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Preface

The first edition of Drafting California Revocable Living Trusts was published in 1972. It was followed by a second edition in 1984 and a third edition in 1994. During the more than 30 years since publication of the first edition, dramatic changes have been made in both trust law and tax law. In 1972 the federal estate tax threshold was $60,000, California had an inheritance tax, there was no federal estate tax marital deduction for community property and the deduction could not exceed 50 percent of separate property, QTIP trusts did not exist, and California statutes concerning revocable trusts were limited to a modest odd assortment of provisions in the Civil Code.

Times change. The second edition of this book was published shortly after enactment of the unlimited marital deduction in 1981 and the repeal of the California inheritance tax by voter initiative in 1982. By the time of the 1994 publication of the third edition, the federal estate tax threshold had increased to $600,000, practitioners had become experienced in addressing generation-skipping transfer tax statutes enacted in 1986, and California's Probate Code had been augmented by a comprehensive trust law.

Changes continue. As this fourth edition goes to press in December 2003, practitioners continue to struggle with a new era of tax laws in which many tax statutes are temporary. These temporary laws pose new challenges for estate planners—particularly the provisions of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) that provide for major increases in the federal estate tax applicable exclusion amount, repeal of the tax in 2010, and restoration of the tax in 2011. Most practitioners agree that amendments will be made to EGTRRA-2001, but there is great uncertainty about the nature of those future amendments.

The tax law changes have been accompanied by changes in trust laws. The Restatement (Third) of Trusts (Prudent Investor Rule) (1992) led to the promulgation of the Uniform Prudent Investor Rule, which California adopted in 1995. Because these works led to the conclusion that trust documents often should not base distribution provisions on classical distinctions between "principal" and "income," it has become clear that "the way it's always been done" is no longer good enough. Other trust law developments are more subtle. The Uniform Trust Code (UTC) was promulgated in 2000 and will be considered for adoption in California in the near future. Major portions of the third edition of the Restatement of the Law of Trusts were approved in 1999, 2001, and 2003. These works reflect other changes in thinking about trusts. For example, following the lead of the California Trust Law, the UTC provides an extensive list of powers that all trustees are presumed to hold in the absence of provisions to the contrary. It is often no longer necessary for trust documents to contain exhaustive and exhausting lists of trustee powers. In contrast, confronted with an increasing number of statutes, drafters must more frequently include express provisions in trusts that limit the application of a particular statute.

Responding to both the tax law uncertainties and the evolving substantive law changes, this fourth edition contains all new forms. The forms place new emphasis on (1) using a consistent document structure for both high value estates and more modest estates; (2) placing all distribution provisions early in the trust document; (3) designing blocks of text in ways that make it easy to make such changes as add or delete all the provisions for a QTIP trust or a trust for a minor beneficiary; and (4) designing distribution provisions in ways that will minimize the need to completely overhaul trust documents in response to tax law changes. Consistent with the desires and wishes of most contemporary clients, the forms generally assume that settlors will usually act as their own initial trustees, and successor trustees will be family members. Marital deduction forms have been amended to specify how distributions are to be made if a settlor dies in a year when there is no federal estate tax. The overall organization of the book has been modified to more closely follow the organization of the forms.

The fourth edition is the first to be published without the oversight of the late John R. Cohan of Irell & Manella, Los Angeles. Mr. Cohan was the original planner and editor of the first and second editions and contributed heavily to the third edition and its updates. The fourth edition continues to reflect his many contributions. Marc M. Stern, partner with Greenberg Glusker Fields Claman Machtinger & Kinsella LLP, Los Angeles, has once again generously assisted as a major consultant, particularly with the chapters devoted to marital deduction estate planning. The CEB attorney in charge of this project was Jeffrey A. Dennis-Strathmeyer, who was assisted by CEB attorneys Janette Tom and Hale Kronenberg.

CEB owes a special debt of gratitude to the many attorneys throughout California who served as authors and consultants for this book. The authors and their qualifications are listed in the "About the Authors" section of this book. The consultants are listed on the "Consultants" page. CEB also wishes to acknowledge the contributions of the authors whose work in the previous editions inspired many of the chapters of this fourth edition.

Robert Denham, Jean Magistrale, Margaret O'Neill, Frederike J. Schilter, and Susan P. Widule performed legal editing. Adriana Paula and Shawn Ridgell provided legal research assistance. Cinda Ely and Richard Dempewolf were responsible for copyediting and production. The index was written by Robert Burke and Kathryn Te Selle. The cover was designed by Grier Thornburg.

September 2010 Update

CEB Attorney Editor Robert Denham and Legal Editors Kate Sheppard and Christine Day contributed to this update. Administrative support was provided by Kenya Denman and Nila Kanzaria. Kathryn Te Selle updated the index. Dorie Riepe handled copyediting and production. Composition was performed by CEB's Electronic Publishing staff.

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Form Sources

Trust clause forms used in this book were adapted from many sources including prior editions of this book, CEB California Will Drafting, and the forms of the various chapter authors and consultants. Some forms are also based on forms provided CEB by the following practitioners.

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Selected Developments

September 2010 Update

As of this writing, the estate tax does not apply to decedents dying in 2010. It seems unlikely that the tax will be retroactively restored. However, the estate tax will apply to decedents dying in 2011 and thereafter, with an applicable exclusion amount of $1 million, unless the law is amended. Although it is now late in the year, it is not too late to consider trust amendments or new trust language that would be effective only in 2010 if the consequences of conventional planning document provisions would be undesirable for settlors dying this year. For example, the distribution provision on the first death could be amended or drafted to limit the percentage (or dollar amount) of the residue passing to the bypass trust under a typical reduce-to-zero marital deduction formula that would otherwise result in the entire deceased settlor's share of trust property passing to the bypass trust. The trust could also be amended or drafted to provide for a different disposition that would take effect only if there is no estate tax in the year of death. Alternatively, the bypass trust could be amended or drafted to give the spouse additional benefits without causing inclusion in the survivor's estate, unless the bypass trust gives the surviving spouse a qualifying life income interest and a QTIP election is made for all or a portion of the trust. Above all, the continuing uncertainty about the estate tax puts an increasing premium on flexibility planning, particularly for married settlors. See chap 14.

The update also discusses the following developments:

Proposed legislation would amend the disqualified person statute to exclude from the definition of "care custodian" certain persons who provide care without remuneration and would restrict the definition of "dependent adult" to persons who are unable to provide properly for their personal needs or have difficulty managing their financial resources or resisting fraud or undue influence. The proposed legislation would also permit the drafting attorney to execute a certificate of independent review for the transfer to a care custodian and would clarify the counseling and confidentiality requirements for a valid certificate consistent with the decision in *Estate of Winans* (2010) 183 CA4th 102, 107 CR3d 167. See §§2.36-2.37.

The IRS has issued interim guidance on whether and when investment advisor expenses of estates and trusts are subject to the 2-percent floor on income tax itemized deductions. See §4.18.

The IRS has issued final regulations regarding the estate tax deduction for administration expenses and claims against the estate. The regulations generally limit the deduction for unpaid and contingent or contested claims. See §§4.119-4.123.

The update has an expanded discussion of the deductibility of interest on so-called *Graegin* loans used to pay estate taxes based on three recent court decisions. See §4.123B.

A court decision has held that the IRS abused its discretion in denying a late application for an extension of time to file an estate tax return and pay tax, but practitioners should not rely on this decision in filing for an extension. See §4.147.

In *Steinhart v County of Los Angeles* (2010) 47 C4th 1298, 104 CR2d 195, the court held that a change in ownership occurs for property tax purposes on the transfer of a life income interest on the death of the settlor. See §4.226.

In *Estate of Tolman* (2010) 181 CA4th 1433, 104 CR3d 924, the court held that a will provision that expressed an intention not to provide for unmentioned heirs or relatives did not sufficiently manifest an intention to prevent the operation of the antilapse statute with respect to the issue of named transferees. See §8.19.

The Federal Deposit Insurance Corporation (FDIC) has issued a rule that permanently raises the insurance limit on revocable trust accounts with five or more different beneficiaries to at least $1,250,000. See §17.17.

Proposed legislation would more clearly limit the ability of settlors to waive trustee duties to report information to beneficiaries when a beneficiary has requested information. See §17.55.

New Prob C §§21310-21313 (effective January 1, 2010) restrict the enforceability of no-contest clauses. The new statute is applicable to all instruments that became irrevocable on or after January 1, 2001. Most case law interpreting the less restrictive former statute is no longer relevant for drafting purposes, and those cases are deleted. Issues raised by the new statute are discussed in §§19.1-19.5A.

In *Rands v Rands* (2009) 178 CA4th 907, 100 CR3d 632, a determination by two physicians that the settlor lacked capacity resulted in the settlor not being able to revoke his revocable trust until a court determined that the settlor had capacity or two physicians certified that the settlor had regained capacity. See §20.1.

In *Luna v Brownell* (2010) 185 CA4th 668, CR3d , the court held that a quitclaim deed transferring property from the grantor to himself as trustee of a trust was not void as between the grantor and grantee merely because the trust had not been created at the time the deed was executed. See §21.10.

Changes to Forms: The sprinkling trust provision in §7.84 is revised to include an optional addition designed to enable California real property to qualify for the grandparent-grandchild exclusion from a "change in ownership."

The special needs trust provisions in §§7.95-7.112 are revised to give the trustee greater discretion in making distributions to the disabled beneficiary.

An optional form of surviving settlor option to purchase a residence from the bypass trust is provided in §14.20A.

An alternative form of no-contest clause incorporating statutory limitations on enforceability is provided in §19.5A.

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Cutoff Dates

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1

Role of Revocable Trusts in California Estate Planning

Nancy E. Howard

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I. USING REVOCABLE TRUST TO ACHIEVE ESTATE PLANNING OBJECTIVES

§1.1 A. Objectives of Estate Planning

The objective of estate planning is to formulate and implement plans for transferring a client's property. To do this, the estate planner must first obtain information on the client's objectives and educate him or her about realistic options for accomplishing them. Client objectives vary, but whatever they are, the client will want them to be achieved efficiently and with a minimum of taxes, expenses, delay, and inconvenience. Even if the estate plan involves inter vivos gifts, the primary transfer usually occurs after death.

Estate planning must address the risk that a client will lose legal capacity before death. A period of incapacity before death may prevent the client from keeping the property transfer plan up to date. The estate planner is usually the most capable person to advise the client about actions that can mitigate the property management issues accompanying incapacity.

Revocable trusts (as defined in §1.2) are commonly used in California as tools for transferring property at death (see §1.3) and managing property during periods of incapacity (see §1.4). Some estate planners offer other services, such as preparing health care directives and planning for Medi-Cal eligibility if the client requires long-term skilled nursing care. Generally, however, revocable trusts are not useful for these purposes, so they are not discussed in this book. On tax neutrality of revocable trusts, see §1.5. On other uses of revocable trusts, see §1.6. On health care directives and durable powers of attorney, see California Estate Planning, chap 29 (Cal CEB 2002). On Medi-Cal eligibility planning, see Estate Plan, chap 30.

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§1.2 B. Definition of Revocable Trust

As used in this book, the term "revocable trust" refers to a trust with the following characteristics:

- The trust is evidenced and governed by a trust document signed by the settlor.
- More than a nominal portion of the settlor's property is subject to the trust during the settlor's lifetime.
- If there is only one settlor, the settlor can revoke or amend the trust at any time until the settlor's death. If the trust is jointly settled by spouses or domestic partners, either settlor may revoke the trust until the first death, except for the other settlor's separate property, and the surviving settlor can revoke the trust as to the survivor's own property until the survivor's death.

As defined above, a revocable trust does not include a "dry" trust with no assets or only nominal assets. A revocable and amendable dry trust is valid in California in the sense that a valid trust will come into existence when property is later transferred to the trust (Prob C §6300), but the use of dry trusts in contemporary estate planning is relatively rare, and they are not discussed in this book. Nevertheless, a dry revocable trust can be useful if a client wants to make a complex distribution of particular property that will pass by beneficiary designation. Dry revocable trusts may be useful in some states when the client wants to make a disposition without disclosing it to other beneficiaries. However, because California law generally requires disclosure of the terms of a revocable trust to beneficiaries and next of kin when the trust becomes irrevocable (Prob C §16061.5), using a dry revocable trust for that purpose is limited. A client with significant privacy concerns might be better advised to use an inter vivos *irrevocable* trust for that purpose. On inter vivos irrevocable trusts, see Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

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§1.3 C. Uses in Property Transfer Planning

The primary objective of a revocable trust is usually to distribute the settlor's property at his or her death without the need for a court proceeding to administer the client's probate estate. This objective is achieved by creating a trust and transferring property to it. On the client's death, the property is deemed owned by the trust rather than by the client for the limited purpose of determining whether court administration is required. The trustee or a successor trustee then administers the trust as provided in the trust document. This process may involve little more than transferring trust property to a single beneficiary, or it may involve continued administration of property in sophisticated irrevocable trusts that continue to operate more or less indefinitely.

Clients often wish to use revocable trusts to avoid probate, and although probate avoidance can be desirable in California for several reasons, it may not always be in the client's best interest. On evaluating revocable trusts as probate avoidance devices, see §§1.7-1.21. On revocable trusts as management devices, see §§1.22-1.31. On alternative transfer devices, see §§1.32-1.37.

Because revocable trusts transfer property at death, they are often described as "will substitutes," although it is incorrect to imply that a revocable trust eliminates the need for a will. At a minimum, the settlor still needs a pour-over will so that all of the client's property ends up being trust property. For discussion of pour-over wills, see §§22.3-22.6.

NOTE: The pour-over will can effectively transfer property to a trust without probate, assuming that the property not transferred to the trust during life does not exceed certain threshold amounts. See, *e.g.*, Prob C §§13100-13116 (procedure for collecting estate by affidavit if estate worth less than $100,000), discussed in §1.32.

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§1.4 D. Uses in Incapacity Planning

If a client chooses to use a revocable trust to transfer property, the trust will usually become the primary device for managing the client's property if the client becomes incapacitated. In this respect it serves as a substitute for a durable power of attorney. On evaluating revocable trusts as incapacity planning devices, see §§1.38-1.41. On alternative incapacity planning devices, see §§1.42-1.55. But just as a revocable trust does not eliminate the need for a will, a revocable trust does not eliminate the need for a durable power of attorney. There are four reasons a durable power of attorney may still be necessary:

- The trustee of the trust can manage only property actually titled in the trustee's name or physically in the trustee's control. Some property (including interests in pensions and IRAs) cannot be transferred to a revocable trust during the client's lifetime. See §1.38. See also chaps 19-21.

- Prudence dictates having a back-up plan for administering the client property that is not transferred to the trust owing to inadvertence or because the property was acquired after the client became incapacitated.

- A power of attorney remains necessary to performs a variety of specific ancillary tasks, such as filing tax returns or applying for public benefits. See §§22.7-22.10.

- An attorney-in-fact can amend a trust to the extent expressly authorized in both the trust document and the power of attorney. Prob C §§4264, 15401(c). Giving an attorney-in-fact appropriately limited power to amend a trust can provide the flexibility needed to address changing circumstances, including changing tax laws, unexpected Medi-Cal eligibility problems, and unexpected beneficiary incapacity or financial problems.

The durable power of attorney must be coordinated with the revocable trust. In many situations, the trustee and the attorney in fact should be the same individual or group of individuals. See §22.7.

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§1.5 E. Tax Neutrality of Revocable Trust

Generally, using a revocable trust provides no tax advantages over using a will. For discussion of the tax neutrality of revocable trusts, see §4.2. Clients who have attended financial planning seminars that promote both revocable trusts and tax savings strategies are often left with the mistaken impression that using a revocable trust is necessary to obtain the desired tax benefits.

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§1.6 F. Other Uses of Revocable Trust

In some situations, a revocable trust is used to avoid commingling certain property with other property. For example, clients with spouses or registered domestic partners may use revocable trusts as a device for holding separate property without commingling it with community property. Less often, revocable trusts are used as a device to settle family concerns about the ultimate disposition of property on a settlor's death. The settlor will transfer property to a "revocable" trust, but the trust instrument will preclude revocation without the consent of one or more individuals. Another, less frequent use for a revocable trust is as a device to manage property with multiple owners, such as a vacation home inherited from parents.

