific property from the testator's estate, and the testator is not opposed to the purchase, express will provisions may be appropriate—especially if sale of the property may be necessary to pay estate expenses and taxes. General authorization to an executor to purchase estate property is usually not appropriate, especially when conflicts with others interested in the estate may ensue, as may happen if the named executor is one of several beneficiaries under the will.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.45 b. Form: Power to Purchase Estate Assets

§33.45 b. Form: Power to Purchase Estate Assets





33.45-1 Power to purchase estate assets

***Power to Purchase Estate Assets*. My executor may purchase, or exchange assets for, assets of my estate or any fractional interests in it for adequate consideration.**

Comment: If desired, this clause may be modified to limit or specify the estate property subject to it or to set guidelines (*e.g.,* minimum price, terms) for the purchase. The clause may also be used to authorize purchases by the executor's attorney or estate beneficiaries.

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10. Retaining Estate Assets

§33.46 a. Authorization to Retain Assets Protects Executor

A personal representative is held to a standard of ordinary care and diligence in management of the estate. Prob C §9600. Although an executor is normally not responsible for failure to anticipate fluctuations in the price of a publicly traded stock arising from general market conditions, he or she must exercise reasonable care to be informed of special circumstances that might affect the values of estate assets. An executor with special skills (*e.g.,* a bank) is held to a higher standard of care than an ordinary nominee. *Estate of Beach* (1975) 15 C3d 623, 125 CR 570. Because retaining certain assets may be costly to the estate (*e.g.,* when insurance or storage charges accrue), a personal representative may be liable for the extra expense or decline in asset values that results from retaining an asset in apparent violation of the standard of care. Prob C §9601.

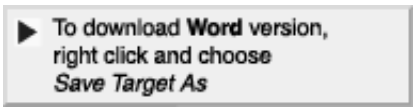
A testator who wants the executor to retain particular assets for distribution, or who wants to protect the executor from potential liability, should include in the will a specific testamentary authorization to retain property. The power may be broad or restricted to particular assets. For example, the authorization may specifically mention assets likely to deteriorate or fluctuate in value. A broad retention power should be used with care, however, because it may excuse negligence on the executor's part.

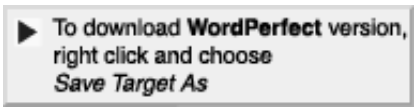
From a tax standpoint, express authorization to retain assets may help secure deduction of the costs of property storage and maintenance as estate administration expenses. See Reg §20.2053-3(d)(1).

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.47 b. Form: Power to Retain Estate Assets

§33.47 b. Form: Power to Retain Estate Assets





33.47-1 Power to retain estate assets

***Power to Retain Estate Assets*. My executor may retain any asset of my estate (including unproductive, speculative, or fluctuating assets) for as long as the executor considers proper. My executor shall not be liable for any resulting losses unless the executor acts in bad faith, is grossly negligent, or engages in willful misconduct.**

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§33.48 11. Instructions Regarding Disposition of Remains and Services; Other Matters

Instructions in the will for the disposition of the testator's remains and for funeral arrangements must be honored, even before the will is admitted to probate. Health & S C §7100(e). The attorney should advise the client that, because a will is often not consulted immediately after death and may not even be readily available to survivors, instructions for disposition of remains and for services or other gatherings should also be provided in a separate writing to the nominated executor and close friends or relatives. Obviously, statements in the will on these matters must not contradict those made outside the will. See §3.55.

The term "funeral expenses" used in a will does not include payment for continuing religious services, *e.g.,* the saying of masses or the Kaddish. *Estate of Silverstein* (1984) 159 CA3d 221, 205 CR 294. Consequently, a decedent who desires continuing religious services should consider authorizing the executor to expend estate assets for that purpose. On devises for care of monuments and burial plots, see §7.15.

Although the testator may give instructions in the will regarding the location of documents, the existence of trusts or other entities in which the testator has an interest, and like matters, this information should be conveyed to the executor by documentation outside the will so that later changes in personal arrangements will not require a codicil to the will or a new will. A letter of instructions is suitable for this purpose. See §5.4.

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§33.49 12. Qualified Terminable Interest Property (QTIP) Elections

Under IRC §2056(b)(7), property passing from a decedent in which the surviving spouse has a "qualifying income interest for life" will be "qualified terminable interest property" (QTIP), which can be deducted from the decedent's gross estate for purposes of determining the taxable estate if the executor makes an election with respect to that property. The election is irrevocable. IRC §2056(b)(7)(B)(v). Uses of QTIP trusts are discussed in chaps 17-19. See also California Estate Planning, chap 17 (Cal CEB 2002).

Because IRC §2056(b)(7)(B)(v) authorizes the executor to make an election to obtain the QTIP marital deduction, the executor has the power to make the election even if the will contains no express authorization to do so. Nevertheless, a clause authorizing the election may be advisable for the following reasons:

- To remind the executor that an election is necessary to obtain the marital deduction.
- To identify the property for which the QTIP election is intended. In wills that contain a QTIP trust and a bypass trust with similar provisions, the will drafter should make clear not only that an election should be made for the QTIP trust but also that an election should not be made for the bypass trust.
- To provide the executor with the testator's guidance on the circumstances under which the election is inadvisable, *e.g.,* when election for a marital deduction in the testator's estate would result in higher combined taxes for the testator's and surviving spouse's estates. (A decision not to make the election would result in shifting a portion of the estate tax burden from the survivor's estate to the estate of the first spouse to die. Note that when the taxes are borne by different beneficiaries in each estate, the executor could be subjected to claims by the affected beneficiaries. A will clause giving the executor discretion to consider the tax consequences of an election on both estates would provide the executor some protection against such claims.)

Some will drafters take the approach that the executor should be not only authorized, but required, to make the QTIP election. Under this view, the surviving spouse's right to file a qualified disclaimer over some or all of his or her interest in the QTIP trust gives the surviving spouse rather than the executor the power to determine how large a marital deduction to claim. Once the surviving spouse has made the disclaimer, the executor can safely be directed to make the election over property that the spouse has allowed to remain in the QTIP trust. On using spousal disclaimers as a postdeath planning device, see Estate Plan §§14.14-14.15. See §19.29 for QTIP election forms.

For forms allocating estate assets to marital deduction and nonmarital deduction portions, see the formula clauses in chap 17. For trust-creating and tax formula clauses for marital deduction power of appointment and QTIP trusts, see chaps 18-19. Clauses for bypass trusts and disclaimer trusts can be found in chap 20.

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Source: Estate Planning/California Will Drafting/33 Powers and Duties of Executor/§33.50 13. Powers Regarding Application of Generation-Skipping Transfer (GST) Tax

§33.50 13. Powers Regarding Application of Generation-Skipping Transfer (GST) Tax

Under the generation-skipping transfer (GST) tax, each individual has a lifetime exemption. IRC §2631. An executor is responsible for allocating a decedent's exemption to the extent that it was not allocated during the decedent's lifetime. See IRC §2632. The GST tax, including the "reverse QTIP election," is discussed in detail in chap 15.

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34

Rule Against Perpetuities

Edward C. Halbach, Jr.

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§34.1 I. CALIFORNIA'S UNIFORM STATUTORY RULE AGAINST PERPETUITIES

California has adopted the Uniform Statutory Rule Against Perpetuities (USRAP). Prob C §§21200-21231. USRAP supersedes the common law rule against perpetuities. Prob C §21201. Although USRAP became effective on January 1, 1992, it applies to all nonvested property interests and unexercised powers of appointment, regardless of their date of creation, except for the validity of property interests or powers of appointment that were determined in a judicial proceeding or by a settlement among interested persons before January 1, 1992. Prob C §21202.

The basic common law rule against perpetuities was articulated in former CC §715.2:

> No interest in real or personal property shall be good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest and any period of gestation involved in the situation to which the limitation applies.

USRAP fundamentally changed and liberalized the common law approach to the rule against perpetuities by adopting a 90-year wait-and-see approach when it is initially uncertain whether the interest will vest within the traditional period. See §34.8. This liberalization does not necessitate revision of existing documents or changes to standard perpetuity savings clauses. USRAP continues to validate any interest that would have been valid under traditional perpetuities law; it also validates any previously void interest that "vests or terminates within 90 years after its creation." Prob C §21205(b).

At the same time that the legislature enacted USRAP, it amended or enacted related legislation on a number of associated problems, such as accumulations, trusts for animals and various noncharitable purposes, and termination of trusts after the allowable perpetuities periods have expired.

In addition, USRAP preserves and adapts the cy pres power that was first granted to California courts in 1963, directing that noncomplying interests be modified in order to approximate the testator's objectives within the allowable period. Prob C §21220. The power no longer need be exercised, however, unless and until a necessity arises, usually after waiting until the end of the 90-year period. By combining the statutory wait-and-see approach with cy pres, USRAP significantly reduces the risk of frustrating the client's intent and thus of attorney malpractice.

USRAP makes clear that testators may not use a "two-pronged" saving clause to take advantage of the longer of the traditional period or the 90-year wait-and-see period. Prob C §21209. The prohibition against such a clause serves both to satisfy certain Internal Revenue Service concerns and to eliminate the need for practitioners to revise their forms or existing instruments.

In general, practitioners should leave existing wills as they are and continue to use traditional forms of will (see §34.41) that are based on a designated, reasonably ascertainable group of lives in being plus 21 years. These forms will usually (and, when coupled with the use of powers of appointment, almost certainly) allow for greater duration should this prove worthwhile.

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II. CALIFORNIA AND COMMON LAW RULE AGAINST PERPETUITIES

§34.2 A. Present-Day Perpetuities Problem

Although the rule against perpetuities is often associated with famous old English cases, it is actually a modern problem. Current tax law encourages trust dispositions that challenge the rule by tying up property in future interests, especially exempt (zero inclusion-ratio) trusts under the generation-skipping transfer (GST) tax. See IRC §§2601-2663. These trusts usually involve extensive use of powers of appointment and discretionary powers in trustees—provisions that are particularly susceptible to unanticipated violations of the rule.

Attorneys planning and drafting wills in California must be familiar with Prob C §§21200-21231, California's rule against perpetuities, and with the related rules in CC §§715, 718, and 718f. California's statutory rule permits the thoughtful, adequately informed will drafter great leeway in the creation of long-term arrangements. The rule rarely creates a serious problem for alert drafters and seldom obstructs the reasonable objectives of clients. Dispositions that appear entirely innocent, however, can fail if the drafter overlooks the rule. See *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821.

Recognition of perpetuities problems usually requires no more than a basic acquaintance with key aspects of the rule. As a practical matter, self-restraint normally inhibits clients from attempting to extend the dead hand beyond the perpetuities period. For the inevitable occasions of human oversight, a few good habits can protect the client's plan and the attorney's reputation. See §§34.30-34.34.

Restatement (Second) of Property §§1.4-1.5 (1977) significantly modify American Law Institute positions on the rule against perpetuities. In Restatement §1.4, a wait-and-see approach is adopted to determine whether the rule is violated (validating an interest if it *actually* vests during the allowed period even though, viewed at its creation, it *might* not have vested in time; see §34.5). In Restatement §1.5, a reformation rule is adopted as a cure when violations occur (see §34.13). Because the Restatement purports to express a preferred view of American common law, these positions can be expected to influence the evolution of perpetuities doctrine in various states and the planning and drafting of California documents for the reasons noted in §34.40. On the likelihood of influencing California law, see §34.3.

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§34.3 B. Present-Day California Rule

Probate Code §21205 sets forth the basic statutory rule against perpetuities under California law:

> A nonvested property interest is invalid unless one of the following conditions is satisfied:
> (a) When the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive.
> (b) The interest either vests or terminates within 90 years after its creation.

With some modification, the first clause of Prob C §21205 restates Gray's classic formulation of the rule. See Gray, The Rule Against Perpetuities §201 (4th ed 1942). The rule relates only to remoteness of vesting (see §34.5) and not to the duration of interests (see §34.14).

Various problems arising under the common law rule have been dealt with in other provisions of USRAP. The so-called cy pres power by which courts can validate an otherwise invalid disposition has been codified at Prob C §21220. Probate Code §21231 deals with the special "unborn widow" problem. (see §34.17).

Although the primary emphasis of this chapter is USRAP, familiarity with common law principles is essential for several reasons:

- First, there are few cases construing the statutory law, and the legislation must be analyzed against the background of the common law rule.
- Second, even though Prob C §21220 provides for reformation of an otherwise invalid disposition, drafting to avoid common law problems eliminates the need for and possible shortcomings of reformation.
- Third, California wills should avoid violating the laws of other states, most of which follow the common law or closely related statutory rules. It is possible that there will be contacts with states when the will takes effect. These states may not refer to California law or permit reformation when their laws would be violated.

The decisions of California courts have often been influenced by Restatement positions. Thus, in some respects, the positions of the Restatement (Second) of Property (1977) noted in §34.2, along with developments noted elsewhere, may influence California perpetuities law and practices. Some features of the present California statutory rules, however, have preceded the Restatement (see §§34.12-34.13, 34.17), while others may be limited to traditional doctrine by specific legislative wording (see §34.5).

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C. California Rule Dissected

§34.4 1. "A Nonvested Property Interest Is Invalid"

As used in the statute and in Gray's statement of the common law (see §34.3), the phrase "a nonvested property interest is invalid" means that any interest that violates the rule is void. Other interests under the same instrument ordinarily remain valid.

Occasionally, however, on the basis of authority and equitable principles other than the rule itself, courts have applied the doctrine of "infectious invalidity" to invalidate other interests in order to avoid the distortions and unduly harsh consequences that would flow solely from application of the rule. Under Prob C §21220, the violating interest can be reformed to preserve the testator's purposes as far as they can be ascertained. See §34.13.

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§34.5 2. "Is Certain to Vest or Terminate"

The words "is certain to vest or terminate" replace the words "unless it must vest, if at all" in the more traditional formulation of the rule. They indicate what must occur within the prescribed period. There must be absolute certainty that the interest, viewed from the date of its creation, will satisfy the rule's requirements. See *Prime v Hyne* (1968) 260 CA2d 397, 67 CR 170; *Taormina Theosophical Community, Inc. v Silver* (1983) 140 CA3d 964, 977, 190 CR 38, 46.

Thus, the faintest possibility of noncompliance would render an interest void at the outset under common law and will apparently require reformation in California. An instrument is improperly drafted if under some imagined set of developments the vesting of any interest created by it might be too remote. The formulation of the rule in the alternative under Prob C §21205, however, eliminates the possibility that a literal reading of former CC §715.2 could have precluded judicial adoption of the Restatement's wait-and-see approach (if the interest "*does not* vest" in time; emphasis added).

In this context, "vest" means to vest in interest and does not refer to the interest's becoming possessory within the period. See *Estate of McCray* (1928) 204 C 399, 268 P 647. There is one major exception to the conclusion that "vest" means only to be owned by an ascertained person and to be free of all conditions precedent. If the future interest is given to a class, the rule also generally requires that the interests of *all* class members must vest before the interest of *any* member can satisfy the rule. This is because the size of each class member's share must also be ascertainable within the period. Thus, even though the interest of a particular class member is technically vested within the period, it will fail if, as originally drawn, the class *may* remain open to additional members or if any class member's share *may* remain subject to a condition precedent beyond the period.

"If at all" means that the rule is satisfied if the interest, as originally drawn, will certainly vest or fail within the period. Thus, the certainty required is that, if the interest will ever vest, it will necessarily do so within the period. That it may never vest does not matter as long as the contingency will be settled one way or the other within the period. In other words, an interest violates the rule if, according to the original terms creating it, it might vest after the period's expiration. The rule is satisfied if vesting will occur or the possibility of vesting will be eliminated during the period.

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3. "21 Years After the Death of an Individual Then Alive"

§34.6 a. When Period Begins

The words "21 years after the death of an individual then alive" when the interest is created state the maximum period allowed by the rule. "When the interest is created" fixes the start of the measuring period. For this purpose, interests are generally considered to be created on the effective date of the instrument.

Thus, if the interest is created by will, the testator's death starts the perpetuities period. If the interest is created by an irrevocable inter vivos transfer (*e.g.,* an irrevocable trust), the starting point is the effective date of the instrument (*i.e.,* on delivery of the deed of transfer). If the inter vivos transfer is wholly revocable, however, as in a revocable trust created by one individual, the period does not begin until the power of revocation ceases, which normally occurs at the settlor's death. Former CC §716.

When there are two or more settlors of a "revocable" trust (*e.g.,* when community property is placed in a trust), Prob C §21211(b) provides that the joint power with respect to community property held by a married couple is considered a power exercisable by a single person. Thus, the statute's requirement that the person "become the unqualified beneficial owner" will be satisfied. Therefore, either a joint power of revocation or the usually recommended sole power, under which one settlor can direct reconveyance of community property to both settlors, fulfills these requirements.

An exception similar to that for wholly revocable transfers exists for presently exercisable general powers of appointment. See Prob C §21211(a). Although the period ordinarily begins on the effective date of the instrument creating an interest, the rule does not apply while a person holds an unrestricted power to take absolute ownership of the property. The rule is satisfied when the power comes into existence, and the period begins when the power ceases. See §§34.21-34.22.

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§34.7 b. Measuring Lives

In determining whether the interest is "certain to vest or terminate," the measuring "individual then alive" must be that of a person actually alive when the period commences. The possibility that an individual will have children after death is to be disregarded. Prob C §21209. Thus the old common law rule concerning periods of gestation has been jettisoned as unnecessary. Measuring lives can be selected by the testator and expressly set out in the instrument. Any person's life can be selected for this purpose and more than one life can be used; in fact, use of a class of "lives" is the normal practice. The lives chosen, however, "may not be so numerous or so situated that evidence of their deaths is likely to be unreasonably difficult to obtain." Prob C §21230. (See the classic extreme case of *In re Villar* (1929) 1 Ch 243, in which the court upheld reference to all descendants of Her Late Majesty Queen Victoria living at the time of the testator's death.) The "21 years" cannot precede the measuring life; such a life would not be one "in being at the creation of the interest."

EXAMPLE: *A* devises in trust "for my brother *B* for life, then for *B*'s daughter *C* for life, with the remainder to any of *C*'s children who reach age 21." At *A*'s death, both *B* and *C* are alive. The entire disposition is valid, whether or not *C* has children at the time. The two life estates are clearly good, "vesting" in *B* and *C* on *A*'s death even though *C*'s interest will not become possessory until *B*'s death (and, in fact, may "expire" before *B*'s death). As written, no interest in the remainder to *C*'s children who reach age 21 could vest beyond the permissible period because each will vest, if it does vest, when the child reaches age 21. The possibility that *C* could have children after her death is disregarded for purposes of determining validity of interests. Prob C §21208. All the children will necessarily be born by the end of *C*'s life (a life in being at *A*'s death), with the vesting of all the children's interests necessarily to occur, if ever, not more than 21 years afterwards.

If the remainder had been "to *C*'s children who reach age 25," however, it would violate the rule set forth in Prob C §21205(a). When the interest was created, it was possible that both *B* and *C* (and any children of *C*) might die before one or more of *C*'s afterborn children reach age 4. Because the children must reach age 25 to share in the remainder, the interest in the class of *C*'s children might vest no later than 21 years after the death of an individual then alive. The mere possibility of this would invalidate the interest under common law and require reformation under Prob C §21220, regardless of what actually occurs. See §34.13.

Under Prob C §21205(b), however, what actually has occurred will be considered 90 years after *A*'s death. If *C* has died and the remainder has vested in her children, the devise is not invalid. If *C* has not died, the devise will need to be reformed under Prob C §21220.

Age contingencies over 21 years in gifts of this type can be used without violating the rule through certain techniques that effectively "extend" the perpetuities period. See §§34.19-34.23.

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§34.8 4. Alternative Period: 90 Years

Probate Code §21205(b) provides that an interest is valid if it "either vests or terminates within 90 years after its creation." This provision will save a disposition only if the interest actually vests or terminates within 90 years of its creation under a wait-and-see approach. In contrast, former CC §715.6, like the common law rule itself, operated on the basis of possibilities judged when the interest was created. The primary value of Prob C §21205(b) is to allow events to take their course and to allow revisiting the situation at the end of 90 years. If, at the end of 90 years, the interest has not vested or terminated, or if the common law rule codified in Prob C §21205(a) is not certain to be satisfied, the disposition must be reformed in a manner that most closely approximates the testator's manifested intent. Prob C §21220.

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D. Interests Exempt From Rule

§34.9 1. Gifts to Charity

Charitable interests are not granted general immunity from the rule against perpetuities. The one pertinent exemption exists when, within the period, the property becomes "vested in charity" so that any shifting of interests thereafter is solely among charities. Prob C §21225(e). A gift over from a private to a charitable purpose is subject to the rule, requiring the charitable interest to vest within the period. If, however, a remainder is certain to vest in one charity within the period of the rule, a gift over from that charity to another charity is valid even though the shift may occur after the period. See Prob C §21225(e); Restatement (Second) of Property §1.6 (1977); *Estate of Sutro* (1909) 155 C 727, 102 P 920 (ruling made under earlier constitutional rule, reenacted in identical language in former CC §715); *Lynch v Surprise Valley Lodge No. 235* (1972) 26 CA3d 265, 103 CR 1.

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§34.10 2. Vested Interests

Vested interests, except vested class-gift interests that are subject to partial divestment by increase of the class, are safe from the rule. When an interest is vested subject to complete defeasance on a condition subsequent that might occur beyond the period, only the divesting interest violates the rule. In fact, the vested remainder becomes indefeasible under most common law authorities, having been relieved of the excessively remote executory interest (see §34.12), but the matter becomes one of possible reformation under Prob C §21220. See §34.13.

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Source: Estate Planning/California Will Drafting/34 Rule Against Perpetuities/§34.10A 3. Nondonative Transfers

§34.10A 3. Nondonative Transfers

Nonvested property interests and powers of appointment arising out of nondonative transfers generally are not subject to Uniform Statutory Rule Against Perpetuities (USRAP). Prob C §21225(a). Such interests and powers are covered by USRAP if they arise out of or in connection with

- an existing, previous, or prospective marital relationship;
- contracts to make or not to revoke a will or trust or to exercise or refrain from exercising a power of appointment;
- transfers in satisfaction of the duty of support or reciprocal transfers. Prob C §21225(a).

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Source: Estate Planning/California Will Drafting/34 Rule Against Perpetuities/§34.10B 4. Fiduciary Powers

§34.10B 4. Fiduciary Powers

Fiduciary powers relating to administration or management of assets, including the power to sell, lease, or mortgage property, are not subject to the Uniform Statutory Rule Against Perpetuities (USRAP). Prob C §21225(b). Nor is the power to appoint a fiduciary subject to USRAP. Prob C §21225(c).

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§34.11 5. Other Exempt Interests

The common law rule does not apply to possibilities of reverter or rights of entry. See *Strong v Shatto* (1919) 45 CA 29, 187 P 159. Various other interests are exempted from the California rule by statute. See, *e.g.,* the provisions for profit sharing, retirement, hospital services, and certain insurance trusts in Prob C §21225(f), (h). See also CC §§715-719 (leases and term grants). These various dispensations have little relevance to will drafting and are not further discussed in this book.

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§34.12 E. Effect of Violations

Any interest that violates the common law rule was void from the time of its attempted creation (see §34.4), usually leaving a reversionary interest in (or a resulting trust for) the grantor or a successor in interest. When an executory interest was invalidated, however, the valid vested interest that was subject to it typically became indefeasible. See §34.10.

This special treatment of technically vested but defeasible interests necessarily placed great emphasis on the purely formal distinctions between such interests and those that were contingent, *i.e.,* those that were subject to a condition *precedent*. Thus, a remainder in equal shares to "any of my grandchildren who reach age 25" was contingent and void, assuming the testator was survived by children. The grandchildren's remainder would have been valid (and indefeasible because of the invalidity of the divesting interest) if it were vested, as under the wording "to my grandchildren in equal shares, but if any grandchild dies before age 25, his share to …" See Gray, The Rule Against Perpetuities §105 (4th ed 1942). But see *Estate of Budd* (1913) 166 C 286, 135 P 1131, in which the court avoided the result by construction.

Violations of the common law rule by some interests generally do not invalidate other interests that are created by the same disposition but conform to the rule. *Otto v Union Nat'l Bank* (1951) 38 C2d 233, 238, 238 P2d 961. In certain circumstances, however, the invalidity of some interests led to a finding that other initially valid interests also fail under the doctrine of "infectious invalidity" in order to prevent severe distortion of the testator's dispositive scheme.

Under the wait-and-see approach of Prob C §21205(b) and the cy pres principle of Prob C §21220, neither infectious invalidity nor the technical distinction between conditions precedent and subsequent are now likely to be important in California. Under USRAP, a violation of the common law rule, rather than completely invalidating an interest at its creation, requires reconsideration 90 years later and, only then, reformation. If the rule is violated by exercise of a power of appointment, Prob C §21220 must be considered together with Prob C §672.

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§34.13 F. Construction and Reformation of Wills

There is no counterpart under USRAP to former CC §715.5, which provided for judicial construction of intent so as not to avoid the common law rule. Instead, under USRAP California courts are directed by Prob C §21220 to reform a document at the end of the 90-year period so that the transfer satisfies the rule against perpetuities in the manner that most closely approximates the creator's general intent. The court is directed by former CC §715.5 to reform the will if by so doing the gift can be brought within the limits of the rule in harmony with the testator's general intentions (*Estate of Ghiglia* (1974) 42 CA3d 433, 116 CR 827). See also Restatement (Second) of Property §1.5 (1977). Thus, if the will leaves property in trust for *X* for life and the remainder to *X*'s children when the youngest reaches 50, the court (after waiting for 90 years from the creation of the interest under Prob C §21205(b)) can reform the provision so that the remainder vests when the youngest of *X*'s children alive when *X* died reaches 21. See *Estate of Grove* (1977) 70 CA3d 355, 138 CR 684.

The court will not change the will more than necessary to bring the disposition within the limits of the rule. *United Cal. Bank v Bottler* (1971) 16 CA3d 610, 94 CR 227. Attorneys, therefore, should not rely on Prob C §21220 to correct all their perpetuities problems. Furthermore, if the law of a jurisdiction other than California governs, judicial reformation may not be available. Even if Prob C §21220 cures the defect, the beneficiaries may view the cost of the litigation as an expense caused by negligence. The best solution is to prevent violations of the rule by proper drafting and the use of a saving clause (see §§34.35-34.41).

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III. RELATED RULES

§34.14 A. Duration of Trusts

The rule against perpetuities limits only the remoteness of vesting and imposes no restriction on the duration of a trust in which all interests are vested. For example, a trust for *X* for life, then for *X*'s children for their lives, and with the remainder to a designated charity, satisfies the rule because all life interests and the remainder vest at *X*'s death and *X* is an individual then alive. Charitable trusts can last for an unlimited time. Prob C §21225(e).

Under a common law rule analogous to the rule against perpetuities, a private trust cannot be made indestructible for longer than the period of the rule. Also, spendthrift restraints beyond that period are invalid, permitting termination by consent of all beneficiaries. A similar result occurs under the current rule. Ninety years after the interest is created, the events that occurred are revisited to determine whether all interests have vested or terminated. If they have not, an interested person must petition the court to reform the disposition in the manner that most closely approximates the transferor's manifested plan of distribution. Prob C §21220.

Although private trusts may endure beyond the perpetuities period, it is generally better practice to limit their duration to that period. Otherwise, discretionary powers, spendthrift clauses, direct and indirect accumulations, and indestructibility provisions in the trust (as well as any nonvested interests) may violate the rule against perpetuities or related rules. Almost any of a testator's reasonable objectives can be achieved within the period of the rule, at least with the aid of a perpetuities saving clause (see §34.35), which should be included in every trust and in all but the simplest wills.

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§34.15 B. Limitations on Accumulations

If accumulation is not expressly directed or authorized, income not disposed of belongs to the persons presumptively entitled to the next eventual interest (CC §733) and must therefore be distributed currently to such persons instead of being accumulated. See *Estate of Lefranc* (1952) 38 C2d 289, 239 P2d 617. If the governing instrument expressly directs or authorizes accumulation, however, income accumulation may not extend beyond the period of the rule against perpetuities. CC §724(a). This rule does not apply to profit-sharing plans. CC §724(b). In addition, discretionary powers to distribute or accumulate income are subject to the rules relating to special powers of appointment. See §34.20.

Certain administrative provisions may result in accumulations, thus causing difficulty when a trust will endure beyond the period of the rule. Examples include provisions authorizing a trustee to allocate to principal items that are income under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), to use income to discharge liens on property, and (possibly) to invest in insurance on the life of a beneficiary. Such powers are excepted from the rule, however. Prob C §21225(b).

The consequences of requiring accumulations for an excessive period are not severe. The trust is not invalid; the direction to accumulate is not even void in its entirety. The direction is "void as respects the time beyond the limit prescribed … [in CC §724], and no other part of such instrument is affected by the void portion of such direction." CC §725. Thus, these restrictions pose no serious hazards. Nevertheless, accumulating income may be undesirable for income tax reasons inasmuch as the income tax brackets applied to trusts permit only small accumulations before income is taxed at the highest rate. IRC §1(e).

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IV. CAUTIONS AND RECOMMENDATIONS FOR DRAFTING

§34.16 A. Recognizing and Avoiding Pitfalls

Virtually any reasonable objective can be accomplished by a careful attorney without violating the rule against perpetuities. An informed will drafter can readily avoid pitfalls by careful drafting and use of a saving clause to protect against oversight, thus allowing actual events and not possibilities to control. See §§34.36-34.37.

Even though Prob C §21205(b) adopts the 90-year wait-and-see approach, in order to carry out the testator's intent it will generally be better to obtain certainty in vesting or termination under Prob C §21205(a). This eliminates the need to seek a judicial reformation that may frustrate the testator's intent, and it will certainly eliminate the costs and other problems associated with a reformation. See §34.13.

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§34.17 1. Common Law Technical Traps

As indicated above, the substance of the common law rule remains intact in Prob C §21205(a). Even though the 90-year wait-and-see look-back period may save dispositions that violate the common law rule, other statutory provisions and doctrines continue to apply to the common law rule. Following are examples of situations where the common law rules continue to impact devises. Prob C §21231.

- *The "unborn widow." A* leaves a seemingly routine devise "to my son *B* for life, then to his wife for her life, and the remainder to his then-surviving issue." Because *B*'s current wife might not be his wife at death, she conceivably could be a person born after *A*'s death. Her life estate would be valid because it would vest at *B*'s death, but she might live for more than 21 years after the death of *B* and all other lives in being at *A*'s death. Therefore, the remainders to the issue, who are expressly required to survive the widow, might not vest until after the period of the common law rule has run. Thus, the remainder is void at its inception under common law. Probate Code §21231 eliminates this violation by treating the spouse of an individual alive when the period begins as an individual alive when the interest is vested. Because California law might not apply when the testator dies, however, this danger cannot be ignored.
- *"Administrative contingency."* To avoid unnecessary taxation or an extra probate if a devisee dies while the estate is being administered, *X* leaves her property "to my issue surviving at distribution of my estate." Conceivably, the estate will not be distributed within lives in being and 21 years, so the common law rule against perpetuities is violated. See *Estate of Campbell* (1938) 28 CA2d 102, 82 P2d 22; *Prime v Hyne* (1968) 260 CA2d 397, 67 CR 170 (court refused to apply "reasonable time" test judicially adopted for commercial transactions). The negligence action against the will drafter in *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821, resulted from an "administrative contingency" violation. Today in California, reformation would be required, possibly providing for vesting at distribution or after 90 years, whichever is sooner.
- *The "fertile octogenarian."* A testamentary trust for 80-year-old *X* "for life, then for *X*'s children for life, remainder on the survivor's death to *X*'s grandchildren," violates the common law rule because *X* is "conclusively presumed" to be able to have more children. Compare *Fletcher v Los Angeles Trust & Sav. Bank* (1920) 182 C 177, 187 P 425, with the classic case *Jee v Audley* (Ch 1787) 29 Eng Rep 1186. See also the "precocious toddler" in *In re Gaite's Will Trusts* (1949) 1 All ER 459. Even a woman's childbearing limitations are irrelevant, and Prob C §15406 (presumption of fertility rebuttable) applies only to trust modification and termination by beneficiaries. Of course, if there is no possibility of afterborn children, there is no danger of excluding such children or their issue simply by providing life estates only for *X*'s children "who are living at my death."

A safer and broader protection for all of these cases can be provided by a saving clause. See §34.41.

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§34.18 2. Rules of Thumb as Warnings and Guides

The following rules of thumb can serve as general will drafting guides:

- By will (or by wholly revocable living trusts but not by deed or irrevocable inter vivos trust), a client can create interests to vest in his or her own grandchildren and can even require survival up to age 21.
- A testator cannot create interests in his or her great-grandchildren or even in his or her grandchildren to vest at an age over 21 years (unless in either case the testator outlives all the children).
- A testator cannot create interests in anyone else's grandchildren or even in the children of another with age contingencies over 21, unless that person predeceases the testator.

Any of these "prohibited" objectives can be achieved for the client, at least substantially, by skillful drafting. See §§34.35-34.41.

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§34.19 B. Class Gifts

Dispositions most likely to violate the common law rule against perpetuities are those in the form of class gifts. Hence, the drafter should understand the common law rule's application to such gifts.

If the share of each class member is dependent on the number of class members, the aggregate interest of all members is judged as a single interest. Thus, it is generally accepted that if the interest of *any* member could vest beyond the period, the interests of all must fail under the common law. In the less common situation in which each class member is to receive a stated amount (a per capita class gift), each interest is independent of the others and the validity of each is judged separately under the common law rule.

EXAMPLE: *A* devises in trust "for *B* for life, with the remainder to *B*'s children who reach age 25." *B* survives *A*. Each child of *B* who is alive at *A*'s death receives an interest that will assuredly vest, if at all, within his or her own lifetime. Any child born to *B* after *A*'s death, however, might reach age 25 more than 21 years after the death of any potential measuring life in being at *A*'s death. Therefore, with the amount of each child's share being dependent on the number of children to attain age 25, the entire gift to the children violates the common law rule. See *Estate of Troy* (1931) 214 C 53, 3 P2d 930. For cases decided under former CC §715.5, compare *Estate of Grove* (1977) 70 CA3d 355, 138 CR 684 (intent and circumstances justified a construction excluding possible afterborn class members), with *Estate of Ghiglia* (1974) 42 CA3d 433, 116 CR 827 (reformation to reduce age contingency).

EXAMPLE: *A* devises "$10,000 to each child of *B*, whenever born, who reaches age 25." Under this per capita gift, the interest of a child alive at the testator's death is valid; it is independent of the interests of other children and will necessarily vest or fail within the child's own lifetime. Only the provision for *B*'s afterborn children may violate the common law rule and, in California, require reformation. Again, depending on a number of factors, the 90-year wait-and-see approach is likely to validate this devise under USRAP. Prob C §21205.

A class gift may become subdivided into separate "subclasses" within the perpetuities period. If it is certain that this will occur, the aggregate share of the members of each subclass will not be affected by developments within other subclasses after the separation, and the gift of each subclass is judged separately. Thus, the remainder to one subclass may be valid even though the remainder intended for another subclass violates the common law rule.