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II. EVALUATING REVOCABLE TRUST AS PROPERTY TRANSFER DEVICE

A. Probate Avoidance

§1.7 1. When Probate Is Necessary

"Probate" refers to the entire court process of administration of a decedent's estate. Probate involves proving the will, collecting the decedent's assets, paying debts and taxes, and distributing property to beneficiaries or to trusts for the beneficiaries' benefit. These activities are carried out by the executor or administrator under the probate court's supervision. On probating an estate, see California Decedent Estate Practice (2d ed Cal CEB 2009). On advantages of avoiding probate, see §1.8. On disadvantages of avoiding probate, see §1.9.

Property in a decedent's estate that is subject to distribution under a will must be administered and distributed through probate unless summary administration procedures are available. See Decedent Estate Prac, chap 3. In contrast, property transferred to a revocable trust during the settlor's lifetime is not part of the settlor's probate estate. *Nichols v Emery* (1895) 109 C 323, 41 P 1089; *Estate of Heigho* (1960) 186 CA2d 360, 9 CR 196. When a settlor dies, the trust functions like a will, disposing of the decedent's property without court supervision (unless requested by an interested party, including the trustee). Trust assets are administered and distributed by the trustee under the terms of the trust. See California Trust Administration (2d ed Cal CEB 2001).

A will must usually be probated if the value of the decedent's assets, including both real and personal property, passing to someone other than a surviving spouse or registered domestic partner exceeds $100,000. See Prob C §§13100, 13151; Fam C §297.5. Motor vehicles, mobilehomes, vessels, and unpaid employee compensation do not count against the $100,000 limit. Prob C §13050. Joint tenancy property, pay-on-death (POD) accounts, and other nonprobate transfers also do not count against the limit. See §§1.32-1.37. Proposed legislation could eliminate the need to probate a will in most cases by allowing a decedent's real property to pass as directed in a revocable transfer on death (TOD) deed, although similar proposed legislation failed in 2007. AB 724 (2009).

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§1.8 2. Advantages of Avoiding Probate

Probate avoidance can be desirable in California for several reasons. Notably, formal court-supervised administration of a decedent's estate tends to be slow and expensive. As a practical matter, the minimum period for a probate proceeding is 6 months. Costs include court filing fees, probate referee appraiser fees, the personal representative's commission (unless waived), and attorney fees that are usually established by a statutory fee schedule that, depending on the circumstances, may not be fair to the estate or the attorney. In contrast, a revocable trust can *sometimes* be administered fairly quickly and at a nominal cost if, *e.g.,* the trust has few assets, no tax problems, and a trustee who is also the sole beneficiary. See §§1.10-1.18.

Another potential benefit of avoiding probate is to maintain family privacy. The court file of a probate proceeding discloses extensive information about a decedent's assets, debts, and disposition of the assets. The court file is a public record, easily viewed by anyone willing to go to the court clerk's office and make a request. In contrast, information in a revocable trust can be kept confidential as long as the beneficiaries and next of kin cooperate. See §1.21.

Although there are other probate-avoiding devices (see §§1.32-1.37), few are well suited to the task of providing for a coordinated disposition of all of a decedent's property. For example, it is extremely difficult to use joint tenancies to equally distribute all of a client's property among multiple beneficiaries and also provide for distributions to alternate beneficiaries. Still, revocable trusts are not appropriate in all situations, and planners have a duty to consider appropriate options.

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§1.9 3. Disadvantages of Avoiding Probate

Many clients request revocable trusts because they wish to avoid probate, sometimes mistakenly believing that avoiding probate reduces death taxes. Although a revocable trust is an effective means to avoid probate, it may not always be in the client's best interest. Avoiding probate may simplify and expedite management of the client's assets at death (see §§1.22-1.23), improve privacy (see §1.21), and reduce costs (see §1.10-1.18), but in some situations, the expense and administrative burdens of a revocable trust during the client's lifetime outweigh these benefits and probate does have the benefits of court supervision (see §1.19) and applicability of probate law (see §1.20). In addition, the client may have simpler and cheaper ways to transfer property at death, particularly if the estate is small and does not include real estate. Finally, some clients with spouses or registered domestic partners want to dispose of their halves of community property without disclosing the details of their disposition plans to the spouse or partner. A jointly settled revocable trust is rarely appropriate for accomplishing such a purpose.

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§1.10 4. Administrative Costs of Trust and Probate

Conventional wisdom holds that using a revocable trust as a will substitute saves significant administrative costs because doing so avoids probate. This may not be true in each situation, however. For each client, the attorney should do a comparative analysis of the probable costs of administration of a revocable trust and a will to ascertain whether there is a net cost differential; the attorney should not assume that administrative costs are always lower for a trust. Even if probate costs exceed trust administrative expenses, the higher start-up costs of a revocable trust may make a trust a less attractive proposition, especially after the time value of money is considered. Legal fees for planning, drafting, and transferring assets to a trust are normally higher than the fees for preparing a will.

The administrative costs of a probate proceeding include court filing fees, the executor's commissions and attorney fees, referee appraisal fees, and publication costs. The last two expenses are minor and seldom affect the choice between a revocable trust and a will. Court filing fees are changed periodically and may be a consideration. Govt C §70650. The administrative costs of a revocable trust include the trustee's fees, the trustee's attorney fees, and various transfer costs. Executor's and trustee's fees are compared in §1.11. Attorney fees are compared in §1.18.

Often there is only a negligible difference in the administrative expenses of a will and a revocable trust because what needs to be done in a probate is similar to what needs to be done in postmortem administration of the trust. In both situations, it may be necessary to marshal assets, pay appropriate debts, sell property to gain liquidity, prepare tax returns, provide an accounting, distribute assets to the appropriate persons, and obtain receipts. Any net cost differential that does exist must be adjusted for the savings resulting from tax deductions permitted for administrative expenses in federal estate or federal and state income tax returns.

NOTE: Even when a revocable trust is used, a probate proceeding may still be required. A probate may be needed to administer assets inadvertently not transferred to the trust or unable to be conveyed to the trust, *e.g.,* a personal injury claim arising from the decedent's accidental death or an inheritance received by the settlor shortly before death.

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§1.11 a. Executor's Commissions and Trustee's Fees

To calculate whether the executor's commissions in a probate estate will exceed the trustee's fees for administration of a revocable trust, the attorney must examine the nature and value of the administered property and the duration of the administration. With community property, only the decedent's half is subject to probate administration unless the parties elect otherwise.

PRACTICE TIP: When analyzing relative fee considerations, the attorney should consider the possibility that the intended executor or trustee will waive fees. If, for example, an individual is both the executor and the sole residuary beneficiary under a will, it is highly likely that the individual will waive statutory executor commissions absent countervailing income tax considerations.

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§1.12 (1) Statutory Probate Fees

An executor's compensation for routine services is the statutory commission provided in Prob C §10800:

- 4 percent of the first $100,000 of the estate accounted for by the personal representative;
- 3 percent of the next $100,000;
- 2 percent of the next $800,000;
- 1 percent of the next $9 million;
- 0.5 percent of the next $15 million; and
- For amounts over $25 million, a reasonable amount to be determined by the court.

EXAMPLE: If the probate estate accounted for is $200,000, the commission is $7,000. For an estate accounted for of $1 million, the commission is $23,000.

The commission is a single commission for the entire administration of the estate, not an annual fee.

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§1.13 (2) Trustee's Fees

Because a revocable trust is not automatically subject to the probate court's jurisdiction, when the trust instrument is silent on trustee's fees, they become a matter for negotiation and may vary widely, depending on the assets and management responsibilities involved.

Occasionally, the trustee's fees are set by the terms of the trust. Probate Code §15680 requires that the trust instrument's fee terms be followed but authorizes the court to adjust this compensation if:

- The trustee's duties are significantly different from those contemplated when the trust was created;
- It would be inequitable or unreasonably high or low; or
- Extraordinary circumstances justify equitable relief.

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§1.14 (3) Corporate Trustee Fees

For routine trust services, many corporate trustees charge an annual fee based on a percentage of the fair market value of the trust assets. When the assets include real property, however, the fee may be based on additional factors such as income or rent from the real property. Some discounts are offered for large trusts. In addition, corporate trustees often request a distribution fee for all assets they distribute.

Corporate trustee fees commonly range from ¾ of 1 percent to 1.1 percent per year for the first $1-2 million of assets, with progressively lower fees for higher amounts. The fees are usually higher (often 1.25 percent) if the trust contains real property that must be actively managed and the trustee does not hire an outside management firm to handle this responsibility. In addition, many corporate trustees charge $350-500 per year to prepare tax returns. Other extraordinary services (*e.g.,* preparing special tax forms or the sale of real estate) generate additional fees. Some trustees also charge an acceptance fee and a termination fee on distribution of the trust.

Corporate trustees typically charge a one-time premium if they are asked to serve as successor trustee. To act as successor trustees, corporate trustees usually request an acceptance fee of at least 1/10 of 1 percent of trust assets. If past records for the trust are inadequate or unavailable, or if the trust has other problems, the acceptance fee will be greater. This charge, like all other trustee's fees, is negotiable.

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§1.15 (4) Fees for Continuing Trusts

If the client's estate plan calls for continuing trusts after the initial administration of the estate, such trusts can be created and governed by either a revocable trust or a will. The rules and practices setting the trustee's fees for a revocable trust also apply to setting the fees of the trustee of a testamentary trust. Probate Code §15680 controls, but if the will is silent on the fees, Prob C §15681 directs the court to award the trustee "reasonable compensation." Unless the will provides that the trust is subject to continuing jurisdiction, only trusts that were created under a will executed before July 1, 1977, that were not incorporated by reference in a later will, and that do not have a trust company as trustee are subject to ongoing court supervision. Prob C §§17300-17303, 17350-17354.

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§1.16 (5) Court Approval of Fees

The settlor may require court approval of the trustee's fees. The trustee may petition the court to fix the fee. Prob C §17200(b)(9). If court approval is required or requested, "reasonable compensation" (see Prob C §15681) for a trustee's usual services has traditionally been a percentage of the fair market value of the trust assets, with some discounts for bigger trusts. The percentage varies over time and from county to county. Courts in many counties do not automatically award percentage-of-assets fees but require the trustee to justify the fees with a declaration of time spent, responsibility assumed, nature and extent of services rendered, and results produced.

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§1.17 (6) Extraordinary Fees

The fees discussed in §§1.11-1.16 are compensation for ordinary services. Executors and trustees of both revocable and testamentary trusts are entitled, on a proper showing, to reasonable compensation for any extraordinary services. Prob C §§10801. See Prob C §§15680(b)(2)-(3) (court's power to allow greater trustee compensation than that specified in trust), 15681 (trustee's entitlement to reasonable compensation if trust instrument does not specify compensation).

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§1.18 b. Attorney Fees

The attorney fee for ordinary probate services provided to an executor is the same as that for executors. See Prob C §10810. On a proper showing, the probate court may also award the attorney compensation for extraordinary services rendered. Prob C §10811. The statutory fee in §10810 is the *maximum* that an attorney may receive for ordinary probate-related services. The executor is free to negotiate with the attorney a lower-than-statutory fee for ordinary services (*e.g.,* the lower of the statutory fee and the fee based on the attorney's hourly rate) at the time the attorney is retained.

There is no statutory formula for setting the fee of an attorney for a trustee; trustees and attorneys are free to negotiate a fair fee.

NOTE: When the revocable trust instrument has been carefully drafted, the trust properly operated, and adequate records maintained, the services that an attorney must render after the settlor's death are usually fewer than those that an attorney must provide for a probate administration. Consequently, the attorney fee after the settlor's death will be less than if a will were used, although legal fees during the settlor's lifetime will be higher.

In making fee estimates for a trust, the attorney should bear in mind that the appropriate amount of legal fees often relates more to the nature of the assets involved than their value. For example, a trust containing liquid assets such as cash or publicly traded securities usually requires far fewer legal services than one with a minority interest in a business, an apartment building, an art collection, or an author's royalty rights and copyrights.

WARNING: An attorney has an ethical obligation to describe fairly and accurately the possible cost savings from the use of a revocable trust and to recommend a revocable trust if that is in the client's best interest, even though the fees after death that the attorney will earn would then be less than if the estate were subject to probate.

There are restrictions against dual compensation to an attorney personal representative or an attorney trustee. See Prob C §§10804 (attorney-personal representative), 15687 (attorney-trustee). For further discussion of limitations on attorney trustees, see §5.12.

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§1.19 5. Court Supervision

The probate court has general supervision over the administration of a decedent's probate estate, but a revocable trust used as a vehicle for administration and distribution of an estate is not supervised unless the court's jurisdiction is explicitly invoked. A trustee, therefore, can generally act more quickly than an executor to carry out necessary fiduciary duties.

An executor cannot begin to perform his or her duties without first receiving letters testamentary from the court. Prob C §8400(a). Often, these letters are not received until two or three months after the decedent's death. It can take longer if the addresses of all persons entitled to notice of the petition for letters are not immediately available or if anyone objects to or contests the petition. The delay can be minimized by petitioning for letters of special administration (see Prob C §§8540-8542), but doing so will result in additional expense.

Although court supervision has drawbacks, it has some advantages. Foremost among these is the protection of beneficiaries. For example, notice periods give interested parties an opportunity to object to the matters covered by the notice. Also, if there is a will contest or a large creditor's claim, spouses, registered domestic partners, and children can be provided for by a family allowance, which has priority over most creditors' claims. No such protection is available with a revocable trust. See Prob C §19001(a); Fam C §297.5(c). See also §1.25.

Court supervision may also be helpful in administrations that involve complex transactions or distribution requirements. Although a lengthy petition for final distribution is required, the court does review and approve final accounts and distributions in varying degrees, thus sometimes providing some protection and finality for all involved. Furthermore, because Prob C §10501(a)(2) requires court approval for all payments to the executor's attorney, extraordinary fees for such services as property sales and estate tax returns may be lower in an estate administration than in a trust administration because courts may decrease requested fees for such services.

Court supervision is available in a revocable trust administration in that a trustee or beneficiary may invoke the probate court's jurisdiction to instruct the trustee or to grant other relief. Prob C §§850(a)(3), 17200. It is usually somewhat more cumbersome, however, for a trustee or beneficiary to obtain a court order than for an executor to do so.

In *Estate of Kraus* (2010) 184 CA4th 103, 108 CR3d 760, the court of appeal held that the probate court did not exceed its jurisdiction under Prob C §850(a)(3) when it ordered the decedent's brother to deliver misappropriated funds to a personal representative who would be appointed by the court in the future. The brother had moved the funds from decedent's bank accounts to accounts in his own name using an invalid power of attorney. The petitioners were the residuary beneficiaries of decedent's revocable trust and the misappropriated funds were allegedly intended to pass to the trust under decedent's pourover will. The probate court granted the petition even though the court did not determine that the petitioners would ultimately be entitled to the misappropriated funds.

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§1.20 6. Applicability of Probate Law

California has a large body of both statutory and case law dealing with probate estates. Portions of this body of law clearly apply to revocable trusts. Probate Code §§21101-21140, for example, provide rules for interpretation of instruments including wills, trusts, deeds, and other instruments. Probate Code §§21600-21630 provide for omitted spouses, registered domestic partners, and children under both estates and trusts that become irrevocable on the death of the settlor.

Other helpful rules applicable in the probate context quite clearly do not apply to revocable trusts. For example, Prob C §9630 states that, when there are more than two executors, a majority of them can act on the estate's behalf. There is no corresponding provision dealing with trusts. Absent a trust provision to the contrary, Prob C §15620 generally requires that trustees act unanimously.

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§1.21 7. Privacy of Trust Administration

Because a revocable trust need not be filed with the probate court, the publicity of court filings and proceedings may be eliminated. Entertainers, persons of great wealth, and other public figures are particularly attracted to this aspect of revocable trusts. Trust provisions may become public if an interested party invokes the court's jurisdiction under Prob C §17200, but by that time, the interest of the public and press in the decedent's affairs may have subsided.

Sometimes clients do not want their dispositions disclosed to certain family members. With respect to family members, the privacy benefits of California revocable trusts are extremely limited by the notification provisions of California's laws. These laws generally require the trustee to give copies of the terms of the trust that becomes irrevocable to any beneficiary or heir at law who requests them. The trustee is required to notify these persons of that right. Prob C §§16060.5-16061.9. If a client desires to promote privacy for a specific disposition, the client should consider using some nonprobate transfer method for that particular disposition.

Generally, California law makes it possible for a trustee to administer a trust without disclosing the dispositive provisions to third parties involved in business transactions with the trust. Third parties are protected in transactions with trustees if the trustee provides a specified certification concerning trust information and discloses certain information that notably does *not* include the dispositive provisions. Prob C §18100.5. On certifications of trust, see §22.1-22.2.

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B. Management

§1.22 1. Continuity of Management

A funded revocable trust makes continuity of management of the settlor's assets possible. The trustee's powers are not interrupted by a settlor's death. Even when the deceased settlor was the trustee, if the trust instrument names a successor trustee, trust assets can be managed by the new trustee with minimal delay.

In contrast, at least three to four weeks are required to appoint an executor in a probate proceeding. Although a special administrator can be appointed almost immediately in emergency situations (Prob C §§8540-8541), the estate incurs additional expense if this is done. A funded revocable trust can be particularly helpful, therefore, if the settlor's assets may require uninterrupted management or rapid decision making after the settlor's death.

A revocable trust's feature of continuous financial management allows a settlor to provide quickly and adequately for his or her beneficiaries. After a settlor's death, distributions may be made to named beneficiaries in the amounts and at the times provided in the trust instrument, and sprinkling provisions may permit the trustee to adjust distributions for each beneficiary's needs. For a discussion of sprinkling provisions, see §§7.80-7.84. Distributions are limited only by the settlor's instructions and not by any statutory requirements. The trustee can begin making distribution payments immediately, instead of having to wait for court appointment or approval. On distributions and tax considerations, see chap 4.

In contrast, in a probate administration, distributions to ultimate beneficiaries are often delayed for months or even years. (Long delays, however, are often principally the result of tax or litigation problems that a revocable trust could not eliminate.) In the interim, a family allowance may be paid to the surviving spouse; registered domestic partner; minor, incapacitated, or dependent adult children; and dependent parents. Prob C §6540; Fam C §§297.5, 299.3. Even the payment of this allowance, however, can be made only with court approval or by complying with the notice of proposed action procedure. Prob C §10535. A family allowance, moreover, may be inconsistent with the decedent's testamentary plan. See 2 California Decedent Estate Practice §17.39 (2d ed Cal CEB 2009).

There is no statutory provision for a family allowance from a revocable trust. If a trust contest or other problem occurs, the trustee may refuse to make any interim distributions similar to a family allowance.

The executor may be able to make preliminary distributions to provide for beneficiaries (see Prob C §11623), but these distributions cannot be made immediately and will create extra expense and administrative burdens. The use of preliminary distributions to provide for the beneficiaries' interim needs may also be limited by tax considerations. See chap 4.

Instead of relying on a family allowance or preliminary distribution to provide for immediate beneficiary needs, a client may use joint tenancies, Totten trusts, or life insurance proceeds. These devices are inflexible, however, and could be inconsistent with the client's overall estate plan; the amount of the payment is usually fixed, and distribution to a beneficiary must be outright rather than in trust. Life insurance proceeds can be paid to a testamentary trust before distribution of the estate, but a court order must be obtained establishing the trust and appointing the trustee.

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§1.23 2. Coordination of Management

A revocable trust can serve as a unified collection and distribution receptacle for all the client's assets, including the residue under a will (Prob C §6300), life insurance proceeds, benefits payable under pension and profit-sharing plans, and other contractual payments such as deferred compensation. A trust permits better coordinated management and greater flexibility after death than is possible with a separate and uncoordinated administration of insurance benefits, retirement plans, and a will.

A revocable trust provides more flexibility in distribution terms than is available in most insurance or retirement plan settlement options. Sprinkling provisions, invasion powers, and spendthrift limitations, for example, may be included in a trust to allow income tax planning and to provide beneficiaries with added protection from creditors. For a discussion of sprinkling provisions, see §§7.80-7.84.

Alternatively, postmortem administration of a client's assets can be unified by channeling all assets to the probate estate and distributing them through the will. This strategy, however, subjects all assets to the delay and administrative burden of probate, and generates additional statutory fees. See §1.12.

As another management device, the client can designate a testamentary trust as the recipient of both probate and nonprobate assets. Insurance proceeds, pension plan benefits, and similar assets payable to the trustee of a testamentary trust will not be subject to probate administration or the decedent's debts. See generally Prob C §§6320-6330. Use of a testamentary trust may cause some delay, however. Practically speaking, the trust may not come into existence until a court order establishes it and appoints the trustee. See *Estate of Barter* (1947) 30 C2d 549, 557, 184 P2d 305. In at least one county, however (Los Angeles), the probate court is willing to issue an order establishing a testamentary trust as soon as an executor is appointed.

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§1.24 C. Tax Considerations

Generally, revocable trusts are tax neutral and offer no significant tax advantages or disadvantages compared with a will. See §4.2. With respect to the period immediately after death, a revocable trust may elect to be treated *as* a probate estate or *as part* of a probate estate. IRC §645.

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§1.25 D. Creditors' Claim Issues

In most situations not involving death bed planning, creditor rights' issues will not play a major role in determining whether a client should use a revocable trust. Statutes applicable to the probate court administration of decedent's estates provide several benefits for members of the decedent's family. The spouse or registered domestic partner and minor children are entitled to temporary possession of the family dwelling, most tangible property, and property exempt from enforcement of a money judgment. Prob C §6500; Fam C §297.5(c). Property exempt from a money judgment can be permanently set aside (Prob C §6510), and the court has discretionary power to set aside a dwelling as a probate homestead for a term determined by the court (Prob C §6520-6528). The court also has a discretionary power to order payment of a family allowance during administration of the estate. Prob C §6540-6545.

There are no comparable protections for the spouse or registered domestic partner and minor children of a decedent who held property in a revocable trust. Property in a revocable trust is subject to the claims of creditors of a deceased settlor's estate to the extent that the probate estate is inadequate to satisfy those claims. Prob C §19001(a). For further discussion of this liability, see §15.22.

PRACTICE TIP: These statutes seem to suggest that using a revocable trust results in some loss of family protection when the decedent is survived by a spouse, registered domestic partner, or minor children. However, it is also necessary to consider the fact that probate proceedings compel diligent efforts to notify the decedent's creditors of the decedent's death and their opportunity to file claims. See Prob C §9050 (personal representative must give notice to specific creditors). There is no similar requirement to give notice to creditors when administering a revocable trust unless the trustee voluntarily chooses to use the creditor claim procedures for revocable trusts in Prob C §§19000-19403. See §15.26.

PRACTICE TIP: It is sometimes possible to minimize property exposure to a decedent's creditors by holding property as joint tenants. It appears that such property cannot be reached by creditors after death unless the creation of the joint tenancy was a fraudulent conveyance under the Uniform Fraudulent Transfer Act (CC §§3439-3439.12). See *Grothe v Cortlandt Corp.* (1992) 11 CA4th 1313, 15 CR2d 38. But see *Dieden v Schmidt* (2002) 104 CA4th 645, 128 CR2d 365 (judgment lien enforceable against joint tenant's interest after death because lien had attached when tenants held property as tenancy in common before they converted to joint tenancy and before right of survivorship attached).

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§1.26 E. Mobility and Choice of Forum

Use of a revocable living trust can help the client avoid one or more ancillary probate proceedings in other jurisdictions where a settlor owned real or tangible personal property, because property held in a living trust is not subject to probate in the jurisdiction where the property is located. Thus a revocable trust eliminates the administrative burden and expense of several probate proceedings.

Further, consolidating the management of assets located in several states after the settlor's death may be easier if no state's probate court jurisdiction has to be invoked.

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§1.27 F. Comparing Will and Trust Contests

As a practical matter, the risk of a contest is usually not a factor in deciding whether to use a revocable trust. Both wills and trusts may be challenged on grounds of lack of capacity, undue influence, fraud, duress, mistake, and violation of the rules invalidating transfers to drafters of instruments and other "disqualified persons." See Prob C §§21350-21356. See §§2.36-2.39. For further discussion, see California Trust and Probate Litigation, chap 6 (Cal CEB 1999). See also Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide April 2010).

NOTE: Although it is occasionally suggested that a trust may be easier to attack than a will because the standard of capacity may be higher, the issue is moot if the client also executes a pour-over will that provides the same distribution on death or incorporates the revocable trust document by reference. See §§22.3-22.6.

The time period for contesting a will is substantially the same as for a trust. A challenger may contest a will any time up to 120 days after the will is admitted to probate. Prob C §8270(a). A challenger may contest a revocable trust for 120 days after the date of notification by the trustee or 60 days after the mailing or personal delivery of a copy of the terms of the trust during that 120-day period, whichever is later. Prob C §16061.8.

In a particularly high-risk situation, the fact that a family allowance can be ordered in a probate proceeding may be a factor to consider if the decedent is likely to be survived by a spouse or registered domestic partner or minor children. The court can order payments for their support during administration of the estate (Prob C §§6540-6545; Fam C §297.5(c)), but there is no comparable provision for supporting the beneficiaries of a revocable trust during a trust contest.

For a no-contest clause in a trust, see §19.5.

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§1.28 G. Legal Uncertainties Concerning Specific Assets

Practitioners have long been concerned about possibilities that transfers of various assets to a revocable trust might have negative results in taxes or legal rights. As a consequence of the growing use of revocable trusts, many laws, particularly tax laws, have been amended to eliminate negative consequences, but some uncertainties remain. These are discussed in §§1.29-1.31.

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§1.29 1. Encumbered Real Property

In California, the standard instrument used to impose an encumbrance on real property to secure an obligation of the owner is the deed of trust. Most deeds of trust and the notes they secure contain a "due-on-sale" clause that purports to give the lender a right to accelerate the secured obligation if the owner transfers the property. This raises the issue of whether a transfer to a revocable trust triggers the clause.

The Garn-St. Germain Depository Institutions Act of 1982 (Garn Act) (Pub L 97-320, 96 Stat 1469) provides that a due-on-sale clause cannot be enforced on "a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property." 12 USC §1701j-3(d)(8). The Code of Federal Regulations interprets this provision of the Garn Act to mean that the borrower must remain the occupant of the real property for the prohibition to apply. 12 CFR §591.5(b)(1)(vi). Therefore, a risk of acceleration still exists for transfers of encumbered investment property.

Civil Code §2924.6(a)(4) provides that an obligee may not accelerate the maturity date on loans executed or refinanced on or after January 1, 1976, that are secured by residential real property (defined as real property containing one to four housing units) if the property is transferred into a living trust in which the obligor is a beneficiary. Thus, CC §2924.6 does not include the Garn Act requirement that the borrower remain an occupant of the real property in order for the prohibition on due-on-sale acceleration to apply.

The Garn Act, however, was intended to preempt state law, except as expressly stated in the Act. See 12 USC §1701j-3(b). Thus, except for particular types of transfers excepted by 12 USC §1701j-3(d), the Garn Act appears to permit enforcement of due-on-sale clauses when there is a transfer of rights of occupancy in the trust property, regardless of state law, under the contract between the parties and without a showing of impairment of security or increased risk of default. 12 USC §1701j-3(b)(2).

To the extent that CC §2924.6 is preempted, it is ineffective insofar as it conflicts with the Garn Act (*i.e.*, when the borrower/trust beneficiary is no longer an occupant of the property). It is not clear, however, that state or federal courts will find the circumscribed provisions of §2924.6 to be preempted, particularly because they deal with the sensitive and heavily regulated issue of loans on small residential properties.

PRACTICE NOTE: Practitioners who are concerned about this risk may apply to lenders for permission to transfer encumbered property to trusts. Lenders charge fees for these waivers. The fees are usually modest, but there is no assurance that this will be true if an existing loan provides an exceptionally low rate of interest compared with the current market rate. However, most practitioners do not apply for waivers, noting that historically lenders have not attempted to accelerate loans merely because of a transfer to a revocable trust.

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§1.30 2. Assets Covered by Title Insurance

Title insurance issues can be important if the client owns real estate or a promissory note secured by real estate. Generally, a transferee of an interest in real property is not protected by a title insurance policy issued to the transferor, although some title companies now offer policies that expressly extend the owner's coverage to the trustee of the owner's revocable trust. Whether a title insurance company could successfully deny coverage for property transferred to a revocable trust is open to debate. During the period that the trust is revocable, the settlor might well be successful in contending that the original insurer is still obligated to protect the settlor's retained equitable interest in the property—particularly if the settlor removed the property from the trust before making a claim against the policy. There is little evidence that California title companies have attempted to deny coverage in this situation. Some title companies now issue an "additional insured endorsement" at the time property is transferred to a trust, thereby extending coverage to the trustee. Premiums are usually modest for residential properties.

PRACTICE TIP: Most practitioners do not routinely suggest that their clients apply for additional insured endorsements, but clients should be advised of the option.

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§1.31 3. Stock in IRC §1244 Small Business Corporation

If a corporation qualifies as a small business corporation under IRC §1244, a stockholder who acquired stock directly from the corporation in exchange for money or property may be able to treat a loss on disposition of the stock as an ordinary loss rather than a capital loss. Although it is sometimes suggested that this benefit is lost if the stock has been transferred to a revocable trust, this suggestion is highly questionable. It is true that a trust cannot claim a loss under §1244, but a loss by a revocable trust is treated as a loss by the settlor for income tax purposes under IRC §671. Treas Reg §1.1244(a)-1(b). Most clients do not own IRC §1244 stock, and those who do are seldom concerned about the possible loss of §1244 benefits, either because the corporation has been successful or because the corporation was so thinly capitalized that the maximum loss on disposition of the stock would be nominal in any event.

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III. ALTERNATIVE PROPERTY TRANSFER DEVICES

§1.32 A. Small Estate Procedures

A procedure for collecting an estate by affidavit if the estate's value does not exceed $100,000 is set forth in Prob C §13100-13116. Many assets are ignored in determining whether the estate's value exceeds $100,000, including assets held in joint tenancy, assets passing to a surviving spouse or registered domestic partner, revocable trust property, motor vehicles, motor homes, and vessels. Prob C §13050; Fam C §297.5(c). These statutes sometimes make it possible to pass even a sizable estate without probate and without using a revocable trust, although it is necessary to take into account that the procedures are not available until 40 days after death. Prob C §13100.

EXAMPLE: A client may have a sizable brokerage account that will pass to an only child under a transfer-on-death security registration. See §1.36. The account will not count against the $100,000 limit, with the consequence that the rest of the estate can be disposed of by will. This situation often arises when a client lives in a retirement community but does not have an ownership interest in his or her dwelling unit that will be part of his or her estate.

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§1.33 B. Property Passing to Surviving Spouse or Registered Domestic Partner

No probate is required for property passing under a will (or by intestate succession) to a surviving spouse or registered domestic partner. Prob C §13500; Fam C §297.5(c). On the other hand, probate has the advantage that the surviving spouse or partner may elect to have his or her share of community property administered in the probate proceeding along with the decedent's share. Prob C §13502.

NOTE: If the procedures described below are not available, the surviving spouse or partner may claim the property by spousal property petition under Prob C §13650. However, the surviving spouse or partner may be estopped from claiming the property by petition if the estate has already been administered. *Estate of Bonanno* (2008) 165 CA4th 7, 80 CR3d 560.

A spouse or partner entitled to estate property can gain control and title to the property in a variety of ways:

- If the value of estate property not passing to the spouse or partner is under $100,000, the spouse or partner can collect personal property by affidavit under Prob C §13100, regardless of the value of the property passing to the spouse, because that property does not count against the $100,000 limit.
- If the property is real property, the spouse or partner can use the same simplified procedures in §13100 to transfer it.
- If the value of real property passing to others is under $20,000, the spouse or partner can use the affidavit procedure described in Prob C §§13200-13210.
- If the value of real property passing to others is under $100,000, the spouse or partner can use the simplified court proceeding for a court order determining succession to property described in Prob C §13150.
- If the spouses or partners took title in a manner showing that the property was community property or even simply described the owners as husband and wife, no proceeding is necessary, and the surviving spouse can sell the property 40 days after death under Prob C §13540.

PRACTICE TIP: The availability of these procedures is particularly important when assessing the need for a revocable trust for a younger couple. Because no probate will be necessary except in the case of death in a common disaster, it is often worthwhile for young couples to use simple wills rather than a revocable trust as their primary property transfer device. The risk of incapacity can be dealt with by using durable powers of attorney. If desired, the durable power can confer the power to establish a revocable trust that is consistent with the client's will.