EXAMPLE: *A* creates a testamentary trust for "*B* for life, then to pay the income in equal shares to *B*'s then-living children for their respective lives; on each child's death, the share of corpus from which he or she has been receiving income to go to his or her issue." If *B* has additional children after *A*'s death, the remainder to the issue of such a child (who is not a life in being at *A*'s death) might vest beyond the period of the common law rule. Thus, although the afterborn child's life interest is itself valid (vesting, with its amount fixed, by *B*'s death), the remainder to that child's issue vests too remotely under the common law. The remainder to the issue of any child of *B* alive at *A*'s death, however, does not violate the rule because the issue of that child (a life in being) will be determined and this interest will necessarily vest at the child's death.

These interests cannot be affected by occurrences in any other group of issue, the size of the subshare being determined at *B*'s death or by remote contingencies that might occur with respect to the shares of any afterborn children. Stated differently, the subclass shares are judged separately because, within the period, they become divided into independent class gifts to each child and his or her issue. See *Estate of Micheletti* (1944) 24 C2d 904, 151 P2d 833. In marginal cases, the 90-year wait-and-see approach of Prob C §21205(b) can be used, and cy pres provisions under Prob C §21220 are available.

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§34.20 C. Powers of Appointment and Trustee's Powers

Drafting appointive and discretionary powers is a significant part of most estate plans. The drafter must understand how the rule against perpetuities applies to those powers and recognize the major danger areas even though the classic formulation of the rule against perpetuities does not directly address powers of appointment. Probate Code §§21206 and 21207 deal explicitly with the application of the rule to powers of appointment and are quite easy to master. *Estate of Bird* (1964) 225 CA2d 196, 37 CR 288.

Nonetheless, appointive and discretionary powers are frequent violators of the rule, usually as the result of oversight or careless procedures. Both donors (creators) and donees (holders) of powers must be careful; even seemingly innocent provisions are vulnerable. Properly planned powers, however, can actually "stretch" the perpetuities period. See §34.23.

The generation-skipping transfer tax (see IRC §§2601-2663) increases the importance of understanding the rule's operation, limits, and opportunities with respect to powers. To the extent that trusts are exempt or otherwise sheltered, there is increased incentive to extend their duration over several generations, with special assistance from the second look permitted for appointed interests (see §34.23), in addition to the wait-and-see approach offered by a saving clause (see §34.36). Even in nonexempt trusts, the "Delaware trap" (see §34.28) may now sometimes be used with respect to special powers to save taxes, while various forms of general powers have suddenly achieved a new popularity. In the planning of both exempt and nonexempt trusts, drafters must understand that a fresh perpetuities period is allowed following taxation of a general power only if it was exercisable inter vivos (see §§34.21-34.22).

For purposes of the rule, powers of appointment fall into two categories: (1) presently exercisable general powers, which are the equivalent of outright ownership of the property involved (Prob C §21211); and (2) all other powers. A power is "presently exercisable" when the donee can make an immediate, irrevocable appointment during life. Prob C §612(b). A power is "general" under common law if it is exercisable in favor of anyone, including the donee, and in California if it is exercisable in favor of the donee, the donee's estate, or the creditors of either, whether or not exercisable in favor of others. Prob C §611.

Other powers, which are not equivalent to ownership, include general testamentary powers and all special or nongeneral powers. For these purposes, special powers include not only formal powers of appointment but also fiduciary powers to determine distributions of income or principal. A trustee's administrative powers (*e.g.,* power of sale) are not powers of appointment for perpetuities purposes at common law, and this seems implicit in the rule that trusts may endure beyond the period. Prob C §21225(b).

Similar to the wait-and-see approach provided by USRAP about the vesting or termination of interests in property, USRAP also provides a wait-and-see approach with respect to the validity of powers of appointment. Prob C §§21206(b), 21207(b). See §34.8.

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§34.21 1. Donor's Problem: Validity of Power

A general inter vivos power is valid only if there is absolute certainty that (1) the power will become exercisable, if at all, no later than 21 years after the death of an individual alive when the power is created, or (2) the power will become either exercisable or not exercisable within 90 years of its creation. A valid power is the equivalent of ownership and satisfies the policy objectives of the rule, and the possibility of the power's exercise beyond the period is immaterial. Prob C §21206. See 20 Cal L Rev'n Comm'n Reports 2564 (1990).

All other powers are valid if, viewed at the time of their creation, it would not be possible for them to be exercised beyond the period of the rule or the power is exercised or terminates within 90 years of its creation. Prob C §21207. Thus, the power must be exercised, or be capable of being exercised, if at all, within the period. Consequently, unless specially drafted to expire within the perpetuities period, such a power cannot be created in an unborn person and a discretionary power cannot be exercisable in favor of an unborn person if it runs with the office of trustee. *Davenport v Davenport Found.* (1950) 36 C2d 67, 222 P2d 11.

The mere fact that a power might be exercised to create appointive interests that are too remote (see §34.22) does not invalidate the power itself. See generally Prob C §§21206(a), 21207(a); Restatement (Second) of Property §1.2, Comment h (1977).

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2. Donee's Problem: Validity of Exercise

§34.22 a. Measuring Period: Relation Back

The donee of a valid power must be careful not to exercise it in a manner that will violate the rule against perpetuities. See Restatement (Second) of Property §1.2, Comments d, f (1977). With the exception of presently exercisable general powers, this means that, for any but outright appointments, the donee must not think of the appointive assets as his or her own.

For presently exercisable general powers, planning can safely proceed as if the assets were the donee's own, because the validity of appointed interests is determined by measuring the period from "when the power to become the unqualified beneficial owner terminates." Prob C §21211(a). For all other powers, appointive assets must be considered separately from the donee's own assets. Interests appointed under testamentary and special powers must vest within a perpetuities period measured from the date on which the power was originally created. Prob C §21212. If such a power is exercised to create a new power, the new power must satisfy the rule against perpetuities under Prob C §21205, measured from the date of the original power's creation. See Prob C §21212.

Thus, except for the second-look doctrine (see §34.23), appointed interests under these powers are judged as if they had been created by the donor of the original power. Under the relation-back doctrine, the appointment is considered to have essentially filled in the terms of the creative instrument. In particular, appointments into new trusts containing discretionary powers must be carefully planned. See §§34.26-34.28. See also *United Cal. Bank v Bottler* (1971) 16 CA3d 610, 94 CR 227; 20 Cal L Rev'n Comm'n Reports 2585 (1990).

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§34.23 b. Second-Look Doctrine

When the perpetuities period is measured from the creation of the power, the so-called second-look doctrine may be helpful. See Prob C §§21206-21207. Because the validity of an appointed interest cannot be judged until the power is exercised, the interest is evaluated in light of the facts and circumstances as they then exist, not as they existed when the power was created. Thus, although the running of the period is based on the relation-back doctrine, the appointed interests are evaluated on (1) *actual* events occurring between the date of the power's creation and the date of its exercise, and (2) what *might* happen afterwards. See *Estate of Bird* (1964) 225 CA2d 196, 37 CR 288.

Many events that were possible when the donor died will not have occurred and will no longer be possible when the donee exercises the power. Thus, by the time of the second look, an otherwise invalid interest can become valid. Many violations, particularly technical ones (see §34.17), will be eliminated. In fact, knowledge of developments since the donor's death permits the donee effectively to extend the perpetuities period. Thus, for example, it is regularly possible to impose otherwise excessive age contingencies or to achieve special tax advantages.

EXAMPLE: The doctrine's operation and its usefulness in "stretching" the period of the rule is illustrated by *A*'s devise in trust for her 50-year-old son *B* for life, then to *B*'s children for their lives, with the remainder, on the death of the last of the children, to *B*'s then-living issue per stirpes. Assuming that *B* survives *A,* the remainder to his issue violates the rule because *B* may have more children after *A*'s death, whether or not this actually occurs.

If *A* had given *B* a life interest and a testamentary power to appoint the property among his issue, *B* could have validly appointed the same interests described above for his children and their issue, assuming he has no children born after *A*'s death. With the benefit of a second look at the date of exercise, the possibility of afterborn children has been removed, and no other events that might still occur could cause a violation of the rule.

A similar example can readily be constructed to illustrate how the rule may be stretched to cover the more common case of a desired distribution to *B*'s children with an age contingency over 21.

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3. Creating Powers of Appointment

§34.24 a. General Precautions

Dangers rarely arise in creating regular powers of appointment because they are rarely conferred on persons born after the trust is created. Caution is necessary, however, whenever a power of appointment will be granted to any but named beneficiaries. The donor's attorney should consider the rule against perpetuities from two points of view: (1) the validity of the power and (2) possible errors by the donee at the time of exercise. Particular caution is required if a power is to be conferred on an unborn beneficiary.

In a trust for *A* for life, with trusts thereafter to continue for *A*'s children, any power given to the children (other than a general inter vivos power) not only should become exercisable but also should be certain to be exercised, if at all, only within the period. Otherwise, they will need to be reformed if not actually exercisable or exercised within 90 days of the creation of the trust. Prob C §21220. Thus, the instrument should specifically restrict such powers to exercise by, or within 21 years after the death of, persons alive at the creation of the power (*i.e.,* on the trust's effective date).

The simplest way for the donor's attorney to avoid these hazards to trustee discretionary powers is to specify that the trust will terminate within the perpetuities period. If it is important to create a trust that may last beyond the period, the donor must ensure that any discretionary powers given to a corporate trustee or made to run with the office of trustee will terminate within the allowed period. See §34.12. A further prudent step is to include a saving clause in the instrument. See §34.41.

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§34.25 b. Relation-Back Rule: Reminders to Donees

To lessen the danger of oversight by the donee, the donor may insert a reminder in the creative instrument itself, warning the donee and the donee's attorney of the relation-back problem of Prob C §21212. Thus, the donor's will may warn the donee that appointed interests must be certain to vest within the applicable perpetuities period measured from the donor's death. Also, it is normally wise to restrict testamentary exercise to an instrument specifically referring to and exercising the particular power in an effort to prevent inadvertent or thoughtless exercise—a frequent source of perpetuities violations (see §34.26).

An additional precaution, and one strongly recommended by the update author, is to make the saving clause in the donor's will expressly applicable to interests later appointed by donees. See §34.41.

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4. Exercising Powers of Appointment

§34.26 a. Inadvertent Exercise

Violations are more common in exercising than in creating powers of appointment because of the relation-back doctrine. Prob C §21212. See §34.22. For the most commonly used types of powers, much of the period has usually run by the time of exercise. This is easily overlooked, even when the donee intentionally exercises the power.

The most frequent source of these violations is the use of an all-inclusive residuary clause to create a trust of, *e.g.,* "all the rest of my estate, including property over which I hold a power of appointment." Relation back creates appointment risks even in trusts that are perfectly safe for the donee's own assets. The problem can be avoided by drafting dispositive provisions that differentiate between appointive assets and the donee's own assets.

Under the law of many states, powers are likely to be exercised casually or inadvertently by residuary clauses that make no mention of powers. This is no longer the case in California. Even for general powers, Prob C §641(a) presumes no exercise of the power unless it is specifically referred to or there is some other indication of intention to exercise it.

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§34.27 b. Creating New Powers of Appointment

Outright appointment is the simplest and safest way of exercising powers, especially if for some reason the testator intends to include potentially unknown powers. When appointing in further trust, however, the drafter should take various precautions. To take advantage of the second-look doctrine, the attorney must determine relevant present lives that were in being at the date of creation of the power, in addition to examining the creative instrument. See §34.23.

If the donee will create new powers other than presently exercisable general powers (see §34.21 on ownership equivalence), the period within which the new powers must be exercised should be limited to the original common law perpetuities period. Thus, special precautions are required unless it is clear that the new power will be exercisable only by or in favor of persons living when the donee's power (the original one) was created. The fact that the objects or donees of new powers were born within 21 years of that date is not sufficient because the 21 years cannot precede the measuring lives. See §34.7.

In drafting a will that exercises a power of appointment by creating a further trust or new future interests, the donee's attorney should adapt the general perpetuities saving clause (see §§34.38-34.41) to the special danger presented. In other words, the cutoff date for appointive assets should be set in relation to lives in being at the date of the power's origin. It may therefore by necessary to create two parallel sets of trusts, each differing only in its ultimate cutoff date.

An appointment should not be made by a residuary clause that creates a trust unless specifically considered and found to be valid with respect to the appointive assets. See §34.26. The donee should consider using the appointive assets for outright devises (to objects within the scope of the power, of course). Thus, the donee's own assets can be saved for the trust. The common residuary clause indiscriminately disposing of "all property I may own, including all property over which I hold a power of appointment," is therefore not recommended; nor is this clause safe, even under Prob C §641(a).

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§34.28 c. Estate Tax ("Delaware") Trap

The donee of a special power normally should not exercise it to create a general inter vivos power (see §§34.21-34.22) because the special power will become taxable as if it had been general. See IRC §2041(a)(3)(A), under which the first power is treated as general if the new power is entitled to a fresh perpetuities period. Therefore, when a donee holds a special power, an outright appointment is normally preferable to conferring a general inter vivos power, which includes not only the traditional presently exercisable general power of appointment but also an unlimited power to withdraw corpus or a power to terminate a trust in favor of the powerholder.

Ordinarily, there is no comparable tax danger in creating successor special or fiduciary powers, nor should there be in creating successor general testamentary powers, because under California law (and generally) such powers cannot be used "to postpone the vesting … for a period ascertainable without regard to the date of the creation of the first power." IRC §2041(a)(3). See Prob C §21212; §34.22.

The generation-skipping transfer (GST) tax provides a potential exception to the admonition that special powers should not be exercised to cause general power treatment for estate and gift tax purposes. Occasions may arise when taxation of a nonexempt trust can be reduced if a GST tax is avoided by incurring an estate or gift tax under IRC §2041 or §2514 (see §15.23), especially by having the donee of a special power appoint a presently exercisable general power to a remainder beneficiary who would otherwise receive trust corpus outright.

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§34.29 d. Creating Discretionary Trusts

Another significant and common perpetuities danger area is in exercising testamentary or special powers to create a wholly or partially discretionary trust. The difficulties arise from fiduciary distributive powers that can be exercised more than 21 years after the death of an individual alive at the creation of the power. The typical situation is one in which powers that run with the trustee's office are exercisable in favor of beneficiaries who could be born after the trust's creation. Trusts can last beyond the period of the rule but, because all interests must then be vested (see §34.5), all discretionary powers over distributions must expire by the end of the perpetuities period.

EXAMPLE: A trust for "*X* for life, then income in equal shares to *X*'s children for life, and on the death of each child to distribute the corpus from which he or she was receiving income to *Y* charity," is entirely valid under the rule because all interests will be vested at *X*'s death. (It does not matter that *X* may have children after the testator's death who may live for more than 21 years after the end of all lives in being.) If, however, the testator had given the trustee discretionary power to distribute income to children or to accumulate it, or even a power to distribute corpus as a supplement to the children's income right, the trustee's power would violate the rule because its exercise is possible after the perpetuities period expires. Furthermore, the power to pay out or accumulate would also apparently violate CC §724, which limits the period of accumulations (see §34.15). See *Davenport v Davenport Found.* (1950) 36 C2d 67, 222 P2d 11.

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§34.30 D. Good Drafting Habits for All Future Interests

Even well-informed will drafters are not infallible, particularly under the pressures of a busy practice. Therefore, the use of a saving clause is a fundamental precaution for trust wills. See §§34.35-34.41. In addition, good drafting habits should be cultivated as a matter of office routine to safeguard against oversight.

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§34.31 1. Review by Colleague

Because it is difficult for one who has drafted an instrument to review it with detachment and objectivity, review by another trained person is helpful as a standard practice. Disclosing a client's affairs to another member of the law firm is not a breach of client confidence unless the client requested otherwise. See §1.7. Review of an instrument by another attorney may uncover errors that have escaped the drafter. A professional fiduciary or trust officer may be a good choice for such a review, but the drafter should obtain the client's consent or delete all material that could identify the client before letting anyone outside the firm see the document.

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§34.32 2. Applicability of Foreign Law

The California rule against perpetuities and related rules may not govern all aspects of a will. For instance, the testator can change domicile, acquire land in another state, or exercise a power of appointment governed by foreign law. The drafter should check perpetuities rules of any jurisdiction with which significant contact is likely. A testator probably can expressly select the law to govern perpetuities matters if reasonable contacts exist with the selected state (see *Shannon v Irving Trust Co.* (1937) 275 NY 95, 9 NE2d 792), but it is not wise to rely solely on such a selection.

For these reasons, California will drafters should not rely on the liberal 90-year wait-and-see approach afforded by California law, but instead should satisfy the rule within the will.

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§34.33 3. Possible Afterborn Beneficiaries

The drafter should examine a will for dangers resulting from interests that will be provided for beneficiaries who may be born after the client's death. Particular care is required whenever, by descriptive or class terminology, a possible unborn person may receive an interest (a) on marriage, (b) by surviving until distribution, or (c) by attaining an age over 21.

A survival requirement is no problem with respect to the interest of a named person or class of persons who are all necessarily alive on the instrument's effective date. Thus, there is no administrative contingency risk in devises to a person (*e.g.,* the testator's spouse) or class of persons (*e.g.,* the testator's children) whose lives are necessarily in being at the testator's death. See, *e.g., Estate of McCollum* (1941) 43 CA2d 313, 110 P2d 721. But if survival until estate distribution is required of a class whose members might include afterborn persons (*e.g.,* the testator's issue or the children of a living person), conditions might be limited to 21 years to eliminate far-fetched possibilities.

Sometimes it may be practical for the drafter to designate beneficiaries by name rather than using class designations, thus eliminating the risk that the barest possibility of afterborn class members will void an interest (or trigger the 90-year look-back to determine the interest's validity). Excess of caution should be avoided, however, when this practice would not carry out a client's intentions. Fear has prompted some drafters to limit remainder beneficiaries unnecessarily to the living children of a youthful life beneficiary, thereby excluding any afterborn children.

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§34.34 4. Scrutinize Trusts That May Outlast Perpetuities Period

Trusts may validly endure beyond the perpetuities period (see §34.14), but discretionary powers, spendthrift clauses, direct and indirect accumulations, and indestructibility provisions (as well as nonvested interests) in such trusts may violate the rule against perpetuities or related rules. The problem can be avoided by confining private (*i.e.,* noncharitable) trusts to the common law perpetuities period. When a longer duration may be necessary, great care must be taken.

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V. PERPETUITIES SAVING CLAUSE

§34.35 A. Clauses Apply Only to Trusts

Most modern perpetuities violations involve trusts, and the clauses in this chapter are drawn for such situations. These clauses do not apply to outright gifts, such as those that cause the "administrative contingency" violation (see §34.17). The provisions in this chapter terminate the entire trust at the end of the common law period, not merely the offending interests or powers, although a final termination may not always be necessary. Whenever a trust lasts beyond the common law period, however, there is danger that some provisions, interests, or powers may violate the rule or associated doctrines; furthermore, a trust can usually be drawn to achieve the testator's entire purpose within the common law period of the rule. For these reasons, and simply to make the busy will drafter's task practical, it is almost always preferable to provide (as form 34.41-1 does) for the termination of the entire trust when the common law period expires. Satisfying the common law rule also precludes the possibility of a costly and inconvenient reformation proceeding under Prob C §21220. See §34.13.

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§34.36 B. How Clauses Operate

A perpetuities saving clause in a testamentary trust operates by terminating the trust and all its original interests at the end of the allowable common law period if the trust actually lasts that long. The clause also sets forth an alternative distribution for the trust property in that event.

"Wait-and-see" function. The saving clause in effect changes the test of validity from one of events that are possible as of the instrument's effective date to one of actual occurrences. If the common law period could or would actually be exceeded by the trust terms, the clause terminates the trust and distributes its property, thereby removing any possibility of a violation. Thus, no violation can possibly occur; the instrument itself prevents a violation by modifying any potentially offending interest so that it will vest in time. If an entire disposition can run its course within the common law period, it is given the opportunity to do so. If it does not do so, the plan will be cut short by a disposition that complies with the common law rule.

Alternative distribution. If a trust is terminated by the cutoff provision of a saving clause, the second part of the clause specifies the alternative distribution to be made. The property is then usually to be distributed to the trust's present beneficiaries. (The drafting problems involved are discussed in §§34.40-34.41.) Although Prob C §21220 permits judicial reformation of a disposition that violates the rule (see §34.13), the alternative gift prescribed in a saving clause operates to modify the original trust, with the result that the interest in question is neither void nor in need of judicial reformation.

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§34.37 C. Clause Extends Perpetuities Period

In some cases, attorneys have good reasons for drafting dispositions that might require the saving clause to operate under some conditions the clause is designed to keep from actually arising. For example, the client may wish her grandchildren to take their shares only after the youngest reaches age 25. This runs the risk of violating the rule. See §34.18. Yet, by drafting the provision and relying on the saving clause to bring about a premature termination if necessary, the attorney is likely to accomplish the client's full objective. The disposition will be carried out exactly as desired, provided the youngest grandchild is at least four years old when the last of the client's children and all grandchildren born in the client's lifetime have died. The only risk is that the trust may conceivably have to terminate when the youngest grandchild is between 21 and 24-plus years of age. Thus, there is a wait-and-see result with no possibility of actually violating the rule, because the clause will modify the disposition slightly (by a maximum premature termination of four years) if events occur that would otherwise have caused a violation of the rule.

Conscious "extension" of the rule by relying on a saving clause is useful for many common and reasonable dispositions (some going far beyond that in the above situation), but the attorney should carefully consider the precise terms of both the intended disposition and the clause before drafting.

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§34.38 D. Saving Clause for Testamentary Trust

A perpetuities saving clause generally includes a cutoff clause and a postcutoff distribution clause. See discussion in §§34.39-34.40.

The forms in §34.41 are to be used in drafting a testamentary trust only. For forms of saving clauses applicable to inter vivos trusts, see Drafting California Irrevocable Trusts §§9.59, 18.43, 20.25 (3d ed Cal CEB 1997) and Drafting California Revocable Trusts §13.21 (4th ed Cal CEB 2003).

If the law of a jurisdiction other than California applies to the trust, a slight possibility exists that the wording of these forms may not be appropriate. If significant contacts with other states are anticipated, the law of those states should be examined and the clause adapted accordingly. Most importantly, an express selection of California law (see §34.32) should be included in the will. A saving clause that specifies termination "at the expiration of the period allowed under the governing law relating to perpetuities" is not adequate, because such a provision fails to select and limit the measuring lives. See Prob C §21230.

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§34.39 1. Cutoff Clause: Terminates Trust

Form 34.41-1 terminates any trust, if it has not already been terminated, at the end of the common law period within which an interest must vest or be void under the common law rule. Prob C §21205. The clause reaches trusts created directly by the will and any trust that may be created by the donee of a power of appointment conferred by the will.

The time for termination is set by reference to expressly selected lives in being (see §34.7). The drafter should choose measuring lives that best suit the particular situation. Some prefer to specify the measuring lives by name. Use of trust beneficiaries living at the testator's death is another obvious possibility, tying the allowable period directly to the lives of persons associated with the trust or trusts. This may be done by using the phrase "the beneficiaries of the trust created under my will who are living at my death." But in any will in which the ultimate contingent beneficiaries of some trusts include "the heirs" of someone or include appointees under a power of appointment, this language may be unsatisfactory because inclusion of the heirs or appointees in the designated group of measuring lives may render them "so numerous or so situated that evidence of their deaths is likely to be unreasonably difficult to obtain." Prob C §21230. See §34.7.

Thus, it is usually preferable not to use language referring to all beneficiaries living at the testator's death but to refer to the more important beneficiaries or classes of beneficiaries, *e.g.,* "my spouse and those of my issue living at my death." This alternative has the disadvantage of requiring the saving clause to be adapted to the particular will, but this is normally easy to do and avoids the difficulty mentioned above when a trust involves a broad array of potential beneficiaries.

If there are only a few substantial beneficiaries presently in being and all or most are descendants of the testator, use of "issue" as measuring lives is likely to prove adequate to the client's objectives. If the client's children are used, the reference simply to "my children" is sufficient because all the children will necessarily be in being by the testator's death. This is not true of a testator's "issue" or "descendants": Those terms must be qualified (*e.g.,* "those of my issue who are living at the time of my death"). Similar qualification is required for "children" of a living person other than the testator.

If all or most of the beneficiaries are the issue of someone other than the testator (*e.g.,* when a second spouse leaves property in trust for the other spouse's children), that person's descendants living at the testator's death might be selected as the measuring lives.

When a class is used, it may be worthwhile for the executor's attorney to determine the names of all class members living at the testator's death and to list them in the decree of distribution. This will help keep track of the measuring lives and ensure that the trust satisfies the Prob C §21230 requirement that the measuring lives be easy to determine.

The validity of extending the reach of a cutoff clause to trusts created by the donee of a power seems supported by the donor's well-recognized right to limit the interests that the donee can create. The added language does not otherwise affect the operation of the clause, and thus it may be used routinely regardless of whether the particular will confers any powers of appointment.

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§34.40 2. Postcutoff Distribution Clause

The distribution clause in form 34.41-2, specifying how the property will be distributed if the trust is terminated by the cutoff clause, is difficult to draft because it must be adapted to the distributive scheme of each trust.

Because premature termination ends a dispositive plan, the alternative plan should approximate the original as closely as possible. Often this is best accomplished by distributing the trust estate to the trust's current income beneficiaries at the cutoff date. See Comment to form 34.41-2. Frequently these current beneficiaries have a life interest and are the parents of the would-be remainder beneficiaries, so that premature distribution will enable them to enjoy the property for the rest of their lives and then pass it on to the intended remainder beneficiaries. The clauses in §34.41 follow this pattern.

The distribution pattern should be consistent with the rest of the will. This form uses the pattern of distribution to "issue" (either the testator's or another's). Distribution "by right of representation" is used rather than distribution in equal shares because the former generally corresponds more closely to a testator's objectives. Some clients may prefer to have distribution made "as provided by California Probate Code §240 (as it exists on the date my will is executed)" because this wording follows the intestate pattern rather than the strict per stirpes pattern. See generally Prob C §§245-246. Compare Prob C §240 with Prob C §247.

The clause provides for distribution to issue (or it could as well be to "descendants") rather than to beneficiaries of the trust because distribution by right of representation (or in accordance with Prob C §240) is applied with certainty only by reference to the descendants of a common ancestor. Distribution to issue may not be appropriate if there are trust beneficiaries who are not issue, *e.g.,* spouses of descendants. In the normal case, however, the trust beneficiaries, particularly those under the later interests that are most apt to run afoul of the rule against perpetuities, consist exclusively or principally of someone's issue. If spouses of issue are also discretionary recipients, they normally are not appropriate principal distributees on termination. Again, however, the clause must be adapted for consistency with the rest of the testator's will.

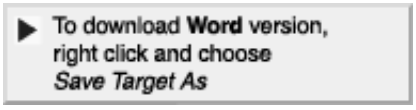
Some saving clauses provide simply for distribution "to my then-living issue" or "to those of my issue who are then beneficiaries of the trust." Such provisions are usually inappropriate because the shares of some lines of descendants are likely to already have been completely distributed before the cutoff date. If this has occurred, those who have received their shares may still be remote contingent beneficiaries of the continuing shares and thus would benefit inappropriately a second time on the premature termination. On the other hand, such beneficiaries normally are not entitled or authorized to receive income currently, which is the test under the present clause. They are thus prevented from receiving double benefit by the clause, because distribution is made only among the line or lines of descendants who are immediate trust beneficiaries at the time of termination.

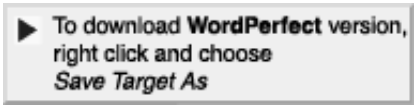
Some saving clauses merely provide for distribution to those "then entitled to the principal of the trust." Such provisions beg the question, because no one is then entitled to the principal. Some specific distribution clause must be supplied for the event of premature termination.

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Source: Estate Planning/California Will Drafting/34 Rule Against Perpetuities/§34.41 3. Form: Perpetuities Saving Clause

§34.41 3. Form: Perpetuities Saving Clause





34.41-1 Cutoff clause

Unless terminated earlier, any trust created by my will or by the exercise of any power of appointment conferred by my will (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*name or description of class to be measuring lives*]_ _ living at my death.

34.41-2 Postcutoff distribution clause

The principal and undistributed income of any trust terminated under this clause shall be distributed to the trust's income beneficiaries in the same proportions in which they are entitled to receive income immediately before termination. If those proportions are not fixed by the terms of the trust, distribution shall be by right of representation to issue of _ _[*name*]_ _, who are then entitled or authorized to receive income distributions from the trust.

Comment: Form 34.41-1 terminates at the end of the common law perpetuities period any trust under the will that has not then ended under its normal terms. The clause also protects against oversight by the donee of a power of appointment who might exercise the power to create new interests that violate the common law rule. On perpetuities problems in exercising powers, see §§34.22-34.23, 34.26-34.29. The language in parentheses provides, *e.g.,* for the possibility that a power may be general and presently exercisable and thus may be treated as complete ownership for perpetuities purposes (see §§34.20-34.21).

If only one trust will be created under the will, the wording of form 34.41-1 may be adapted accordingly, but the clause will operate satisfactorily without adaptation. It is designed for use in testamentary trusts, however, and may not be appropriate for inter vivos trusts.

The purpose of form 34.41-2 is to provide an alternative distribution if the cutoff clause terminates the trust before intended distribution occurs. It is a difficult clause to draft because it must be adapted to the dispositive scheme of each trust and should approximate the testator's original dispositive plan as closely as possible. The first sentence of the clause applies to trusts that require the trustee to pay trust income in specified shares to one or more current income beneficiaries at times when cutoff may occur, with no discretion in the trustee to omit or alter the proportional share of any beneficiary. The sentence merely adopts the pattern of income distribution as it then exists. In rare cases in which the trust terms consistently provide such fixed income shares, the first sentence of the clause alone would be adequate to provide for distribution after cutoff under the saving clause.

When the trustee has, or at any stage of the trust may have, discretion whether or to whom to pay income or in what proportions, the first sentence alone will not be adequate. The saving clause itself must specify a pattern of distribution.

Form 34.41-2 must be adapted to the plan of the particular will. Thus, if the beneficiaries of the trust are the children and other descendants of some person other than the testator, the illustrative bracketed wording should be changed.

The reference to issue who are "then entitled or authorized in the trustee's discretion" to receive income payments covers not only trusts or trust periods in which payments are wholly discretionary but also trusts or periods in which the trustee has a duty to make payments to a beneficiary with discretion only in setting the amounts (*e.g.,* a "support" trust).

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§34.42 VI. CONCLUDING OBSERVATIONS

Throughout the United States, a great deal of attention has been devoted in recent years to reforming the rule against perpetuities. Now that Prob C §21205 makes the common law rule (with a few modifications including a 90-year wait-and-see provision) law in California, the estate planner's perpetuities problems are not too difficult, and statutory provisions for reformation (such as Prob C §21220) can cure drafting failures when necessary.

Reformation by court is a remedy, however, not a substitute for proper planning. Consequently, the will drafter should understand perpetuities rules and dangers and should rely on saving clauses to give clients the benefit of a wait-and-see privilege, with a cutoff and alternative disposition if all else fails or if the client's objectives require a saving clause to stretch the allowable time.

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Concluding Clauses

Clare H. Springs

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.1 I. DISINHERITANCE AND NO-CONTEST CLAUSES DISTINGUISHED

§35.1 I. DISINHERITANCE AND NO-CONTEST CLAUSES DISTINGUISHED

A disinheritance clause is directed only toward the testator's spouse or children who are not to receive property under the will. Unless expressly disinherited in the will, they may be able to claim intestate shares as omitted heirs. Prob C §§21610-21612; Fam C §§297.5(c) (spouse or registered domestic partner), Prob C §§21620-21623 (children). See §35.3 on omitted spouses and domestic partners; see §35.4 on omitted children. The disinheritance clause is designed to prevent such claims. See §35.2.

Although nominal devises (*e.g.,* $1-10) in disinheritance clauses accomplish nothing, a relatively small devise (*e.g.,* $5000-10,000) to a disinherited heir may deter the heir from contesting the will, especially if the attorney explains the cost of the contest and the likelihood of the beneficiary's prevailing. Although such a devise may be distasteful to the testator, it may preserve the bulk of the estate for those whom the testator intended to benefit rather than to dissipate it on the attorney fees and costs of a will contest.

A no-contest clause is directed toward any beneficiary under the will who contests the will or any of its provisions. The clause is meant to protect the will from attack by providing that any contesting beneficiary must forfeit benefits that he or she would otherwise take under the will.

A no-contest clause alone cannot defeat claims of omitted heirs, because they do not contest the will but attempt to take in spite of it. *Estate of Leonetti* (1981) 115 CA3d 378, 383, 171 CR 303, 306.

No-contest clauses are often combined with general disinheritance language so that the effect is a combination no-contest and disinheritance clause. See *Estate of Leonetti, supra*. Because the no-contest and disinheritance clauses serve separate purposes, however, they are better stated separately, particularly when an heir is intentionally omitted from the will.

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II. DISINHERITANCE CLAUSES

§35.2 A. Avoiding Omitted Heirs

An attorney who had reason to anticipate a claim by a omitted heir and who failed to meet the technical requirements of the omission statutes could be liable to the beneficiaries under the will who were denied property as a result. See *Heyer v Flaig* (1969) 70 C2d 223, 74 CR 225, overruled on other grounds in *Laird v Blacker* (1992) 2 C4th 606, 617, 7 CR2d 550.

During the initial interview, the attorney should question the client about all marital and domestic partnership or parental relationships. A surprising number of individuals keep marriages or partnerships and parenthood a secret, and most people do not realize that stepchildren or foster children may have inheritance rights. Careful attention to this issue should forestall much second-family litigation. If a client does not wish to provide for a spouse or child, including a stepchild or foster child, an explicit statement of that fact must appear in the will.

The client who has neither an intended spouse or domestic partner nor a child when the will is executed should be informed (preferably in writing as well as in person) that later marriage or declaration of domestic partnership or parenthood (including adoption, taking in foster children, or relationships with stepchildren) can make the estate plan vulnerable to challenge after the client's death. This information will encourage the client to provide the attorney with a complete roster of relations and to bring the will up to date at major life changes.

As part of a periodic will review, the attorney should remind clients of the effect that marriage or parenthood can have on an existing will. See §§35.3-35.4 on omitted spouses and children; §2.2 for a client interview checklist; chap 4 on review of existing wills.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.3 B. Omitted Spouse or Registered Domestic Partner

§35.3 B. Omitted Spouse or Registered Domestic Partner

Except in the circumstances described in Prob C §21611, if a testator fails to provide by will for a spouse or registered domestic partner who married the testator or filed a declaration of domestic partnership with the testator after execution of the testator's will, the surviving spouse or partner is entitled to take the following from the estate (Prob C §21610; Fam C §297.5(c)):

- All the decedent's half of community and quasi-community property of the marriage or domestic partnership; and
- That share of the decedent's separate property that would be the spouse or partner's share if the decedent had died intestate, up to half of the separate property.

The spouse or registered domestic partner will not receive the described share if any of the following circumstances is established:

- The testator intended not to provide for the spouse or partner, and that intention "appears from the will" (Prob C §21611(a));
- The testator provided otherwise for the spouse or partner, and the intention that those provisions were made instead of testamentary provisions is "shown by statements of the decedent or from the amount of the transfer or by other evidence" (Prob C §21611(b)); or
- The spouse or partner waived the right to inherit in "a valid agreement" (Prob C §21611(c)).

The exceptional circumstances outlined in Prob C §21611 must exist just as described for the surviving spouse or partner to be denied an intestate share.