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§1.34 C. Joint Tenancy and Community Property With Right of Survivorship

Joint tenancy is sometimes considered an alternative to a revocable trust for distribution of assets on death. Although a joint tenancy avoids probate more easily and cheaply than does a revocable trust, it lacks the trust's flexibility. The particular pros and cons of joint tenancies vary, depending on the asset:

- If the asset is real property, the creation of a joint tenancy may result in an immediate gift. The client loses control of the gifted interest, which can be reached by the new joint tenant's creditors.
- If the asset is an individually held security, the client may lose the ability to unilaterally transfer his or her own retained interest.
- If the asset is a financial institution account, the client retains the ability to revest the account assets in himself, but there is a risk that the other joint tenant will withdraw and dissipate the assets.

Regardless of the type of asset, it is not possible to name contingent joint tenants who will take the property if deaths occur out of order. Accordingly, joint tenancies create the risk that a probate will be necessary to transfer the decedent's property.

Community property with a right of survivorship (see CC §682.1(a)) is a similar device. Property owned in this form apparently retains all features of community property (including receipt of a new basis on death for both halves in the case of married settlors for both federal and state income tax purposes under IRC §1014 or §1022) except that the property passes on death to the survivor in the same manner as joint tenancy property. Community property with right of survivorship appears to be community property for purposes of liability for debts and would therefore generally be liable for the debts of either spouse or registered domestic partner.

PRACTICE TIP: In some situations, true joint tenancy may provide better asset protection than would community property with a right of survivorship, particularly with respect to debts of the deceased spouse or registered domestic partner.

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§1.35 D. Totten Trusts and Pay-on-Death Accounts

In California, some financial institutions permit establishment of accounts in the form "X, Trustee for Y." These accounts, called "Totten trusts," permit a settlor to retain exclusive rights to the account during his or her lifetime. On a settlor'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, 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).

NOTE: A joint account may not protect the rights of the settlor. While Prob C §5301(a) generally provides that a joint account belongs, during the lifetime of all parties, to the parties in proportion to the net contributions of each to the sums on deposit, at least one court has held that this statute applies only while the sums remain on deposit. Accordingly, the court held that an account owner who withdraws more than that owner's share of the account contributions has no duty to account to the other owner. *Lee v Yang* (2003) 111 CA4th 481, 3 CR3d 819.

Most spouses use a joint account rather than a Totten trust or POD account to hold cash or securities, 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. *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240.

A Totten trust or POD account is similar to a revocable trust in that the settlor may revoke the trust or account at any time before death. See Prob C §5301(a). Moreover, the trust or POD account is includable in the settlor's gross estate, to the extent of his or her interest in it, for federal estate tax purposes. See IRC §2038.

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.

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§1.36 E. Transfer on Death 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 §1.35.

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§1.37 F. Irrevocable Trusts

In contemporary estate planning, irrevocable trusts are primarily used to facilitate inter vivos gifts rather than to make transfers at death. Unlike revocable trusts, transfers to irrevocable trusts commonly have significant tax consequences, so most of these trusts are tax-motivated. Irrevocable inter vivos trusts are particularly used for the purpose of holding life insurance policies.

PRACTICE TIP: It is sometimes suggested that an irrevocable trust can be used instead of a revocable trust in order to circumvent the Prob C §§16061.5-16061.7 trustee notification provisions that effectively allow heirs at law to obtain copies of revocable trusts when a settlor dies. The settlor could name him- or herself as a beneficiary of the trust during life and could retain a broad power to change the provisions for the distribution of the trust estate following the settlor's death. Alternatively, confidentiality might be achieved by establishing a revocable trust that simply provides that on the settlor's death the entire estate is to be distributed to a separately established irrevocable trust. For further discussion of irrevocable trusts, see Drafting California Irrevocable Trusts, chap 1 (3d ed Cal CEB 1997). See also California Estate Planning, chap 6A (Cal CEB 2002).

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IV. EVALUATING REVOCABLE TRUST AS INCAPACITY PLANNING DEVICE

§1.38 A. Limitations of Revocable Trust

A fully funded revocable trust is a useful device for managing client property in the event of the client's incapacity, although it suffers from several potential weaknesses. The first weakness arises when the settlor is the original trustee and the settlor's incapacity is uncertain. The situation may be aggravated if the trust document has provisions that make determinations by physicians or named individuals mandatory instead of optional. If the provisions are optional, the practical solution to the capacity determination problem is to have the settlor sign a resignation. A successor trustee who is armed with a signed resignation can then safely execute a certificate of trust (see Prob C §18100.5) declaring that the successor is the incumbent trustee and thereby take control of the trust assets. It is immaterial whether the settlor has capacity to execute the resignation. If the settlor has capacity, the resignation is valid. If the settlor lacks capacity, the successor is entitled to be trustee in any event.

A second significant weakness of a revocable trust as a device for managing the property of an incapacitated person is that the trustee as such can only manage trust property. If property cannot be transferred to the trust or is inadvertently omitted from the trust, problems arise. Usually these can be addressed by also having the client execute durable powers of attorney that authorize agents (usually the same persons who are the successor trustees) to transfer property to the trust and take management actions with respect to property that cannot be transferred. See §16.45.

Finally, a trustee of a revocable trust lacks the authority to take a variety of personal actions for an individual. For example, a trustee cannot file tax returns or initiate law suits for personal injuries. Again, it is necessary for a client to have a durable power of attorney regardless of whether the client has a revocable trust.

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§1.39 B. Administrative Burdens

In contrast to the use of a durable power of attorney to administer a client's affairs during incapacity, the use of a revocable trust requires the transfer of assets to a trustee. Later, during any period of incapacity, the trustee is generally subject to obligations to render accounts even without a court order, while an attorney-in-fact is rarely required to do more than maintain adequate records. Compare Prob C §§16062-16064 (trustee must make annual accounts in absence of contrary provision in trust document) with Prob C §4236 (attorney-in-fact need only maintain records unless account ordered by court or demanded by principal, principal's conservator, or personal representative of principal's estate).

Sometimes business transactions are more complicated if conducted by a trust. For example, although exceptions are becoming more common, many banks and other lenders will not make a secured loan to a revocable trust. They insist that the property be transferred out of the trust until the loan is completed. Title insurance examiners and stock transfer agents often require a certified copy of the trust instrument, or at least an abstract of it, before insuring or transferring title to assets held in a trust. Banks also may require a copy of at least an abstract of the trust document before establishing a bank account for the trust.

PRACTICE TIP: Probate Code §18100.5 authorizes a trustee to present a certification of trust to any person in lieu of providing a copy of the trust document to establish the existence or terms of the trust. The certification may include an abstract of relevant portions of the trust. For a sample certification of trust, see §22.2.

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§1.40 C. Expenses of Revocable Trust

One disadvantage of a revocable trust is the cost of establishing and administering it. Legal fees for planning and drafting the trust may be substantial. Brokerage charges, recording fees, and other transfer costs may be incurred when the trust is funded as well as legal expenses to arrange for the transfer of complex assets such as limited partnership interests. Some of these expenses, however, may be deductible if they are related to the management of income-producing property (IRC §212(2)) or to tax advice (IRC §212(3); *Sidney Merians* (1973) 60 TC 187, acq 1973-2 Cum Bull 2; see also *Arthur K. Wong*, TC Memo 1989-683). Such expenses are subject to the 2-percent floor on miscellaneous itemized deductions under IRC §67. See §4.18.

The deduction for trust administration expenses of a grantor trust are passed through to the settlors during the settlors' lifetimes and are also subject to the 2-percent floor on miscellaneous itemized deductions. IRC §67(c); Temp Reg §1.67-2T(b).

The most significant expense is likely to be the third party trustee's fees. These fees generally are the same before and after death. If a settlor acts as trustee, trustee's fees will not be incurred. When a settlor is also the trustee, however, some of the lifetime management benefits of the trust are not realized. In addition, acting as one's own trustee may not save trustee's fees in the long run. If a settlor trustee has not kept accurate and complete records, or if the trust does not clearly exonerate a successor trustee for the prior trustee's acts, the person or institution appointed as successor trustee may be willing to act on the death or incapacity of the settlor only if there will be adequate compensation for the extraordinary work required to marshal the trust assets and set up the trust properly.

Trustee's fees and other trust administration expenses are deductible for income tax purposes to the extent that they are allocable to the production of taxable income. See Rev Rul 58-53, 1958-1 Cum Bull 152. See also *Trust of Bingham v Commissioner* (1945) 325 US 365, 89 L Ed 1670, 65 S Ct 1232. If fees paid after a settlor's death are allocable to predeath services relating to income-producing assets, they may be deductible by the estate for income tax purposes under IRC §691(b) and also for estate tax purposes. See Rev Rul 76-498, 1976-2 Cum Bull 199. Fees for predeath services relating to non-income-producing assets do not qualify for an income tax deduction and are therefore deductible only for estate tax purposes as claims against the estate.

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§1.41 D. No Significant Tax Effects

Creating a revocable trust in itself has no significant tax effects during the settlors' lifetimes because the trust property is treated as owned by the settlors. IRC §671. See §§4.2-4.11.

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V. ALTERNATIVE INCAPACITY PLANNING DEVICES

§1.42 A. Durable Power of Attorney

A power of attorney is a written instrument in which one person (the principal) designates another (the agent) to act on the principal's behalf. Like a revocable trust, a power of attorney enables a client to entrust the management of his or her financial affairs to another.

If a power of attorney is made "durable," it remains in effect even when the principal later loses capacity. To be durable, the instrument creating the power must contain the words "This power of attorney shall not be affected by subsequent incapacity of the principal" or similar words showing the same intent. Prob C §4124. A durable power of attorney (DPOA) for financial management, therefore, provides a client with the means for surrogate management of his or her financial affairs during lifetime, regardless of capacity.

In general, a durable power of attorney is effective until the principal's death, the revocation of the power, or the termination of the power by its terms. See Prob C §4152.

A DPOA may be designed to be effective immediately on its execution (an immediate power) or only when the principal becomes incapacitated (a springing power). Prob C §§4030, 4124, 4129.

PRACTICE TIP: If a client desires a springing DPOA, the attorney should point out that proving the principal's incapacity may mean frustration and delays for the agent when the DPOA must be used. One solution for this problem is to designate in the power of attorney specific persons who have the power to determine that the client is incapacitated. Third parties are entitled to rely on that person's declaration under penalty of perjury that the principal has lost capacity. Prob C §4129.

For complete discussion of DPOAs, including drafting tips and sample forms, see California Powers of Attorney and Health Care Directives, chap 4 (Cal CEB 2008).

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§1.43 1. Advantages of DPOA

Of the three major legal options for surrogate lifetime financial management (revocable trust, durable power of attorney, conservatorship), a durable power of attorney (DPOA) for financial management is the simplest to implement. The instrument establishing the DPOA can be easily prepared and executed. See California Powers of Attorney and Health Care Directives, chap 4 (Cal CEB 2008). No transfer of title to assets is required, court supervision is unnecessary, and administrative requirements are minimal.

Because the DPOA is easy to implement, it is an economical device. Attorney fees for preparing and executing a DPOA are substantially less than those for setting up a revocable trust or establishing a conservatorship.

Like a revocable trust, the DPOA's lack of court supervision ensures the principal's privacy and minimizes delays in financial transactions. If court supervision is desired, a relatively simple procedure to obtain court review is available. See Prob C §§4500-4545. On appealability of DPOA orders, see Prob C §1302.

A DPOA is also quite flexible. The powers granted to the agent may be as broad or as narrow as the principal wishes. In fact, the agent may be authorized to do virtually anything the principal can do, other than exercise the principal's fiduciary duties, make a will for the principal, or perform other acts requiring the principal's personal attention.

NOTE: Despite this flexibility, a revocable trust can in some ways be more easily tailored to the client's particular needs than can a DPOA. For example, a trust may include investment powers and accounting responsibilities, which are not usually included in a DPOA.

Like a revocable trust, an immediately effective DPOA confers on the client the ability to make a "trial run" of the management of his or her financial affairs by another. If the agent is permitted to handle property matters while the principal has capacity, the principal can monitor the agent's performance.

A DPOA is particularly useful when surrogate financial management is desired for only a short time. Because a revocable trust involves an important change in legal relationships and title to property, it is generally used only when long-term management is contemplated. For example, if all that is required is someone to handle the client's affairs while he or she is spending the summer abroad, a DPOA is more suitable than a trust.

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2. Disadvantages of DPOA

§1.44 a. Third Party Acceptance Problems

A persistent problem with the DPOA is the reluctance of some third parties to honor it. Some third parties, particularly title companies, are less willing to transact business with an agent under a DPOA than with a conservator or trustee, despite statutory provisions protecting the third parties. See, *e.g.*, CC §1216 (requiring recordation of certain revocation instruments); CC §2356(b) (protecting anyone entering into bona fide transaction with agent who is ignorant of revocation, death, or principal's incapacity); Prob C §§4303-4305 (protecting third parties to transaction who are ignorant of agency's termination); Prob C §4406 (allowing agents to compel third parties to honor statutory form power of attorney). Banks and other financial institutions are often reluctant to recognize a power of attorney not executed on their own forms. Discussions with the institutions may resolve the problem but not without some delay.

Third parties may particularly react with suspicion when presented with a broadly written DPOA instrument that does not specifically enumerate the agent's powers. Many third parties want the instrument to state specifically that the agent has the authority to take the action that the agent is attempting to undertake. There is a risk, however, in enumerating the agent's powers. The specific power sought to be exercised may not be among the enumerated powers.

NOTE: Third parties are generally quicker to acknowledge the authority of trustees and conservators. Unlike the laws about durable powers of attorney, the laws governing revocable trusts are well established and familiar to most institutions. Because conservators bear the stamp of court appointment, they face few acceptance problems.

PRACTICE TIP: DPOA acceptance problems can be somewhat alleviated by taking some extra precautions. For example, the attorney could include in the DPOA document a clause that exonerates third parties from liability for accepting the DPOA. Some attorneys even have the DPOA recorded. Recordation satisfies some title companies troubled by use of an "old" DPOA, *i.e.*, one executed over a year before its use. For other recommended precautions, see California Powers of Attorney and Health Care Directives, chap 4 (Cal CEB 2008). Probate Code §4406 provides further measures to induce third persons to honor the authority of an agent under a statutory form DPOA.

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§1.45 b. Lack of Understanding by Principals, and Abuse by Agents

The ease with which a DPOA can be implemented has its drawbacks. Because DPOAs are so easily prepared and executed, principals sometimes sign them without fully understanding their terms, 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, agents tend to take their responsibilities lightly, growing careless about recordkeeping, accounting, and the principal's affairs in general.

In addition, the DPOA's ease of implementation sometimes invites abuse. Unscrupulous agents may obtain a DPOA prematurely and put it into effect without the principal's knowledge and to the principal's detriment. Although Prob C §§4500-4545 provide a way to sue an agent for abuse of authority, an agent's improper acts may go undetected for a long time. The principal may not be able to notify all persons who might otherwise act in reliance on the power of attorney and, therefore, may not be able to prevent an unscrupulous agent from using the power after revocation.

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§1.46 c. Limitation to Lifetime Management

A DPOA, like a conservatorship but unlike a revocable trust, can be used only for lifetime management purposes. It confers no powers over the principal's assets after the death of the principal. Among other things, this limitation creates transition problems at the principal's death because the agent has no power to continue managing assets postmortem. CC §2356(a)(2). (These problems may be eased, however, if the agent has been designated as the personal representative and secures special administration powers.) Postmortem management must await the appointment of a personal representative for the principal's estate. In contrast, even if a trust, by its terms, terminates at death, the trustee may exercise all necessary powers to settle the affairs of the trust. Prob C §15407(b).

Serious transitional problems may also arise 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. With a revocable trust, if the trustee is no longer able to serve, the successor trustee assumes management or, if none, the court can be petitioned to appoint a successor. See Prob C §15660.

The agent may not make gifts on the principal's behalf unless the DPOA specifically authorizes the agent to do so. Prob C §4264(c). Annual exclusion gifts by the agent under IRC §2503(b) will be included in the principal's estate if the agent was not authorized to make the gifts. *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345. The court noted that oral assent to a gift does not ratify the gift and make it valid. *Estate of Huston* (1997) 51 CA4th 1721, 1726, 60 CR2d 217. For further discussion of gifts by an agent under a DPOA, see California Powers of Attorney and Health Care Directives, chap 6 (Cal CEB 2008).