EXAMPLE: In *Estate of Shannon* (1990) 224 CA3d 1148, 274 CR 338, the decedent executed his will in 1974, married in 1986, and died 2 years later with his will unchanged. The will, in which the decedent left everything to his daughter, included a standard disinheritance and no-contest clause. The decedent's attorney was prepared to state in a declaration (not admitted at trial but referred to by the appeals court) that the decedent had told him during the year before his death that, because his wife had more than he did, he wished to provide only for his daughter. Despite this, the court reversed the lower court's order denying the widow's petition for heirship.

Even if the conditions described in Prob C §21611(b)-(c) exist, a clear statement in the will that the testator intends that the spouse or partner not take under the instrument will discourage the survivor from claiming an intestate share and avoid the need to establish the existence of the other conditions. The burden of proving the existence of a circumstance described in Prob C §21611 is on the proponent of the will. *Estate of Shannon, supra*.

See §35.6 for discussion of drafting to disinherit a spouse or domestic partner.

If the client has a prenuptial or postmarital agreement, the drafter should review the provisions of the agreement to ensure that it is consistent with the client's testamentary instruments. If the client intends to exclude his or her spouse or partner from the will, that intention should be clear.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.4 C. Omitted Child

§35.4 C. Omitted Child

Except in the circumstances described in Prob C §21621, if a testator fails to provide by will for a child born or adopted *after* execution of the will, the surviving child is entitled to take from the estate that share of the decedent's estate that would be the child's share if the decedent had died intestate. Prob C §21620. For intestate share of a surviving child, see Prob C §§6400-6414, particularly Prob C §6402. In the absence of a testamentary disposition, all of the decedent's community and quasi-community property goes to the decedent's surviving spouse or registered domestic partner and none to children. Prob C §6401(a)-(b); Fam C §297.5(c). One-half of the decedent's separate property is allocated to the decedent's surviving spouse or domestic partner if the decedent leaves only one child and one-half is allocated to the child, and one-third of the decedent's separate property is allocated to the decedent's surviving spouse or domestic partner if the decedent leaves more than one child and two-thirds is allocated to the children. Prob C §6401(c).

The child will not receive his or her intestate share if any of the following circumstances is established:

- The testator intended not to provide for the child, and that intention "appears from the will" (Prob C §21621(a));
- The testator had a child or children when the will was signed and devised "substantially all the estate" to the other parent of the omitted child (Prob C §21621(b)); or
- The testator provided otherwise for the child, and the intention that the provisions were made instead of testamentary gifts is "shown by statements of the decedent or from the amount of the transfer or by other evidence" (Prob C §21621(c)).

Further, if the testator fails to provide in the will for a living child (*i.e.,* a person qualifying as the testator's child before the will's execution), and the omitted child can establish that the only reason for his or her omission from the will was the testator's ignorance of the child's birth or belief that the child is dead, the omitted child may claim an intestate share against the testator's estate. Prob C §21622.

Probate Code §21620 does not protect omitted grandchildren or more remote issue of a deceased child of the testator. In addition, Prob C §21622 protects an omitted living child only if the testator mistakenly believed that the child was dead or did not know of the child's birth.

Because "child" is defined in Prob C §26 as a person who can claim from a parent by intestate succession, it is unclear whether Prob C §6454 entitles stepchildren or foster children to claim as omitted children under Prob C §21620. Section 6454, which describes the parent-child relationship for purposes of intestate succession, gives inheritance rights to some stepchildren and foster children. (On the intentional inclusion of stepchildren as "children," see Cal L Rev'n Comm'n Comment to Prob C §26.) Under Fam C §297, children of the decedent's domestic partner may be considered the decedent's stepchildren. Children born to the domestic partner during the partnership also may be considered the decedent's natural children under the Uniform Parentage Act (UPA) (Fam C §§7600-7730). Therefore, if any such stepchildren or foster children are meant to be disinherited, they should be separately defined in the will as part of the class of "children" if a general clause is used. It is preferable, however, to disinherit any known stepchildren or foster children by name. See forms and discussion in §§35.7-35.8.

EXAMPLE: In *Estate of Turkington* (1983) 147 CA3d 590, 195 CR 178, the testator left a will giving his estate equally to two nieces whom he had raised. After execution of the will, he adopted only one niece and did not change his will. The court held that the adopted niece was an omitted heir entitled to the entire estate.

NOTE: If the testator wishes to disinherit any children born or adopted after the will is executed, that intention should be clearly stated in the will to avoid having to establish other grounds for rejecting an omitted child's claims against the will. In the author's opinion, prudent drafters always make unusual intentions such as disinheriting a child absolutely clear on the face of the document.

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D. Drafting Disinheritance Clauses

§35.5 1. Purpose of Disinheritance Clause

Although the Probate Code substantially limits the classes of persons who are able to claim inheritance as omitted heirs, the plethora of litigation under the prior statutes warns that the client intending to disinherit spouse or children is best served by an explicit declaration of intent. The declaration should state that the testator intends not to provide for any spouse, child, or grandchild not named in the will, including natural, adoptive, step-, and foster children whose names are not known when the will is executed.

Disinheritance clauses often give a nominal devise to persons who are intended to be otherwise disinherited, but such devises are unlikely to add anything to the validity of disinheritance provisions. In *Estate of Carroll* (1956) 138 CA2d 363, 291 P2d 976, the testator left a substantial gift to her predeceased sister and one dollar to each of the sister's sons. Refusing to admit extrinsic evidence showing the testator's intent to disinherit by the dollar gifts, the court applied the antilapse statute to pass the gift to the testator's nephews. Moreover, the nominal devise requires the executor to communicate with the disinherited person, who will probably not be cooperative, to make the distribution and obtain a receipt for the distribution, which may prove troublesome for the executor.

Occasionally, a person is disinherited for reasons that are unrelated to animosity, such as when a spouse or child has a substantial estate in his or her own right and there is no reason to increase it with the testator's assets. Although some drafters state the reason for the disinheritance, it is better practice to avoid stating any reason. If circumstances change, such a statement may open the door to litigation on the question of what the testator would have done had the testator known of the change in circumstances. In the author's opinion, the drafter should never state reasons for disinheritance unless, if circumstances changed, the testator would want the person to share under the will.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.6 2. Drafting to Disinherit Spouse or Registered Domestic Partner

§35.6 2. Drafting to Disinherit Spouse or Registered Domestic Partner

Probate Code §21611 requires that the testator's omission of a spouse as beneficiary of a will must appear to be intentional for language in the will to defeat the spouse's claim of omission. The statute also applies to the omission of a registered domestic partner. Fam C §297.5(c). The will should make clear the testator's intention to omit anyone who might be considered a spouse or domestic partner of the testator, including former spouses or partners and putative spouses or partners, whenever there is any question about the testator's marital or partnership status. See §10.7. In a line of cases that arose under former Prob C §70, the courts considered what language demonstrates the testator's intent to omit the spouse. The courts held that:

- The surviving spouse may claim omission unless provision for or omission of the spouse in the will refers to that person as the testator's spouse. In *Estate of Poisl* (1955) 44 C2d 147, 280 P2d 789, a devise to the person who became the testator's spouse after the will's execution was held insufficient to prevent revocation of the will as to the spouse. Similarly, in *Estate of Paul* (1972) 29 CA3d 690, 105 CR 742, the court held that mere mention of the spouse's name (as an alternate executor), without specific provision for her as "spouse," did not defeat a claim of omission.
- Any statement in the will that the spouse is intentionally omitted must be clear and specific. In *Estate of Axcelrod* (1944) 23 C2d 761, 147 P2d 1, the court held that a general disinheritance clause was insufficient to disinherit a surviving spouse under former Prob C §70. In *Estate of Shannon* (1990) 224 CA3d 1148, 274 CR 338, the court held that similar language was insufficient to disinherit a surviving spouse under Prob C §§21610-21611. See §35.3.
- A provision in a will specifically excluding a prospective spouse will not apply to a different spouse. In *Estate of Green* (1981) 120 CA3d 589, 174 CR 654, the decedent's will specifically failed to provide for a woman to whom the decedent was then contemplating marriage. Holding that the surviving spouse was an omitted spouse, the court refused to read the disinheritance of the named individual as a specific omission of the surviving spouse.

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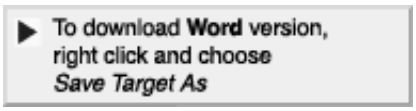
§35.7 3. Drafting to Disinherit Children

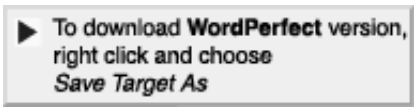
Although Prob C §§21620-21622 provide very limited protection for children not mentioned in a will and comparable statutes in other jurisdictions provide no protection for children mentioned in a will but not receiving a devise, it is frequently unnecessary to expressly disinherit a child as long as the child has been mentioned. As a practical matter, however, situations may arise in which express disinheritance will be desirable if only to provide the client with peace of mind. Such a clause is also desirable if the client is concerned that there may be a child whose name is unknown—particularly if the laws of another jurisdiction might apply.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.8 E. Form: Disinheritance Clauses

§35.8 E. Form: Disinheritance Clauses





35.8-1 Disinheritance of spouse

***Omitted Heirs*. I am contemplating marriage to _ _[*name*]_ _ I intentionally and with full knowledge of the consequences do not provide in my will for _ _[*name*]_ _ Further, I intend that this disinheritance specifically defeat the application of any statutory heirship interest.**

35.8-2 Disinheritance of named person (reason not stated)

***Omitted Heirs*. I intentionally and with full knowledge of the consequences disinherit, and omit any provision in my will for, the following person: _ _[*Name*]_ _ All provisions of my will shall be interpreted as though that person had predeceased me _ _[*without issue*]_ _.**

35.8-3 Disinheritance of children

***Omitted Heirs*. I intentionally and with full knowledge of the consequences do not provide in my will for my child or children conceived, born, or adopted by me before or after execution of my will, or who became my child or children through a step or foster relationship before or after execution of this instrument. I intend that this disinheritance specifically defeat the application of any statutory heirship interest.**

35.8-4 Disinheritance of domestic partner

***Omitted Heirs*. I am contemplating filing a declaration of domestic partnership with _ _[*name*]_ _ I intentionally and with full knowledge of the consequences do not provide in my will for _ _[*name*]_ _ Further, I intend that this disinheritance specifically defeat the application of any statutory heirship interest.**

Comment: In form 35.8-2, the optional phrase "without issue" should be used if the testator wants to prevent any chance that the antilapse statute will operate in favor of the descendants of a disinherited child. See §12.17 for discussion of the antilapse provisions.

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III. NO-CONTEST CLAUSES

§35.9 A. Discouraging Contests by Beneficiaries

No-contest clauses are used to discourage will contests by providing that any beneficiary who contests the will forfeits what he or she would have received under the will. A no-contest clause may also provide that the contesting beneficiary's issue forfeit any right to take in place of the contestant. This prevents the contestant's issue from taking when the contestant, by virtue of the no-contest clause, is treated as having predeceased the testator. On this and other optional provisions of a no-contest clause, see §35.9F.

A "contest" is defined in Prob C §21310(a) as a pleading filed with the court by a beneficiary that would result in a penalty under a "no contest clause." A "direct contest" is defined in Prob C §21310(b) as a contest that alleges the invalidity of a protected instrument on one of six specified grounds. "No contest clause" is defined in Prob C §21310(c) as "a provision in an otherwise valid instrument that, if enforced, would penalize a beneficiary for filing a pleading in any court." A "protected instrument" is defined in Prob C §21310(e) as including the instrument that contains the clause and an instrument in existence on the date the instrument containing the clause is executed (*i.e.*, not a later codicil or amendment) that is expressly identified in the clause as being governed by the clause.

Probate Code §21311(a)(1) generally provides that a no-contest clause may be enforced only against a direct contest brought without "probable cause" (as defined in Prob C §21311(b)), although the statute also allows enforcement of a no-contest clause against pleadings challenging the decedent's ownership of property (Prob C §21311(a)(2)) or the filing of creditor's claims (Prob C §21311(a)(3)) if the clause expressly provides for that application. The exception in Prob C §21311(a)(2) is intended to permit a forced election by the surviving spouse with respect to marital property. See §17.43.

Probate Code §21312 states that the clauses must be strictly construed in determining the transferor's intent. The will cannot change the rules provided in Prob C §§21310-21311. Prob C §21314. The common law continues to apply to the extent that these statutes do not apply. Prob C §21313. The statutes apply to instruments whenever executed that became effective on or after January 1, 2001. Prob C §21315. However, the provisions of Prob C §§21300-21322 continue to apply until January 1, 2010. Under these provisions, no-contest clauses are generally enforceable against any form of contest with specified exceptions. See §§35.9A-35.9E.

Conforming amendments to CCP §§366.2-366.3 and Prob C §§1303-1304 recommended by the California Law Revision Commission (CLRC) make clear that declaratory relief (safe harbor petitions) under Prob C §21320 will remain available for instruments that became irrevocable before January 1, 2001. See 38 Cal L Revision Comm'n Reports 203 (2009).

For further discussion of will contests, see Decedent Estate Practice, chap 26 (2d ed Cal CEB 2009). See also California Trust and Probate Litigation, chap 17 (Cal CEB 1999).

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.9A 1. Actions That Do Not Violate No-Contest Clause Unless Expressly Provided (Before January 1, 2010)

§35.9A 1. Actions That Do Not Violate No-Contest Clause Unless Expressly Provided (Before January 1, 2010)

Under Prob C §21305(a), certain actions do not violate the clause unless the clause expressly states otherwise:

- The filing of a creditor's claim or prosecution of a suit based on it;
- An action or proceeding to determine the character of property;
- Challenge to the validity of an instrument other than the instrument containing the no-contest clause.

The restrictions in Prob C §21305(a) do not apply to a will executed before January 1, 2001. These restrictions also do not apply to a codicil to the will executed on or after January 1, 2001, unless the codicil specifically adds or amends a no-contest clause contained in the will. Prob C §21305(c). See also *Cory v Toscano* (2009) 174 CA4th 1039, 94 CR3d 841 (no-contest clause does not apply to handwritten changes made after execution of trust instrument containing the clause). The statute is superseded by new Prob C §§21310-21313, effective January 1, 2010. See §35.9.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.9B 2. Public Policy Exceptions to Enforcement of No-Contest Clause (Before January 1, 2010)

§35.9B 2. Public Policy Exceptions to Enforcement of No-Contest Clause (Before January 1, 2010)

Under Prob C §21305(b)(1)-(12), certain actions do not violate a no-contest clause as a matter of public policy:

- Pleading regarding modification or termination of a trust;
- Pleading regarding appointment of a conservator;
- Pleading under the power-of-attorney laws;
- Pleading regarding an order annulling a marriage of the settlor;
- Pleading regarding instructions of a conservator;
- Pleading regarding the exercise of a fiduciary power (Prob C §21305(b)(6));
- Pleading regarding the appointment of a fiduciary or the removal of a fiduciary;
- Objections or other responsive pleading to the account of a fiduciary;
- Pleading regarding the interpretation of the instrument containing the no-contest clause (Prob C §21305(b)(9));
- Pleading regarding approval of a settlement or compromise affecting the terms of the instrument;
- Pleading regarding the reformation of an instrument to carry out the intention of the person creating the instrument (Prob C §21305(b)(11)); and
- Petition to compel an accounting or report of a fiduciary.

In *Bradley v Gilbert* (2009) 172 CA4th 1058, 91 CR3d 680, the court held that a no-contest clause that would penalize a beneficiary for seeking court review of actions a surviving spouse took as trustee of QTIP and bypass trusts was not enforceable under Prob C §21305(b)(6).

The provisions of Prob C §21305(b) apply to instruments whenever executed. See Prob C §21305(d). The provisions of Prob C §21305(b)(6), (9), (11) do not apply if the court finds that the filing of the pleading is a direct contest. Prob C §21305(e). A pleading includes a petition, complaint, response, objection, or other document filed with the court that expresses the position of a party. Prob C §21305(f). The statute is superseded by new Prob C §§21310-21313, effective January 1, 2010. See §35.9.

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§35.9C 3. Other Statutory Exceptions to Enforcement of No-Contest Clause (Before January 1, 2010)

There are two other statutory exceptions to enforcement of a no-contest clause, in addition to those provided in Prob C §21305 (see §§35.9A-35.9B); however, the statute is superseded by new Prob C §§21310-21313, effective January 1, 2010. See §35.9.

A no-contest clause will not be enforced for:

(1) A contest brought with reasonable cause limited to one or more of the following grounds: forgery, revocation, an action to establish the invalidity of a transfer to a "disqualified" person under Prob C §21350 (see §1.35), or a petition under Prob C §15642(b)(6) to remove a sole trustee who is a disqualified person (see §28.4) (Prob C §21306); or

(2) A contest brought with probable cause against a provision benefiting a person who drafted or transcribed the will, a person who directed the drafter on substantive matters in the will or on the no-contest provision in the will (unless the testator also directed the inclusion of those contents), or a witness to the will (Prob C §21307).

NOTE: Probate Code §§21306 and 21307 overlap and are somewhat contradictory insofar as a contest is based on a provision benefiting the drafter of the will. For example, §21306 requires an action to establish the invalidity of the transfer under §21350, while §21307 does not require such a proceeding, but requires instead that there be a clause benefiting specified persons. Section 21307 applies to a broader range of participants than does §21350 (*e.g.,* anyone—not just a person in a fiduciary relationship—who transcribes the instrument; a witness to the instrument). However, §21350 also applies to persons with specified personal or business relationships to the drafter or the transcriber, to the extent covered. See §1.35.

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§35.9D 4. Common Law Cases on Enforcement of No-Contest Clause

The statutory scheme does not preempt case law. Under Prob C §21313, the "common law governs enforcement of a no-contest clause to the extent" that the statutes do not apply. See *Estate of Ferber* (1998) 66 CA4th 244, 77 CR2d 774. Thus, when considering whether a foreseeable challenge might qualify as a contest, the practitioner should consult previous decisions. Many of these decisions, however, may be superseded by the enforceability restrictions of new Prob C §§21310-21313, effective January 1, 2010. See §35.9.

In *Estate of Strader* (2003) 107 CA4th 996, 132 CR2d 649, for example, the court held that claims concerning rights in the net amount recovered from the testator's conservator in surcharge litigation did not violate the no-contest clause in the testator's will, because the will did not give an unequivocal indication of the testator's intent with respect to the property as required by *Burch v George* (1994) 7 C4th 246, 27 CR2d 165.

In *Estate of Coplan* (2004) 123 CA4th 1384, 20 CR3d 686, the court held that the executor of a will that provided that no compensation was to be paid to the personal representative did not violate the will's no-contest clause by applying for fees. In *Estate of Davies* (2005) 127 CA4th 1164, 26 CR3d 239, the court held that a claim that a deceased beneficiary satisfied a 120-day survivorship requirement was not a contest. In *Giammarrusco v Simon* (2009) 171 CA4th 1586, 91 CR3d 50, the court held that a petition seeking reformation of an ambiguous trust provision to conform the document to the settlor's alleged intent regarding the exercise of a power of appointment would not violate a no-contest clause.

In *Tunstall v Wells* (2006) 144 CA4th 554, 50 CR3d 468, the court upheld a clause providing that a contest will result in a forfeiture not only of the gift to the contestant, but also of gifts to other beneficiaries. The court held that the clause did not violate public policy. In *Colburn v Northern Trust Co.* (2007) 151 CA4th 439, 59 CR3d 828, the court upheld a similar clause that effectively forced the decedent's former spouse and minor children to elect either the benefits of the decedent's trust or their rights arising out of a marital dissolution judgment. But see *Safai v Safai* (2008) 164 CA4th 233, 78 CR3d 759 (no-contest clause that purported to disinherit any beneficiary who voluntarily participated in a proceeding to set aside a revocable trust did not apply to minor child represented by the deceased settlor's former spouse as guardian ad litem).

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§35.9E 5. Safe Harbor Petition for Proposed Actions Under Prob C §21320

Probate Code §21320 has been characterized as a "safe harbor" petition by which a beneficiary can ask a court to determine that a planned petition, motion, or act does not constitute a contest. A no-contest clause is not enforceable to the extent that the beneficiary has made an application for the court's determination. Prob C §21320(b). Probate Code §21308 further provides that the statute of limitations for the commencement of any motion, petition, or other act referred to in Prob C §21320(a) will be tolled beginning with the date on which the application for the court's determination is made and ending with the date on which the court's determination becomes final. However, no safe harbor petition is available under Prob C §§21310-21313 in an action involving a no-contest clause in an instrument that became irrevocable on or after January 1, 2001. See §35.9.

In *Nairne v Jessop-Humblet* (2002) 101 CA4th 1124, 124 CR2d 726, for example, the court held that a claim that the decedent promised to give the claimant a specific property at death would violate a no-contest clause in a revocable trust that listed the property as an asset. Similarly, in *Zwirn v Schweizer* (2005) 134 CA4th 1153, 36 CR3d 527, the court held that a beneficiary's effort to enforce an oral contract that contravened the testator's plan of distribution constituted a claim in violation of the no-contest clause outside of the creditor's claim exception in Prob C §21305(a). See §35.9A.

Practitioners may, however, be unable to obtain a preliminary determination under Prob C §21320 that a statutory exception precludes enforcement of a no-contest clause. Although both Prob C §§21306 and 21307 provide that the no-contest clause is not enforceable against a beneficiary to the extent that the action is commenced "with probable cause" or "with reasonable cause" (see §35.9C), Prob C §21320(d) specifically prohibits declaratory relief to obtain a court determination, before the outset of the litigation, that there is probable cause to bring an action described in Prob C §§21306 and 21307. *Genger v Delsol* (1997) 56 CA4th 1410, 1426, 66 CR2d 527. Further, a preliminary determination may not be made if a determination of the merits of the particular action is required. Prob C §21320(c). In *Montegani v Johnson* (2008) 162 CA4th 1231, 76 CR3d 621, the court held that a trial court order that a proposed proceeding would not violate a no-contest clause could be reconsidered and reversed after a court decision in a related appeal established that the beneficiary had already violated the no-contest clause in an earlier proceeding and therefore no longer had standing. See also *Estate of Goulet* (1995) 10 C4th 1074, 43 CR2d 111 (trustee may be "aggrieved party" for purposes of standing to appeal order that beneficiary's proposed filing of creditor's claim was not a contest within meaning of no-contest clauses of will and trust).

In *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129, the court held that a trust income beneficiary's proposed petition to compel the trustee to exercise the Prob C §16336 power to adjust between principal and income would violate the trust's no-contest clause. See discussion in §7.19. See also *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473 (petition compelling trustees to pay greater income would violate no-contest clause because trust instrument allowed trustees to determine what is income and what is principal). But see *Meyer v Meyer* (2008) 162 CA4th 983, 76 CR3d 546 (petition for information from trustee of testamentary trust would not violate no-contest clause in the will because the decree of distribution did not include the clause or incorporate it by reference and the clause did not refer to the trust, unlike the clause in *Hearst v Ganzi, supra*).

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§35.9F 6. Optional Provisions of No-Contest Clause

If the testator wants to increase the penalty for contesting, the statement in the clause that the contestant will be treated as if deceased "without issue" not only bars the contestant from inheriting under the will but also prevents the forfeited gift from passing to the contesting party's descendants under Prob C §21110, the antilapse statute. Because this statute will not go into effect if gifts under the will depend on the beneficiaries' surviving the testator for a specified period of time, the "without issue" phrase is superfluous if all gifts require survival for a given length of time. If all gifts are not so conditioned, however, the testator may want to use the phrase "without surviving issue" in form 35.10-1.

Drafters may want to add language making it clear that the no-contest clause does not apply to future codicils. See Option 2 in form 35.10-1. Many drafters use this approach because the drafter has no way of knowing in advance whether a future codicil or amendment will be executed in questionable circumstances, *e.g.,* when the principal is subject to undue influence. See *Graham v Lenzi* (1995) 37 CA4th 248, 43 CR2d 407, in which the court held that a no-contest clause did not apply to a claim of undue influence involving a disqualified person under Prob C §21350. See also *Montegani v Johnson* (2008) 162 CA4th 1231, 76 CR3d 621, in which the court held that a no-contest clause in a revocable trust executed in 1999 and revoked in 2001 applied to a claim of undue influence involving a transfer of life insurance from an irrevocable trust executed in 1999 to another trust executed in 2001.

A no-contest clause that applies to future instruments is ill-advised and may constitute a breach of the duty owed the client. The ironic effect of the clause is that it may make it more difficult for the current beneficiaries to protect their interests under the very plan the drafter just created. Future drafted amendments can include their own no-contest clause when appropriate. See *Townsend v Townsend* (2009) 171 CA4th 389, 89 CR3d 760; *Perrin v Lee* (2008) 164 CA4th 1239, 79 CR3d 885; *Estate of Rossi* (2006) 138 CA4th 1325, 42 CR3d 244 (no-contest clause in trust document did not apply to trust amendment under Prob C §21305(a)). Beginning January 1, 2010, Option 2 in form 35.10-1 may be unnecessary because a no-contest clause in an instrument that became irrevocable on or after January 1, 2001, will not be applied to any instrument that was not in existence on the date that the instrument containing the no-contest clause was executed. Prob C §21310(e)(2). See §35.9.

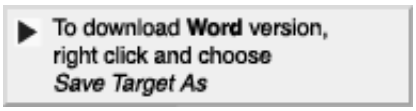
Drafters may also want to authorize the executor to defend a contest or an attack on the estate. See Option 1 in form 35.10-1. Without such a clause, the executor might be hesitant to defend the will because a court may rule that an attorney who represents the executor in an unsuccessful defense of a will contest is not entitled to have fees paid from the estate. For example, in *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742, the court found that an undue-influence contest of a decedent's trust was essentially a dispute between beneficiaries and it would be inequitable to effectively charge the prevailing party with the loser's expenses. Of course, using such language runs the risk of depleting the estate in unforeseen circumstances when a defense of the will would be undesirable.

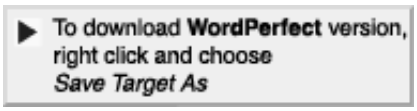
If the will includes a testamentary trust, the no-contest clause should refer specifically to the trust to avoid the problem presented in *Estate of Flint* (1972) 25 CA3d 945, 102 CR 345. In *Flint,* a general disinheritance and no-contest clause was effective for specific gifts under the will, but the contesting daughter was not disqualified from inheriting a remainder share of the testamentary trust, which was not interpreted as a gift from "the will." See form 35.10-1 for language to be used in a no-contest clause when the will includes a trust.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.10 B. Form: No-Contest Clause

§35.10 B. Form: No-Contest Clause





35.10-1 No-contest clause

***No-Contest Clause*. If any beneficiary of my estate, singly or in conjunction with any other person or persons, contests in any court the validity of this will or of any trust receiving property under this will, or shall seek to obtain an adjudication in any proceeding in any court that this will or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside any of the provisions of this will, then the right of that person to take any property under this will shall be determined as it would have been determined had the person predeceased me _ _[*without surviving issue*]_ _.**

[*If appropriate, add one or more of the following options*]

[*Option 1: Trustee authorized to defend contest*]

The executor is authorized to defend, at the expense of my estate, any contest or other attack of any nature on this will or any of its provisions.

[*Option 2: No-contest clause does not apply to amendments and codicils*]

This paragraph shall not apply to any codicil of this will.

Comment: Some drafters wish to make it clear that the no-contest clause does not apply to future codicils (see Option 2) although this clause may be unnecessary for wills executed after 2009. See §35.9F. Some drafters may wish to encourage the executor to defend the will. In that event, the drafter may use Option 1. See §35.9.

The drafter should use the phrase "without surviving issue" for the testator who wants to prevent any chance that the antilapse statute will operate in favor of the descendants of a disinherited contesting beneficiary who is kindred of the testator or the testator's spouse. See §12.17 on the antilapse provisions.

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IV. DEFINITIONS

§35.11 A. Purpose of Definition Clauses

Definition clauses in wills have several uses, which often overlap:

- *To clarify whom the testator intends to include in a class referred to in the will*. For instance, when the testator refers to "children," does the class include children of all the testator's marriages? Children born out of wedlock or adopted? Stepchildren? Children of the half blood? Does "spouse" include a spouse in the process of divorce? A spouse living apart from the testator or a beneficiary?
- *To enable the drafter to substitute a single word or short phrase for a total description of circumstances or aspects included in that term*. For example, "death tax" typically covers federal estate taxes as well as state and local transfer taxes payable on property passing at the testator's death. The drafter can use the definition clause to clarify whether the term includes interest and penalties and generation-skipping or other specialized transfer taxes.
- *To allow the drafter to eliminate strings of pronouns and lists by stating that one term includes certain others*. Typical clauses of this type state that reference in the will to one gender includes reference to the other, that the singular includes the plural and vice versa, and that "trustee" includes any cotrustee and successor trustee. Without such clauses, the drafter might feel constrained to refer to "they, he, she, or it" in, *e.g.,* clauses covering powers allocation among male, female, and corporate cotrustees or successor trustees of a testamentary trust.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.12 B. Statutory Definitions

§35.12 B. Statutory Definitions

The Probate Code rules of construction for terms apply if the will does not otherwise define the terms. Prob C §21102(b). Under these rules:

- "Heirs," "heirs at law," "next of kin," "relatives," and "family" are defined to mean those who would take under the laws of intestate succession. Prob C §21114. See Prob C §44 for definition of "heirs." See also §12.30.
- "Halfbloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons when appropriate to the class" are included in the terms of a class gift or relationship according to the rules of relationship and intestate succession. Prob C §21115(a). Probate Code §21115(b) imposes other requirements when the testator is not the natural or adoptive parent of the child. See Prob C §§6400-6414 for rules of relationship and intestate succession. See also §12.29.

In the absence of specific provisions in the will, the definitions in Prob C §§20-88 may become important. See, *e.g.,* Prob C §§26 ("child"), 37 ("domestic partner"), 50 ("issue"), 59 ("predeceased spouse"), and 78 ("surviving spouse").

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§35.13 C. When to Include Definition Clauses

The testator can provide his or her own definition for any term used in the will. "The intention of the transferor as expressed in the instrument controls the legal effect of the dispositions made in the instrument." Prob C §21102(a). The statutory rules of construction apply only when the testator's intention is "not indicated by the instrument." Prob C §21102(b). Extrinsic evidence may be used to determine the intention of the transferor. Prob C §21102(c).

In any situation in which the meaning of a term significantly affects the will's interpretation, and a misunderstanding may lead to mistake, confusion, or dispute, the drafter should consider including special definition clauses. The term can refer to a gift, devisees, or manner of distribution or estate administration. Even when the statutory rules of construction accord with the testator's intentions, a cautious drafter will consider special definition clauses when:

- *Major gifts are made to a class*. Explaining who belongs to the class will guide the executor (or trustee of a testamentary trust) and discourage conflicts among beneficiaries. See §§12.27-12.34.
- *The will contains a technical term*. Defining the term will ensure that it will be properly interpreted. The definition will also ease the fiduciary's task of explaining the term to the beneficiaries and administering the estate. Although technical words in an attorney-drafted will are usually considered to be used in their technical sense (Prob C §21122), defining the terms is the only assurance that they will convey their intended meaning.
- *The statutory rules of construction do not reflect the testator's intentions*. For example, the testator might not want to include stepchildren in the class of "children," but stepchildren would be included in this class under Prob C §21115(a) if the circumstances described in Prob C §6408 exist (see §35.4).
- *The statutes do not provide any rule for interpretation or definition of a term.*

The drafter typically adds definition clauses at different points within a will. For example, members included in classes named in class gift provisions are usually described in the portion of the will making class gifts. Trust terms are usually defined in the sections describing the testamentary trust. Tax terms are usually defined in tax clauses. Definitions that apply to the entire will are usually placed at the end of the will.

PRACTICE TIP: The use of definitions places a heavy burden on the drafter to assure that the will does not inadvertently contain any use of the defined term that is inconsistent with the definition. Further, when definitions are particularly significant, as when they define a class of beneficiaries, it is important to refer to the definition when the term is used—particularly when the definition appears near the end of a lengthy document. Failure to provide the cross-reference may cause doubt as to whether the testator (or even the drafter) was consciously aware of the remotely located definition when the term was used.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/ D. Common Types of Definition Clauses/ §35.14 1. Some Terms Defined in Other Articles of Will

D. Common Types of Definition Clauses

§35.14 1. Some Terms Defined in Other Articles of Will

Sections 35.15-35.18 discuss and provide a few definitions that are often seen in wills. These definitions are usually placed toward the end of the will.

This chapter does not repeat definitions described in chapters in this book that discuss the topics to which the clauses relate. See, *e.g.,* forms 12.33-1 ("children"), 26.34-1 ("death tax"), 32.16-1 ("executor").

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/ 2. Gender and Number/§35.15 a. Use of Proper Gender and Number Designations

2. Gender and Number

§35.15 a. Use of Proper Gender and Number Designations

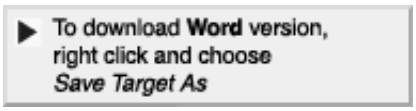
Many will drafters provide proper gender and number designations throughout the will. Although this makes the will more readable to the client, it also increases the chance for error (particularly in form wills) and makes the will more expensive to prepare. In some situations, proper designations make will sections needlessly cumbersome. This may occur, for instance, when cotrustees or successor trustees may be of either gender.

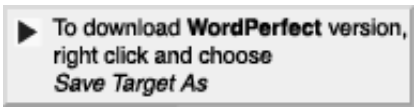
Even if the will drafter prefers to provide proper gender and number designations throughout the will, form 35.16-1 will cover any errors or oversights. Some practitioners believe the clause is unnecessary, observing that the topic is virtually never the subject of litigation.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.16 b. Form: Gender and Number

§35.16 b. Form: Gender and Number





35.16-1 Gender and number

***Gender and Number*. In any interpretation of my will necessary to give effect to any provision of the will, the masculine includes the feminine and neuter, the feminine includes the masculine and neuter, the neuter includes the masculine and feminine, the singular includes the plural, and the plural includes the singular.**

Comment: This clause is usually placed toward the end of the will in a section devoted to definitions.

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3. "Spouse," "Husband," or "Wife" and "Domestic Partner"

§35.17 a. Purpose of Relationship Definition

The identity of the *testator's* spouse, if any, should be established immediately in the will in the introductory clauses. See §§10.7-10.8. It may be helpful, however, to include a definition describing which individuals are meant by the terms "spouse," "husband," or "wife" when they do not refer to the testator's spouse. For a form of definition of "spouse," "husband," or "wife," see §35.18. For a similar form of definition of "domestic partners," see §35.18A.

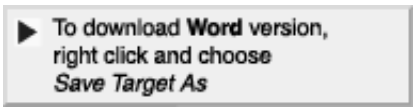
For example, the testator may provide through power of appointment that a child's spouse may share in the estate (usually only if the child is deceased). Is the spousal relationship determined as of the date of execution of the will (regardless of a later dissolution or separation) or as of the date of the testator's death? Does remarriage change the rights of a person who was the spouse of a child of the testator when the will was executed?

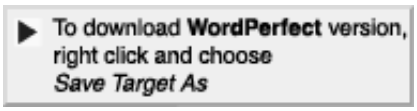
PRACTICE TIP: In many cases, the testator may want different definitions to apply to different provisions. A single will may contain various outright gifts, provisions for trust distributions over a prolonged period, and powers of appointment. Each of these provisions must be analyzed separately before deciding whether a single definition is appropriate.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.18 b. Form: Spouse, Husband, or Wife

§35.18 b. Form: Spouse, Husband, or Wife





35.18-1 Spouse, husband, or wife

***Spouse, Husband, or Wife*. In reference to any deceased beneficiary of my will, the term "spouse," "husband," or "wife" is limited to the lawfully married spouse of the beneficiary who at the time of death of this beneficiary (referred to in this paragraph as "then") (1) was then permanently residing with that beneficiary, (2) was not then suing or being sued in any jurisdiction for limited or absolute divorce or dissolution of marriage or for separate maintenance or legal separation from that beneficiary, and (3) was not then subject to an interlocutory decree of divorce or dissolution of marriage.**

[*If applicable, add the following option*]

[*Option: Spouse considered deceased on remarriage*]

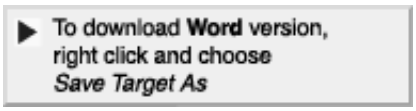
On remarriage, this spouse shall be considered deceased for all purposes under my will.

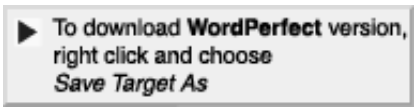
Comment: This clause may used with a class gift that includes the marital partners of beneficiaries. Excluding a remarried widowed spouse from the class of permitted distributees may be unwise if the will provides a long term trust. If a lineal descendant dies leaving a spouse and small children, deterring remarriage of that spouse may not be in the best interests of those children. Different problems occur if no provisions are made for a surviving spouse who is the parent of issue: The issue may be wealthy but end up living under less than ideal conditions because of the financial insecurity of the parent. Note that the term "spouse" in this clause may include a same-sex spouse in only very limited circumstances under *In re Strauss v Horton* (2009) 46 C4th 364, 94 CR3d 591. For this reason, the testator may wish to include domestic partners in a class gift as provided by the form of definition in §35.18A.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.18A c. Form: Domestic Partner

§35.18A c. Form: Domestic Partner





35.18A-1 Domestic partner

***Domestic Partner*. In reference to any deceased beneficiary of any trust created under this document, the term "domestic partner" is limited to a person who at the time of the beneficiary's death was the domestic partner of the beneficiary as defined in Probate Code §37 who (1) was then permanently residing with that beneficiary, (2) was not then suing or being sued in any jurisdiction for dissolution of domestic partnership or for separate maintenance or legal separation from that beneficiary, and (3) was not then subject to an interlocutory decree of dissolution of domestic partnership.**

[*If appropriate, add the following option*]

[*Option: Domestic partner considered deceased on entry into another domestic partnership*]

On filing with the Secretary of State a declaration of domestic partnership with a person other than the beneficiary, this domestic partner shall be considered predeceased for all purposes under this document.

Comment: This clause may be used with a class gift that includes the domestic partners of beneficiaries in addition to the spouses of beneficiaries as discussed in §35.17. Under the basic definition a person is not a domestic partner unless the person satisfies registration and other requirements described in Fam C §§297-299.6. The clause may be adapted for class gifts to nonresident beneficiaries.

Under Fam C §299.2, a person who did not file a declaration of domestic partnership with the beneficiary may be considered the beneficiary's domestic partner if they validly formed a legal union in another jurisdiction substantially equivalent to a domestic partnership. Such a legal union arguably may include an Oregon domestic partnership or a civil union in New Jersey. The application of the statute to same-sex spouses married in Connecticut, Iowa, Maine, Massachusetts, New Hampshire, or Vermont is uncertain.

The optional addition should be used with caution. See Comment in §35.18.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.19 4. 'Child,' 'Children,' 'Issue,' and 'Heirs'

§35.19 4. "Child," "Children," "Issue," and "Heirs"

See §§12.27-12.34 on the need to define "child," "children," "issue," and "heirs." The clause defining these terms, which can be extremely important, is usually included with the clause making gifts to the class defined. In most cases, the drafter should not attempt to override statutory definitions and certainly should not do so based on the drafter's own notions of "what people want."

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V. SEVERABILITY CLAUSE

§35.20 A. Purpose of Severability Clause

A severability clause authorizes deletion of any will clauses that may be invalid, without affecting the will's valid portions. See *Davenport v Davenport Found.* (1950) 36 C2d 67, 222 P2d 11 (severance is appropriate means to deal with invalid portion of will).

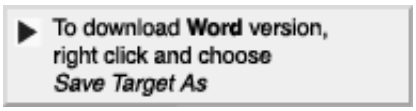
Whether severance can be used to eliminate an invalid or ineffective part of a will depends on whether the part is so entangled with desired portions that its elimination will defeat the testator's overall intent or create inequities among the beneficiaries. *Estate of Micheletti* (1944) 24 C2d 904, 909, 151 P2d 833.

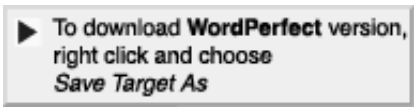
It is standard practice to include a severability clause, but the drafter should not simply rely on such a clause to save remaining vulnerable portions of the will. If the drafter suspects that any part of the will may be ineffective, an alternative gift or power should be provided that will carry out the testator's intent, prevent a gift from falling into the residuary estate or passing by intestacy, and remove any incentive for beneficiaries to attack the questionable portion.

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Source: Estate Planning/California Will Drafting/35 Concluding Clauses/§35.21 B. Form: Severability Clause

§35.21 B. Form: Severability Clause





35.21-1 Severability clause

If any provision of my will is unenforceable, the remaining provisions shall remain in full effect.

Comment: This clause is usually included at the end of the will, just before the execution and attestation sections discussed in chap 36. Some drafters believe the clause is not really helpful and that issues concerning the effect of an unenforceable provision should be left to regular rules of construction.

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36

Execution of Wills

Clare H. Springs

I. EXECUTION REQUIREMENTS
- A. Witnessed Will §36.1
- B. Other Wills §36.2

II. TESTATOR'S SUBSCRIPTION OR ACKNOWLEDGMENT §36.3

III. ATTESTING WITNESSES §36.4
- A. Using Disinterested Witnesses §36.4A
- B. Attorney Selection of Witnesses §36.4B

IV. SELF-PROVING WILLS §36.5

V. PROCEDURE FOR EXECUTION
- A. Model Procedure §36.6
- B. Duplicate Originals §36.7
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- D. Interlineated Corrections and Additions §36.9
- E. Safekeeping and Custody of Wills §36.10
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- F. Destruction of Prior Wills §36.11
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- A. Documentation of Capacity §36.13
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- C. Perpetuating Testimony of Witnesses §36.15

VII. FORM: EXECUTION AND ATTESTATION CLAUSES §36.16

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I. EXECUTION REQUIREMENTS

§36.1 A. Witnessed Will

The requirements for a witnessed will (also called an attested will or a formal will) are set forth in Prob C §6110. On other types of wills, see §36.2. To be valid, a witnessed will must be:

- In writing (Prob C §6110(a));
- Either signed by the testator (Prob C §6110(b)(1)) or signed in the testator's name by some other person in the testator's presence and by his or her direction (Prob C §6110(b)(2)) or signed by the "testator's" conservator (Prob C §6110(b)(3)) under a court order to make a will under Prob C §2580;
- Signed or acknowledged by the testator or conservator in the presence of two witnesses, both of whom must be present at the same time (Prob C §6110(c)(1)(A)); and
- Signed by the two witnesses with the understanding that they are signing the testator's will (Prob C §6110(c)(1)(B)).

It is not required that the testator and witnesses sign at the end of the will, that the testator declare to the witnesses that the instrument is the testator's will and request that the witnesses sign it, or that the witnesses sign the will in the testator's presence. Nevertheless, it is good practice to follow those procedures. See §36.6. For additional procedures, see §§36.7-36.12. For special precautions in certain cases, see §§36.13-36.15. For a form of execution clause, see §36.16. On the testator's subscription or acknowledgment, see §36.3. On attesting witnesses, see §§36.4-36.4B. On self-proving wills, see §36.5.

WARNING: A will that is not executed in compliance with these execution requirements for a witnessed will may be treated as in compliance if the proponent of the will establishes by clear and convincing evidence that, at the time the testator signed the will, the testator intended the will to constitute the testator's will. Prob C §6110(c)(2). Some practitioners believe that this provision may open the door to more fraud and abuse and may cause a substantial increase in litigation over the validity of wills. See Temmerman, *Recent California Case Law, Legislative Developments, and New Court Rules and Judicial Council Forms*, Estate Planning 2008 §1.89 (Cal CEB 2008).

Surprisingly, there is no requirement that a witnessed will be dated. The will should include the date of execution, however, in case there is any question about whether it is the testator's last will. Likewise, there is no requirement that a will state the place of execution, but good practice demands that the will include it. Including the place of execution may be useful if the will is offered for admission to probate in another state. The laws of many states provide that a will is valid if executed in accordance with the law of the place where the will was executed. See §37.15.

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§36.2 B. Other Wills

Other types of wills have different execution requirements from those for witnessed wills discussed in §36.1. For discussion of the requirements for a valid holographic will, see §2.25. On the execution formalities of an international will, see §§37.16-37.17. For the requirements imposed on a statutory will, see §§2.26-2.29.

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§36.3 II. TESTATOR'S SUBSCRIPTION OR ACKNOWLEDGMENT

A witnessed will must be signed by the testator or by some other person at the testator's direction or by a conservator pursuant to a court order. Prob C §6110(b). Usually, the testator subscribes the will by personally affixing his or her signature. The testator should sign his or her name in the same form as it appears in the will's title and introductory clause. If a conservator signs the will, reference to the court order under Prob C §2580 should be made. Even when a conservator signs the will, it must be witnessed under Prob C §6110(c)(1). Compliance with this requirement is especially important because attacks on a will executed by a conservator pursuant to a court order may be barred by collateral estoppel. See *Murphy v Murphy* (2008) 164 CA4th 376, 78 CR3d 784.

The testator may sign by a mark, however, if the testator is unable to write because of illiteracy or a physical impairment. If the testator signs by a mark, the testator's name must be written near the mark by a person who must then write his or her own name as a witness. CC §14; CCP §17. See *Estate of Mangeri* (1976) 55 CA3d 76, 81, 127 CR 438, 440 (will not properly executed because the person who typed the testator's name was not present when the mark was made and did not sign his own name as a witness). But see *Estate of McCabe* (1990) 224 CA3d 330, 274 CR 43 (will executed by mark held valid despite witness's failure to write testator's name near mark). Although not a requirement for a valid execution, having someone other than one of the attesting witnesses be the witness to the testator's mark is good practice. See *Estate of Toomes* (1880) 54 C 509.

NOTE: The validity of a will is not impaired if a testator's physical weakness necessitates that someone guide the testator's hand when he or she signs the will or makes his or her mark. *Estate of Holloway* (1925) 195 C 711, 235 P 1012; *Estate of Clark* (1915) 170 C 418, 149 P 828. Many attorneys consider assistance to be preferable to subscription of a will by another person signing the testator's name in the testator's presence and by his or her direction. Although permitted by statute (see Prob C §6110(b)(2)), that method of execution should be used only when absolutely necessary because of its particular susceptibility to claims of undue influence or fraud. Note that other transfer documents signed by another person under the transferor's oral instructions need not be signed in the transferor's presence. See *Estate of Stephens* (2002) 28 C4th 665, 122 CR2d 358.

If the testator does not sign the will in the presence of the attesting witnesses (see §36.4), the testator must later acknowledge either the signature or the will in the presence of each of the witnesses at the same time. Prob C §6110(c)(1). Because the witnesses are less likely to recall the circumstances of signing when the will is not signed by the testator in their presence at a "signing ceremony," to rely on the testator's acknowledgment may jeopardize the validity of the will. Whenever possible, it is better practice for the testator to sign in the presence of the witnesses and for the witnesses to sign in the presence of the testator, although this is not required. In any event, the witnesses must sign the will before the testator's death. See *Estate of Saueressig* (2006) 38 C4th 1045, 44 CR3d 672. See also Comment to Uniform Prob C §2-502. See the recommended model procedure for execution of wills in §36.6.

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§36.4 III. ATTESTING WITNESSES

Any person competent to testify to the requisite facts may act as an attesting witness. Prob C §6112(a). Probate Code §6112 does not prescribe an age requirement for a witness. California requires at least two attesting witnesses to a will. Prob C §6110(c)(1). Although two witnesses are legally sufficient, an extra witness is desirable in case of the subsequent death or incompetence of one witness.

A creditor of the testator may be competent to act as a witness. See Prob C §6112(b). A person nominated in the will as executor can be a competent witness. *Estate of LaMont* (1952) 39 C2d 566, 248 P2d 1; *Estate of Haupt* (1926) 200 C 147, 252 P 597. Similarly, an individual named as trustee of a trust established in a will may serve as a witness to the will. See Prob C §6112(c). On using disinterested witnesses, see §36.4A. On attorney selection of witnesses, see §36.4B.

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§36.4A 1. Using Disinterested Witnesses

Although a beneficiary of a will is competent to act as a witness, he or she should not do so. Under Prob C §6112(c), unless there are two other disinterested witnesses, a devise to a witness creates a presumption affecting the burden of proof that the devise was procured by duress, menace, fraud, or undue influence. If the witness fails to rebut the presumption, the witness takes only that portion of the devise that he or she would have taken if the will were not established.

NOTE: An interested witness does not become disinterested merely by disclaimer of his or her interest in the will. In *Estate of Parsons* (1980) 103 CA3d 384, 163 CR 70, the court held that the function of a witness is performed at the time of execution of the will and that subsequent disclaimer of the interest by a witness who is a beneficiary under the will does not transform the witness from an interested witness into a disinterested one.

Because the spouse of a beneficiary has no interest in separate property passing under the will, he or she may act as an attesting witness without putting the devise to the beneficiary in jeopardy. *Estate of Hartman* (1937) 21 CA2d 266, 68 P2d 744. This is not the rule in all states, however. For obvious reasons, it is better practice not to use the spouse or any close relative of a beneficiary as a witness to the will.

The presumption of undue influence does not apply if the will is witnessed by a person to whom a devise is made solely in a fiduciary capacity. Prob C §6112(c). Likewise, if a will is witnessed by a person who will indirectly benefit from a devise to another person or organization, the presumption of undue influence does not apply.

EXAMPLE: In *Estate of Tkachuk* (1977) 73 CA3d 14, 139 CR 55, the decedent's will left the bulk of his estate to a church. The minister of the church had witnessed the will. Although the court found that the minister was not a disinterested witness, it refused to invalidate the gift to the church. The court held that an indirect benefit to an interested subscribing witness will not void a bequest to a beneficiary who is not the witness.

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§36.4B 2. Attorney Selection of Witnesses

Whenever feasible, the attorney who prepares the will should select the witnesses. If possible, the witnesses should be credible, nontransient, healthy adults who are younger than the testator and can therefore be expected to survive the testator and to provide evidence about the validity of the will when it is introduced for probate. A person who is well acquainted with the testator is preferable to one who is not.

The selection of witnesses is often influenced by the place where the will is executed. If the will is executed in the attorney's office, the attorney may select partners, associates, and clerical staff as witnesses. If the will is executed at a hospital, the attorney should bear in mind that although most hospitals prohibit members of their medical staff from acting as witnesses, hospital administrators will generally provide competent witnesses on request. If execution takes place at the client's office or home, the client may make the arrangements for witnesses to be present. The attorney should emphasize to the client that the witnesses should be persons who are likely to be alive and easy to locate after the client's death.

There is no prohibition against an attorney's serving as a witness to a will drafted by him or her. Some attorneys, however, refrain from witnessing such wills unless no other competent witness is available, because having to testify in a will contest may disqualify the attorney from acting as counsel for proponents of the will. See Cal Rules of Prof Cond 5-210. Other attorneys routinely witness wills they have drafted. They believe that, as an attesting witness, the attorney is in a good position to offer opinion testimony on the state of the testator's mind without having to qualify as an "intimate acquaintance." See Evid C §870. Further, from a practical standpoint, the attorney can more easily procure the probate of a noncontested will if he or she is one of its witnesses.

The testimony of one attesting witness is sufficient to prove a contested will if no other witness is available. Prob C §8253; *Estate of Burdette* (2000) 81 CA4th 938, 97 CR2d 263. If all attesting witnesses are dead or cannot be located after the testator's death, the law permits proof of the will by proof of the handwriting of the testator and of any attesting witness. Prob C §8221. Accordingly, if an attesting witness is not well known to the attorney, the attorney should get sufficient information from the witness to enable the attorney to prove the witness's handwriting. The names and addresses of persons familiar with the witness's signature or the name and location of the witness's place of banking will usually suffice for this purpose. If a witness is a stranger to the attorney, the attorney should obtain the correct spelling of the witness's name and address. A witness's handwriting is sometimes difficult to read.

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§36.5 IV. SELF-PROVING WILLS

Probate Code §8220(b) permits proving an uncontested will by "an affidavit in the original will that includes or incorporates the attestation clause." A will that includes this affidavit is known as a self-proving will. A self-proving will can be admitted to probate with no evidence from any attesting witness other than the affidavit in the will. A declaration under penalty of perjury can be substituted for an affidavit if the attorney prefers. See CCP §2015.5. Some courts in other states have allowed the signatures on a self-proving affidavit to be used as a substitute for the signatures required for valid execution of a contested will, but this procedure is not authorized by the statute. See, *e.g., Hampton Roads Seventh-Day Adventist Church v Stevens* (Va 2008) 657 SE2d 80. For an attestation clause and a declaration that satisfy the requirements for a self-proving will, see §36.16.

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V. PROCEDURE FOR EXECUTION

§36.6 A. Model Procedure

The provisions of the Probate Code described in §§36.1-36.4 substantially relax the requirements for execution of witnessed wills. Nevertheless, to increase the will's chances of withstanding a contest, the attorney should still use the following traditional procedure for the execution of wills:

- When the testator, three disinterested witnesses, and the attorney who prepared the will are all assembled in the same room, the attorney informs them that the purpose of the gathering is to witness the will's execution.
- The testator, who should have already examined and approved the instrument, states to all witnesses that this is his or her will and requests them to act as witnesses to it.
- The testator signs the will, using the same form of his or her name that appears in the title and introductory clause of the will. All the witnesses watch.
- The attorney reads the attestation clause aloud while the witnesses listen. (Although this procedure is not legally necessary, it is a convenient way of focusing the witnesses' attention on their function.)
- Each witness signs his or her name and writes his or her address below the attestation clause while the testator and other witnesses look on.

If the attorney acts as one of the witnesses, this procedure should be adapted accordingly.

NOTE: Some attorneys require the testator to initial or even sign every page of the will. This practice is not legally necessary, but it may discourage substitution of pages after the will is executed and assure later readers of the will that pages have not been substituted. The testator should be able to accomplish these purposes by initialing, rather than signing, each page. Some attorneys also require the witnesses to initial or sign each page. This practice, which accomplishes nothing, is a time-consuming procedure that may unnecessarily reveal the contents of the will to the witnesses.

The attorney should always supervise the execution of a will. See *Will of Carter* (Del 1989) 565 A2d 933 for an illustration of the problems that can result from unsupervised execution of a formal will. The execution procedure should never be rushed. The attorney should conduct the proceedings in a dignified manner to underscore the seriousness of the actions being taken.

The attorney should try to follow the same procedure when executing any will. If there is a contest to a will and the attorney does not clearly recall the circumstances of the will's execution, at least the attorney can describe the execution procedure that he or she always follows. See Effective Introduction of Evidence in California, chap 32 (2d ed Cal CEB 2000).

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§36.7 B. Duplicate Originals

Although some attorneys disagree, the author believes that only one original of a will should be executed. If a testator executes a will in duplicate and one of the duplicates cannot be found after the testator's death, a suspicion that the testator destroyed it with revocatory intent may arise. Under Prob C §6121, a will executed in duplicate can be revoked by destroying only one of the wills if destruction is done with intent to revoke. Under Prob C §6124, a will is presumed destroyed with intent to revoke if the will was last in the testator's possession, the testator was competent, and neither the will nor a duplicate original can be found after the testator's death. Although all relevant facts must be considered in determining whether the testator intended to revoke the will (*Estate of Janes* (1941) 18 C2d 512, 517, 116 P2d 438), the absence of one of the duplicate copies inevitably casts doubt on the validity of the remaining duplicate. For these purposes, a photocopy of a will is not considered a duplicate original. Therefore, finding a photocopy of a missing will in the testator's possession will not overcome the presumption of revocation. *Lauermann v Superior Court* (2005) 127 CA4th 1327, 26 CR3d 258. Further, execution of the will in duplicate may complicate its probate (local rules may require both originals to be offered for probate) or its revocation (the testator may destroy the will with intent to revoke but fail to destroy the duplicate, raising doubts under Prob C §6124).

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§36.8 C. Number of Copies

The attorney should keep a fully conformed copy of every will that he or she prepares. This practice facilitates future revision of these wills by the attorney. Further, if the original will is lost, a conformed copy may qualify for admission to probate. See Prob C §8223.

A conformed copy of the will should be given to the testator, whether or not the testator has custody of the original. On the testator's request or with the testator's consent, conformed copies may be sent to persons nominated as executors, trustees, or guardians. Corporate executors and trustees particularly like to receive copies of wills in which they are nominated as fiduciaries. Beneficiaries under a will generally should not be sent copies.

On safekeeping and custody of the original will, see §36.10.

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§36.9 D. Interlineated Corrections and Additions

Sometimes immediately before or during the execution of a will, the attorney discovers an error in an amount or a name or the client wishes to make some last minute change in the will. Minor additions or corrections may be made in pen before, but not after, execution of the will if the testator and all witnesses initial in the margin opposite the change. Initialing helps counter the presumption that the change was made by the testator after execution. It also is evidence that the change was not the result of tampering by others. Adding a reference to the change in the attestation clause will also be helpful. Changes made after execution of the will and without the proper formalities required of a holographic or witnessed codicil are wholly invalid. See 14 Witkin, Summary of California Law, *Wills and Probate* §171 (10th ed 2005).

If the proposed change is not minor, the attorney should redraft the affected part of the will or have the client execute the will as is, making the change afterward by prompt execution of a codicil. The attorney must determine whether a change is minor or substantial. In making this determination, the attorney should give greater weight to the effect of the proposed change than to its length.

EXAMPLE: *Estate of Phifer* (1984) 152 CA3d 813, 200 CR 319, illustrates the dangers of making handwritten changes to an existing will. In this case, the decedent made some changes in his formal, witnessed will a day before he committed suicide. The changes, made in his own handwriting, were dated and initialed. For the most part, they reduced gifts he had made to an intimate friend. The decedent also wrote a letter to his friend explaining the changes. The court held that both the letter and the handwritten interlineations in the formal will were a testamentary nullity. The court reasoned that because the handwritten changes were unintelligible and devoid of testamentary intent without reference to the typewritten provisions of the formal will, they did not meet the requirements of a valid holographic codicil.

On the effect of handwritten interlineations on a California statutory will, see §2.28.

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Source: Estate Planning/California Will Drafting/36 Execution of Wills/§36.10 E. Safekeeping and Custody of Wills

§36.10 E. Safekeeping and Custody of Wills

The executed will should be kept in a place in which:

- The risk of loss or destruction of the will is reduced to a minimum;
- The will is accessible to the testator and to the executor at the testator's death; and
- The will is not accessible to persons adversely affected by it.

The most common places that meet these requirements are the client's safe-deposit box, the attorney's safe-deposit box, and the vault of a corporate executor (*e.g.,* a bank or trust company).

Access to the client's safe-deposit box may be limited at the time of his or her death. In most cases, a member of the testator's family or the nominated executor will have to accompany the attorney to the financial institution to retrieve the will from the safe-deposit box. A death certificate will be required for the attorney to retrieve the will. If the key to the box cannot be found, the attorney will have to undergo the time and expense of having the box drilled open. See California Decedent Estate Practice §§1.34-1.35 (2d ed Cal CEB 2009). In contrast, if the will is kept in the attorney's safe-deposit box or the corporate executor's vault, it can be immediately delivered to the executor with a minimum of fuss. See, however, Prob C §331, which describes how an individual can gain access to a decedent's safe-deposit box before letters have been issued. This newly enacted statute may alleviate problems of access to the decedent's safe-deposit box.

If the attorney keeps the original will, the testator is more likely to return to him or her for subsequent estate planning and to retain the attorney to handle the probate at the testator's death. Retaining custody of an original will has disadvantages, however. Several years later, the client may execute a new will under the supervision of another attorney. If the client does not bother to inform the attorney holding the original will that it has been superseded, the attorney will be unaware that the will no longer is valid and will continue to safeguard it. If the attorney later suspects that the will has been superseded, he or she may make efforts to contact the client, which may prove fruitless if the client has moved or died. In addition, some attorneys do not keep original wills because they believe that this might increase their exposure to claims that they have a duty to inform their former clients of changes in the law affecting their wills. See §1.20.

Because access to a will kept in a safe-deposit box is limited to business hours of the financial institution, some testators choose to keep their wills in office or home safes. Because the contents of these safes are usually available to others, this practice is not recommended.

PITFALL: Whenever the attorney keeps the original will, the first page of the client's conformed copy should specify where the original is being held. If the client keeps the original will, it is a good idea to have the client sign a receipt for it. This will protect the attorney against a claim that he or she lost the original will.

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§36.10A 1. Preservation of Wills Held by Attorneys for Safekeeping

Many attorneys eventually find themselves in the position of holding original wills of clients whose whereabouts are unknown. The issues and responsibilities raised by this problem are now addressed by Prob C §§700-735.

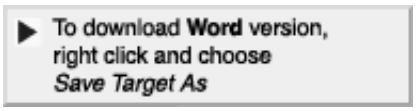
Under Prob C §710, if an original will or codicil is deposited with an attorney, the attorney (or successor attorney who accepts transfer of the document) must use ordinary care for the will's preservation whether or not consideration is given. The attorney is required to place the document in a safe, vault, safe deposit box, or other secure place. This duty of care is the cornerstone of the deposit law, which goes on to describe ways in which an attorney may reduce the level of the duty or dispose of the document in a manner that discharges the duty. On reducing the duty of care to the standard of "slight care," see §36.10B.

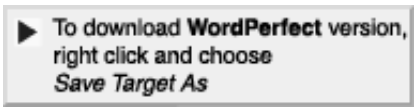
The attorney may "terminate" the deposit by following the provisions of Prob C §§731-735. Prob C §730. Significantly, the law now permits deposit of wills with the court clerk of the county of the testator's last known domicile in limited situations. The attorney must be deceased, lack legal capacity, or no longer be an active member of the state bar. Prob C §732(c).

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Source: Estate Planning/California Will Drafting/36 Execution of Wills/§36.10B 2. Form: Agreement for Deposit of Will

§36.10B 2. Form: Agreement for Deposit of Will





36.10B-1 Notice and Acknowledgment

To: _ _[*Name of depositor*]_ _
_ _[*Address*]_ _
_ _[*City, state, and ZIP*]_ _

I have accepted your will or other estate planning document for safekeeping. I must use ordinary care for preservation of the document.

You must keep me advised of any change in your address shown above. If you do not and I cannot return this document to you when necessary, I will no longer be required to use ordinary care for preservation of the document, and I may transfer it to another attorney, or I may transfer it to the clerk of the superior court of the county of your last known domicile, and give notice of the transfer to the State Bar of California.

_____
_ _[*Signature of attorney*]_ _
_ _[*Address of attorney*]_ _
_ _[*City, state, ZIP*]_ _

My address shown above is correct. I understand that I must keep you advised of any change in this address.

Dated: _ _ _ _ _ _ _____
_ _[*Signature of depositor*]_ _

Comment: If the above agreement is signed, and the attorney follows the termination procedure of Prob C §732(a), the attorney need only use "slight care" for preservation of the will. Prob C §716.

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§36.11 F. Destruction of Prior Wills

Clients frequently ask their attorneys whether they should physically destroy superseded wills. Generally, it is inadvisable for a client to keep a series of original wills. If the last will omits a beneficiary named in a previous will or reduces a gift to a prior beneficiary, the existence of the previous will may permit the affected individual to discover the change. The individual's disappointment may lead to litigation. A later-discovered will or codicil may be admitted to probate at any time before distribution of the estate unless the proponent of the will has been served with a notice of petition to administer the estate, in which case a petition for probate of the will must be filed within the later of 120 days after issuance of an order admitting the first will to probate or 60 days after discovery of the later will under Prob C §8226(c). *Estate of Earley* (2009) 173 CA4th 369, 92 CR3d 577 (later will not admitted); *Estate of Kelly* (2009) 172 CA4th 1367, 91 CR3d 674 (later will admitted). Note that under Prob C §8200, if a series of original wills is kept in a safe-deposit box, the financial institution where the safe-deposit box is located must file all the wills with the probate court within 30 days after discovering the death of the owner of the box.

If a challenge to the last will is likely, the attorney should advise the client to keep prior wills provided they are somewhat similar to the last will. If the last will is successfully contested, the next preceding will may then be offered for probate. A disappointed relative is less likely to challenge a will knowing that he or she has been left out of a series of wills, all of which must be set aside before he or she can take by intestate succession. Further, a will executed years before the last will, which makes dispositions similar to the last will, may be evidence to refute a claim that the testator lacked capacity or was unduly influenced by another when the last will was executed.

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§36.12 G. Adjustments for Illiterate, Non-English-Speaking, or Blind Clients

The execution requirements for the will of a client who, for reasons of illiteracy, linguistic differences, or physical disability, cannot read the will are the same as those for the will of any other client. However, the attorney should adjust the execution procedure to ensure not only that the testator knows the contents of the will but also that all witnesses are satisfied that the testator has that knowledge.

EXAMPLE: In *Camperi v Chiechi* (1955) 134 CA2d 485, 286 P2d 399, the court held that a will prepared in English was valid even though the testator had only a limited understanding of English. The court was satisfied that the testator knew the contents of the will by evidence (1) that the will was translated into Italian, the testator's native language, by a friend of the testator while the attorney read it aloud during the execution procedure; and (2) that, when the attorney paused at several intervals during the reading of the will to ask the testator whether he understood what had been read, the testator made statements indicating that he understood.

Although a showing that the will was read aloud during the execution procedure is not essential to prove that the testator had knowledge of the contents of the will, it remains the best way to demonstrate such knowledge. The attestation clause may be modified to state that the will was read to the client in the presence of all witnesses and that he or she understood it.

For additional discussion on will drafting for illiterate and non-English-speaking clients, see §2.39.

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VI. SPECIAL PRECAUTIONS IF WILL CONTEST FORESEEABLE

§36.13 A. Documentation of Capacity

An attorney who prepares a will can help discourage or defeat a will contest based on a claim of incapacity. See §§2.9-2.15 on lack of testamentary capacity as a basis for a will contest. See also California Decedent Estate Practice §§26.28-26.30 (2d ed Cal CEB 2009).

At a minimum, the attorney should converse with the client in the presence of the attesting witnesses to demonstrate that the client knows what he or she is doing. The attorney should review the entire will with the client paragraph by paragraph, even though this is a tedious task, paying particular attention to disinheritance and no-contest clauses. See chap 35. The attorney should have the client show that he or she knows who his or her heirs are and the nature and extent of his or her property. It is also a good idea to give ample time for the witnesses to chat with the testator to form an opinion about the testator's capacity at the time of execution. The attorney should make a record for the files indicating what was done. This record will refresh the attorney's recollection if he or she is later called to testify.

If a will contest is foreseeable, the attorney should be particularly careful in selecting the attesting witnesses. Three disinterested witnesses who personally know the testator should be selected; the attorney or anyone in his or her office should probably not serve as a witness.

In particularly risky situations, some attorneys insist that the testator undergo a psychiatric examination just before execution of the will. This provides the proponents of the will with a highly credible witness if a later contest ensues. This strategy, however, suggests that the attorney entertained doubts about the testator's capacity at the time of execution.

If the testator is under constant medical care and especially if he or she is in a hospital, the attorney should confer with the testator's physician about the best time to execute the will. For several hours before the execution, the testator should not receive any drugs that might affect his or her capacity. An entry that no drugs affecting capacity were administered to the testator should be made in the testator's hospital medical record.

NOTE: Some attorneys support a testator's capacity in a questionable case by a videotape record of the entire conference during which the will execution takes place. In addition to demonstrating the testator's capacity, the videotape gives the testator an opportunity to explain any unusual provisions in the will. The videotape may deter disgruntled relatives from bringing a contest. If a contest is brought anyway and if the tape is admitted into evidence, it permits the trier of fact to form his or her own impression of the testator's mental state. If the proper foundation has been laid to ensure the authenticity and reliability of the tape, there seems to be no reason why the tape cannot be admitted into evidence. Many judges are wary of admitting such tapes, however, because of the ease with which they can be altered.

The attorney should be aware that videotapes have risks. If the testator appears to be in a deteriorating physical condition or hesitates unduly in answering questions or exhibiting knowledge of his or her property or family relationships, the videotape may work to the disadvantage of proponents of the will. The existence of such a videotape is likely to come up in pretrial discovery for a will contest and may substantially affect the final settlement or trial outcome.

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§36.14 B. Establishing Absence of Undue Influence

When the attorney anticipates a claim of undue influence after the testator's death, practical measures should be taken to diminish the chances of such a claim's being made or being made successfully. The practical measures to be undertaken are essentially the same as those taken to refute a possible claim of lack of testamentary capacity. See §36.13. On undue influence as a basis for a will contest, see §§2.16-2.21; California Decedent Estate Practice §26.31 (2d ed Cal CEB 2009). See also Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2010).

It is particularly important that the attorney not allow anyone who is interested in the will or stands in a confidential relationship to the testator to be present during execution of the will. Witnesses to the will should be disinterested persons. The testator should explain to them any unusual provision in the will and, if appropriate, why the will varies from the testator's previously expressed intentions.

PITFALL: The attorney should ensure that any bill for legal services is presented to and paid by the testator. If a beneficiary or someone close to a beneficiary pays the bill, undue influence will be suspected. Further, if a claim of undue influence is anticipated, it is important not to undercharge the client. In a will contest case based on undue influence, a jury may suspect that an attorney who was paid only a small amount by the testator for his or her services was secretly compensated by a beneficiary.

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Source: Estate Planning/California Will Drafting/36 Execution of Wills/§36.15 C. Perpetuating Testimony of Witnesses

§36.15 C. Perpetuating Testimony of Witnesses

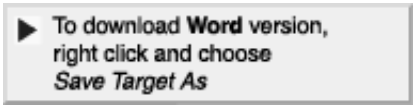
In certain circumstances, the attorney should discuss with the client whether to take depositions or seek responses to written interrogatories to perpetuate the testimony of witnesses supporting the will. If the attorney and client decide that the circumstances justify the expense and emotional distress to the client of such presuit measures, the detailed provisions of CCP §2035 should be followed. A complete description of these provisions can be found in California Civil Discovery Practice §§5.147-5.155 (4th ed Cal CEB 2006). Note that any expected adverse party must be notified of the client's petition for an order authorizing this presuit discovery. CCP §2035(e). The deposition or interrogatories taken under such an order may be admitted in evidence at a later trial against any party named as an expected adverse party in the client's petition. CCP §2035(g).