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B. Conservatorship of Estate

§1.47 1. Conservatorship for Property Management

Although a revocable trust may be used to manage the property of a settlor who is too ill to do so, a conservatorship of the estate can perform the same function. A conservatorship of the estate is a court-supervised proceeding for management of the financial affairs of an incapacitated person. See Prob C §1801. In a conservatorship proceeding, if an individual is adjudged to lack legal capacity, a conservator is appointed to manage his or her finances (*e.g.,* to enter into contracts, sell or buy property, or pay bills). See Prob C §1872. On the evidence necessary to support an adjudication of incapacity, see Prob C §§811, 1801(e).

Probate Code §1812 gives the court sole discretion in the appointment of the conservator, although some guidelines must be followed. For clients who wish a measure of certainty, a nomination of conservator is essential. See California Will Drafting §§3.6-3.7 (3d ed Cal CEB 1992).

The conservatee retains some limited powers, *e.g.,* the ability to contract to provide for the necessaries of life and to make a will. Prob C §1871(c)-(d). The court has discretion to modify the powers that the conservator assumes and those that the conservatee retains. See Prob C §§1873-1874, 1880, 1901, 1910.

For more information on conservatorships of the estate, see California Conservatorship Practice (Cal CEB 2005).

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2. Comparison of Conservatorship and Revocable Trust

§1.48 a. Advantages of Conservatorship

Because a conservatorship of the estate is supervised by the probate court, it provides the most complete protection of the client's interests. Conservatorship proceedings contain several procedural safeguards, including appointment of an independent court investigator, bond and accounting requirements, and the need for prior court approval for certain significant transactions.

Court supervision also protects the conservator, giving the conservator the means to obtain court approval before acting on sensitive issues. Further, if the conservator dies or becomes incapacitated, the conservatorship proceeding provides an established forum for an organized transfer of management to a successor conservator.

It bears mentioning, however, that court supervision of the internal affairs of a revocable trust is also available on petition to the court. Prob C §17200. These affairs include interpreting the terms of the trust instrument, settling accounts, setting trustee compensation, appointing or removing a trustee, and authorizing transfer of the trust to another jurisdiction. Prob C §17200(b). A trustee or beneficiary may also seek an order to resolve conflicting claims to property between the trust and others. Prob C §850(a)(3).

A conservatorship provides the conservator with more extensive management powers than those afforded the trustee of a revocable trust. No matter how extensively a trustee's powers are drawn, they can be used only to manage assets in the trust. A trustee cannot consent to split gifts with the settlor's spouse, sign and file the settlor's personal income tax returns, or make any number of other decisions not involving the trust. In contrast, a conservator may, with court authorization, even engage in estate planning for the conservatee under the broad powers of substituted judgment available in Prob C §§2580-2586. For a thorough discussion of the powers and duties of a conservator of the estate, see California Conservatorship Practice, chap 14 (Cal CEB 2005).

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b. Disadvantages of Conservatorship

§1.49 (1) Court Supervision

The drawbacks of court supervision are well known. First, court proceedings are public. The conservatee is publicly adjudged to be unable to manage his or her affairs, with a potentially grueling showing of deficits in specified mental functions required. See Prob C §811. In addition, the conservatee's financial affairs become a matter of public record because of the conservatorship's inventory and accounting requirements.

Second, court supervision means delays. It may take weeks for the court to appoint a conservator. Sales, leases, loans, and many other transactions are delayed by the requirement of prior court approval. See Prob C §§2540-2574.

PRACTICE TIP: The problem of delays may be ameliorated if the court can be persuaded to grant the conservator the power to act independently of court supervision. See Prob C §§2590-2595. However, a detailed petition must be filed to obtain the power to sell a personal residence and a reappraisal of the property may be required for sale. Prob C §§2591(d), 2591.5. These requirements eliminate much of the "independence" of the power to sell a personal residence.

Third, court supervision means substantial costs, including initial and periodic legal fees, court filing fees, court investigator's fees, bond fees, and possibly conservator's fees. Conservatorship costs usually substantially exceed those of preparing and administering a revocable trust.

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§1.50 (2) Limitation to Management During Incapacity

A conservatorship may be used only to manage a client's financial affairs during incapacity; it terminates on the conservatee's death. Prob C §1860(a). In contrast, a revocable trust can be used both to manage a settlor's assets during incapacity and to distribute them to a settlor's beneficiaries at death without the expense and delays of probate administration. A revocable trust can also be designed to continue for years beyond a settlor's death, making it an attractive estate planning option for those who want their assets managed for the beneficiaries' benefit. Further, because the trustee's powers continue after the settlor's death, a smooth transition from lifetime to postmortem management is possible.

A revocable trust can more easily be tailored to the client's particular needs than can a conservatorship of the estate. For example, the client can prescribe trustee investment guidelines and accounting requirements not commonly available to conservators by statute.

A revocable trust permits a "trial run" while the client still has the ability to oversee it. A settlor who is not fully satisfied with the trust's operations can change its administrative provisions, substitute trustees, or make other adjustments. A conservatorship affords the conservatee no such opportunity.

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C. Coordinated Use of Revocable Trust, DPOA, and Conservatorship of Estate

§1.51 1. Coordinated Property Arrangements to Meet Client's Needs

That revocable trusts, DPOAs, and conservatorships of the estate fulfill similar functions does not make them mutually exclusive. The client's interests are frequently best served by a combination of a revocable trust and one or more of its major alternatives.

For example, because of the following two trust limitations, a DPOA should also be prepared for clients who are setting up revocable trusts:

- The trustee has no ability to manage property of a settlor that has not been transferred to the trust.
- The trustee cannot perform various other financial transactions for a settlor (*e.g.,* applying for insurance on a settlor's life, receiving benefits payable to a settlor) and may not sign a settlor's personal income tax returns (Treas Reg §31.6061-1).

To address the first trust limitation, the DPOA should specifically grant the agent the power to transfer the principal's property to the revocable trust. See California Powers of Attorney and Health Care Directives, chap 2 (Cal CEB 2008). This provision is particularly important if the revocable trust is unfunded and is intended to be funded only if the settlor loses capacity. Usually it is desirable to grant this specific power in a DPOA that takes effect immediately, even if the client desires to use a springing DPOA for other purposes. A power that merely authorizes funding an existing properly drafted revocable trust presents little opportunity for abuse.

To address the second trust limitation, the DPOA should, at a minimum, authorize the agent to take desired actions with respect to pension benefits, IRAs, public benefits, and taxes.

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§1.52 2. Avoiding Potential Conflicts

The attorney should anticipate possible conflicts when more than one option for surrogate financial management is being considered.

For example, a conservator of the estate has the same power to amend or revoke a revocable trust as the conservatee, subject to court approval. Prob C §2580(b)(11). Although it is permissible to include a provision in a trust document that prevents revocation or amendment of the trust by a conservator, such provisions are not recommended. Prob C §2580(b)(11). See §20.7.

To minimize the risk of disputes, the client usually should execute a document that nominates the future trustees as the persons who will be the client's conservators if the appointment of conservators is required. Prob C §1810.

An agent under a DPOA may not revoke or modify a revocable trust unless both the DPOA and the trust instrument authorize this action. Prob C §§4465, 15401(c). Consequently, if the attorney and the client decide that both a DPOA and a revocable trust are appropriate, they should also decide whether to give the agent the power to modify or revoke the trust. It may be advisable, in any event, for the client to pick the same person to serve as both agent and trustee (or as successor trustee if the client wishes to serve as trustee) to eliminate any possibility of conflict over management of the client's affairs. For further discussion, see §20.8.

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§1.53 D. Joint Tenancy

Clients sometimes use joint tenancy financial institution accounts as an informal device for enabling a friend or relative (the noncontributing joint tenant) to pay bills. These arrangements routinely lead to disputes following death because it is usually impossible to determine from objective evidence whether the decedent put the noncontributing joint tenant on the account with the intent of passing the property at death or because the decedent merely wanted bills paid. Sometimes predeath disputes arise if the friend or relative uses the account property for his or her own purposes before the client's death.

PRACTICE TIP: This type of arrangement can be acceptable if a noncontributing joint tenant will receive the property on the death of the contributing joint tenant in any event, or if the parties' intentions are memorialized in a short agreement—as is sometimes the most practical approach in death bed situations. The agreement can create a quasi-trust, with the noncontributing joint tenant agreeing to pay bills and funeral expenses and then make a specified distribution.

Joint tenancy is also sometimes used as a device for managing a motor vehicle. In California, either owner can sell a vehicle titled in joint tenancy or with the names of the co-owners separated by "or." See Veh C §4150.5(a). For most assets, however, including real estate and individually owned stocks, joint tenancy is not effective as a device for managing property during incapacity, because all owners must join in transactions concerning the property. Note that joint title to a motor vehicle also may be insufficient to establish ownership by a surviving spouse as community property. See *Estate of Bibb* (2001) 87 CA4th 461, 469, 104 CR2d 415.

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§1.54 E. Community Property Management by Spouse or Registered Domestic Partner

Generally, either spouse or registered domestic partner may perform many property management activities without the participation of the other spouse or partner. To the extent this is the case, the power of one spouse or partner to act alone is not lost as a consequence of the other spouse's or partner's losing capacity. Fam C §297.5(a), 1100-1103. This management authority also does not end when the incapacitated spouse or partner is placed under a conservatorship. Prob C §3051(b)(1). Generally, no part of the community property is included in the conservatorship estate unless the spouse or partner with capacity consents. Prob C §3051(b)(2)-(c). Apparently, a court may create an exception to this rule if mismanagement by the controlling spouse or partner is involved. See Prob C §3057.

The power of one spouse or partner acting alone to manage community property is limited. A spouse or partner cannot unilaterally make a gift of community property, sell or encumber a personal property dwelling, sell or encumber furniture or furnishings, or sell or encumber real property. Fam C §§1100, 1102. When desired, limitations on the ability of one party to act alone in the event of incapacity of the other party can be addressed while both spouses have capacity through the use of durable powers of attorney for financial management (DPOA). In the absence of a DPOA, court approval will be required to take an action requiring the consent of both spouses. If a conservatorship has been established for the incompetent spouse or partner, court approval for the transaction must be obtained. Prob C §§3071-3072.

If the incapacitated spouse or partner has neither a conservator nor an agent under a DPOA, the spouse or partner with capacity must resort to the procedures available under Prob C §§3100-3154 for court approval of a community property transaction requiring consents. Prob C §3102. "For good cause shown," the court may extend its order to include a spouse's or partner's separate property that is involved in a proposed transaction. Prob C §§3100, 3121(g), 3144(a)(1). These procedures provide an efficient way to obtain approval for a single transaction and are often used to obtain authority to make Medi-Cal or estate tax planning decisions for a spouse or partner who lacks capacity. A conservatorship may be the more sensible approach, however, if the spouse or partner with capacity is likely to undertake a series of actions requiring the incapacitated spouse's or partner's consent.

PRACTICE TIP: It is generally unwise to rely exclusively on community property management powers when planning for property management on incapacity, because spouses or partners of similar age may slip into incapacity at about the same time, and either or both may own significant separate property. Of course, a spouse or domestic partner may transmute separate property to community property, but it is not wise to do so simply to gain the rather limited management advantages of such a change. On management of community property held in trust when one spouse or partner becomes incapacitated, see chap 6.

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§1.55 F. Representative Payee

If a client's sole concern is management of his or her income from a government program such as veterans' or Social Security benefits, appointment of a representative payee can resolve any financial management concerns. See, *e.g.,* 42 USC §405(j) (Social Security benefits). Appointment of a representative is made by application to the payor agency. Many private or public pension plans also allow recipients to designate a payee to receive payments on their behalf.

Anyone can be a representative payee, including family members, friends, community service organizations, custodial institutions, and properly licensed board and care facilities. Preference, however, is given to relatives and friends who show concern for the beneficiary. 20 CFR §§404.2021, 416.621. A creditor of the beneficiary generally cannot be a representative payee unless the financial relationship presents no substantial conflict of interest and the creditor is a relative living in the same household as the beneficiary, a legal guardian or legal representative of the beneficiary, or a licensed care facility. 20 CFR §§404.2022(e), 416.622(e).

The Social Security Administration (SSA) requires a showing that appointment of a payee is in the beneficiary's interest, and persons convicted of offenses resulting in imprisonment for more than 1 year are disqualified from service. 42 USC §405(j). Practically speaking, this means that the SSA will appoint qualified payees for beneficiaries who are incompetent, physically or mentally incapacitated, minors, or (for Supplemental Security Income (SSI) disability recipients) drug addicts or alcoholics. See 42 USC §§405(j)-(k), 1382(e)(3)(A), 1383(a)(2)(A); 20 CFR §§404.2010, 416.610.

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2

Professional Responsibility

Susan T. House

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§2.1 I. IMPORTANCE OF ETHICAL RULES IN DRAFTING REVOCABLE TRUSTS

A client's goals in creating a revocable trust are largely the same postmortem goals as those the client has generally —namely, to ensure the beneficiaries' enjoyment of the estate after the client's death. With a revocable trust, however, the client usually has lifetime goals as well, ranging from segregation of the client's separate or community property from other assets, to delegation of management tasks, to avoidance of conservatorship. The client's attorney must be aware of all the ethical considerations implicated in assisting the client in accomplishing these various goals. The attorney will often work closely not only with the client and his or her property but also with other members of the client's family and their property. More often than not, when the client is married, the attorney will represent both spouses as clients. The same may be true of domestic partners.

The attorney must know where to find the rules governing ethics (see §2.2) and must be conversant with the duty of confidentiality (see §§2.12-2.20), the duty of skill and care (see §§2.21-2.26), conflicts of interest (see §§2.27-2.35), limitations on when the attorney may or should serve as trustee, executor, or beneficiary (see §§2.36-2.41), and how to counter the threat of malpractice claims from disgruntled beneficiaries (see §§2.42-2.46A). In addition, the attorney must often be prepared to address special problems associated with clients who have diminished mental capacity. See §§2.47-2.51.

An important aspect of an attorney's duty of professional responsibility is defining the breadth of the representation, the nature of the engagement, and the fees. See §§2.7-2.11. Drafting a revocable trust for a client often requires preparing more than just the trust document. For example, a client usually needs a pour-over will prepared in conjunction with the trust. In addition, assets that will not be controlled by the trust, such as life insurance, annuities, or employee benefits, may require special attention. Clients with spouses or domestic partners holding title to assets as joint tenants or otherwise may require a formal property agreement to affirm the community property character of all or some of their assets. See chap 1. A single client who owns an asset with one or more persons may need advice on the best manner to hold title. In addition, lifetime gifts, transfers for consideration, and other nontestamentary devices may be required to minimize federal and state tax burdens for clients with larger estates. See California Estate Planning (Cal CEB 2002).

WARNING: Most attorneys have encountered clients who, believing that their affairs and intentions are straightforward, want only a "simple" living trust and not an estate plan. These clients assume that the attorney's job should be correspondingly simple (and inexpensive). The attorney who accedes to the client's wishes and functions as a mere scrivener does so at his or her peril. For example, if the client's estate is later subject to significant estate taxes or incurs probate costs because some assets were not transferred to the trust, the beneficiaries may sue for malpractice, claiming that the attorney should have informed the client of the options available in order to minimize taxes or to avoid probate completely, *i.e.,* that the attorney should have performed full-scale estate planning for the client.

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II. RULES GOVERNING PROFESSIONAL RESPONSIBILITY

§2.2 A. Where to Find Rules

The rules of professional conduct governing California attorneys stand alone. Unlike the rules in many other states, they are not the ABA Model Rules of Professional Conduct, nor are they even derived from the Model Rules.

The California rules are located in numerous places, including the California Rules of Professional Conduct (promulgated by the California Supreme Court), the Business and Professions Code, the Probate Code, the Evidence Code, the Penal Code, and the Welfare and Institutions Code. Interpretive authority is provided in case law, in formal opinions issued by the Standing Committee on Professional Responsibility and Conduct of the State Bar of California (COPRAC), and in formal and informal opinions of county bar associations.