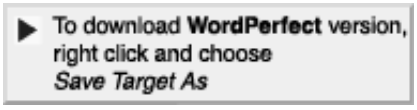
Securing affidavits of witnesses is not a satisfactory alternative to the procedures delineated in CCP §2035. Affidavits are hearsay even if the affiant is present in court and they may be received in evidence only when offered in an uncontested proceeding under Prob C §1022. See *Elkins v Superior Court* (2007) 41 C4th 1337, 63 CR3d 483. Accordingly, affidavits can be introduced in a later will contest only to impeach the affiant's inconsistent testimony. If the witness dies before the contest or is incompetent or otherwise unable to testify, the affidavits are of no help whatsoever to the client. On the contrary, the fact that affidavits were prepared only emphasizes the attorney's concern about the client's testamentary capacity and substantially impairs the attorney's ability to testify forcefully on that subject. The taking of depositions or the promulgation of written interrogatories likewise shows the attorney's concern, but that disadvantage is usually outweighed by having the testimony of witnesses preserved in a form that is admissible in evidence in a later will contest.

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Source: Estate Planning/California Will Drafting/36 Execution of Wills/§36.16 VII. FORM: EXECUTION AND ATTESTATION CLAUSES

§36.16 VII. FORM: EXECUTION AND ATTESTATION CLAUSES





36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: Many attorneys do not have the witnesses sign twice; the first set of signatures in the form are eliminated. The probate courts of some counties, however, do not consider wills executed in this manner to be self-proving. These courts (1) consider the witnesses' signatures to be an integral part of the act of attestation and the attestation clause and (2) believe that the declaration that the attestation was properly done must be completely distinct from the attestation clause.

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37

Multijurisdictional Issues in Will Drafting

CEB Staff

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§37.1 I. ESTATE PLANNING FOR CLIENTS WITH OUT-OF-STATE CONCERNS

As the mobility of the population increases, attorneys more frequently encounter clients with a variety of out-of-state estate planning concerns. One such client, for example, is the individual who currently resides in California but plans to move or retire to another state or country in the near future. Another such client is the individual who has no intention of moving but owns property in one or more other states or countries. The purpose of this chapter is to alert the will drafter to the particular needs of these clients.

For further discussion of tax and conflict problems of multistate trusts, see Drafting California Revocable Trusts, chap 23 (4th ed Cal CEB 2003).

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§37.2 II. CONFLICT-OF-LAWS BACKGROUND

At the outset, it is important to make two points. First, even if multiple jurisdictions are implicated in an estate plan, the will drafter faces no conflicts problem if the relevant laws of those jurisdictions are substantially the same. If they are, it makes no difference which jurisdiction's laws control.

Second, it is not easy to predict how courts will resolve a particular conflicts problem. The law and principles of conflict of laws are constantly changing. See Drafting California Revocable Trusts §23.3 (4th ed Cal CEB 2003). Additionally, courts are increasingly inclined to ignore traditional conflicts rules when such deviations would further the perceived intentions of the testator. See Restatement (Second) of Conflict of Laws §239, Comment g (1971). See also Revocable Trusts §§23.4, 23.13.

In general, the answer to the question about which law should be applied to resolve an issue concerning a will with multijurisdictional contacts depends on the nature of the issue and the disputed property. The conflicts rules that apply to resolve an issue about the validity of a will do not necessarily apply when the issue is one of interpretation of a will. Similarly, the conflicts rules applicable to disputes over real property do not apply to personal property issues. The discussion of basic conflicts rules in §§37.3-37.13, therefore, is organized around these categorical differences.

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§37.3 A. Law Controlling Validity of Will

The conflicts rules discussed in §§37.4-37.8 apply when the question to be resolved involves the validity of a will or one of its devises. Those rules, therefore, apply to issues about the capacity of the testator or a beneficiary to accept a devise as well as to questions about whether the will has been properly executed. Questions about whether a devise violates the rule against perpetuities, passes "after-acquired" property, or is revoked also fall within the scope of those rules. See Restatement (Second) of Conflict of Laws §239, Comment a (1971).

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§37.4 1. Personal Property

Under Restatement (Second) of Conflict of Laws §263 (1971), the validity of a will disposing of personal property is "determined by the law that would be applied by the courts of the state where the testator was domiciled at the time of his death." See also CC §946. These courts usually apply their own local law in determining such questions.

EXAMPLE: In *Estate of Moore* (1961) 190 CA2d 833, 12 CR 436, the decedent made a holographic will while she was a resident of California. Later, the decedent moved to Florida where she died, leaving property in both California and Florida. At issue was the disposition of $200,000 in bank accounts in California. If the law of the situs of the money controlled, then the $200,000 would be distributed to the beneficiary under the holographic will. If the law of the deceased's domicile controlled, then the money would pass by intestate succession because Florida did not recognize the validity of holographic wills. The court held that, because personal property was at issue, the law of the testator's domicile at death should control. See also *Estate of Brace* (1960) 180 CA2d 797, 4 CR 683 (court upheld validity of holographic codicil made in Mexico but not in conformance with Mexican law because, although decedent died in Mexico, he was domiciled in California at his death).

NOTE: The courts of the testator's domiciliary state do not always apply their own local law in deciding questions of validity. Courts, for example, sometimes apply the law of the state of the beneficiary's domicile to determine the beneficiary's capacity to accept a devise. Restatement §263, Comment b. A court is particularly likely not to apply its local law when (a) another state has a close relationship to the case, (b) the differences between local law and that of the other state do not arise from substantial policy differences, and (c) giving effect to the other state's law will give effect to the testator's intentions. Restatement §263, Comment g.

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§37.5 a. Definition of Domicile

The domicile of a testator is the place that he or she considers home. 2 Witkin, California Procedure, *Jurisdiction* §151A (4th ed 1996). In *Estate of Glassford* (1952) 114 CA2d 181, 186, 249 P2d 908, the court elaborated on this basic definition as follows:

> The concept of domicile involves the concurrence of physical presence in a particular place with the intention to make that place one's home. "The acquisition of a new domicile is generally understood to require an actual change of residence accompanied by the intention to remain either permanently or for an indefinite time without any fixed or certain purpose to return to the former place of abode." … Also, domicile has a continuing quality because a person always has a domicile and does not lose one until another is acquired.

A complete discussion of the concept of domicile is beyond the scope of this book. See Restatement (Second) of Conflict of Laws, chap 2 (1971); California Decedent Estate Practice §§11.2-11.4 (2d ed Cal CEB 2009); 10 Witkin, Summary, *Parent & Child* §§22-28.

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§37.6 b. Statutory Residence Rules

Government Code §244 lists rules that should be observed in determining an individual's place of residence:

> (a) It is the place where one remains when not called elsewhere for labor or other special or temporary purpose, and to which he or she returns in seasons of repose.
> (b) There can only be one residence.
> (c) A residence cannot be lost until another is gained.
> …
> (f) The residence can be changed only by the union of act and intent.
> (g) A married person shall have the right to retain his or her legal residence in the State of California notwithstanding the legal residence or domicile of his or her spouse.

NOTE: "Residence" and "domicile" are not necessarily interchangeable terms. 2 Witkin, California Procedure, *Jurisdiction* §151D (4th ed 1996). In Govt C §244, however, "residence" is used synonymously with "domicile." *Smith v Smith* (1955) 45 C2d 235, 239, 288 P2d 497. Thus, when determining a testator's domicile, the attorney should use these statutory rules along with common-law principles of domicile.

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§37.7 2. Real Property

To the extent that a will disposes of real property, its validity is determined "by the law that would be applied by the courts of the situs." Restatement (Second) of Conflict of Laws §239 (1971). See CC §755. Questions concerning execution requirements, testamentary capacity, the capacity of a beneficiary to accept a devise, and the validity of the will in other respects (*e.g.,* whether it violates the rule against perpetuities) are answered by reference to the law selected by this rule. Restatement §239, Comment a.

The courts of the situs of the real property usually apply their own local law when deciding questions concerning the validity of a will. When a situs court believes, however, that the interests of another state in the matter before the court outweigh the interests of the situs state, it may choose to apply the law of that other state. Restatement §239, Comment c. See also Drafting California Revocable Trusts §§23.4, 23.13 (4th ed Cal CEB 2003). Further, situs courts sometimes apply the law of another state that has close contacts with the case if this would give effect to the testator's intent. Restatement §239, Comment g. See §§37.4, 37.11.

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§37.8 3. Doctrine of Equitable Conversion

Probate Code §21107 states:

> If an instrument directs the conversion of real property into money at the transferor's death, the property and its proceeds shall be deemed personal property from the time of the transferor's death.

The effect of this statute is that, in determining the validity of a will that directs the executor to sell the testator's California real property and distribute the proceeds, a court will usually apply the law of the testator's domicile at the time of his or her death. If the testator's domicile is outside California, this statute can be of obvious significance. Section 21107 codifies the common-law doctrine of equitable conversion.

This doctrine applies when a court has to determine not only the validity of a will that directs the sale of the testator's real property but also the meaning of any of its provisions. The doctrine will not be invoked if it would defeat the testator's intent. 13 Witkin, Summary of California Law, *Equity* §177 (10th ed 2005).

EXAMPLE: In *McCaughna v Bilhorn* (1935) 10 CA2d 674, 52 P2d 1025, the testator, a resident of Illinois, made an unwitnessed holographic will directing the sale of some California land and distribution of the proceeds of 40 acres of it to her brother. If the doctrine of equitable conversion were invoked, the land would be considered personal property, subject to the laws of Illinois. Because Illinois did not recognize unwitnessed holographic wills, the proceeds of sale of the land would pass to her husband under an earlier witnessed will. Because disinheriting her brother was clearly contrary to the testator's intent, the court refrained from invoking the doctrine of equitable conversion.

The doctrine of equitable conversion also applies to personal property. If a will directs that cash in the estate be used to buy real property, which should then be distributed to a designated beneficiary, the cash will be regarded as real property. 11 Witkin, Summary, *Equity* §177.

NOTE: Whether real property is equitably converted into personal property for choice-of-law purposes is determined in the same way as the courts of the situs would determine it. Restatement (Second) of Conflict of Laws §225 (1971). For real property located outside California, counsel must become familiar with the laws of the state where the real property is located to discover whether and how the equitable conversion doctrine will be applied.

For further discussion of the doctrine of equitable conversion, see Restatement §225. See also 11 Witkin, Summary, *Equity* §177; 14 Witkin, Summary, *Wills and Probate* §57.

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B. Law Controlling Interpretation of Will

§37.9 1. Law Designated by Testator Controls

Different conflicts rules apply when the question before the court is one of interpretation, not validity, of a will. The main difference is that a court will generally give effect to a provision in the will that the will must be construed in accordance with the rules of construction of a particular state. Restatement (Second) of Conflict of Laws §§240, 264 (1971). There does not need to be a substantial connection between the designated state and the testator or the estate. Restatement §264, Comment e.

In California, Prob C §21103 explicitly gives the testator the power to designate a particular state's law to determine the meaning of any disposition in the will. A court will not give effect to the designation, however, if application of the chosen state's laws impairs (Prob C §21103):

- The rights of the surviving spouse in community and quasi-community property;
- Any of the family protection rights available under Prob C §§6500-6615; or
- Any related public policy of California.

If the testator has not provided that the will must be construed in accordance with the rules of construction of a particular state, the law that controls the construction of provisions in the will must be chosen according to the conflicts rules stated in §§37.10-37.11. Restatement §§240, 264. See also Drafting California Revocable Trusts, chap 23 (4th ed Cal CEB 2003).

The testator should realize that a provision in the will designating which state's rules of construction should be applied to construe the will is of limited effect. A court must always first give the meaning to words in a will that the court believes the testator intended them to convey, based on the available evidence. Only when the court does not have adequate evidence to determine the testator's intentions does it turn to rules of construction for guidance. See Restatement §§240, 264. Rules of construction generally are used to infer what probably would have been the testator's intention if the matter had been foreseen. Restatement §240, Comment d. Rules of construction also may produce surprising results. In *Ehrenclou v MacDonald* (2004) 117 CA4th 364, 12 CR3d 411, the court held that persons adopted in Colorado by the settlor's child were not issue of the child entitled to receive the remainder of the trust on the child's death because they would not have been treated as issue under Colorado law, even though the document provided that the administration of the trust was governed by California law. Under the California law of conflicts, an adopted person's status and rights must be determined under the law of the state in which the adoption occurred. On adopted children in California, see §12.29.

For a choice-of-law clause, see form 37.19-1.

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§37.10 2. Personal Property

A will, to the extent that it devises personal property, is construed according to the rules of construction that would be applied by the courts of the state where the testator died while domiciled, if the testator had not designated a particular state's laws for construction of the will. Restatement (Second) of Conflict of Laws §264 (1971).

EXAMPLE: The testator dies while domiciled in state *X.* The testator's will devises some personal property, located in state *Y,* to the "heirs" of a friend, who has an adopted son. The testator's will does not designate any particular state's laws as the basis for construing the will. In determining whether the adopted son is included in the gift to the friend's "heirs," a court would first review the available evidence to determine the testator's intent on the matter. If there is no satisfactory basis to determine this intent, the court would use state *X*'s rules of construction to resolve the matter. See Restatement §264, Comment f.

NOTE: Construing a will in accordance with the rules of construction that would be applied by the courts of the state where the testator died while domiciled does not necessarily mean ignoring any other state's laws. One generally accepted rule of construction is that a word or phrase in a will should usually be construed to be consistent with the usage prevailing in the state where the testator was domiciled at the time the will was executed. Application of this rule presumably leads to a result most consistent with the testator's expectations. Therefore, if in the above example the testator had executed the will while domiciled in state *Z,* the courts of state *X* would probably decide the matter by following the prevailing usage of the term "heirs" in state *Z*. Restatement §264, Comment f.

For discussion of "domicile," see §§37.5-37.6.

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.11 3. Real Property

§37.11 3. Real Property

When interpreting provisions in a will disposing of real property, a court attempts to give them the meaning demonstrated by the evidence as the meaning the testator intended them to convey. If the court is not presented with evidence sufficient to determine the testator's intent, the court must turn to rules of construction to construe the words. The hope is that the application of rules of construction will effectuate what would have been the testator's intent had he or she foreseen the issue. Restatement (Second) of Conflict of Laws §240, Comment d (1971). If the will being construed has multijurisdictional contacts, the court will apply the rules of construction of the state designated by the testator in the will. See §37.9. If no designation has been made, the provisions in the will disposing of real property will be construed according to the rules of construction that would be applied by the courts of the situs. Restatement §240.

It is not clear whether the courts of the situs will apply their local rules of construction or the rules of another state. Restatement (Second) of Conflict of Laws argues that the better practice is to apply the rules of construction of the state where the testator was domiciled at the time the will was executed, because (Restatement §240, Comment f):

- The testator and drafter are more likely to have known the rules of construction of the state of domicile at the time of will execution than those of the situs state; and
- The testator is not likely to have intended words in the will to be construed differently, depending on whether they affect real or personal property.

The doctrine of equitable conversion applies to issues involving the meaning of a will as well as its validity. See §37.8.

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C. Domiciliary and Ancillary Administration

§37.12 1. Jurisdiction to Administer Estate

Apart from the question of which state's laws apply to interpret a will or determine its validity, there is the issue of which state has jurisdiction to probate a will and administer the decedent's estate. The state where the decedent was domiciled at the time of his or her death has jurisdiction to probate the will. Restatement (Second) of Conflict of Laws §314 (1971). The state within which the decedent's assets are physically located, however, has the power to administer the assets. *Estate of Glassford* (1952) 114 CA2d 181, 188, 249 P2d 908. See 14 Witkin, Summary of California Law, *Wills and Probate* §60 (10th ed 2005).

EXAMPLE: If the decedent died while domiciled in California and left personal property located in California and New York, a California probate court will administer the estate located within its borders and a New York probate court will oversee an ancillary administration of the assets located there. In the ancillary administration, the New York court will apply California law in interpreting the will. Restatement §263.

For further discussion, see Restatement §314; California Decedent Estate Practice, chap 11 (2d ed Cal CEB 2009). On the concept of "domicile," see §§37.5-37.6.

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§37.13 2. Location of Intangible Property

If a decedent dies leaving intangible assets in his or her estate, the location of the assets must be identified to determine which state has jurisdiction to administer them. When the intangible property consists of a claim represented by a negotiable document such as a bond, the property is located where the document is physically located. *Estate of Glassford* (1952) 114 CA2d 181, 190, 249 P2d 908. When the property consists of an ordinary chose in action or a claim not represented by a negotiable document, the property is located where the debtor is domiciled. *Estate of Glassford, supra*. When the assets are shares of stock, they are considered to be located in the state of incorporation. *Murphy v Crouse* (1901) 135 C 14, 66 P 971. There is some authority, however, that shares of stock should be regarded as located where the share certificates are located. See 14 Witkin, Summary of California Law, *Wills and Probate* §59 (10th ed 2005).

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III. WILL DRAFTING FOR CLIENT WITH OUT-OF-STATE PROPERTY

§37.14 A. Avoiding Multijurisdictional Will Drafting Problems

The attorney should first determine whether the existence of out-of-state assets belonging to the client poses a particular will drafting problem. The attorney should consider these questions:

- Will the law of the situs control the will's effect on the assets?
- If so, is this likely to cause a problem?
- At the client's death, are summary administration procedures available as an alternative to formal ancillary proceedings?
- If not, is an ancillary administration likely to be expensive, complicated, and time consuming?

If the law of the situs of the out-of-state assets is likely to present a particular problem or if ancillary proceedings are unavoidable and expensive, the attorney should explore with the client nontestamentary methods for dealing with the problem.

If out-of-state assets pose a problem, the client should consider removing them from his or her estate. A lifetime gift of the assets to the person who would have been their recipient under a will may be in order, especially if there are no particular gift, estate, income, and property tax disadvantages. Alternatively, the client might be willing to sell the assets. If the sale is on an all-cash basis, this would eliminate the problem of assets located in another state. Of course, there may be good tax reasons not to sell, or the client may simply be unwilling to part with his or her ownership of the out-of-state property (which may also happen with a gift).

The client should also consider various probate-avoidance devices. If title to the out-of-state assets can be put into joint tenancy, ancillary administration can be avoided. Sometimes the most sensible option is to put the assets in a revocable trust. The trust will eliminate the need for an ancillary probate and, if it specifies that California law controls, will greatly minimize the role played by any other state's laws. See Drafting California Revocable Trusts, chap 1 (4th ed Cal CEB 2003). See §12.1 for discussion and references about California probate-avoidance devices.

PITFALL: To advise the client properly, the attorney must find out the nontestamentary options law of the state in which the assets are located. If the attorney is unwilling to do so, the client should be referred to local counsel in that state.

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B. Execution Requirements

§37.15 1. Importance of Checking Will's Validity Under Law of Situs of Real Property

If a client owns or expects to own real property in another state, it is important for the attorney to check whether a will that meets California execution requirements also satisfies the execution requirements of the other state. See §37.7. If the will does not meet these requirements, the attorney should check whether the other state has a statute similar to Prob C §6113(b)-(c), which provides that a written will is validly executed if:

> (b) The execution of the will complies with the law at the time of execution of the place where the will is executed.
>
> (c) The execution of the will complies with the law of the place where at the time of execution or at the time of death the testator is domiciled, has a place of abode, or is a national.

Such a statute will ensure the will's validity in the other state.

If the other state's requirements for a valid testamentary execution differ from California's and the state has no provision similar to Prob C §6113(b)-(c), the attorney should modify the execution procedure (see chap 36) to accommodate the requirements of both states.

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§37.16 2. Uniform International Wills Act

A will executed in conformity with the Uniform International Wills Act (Prob C §§6380-6390) is known as an "international will" and will be accepted as valid by all states and countries that have adopted the act. See §2.30. An international will may be appropriate, therefore, for the client who owns real property in another jurisdiction that has adopted the act. See Prob C §6381(a) (international will valid regardless of place of execution, location of assets, and nationality, domicile, or residence of testator). The act has been adopted by California, Colorado, Connecticut, Delaware, Illinois, Michigan, Minnesota, Montana, New Hampshire, New Mexico, North Dakota, Oregon, and Virginia. For other options when the will's validity in another state is vital, see §37.15.

For a will to qualify as an international will, the testator must declare, in the presence of two witnesses and a person authorized to act in connection with international wills, that the document is his or her will and that he or she knows its contents. The contents of the will need not be disclosed. Prob C §6382(b). The testator must sign or acknowledge his or her signature in the presence of the witnesses and the authorized person. Prob C §6382(c). The witnesses and the authorized person must then attest the will by signing in the presence of the testator (Prob C §6382(e)) at the end of the will (Prob C §6383). Each page of the will must be numbered and must be signed by the testator. Prob C §6383(a). The will should be dated by the authorized person. Prob C §6383(b). The will may be written in any language. Prob C §6382(a). Probate Code §6382(d) describes the procedure to follow if the testator is unable to sign.

After the will is executed, the authorized person must sign and attach to the will a certificate establishing that the requirements of the Uniform International Wills Act have been fulfilled. Prob C §6384. This certificate is conclusive evidence of the formal validity of the document as an international will. Prob C §6385.

"Authorized persons" include practicing attorneys in good standing. Prob C §6388.

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.17 3. Form: Attestation and Prob C §6384 Certificate for International Will

§37.17 3. Form: Attestation and Prob C §6384 Certificate for International Will

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

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

37.17-1 Attestation clause

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will. The testator also declared to us that the testator knew the contents of this will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of authorized person*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of authorized person*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

37.17-2 Certificate (convention of October 26, 1973)

1. I, _ _[*name, address, capacity*]_ _, a person authorized to act in connection with international wills,

2. certify that on _ _[*date*]_ _, at _ _[*place*]_ _

3. _ _[*testator's name, address, date, and place of birth*]_ _ in my presence and that of the witnesses,

4. (a) _ _[*name, address, date, and place of birth of witness*]_ _,

(b) _ _[*name, address, date, and place of birth of witness*]_ _, has declared that the attached document is _ _[*his/her*]_ _ will and that _ _[*he/she*]_ _ knows its contents.

5. I further certify that

6. (a) in my presence and that of the witnesses

(1) the testator has signed the will or has acknowledged _ _[*his/her*]_ _ signature previously affixed.

(2) following a declaration of the testator stating that _ _[*he/she*]_ _ was unable to sign _ _[*his/her*]_ _ will

because _ _[*reason*]_ _, I have mentioned this declaration on the will, and the signature has been affixed by _ _[*name and address*]_ _

7. (b) the witnesses and I have signed the will;

8. (c) each page of the will has been signed by _ _[*name*]_ _ and numbered;

9. (d) I have satisfied myself as to the identity of the testator and of the witnesses as designated above;

10. (e) the witnesses met the conditions requisite to act as such according to the law under which I am acting;

11. (f) the testator has requested me to include the following statement concerning the safekeeping of _ _[*his/her*]_ _ will:

_____
_____
_____

12. Place of execution:_____ .

13. Date: _ _ _ _ _ _

14. Signature and, if necessary, seal: _ _ _ _ _ _ _ _ _ _ _ _

Comment: The certificate form is from Prob C §6384. Parts 6(a)(2), 8(c), and 11(f) should be completed only if appropriate. Part 11(f) is derived from Prob C §6383(c), which requires the authorized person to ask the testator whether he or she wishes to make a statement concerning the safekeeping of the will. The certificate must be attached to the will. The authorized person should keep a copy and give a copy to the testator. Prob C §6384.

On the two sets of witness signature lines in the attestation clause, see §36.16.

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C. Avoiding Problems Over Interpretation of Will

§37.18 1. Need for Precision in Drafting

Questions of interpretation of words in a will usually result from the drafter's imprecise language. If a will is crafted carefully, there is little probability that differing interpretations of any of its provisions will arise. Wills that have been carefully drafted rarely lead to future problems of conflicting state laws.

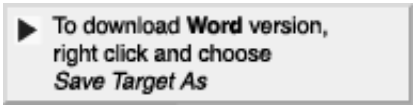
Technical terms used in a will should be defined if their meaning is likely to vary from state to state. For example, some states include adopted children in the term "children," while other states do not.

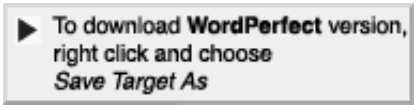
If the attorney does not wish to rely solely on the precision of his or her drafting, a choice-of-law provision should be added to the will. See form 37.19-1 for a clause.

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.19 2. Form: Construction of Will Governed by California Law

§37.19 2. Form: Construction of Will Governed by California Law





37.19-1 Construction of will governed by California law

The interpretation and construction of any provision of my will shall be governed by the laws of California in force _ _[*when I execute my will/on the date of my death*]**_ _.**

Comment: See discussion in §37.9. If the will creates a trust that includes a choice-of-law provision, the drafter should ensure that it is consistent with this clause. See §31.34.

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§37.20 D. Ancillary Administration

If the testator owns property requiring administration outside California, he or she may wish to nominate an executor for the ancillary probate. In that case, the drafter should consult the law of the situs of the property to ascertain its requirements for executors. Alternatively, under Prob C §8422, the testator may authorize an individual to nominate an ancillary executor if necessary. See §32.3.

The main purpose of an ancillary probate is to ensure that valid local creditors of the decedent are paid. See *Richards v Blaisdell* (1909) 12 CA 101, 110, 106 P 732. Payment of these creditors can be a particularly difficult and complex matter if the testator's out-of-state property is illiquid or is an asset that the testator does not wish to be sold (*e.g.,* the family home). The attorney should explore with the testator how he or she wishes the estate to pay out-of-state claims as well as administrative expenses, fees, and taxes attributable to the ancillary administration. If necessary, the will should direct payment of these liabilities in a specified manner.

On ancillary proceedings in California, see California Decedent Estate Practice, chap 11 (2d ed Cal CEB 2009). On ways to avoid ancillary administration, see §37.14.

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§37.21 E. Special Concerns for Testator With Out-of-State Property

When drafting a will that disposes of real property located in another state, the attorney should be on the lookout for ways in which that state's laws may unfavorably affect the will. The most common ways this may happen (execution requirements and ancillary administration) are discussed in §§37.15-37.17, 37.20. A state's laws may also unfavorably affect the will in numerous other ways.

For example, if there is an issue about the capacity of the testator or a beneficiary, the other state's laws will determine its resolution to the extent that the out-of-state real property is involved. If there is a question about omitted heirs, the other state's laws on the subject should be consulted. If the will makes a gift of out-of-state real property to charity or attempts to pass real property acquired after execution in another state, the other state's laws will determine the validity of the gift. See §37.7. See also 14 Witkin, Summary of California Law, *Wills and Probate* §55 (10th ed 2005).

If the attorney becomes aware of an issue that depends on another state's laws, the attorney should become familiar with that state's laws on the issue or explore ways (*e.g.,* the doctrine of equitable conversion; see §37.8) to make California law control resolution of the issue. Alternatively, the client should be advised to have the will reviewed by an attorney licensed to practice in the other state.

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§37.22 1. Rule Against Perpetuities

When drafting a will disposing of property in California and real property in another state, the attorney should ensure that the will does not violate the perpetuities laws of either state. See §34.3. The drafter should check the perpetuities provisions of any other state with which the testator is likely to have substantial contact, either by acquiring real property there or by moving his or her domicile there. A testator may be able to effectively select the law that will govern in perpetuities matters, if reasonable contacts exist with the selected state. See *Shannon v Irving Trust Co.* (1937) 275 NY 95, 9 NE2d 792. It is not wise to rely exclusively on such a selection, however.

If the will includes a perpetuities saving clause for a testamentary trust, the attorney should adapt the clause, if necessary, after examining the law of all states with which the testator has or is likely to have significant contacts. See §34.38.

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§37.23 2. Revocation of Prior Wills

It is important to realize that the conflicts rules that specify which law determines whether a will has been revoked are the same rules that specify which law determines whether a will has been validly executed. 14 Witkin, Summary of California Law, *Wills and Probate* §58 (10th ed 2005). See §§37.3-37.8. Thus, if a testator who owns out-of-state real property revokes a will or has it revoked in a manner other than an express revocation clause in a subsequent will (*e.g.,* by operation of law), the attorney should verify that the other state's laws will give effect to the revocation. Similarly, if a testator, by performing a particular act, revokes a will that disposes only of personal property and thereafter changes domicile and dies in another state where that act is not recognized as a revocation, the will is still valid because the law of the domicile at the time of the testator's death governs. *Estate of Patterson* (1923) 64 CA 643, 222 P 374.

If the issue of revocation arises about a will that disposes of out-of-state real property, the court of the situs usually applies its own local law in deciding the issue. Restatement (Second) of Conflict of Laws §239, Comment i (1971). Sometimes, however, a situs court interprets a local law providing that a will is valid if it complies with the formal requirements of the state where it was executed to mean also that a revocation is valid if the act of revocation complies with the requirements of the state where the act was performed. Restatement §239, Comment i. Further, situs courts sometimes refrain from applying their own local law when to do so would obviously defeat the testator's intentions. Restatement §239, Comment i. See also Restatement §263, Comment i, on similar exceptions to courts' applying their own local laws when personal property is involved.

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§37.24 3. Granting Trustee Powers

California law grants to a trustee many desirable management and administrative powers even if the trust instrument does not specifically confer those powers on the trustee or incorporate them by reference. Prob C §§16200-16249. See chaps 29-31. Because of this, some attorneys prefer not to specifically confer powers already granted trustees by law. This practice could pose a problem if the trust will include real property in another state, because the other state's laws, which may not grant such desirable powers, may then apply to trust management of the real property. Even if the drafter includes a choice-of-law clause in the trust, the other state may not honor such a clause. The safest course is to specify in the trust document all the powers the attorney wishes the trustee to have. See §§29.2-29.3. For complete discussion of conflicts issues involving trusts, see Drafting California Revocable Trusts, chap 23 (4th ed Cal CEB 2003). See also 5A Scott & Fratcher, The Law of Trusts §§553-666 (4th ed 1989).

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§37.25 4. Disinheritance Clauses

Careful drafting is required if the testator owns real property outside California and wants to disinherit a spouse or partner, child, or grandchild. The law of the situs may protect a broader class of heirs than does the law of California. See Prob C §§21610-21611; Fam C §297.5(c) (omitted spouse or registered domestic partner); Prob C §§21620-21623 (omitted children). Further, the law of the situs may have requirements for an effective disinheritance clause that differ from those under California law. See §§35.2-35.8 for discussion and forms.

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§37.26 5. Tax Payment Clauses

If a will client with a large estate owns out-of-state real property or is likely to change his or her domicile, the attorney should anticipate how conflict-of-laws issues might impact the manner in which death taxes are apportioned. See chap 26 for discussion of death tax clauses. Correctly anticipating this impact is not an easy matter. Perhaps the most perplexing and least predictable issue in the area of death tax apportionment is which law should govern apportionment questions in multijurisdictional estates. Even if the law that applies is fairly clear, this does not mean that the court will apply it. Especially in this area, courts prefer to apply their own state's law if possible or tend to select the law that leads to the results they prefer.

The best and easiest way to avoid a conflict-of-laws issue over payment of death taxes is to specify the method of apportionment in the will or any appropriate estate plan document. This should be done carefully, however, with full knowledge of all possible consequences. If the drafter is inclined merely to insert a routine, boilerplate apportionment clause in the will, many attorneys believe it is wiser for the drafter to do nothing at all about this matter. Alternatively, the will may dictate the law that should apply to the apportionment issue, as long as there is a substantial relationship between the client's estate or estate plan and the jurisdiction whose law is selected.

For further discussion of death tax apportionment issues in a multijurisdictional estate, see Pennell, *Tax Payment Provisions and Equitable Apportionment*, Estate Planning 1990 §§4.47-4.51, 4.61 (Cal CEB 1991).

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§37.27 IV. WILL DRAFTING FOR MOBILE CLIENTS

Much of the discussion in §§37.14-37.26 of will drafting for the client with out-of-state property also applies to the client who intends to move his or her domicile to another state. In both cases, the client and the attorney need to pay attention to another state's will and probate laws. For a client with out-of-state property, the focus is usually on how the laws of the state where out-of-state real property is located affect the provisions in the client's will disposing of real property. For a client who intends to move to another state, the focus is on how the laws of the state of intended domicile affect the provisions in the will disposing of personal and real property located there. See §§37.4-37.6, 37.10.

The attorney must verify whether a will executed in conformance with California requirements will be valid in the state of intended domicile. If it will not be valid, the attorney must modify the execution procedure to accommodate the requirements of both states. See §§37.15-37.17. Unlike the situation in which a client has out-of-state property, ancillary administration is not a concern for a client who intends to move to another state. See §37.20. If the client moves to another state and dies domiciled there, however, any probate administration needed will probably occur in that state. The attorney should query whether the likelihood of a probate in the state of intended domicile raises issues that the will should address. For example, does the other state demand any unusual qualifications for executors? Are the other state's laws concerning payment of debts, proration of taxes, or abatement of gifts likely to impact the will in ways inconsistent with the client's intentions? On proration of taxes, see §37.26.

The ways in which the laws of the state of intended domicile may affect a will being drafted in California are as numerous as the ways in which a will disposing of real property in another state may be affected by that state's laws. Any issue of testamentary capacity will be resolved by application of the laws of the state of domicile at the testator's death (except probably for devises of nondomiciliary real property; see §37.7). Whether a will provision violates the rule against perpetuities or is "saved" by a perpetuities saving clause will also be determined by the laws of the testator's domicile at death. See §37.22. The interpretation of a class gift involving assets other than nondomiciliary real property will be controlled by the laws of the domiciliary state, if the testator has not designated another state's laws to control. The powers available to the trustee of a testamentary trust and the validity of a pourover devise are further examples of the type of will issues likely to be resolved by reference to the laws of the state of domicile at death.

For discussion of the ways in which a change of domicile by the testator or a beneficiary affects the creation and exercise of a power of appointment, see §§16.34-16.36, 16.39.

Attorneys generally are more wary when preparing a will for a client who intends to move than they are for a client with out-of-state property, because out-of-state laws affect the disposition of a much greater percentage of the estate of a client who intends to move than the estate of one with out-of-state property. In fact, for mobile clients, many attorneys only prepare wills in conformance with California laws and advise the client to have the will reviewed by an attorney in the new state once the client has established domicile there.

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§37.28 A. Characterization of Property

The attorney advising a mobile client should be aware that a client's change of domicile sometimes affects the ownership character of the client's assets. This is particularly true when the client is married and moves to a common-law state. Community property does not automatically lose its characteristics as community property when spouses move to a common-law state, but those characteristics may be lost inadvertently or as a result of ignorance. For example, an inadvertent loss may result from a failure to maintain the records necessary to trace the community property after the move to the new domicile.

The attorney should discuss the features of community and separate property with married clients intending to move to a common-law state and help them decide whether to preserve the community character of their assets. For example, on the death of a spouse only his or her one-half share of the community property will be includable in his or her estate for estate tax purposes, but both halves of the community property will receive a step-up (or step-down) in basis under IRC §1014 (or may be allocated aggregate basis increase, limited to fair market value of the property at death, under IRC §1022 for decedents dying in 2010). Each spouse has a right to dispose of his or her share of community property by testamentary disposition. In the absence of a specific disposition, the deceased spouse's share of the community property will pass as part of his or her residuary estate. In the absence of a will, it will pass to the heirs of the deceased spouse under the applicable laws of intestacy.

If the clients decide to maintain community property, the attorney should outline the steps they should take to preserve their community property. These steps include an inventory of their assets at the time of the move and the execution of an agreement specifying that the assets are and will remain community property. Segregating these assets from future assets may also be advisable, either by separate accounts or by use of a revocable living trust. The attorney should emphasize to the clients the need to seek the advice of an attorney in the new jurisdiction who will be both aware of the peculiar nature of community property and willing to deal with it. The attorney should also consider the impact of the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA), which preserves the rights of each spouse in property that was community property before a change of domicile, as well as in property substituted for such property, when the spouses have not indicated an intention to sever or alter their community rights. The Act has been adopted by Alaska, Arkansas, Colorado, Connecticut, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Virginia, and Wyoming.