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.3 B. Rules Applicable to Attorneys Drafting Revocable Trusts

§2.3 B. Rules Applicable to Attorneys Drafting Revocable Trusts

Every California attorney, regardless of practice area, must abide by all rules of professional responsibility in California when they are relevant to the facts and circumstances. The rules usually of concern to an attorney who is drafting a revocable trust include:

- The duty to enter into a written contract (Bus & P C §6148(a));
- The duty to avoid actual and potential conflicts of interest (Cal Rules of Prof Cond 3-310);
- The duty to maintain the client's confidences (Bus & P C §6068(e));
- The duty to perform services competently and diligently (Cal Rules of Prof Cond 3-110);
- The duty to avoid third party interference with the attorney's independent judgment (Cal Rules of Prof Cond 1-600(A));
- The duty to communicate with the client (Cal Rules of Prof Cond 3-500);
- The duty not to charge unconscionable fees (Cal Rules of Prof Cond 4-200(A)); and
- The duty to segregate a client's trust moneys (Bus & P C §6211(a)).

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C. Consequences of Violating Rules

§2.4 1. Discipline by State Bar

The most obvious consequence of violating one of the rules of professional responsibility is discipline by the California State Bar. The bar imposes attorney discipline, which ranges from probation to suspension to disbarment for violating ethical rules. Many instances of discipline arise from an attorney's commingling client funds with his or her own funds or an attorney's failure to perform the work for which he or she was engaged. Other ethical grounds of particular interest to an attorney drafting a living trust are, *e.g.,* when an attorney prepares living trusts in conjunction with a "marketer" who holds seminars pressuring attendees to obtain such trusts. See California State Bar Formal Opinion No. 1997-148 (Apr. 21, 1997). As noted in that opinion, such an arrangement may raise such ethical issues as interference with independence of professional judgment and representation of adverse interests. See also *In re Flack* (Kan 2001) 33 P3d 1281, in which the Kansas Supreme Court disciplined an attorney for participation in a "trust mill." The attorney did not meet with clients or supervise nonattorneys who met with clients. The analogous California rules that might apply in such an arrangement include Cal Rules of Prof Cond 1-300 (unauthorized practice of law), 1-320 (financial arrangements with nonlawyers), 1-400 (advertising and solicitation), 3-110 (failing to act competently), 3-310 (avoiding the representation of adverse interests), and 3-500 (communication with clients).

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§2.5 2. Malpractice Liability

There is strong malpractice liability exposure associated with violating the rules of professional conduct. Violation of an ethical duty by an attorney drafting a revocable trust (*e.g.,* representing multiple clients despite a conflict of interest without first obtaining the clients' informed written waiver) is often the most valuable tool a malpractice plaintiff's attorney has, first to force settlement, and ultimately to impose liability at the trial level. For a discussion of the relationship between an attorney's ethical duty and liability for malpractice, see *Day v Rosenthal* (1985) 170 CA3d 1125, 217 CR 89. Among other things, the court stated in *Day* that (170 CA3d at 1147):

> An attorney's duty, the breach of which amounts to negligence, is not limited to his failure to use the *skill* required of lawyers. Rather, it is a wider obligation to exercise due care to protect a client's best interests in all ethical ways and in all circumstances.

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§2.6 3. Court Order Setting Aside Client's Estate Plan

Another, more subtle consequence of a violation of ethical duties in drafting a client's revocable trust is that it can result in an unraveling of the client's estate plan, as illustrated in *Haynes v First Nat'l State Bank* (NJ 1981) 432 A2d 890. In *Haynes,* the attorney prepared a will and related trust agreements for a client's mother, under which the mother essentially disinherited one child, leaving her entire estate to another child, who was the attorney's client. After the mother's death, the New Jersey Supreme Court set aside the will on the grounds of undue influence, partly because the mother had not been advised of the conflict of interest inherent in the attorney's representation of both the favored child and the mother. The court stated that it might have reached a different result if the mother had been fully advised in writing and had executed a written waiver of the conflict of interest.

PRACTICE TIP: An attorney drafting revocable trusts and related documents does well to keep the *Haynes* decision in mind, not only as an incentive to watch for such conflicts, but also as a way of explaining to the client in a multiple representation situation why a written explanation and waivers of conflicts of interest are necessary: they do not protect just the attorney. For two forms of consent to dual representation, see §§2.32-2.33.

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III. ENGAGEMENT AND FEES

§2.7 A. Scope of Representation

The attorney engaged to draft a revocable trust must describe the nature of the services to be rendered (*i.e.,* the scope of the representation) in the engagement letter. Bus & P C §6148(a)(2). Failure to do so can result either in the attorney's failing to provide fully the services the client expected (resulting in a possible malpractice action) or in the attorney's providing too many services (resulting in the client's refusal to pay for something neither wanted nor expected).

In addition to telling the client what will be done within the representation, the attorney should tell the client what will not be done. The attorney and the client should determine, for example, who will be responsible for implementing the funding of the trust and carrying out necessary transfers of title. Many clients opt to handle title transfers on their own to save costs, although typically the attorney prepares, supervises the execution of, and records deeds and related real property forms that may be necessary to implement the plan. On funding instructions that should be included in the final letter to the client, see §2.10.

The attorney should limit the scope of engagement so that he or she will not be expected to do more than can effectively be done for the quoted fee. On negotiating the fee, see §2.11.

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§2.8 B. Identifying the Client

In many instances, "Who is the client?" is inextricably linked to the scope of representation. Both issues must be answered at the outset of the representation, and the answers should be regularly reconsidered as the representation continues. The answer to "Who is the client?" is often not as easy as it appears. If the attorney fails to consider the question or answers it incorrectly, serious ethical risks can arise, including violating the rule on confidentiality of a client's affairs (Bus & P C §6068(e); see §§2.12-2.19) and the rule against representing adverse interests (Cal Rules of Prof Cond 3-310; see §§2.27-2.35).

Once the attorney determines who is the client, the conclusion should be documented in the engagement letter. See §2.9.

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.9 C. Engagement for Hire and Engagement Letter

§2.9 C. Engagement for Hire and Engagement Letter

The initial letter to the client can also be an engagement letter, which typically includes:

- A reference to the initial telephone contact and the place and time of the first meeting, if one was scheduled;
- A description of the scope of the engagement;
- An outline of the basic choices the client will be required to make so that he or she can begin considering them (*e.g.,* choice of trustees);
- The written fee agreement as required under California law (Bus & P C §6148; see §2.11); and
- A description of any conflicts that may be created by the engagement (*e.g.,* by dual representation of a husband and wife) and a request for a waiver by the client(s) regarding those conflicts. The letter might also request a waiver for any potential future conflicts relating to other clients or positions in other matters that might be adverse to this client, as long as those other matters are not substantially related to the estate plan and the attorney is not in possession of confidential information as a result of this representation that relates to those other matters. For two forms of consent to dual representation, see §§2.32-2.33.

The initial/engagement letter, containing the fee agreement and waivers, can be confirmed by asking the client(s) to sign a copy of the letter and return it to the attorney before or at the time of the first meeting. For a sample engagement letter, see California Estate Planning §1.62 (Cal CEB 2002).

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§2.10 D. Determining When Representation Terminates

For many attorneys, defining the scope of the representation includes the duration of the representation. The relationship between an attorney drafting a revocable trust and the client is often open-ended. Consequently, some practitioners address in the engagement letter or some other document when the relationship ends. Other practitioners rely on the concept of the "dormant" attorney-client relationship—there is no affirmative duty for further service once the initial services are rendered, but the attorney is available for the inevitable occasional questions and later review and revision of the plan as time passes. With estate planning clients, ongoing representation can continue until the client's death (and sometimes beyond).

Some attorneys send a final letter to the client to mark the termination of the engagement. In this letter, the attorney should discuss the transfer of title of assets into the trust, as well as the retention of original estate planning and related documents.

If the client will handle the transfers of title, the termination letter should set forth detailed instructions, showing the name in which title should be taken, and should advise the client to take title to subsequently acquired assets in the name of the trust.

On funding the trust, see chap 21. On whether there is a duty to notify a former client of changes in the law, see §2.46.

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.11 E. Fee Agreement

§2.11 E. Fee Agreement

One of the most sensitive aspects of the attorney-client relationship is the fee. Written fee agreements for estate planning are generally required in California. See Bus & P C §6148. A written attorney-client contract is required whenever it is reasonably foreseeable that the total expense to a client, including attorney fees, will exceed $1000. The contract must contain the attorney's hourly rate and other standard rates, fees, and charges; the nature of the legal services to be provided; the respective responsibilities of both attorney and client; and the attorney's lack of errors and omissions insurance if he or she lacks such insurance and has not filed a specified agreement with the State Bar. See generally Fee Agreement Forms Manual (2d ed Cal CEB 2007).

A lawyer may not charge or collect an illegal or unconscionable fee. A fee is unconscionable when it is so exorbitant and wholly disproportionate to the services performed that it shocks the conscience of lawyers of ordinary prudence practicing in the same community. For a partial list of factors to consider in setting the fee, see Cal Rules of Prof Cond 4-200.

The fee should be discussed before the lawyer begins work on an estate planning assignment. The client will usually inquire about the fee.

PRACTICE TIP: It may be prudent to quote a range of fees for the estate planning work and require a retainer before doing the actual work.

On referral fees and division of fees with a specialist, see §2.26.

PRACTICE TIP: The practitioner should inform the client that fees may or may not be deductible and, on billing statements, should allocate fees charged between what is and what is not deductible. The Internal Revenue Code does not specifically allow the deduction of attorney fees for estate planning purposes, but fees may be deductible under IRC §162 as a business expense or, under IRC §212, as an expense for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax. Legal fees for the tax planning aspects of an estate plan are arguably deductible under IRC §212(3). Therefore, the attorney may need to estimate what portion of the total legal fees relate to tax planning, and give the client that information. The attorney might suggest that the client discuss this deduction with his or her accountant to determine whether it is appropriate. Under IRC §67, IRC §212 deductions are allowable only to the extent they exceed 2 percent of the client's adjusted gross income.

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IV. CONFIDENTIALITY

§2.12 A. Duty to Maintain Client Confidences

The attorney's duty to maintain client confidences is a cornerstone of the attorney-client relationship. The California rule is in Bus & P C §6068(e)(1), which provides that it is an attorney's duty to "maintain inviolate the confidence, and at every peril to himself or herself, to preserve the secrets of his or her client." Disclosure of certain confidential information is permitted but not required if the attorney reasonably believes the disclosure is necessary to prevent any criminal act that the attorney reasonably believes is likely to result in death or substantial bodily harm to an individual. Bus & P C §6068(e)(2).

In revocable trust drafting, confidentiality can be particularly problematic when:

- The attorney represents multiple clients, either jointly or separately (see §2.28);
- The representation entails the use of one or more agents, such as an accountant, a life insurance agent, or an appraiser;
- The attorney has represented a couple jointly during their marriage or domestic partnership, the marriage or partnership is dissolved, and both former spouses or partners wish to continue using the attorney separately for estate planning purposes (see §2.29); or
- The IRS requests information from the attorney about the client's finances (see §2.18).

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.13 B. Duty of Confidentiality

§2.13 B. Duty of Confidentiality

It is the duty of the attorney to maintain complete confidentiality on the information received from the client in the course of drafting the revocable trust. See Bus & P C §6068(e). For permissible disclosure of confidential information, see §2.12. If the lawyer anticipates the need to work with and discuss aspects of the estate plan with other advisers of the client (*e.g.*, an accountant, business manager, secretary, child, or physician), the lawyer should explicitly address this subject with the client and obtain the client's permission to discuss the client's business with the appropriate person to the extent the attorney deems appropriate.

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§2.14 C. Duty to Communicate With Client

An attorney also has the duty to communicate with his or her client. Bus & P C §6068(m); Cal Rules of Prof Cond 3-500. Although this responsibility is a "stand-alone" duty within the Business and Professions Code and the Rules of Professional Conduct, it is also an integral part of the duty to render competent representation under Cal Rules of Prof Cond 3-110 because, without mutual communication between the attorney and the client, it is impossible for a trusts and estates attorney to craft and draft an appropriate revocable living trust.

It is incumbent on the attorney, who is familiar with the process, to determine to what extent the client is able to provide the information needed. Occasionally, the attorney will have to undertake an independent investigation to gather the needed data (see discussion in §2.16 on the confidentiality issue that arises in this context), working with third parties as required. The attorney should have a clear agreement with the client when this is necessary, and the client should be advised in advance of the likely additional costs involved in having the attorney and his or her staff perform this function.

Some information must be supplied by the client. A client's health, personal, or financial problems, the needs of potential beneficiaries, the qualifications of proposed fiduciaries, and family conflicts are all relevant to the advice expected from the attorney, and the client must understand that complete candor is essential.

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§2.15 D. Multiple Representation

Except for problems that arise with regard to the client's family members, the duty to maintain a client's confidences seldom poses a problem when only one person is involved in the representation.

However, in California it is common for an attorney to draft revocable trusts for both spouses or domestic partners when a couple is doing estate planning. In this situation, the attorney usually represents the spouses or partners as "joint" clients, and, unless explicitly agreed otherwise, the attorney is presumed to represent them jointly.

Under Cal Rules of Prof Cond 3-310(C)(1), an attorney may not represent "more than one client in a matter in which the interests of the clients" potentially conflict, unless the clients give informed written consent. At the same time, the attorney may not disclose confidential information without the client's informed written consent. Bus & P C §6068. Joint representation in the estate planning context always involves potential conflicts of interest and always involves the need for free exchange of confidential information between the attorney and all clients. Therefore, the attorney in such joint representation situations must be especially cautious.

Joint representation rests on the premise that, absent contrary evidence, no actual adversity exists between the parties. It assumes that all information received by the attorney on the subject of the representation will be shared between the clients and that confidentiality will be maintained as to all other matters and other people. As long as no actual conflict of interest exists, multiple parties such as spouses or domestic partners are often better served by joint representation because it produces a more coordinated result at a lower cost than if each party were individually represented by a different attorney.

Even if the spouses' or partners' goals are not entirely consistent, the attorney is not necessarily precluded from representing both. The attorney may still be able to advise spouses or partners with somewhat different objectives; and advice and counsel may be consistent with their interests and the estate planning attorney's traditional role as the "family" attorney.

Nevertheless, the attorney should be aware that, with two or more clients, certain confidentiality issues commonly arise. The most common questions are the following:

- If the attorney is drafting a revocable trust for both spouses or partners, is there confidentiality of information vis-à-vis the other spouse or partner for information disclosed by one of them to the attorney outside the presence of the other?
- If the attorney represents both spouses or partners, and if one of them reveals information to the attorney with the direction that the attorney not reveal it to the other, what should the attorney do?
- If the attorney represents multiple family members separately in drafting their revocable trusts or otherwise developing their estate plans, but there is a shared desire to coordinate the plans, what confidentiality rules govern?

In the first two instances, there can be no confidentiality with regard to information needed to properly represent the other party, because the attorney who is representing two spouses or partners jointly cannot perform the services competently without a free exchange of information. Consequently, the duty to maintain confidentiality irreconcilably conflicts with the duty to perform competent services and the duty of loyalty to both clients. The clients must decide which duty is more important. If confidentiality prevails for any one of the clients, multiple representation cannot be undertaken. But if all the clients are comfortable with full disclosure, the attorney may obtain informed written consents from multiple clients that waive the usual confidentiality rules. See §2.31.

The attorney should address the confidentiality issue in the initial engagement letter when the multiple representation is undertaken. Otherwise, the attorney will face an impossible situation when one client expects or demands that information be withheld. For sample forms of initial engagement letters, see §§2.32-2.33.

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§2.16 E. Third Party Agents and Family Members

Disclosure of confidential information to agents assisting the attorney in drafting or funding a revocable trust is often necessary. Technically, the client should give written authorization before the attorney discloses any confidential information to anyone. In practice, however, this approach is usually impossible. Most attorneys do not obtain the client's written consent in every situation (*e.g.*, for disclosure to the attorney's or client's office staff, the client's accountant, or life insurance agent). However, when the attorney must use the services of outside agents such as appraisers or other experts, he or she should always obtain the client's written authorization.

An attorney drafting a revocable trust may face special confidentiality issues in dealing with family members. Issues may arise when the client relies on a child or other close relative for assistance, ranging from merely accompanying the client to the attorney's office, to gathering information needed for the attorney, to being involved in the actual drafting process. In other situations, the issues arise after the trust is complete, the estate plan is in place, and the client instructs the attorney either "to work freely with my daughter" or " to let my son know what is going on."

The attorney must be especially careful in these situations to ensure that the client knows the confidentiality ramifications of these instructions, and the attorney should determine exactly what role the client intends the child or other person to play. To make this decision, the attorney should have a frank discussion with the client, positing various questions and describing alternative scenarios to learn what the client wants. For example, does the client want the attorney to inform the child whenever any change is made to the trust and send a copy of the change? Often, when presented with a specific example and question, the client rethinks the initial broad directions and tailors them to suit his or her actual goals. Regardless of what the client decides, the extent to which the attorney may disclose information should be documented and signed by the client.

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§2.17 F. Current or Former Clients

The duty of confidentiality is also found in Cal Rules of Prof Cond 3-310(E). Under that rule, an attorney may not accept employment adverse to a client or former client when "by reason of the representation of the client or former client, the member has obtained confidential information material to the employment." An attorney may confront this issue when drafting a revocable trust for one family member while separately representing another family member or after formerly representing another family member or when preparing a trust for a client following dissolution of a marriage or domestic partnership after formerly representing both spouses or partners. Informed written consent after disclosure of the material facts is required in these situations. Cal Rules of Prof Cond 3-310(E).

On the duty to avoid conflicts under Cal Rules of Prof Cond 3-310(E), see §2.27.

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§2.18 G. IRS Demands for Information

Information obtained by an attorney in the course of providing estate planning services for a client is often of interest to the Internal Revenue Service. See, *e.g.*, *Segerstrom v U.S.* (ND Cal 2001) 2001-1 USTC ¶50,315, 87 AFTR2d 1153 (court quashed IRS summons issued to several estate planning attorneys demanding certain documents related to formation, operation, and valuation of limited liability company after attorneys had refused to produce documents on grounds of attorney-client privilege). Faced with this situation, the lawyer must either obtain a waiver by the client if the lawyer and client conclude that it will actually further the client's case to disclose information, or refuse to make any disclosure based on both ethical (Bus & P C §6068(e)) and evidentiary privilege (Evid C §952) grounds. However, estate planning attorneys should be aware that communications about tax return preparation are not privileged. *U.S. v Lawless* (7th Cir 1983) 709 F2d 485; *U.S. v KPMG LLP* (D DC 2004) 316 F Supp 2d 30.

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§2.19 H. Ethical Duty Compared With Attorney-Client Privilege

The confidentiality rule of Bus & P C §6068(e) (see §2.12) is related to the attorney-client communications privilege defined in Evid C §952, but the scope of the confidentiality rule is much broader than that of the Evidence Code privilege. Because the purpose of the confidentiality rule is to encourage complete candor with the attorney, even nonverbal "communications" with the attorney are covered by the duty of confidentiality. For example, in a challenge to the capacity of the client, capacity is often determined based not on what a client says, but on the client's demeanor and actions. Therefore, Bus & P C §6068(e) also applies to those types of communications. In other words, there is an absolute prohibition against divulging a client's "secrets," of any type, to the client's disadvantage.

The duty to maintain a client's confidences can create problems in the context of drafting a revocable trust, especially when the rule in Bus & P C §6068(e) collides with the rule in Evid C §952 and its explicit exceptions. Exceptions to §952 include permitting disclosure in a fee dispute with the client (see Evid C §958) or disclosures that the attorney reasonably believes are necessary to prevent any criminal act likely to result in death or substantial bodily harm (see Evid C §956.5). Although the latter disclosures are permitted under Bus & P C §6068(e)(2), there are no other such exceptions to the ethical rules—and there is no guidance for the estate planning attorney caught in the middle. For a discussion of this dilemma, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust, and Probate Counsel §§5.1.1-5.1.2 (2d ed 2008).

The "absolute" nature of the §6068(e) rule of confidentiality has been reaffirmed in various ethics opinions and other forums as if the principles behind the various Evidence Code exceptions were irrelevant. If the privilege is indeed "absolute," the attorney is placed in the untenable position of being permitted (if not required) to disclose certain confidential information under the Evidence Code, but prohibited from disclosing that same information under Bus & P C §6068(e).

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.20 I. Obtaining Consent to Waive Confidentiality

§2.20 I. Obtaining Consent to Waive Confidentiality

There is not complete agreement within the estate planning bar and there are no ethics opinions directly on point as to the extent to which an attorney can competently represent multiple clients while not making full disclosure to each client of information received from another client. However, in addressing the problem of confidentiality when representing both spouses or domestic 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.

These attorneys believe that it is possible to provide competent, ethical representation under these guidelines. In contrast, other attorneys insist that both clients 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 House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust, and Probate Counsel §§5.5-5.6 (2d ed 2008). These attorneys do not believe that keeping confidences between the two spouses or domestic partners is ethically possible.

Regardless of the attorney's position on the need for full disclosure, before obtaining the clients' consent to joint representation, the attorney should discuss with them Evid C §962, which mandates 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. The clients should understand that, if they each employ separate counsel, their communications to their respective attorneys will be fully protected from disclosure in any later civil proceeding.

For two forms of sample letters to the clients waiving confidentiality, see §§2.32-2.33.

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V. DUTIES OF SKILL AND CARE

§2.21 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 in similar circumstances. See Cal Rules of Prof Cond 3-110(B); 2 Mallen & Smith, Legal Malpractice §19.2 (5th ed 2000). An attorney who fails to meet that standard when drafting a living trust risks being held liable for any resulting damage to the client's intended beneficiaries or heirs. In *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, for example, 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 (see §2.37) breached a duty of care owed to both the testator and the care custodian and was therefore liable to the care custodian who failed to receive the testator's estate. In *Garcia v Borelli* (1982) 129 CA3d 24, 180 CR 768, the intended beneficiaries of a will were permitted to sue the drafter because the will attempted to devise community property interests in property held by the testator and his wife as joint tenants. In *Buquet v Livingston* (1976) 57 CA3d 914, 129 CR 514, the beneficiaries were permitted to sue an attorney who inadvertently gave a surviving spouse a general power of appointment over an intended bypass trust by giving the surviving spouse the power to amend or revoke that trust after the death of the deceased spouse.

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. See *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821 (although testamentary trust was invalid owing to remote, obscure possibility of violation of rule against perpetuities, court found that attorney who drafted trust was not liable, because attorney of ordinary skill acting in same circumstances might have made same mistake). However, the attorney may still be held liable for failing to do research. See *Smith v Lewis* (1975) 13 C3d 349, 360, 118 CR 621, overruled on other grounds in *Marriage of Brown* (1976) 15 C3d 838, 851, 126 CR 633. On the duty to do research, see §2.23. 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. *Horne v Peckham* (1979) 97 CA3d 404, 158 CR 714, disapproved on other grounds as stated in *Tchorbadjian v Western Homes Ins. Co.* (1995) 39 CA4th 1211, 1222, 46 CR2d 370. On the duty to consult or refer the client to a specialist, see §§2.24-2.26.

An attorney's exposure to a malpractice claim involving trust 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. Because beneficiaries of a revocable trust normally do not discover the facts to establish a cause of action for negligent drafting and do not sustain damages until the settlor dies and the trust becomes irrevocable, the statute of limitations for malpractice may not even begin to run until many years after the trust is prepared.

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

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§2.22 B. Duty to Function Competently

An attorney may not intentionally or recklessly fail to perform legal services competently. Cal Rules of Prof Cond 3-110(A). Performing legal services competently means diligently applying the learning and skill necessary to perform the attorney's duties that arise from representing the client. If the attorney does not have sufficient learning and skills, he or she may continue to represent the client if the attorney associates or professionally consults another attorney who is competent. See §2.24. Alternatively, an attorney who has enough time and resources may acquire the necessary learning and skills before any performance is required. Cal Rules of Prof Cond 3-110(B). Because the nature of revocable trust preparation in the context of estate planning generally requires not only technical drafting and tax advice skills, but also advice on choice of fiduciaries, on optimum devices for family protection and well-being, and on many other "human" issues that can be developed only after years of working in the estate planning field, it is doubtful that a lawyer without these essential skills can acquire them for a new engagement.

An attorney should not accept an estate planning assignment unless he or she will be able to handle matters in a diligent, timely manner. *Lewis v State Bar* (1981) 28 C3d 683, 170 CR 634 (attorney disciplined for undertaking estate administration despite complete unfamiliarity with probate laws and procedures).

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§2.23 C. 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. An attorney who fails to do such research when required 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 the nonparticipant spouse's community property rights in the participant spouse's retirement benefits was an unsettled area of the law at the time of the dissolution. However, the court held the attorney liable for malpractice because he failed "to undertake reasonable research in an effort to ascertain relevant legal principles and to make an informed decision as to a course of conduct based upon an intelligent assessment of the problem." 13 C3d at 359.

By extension, it may be a lawyer's obligation to point out potential problem areas in characterizing property as separate or community (see chap 1), pending tax laws, potential family conflicts, or potential difficulties with a "problem" beneficiary, and to suggest ways to deal with those issues.

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§2.24 D. 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. See Cal Rules of Prof Cond 3-110(B). Consequently, a cautious nonspecialist attorney who is confronted with a task in a specialized area of law should either consult or associate a specialist or refer the client to a specialist. On referral fees, see §2.26.

EXAMPLE: In *Horne v Peckham* (1979) 97 CA3d 404, 158 CR 714, disapproved on other grounds as stated in *Tchorbadjian v Western Homes Ins. Co.* (1995) 39 CA4th 1211, 1222, 46 CR2d 370, a general practitioner drafted a Clifford trust (a form of trust used before 1986 to shift taxable income to lower bracket taxpayers) and had it funded with royalties from a nonexclusive license agreement on patents that the client owned. The attorney was sued when the IRS refused to permit the royalty income to be taxed to the trust beneficiaries. The court held the attorney liable for the deficiency because he had neither referred his client to a tax specialist nor consulted a tax specialist himself.

An attorney who gives advice or prepares documents designed to minimize estate and gift tax liability must adhere to a higher standard of specialized professional skill. See, *e.g., Bucquet v Livingston* (1976) 57 CA3d 914, 129 CR 514. The general practitioner is therefore well advised to consult a specialist or 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, which is $3.5 million in 2009). The cautious general practitioner does so even when the client's net taxable estate is not large enough to incur death taxes if:

- The client owns assets (*e.g.,* real property) that may appreciate greatly during the client's lifetime;
- The client is one party in a married or unmarried couple whose combined net taxable estates exceed the applicable exclusion amount;
- The client's spouse is not a United States citizen;
- The client's estate contains special assets like options, intellectual property, substantial retirement assets, or a closely held business; or
- The client has assets in another state or country.

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§2.25 1. Selection of Specialist

An attorney who refers a client to a specialist should exercise caution in the selection of the specialist in order to avoid malpractice exposure for a negligent referral. The referring attorney should consider several issues when selecting a specialist, including the specialist's competence, diligence, ability to communicate, ability to work well with the client, whether he or she has been disciplined by the State Bar, and any possible conflicts of interest with other clients.

The referring attorney should discuss a referral choice with the client at the initial conference. The referring attorney and the client should also discuss their prospective relationship, *e.g.*, whether the specialist will remain in the background as an adviser or a mere scrivener, or whether the specialist will be in direct contact with the client, creating and reviewing documents with the client.

A number of sources are available to identify specialists, including (1) trade associations (*e.g.*, the American College of Trust and Estate Counsel (ACTEC), at http://www.actec.org); (2) the list of California lawyers who have been certified by the State Bar as specialists in estate planning, trust, and probate law; (3) the State Bar Trusts and Estates Section; (4) government or education institutions that work with consultants; (5) commercial directories of experts; and (6) research to locate authors who have written in the problem area.

The referring attorney should have a written fee agreement with the specialist. On referral fees and split fees, see §2.26. Typically, the referring attorney is responsible for supervising the expert's work and ensuring that the client is satisfied.

Significant ethical problems can arise from using experts, including issues involving the confidentiality of information. See Bus & P C §6068(e). On the duty of confidentiality, see §§2.12-2.20.

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§2.26 2. Division of Fees

If the referring attorney and the specialist agree to divide the fees, they must comply with Cal Rules of Prof Cond 2-200(A). This rule prohibits any division of fees unless the client consents in writing after full disclosure and prohibits the total fee from being increased unreasonably or solely by reason of the fee division.

A division of fees is a single billing to a client covering the fee of two or more lawyers who are not in the same firm. The division should be made on the basis of the proportion of services rendered or by agreement between the participating lawyers, if all assume responsibility for the representation as a whole and the client is advised and consents in writing.

However, when an attorney merely brings about the employment of another attorney, but renders no service and assumes no responsibility in the matter, a division of the fees is improper when not in compliance with Cal Rules of Prof Cond 2-200(A). See Cal Rules of Prof Cond 2-200(B).

Referral fees generally may not be paid to nonlawyers. See Cal Rules of Prof Cond 1-320.

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VI. CONFLICTS OF INTEREST

§2.27 A. Duty to Avoid Conflicts

Along with the duties of confidentiality (see §§2.12-2.20) and the duties of skill and care (see §2.21), the duty to avoid conflicting interests is the third pillar of the attorney-client relationship. An attorney may not accept employment if the attorney has or had a relationship with another interested party or has an interest in the subject matter of the engagement, unless all affected clients give their informed, written consent. Cal Rules of Prof Cond 3-310. The attorney may not accept employment adverse to a client or former client if the attorney has confidential information material to the employment, except with the client's or former client's written consent. Cal Rules of Prof Cond 3-310(E). Informed written consent is also required if the attorney concurrently represents (or intends to represent) clients whose interests conflict or potentially conflict. Cal Rules of Prof Cond 3-310(C). 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.

Applying Cal Rules of Prof Cond 3-310 can be very difficult, because it is not always easy for the attorney to foresee the problems at the outset of the representation. Consequently, the ethical attorney must always be aware of both the duty of confidentiality and the duty to avoid actual and potential conflicts of interest, and must be especially sensitized to look for the areas in which it is easy to run afoul of the rules in planning and drafting revocable trusts.

Because the attorney has a fiduciary relationship with the client, the problems of conflicts of interest become more acute. Conflicting interests may interfere with the obligation of undivided loyalty that prohibits the attorney from subordinating the interest of one client to that of another. The attorney should avoid even the appearance of impropriety, which can be as damaging as actual misconduct. Multiple representations in the estate planning context can easily lead to the appearance of impropriety, especially if everyone involved was not fully informed of the potential problems at the outset.

The conflict of interest must be reasonably apparent at the time of counsel's involvement. A mere diversity of opinions between the clients does not create conflicting interests, but counsel should insist on adequate disclosure and consent. Otherwise, he or she is not competently representing the person from whom disclosure is withheld.

EXAMPLE: A lawyer who is asked by the husband to incorporate provisions for the husband's illegitimate child in the estate plan supposedly prepared for both husband and wife cannot do so without full disclosure to the wife despite the husband's request to the contrary.

If the lawyer ignores or overlooks the conflicts prohibited under Prob C §§21350-21350.5, the lawyer may find that the revocable trust and related estate planning documents (including the transfer documents themselves) are void as "disqualified transfers." If the lawyer is a "disqualified person" or has acted under a disqualified person's instructions, the transfer will be invalidated. See §§2.36-2.41.

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Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.28 B. Conflicts in Representing Couples

§2.28 B. Conflicts in Representing Couples

If the attorney is representing two clients jointly, then every action taken in the course of the representation is done for both of them, and there must be full disclosure. Because of the inherent conflicts in representing both spouses or domestic partners, a lawyer representing both must obtain written consent to dual representation. Cal Rules of Prof Cond 3-310. There must be a written engagement letter explaining the potential conflict issues and a written waiver by the clients. Without the explanation and waiver, the attorney has breached his or her ethical duties. Nothing should be assumed—in any dual representation situation, the ethical issues must be addressed in writing. Failure to do so violates Cal Rules of Prof Cond 3-310. For sample forms of consent to dual representation, see §§2.32-2.33. On confidentiality issues involved in joint representation, see §2.15.

In joint representation of multiple clients, the information imparted by one client to the attorney is not privileged from disclosure to the other client. In the event of litigation between jointly represented parties, no protection from disclosure of evidence provided to the attorney is available. The conflict of interest waiver signed by the clients should clearly disclose the fact that there can be no privileged communications between the parties regarding their estate planning.

PITFALL: Many conflict situations cannot be resolved by consent. If the clients' relationship is such that consent by one is seen as undue influence by the other, or if 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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§2.29 C. Future Conflict Caused by Joint Estate Planning

California Rules of Professional Conduct 3-310(E), discussed in §2.17, mandates that an attorney not accept employment adverse to a client or former client when the attorney has confidential information material to the employment. This rule means that the attorney who represents multiple clients in trust drafting may face serious future conflict of interest problems.