NOTE: The community property jurisdictions are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Puerto Rico, Texas, Washington, and Wisconsin. Alaska has an optional community property system. See Shafter & Greer, *Obtaining a Full Stepped-Up Basis Under Alaska's New Community Property System*, 26 Est Plan 109 (Mar./Apr. 1999).

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.29 B. Advising Client on Selection of Domicile

§37.29 B. Advising Client on Selection of Domicile

It is no longer unusual for estate planning clients to spend time and maintain property in two or more states. From a tax and administrative point of view, this can be surprisingly expensive. It may offer an opportunity, however, for creative planning. If the client has the ability and willingness to concentrate personal and financial ties in one state, he or she may be able to select a domicile. See §37.30.

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§37.30 1. Factors to Consider in Selecting Domicile

If the client has significant contacts with two states and does not have strong personal reasons to favor one state over the other as a domicile, the attorney should discuss at least the following factors with the client to aid him or her in making a choice of domicile:

- *Income taxes.* The attorney should compare the basic income tax structures of each state. Are one state's income tax rates significantly lower than the other's? Is capital gain taxed differently in each state? Do the states apply different residence tests to determine whether an individual is subject to the state's taxing authority?
- *Property taxes.* The attorney should ascertain whether one or both states levy a tax on tangible or intangible personal property. How do the rates in each state compare?
- *Estate and gift taxes.* Because the domicile of the decedent determines which state may assess inheritance and estate taxes on all the decedent's property (except real property and tangible personal property located in another jurisdiction), the attorney should compare the death tax structure of each state. For the client contemplating gifts in the future, how do the gift tax structures of each state differ? The number of states with a gift tax is smaller than the number of states with an income tax.
- *Rights of surviving spouse.* The rights of a surviving spouse in the estate of his or her spouse vary widely among states. If this is important to a client, the attorney should review pertinent statutes in each state being considered as a domicile.
- *Marital agreements.* States also vary with respect to the enforceability of premarital and postmarital agreements. The attorney should examine the differences between states and explain them to the client. If the client is in an unmarried intimate relationship, the attorney should also investigate how each state being considered as a domicile treats agreements between unmarried cohabitants.
- *Marital property.* The attorney should compare the marital property laws of each state. Whether a domicile is a community property jurisdiction will have a profound effect on the property rights of the married client.
- *Estate administration.* States differ widely in the requirements, expense, and inconvenience of an administration of an estate. Some states place few restrictions on who may serve as personal representative and allow that person to perform many estate responsibilities without slow and cumbersome court supervision. In other states, probate is a particularly slow and expensive process. If probate administration is a concern for a client, the attorney should consider each state's procedures and requirements.

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.31 2. Establishing Domicile

§37.31 2. Establishing Domicile

Once the client has selected his or her domicile, steps should be taken to ensure that the selection will withstand the scrutiny of other competing states. Because domicile is a function of both fact and intent, the attorney should arrange the client's affairs to confirm the fact and manifest the intent.

The client should be encouraged to take as many steps as possible to support his or her choice of domicile. The following list illustrates the steps that the client should take:

- The client should ensure that his or her will includes a recitation of the new domicile. See §10.4.
- The client should vote in the new domicile and file that state's income tax returns.
- The client should register his or her vehicle in the new domicile and obtain a driver's license there.
- If the state has provisions for doing so, the client should execute a declaration of domicile and file it with the proper agency.
- The client should move bank accounts and safe deposit boxes to the new domicile.
- The client should inform insurance companies, charge card companies, the Social Security Administration, companies whose securities he or she owns, and the post office of the new address.
- The client should establish organizational ties in the new domicile (*e.g.,* churches, social clubs).

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V. WILL DRAFTING FOR CLIENT WITH ASSETS ABROAD OR LIVING ABROAD

§37.32 A. Performing Complete Estate Planning Services for International Client Unwise

Most attorneys are not competent to provide complete estate planning services, including preparation of a will disposing of all assets, for a client who lives abroad or owns property overseas. The attorney who seeks to provide such services must be familiar with the wills, probate, trust, property, and tax laws not only of the country where assets are located but also of any jurisdiction that may claim to be the testator's domicile. In addition, the attorney must be familiar with the conflicts laws of all involved jurisdictions and with any relevant treaties (*e.g.,* estate tax treaties) between the United States and any involved foreign jurisdiction.

Because of this, most attorneys for clients with assets abroad will prepare only wills disposing of United States assets and advise their clients to retain an attorney licensed to practice in the foreign country to prepare a will disposing of the foreign assets. If there is a question of domicile, the advice of a foreign attorney is even more essential because the drafter may have to take foreign laws into consideration when drafting the United States will. For further discussion, see California Estate Planning, chap 16 (Cal CEB 2002).

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Source: Estate Planning/California Will Drafting/37 Multijurisdictional Issues in Will Drafting/§37.33 B. Recommended Provisions in United States Will

§37.33 B. Recommended Provisions in United States Will

An attorney preparing a will that disposes of assets located only in the United States should keep these points in mind:

- The will should clearly specify which assets the testator is disposing of. For example, the property covered by the will might be defined as real property and tangible personal property physically situated in the United States, accounts in banks whose principal offices are in the United States (but not deposits in foreign branches of United States banks), intangible property with certificates physically located in the United States, royalties payable by licensees or copyright owners whose principal place of business is in the United States, sums owing by United States corporations, and not any other property of the testator.
- The will should specify which debts and expenses its executor should and should not pay. The will should also state whether, if the United States property is insufficient to satisfy devises after payment of appropriate liabilities, the executor can call on estate representatives elsewhere for contributions.
- The will should make clear the extent of the obligation of the United States executor to pay death taxes, in this country and elsewhere.
- The usual revocation clause in a will (see §9.3) should be modified to state that prior wills are not revoked except to the extent that they are inconsistent with, or relate to, the property covered by the United States will.

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Introduction to Appendixes

Appendixes A-I contain sample wills that illustrate common dispositive plans. Each appendix has been compiled from the separate clauses in the text.

WARNING: If the will benefits a "disqualified person" or names such a person as a trustee or successor trustee, it usually will be necessary to provide or obtain a "Certificate of Independent Review." Under Prob C §§21350-21351, the primary categories of "disqualified persons" are (1) drafters of donative transfer documents and persons closely associated with the drafters and (2) a care custodian of a transferor who is a dependent adult. Because "care custodian" is broadly defined, the settlors must be carefully interviewed in order to determine whether any transferee or trustee might meet the definition. For an example of a case in which a court determined that a friend was a disqualified person, see *Bernard v Foley* (2005) 130 CA4th 1109, 30 CR3d 716. An attorney who fails to advise the testator that a certificate of independent review is needed may later be sued by the disappointed intended devisee. See *Orsonio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246. For a form of certificate of independent review, see §1.36.

In these appendixes, each clause is preceded by the form number and title from the chapter in this book in which the clause is discussed. When two or more clauses have been combined, the titles and reference numbers for each have been included. When necessary, the clauses from the chapters have been slightly modified to fit the situation described at the beginning of the appendix.

Each sample will is divided into numbered divisions. (Some practitioners use "articles" instead of "divisions.") These numbered divisions are further divided into lettered paragraphs.

NOTE: Appendixes A-I are drafting guides only. The reader should not use them as substitutes for independent decision making.

The appendixes include the following sample wills:

Appendix A	Nontrust Will for Single Person
Appendix B	Nontrust Will for Married Couple With Children: Contingent Separate Trusts
Appendix C	Nontrust Will for Married Couple With Children: Contingent Family Pot Trust
Appendix D	Will With QTIP Trust and Bypass Trust for Married Testator
Appendix E	Will With Bypass Trust for Married Testator
Appendix F	Will for Married Testator With Standby Disclaimer Trust
Appendix G	Pourover Will
Appendix H	Will Creating Special Needs Trust
Appendix I	Nontrust Will With Residue to Domestic Partner

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Appendix A

Nontrust Will for Single Person

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

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

Description

This is a sample nontrust will suitable for an individual who does not currently have a spouse, domestic partner, or issue. The basic form can be used regardless of the anticipated size of the estate.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. No Spouse or Partner

C. No Children or Issue

DIVISION TWO: GIFTS OF PROPERTY

A. Monetary Gifts

B. Gift of __[*specify*]__

C. Gift of Residue

D. Distributions to Young Persons

DIVISION THREE: EXECUTORS

A. Nomination of Executors

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *No Spouse or Partner.* I am not married and I do not have a domestic partner.

C. *No Children or Issue*. I have no living or deceased children or other issue.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that only distributes assets in a foreign country, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

DIVISION TWO
GIFTS OF PROPERTY

12.71-1 General pecuniary gifts

12.23-1 Survivorship conditions

12.34A-1 Class gift to named persons and their issue—equal shares

12.80-1 Gift of residue in equal shares

12.81-1 Retention in further trust until specified age

29.8-1 Trustee may exercise statutory powers

***A. Monetary Gifts.* I give to each of the following persons the sum of money shown opposite their name. Any estate or inheritance tax imposed with respect to any of these gifts shall be paid from the residue of my estate. If any listed person fails to survive me by 30 days the gift to that person shall lapse.**

[*Option: Limitation on total value of gifts of money and property*]

The total value of the foregoing gifts of money, excluding any payments of estate or inheritance taxes, is not to exceed _ _[*number*]_ _ percent of the combined value of the gifts of money and the net value of the property that will be distributed as part of the residue of my estate. In the event that percentage would otherwise be exceeded the value of the monetary gifts shall be reduced on a prorata basis so that their total value does not exceed that percentage.

B. *Gift of* _ _[*specify*]_ _. I give _ _[*gift*]_ _, together with any insurance on it, to _ _[*name of beneficiary*]_ _ if _ _[*he/she*]_ _ survives me by 30 days. If _ _[*name of beneficiary*]_ _ fails to so survive me, I give this gift to _ _[*name of alternate beneficiary*]_ _ if _ _[*he/she*]_ _ survives me by 30 days. If _ _[*name of beneficiary*]_ _ also fails to so survive me this gift shall lapse. Any estate or inheritance tax imposed with respect to this gift shall be paid from the residue of my estate.

C. *Gift of Residue.* The residue of my estate, including any lapsed gifts not otherwise disposed of, shall be divided into as many equal shares as there are persons named in the following list who survive me by 30 days and persons named in that list who do not so survive me but who leave issue who so survive me. Each so surviving listed person shall receive one share and the so surviving issue of each listed person who did not so survive me shall take by representation the share created on account of the ancestor who did not so survive me. The named persons are: _ _[*names, e.g., my niece Mary Doe, my stepson John Doe, and my friend Tim Roe*]_ _

D*. Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The separate trust shall be administered as follows:

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or apply for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee in its discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

***7. Trustee Powers.* The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.**

Comment: The actual dispositions in the Division are examples, but reflect the following desirable features: (1) Express statements of survival conditions and express provisions concerning the failure to survive; (2) Express statements concerning the source of payment of transfer taxes whenever the testator does not desire equitable apportionment; (3) An abatement provision that assures that the pecuniary gifts will not exhaust the residue of the estate if the estate is unexpectedly smaller than expected; and, because the terms of the residuary gift make it possible that a young person might receive distributions, (4) A provision providing for managements of the property of a young beneficiary.

Usually it is not necessary to include a lengthy list of trustee powers in a will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are incorporated only by reference in the will. Cal Rules of Ct 7.650.

DIVISION THREE
EXECUTORS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as

executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _**, at** _ _[*name of city*]_ _**, California.**

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _**, declared to us that this instrument, consisting of** _ _[*number*]_ _ **pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.**

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _**, at** _ _[*name of city*]_ _**, California.**

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix B

Nontrust Will for Married Couple With Children: Contingent Separate Trusts

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

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

Description

This is a nontrust will suitable for a younger couple with children having insufficient assets to present estate tax concerns. In many cases the primary motivation for obtaining a will is to name the persons who would care for the children and the children's property in the event both parents were to die. The will establishes trusts for the children and nominates the guardian of the person who will raise the children. For alternative provisions establishing a "pot" trust for the children, see Appendix C.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Spouse

C. Children and Issue

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. All Estate to Spouse

B. If Spouse Does Not Survive

C. Distributions to Young Persons

DIVISION THREE: EXECUTORS AND GUARDIANS

A. Nomination of Executors

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

D. Guardian of the Person

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets only in a foreign country, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.80-1 Gift of residue to spouse (modified)

12.81-1 Retention in further trust until specified age

29.8-1 Trustee may exercise statutory powers

***A. All Estate to Spouse.* I give all of my estate to my spouse if my spouse survives me by 30 days.**

***B. If Spouse Does Not Survive.* Subject to the following provisions of this Division, if my spouse does not survive me by 30 days, I give all of estate in equal shares to my children who so survive me, but if one or more of my children does not so survive me, I give all of my estate to my issue who so survive, per capita at each generation.**

***C. Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The separate trust shall be administered as follows:**

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at

more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

***7. Trustee Powers.* The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.**

Comment: Usually it is not necessary to include a lengthy list of trustee powers in a will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are incorporated only by reference in the will. Cal Rules of Ct 7.650.

DIVISION THREE
EXECUTORS AND GUARDIANS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

24.20-1 Nomination of guardian of person

D. *Guardian of the Person.* If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix C

Nontrust Will for Married Couple With Children: Contingent Family Pot Trust

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

Description

This is a nontrust will suitable for a younger couple with children having insufficient assets to present estate tax concerns. In many cases the primary motivation for obtaining a will is to name the persons who would care for the children and the children's property in the event both parents were to die. The will establishes a family pot trust for the children and nominates the guardian of the person who will raise the children. For alternative provisions establishing separate trusts for the children, see Appendix B.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Spouse

C. Children and Issue

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. All Estate to Spouse

B. If Spouse Does Not Survive

C. Children's Trust

DIVISION THREE: EXECUTORS AND GUARDIANS

A. Nomination of Executors

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

D. Guardian of the Person

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets in a foreign country only, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.80-1 Gift of residue to spouse with gift over to issue (modified)

28.13-1 Creation of trust; nomination of trustee (modified)

A. *All Estate to Spouse.* I give all of my estate to my spouse if my spouse survives me by 30 days.

B. *If Spouse Does Not Survive.* If my spouse does not survive me by 30 days, I give the residue of my estate, in trust, to _ _[*name of trustee*]_ _. If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The trustee shall hold, administer, and distribute all property allocated to the trust according to the terms of paragraph C of this Division Two.

22.49-1 Principal and income sprinkled among children until youngest child reaches specified age

22.50-1 Discretionary preliminary distribution

22.51-1 Preliminary distributions in excess of child's ultimate share

22.52-1 Termination of trust and distribution of remainder

C. *Children's Trust*. The trustee shall hold, administer, and distribute all property allocated to the children's trust as follows:

1. *Distribution of Principal and Income*. The trustee shall pay to or for my children who survive me by 30 days as much of the principal and net income of the trust as the trustee, in the trustee's discretion, considers necessary for their health, education, support, or maintenance. Any undistributed net income shall be

accumulated and added to principal.

In exercising the trustee's discretion, the trustee shall take into account:

(a) The value of the trust assets and the relative current and future needs of each beneficiary;

(b) The tax consequences of any distribution or failure to distribute; and

(c) Any other factors that the trustee considers relevant.

In exercising the discretion conferred in this paragraph, the trustee may make distributions that benefit one or more of my beneficiaries more than others or that completely exclude others. Any distribution shall be charged against the trust estate as a whole and not against the ultimate distributive share of the beneficiary to whom or for whose benefit the distribution was made.

The trustee shall continue to make the discretionary distributions called for in this paragraph until my youngest child has reached age _ _[*number*]_ _.

2. *Preliminary Distributions*. The trustee shall have the sole discretion to make preliminary distributions of principal from time to time to any of my children who have reached age _ _[*number*]_ _ if there are valid and productive reasons (*e.g.,* starting a business, buying a home) for making the distributions. The trustee shall not make any preliminary distribution if the trustee determines, in the trustee's sole discretion, that the remaining principal and income will not be adequate for the support, health, education, and maintenance of my other children.

If, for any reason, any child of mine receives preliminary distributions that exceed, in the aggregate, the ultimate share distributable to this child under subparagraph 3, the trustee shall not require the child to reimburse the trust for the excess distributions but shall distribute the remaining balance of the trust estate among the other beneficiaries as provided in that subparagraph. The value of each of the child's preliminary distributions shall be its value at the time the distribution was made.

3. *Distribution of Remainder*. When all of my then-living children have reached age _ _[*number*]_ _, the trustee shall divide the adjusted trust estate (defined below) into as many equal shares as there are children of mine then living and children of mine then deceased with then-living issue. Each share set aside for a child of mine then deceased with then-living issue shall be further divided into shares for such issue by right of representation.

The "adjusted trust estate" is equal to the trust estate at the time of termination of the trust plus:

(a) The outstanding balance of any loans made by the trust to any child of mine to any issue of a deceased child; and

(b) The total preliminary distributions made to all my children and any preliminary distributions made to any issue of a deceased child.

Each preliminary distribution shall be charged at its value when the distribution was made.

To compute the actual amount distributable to each beneficiary and without making a charge for interest, the trustee shall charge to each living child's share of the adjusted trust estate (a) the outstanding balance of any loans made by the trust to that child and (b) the preliminary distributions made to that child. The trustee shall similarly charge the equal share set aside for the then-living issue of a deceased child with any outstanding loans and preliminary distributions made to that deceased child or such issue. Each preliminary distribution shall be charged at its value when the distribution was made.

Each share for a beneficiary who has reached age 18 shall be distributed to that beneficiary free of trust. Each share for a minor beneficiary shall be distributed to _ _[*name of custodian*]_ _ as custodian for this minor beneficiary until age _ _[*number*]_ _ under the California Uniform Transfers to Minors Act (Probate Code §§3900-3925).

If all my children die before all of my then-living children have reached age _ _[*number*]_ _, the trustee shall distribute the trust assets on the death of the last child of mine to die to my then-living issue by right of representation. If at that time I have no living issue, the trustee shall distribute the trust assets as follows: _ _[*Distribution*]_ _.

Comment: See §§22.18-22.20 on the family "pot" trust.

22.30-1 Broad definition of "education"

4. *Definition of "Education."* Whenever this trust calls for payments for a beneficiary's education, the term "education" is meant to include vocational, undergraduate, and graduate studies at an institution of the beneficiary's choice if, in the trustee's discretion, they are pursued to advantage by the beneficiary. The trustee may pay for the beneficiary's living and travel expenses reasonably related to the beneficiary's studies.

Comment: See §22.29 on definitions of "education."

22.33-1 Retention and use of testator's residence as home for children

5. *Retention of Residence*. If all or a portion of my residence is held in trust, the trustee may retain the residence in the trust for rent-free occupancy by my children. If any of my children has a guardian of the person, the trustee may allow the guardian and the guardian's spouse and minor children, if any, to reside, rent free, in this residence along with my children until my youngest child reaches age _ _[*number*]_ _ If only a portion of my residence is held in trust, the trustee may seek to arrange for occupancy of the other portion by my children and their guardian.

All costs of maintaining and repairing the residence (or, if the trust owns a portion of it, that part of costs allocable to the trust's interest, together with any rent or other fees paid to the owner of the other portion) shall be paid by the trust out of either income or principal as the trustee, in the trustee's discretion, decides.

Comment: On issues presented by a beneficiary's occupancy of the testator's residence, see §§22.31-22.33, 31.23.

29.8-1 Trustee may exercise statutory powers

6. *Trustee Powers.* The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.

Comment: Usually it is not necessary to include a lengthy list of trustee powers in a will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are only incorporated by reference in the will. Cal Rules of Ct 7.650.

DIVISION THREE
EXECUTORS AND GUARDIANS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

24.20-1 Nomination of guardian of person

D. *Guardian of the Person.* If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix D

Will With QTIP Trust and Bypass Trust for Married Testator

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Description

This is a will for a married testator whose spouse is a United States citizen. The will makes a specific gift of the testator's household furniture, furnishings, and personal effects to the surviving spouse. If the spouse does not survive the testator by 30 days, this gift goes to the testator's children. A gift to the marital deduction qualified terminable interest property (QTIP) trust is made using a formula clause, and the residue of the estate passes to the bypass trust.

The surviving spouse is entitled to all net income of the QTIP trust; income of the QTIP trust that is accumulated but undistributed at the surviving spouse's death is payable to the distributees of the principal. The trustee is authorized to invade principal for the spouse's benefit. At the surviving spouse's death, the principal is divided equally among the testator's surviving children or their issue.

The will does not include clauses qualifying the trust for the marital deduction if the surviving spouse is not a United States citizen. See §§19.32-19.40 for discussion and forms.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Spouse

C. Children and Issue

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. Gift of Tangible Personal Property

B. Fractional Share Marital Formula Gift to Marital and Bypass Trusts

C. If Spouse Does Not Survive

DIVISION THREE: MARITAL TRUST

A. Income to Spouse for Life

B. Distribution of Principal

C. Conversion of Unproductive Property

D. QTIP Election

E. Division Into Exempt and Nonexempt Trusts

F. Distribution on Spouse's Death

DIVISION FOUR: BYPASS TRUST

A. Income to Spouse for Life

B. Distribution of Principal

C. Distribution on Spouse's Death

DIVISION FIVE: OFFICE OF TRUSTEE

A. Nomination of Trustee

B. Trustee Compensation

C. Trustee Power to Employ Agents and Advisers

D. Exculpation of Trustee

E. Limitation on Successor Trustee Liability

DIVISION SIX: TRUSTEE POWERS

A. Investment According to Prudent Investor Rule

B. Power to Retain Trust Property

C. Power to Purchase Bonds at Premium

D. Power to Purchase Bonds at Discount

E. Power to Retain or Acquire Underproductive Property

F. Power to Manage Securities

G. Power to Hold Securities in Alternative Forms

H. Power to Sell, Exchange, or Repair Trust Property

I. Power to Lease Trust Property

J. Disclaimer of Administrative Powers

K. Power to Adjust for Tax Consequences

L. Power to Borrow

M. Power to Insure

N. Power to Abandon Trust Property

O. Power to Initiate and Defend Litigation

P. Power to Compromise Claims

Q. Power to Withhold Distribution

R. Power to Divide Trust Property Into Shares

S. Allocation of Principal and Income

T. Segregation of Assets Not Required

U. No Liability for Trustee Action Before Notice of Event

V. Distribution of Property Subject to Power of Appointment

W. Additions to Trust Authorized

X. Powers Exercised Solely in Fiduciary Capacity

Y. Powers Continue Until Distribution of Trust Property

DIVISION SEVEN: DISTRIBUTIONS TO YOUNG PERSONS

DIVISION EIGHT: CHOICE OF LAW

DIVISION NINE: SPENDTHRIFT CLAUSE

DIVISION TEN: PERPETUITIES

DIVISION ELEVEN: EXECUTORS

A. Nomination of Executor

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets in a foreign country only, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic

partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.46-1 Gift of tangible personal property to individual

12.23-1 Survivorship conditions for particular gifts (modified)

A. *Gifts of Tangible Personal Property*. I give all my jewelry, clothing, household furniture and furnishings, personal automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in will or in any other manner, together with any insurance on the property, to my spouse if my spouse survives me by 30 days. If my spouse fails to so survive me, this gift shall lapse.

Comment: For discussion of a gift of tangible personal property, see §§12.36-12.44. For discussion of a shorter survivorship period for gifts of tangible personal property, see §12.22.

17.81C-1 Fractional share marital formula

B. *Fractional Share Marital Formula Gift to Marital and Bypass Trusts*. If my spouse survives me by 30 days, I give the residue of my estate in shares to the trustees of marital trust and the bypass trust. The marital trust share shall equal the smallest fractional share of the residue that, if taken as a federal estate tax marital deduction, will entirely eliminate (or reduce to the maximum extent possible) any federal estate tax on my death, after taking into account all factors relevant to this estate tax objective, including but not limited to:

(1) All deductions claimed and allowed in determining the estate tax payable by reason of my death.

(2) The net value of all other property included in my gross estate, whether or not it is given under this will and whether it passes at the time of my death or has passed before my death to or in trust for my spouse, so that it is included in my gross estate and qualifies for the federal estate tax marital deduction. If my spouse disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded.

(3) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for: (a) death taxes paid in the estate of one whose death occurs after mine; or (b) any state death tax unless, and to the extent, a death tax would be payable to the state or states regardless of the federal credit.

The bypass trust share shall equal the remaining share of the residue.

These shares shall be determined using the values of assets as finally determined for federal estate tax purposes. The residuary gifts to the marital trust and bypass trust may be satisfied in cash or in kind, in undivided interests, or partly in each, each such asset to be valued for this purpose on the date it is distributed. Any assets that are not eligible for the federal estate tax marital deduction shall be allocated to the bypass trust. Any insurance on my spouse's life and any assets for which a credit for foreign death taxes is allowable for federal estate tax purposes shall be allocated to the bypass trust, unless there is insufficient other property to fully fund the marital trust.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

***D. If Spouse Does Not Survive.* Subject to the provisions of the Division of this will entitled "Distributions to Young Persons," if my spouse does not survive me by 30 days, I give all of estate in equal shares to my children who so survive me, but if one or more of my children does not so survive me, I give all of my estate to my issue who so survive me, per capita at each generation.**

DIVISION THREE
MARITAL TRUST

19.22-1 Introduction to QTIP trust

The trustee shall hold, administer, and distribute all property allocated to the marital trust as follows:

19.23-1 Distribution of QTIP trust income

A. *Income to Spouse for Life.* During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Income not immediately requested by my spouse shall remain subject to my spouse's right to income and may be withdrawn at anytime until my spouse's death. No person shall have the power to appoint any part of the trust property to any person other than my spouse during my spouse's lifetime. Trust income earned between the last distribution date and the date of my spouse's death, and any other trust income not requested by my spouse before death, shall not be distributed to my spouse or my spouse's estate but shall instead be distributed in accordance with the provisions of this trust for distribution of property following my spouse's death.

19.25-1 Discretionary payment of QTIP trust principal (ascertainable standard)

19.26-1 Relevance of other income sources

B. *Distribution of Principal*. In addition to the net income, the trustee shall pay to or apply for the benefit of my spouse as much of the trust principal, up to the whole of the trust, as the trustee considers appropriate for my spouse's health, support, education, and maintenance to maintain at a minimum my spouse's accustomed manner of living. In making these distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and readily available.

29.22-1 Trustee compliance with spouse's direction to convert unproductive property

C. *Conversion of Unproductive Property*. My spouse shall have the right to direct the trustee in writing to convert any unproductive property held in the marital trust to productive property within a reasonable time, and the trustee shall comply with this direction within a reasonable time after receipt of the directive.

Comment: Form 29.22-1 is for use in conjunction with a clause authorizing the retention or acquisition of unproductive property for the trust.

19.28-1 QTIP election

D. *QTIP Election*. I request but do not require my executor to make an election under Internal Revenue Code §2056(b)(7) to qualify all or part of the marital trust for the federal estate tax marital deduction. I recognize that the marital trust will not qualify for the marital deduction if my executor does not make this election. In exercising this discretion, my executor may consider all relevant factors, including the health and life expectancy of my spouse and the impact of the Internal Revenue Code §2013 prior transfer property credit.

15.43-1 Marital trust divided into exempt and nonexempt trusts

E. *Division Into Exempt and Nonexempt Trusts*. If any of my generation-skipping transfer (GST) tax exemption is to be allocated to the marital trust, the assets that would otherwise be used to establish a single marital trust shall instead be allocated on a fractional share basis between two marital trusts, one with a GST tax inclusion ratio of one (the "GST Nonexempt Marital Trust") and the other with a GST tax inclusion ratio of zero (the "GST Exempt Marital Trust"). A reverse QTIP election shall be made for the GST Exempt Marital Trust and the estate taxes resulting from inclusion of that trust in the estate of my spouse under Internal Revenue Code §2044 shall be paid from the GST Nonexempt Marital Trust unless the tax will otherwise be paid from a source other than the marital trusts.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

F. *Distribution on Spouse's Death.* On the death of my spouse the remaining trust property shall be distributed in equal shares to my children who survive my spouse, but if one or more of my children does not so survive, the trustee shall distribute the trust property to my issue who survive my spouse, per capita at each generation. If any distributee is under age _ _[*number*]_ _, the share of that distributee shall be retained in trust in accordance with the provisions of the Division of this will entitled "Distributions to Young Persons."

DIVISION FOUR
BYPASS TRUST

20.19-1 Introduction to bypass trust

20.21-1 Payment of income

The trustee shall hold, administer, and distribute all property allocated to the bypass trust as follows:

A. *Income to Spouse for Life.* During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Undistributed income shall be added to principal.

19.25-1 Discretionary payment of principal (ascertainable standard)

19.26-1 Relevance of other income sources

B. *Distribution of Principal*. The trustee shall pay to or apply for the benefit of my spouse as much of the trust principal, up to the whole of the trust, as the trustee considers appropriate for my spouse's health, support, education, and maintenance to maintain at a minimum my spouse's accustomed manner of living. In making these distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and readily available.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

C. *Distribution on Spouse's Death.* On the death of my spouse the remaining trust property shall be distributed in equal shares to my children who survive my spouse, but if one or more of my children does not so survive, the trustee shall distribute the trust property to my issue who survive my spouse, per capita at each generation. If any distributee is under age _ _[*number*]_ _, the share of that distributee shall be retained in trust in accordance with the provisions of the Division of this will entitled "Distributions to Young Persons."

DIVISION FIVE
OFFICE OF TRUSTEE

28.12-1 Nomination of trustee and successors for all trusts

28.23-1 Waiver of bond

A. *Nomination of Trustee*. I name as trustee and successor trustee of the marital trust and the bypass trust, in the order and priority indicated, the following:

First: _ _[*Name of trustee*]_ _
Second: _ _[*Name of successor trustee*]_ _

All powers vested in the original trustee shall be exercisable by any successor trustee. No named or unnamed, resident or nonresident trustee of this trust shall be required to post bond or security to serve.

Comment: If a successor trustee's powers will differ from those granted to the original trustee, the drafter should delete the last sentence in this clause. For a separate clause to name a successor trustee, see form 28.14-1. For a clause providing for court appointment of a successor trustee, see form 28.15-1. On naming trustees, see §28.11. For discussion of the trustee's bond requirement, see §28.22.

28.25-1 Trustee compensation

B. *Trustee Compensation*. Trustees are entitled to reasonable compensation.

28.30-1 Power to employ agents and advisers

C. *Trustee Power to Employ Agents and Advisers*. The trustee may, in the trustee's discretion, employ and rely on the advice given by any custodian, attorney, accountant, investment adviser, corporate fiduciary, or other agents or advisers to assist the trustee in the administration of this trust. Reasonable compensation for services performed by any agent or adviser shall be paid from either principal or income of the trust estate and shall not decrease the compensation to which the trustee is entitled.

Comment: See §28.29 for discussion of delegation of a trustee's duties.

28.48-1 Trustee exculpation

D. *Exculpation of Trustee.* The trustee shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in

the business of acting as a trustee.

Comment: The drafter may want to limit the exculpation to certain trustees, such as the surviving spouse or partner. See §29.47.

28.50-1 Limitation on successor trustee liability

E. *Limitation on Successor Trustee Liability*. Any successor trustee may, in the trustee's discretion, accept as correct any accounting of trust assets made by any predecessor trustee. No successor trustee shall be under any obligation to institute any action or proceeding for the settlement of the accounts of any predecessor trustee or for any actions or omissions of any predecessor trustee.

A successor trustee may be unwilling to serve unless the will includes a clause limiting the successor's liability. See §28.49.

DIVISION SIX
TRUSTEE POWERS

29.9-1 Introductory clause granting trustee powers

For all trusts under my will, except when my will specifically provides otherwise, the trustee shall have the powers described below:

29.12-1 Investment according to prudent investor rule

A. *Investment According to Prudent Investor Rule*. The trustee may, in the trustee's discretion, invest and reinvest trust funds in every kind of property (real, personal, or mixed) and every kind of investment, specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trust, mortgage participations, market funds and index funds appropriate under the then prevailing circumstances (specifically including, but not limited to, the factors set out in Probate Code §16047(c)):

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.

In so doing, the trustee shall exercise care, skill, and caution to attain the settlor's goals under this instrument. The trustee shall consider individual investments as part of an overall investment strategy having risk and return objectives reasonably suited to the purposes of the trust. The trustee's investments may include stock in, or any common trust fund administered by, the trustee or stock in any entity owned by the trustee or that owns the trustee.

29.16-1 Power to retain any property

B. *Power to Retain Trust Property*. The trustee may, in the trustee's discretion, continue to hold any property that the trustee receives or acquires for as long as the trustee considers advisable, regardless of whether retention of the property prevents the diversification of trust investments.

Notwithstanding the foregoing powers, the aggregate return from all investments from time to time must be reasonable under the prevailing circumstances.

Comment: The drafter should use the last sentence of this clause when a portion of the trust property administered by the trustee is held in a marital deduction trust. See §29.5.

29.48-1 Power to purchase bonds at premium

C. *Power to Purchase Bonds at Premium*. The trustee may, in the trustee's discretion, purchase bonds and pay any premiums connected with the purchase that the trustee, in the trustee's discretion, considers advisable, provided, however, that each premium is repaid periodically to principal from the interest on the bond in a reasonable manner and, to the extent necessary, from the proceeds on the sale or other disposition of the bond.

Comment: See §29.47 for discussion of purchasing bonds at a premium.

29.50-1 Power to purchase bonds at discount

D. *Power to Purchase Bonds at Discount*. The trustee may, in the trustee's discretion, purchase bonds at any discount that the trustee, in the trustee's discretion, considers advisable.

If, however, the trustee determines that the current yield on the bonds is materially less than the rate of return that the trust could otherwise obtain with equivalent safety, all or part of the discount may be credited periodically to trust income in a reasonable manner.

Comment: See discussion of discount bonds in §29.49.

29.20-1 Power to retain or acquire underproductive property (modified)

E. *Power to Retain or Acquire Underproductive Property*. Subject to my spouse's power to compel the trustee to make marital trust property productive, the trustee may, in the trustee's discretion, retain or acquire underproductive property. No such retention or acquisition shall constitute a violation of any duty of the trustee.

Comment: The consequences of holding underproductive or unproductive property in a marital deduction trust are discussed in §§17.31, 29.19, 29.21.

29.44-1 Power to manage securities

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including but not limited to the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements (whether or not extending beyond the term of the trust) and enter into shareholders' agreements, including but not limited to buy-sell agreements and close corporation and S corporation shareholders' agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, in the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

Comment: On managing securities held in trust, see §29.43.

29.46-1 Power to hold securities in nominee's name or in "street name"

G. *Power to Hold Securities in Alternative Forms*. The trustee may, in the trustee's discretion:

(1) Hold securities or other property in the trustee's name as trustee under this trust, in the trustee's own name, or in the name of a nominee, including what is commonly called a "street name"; or

(2) Hold securities unregistered in such condition that ownership will pass by delivery.

Comment: See §29.45.

29.24-1 Power to sell, exchange, and repair trust property

H. *Power to Sell, Exchange, and Repair Trust Property*. The trustee may, in the trustee's discretion, manage, control, grant options on, sell (for cash or on deferred payments, with or without security), convey, exchange, partition, divide, maintain, improve, and repair trust property.

29.26-1 Power to lease, including mineral rights

I. *Power to Lease Trust Property*. The trustee may, in the trustee's discretion, lease trust property for terms within or beyond the term of the trust and for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases, pooling, and unitization agreements.

31.15-1 Disclaimer of administrative powers

J. *Disclaimer of Administrative Powers*. The trustee may, in the trustee's discretion, disclaim, release, or restrict the scope of any administrative power held in connection with any trust created under my will, whether the power is expressly granted in my will or implied by law, in a written instrument specifying the power to be disclaimed, released, or restricted and the nature of the restriction. Any power disclaimed or released shall be extinguished unless the trustee, in the trustee's discretion, appoints an independent special trustee to exercise the disclaimed or released power.

31.18-1 Power to adjust for tax consequences

K. *Power to Adjust for Tax Consequences*. The trustee may, in the trustee's discretion, take any action and make any election to minimize the tax liabilities of (1) any trust held under my will and (2) the trust's beneficiaries. The trustee may allocate the benefits among the various beneficiaries and make adjustments in the rights of any beneficiaries, or between the income and principal accounts, to compensate for the consequences of any tax election or investment or administrative decision that the trustee believes has directly or indirectly benefited one beneficiary or group of beneficiaries over others.

29.28-1 Power to borrow

L. *Power to Borrow*. The trustee may, in the trustee's discretion, borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner of the property in which the trust has an interest.

29.33-1 Power to insure

M. *Power to Insure*. The trustee may, in the trustee's discretion, carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

29.18-1 Power to abandon property

N. *Power to Abandon Trust Property*. The trustee may, in the trustee's discretion, abandon any property or interest in property belonging to the trust if the trustee determines, in the trustee's discretion, that the abandonment is in the best interests of the trust and its beneficiaries.

29.30-1 Power to initiate and defend litigation

O. *Power to Initiate and Defend Litigation*. The trustee may, in the trustee's discretion, initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate that the trustee considers advisable. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

29.31-1 Power to compromise claims

P. *Power to Compromise Claims*. The trustee may, in the trustee's discretion, compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust. The trustee's decision in this regard shall be conclusive. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

31.13-1 Power to withhold distribution pending tax payment and conflict resolution

Q. *Power to Withhold Distribution*. When an event requires the trustee to divide, segregate, or distribute trust property, the trustee may delay the division, segregation, or distribution of all or part of the property for the period of time necessary to ascertain and provide for the payment of any tax, claim, or other liability against the property. During this period, the trustee may pay the net income of the trust property to the persons and entities entitled to it. The provisions of this paragraph shall not be deemed to postpone or defer the vesting of any interest created by the dispositive provisions of the trust.

31.4-1 Broad powers of distribution

R. *Power to Divide Trust Property Into Shares*. When the trustee must divide any trust property into parts or shares for the purpose of distribution or otherwise, the trustee may, in the trustee's discretion, make the division and distribution in identical interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

30.10-1 Uniform Principal and Income Act to govern allocations of principal and income

S. *Allocation of Principal and Income*. Except when my will specifically provides otherwise, the trustee shall determine what is principal and income of the trust estate and apportion and allocate receipts, expenses, and other charges between those accounts according to the provisions of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375).

30.6-1 Physical segregation of separate trusts not required; division into separate trusts permitted

T. *Segregation of Assets Not Required*. Except with respect to trusts created under my will that qualify for the marital deduction, the trustee shall not be required to segregate physically or divide assets among the various trusts, except on termination of any of the trusts. The trustee, however, shall be required to keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms.

31.10-1 Trustee action before notice of events affecting beneficial interests

U. *No Liability for Trustee Action Before Notice of Events*. Unless the trustee receives written notice of the occurrence of an event affecting the beneficial interests in any trust held under my will, the trustee shall not be liable to any beneficiary of the trust for distributions made or other actions taken by the trustee in good faith as though this event had not occurred.

31.11-1 Trustee may distribute if no notice of exercise of power of appointment

V. *Distribution of Property Subject to Power of Appointment*. The trustee may distribute assets held in trust and subject to a power of appointment as if the power had not been exercised, if the trustee has not received any document purporting to exercise the power by the earlier of:

(1) Six months after the death of any person holding a power of appointment over the assets; or

(2) If the powerholder is purported to have a will, expiration of the statutory period in the decedent's domicile within which a will contest must be filed to contest the purported will.

If a document purporting to exercise the power is subsequently located, the trustee shall not be liable to the appointees under that exercise, and the rights of the appointees and the persons to whom the trustee distributed the assets shall be determined as provided by law.

31.26-1 Additions to trust authorized

W. *Additions to Trust Authorized*. With the trustee's written consent, additional property may be added at any time from any source to any trust held under my will.

31.33-1 All powers exercisable solely in fiduciary capacity

X. *Powers Exercisable Solely in Fiduciary Capacity*. The trustee shall exercise all powers in the trustee's fiduciary capacity. The trustee shall have no power under any provision of my will to enlarge or shift any of the beneficial interests under any trust created under my will except as an incidental consequence of the discharge of the trustee's fiduciary duties.

31.31-1 Trustee powers continue until trust distribution

Y. *Powers Continue Until Distribution of Trust Property*. All powers, duties, and immunities of the trustee shall continue after termination of any trust created under my will for a reasonable period until actual distribution of the trust property.

12.81-1 Retention in further trust until specified age (modified)

DIVISION SEVEN
DISTRIBUTIONS TO YOUNG PERSONS

***A. Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, the personal representative or trustee making the distribution shall be the trustee. The separate trust shall be administered as follows:**

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

7. *Trust Administration*. To the extent not inconsistent with the provisions of this Division, the provisions of the Divisions of this will entitled "Office of Trustee," "Trustee Powers," "Choice of Law," "Spendthrift Clause," and "Perpetuities" apply to any trust established by this paragraph.

31.34-1 Choice of law

DIVISION EIGHT
CHOICE OF LAW

Any trust created under my will shall be construed in accordance with the laws of the State of California.

27.9-1 Long-form spendthrift clause

DIVISION NINE
SPENDTHRIFT CLAUSE

If the creditor of any beneficiary who is entitled to any distributions from a trust established under this will (other than from any marital deduction trust requiring the distribution of all income or any qualified Subchapter S trust) attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, notwithstanding any other provision in this instrument, the distribution set aside for that beneficiary shall be disposed of, until the release of the writ of attachment or garnishment or other process, as follows:

(1) The trustee shall pay to or apply for the benefit of that beneficiary all sums that the trustee, in the trustee's discretion, determines to be necessary for the reasonable health, education (including study at an institution of higher learning or vocational school), and support of the beneficiary according to his or her accustomed mode of life; and

(2) The portion of the distribution that the trustee determines to exceed the amount necessary for the health, education (including study at an institution of higher learning or vocational school), and support shall, in the trustee's discretion, either be added to and become principal in whole or in part, or be paid to or applied for the benefit of the other beneficiaries then entitled to receive payments from any trust established under my will, in proportion to their respective interests in the trust estate; or, if there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person or persons presumptively entitled to the next eventual interest, in proportion to their respective interests in the trust.

Comment: Because the clause directs the accumulation of income, which would disqualify the trust for the marital deduction, the clause is specifically made inapplicable to the marital trust. See §§19.4, 27.6.

DIVISION TEN
PERPETUITIES

34.41-1 Cutoff clause

A. *Termination.* Unless terminated earlier, any trust created by my will or by the exercise of any power of appointment conferred by my will (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*name or description of class to be measuring lives*]_ _ living at my death.

34.41-2 Postcutoff distribution clause

***B. Distribution on Termination.* The principal and undistributed income of any trust terminated under this clause shall be distributed to the trust's income beneficiaries in the same proportions in which they are entitled to receive income immediately before termination. If those proportions are not fixed by the terms of the trust, distribution shall be by right of representation to issue of _ _[*name*]_ _, who are then entitled or authorized to receive income distributions from the trust.**

DIVISION ELEVEN
EXECUTORS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executor.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause,

see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix E

Will With Bypass Trust for Married Testator

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

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

Description

This is a will for a married testator, who would leave the testator's entire estate to the spouse but for tax concerns. The will is substantially similar to that in Appendix D, except that the martial deduction gift is made to the spouse outright rather than to a qualified terminable interest property (QTIP) trust. The gift to the spouse is made using a formula clause, and the residue of the estate passes to the bypass trust. If the surviving spouse is not a citizen, it may be necessary for the surviving spouse to transfer property received under the will to a qualified domestic trust (QDOT) to receive a federal estate tax marital deduction. See §§19.32-19.40 for discussion and forms.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Spouse

C. Children and Issue.

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. Gift of Tangible Personal Property

B. Fractional Share Marital Formula Gift to Spouse and Bypass Trust

C. If Spouse Does Not Survive

DIVISION THREE: BYPASS TRUST

A. Income to Spouse for Life

B. Distribution of Principal

C. Five or Five Withdrawal Power

D. Distribution on Spouse's Death

DIVISION FOUR: OFFICE OF TRUSTEE

A. Nomination of Trustee

B. Trustee Compensation

C. Trustee Power to Employ Agents and Advisers

D. Exculpation of Trustee

E. Limitation on Successor Trustee Liability

DIVISION FIVE: TRUSTEE POWERS

A. Investment According to Prudent Investor Rule

B. Power to Retain Trust Property

C. Power to Purchase Bonds at Premium

D. Power to Purchase Bonds at Discount

E. Power to Retain or Acquire Underproductive Property

F. Power to Manage Securities

G. Power to Hold Securities in Alternative Forms

H. Power to Sell, Exchange, or Repair Trust Property

I. Power to Lease Trust Property

J. Disclaimer of Administrative Powers

K. Power to Adjust for Tax Consequences

L. Power to Borrow

M. Power to Insure

N. Power to Abandon Trust Property

O. Power to Initiate and Defend Litigation

P. Power to Compromise Claims

Q. Power to Withhold Distribution

R. Power to Divide Trust Property Into Shares

S. Allocation of Principal and Income

T. Segregation of Assets Not Required

U. No Liability for Trustee Action Before Notice of Event

V. Distribution of Property Subject to Power of Appointment

W. Additions to Trust Authorized

X. Powers Exercised Solely in Fiduciary Capacity

Y. Powers Continue Until Distribution of Trust Property

DIVISION SIX: DISTRIBUTIONS TO YOUNG PERSONS

DIVISION SEVEN: CHOICE OF LAW

DIVISION EIGHT: SPENDTHRIFT CLAUSE

DIVISION NINE: PERPETUITIES

DIVISION TEN: EXECUTORS

A. Nomination of Executor

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets in a foreign country only, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.46-1 Gift of tangible personal property to individual

12.23-1 Survivorship conditions for particular gifts (modified)

A. *Gifts of Tangible Personal Property*. I give all my jewelry, clothing, household furniture and furnishings, personal automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in will or in any other manner, together with any insurance on the property, to my spouse if my spouse survives me by 30 days. If my spouse fails to so survive me, this gift shall lapse.

Comment: For discussion of a gift of tangible personal property, see §§12.36-12.44. For discussion of a shorter survivorship period for gifts of tangible personal property, see §12.22.

17.81C-1 Fractional share marital formula (modified)

B. *Fractional Share Marital Formula Gift to Spouse and Bypass Trust*. If my spouse survives me by 30 days, I give the residue of my estate in shares to my spouse and the trustees of the bypass trust. The share of my spouse shall equal the smallest fractional share of the residue that, if taken as a federal estate tax marital deduction, will entirely eliminate (or reduce to the maximum extent possible) any federal estate tax on my death, after taking into account all factors relevant to this estate tax objective, including but not limited to:

(1) All deductions claimed and allowed in determining the estate tax payable by reason of my death.

(2) The net value of all other property included in my gross estate, whether or not it is given under this will and whether it passes at the time of my death or has passed before my death to or in trust for my spouse, so that it is included in my gross estate and qualifies for the federal estate tax marital deduction. If my spouse disclaims any property that would otherwise qualify for the federal estate tax marital deduction, this disclaimer shall be disregarded.

(3) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for: (a) death taxes paid in the estate of one whose death occurs after mine; or (b) any state death tax unless, and to the extent, a death tax would be payable to the state or states regardless of the federal credit.

The bypass trust share shall equal the remaining share of the residue.

These shares shall be determined using the values of assets as finally determined for federal estate tax purposes. The residuary gifts to my spouse and the bypass trust may be satisfied in cash or in kind, in undivided interests, or partly in each, each such asset to be valued for this purpose on the date it is distributed. Any assets that are not eligible for the federal estate tax marital deduction shall be allocated to the bypass trust. Any insurance on my spouse's life and any assets for which a credit for foreign death taxes is allowable for federal estate tax purposes shall be allocated to the bypass trust, unless there is insufficient other property to fully fund the gift to my spouse.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

***D. If Spouse Does Not Survive.* Subject to the provisions of the Division of this will entitled "Distributions to Young Persons," if my spouse does not survive me by 30 days, I give all of estate in equal shares to my children who so survive me, but if one or more of my children does not so survive me, I give all of my estate to my issue who so survive me, per capita at each generation.**

DIVISION THREE
BYPASS TRUST

20.19-1 Introduction to bypass trust

20.21-1 Payment of income

The trustee shall hold, administer, and distribute all property allocated to the bypass trust as follows:

A. *Income to Spouse for Life.* During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Undistributed income shall be added to principal.

19.25-1 Discretionary payment of principal (ascertainable standard)

19.26-1 Relevance of other income sources

B. *Distribution of Principal*. The trustee shall pay to or apply for the benefit of my spouse as much of the trust principal, up to the whole of the trust, as the trustee considers appropriate for my spouse's health, support, education, and maintenance to maintain at a minimum my spouse's accustomed manner of living. In making these distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and readily available.

21.31A-1 "Five or five" withdrawal power

C. *Withdrawal Power*. In addition to receiving other distributions authorized by this document, my spouse may withdraw property from the trust by delivering a written request to the trustee, subject to the following terms and conditions:

(1) My spouse shall have no withdrawal rights under this provision during any calendar year in which my spouse is not alive on the last day of the calendar year, but the written request may be delivered in advance.

(2) The right to request a withdrawal in a calendar year shall lapse at 6 p.m. on the last day of the calendar year. Any request delivered to the trustee after that time shall be void. Time is of the essence.

(3) The maximum amount that may be withdrawn under this paragraph in any calendar year is the greater of $5000 or 5 percent of the value of the principal of the trust, determined as of the close of business on the last day of the calendar year. The trustee may delay actual distribution for a reasonable time. If my spouse exercises the power in a calendar year but fails to survive until actual distribution, the distribution shall be paid to such person or entity as my spouse may direct, if any, and otherwise to my spouse's. Any such directive must be signed by my spouse or my spouse's duly authorized attorney-in-fact and delivered to the trustee during the powerholder's lifetime.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

D. *Distribution on Spouse's Death.* On the death of my spouse the remaining trust property shall be distributed in equal shares to my children who survive my spouse by 30 days, but if one or more of my children does not so survive, the trustee shall distribute the trust property to my issue who survive my spouse, per capita at each generation. If any distributee is under age _ _[*number*]_ _, the share of that distributee shall be retained in trust in accordance with the provisions of the Division of this will entitled "Distributions to Young Persons."

DIVISION FOUR
OFFICE OF TRUSTEE

28.12-1 Nomination of trustee and successors for all trusts

28.23-1 Waiver of bond

A. *Nomination of Trustee*. I name as trustee and successor trustee of the bypass trust, in the order and priority indicated, the following:

First: _ _[*Name of trustee*]_ _
Second: _ _[*Name of successor trustee*]_ _

All powers vested in the original trustee shall be exercisable by any successor trustee. No named or unnamed, resident or nonresident trustee of this trust shall be required to post bond or security to serve.

Comment: If a successor trustee's powers will differ from those granted to the original trustee, the drafter should delete the last sentence in this clause. For a separate clause to name a successor trustee, see form 28.14-1. For a clause providing for court appointment of a successor trustee, see form 28.15-1. On naming trustees, see §28.11. For discussion of the trustee's bond requirement, see §28.22.

28.25-1 Trustee compensation

B. *Trustee Compensation*. Trustees are entitled to reasonable compensation.

28.30-1 Power to employ agents and advisers

C. *Trustee Power to Employ Agents and Advisers*. The trustee may, in the trustee's discretion, employ and rely on the advice given by any custodian, attorney, accountant, investment adviser, corporate fiduciary, or other agents or advisers to assist the trustee in the administration of this trust. Reasonable compensation for services performed by any agent or adviser shall be paid from either principal or income of the trust estate and shall not decrease the compensation to which the trustee is entitled.

Comment: See §28.29 for discussion of delegation of a trustee's duties.

28.48-1 Trustee exculpation

D. *Exculpation of Trustee.* The trustee shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in the business of acting as a trustee.

Comment: The drafter may want to limit the exculpation to certain trustees, such as the surviving spouse or partner. See §29.47.

28.50-1 Limitation on successor trustee liability

E. *Limitation on Successor Trustee Liability*. Any successor trustee may, in the trustee's discretion, accept as correct any accounting of trust assets made by any predecessor trustee. No successor trustee shall be under any obligation to institute any action or proceeding for the settlement of the accounts of any predecessor trustee or for any actions or omissions of any predecessor trustee.

A successor trustee may be unwilling to serve unless the will includes a clause limiting the successor's liability. See §28.49.

DIVISION FIVE
TRUSTEE POWERS

29.9-1 Introductory clause granting trustee powers

For all trusts under my will, except when my will specifically provides otherwise, the trustee shall have the powers described below:

29.12-1 Investment according to prudent investor rule

A. *Investment According to Prudent Investor Rule*. The trustee may, in the trustee's discretion, invest and reinvest trust funds in every kind of property (real, personal, or mixed) and every kind of investment, specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trust, mortgage participations, market funds and index funds appropriate under the then-prevailing circumstances (specifically including, but not limited to, the factors set out in Probate Code §16047(c)):

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.

In so doing, the trustee shall exercise care, skill, and caution to attain the settlor's goals under this instrument. The trustee shall consider individual investments as part of an overall investment strategy having risk and return objectives reasonably suited to the purposes of the trust. The trustee's investments may include stock in, or any common trust fund administered by, the trustee or stock in any entity owned by the trustee or that owns the trustee.

29.16-1 Power to retain any property

B. *Power to Retain Trust Property*. The trustee may, in the trustee's discretion, continue to hold any property

that the trustee receives or acquires for as long as the trustee considers advisable, regardless of whether retention of the property prevents the diversification of trust investments.

Notwithstanding the foregoing powers, the aggregate return from all investments from time to time must be reasonable under the prevailing circumstances.

Comment: The drafter should use the last sentence of this clause when a portion of the trust property administered by the trustee is held in a marital deduction trust. See §29.5.

29.48-1 Power to purchase bonds at premium

C. *Power to Purchase Bonds at Premium*. The trustee may, in the trustee's discretion, purchase bonds and pay any premiums connected with the purchase that the trustee, in the trustee's discretion, considers advisable, provided, however, that each premium is repaid periodically to principal from the interest on the bond in a reasonable manner and, to the extent necessary, from the proceeds on the sale or other disposition of the bond.

Comment: See §29.47 for discussion of purchasing bonds at a premium.

29.50-1 Power to purchase bonds at discount

D. *Power to Purchase Bonds at Discount*. The trustee may, in the trustee's discretion, purchase bonds at any discount that the trustee, in the trustee's discretion, considers advisable.

If, however, the trustee determines that the current yield on the bonds is materially less than the rate of return that the trust could otherwise obtain with equivalent safety, all or part of the discount may be credited periodically to trust income in a reasonable manner.

Comment: See discussion of discount bonds in §29.49.

29.20-1 Power to retain or acquire underproductive property (modified)

E. *Power to Retain or Acquire Underproductive Property*. The trustee in the trustee's discretion, may retain or acquire underproductive property. No such retention or acquisition shall constitute a violation of any duty of the trustee.

Comment: The consequences of holding underproductive or unproductive property in a marital deduction trust are discussed in §§17.31, 29.19, 29.21.

29.44-1 Power to manage securities

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including but not limited to the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements (whether or not extending beyond the term of the trust) and enter into shareholders' agreements, including but not limited to buy-sell agreements and close corporation and S corporation shareholders' agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, in the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

Comment: On managing securities held in trust, see §29.43.

29.46-1 Power to hold securities in nominee's name or in "street name"

G. *Power to Hold Securities in Alternative Forms*. The trustee may, in the trustee's discretion:

(1) Hold securities or other property in the trustee's name as trustee under this trust, in the trustee's own name, or in the name of a nominee, including what is commonly called a "street name"; or

(2) Hold securities unregistered in such condition that ownership will pass by delivery.

Comment: See §29.45.

29.24-1 Power to sell, exchange, and repair trust property

H. *Power to Sell, Exchange, and Repair Trust Property*. The trustee may, in the trustee's discretion, manage, control, grant options on, sell (for cash or on deferred payments, with or without security), convey, exchange, partition, divide, maintain, improve, and repair trust property.

29.26-1 Power to lease, including mineral rights

I. *Power to Lease Trust Property*. The trustee may, in the trustee's discretion, lease trust property for terms within or beyond the term of the trust and for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases, pooling, and unitization agreements.

31.15-1 Disclaimer of administrative powers

J. *Disclaimer of Administrative Powers*. The trustee may, in the trustee's discretion, disclaim, release, or restrict the scope of any administrative power held in connection with any trust created under my will, whether the power is expressly granted in my will or implied by law, in a written instrument specifying the power to be disclaimed, released, or restricted and the nature of the restriction. Any power disclaimed or released shall be extinguished unless the trustee, in the trustee's discretion, appoints an independent special trustee to exercise the disclaimed or released power.

31.18-1 Power to adjust for tax consequences

K. *Power to Adjust for Tax Consequences*. The trustee may, in the trustee's discretion, take any action and make any election to minimize the tax liabilities of (1) any trust held under my will and (2) the trust's beneficiaries. The trustee may allocate the benefits among the various beneficiaries and make adjustments in the rights of any beneficiaries, or between the income and principal accounts, to compensate for the consequences of any tax election or investment or administrative decision that the trustee believes has directly or indirectly benefited one beneficiary or group of beneficiaries over others.

29.28-1 Power to borrow

L. *Power to Borrow*. The trustee may, in the trustee's discretion, borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner of the property in which the trust has an interest.

29.33-1 Power to insure

M. *Power to Insure*. The trustee may, in the trustee's discretion, carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

29.18-1 Power to abandon property

N. *Power to Abandon Trust Property*. The trustee may, in the trustee's discretion, abandon any property or interest in property belonging to the trust if the trustee determines, in the trustee's discretion, that the abandonment is in the best interests of the trust and its beneficiaries.

29.30-1 Power to initiate and defend litigation

O. *Power to Initiate and Defend Litigation*. The trustee may, in the trustee's discretion, initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate that the trustee considers advisable. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

29.31-1 Power to compromise claims

P. *Power to Compromise Claims*. The trustee may, in the trustee's discretion, compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust. The trustee's decision in this regard shall be conclusive. The trustee's powers under this paragraph shall apply during the

term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

31.13-1 Power to withhold distribution pending tax payment and conflict resolution

Q. *Power to Withhold Distribution*. When an event requires the trustee to divide, segregate, or distribute trust property, the trustee may delay the division, segregation, or distribution of all or part of the property for the period of time necessary to ascertain and provide for the payment of any tax, claim, or other liability against the property. During this period, the trustee may pay the net income of the trust property to the persons and entities entitled to it. The provisions of this paragraph shall not be deemed to postpone or defer the vesting of any interest created by the dispositive provisions of the trust.

31.4-1 Broad powers of distribution

R. *Power to Divide Trust Property Into Shares*. When the trustee must divide any trust property into parts or shares for the purpose of distribution or otherwise, the trustee may, in the trustee's discretion, make the division and distribution in identical interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

30.10-1 Uniform Principal and Income Act to govern allocations of principal and income

S. *Allocation of Principal and Income*. Except when my will specifically provides otherwise, the trustee shall determine what is principal and income of the trust estate and apportion and allocate receipts, expenses, and other charges between those accounts according to the provisions of the Uniform Principal and Income Act (UPAIA) (Probate Code §§16320-16375).

30.6-1 Physical segregation of separate trusts not required; division into separate trusts permitted

T. *Segregation of Assets Not Required*. Except with respect to trusts created under my will that qualify for the marital deduction, the trustee shall not be required to segregate physically or divide assets among the various trusts, except on termination of any of the trusts. The trustee, however, shall be required to keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms.

31.10-1 Trustee action before notice of events affecting beneficial interests

U. *No Liability for Trustee Action Before Notice of Events*. Unless the trustee receives written notice of the occurrence of an event affecting the beneficial interests in any trust held under my will, the trustee shall not be liable to any beneficiary of the trust for distributions made or other actions taken by the trustee in good faith as though this event had not occurred.

31.11-1 Trustee may distribute if no notice of exercise of power of appointment

V. *Distribution of Property Subject to Power of Appointment*. The trustee may distribute assets held in trust and subject to a power of appointment as if the power had not been exercised, if the trustee has not received any document purporting to exercise the power by the earlier of:

(1) Six months after the death of any person holding a power of appointment over the assets; or

(2) If the powerholder is purported to have a will, expiration of the statutory period in the decedent's domicile within which a will contest must be filed to contest the purported will.

If a document purporting to exercise the power is subsequently located, the trustee shall not be liable to the appointees under that exercise, and the rights of the appointees and the persons to whom the trustee distributed the assets shall be determined as provided by law.

31.26-1 Additions to trust authorized

W. *Additions to Trust Authorized*. With the trustee's written consent, additional property may be added at any time from any source to any trust held under my will.

31.33-1 All powers exercisable solely in fiduciary capacity

X. *Powers Exercisable Solely in Fiduciary Capacity*. The trustee shall exercise all powers in the trustee's

fiduciary capacity. The trustee shall have no power under any provision of my will to enlarge or shift any of the beneficial interests under any trust created under my will except as an incidental consequence of the discharge of the trustee's fiduciary duties.

31.31-1 Trustee powers continue until trust distribution

Y. *Powers Continue Until Distribution of Trust Property*. All powers, duties, and immunities of the trustee shall continue after termination of any trust created under my will for a reasonable period until actual distribution of the trust property.

12.81-1 Retention in further trust until specified age (modified)

DIVISION SIX
DISTRIBUTIONS TO YOUNG PERSONS

A. *Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, the personal representative or trustee making the distribution shall be the trustee. The separate trust shall be administered as follows:

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

7. *Trust Administration*. To the extent not inconsistent with the provisions of this Division, the provisions of the Divisions of this will entitled "Office of Trustee," "Trustee Powers," "Choice of Law," "Spendthrift Clause," and "Perpetuities" apply to any trust established by this paragraph.

31.34-1 Choice of law

DIVISION SEVEN
CHOICE OF LAW

Any trust created under my will shall be construed in accordance with the laws of the State of California.

27.9-1 Long-form spendthrift clause

DIVISION EIGHT
SPENDTHRIFT CLAUSE

If the creditor of any beneficiary who is entitled to any distributions from a trust established under this will (other than from any marital deduction trust requiring the distribution of all income or any qualified Subchapter S trust) attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, notwithstanding any other provision in this instrument, the distribution set aside for that beneficiary shall be disposed of, until the release of the writ of attachment or garnishment or other process, as follows:

(1) The trustee shall pay to or apply for the benefit of that beneficiary all sums that the trustee, in the trustee's discretion, determines to be necessary for the reasonable health, education (including study at an institution of higher learning or vocational school), and support of the beneficiary according to his or her accustomed mode of life; and

(2) The portion of the distribution that the trustee determines to exceed the amount necessary for the health, education (including study at an institution of higher learning or vocational school), and support shall, in the trustee's discretion, either be added to and become principal in whole or in part, or be paid to or applied for the benefit of the other beneficiaries then entitled to receive payments from any trust established under my will, in proportion to their respective interests in the trust estate; or, if there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person or persons presumptively entitled to the next eventual interest, in proportion to their respective interests in the trust.

Comment: Because the clause directs the accumulation of income, which would disqualify the trust for the marital deduction, the clause is specifically made inapplicable to the marital trust. See §§19.4, 27.6.

DIVISION NINE
PERPETUITIES

34.41-1 Cutoff clause

A. *Termination.* Unless terminated earlier, any trust created by my will or by the exercise of any power of appointment conferred by my will (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*name or description of class to be measuring lives*]_ _ living at my death.

34.41-2 Postcutoff distribution clause

B. *Distribution on Termination.* The principal and undistributed income of any trust terminated under this clause shall be distributed to the trust's income beneficiaries in the same proportions in which they are entitled to receive income immediately before termination. If those proportions are not fixed by the terms of the trust, distribution shall be by right of representation to issue of _ _[*name*]_ _, who are then entitled or authorized to receive income distributions from the trust.

DIVISION TEN
EXECUTORS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executor*. I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix F

Will for Married Testator With Standby Disclaimer Trust

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

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

Description

This is a will for a married testator who desires to leave all property to the testator's spouse and anticipates that there will be no need to establish a bypass trust for tax purposes. If the facts known at the time of death indicate that a bypass trust would have been desirable, the spouse will have the option of disclaiming property that will then pass to a disclaimer trust. The disclaimer trust serves substantially the same purpose as a bypass trust—the trust makes property available to the spouse as needed but property not distributed to the surviving spouse will not be included in the surviving spouse's estate for estate tax purposes. For an important discussion of disclaimer trusts, see §§20.27-20.32A. In other respects, the will is substantially similar to that in Appendix E.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

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WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets in a foreign country only, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.46-1 Gift of tangible personal property to individual

12.23-1 Survivorship conditions for particular gifts (modified)

A. *Gifts of Tangible Personal Property*. I give all my jewelry, clothing, household furniture and furnishings, personal automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in will or in any other manner, together with any insurance on the property, to my spouse if my spouse survives me by 30 days. If my spouse fails to so survive me, this gift shall lapse.

Comment: For discussion of a gift of tangible personal property, see §§12.36-12.44. For discussion of a shorter survivorship period for gifts of tangible personal property, see §12.22.

12.80-1 Gift of residue to spouse (modified)

B. *Gift of Residue to Spouse and Disposition of Disclaimed Property.* I give the residue of my estate to my spouse if my spouse survives me by 30 days. If my spouse survives me by 30 days but disclaims any interests in any property otherwise passing to my spouse under this will, and the disclaimer is a qualified disclaimer under Internal Revenue Code §2518, the disclaimed interests shall be distributed to the trustees of the Disclaimer Trust.

12.81-1 Retention in further trust until specified age

C. *If Spouse Does Not Survive.* Subject to the provisions of the Division of this will entitled "Distributions to Young Persons", if my spouse does not survive me by 30 days, I give all of my estate in equal shares to my children who so survive me, but if one or more of my children does not so survive me, I give all of my estate to my issue who so survive me, per capita at each generation.

DIVISION THREE
DISCLAIMER TRUST

20.19-1 Introduction to bypass trust

20.21-1 Payment of income

The trustee shall hold, administer, and distribute all property allocated to the disclaimer trust as follows:

A. *Income to Spouse for Life.* During my spouse's lifetime, the trustee shall pay to or apply for the benefit of my spouse as much of the trust income as my spouse requests. Undistributed income shall be added to principal.

19.25-1 Discretionary payment of principal (ascertainable standard)

19.26-1 Relevance of other income sources

B. *Distribution of Principal*. The trustee shall pay to or apply for the benefit of my spouse as much of the trust principal, up to the whole of the trust, as the trustee considers appropriate for my spouse's health, support, education, and maintenance to maintain at a minimum my spouse's accustomed manner of living. In making these distributions, the trustee may, in the trustee's discretion, consider any other income or resources of my spouse known to the trustee and readily available.

21.31A-1 "Five or five" withdrawal power

C. *Withdrawal Power*. In addition to receiving other distributions authorized by this document, my spouse may withdraw property from the trust by delivering a written request to the trustee, subject to the following terms and conditions:

(1) My spouse shall have no withdrawal rights under this provision during any calendar year in which my spouse is not alive on the last day of the calendar year, but the written request may be delivered in advance.

(2) The right to request a withdrawal in a calendar year shall lapse at 6 p.m. on the last day of the calendar year. Any request delivered to the trustee after that time shall be void. Time is of the essence.

(3) The maximum amount that may be withdrawn under this paragraph in any calendar year is the greater of $5000 or 5 percent of the value of the principal of the trust, determined as of the close of business on the last day of the calendar year. The trustee may delay actual distribution for a reasonable time. If my spouse exercises the power in a calendar year but fails to survive until actual distribution, the distribution shall be paid to such person or entity as my spouse may direct, if any, and otherwise to my spouse's. Any such directive must be signed by my spouse or my spouse's duly authorized attorney-in-fact and delivered to the trustee during the powerholder's lifetime.

12.80-1 Gift of residue to spouse with gift over to issue (modified)

12.81-1 Retention in further trust until specified age

D. *Distribution on Spouse's Death.* On the death of my spouse the remaining trust property shall be

distributed in equal shares to my children who survive my spouse by 30 days, but if one or more of my children does not so survive, the trustee shall distribute the trust property to my issue who so survive my spouse, per capita at each generation. If any distributee is under age _ _[*number*]_ _, the share of that distributee shall be retained in trust in accordance with the provisions of the Division of this will entitled "Distributions to Young Persons."

DIVISION FOUR
OFFICE OF TRUSTEE

28.12-1 Nomination of trustee and successors for all trusts

28.23-1 Waiver of bond

A. *Nomination of Trustee*. I name as trustee and successor trustee of the disclaimer trust, in the order and priority indicated, the following:

First: My Spouse
Second: _ _[*Name of successor trustee*]_ _

All powers vested in the original trustee shall be exercisable by any successor trustee. No named or unnamed, resident or nonresident trustee of this trust shall be required to post bond or security to serve.

Comment: Normally the spouse should be nominated as the first trustee. Otherwise the spouse will be less likely to make the disclaimer needed to create the trust. On naming trustees, see §28.11. For discussion of the trustee's bond requirement, see §28.22.

28.25-1 Trustee compensation

B. *Trustee Compensation*. Trustees are entitled to reasonable compensation.

28.30-1 Power to employ agents and advisers

C. *Trustee Power to Employ Agents and Advisers*. The trustee may, in the trustee's discretion, employ and rely on the advice given by any custodian, attorney, accountant, investment adviser, corporate fiduciary, or other agents or advisers to assist the trustee in the administration of this trust. Reasonable compensation for services performed by any agent or adviser shall be paid from either principal or income of the trust estate and shall not decrease the compensation to which the trustee is entitled.

Comment: See §28.29 for discussion of delegation of a trustee's duties.

28.48-1 Trustee exculpation

D. *Exculpation of Trustee.* The trustee shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in the business of acting as a trustee.

Comment: The drafter may want to limit the exculpation to certain trustees, such as the surviving spouse or partner. See §29.47.

28.50-1 Limitation on successor trustee liability

E. *Limitation on Successor Trustee Liability*. Any successor trustee may, in the trustee's discretion, accept as correct any accounting of trust assets made by any predecessor trustee. No successor trustee shall be under any obligation to institute any action or proceeding for the settlement of the accounts of any predecessor trustee or for any actions or omissions of any predecessor trustee.

A successor trustee may be unwilling to serve unless the will includes a clause limiting the successor's liability. See §28.49.

DIVISION FIVE
TRUSTEE POWERS

29.9-1 Introductory clause granting trustee powers

For all trusts under my will, except when my will specifically provides otherwise, the trustee shall have the powers described below:

29.12-1 Investment according to prudent investor rule

A. *Investment According to Prudent Investor Rule*. The trustee may, in the trustee's discretion, invest and reinvest trust funds in every kind of property (real, personal, or mixed) and every kind of investment, specifically including, but not limited to, corporate obligations of every kind; preferred or common stocks; shares of investment trusts, investment companies, and mutual funds; life insurance policies; notes, real estate, bonds, debentures, mortgages, deeds of trust, mortgage participations, market funds and index funds appropriate under the then prevailing circumstances (specifically including, but not limited to, the factors set out in Probate Code §16047(c)):

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.

In so doing, the trustee shall exercise care, skill, and caution to attain the settlor's goals under this instrument. The trustee shall consider individual investments as part of an overall investment strategy having risk and return objectives reasonably suited to the purposes of the trust. The trustee's investments may include stock in, or any common trust fund administered by, the trustee or stock in any entity owned by the trustee or that owns the trustee.

29.16-1 Power to retain any property

B. *Power to Retain Trust Property*. The trustee may, in the trustee's discretion, continue to hold any property that the trustee receives or acquires for as long as the trustee considers advisable, regardless of whether retention of the property prevents the diversification of trust investments.

Notwithstanding the foregoing powers, the aggregate return from all investments from time to time must be reasonable under the prevailing circumstances.

Comment: The drafter should use the last sentence of this clause when a portion of the trust property administered by the trustee is held in a marital deduction trust. See §29.5.

29.48-1 Power to purchase bonds at premium

C. *Power to Purchase Bonds at Premium*. The trustee may, in the trustee's discretion, purchase bonds and pay any premiums connected with the purchase that the trustee, in the trustee's discretion, considers advisable, provided, however, that each premium is repaid periodically to principal from the interest on the bond in a reasonable manner and, to the extent necessary, from the proceeds on the sale or other disposition of the bond.

Comment: See §29.47 for discussion of purchasing bonds at a premium.

29.50-1 Power to purchase bonds at discount

D. *Power to Purchase Bonds at Discount*. The trustee may, in the trustee's discretion, purchase bonds at any discount that the trustee, in the trustee's discretion, considers advisable.

If, however, the trustee determines that the current yield on the bonds is materially less than the rate of return that the trust could otherwise obtain with equivalent safety, all or part of the discount may be credited

periodically to trust income in a reasonable manner.

Comment: See discussion of discount bonds in §29.49.

29.20-1 Power to retain or acquire underproductive property (modified)

E. *Power to Retain or Acquire Underproductive Property*. The trustee in the trustee's discretion, may retain or acquire underproductive property. No such retention or acquisition shall constitute a violation of any duty of the trustee.

Comment: The consequences of holding underproductive or unproductive property in a marital deduction trust are discussed in §§17.31, 29.19, 29.21.

29.44-1 Power to manage securities

F. *Power to Manage Securities*. The trustee shall have all the rights, powers, and privileges of an owner of the securities held in the trust, including but not limited to the powers to:

(1) Vote, give proxies, and pay assessments;

(2) Participate in voting trusts and pooling agreements (whether or not extending beyond the term of the trust) and enter into shareholders' agreements, including but not limited to buy-sell agreements and close corporation and S corporation shareholders' agreements;

(3) Consent to foreclosures, reorganizations, consolidations, mergers, and liquidations;

(4) Deposit securities with and transfer title to any protective or other committee on any terms that the trustee, in the trustee's discretion, considers advisable; and

(5) Exercise or sell stock subscription or conversion rights.

Comment: On managing securities held in trust, see §29.43.

29.46-1 Power to hold securities in nominee's name or in "street name"

G. *Power to Hold Securities in Alternative Forms*. The trustee may, in the trustee's discretion:

(1) Hold securities or other property in the trustee's name as trustee under this trust, in the trustee's own name, or in the name of a nominee, including what is commonly called a "street name"; or

(2) Hold securities unregistered in such condition that ownership will pass by delivery.

Comment: See §29.45.

29.24-1 Power to sell, exchange, and repair trust property

H. *Power to Sell, Exchange, and Repair Trust Property*. The trustee may, in the trustee's discretion, manage, control, grant options on, sell (for cash or on deferred payments, with or without security), convey, exchange, partition, divide, maintain, improve, and repair trust property.

29.26-1 Power to lease, including mineral rights

I. *Power to Lease Trust Property*. The trustee may, in the trustee's discretion, lease trust property for terms within or beyond the term of the trust and for any purpose (including exploration for and removal of gas, oil, minerals, and geothermal energy) and enter into community oil leases, pooling, and unitization agreements.

31.15-1 Disclaimer of administrative powers

J. *Disclaimer of Administrative Powers*. The trustee may, in the trustee's discretion, disclaim, release, or restrict the scope of any administrative power held in connection with any trust created under my will, whether the power is expressly granted in my will or implied by law, in a written instrument specifying the power to be disclaimed, released, or restricted and the nature of the restriction. Any power disclaimed or released shall be extinguished unless the trustee, in the trustee's discretion, appoints an independent special trustee to exercise the disclaimed or released power.

31.18-1 Power to adjust for tax consequences

K. *Power to Adjust for Tax Consequences*. The trustee may, in the trustee's discretion, take any action and make any election to minimize the tax liabilities of (1) any trust held under my will and (2) the trust's beneficiaries. The trustee may allocate the benefits among the various beneficiaries and make adjustments in the rights of any beneficiaries, or between the income and principal accounts, to compensate for the consequences of any tax election or investment or administrative decision that the trustee believes has directly or indirectly benefited one beneficiary or group of beneficiaries over others.

29.28-1 Power to borrow

L. *Power to Borrow*. The trustee may, in the trustee's discretion, borrow money and encumber trust property by mortgage, deed of trust, pledge, or otherwise, for the debts of the trust or the joint debts of the trust and a co-owner of the property in which the trust has an interest.

29.33-1 Power to insure

M. *Power to Insure*. The trustee may, in the trustee's discretion, carry, at the expense of the trust, insurance of the kinds and in the amounts that the trustee considers advisable to protect the trust estate against any hazard and the trustee personally against liability with respect to third persons.

29.18-1 Power to abandon property

N. *Power to Abandon Trust Property*. The trustee may, in the trustee's discretion, abandon any property or interest in property belonging to the trust if the trustee determines, in the trustee's discretion, that the abandonment is in the best interests of the trust and its beneficiaries.

29.30-1 Power to initiate and defend litigation

O. *Power to Initiate and Defend Litigation*. The trustee may, in the trustee's discretion, initiate or defend, at the expense of the trust, any litigation relating to the trust or any property of the trust estate that the trustee considers advisable. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

29.31-1 Power to compromise claims

P. *Power to Compromise Claims*. The trustee may, in the trustee's discretion, compromise, submit to arbitration, abandon, or otherwise adjust any claims or litigation against or in favor of the trust. The trustee's decision in this regard shall be conclusive. The trustee's powers under this paragraph shall apply during the term of the trust and after distribution of trust assets. The trustee shall have no duties, however, regarding any litigation or claims occurring after distribution of trust assets, unless the trustee is adequately indemnified by the distributees for any loss occasioned by exercise of the powers.

31.13-1 Power to withhold distribution pending tax payment and conflict resolution

Q. *Power to Withhold Distribution*. When an event requires the trustee to divide, segregate, or distribute trust property, the trustee may delay the division, segregation, or distribution of all or part of the property for the period of time necessary to ascertain and provide for the payment of any tax, claim, or other liability against the property. During this period, the trustee may pay the net income of the trust property to the persons and entities entitled to it. The provisions of this paragraph shall not be deemed to postpone or defer the vesting of any interest created by the dispositive provisions of the trust.

31.4-1 Broad powers of distribution

R. *Power to Divide Trust Property Into Shares*. When the trustee must divide any trust property into parts or shares for the purpose of distribution or otherwise, the trustee may, in the trustee's discretion, make the division and distribution in identical interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

30.10-1 Uniform Principal and Income Act to govern allocations of principal and income

S. *Allocation of Principal and Income*. Except when my will specifically provides otherwise, the trustee shall determine what is principal and income of the trust estate and apportion and allocate receipts, expenses, and other charges between those accounts according to the provisions of the Uniform Principal and Income Act

(UPAIA) (Probate Code sections 16320-16375).

30.6-1 Physical segregation of separate trusts not required; division into separate trusts permitted

T. *Segregation of Assets Not Required*. Except with respect to trusts created under my will that qualify for the marital deduction, the trustee shall not be required to segregate physically or divide assets among the various trusts, except on termination of any of the trusts. The trustee, however, shall be required to keep separate accounts for the separate undivided interests. The trustee may, in the trustee's discretion, divide any trust created under this instrument into two or more separate trusts that have the same terms.

31.10-1 Trustee action before notice of events affecting beneficial interests

U. *No Liability for Trustee Action Before Notice of Events*. Unless the trustee receives written notice of the occurrence of an event affecting the beneficial interests in any trust held under my will, the trustee shall not be liable to any beneficiary of the trust for distributions made or other actions taken by the trustee in good faith as though this event had not occurred.

31.11-1 Trustee may distribute if no notice of exercise of power of appointment

V. *Distribution of Property Subject to Power of Appointment*. The trustee may distribute assets held in trust and subject to a power of appointment as if the power had not been exercised, if the trustee has not received any document purporting to exercise the power by the earlier of:

(1) Six months after the death of any person holding a power of appointment over the assets; or

(2) If the powerholder is purported to have a will, expiration of the statutory period in the decedent's domicile within which a will contest must be filed to contest the purported will.

If a document purporting to exercise the power is subsequently located, the trustee shall not be liable to the appointees under that exercise, and the rights of the appointees and the persons to whom the trustee distributed the assets shall be determined as provided by law.

31.26-1 Additions to trust authorized

W. *Additions to Trust Authorized*. With the trustee's written consent, additional property may be added at any time from any source to any trust held under my will.

31.33-1 All powers exercisable solely in fiduciary capacity

X. *Powers Exercisable Solely in Fiduciary Capacity*. The trustee shall exercise all powers in the trustee's fiduciary capacity. The trustee shall have no power under any provision of my will to enlarge or shift any of the beneficial interests under any trust created under my will except as an incidental consequence of the discharge of the trustee's fiduciary duties.

31.31-1 Trustee powers continue until trust distribution

Y. *Powers Continue Until Distribution of Trust Property*. All powers, duties, and immunities of the trustee shall continue after termination of any trust created under my will for a reasonable period until actual distribution of the trust property.

12.81-1 Retention in further trust until specified age (modified)

DIVISION SIX
DISTRIBUTIONS TO YOUNG PERSONS

A. *Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, the personal representative or trustee making the distribution shall be the trustee. The separate trust shall be administered as follows:

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

7. *Trust Administration*. To the extent not inconsistent with the provisions of this Division, the provisions of the Divisions of this will entitled "Office of Trustee," "Trustee Powers," "Choice of Law," "Spendthrift Clause," and "Perpetuities" apply to any trust established by this paragraph.

31.34-1 Choice of law

DIVISION SEVEN
CHOICE OF LAW

Any trust created under my will shall be construed in accordance with the laws of the State of California.

27.9-1 Long-form spendthrift clause

DIVISION EIGHT
SPENDTHRIFT CLAUSE

If the creditor of any beneficiary who is entitled to any distributions from a trust established under this will (other than from any marital deduction trust requiring the distribution of all income or any qualified Subchapter S trust) attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, notwithstanding any other provision in this instrument, the distribution set aside for that beneficiary shall be disposed of, until the release of the writ of attachment or garnishment or other process, as follows:

(1) The trustee shall pay to or apply for the benefit of that beneficiary all sums that the trustee, in the trustee's discretion, determines to be necessary for the reasonable health, education (including study at an institution of higher learning or vocational school), and support of the beneficiary according to his or her accustomed mode of life; and

(2) The portion of the distribution that the trustee determines to exceed the amount necessary for the health, education (including study at an institution of higher learning or vocational school), and support shall, in the trustee's discretion, either be added to and become principal in whole or in part, or be paid to or applied for the benefit of the other beneficiaries then entitled to receive payments from any trust established under my

will, in proportion to their respective interests in the trust estate; or, if there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person or persons presumptively entitled to the next eventual interest, in proportion to their respective interests in the trust.

Comment: Because the clause directs the accumulation of income, which would disqualify the trust for the marital deduction, the clause is specifically made inapplicable to the marital trust. See §§19.4, 27.6.

DIVISION NINE
PERPETUITIES

34.41-1 Cutoff clause

A. *Termination.* Unless terminated earlier, any trust created by my will or by the exercise of any power of appointment conferred by my will (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*name or description of class to be measuring lives*]_ _ living at my death.

34.41-2 Postcutoff distribution clause

B. *Distribution on Termination.* The principal and undistributed income of any trust terminated under this clause shall be distributed to the trust's income beneficiaries in the same proportions in which they are entitled to receive income immediately before termination. If those proportions are not fixed by the terms of the trust, distribution shall be by right of representation to issue of _ _[*name*]_ _, who are then entitled or authorized to receive income distributions from the trust.

DIVISION TEN
EXECUTORS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executor*. I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Appendix G

Pourover Will

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Description

This is a married testator's will that transfers the testator's entire estate to a revocable trust. In the typical revocable trust estate plan, the testator will normally transfer all major assets to the trust during life. The will functions as a safeguard, sweeping into the trust any assets inadvertently not transferred to the trust. This will does not contain any tax apportionment provisions because it is assumed that any needed apportionment provisions will be contained in the revocable trust.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Spouse

C. Children and Issue

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. All Estate to Trust

B. Alternate Disposition

DIVISION THREE: EXECUTORS AND GUARDIANS

A. Nomination of Executors

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

D. Guardian of the Person

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Spouse.* I am married to _ _[*name of spouse*]_ _, who is hereafter referred to as "my spouse."

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others, except that the term shall also include any child or children hereafter born to or adopted by me. All references in this will to my "issue" are to my children as so defined and their issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my spouse shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that distributes assets in a foreign country only, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

8.7-1 Disposition of residue to trust

A. *Gift to Trust*. I give all of my estate to the trustee then in office of the trust identified below, to be held and administered by the trustee according to the terms and conditions of that trust including, without limitation, any amendment made to it before my death:

Trust: _ _[*Name of trust*]_ _, established on _ _[*date*]_ _

B. *Alternate Disposition*. If at the time of my death my estate is not permitted by law to be distributed to the trustee, or if the trust is not then in existence, is revoked after the date of my will, or fails for any reason, I give the residue of my estate to _ _[*name*]_ _, as trustee, to be held, administered, and distributed as follows: _ _[*Provisions of "backstop" testamentary trust*]_ _.

DIVISION THREE
EXECUTORS AND GUARDIANS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: Normally the executors should be the same persons or entities who will be the trustees of the revocable trust at the time of death. On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

24.20-1 Nomination of guardian of person

D. *Guardian of the Person.* If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

Comment: The provision appointing a guardian of the person can be deleted if the testator has no minor children.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Source: Estate Planning/California Will Drafting/Introduction to Appendixes/Appendix H Will Creating Special Needs Trust

Appendix H

Will Creating Special Needs Trust

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

Description

This is a sample will suitable for an individual who does not currently have a spouse or domestic partner and who has a child with special needs. The will provides for a pecuniary gift to a special needs trust for the disabled child, with the residue in equal shares to named individuals and their issue.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. No Spouse or Partner

C. Children and Issue

DIVISION TWO: GIFTS OF PROPERTY

A. Monetary Gift

B. Gift of Residue

C. Distributions to Young Persons

DIVISION THREE: SPECIAL NEEDS TRUST

A. Purpose of Trust

B. Distributions of Principal and Income

C. Trustee to Seek Public Agency Support

D. Spendthrift Clause

E. Discretionary Termination of Trust

F. Automatic Termination of Trust

G. Distribution of Remainder

H. Payment of Expenses and Death Taxes

I. Special Power of Appointment

DIVISION FOUR: OFFICE OF TRUSTEE

A. Nomination of Trustee

B. Trustee Powers

C. Compensation of Trustee

D. Exculpation of Trustee

DIVISION FIVE: EXECUTORS AND GUARDIANS

A. Nomination of Executor

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

D. Guardian of the Person

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children (modified)

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *No Spouse or Partner.* I am not married and I do not have a domestic partner.

C. *Children and Issue*. The names and birthdates of my children are: _ _[*Names of children and birthdates*]_ _. I have no deceased children. All references in this will to my "children" are to the children just named and no others. All references in this will to my "issue" are to my children as so defined and their issue.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that only distributes assets in a foreign country, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

DIVISION TWO
GIFTS OF PROPERTY

12.71-1 General pecuniary gifts

12.23-1 Survivorship conditions

12.34A-1 Class gift to named persons and their issue—equal shares (modified)

12.80-1 Gift of residue in equal shares

12.81-1 Retention in further trust until specified age

29.8-1 Trustee may exercise statutory powers

A. *Monetary Gift.* If _ _[*name of child with special needs*]_ _ survives me by 30 days, I give _ _[*dollar amount*]_ _ to the trustee of the trust created under the Division of this will entitled "Special Needs Trust" to provide for the special needs of _ _[*name*]_ _, my disabled child.

B. *Gift of Residue.* The residue of my estate, including any lapsed gifts not otherwise disposed of, shall be divided into as many equal shares as there are persons named in the following list who survive me by 30 days and persons named in that list who do not so survive me but who leave issue who so survive me. Each so surviving listed person shall receive one share and the so surviving issue of each listed person who did not so survive me shall take by representation the share created on account of the ancestor who did not so survive me. The named persons are: _ _[*names, e.g., my other children Mary Doe and John Doe, and my stepson Tim Roe*]_ _

C*. Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The separate trust shall be administered as follows:

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

Comment: Usually it is not necessary to include a lengthy list of trustee powers in a will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are incorporated only by reference in the will. Cal Rules

of Ct 7.650.

DIVISION THREE
SPECIAL NEEDS TRUST

23.27-1 Trust purpose

A. *Purpose of Trust*. The primary beneficiary of this trust has a disability that substantially impairs the beneficiary's ability to provide for the beneficiary's own care or custody and constitutes a substantial handicap. The purpose of this trust is to provide financial aid that is supplemental to, rather than a replacement for, government benefits provided to the beneficiary, without disturbing government benefits that would be available to the beneficiary if the trust did not exist. The trustee shall hold, administer, and distribute all property allocated to the trust for the benefit of the following beneficiary during the beneficiary's lifetime, unless this trust is earlier terminated: _ _[*Name of primary beneficiary*]**_ _.**

23.31-1 Distributions of income and principal

23.32-1 Power to make monthly distributions

23.34-1 Trustee to consider beneficiary's other resources

B. *Distributions of Income and Principal*. In accordance with the purpose of this trust and subject to the guidelines provided below, the trustee may pay to or apply for the benefit of the beneficiary as much of the trust net income and, if that income is insufficient, the trust principal, as the trustee determines, in the trustee's sole discretion, to be necessary or desirable to meet the beneficiary's special needs. "Special needs" are items or services that the trustee considers necessary for the beneficiary's health, protection, and welfare and that cannot, in the trustee's opinion, be provided by grants, services, and supplies available through any public agency, office, or department of California, any other state, or the United States. "Special needs" may include funds, items, or services that enhance the beneficiary's quality of life. Examples of funds, items, or services meeting special needs are incidental spending money, travel funds, personal items such as radios and televisions, gifts on the beneficiary's behalf to friends and relatives, a paid companion, health care services, supplies, special equipment, training programs, and rehabilitation supplemental to those that the beneficiary is entitled to receive under a government assistance program. The trustee is neither obligated nor compelled to make any distribution. Any undistributed income shall be accumulated and added to principal.

The trustee may, in the trustee's sole discretion, elect to make distributions to the beneficiary from the trust net income and the trust principal as a monthly allowance, even to the extent of exhausting the entire principal over a short period.

In determining whether to make a distribution, how a distribution will be made, and the amount to distribute, the trustee shall consider (1) any other income or resources of the beneficiary known to the trustee and readily available to the beneficiary and (2) all benefits available to the beneficiary from any government agency. Such benefits include but are not limited to Social Security and Supplemental Security Income; Medicare, Medicaid, Medi-Cal, and any other payments for medical, nursing, or custodial care; food stamps; and direct cash grants.

23.36-1 Trustee to seek public agency support

C. *Trustee to Seek Public Agency Support*. The trustee may seek support and maintenance for the beneficiary from all available public resources, including but not limited to Social Security payments, Supplemental Security Income, Social Security Disability Insurance, Veterans Administration benefits of every kind, Medicare, and Medi-Cal or other Medicaid payments.

If the trustee receives government assistance benefits on the beneficiary's behalf, the trustee shall collect, expend, and account for those benefits separately from, and not commingle them with, all other assets of this trust.

23.42-1 "Spendthrift" clause

D. *Spendthrift Clause*. No interest in the principal or income of this trust may be anticipated, assigned, encumbered, or subject to any creditor's claim or to legal process before actual receipt by the beneficiary. Because this trust is intended to be conserved and maintained for the beneficiary's special needs, no part of the trust principal or income may be subject to the claims of voluntary or involuntary creditors for any costs incurred or sums expended by any public agency, office, or department of California, any other state, or the United States, for the provision of care and services (including residential care) to or for the beneficiary (whether prospectively or in reimbursement). The beneficiary of the trust has a disability that substantially impairs the beneficiary's ability to provide for the beneficiary's own care or custody and constitutes a

substantial handicap.

23.44-1 Power to terminate trust if trust interferes with beneficiary's government benefits

E. *Discretionary Termination of Trust*. If a court or government agency determines that the trust renders the beneficiary ineligible for government benefits for which the beneficiary would be eligible if the trust did not exist, the trustee shall evaluate the financial loss caused to the beneficiary by the beneficiary's ineligibility for government benefits as compared to the financial gain to the beneficiary resulting from the trust's continued operation, to determine whether to maintain the trust in operation or to terminate the trust. If the trustee determines that the benefits conferred by the trust do not outweigh the detriment caused by the loss of government benefits, the trustee may, in the trustee's sole discretion, terminate the trust and distribute the trust assets as provided in the paragraph of this Division entitled "Distribution of Remainder."

23.45-1 Automatic trust termination if court orders reimbursement

F. *Automatic Termination of Trust*. The trustee shall terminate this trust and distribute its assets as provided in the paragraph of this Division entitled "Distribution of Remainder" if:

(1) A court of competent jurisdiction issues an order compelling the trustee to reimburse a government agency for payments made, services rendered, or materials supplied to or for the beneficiary by that agency; or

(2) The trustee determines, in the trustee's sole discretion, that the trust may be subject to garnishment, attachment, or execution by any creditor (including a government agency) and that no appeal or any other legal remedy can defeat the order for reimbursement or anticipated garnishment, attachment, or execution, or that legal challenge to that order, garnishment, attachment, or execution would be excessively costly to the trust in view of the then remaining trust assets and the needs of any other beneficiary.

23.47-1 Distribution on trust emergency termination

G. *Distribution of Remainder*. If the trust terminates during the beneficiary's lifetime, the trustee shall, after paying the expenses of trust administration and termination, distribute the remaining trust principal, together with any undistributed income, to the person named below. That remainder beneficiary is requested, but not directed, to conserve, manage, and distribute the proceeds of the former trust estate for the benefit of the former beneficiary of the trust, in accordance with the provisions set forth in this trust for administration and distribution of the trust assets while the original beneficiary was beneficiary of this trust. The trustee shall distribute the trust remainder to _ _[*name of remainder beneficiary*]_ _.

23.50-1 Expense payments after beneficiary's death

H. *Payment of Expenses and Death Taxes*. The trustee may, in the trustee's discretion, pay last-illness and funeral expenses, any death taxes attributable to any part of the trust estate, and expenses from the administration or distribution of the trust estate. "Death taxes" includes all estate and inheritance taxes, generation-skipping transfer taxes, and interest and penalties on such taxes. The trustee shall not pay expenses for which, in the trustee's opinion, there is an adequate source of payment outside the trust. The trustee shall also not pay expenses incurred by or on behalf of the beneficiary during the beneficiary's life if a government benefits program was obligated to meet those expenses while the beneficiary was alive.

23.52-1 Beneficiary's testamentary special power of appointment (modified)

I. *Special Power of Appointment*. At the death of the beneficiary, the trustee shall distribute any remaining balance of the trust property (including accrued income and undistributed income) to one or more of the group consisting of the class specified below, on such terms and conditions (outright, in trust, or by creating further powers of appointment) as the beneficiary shall appoint in a valid will or inter vivos document executed after my death, specifically referring to and exercising this power of appointment. If the beneficiary does not effectively appoint all the trust estate, the trustee shall distribute the omitted property according to the distribution clause in the paragraph of this will entitled "Gift of Residue."

Class: _ _[*Name of class, e.g., my issue and their spouses or domestic partners*]_ _

DIVISION FOUR
OFFICE OF TRUSTEE

28.12-1 Nomination of trustee and successors for special needs trust (modified)

A. *Nomination of Trustee*. I name as trustee and successor trustee of the Special Needs Trust created under

Division Three of this will, in the order and priority indicated, the following:

First: _ _[*Name of trustee*]_ _
Second: _ _[*Name of successor trustee*]_ _

All powers vested in the original trustee shall be exercisable by any successor trustee. No named or unnamed, resident or nonresident trustee of this trust shall be required to post bond or security to serve.

Comment: If a successor trustee's powers will differ from those granted the original trustee, the drafter should delete the last sentence of this clause. For a separate clause to name a successor trustee, see form 28.14-1. For a clause providing for court nomination of a successor trustee, see form 28.15-1. On naming trustees, see §28.11. For discussion of the trustee's bond requirement, see §28.22.

29.8-1 Trustee may exercise statutory powers

B. *Trustee Powers.* The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.

28.25-1 Trustee compensation

C. *Trustee Compensation*. Trustees are entitled to reasonable compensation.

Comment: See §28.24 on trustee compensation.

28.48-1 Trustee exculpation

D. *Exculpation of Trustee.* The trustee shall not be liable to any beneficiary for the trustee's acts or omissions, except in cases of willful misconduct, bad faith, or gross negligence. The preceding sentence does not relieve a trustee of any obligation to restore to the trust any benefits received by the trustee as a result of a breach of the trust. This paragraph does not apply to a financial institution or individual regularly engaged in the business of acting as a trustee.

Comment: See §28.47 on trustee exculpation.

DIVISION THREE
EXECUTORS AND GUARDIANS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

24.20-1 Nomination of guardian of person

D. *Guardian of the Person.* If for any reason it is necessary to appoint a guardian of the person of any of my children, I nominate _ _[*name and identifying information*]_ _ to act as the guardian. If this nominee shall fail to qualify or cease to act, I nominate _ _[*name and identifying information*]_ _ to act as the guardian.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Source: Estate Planning/California Will Drafting/Introduction to Appendixes/Appendix I Nontrust Will With Residue to Domestic Partner

Appendix I

Nontrust Will With Residue to Domestic Partner

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

Description

This is a sample nontrust will suitable for an individual with a registered domestic partner who does not have issue. The will is substantially similar to the will for a married couple in App B, except for the absence of children.

NOTE: This sample document is intended only as a drafting guide. The drafter should refer to the text of this book before preparing any document.

OPENING DECLARATION

DIVISION ONE: INTRODUCTION

A. Revocation

B. Partner

C. No Children or Issue

D. No Contract to Make Wills

DIVISION TWO: GIFTS OF PROPERTY

A. All Estate to Partner

B. If Partner Does Not Survive

C. Distributions to Young Persons

DIVISION THREE: EXECUTORS

A. Nomination of Executors

B. Power to Sell or Lease Estate Property

C. Nonprorata Distributions

EXECUTION AND ATTESTATION CLAUSES

WILL
of
_ _[*Name of testator*]_ _

10.6-1 Introduction

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will.

Comment: For discussion of the introductory clause, see §§10.2-10.5. On establishing a domicile, see §37.31.

DIVISION ONE
INTRODUCTION

9.3-1 Revocation of prior will

10.8-1 Declaration of marital or partnership status

10.10-1 Declaration concerning children

10.13-1 No contract to make wills

A. *Revocation.* I revoke all wills and codicils that I have previously made.

B. *Partner*. I am currently registered with the California Secretary of State as the domestic partner of _ _[*name of partner*]_ _, who is hereafter referred to as "my partner."

C. *No Children or Issue*. I have no living or deceased children or other issue.

D. *No Contract to Make Wills*. I have not entered into any contract to make this will, and any similarity of the provisions of this will to the provisions of a will of my partner shall not be construed as evidence of such a contract.

Comment: For discussion of revocation by subsequent instrument, see §9.2. If the testator does not wish to revoke a will that only distributes assets in a foreign country, see §37.33.

For discussion of declarations about marital or partnership status, emphasizing the pitfalls of an omitted spouse or domestic partner, see §10.7. For alternative clauses, see form 10.8-1 (never married, marriage dissolved, deceased spouse, currently in a domestic partnership, domestic partnership terminated or dissolved, deceased domestic partner).

For discussion of declarations about children, emphasizing the pitfalls of omitting to name a child, see §§10.7, 10.9. For alternative clauses, see form 10.10-1 (no children, deceased children only, children from prior marriage or domestic partnership).

For discussion of will contracts, see §10.12.

DIVISION TWO
GIFTS OF PROPERTY

12.80-1 Gift of residue to partner (modified)

12.81-1 Retention in further trust until specified age

29.8-1 Trustee may exercise statutory powers

A. *All Estate to Partner.* I give all of my estate to my partner if my partner survives me by 30 days.

B. *If Partner Does Not Survive*. If my partner does not so survive me, I give the residue as follows:

(1) Half equally to my parents, if they survive me by 30 days, or to the one of them who so survives me. If neither parent so survives me, this half to their issue who so survive me, by right of representation. If none of their issue so survive me, this half to be added to the share described in (2).

(2) Half equally to my partner's parents, if they survive me by 30 days, or to the one of them who survives me. If neither parent so survives me, this half to their issue who so survive me, by right of representation. If none of their issue so survive me, this half to be added to the share described in (1).

C. *Distributions to Young Persons*. If any person otherwise entitled to outright distribution of any property under this will is under the age of _ _[*age*]_ _ at the time distribution is to be made, the property shall not be distributed to that person, but shall, instead, be distributed to _ _[*name of trustee*]_ _ as trustee, to be held as a separate trust for the benefit of the underage person ("Beneficiary"). If the nominated trustee fails to qualify or ceases to act, and that trustee has not nominated a successor, _ _[*name of alternate trustee*]_ _ shall be the trustee. The separate trust shall be administered as follows:

1. *Unproductive Property*. The trustee shall hold as unproductive property any property that the trustee in its discretion determines should be preserved for distribution in kind to Beneficiary, including, in particular, tangible personal property of sentimental value. Such property shall be distributed to Beneficiary at such time as the trustee deems appropriate, but no later than the time of distribution of the remaining property.

2. *Periodic Distributions*. The trustee shall pay to or for the benefit of Beneficiary, quarter annually or at more frequent intervals, as much of the income and principal of the trust as the trustee, in the trustee's discretion, considers advisable for Beneficiary's support, health, and education, including professional education, after taking into consideration other resources of Beneficiary, the resources of the trust, and the

likely future needs of Beneficiary within the trust term.

3. *Additional Distributions of Principal*. When Beneficiary attains the age of _ _[*first age*]_ _, the trustee shall distribute to Beneficiary one-third of the then remaining trust property. When Beneficiary attains the age of _ _[*second age*]_ _, the trustee shall distribute to Beneficiary half of the remaining trust property. When Beneficiary attains the age of _ _[*third age*]_ _, the trustee shall distribute to Beneficiary the entire remaining trust property. If any of the specified ages have been attained at the time of the initial funding of the trust, the appropriate distributions shall be made immediately.

4. *Power to Delay Distributions*. Despite the foregoing distribution provisions, the trustee may delay any distribution until a time no later than Beneficiary's death if the trustee determines that it is reasonably certain that the distributions are not in the Beneficiary's best interests because the beneficiary is incompetent, suffers from substance abuse, or because Beneficiary's financial circumstances are such that failure to delay distributions will actually reduce the trust benefits to Beneficiary.

5. *Beneficiary's Failure to Survive*. If Beneficiary dies before final distribution, the trust shall terminate and the remaining trust property shall be distributed to such persons, including Beneficiary's estate and creditors, as Beneficiary may appoint. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then surviving issue of Beneficiary, per capita at each generation, and, if none, then to the then living siblings of the Beneficiary, with the then living issue of deceased siblings taking the shares of deceased siblings per capita at each generation; and, if none, then to the persons entitled to the Beneficiary's estate under the California laws of succession.

6. *Trustee*. The trustee of any trust established under this paragraph shall have the power to name successors and may amend the trust to provide for administration of the trust by multiple trustees in such manner as the trustee deems appropriate. The trustee is encouraged to provide a trustee arrangement that results in more than one adult having access to the books and records of the trust during Beneficiary's minority.

***7. Trustee Powers.* The trustee of any trust established under my will shall have all powers conferred on trustees by California law in the absence of a limitation in the trust instrument. These powers shall be deemed to include the power to invest in any kind of property without regard to statutory limitations, insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without any otherwise applicable requirement for a court order.**

Comment: Usually it is not necessary to include a lengthy list of trustee powers in a will if there is reasonable certainty that the testator will die domiciled in California. In California, if the trust is actually established, the governing document will be the decree of final distribution of the probate estate. If desired, a list of trustee powers conferred by California law can be included in that decree even though they are incorporated only by reference in the will. Cal Rules of Ct 7.650.

DIVISION THREE
EXECUTORS

32.10-1 Nomination of executor and alternate or successor executor

32.18-1 General waiver of bond

A. *Nomination of Executors.* I nominate the persons listed below, in the order and priority indicated, as executor and alternate or successor executor of my will:

First: _ _[*Name of executor nominee*]_ _
Second: _ _[*Name of alternate or successor executor nominee*]_ _

I request that no bond be required of any executor nominated in my will.

Comment: On factors to consider when selecting an executor, see §§32.3-32.9. For advice on how to fill in this clause, see Comment to form 32.10-1. For alternative clauses, see §§32.11 (coexecutors), 32.12 (professional fiduciary), 32.13 (delegation of authority to designate executor), 32.14 (attorney as executor). For discussion of the need to define "executor," see §32.15. For discussion of bond considerations, see §§32.17-32.18. For an alternative clause, see Alternative 2 in form 32.18-1 (requirement of bond).

33.16-1 Power to sell or lease estate assets

B. *Power to Sell or Lease Estate Property*. My executor may sell or lease, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

33.26-1 Power to distribute property nonprorata

C. *Nonprorata Distributions*. When making any division or distribution of property, the executor may, in the executor's discretion, make the division and distribution in undivided interests, in kind, or partly in kind and partly in money, prorata or nonprorata. The trustee may make sales of the trust property that the trustee considers necessary to accommodate such distributions.

[*EXECUTION AND ATTESTATION CLAUSES*]

36.16-1 Execution and attestation clauses

Signed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____
[*Signature of testator*]

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]

We declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_____	_____	_____
[*Signature of witness*]	[*Signature of witness*]	[*Signature of witness*]
Name and address:	**Name and address:**	**Name and address:**
_____	_____	_____
_____	_____	_____
_____	_____	_____

Comment: See chap 36 for discussion of execution requirements and recommended procedures. For the attestation and certificate for an international will, see §37.17.

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Source: Estate Planning/California Will Drafting/Table of Statutes, Regulations, and Rules

Table of Statutes, Regulations, and Rules

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