For example, an attorney who drafts revocable trusts for two spouses or domestic partners faces a serious conflict of interest by later representing one spouse or partner in a dissolution proceeding. See LA County Bar Ass'n Ethics 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 married couple could not later represent the husband in drafting a *Marvin* agreement with his paramour without his wife's consent.

Similarly, the attorney may not represent one of two clients who later wishes, without the knowledge and written consent of the other client, to alter the trust to the other's detriment.

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§2.30 D. Consequences of Representing Conflicting Interests

An attorney who represents conflicting interests may be subject to professional discipline (see §2.4), may be liable for malpractice by causing harm to the client or a beneficiary (see §2.5), and may lose fees. See *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).

If an issue of conflict of interest is litigated, an attorney is at a particular disadvantage. 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. But see *Neal v Health Net, Inc.* (2002) 100 CA4th 831, 845, 123 CR2d 202 (mere exposure to confidential information).

NOTE: When accused by a client of not fully representing the client's interests because of a conflict of interest, an attorney cannot rely on "honesty of purpose, intention and motive" as a defense. *Hammett v McIntyre* (1952) 114 CA2d 148, 155, 249 P2d 885. The attorney is liable even for an error committed in good faith. *Hammett* should be of particular interest to an estate planning attorney who is regularly asked and expected to help families balance and resolve their differences.

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E. How to Deal With Conflicts

§2.31 1. Obtain Consent to Representation of Potentially Adverse Interests

The attorney should always obtain the clients' written consent when representing both spouses or unmarried partners. See Cal Rules of Prof Cond 3-310(C). See forms in §§2.32-2.33. When an attorney is asked to represent both parties, each party is interested in the attorney's representation of the other.

The hardest task is ensuring that the consents are "informed." Under Cal Rules of Prof Cond 3-310(A)(1), the client must be advised of "the relevant circumstances and of the actual and reasonably foreseeable adverse consequences."

To meet this standard, the attorney should explain the potential for conflicts in at least the following 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 California Estate Planning §1.62 (Cal CEB 2002).

WARNING: Full disclosure by the attorney includes informing the 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 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 that a conflict exists, 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 conflicts of interest, recent newspaper articles on actual problems between jointly represented clients, or examples from the attorney's own practice.

It is a mistake not to discuss the issues of potential conflict and confidentiality with the clients in person and before presenting them with the written waiver and consent. Clients who have had an opportunity to discuss the subject face to face, or at least over the telephone, are seldom upset by the waiver and consent document itself. Without this preparation, however, the clients are often, at best, confused, and at worst, offended.

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§2.32 a. Form: Consent to Dual Representation—Short Form

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

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

2.32-1 Consent to dual representation—short form

Consent to Dual Representation

We the undersigned _ _[*husband and wife/spouses/domestic partners*]_ _ consent to _ _[*name of attorney*]_ _ representing both of us in drafting our revocable trusts and otherwise planning our estates.

We know and understand that representation by a single attorney will have the following consequences compared with each of us having our own attorney:

1. *Limited Confidentiality*. If we were each represented by a separate attorney, we would each be able to tell our own attorney confidential information about our estate plan and be certain that the attorney could not disclose the information to the other of us. In contrast, if we are both represented by a single attorney, anything that either of us tells the attorney will be disclosed to the other of us if the attorney believes that a failure to disclose would violate _ _[*his/her*]_ _ duty to protect the other.

2. *Lack of Separate Advocate*. If we each had a separate attorney, we would each have an attorney who would "take sides" and argue on our behalf to maximize such things as our ability to own or control property in comparison to the other of us.

3. *Less Protection From Possible Overreaching by the Other*. In the nature of things, an attorney representing both parties is likely to view his or her task as attempting to accomplish the stated common goals of the representation, and may be less likely than an attorney representing a single party to warn of possible improper action by the other party. For example, if each of us proposes to give the other a power of attorney, an attorney representing both parties may be more inclined to assume that the parties are aware of the obvious risks of giving powers of attorney, rather than explicitly pointing out that the other of us might use the power of attorney to mortgage the house and spend the funds. Similarly, if each of us proposes to leave all of his or her estate to the other, an attorney representing both parties may be less likely to suggest ways in which the first of us to die could restrict what the survivor could do with the inherited property.

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

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

Comment: This form of consent to dual representation is appropriate to use at the initial interview or otherwise early in the representation. For a form to use later in the process when the attorney has acquired more information about the clients, see §2.33.

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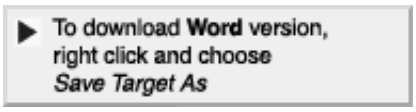
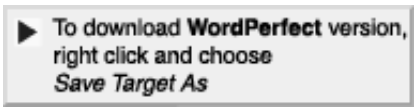
Source: Estate Planning/Drafting California Revocable Trusts/2 Professional Responsibility/§2.33 b. Form: Consent to Dual Representation--Long Form

§2.33 b. Form: Consent to Dual Representation—Long Form





2.33-1 Consent to dual representation—long form

Consent to Dual Representation

It is customary for _ _[*a husband and wife/spouses or domestic partners*]_ _ to retain the same attorney to assist them in drafting their revocable trust(s) and otherwise planning their estates. However, it is important that you understand that, because I would be representing both of you, each of you would be my client. As a result, matters that one of you might discuss with me would not be protected by the attorney-client privilege from disclosure to the other. The Rules of Professional Conduct of the State Bar of California prohibit me from agreeing with either of you to withhold information from the other that I would otherwise have had a duty to disclose. Also, each of you is entitled to full privacy and confidentiality from the other as respects the contents of your trust and other estate planning documents. To the extent that I represent both of you, and our discussions are carried on in the presence of both of you, each is waiving that right of privacy and confidentiality.

In addition, under the Rules of Professional Conduct, I am required to disclose to you any actual or potential conflicts of interest that may arise from my representing both of your interests and to obtain your written consent to representing both of you despite such conflicts. If the two of you have a difference of opinion about your proposed revocable trusts or your estate plan, I can point out the pros and cons of such different opinions. The Rules of Professional Conduct prohibit me from advocating one of your positions over the other.

***Privilege.* Anything either of you discusses with me is privileged from disclosure to third parties in a litigated matter. If I represent both of you, if a later dispute arises between the two of you, what I learned during my representation of you is not privileged vis-à-vis that dispute.**

***Conflicts Regarding Community and Separate Property.* At present there is a potential conflict regarding the characterization of your real and other property as separate or community property.**

[*Add one of the following alternatives*]

[*Alternative 1: Property will retain its character as separate or community; no specification*]

Your revocable trust documents will not specifically identify separate property and community property and will provide that separate property and community property will retain their character as such, *i.e.*, the characterization of your property as separate or community will not change as a result of the estate planning that I perform and the documents that I draft for you. I am accepting the facts regarding your property as represented by you, and I will not seek to trace the property to determine or change its characterization.

[*Alternative 2: Property to be identified as separate or community*]

After our discussion at our office conference, I am accepting the facts regarding your property as represented by you, and I am accepting our mutual conclusions based on those facts and discussion regarding the characterization of your property as separate or community. The property will be thus identified as separate or community in your estate planning documents, and I will not seek to trace the property to determine or change such characterization.

[*Continue*]

If you were each represented by a separate attorney who advocated your position alone, it is possible that the characterization of your property would be different from that as presently understood, and that issues would

arise in determining and protecting the separate or community property nature of your property and in asserting and pursuing claims that you may have against each other with respect to that property.

Survivor as Trustee of Bypass Trust **_ _[*and QTIP Trust*]_ _. The Bypass Trust _ _[*and QTIP Trust*]_ _ _ _[*provides/provide*]_ _ benefits for the surviving _ _[*spouse/partner*]_ _. Because the surviving _ _[*spouse/partner*]_ _ is the trustee of those trusts, _ _[*he/she/he or she*]_ _ could deplete them under the "health, education, maintenance, or support" standard and leave few, if any, assets available for the deceased _ _[*spouse's/partner's*]_ _ other beneficiaries.**

[*Add when QTIP Trust is used*]

Although the foregoing standard is common for a bypass trust, it is less common, although not unusual, for a QTIP trust.

[*Continue*]

To some degree, each of you is thus trusting the other not to take undue advantage of his or her position as trustee of _ _[*that trust/those trusts*]_ _.

Withdrawal as Attorney**. Although it is unlikely to happen, if conflicts do arise between the two of you of such nature that it is impossible in my judgment to perform my obligation to each of you in accordance with this letter, I may determine that I must withdraw as your joint attorney, and I will advise one or both of you to obtain independent counsel.**

Endorsement. **Please read the following endorsement. If the terms are acceptable to you, please sign below.**

ENDORSEMENT

We have read the above statement and understand its contents. We consent to having _ _[*name of attorney*]_ _ represent both of us on the terms and conditions set forth above. We understand the discussion of conflicts of interest in the letter and waive any potential conflict of interest. We agree that there shall be no confidential information between the two of us with respect to information either of us provides to _ _[*name of attorney*]_ _.

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

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

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§2.34 2. Treat Each Party as Client

The attorney must treat each party in a joint representation as a client. Although many couples prefer to have one person deal with the attorney and have the other person meet with the attorney only to execute documents, this practice is extremely unwise. Despite the fact that an early meeting with only one of the clients is sometimes necessary just to gather the basic financial and family information, it is preferable that the attorney meet with both parties at all stages in the estate planning process. The attorney should be particularly wary if 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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§2.35 3. Withdraw From Representation

When there is a conflict, the lawyer must withdraw from representation unless he or she obtains the written consent of all concerned parties. Cal Rules of Prof Cond 3-310. Withdrawal may be required even if it will have an adverse economic effect on innocent clients. The court may order withdrawal if the lawyer cannot extricate him- or herself from the representation. Clearly, the client's best interest requires that, if the lawyer discerns an irreconcilable conflict, he or she should withdraw before investing too much time in the matter or before one or both clients suffer too much detriment.

An attorney who must withdraw should assist the clients in finding other competent counsel. The attorney probably should not direct the client to another person in the same office, nor should the attorney select the new counsel. At most, he or she should identify two or three competent attorneys and suggest that the clients interview all of them before deciding on one. When the need for withdrawal is the result of a serious adversarial turn in the clients' relationship (*e.g.*, marital dissolution), the attorney should be wary of even making a referral for fear that the act of referring either client constitutes a breach of the duty of loyalty to the other. See *Flatt v Superior Court* (1994) 9 C4th 275, 36 CR2d 537.

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VII. ETHICAL ISSUES CONCERNING ATTORNEY AS INTERESTED PARTY

A. Attorney as Beneficiary

§2.36 1. Disqualified Person Statute

The attorney who drafts the revocable trust must not name him- or herself as a beneficiary, because California prohibits the drafter of an instrument from having a beneficial interest (with certain exceptions; see §2.37). Furthermore, the attorney who drafts the trust should rarely name him- or herself as trustee and only after taking steps to ensure that the client has explored all the alternatives and understands the risks inherent in the attorney's serving as trustee.

As a rule, no provision of an instrument is valid to make a donative transfer to the following "disqualified persons" (Prob C §21350(a)):

- The person who drafted the instrument (see §2.38);
- A person who has a fiduciary relationship with the transferor, including a conservator or trustee, and who transcribes the instrument or causes it to be transcribed (but see *Rice v Clark* (2002) 28 C4th 89, 120 CR2d 522 (beneficiaries who provided information needed to prepare will and trust instruments and encouraged decedent to execute instruments were not persons who caused instruments to be transcribed for purposes of statute) and *Estate of Swettman* (2000) 85 CA4th 807, 102 CR2d 457 (conservator who arranged conservatee's meetings with estate planning agent, attended those meetings, and paid for drafting of conservatee's revocable trust instrument was not person who caused instrument to be transcribed); see also *David v Hermann* (2005) 129 CA4th 672, 28 CR3d 622 (contestant proved undue influence by preponderance of the evidence even if she failed to prove that defendant beneficiary procured trust documents));
- The drafter's or fiduciary's relatives by blood or marriage, registered domestic partners, cohabitants, and employees;
- Specified business associates of the drafter; and
- The care custodian of a dependent adult (see, *e.g., Estate of Shinkle* (2002) 97 CA4th 990, 119 CR2d 42 (long-term care ombudsman remained disqualified person even after skilled nursing facility patient returned home); see also *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248 (individual need not receive compensation to qualify as care custodian; no preexisting personal friendship exception to definition of "care custodian" in Welf & I C §15610.7 as implied in *Shinkle*), and *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390 (paid live-in caregiver provided "social services" and was therefore a care custodian)). Proposed legislation would exclude from the definition of "care custodian" certain persons who provide care without remuneration and would restrict the definition of "dependent adult" so that it would apply only to persons who are unable to provide properly for their personal needs or have difficulty managing their financial resources or resisting fraud or undue influence. The proposed legislation would also permit the drafting attorney to execute a certificate of independent review for a transfer to a care custodian and would clarify the counseling and confidentiality requirements for a valid certificate consistent with *Estate of Winans* (2010) 183 CA4th 102, 107 CR3d 167, as discussed in §2.37. Prop Prob C §§21360-21392; SB 105 (2009).

"Related by blood or marriage" under §21350(a) includes a spouse or predeceased spouse and includes relatives within the third degree of the person or person's spouse and the spouses of those relatives. Prob C §21350(b). While the statute specifically lists domestic partners of the drafter or fiduciary (but not the partner's relatives) 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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§2.37 2. When Disqualification Does Not Apply

Disqualification under Prob C §21350 (see §2.36) does not apply under any of the following circumstances (Prob C §§21350.5, 21351):

- The transferor is related by blood or marriage to the transferee or the person who drafted the instrument, is cohabitant with, or is the California-registered domestic partner of the transferee or the person who drafted the instrument;
- An independent attorney counsels the transferor about the nature and consequences of the intended transfer, attempts to ascertain whether it is the result of fraud, menace, duress, or undue influence, and delivers to the transferor a Certificate of Independent Review, in substantially the form specified in Prob C §21351(b), with a copy to the drafter (see §5.15; see also *Estate of Winans* (2010) 183 CA4th 102, 107 CR3d 167, discussed in Dennis-Strathmeyer, *Certificates of Independent Review After* Estate of Winans: *Would You Sign One?*, 31 CEB Est Plan Rep 105 (Apr. 2010) (reversing summary judgment upholding validity of new will benefiting care custodian despite certificate of independent review on the basis of reviewing attorney's lack of independence, because reviewing attorney was named as executor, and failure to satisfy counseling and confidentiality requirements); *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, discussed in §2.21);
- After full disclosure of the relationships involved, the instrument is approved by a substituted judgment order in a conservatorship proceeding;
- For certain specified instruments (see Prob C §21351(e)), the court determines, on clear and convincing evidence, but not solely based on 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;
- The transferee is a governmental entity or a tax-exempt charitable entity or a trust holding an interest for such entity (but only to the extent of such entity's or trustee's interest);
- 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; 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. 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 *Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895, the court refused to set aside donative transfers made to a care custodian who entered into a confidential marriage with the donor. The court found no support in the language or legislative history of Prob C §21351(a) for an exception to the rule that a spouse may receive a donative transfer. For purposes of Prob C §21351(a), "related by blood or marriage" includes persons within the fifth degree of kinship and heirs of the transferor. Prob C §21351(g). Fifth-degree relatives include first cousins once removed, and great- or granduncles, aunts, nieces, and nephews. See table of consanguinity in 1 California Decedent Estate Practice §7.105 (2d ed Cal CEB 2009). On removal of a disqualified person who is a sole trustee, see chap 16.

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§2.38 3. Attorney as Beneficiary

As discussed in §2.36, no provision of an instrument is valid to make a donative transfer to certain "disqualified persons," including the person who drafted the instrument. Prob C §21350(a). Thus, attorneys cannot draft documents in which they are beneficiaries except in very narrow circumstances. See §2.37.

By virtue of the long-term relationship that often develops between the estate planning attorney and the client, the application of Prob C §§21350-21351 is particularly common. After many years of representation in which the attorney has worked closely with the client, giving valued advice in personal situations, it may be difficult to determine where the professional relationship ends and friendship begins. As the line between these relationships blurs, and as the client becomes increasingly vulnerable because of the aging process, he or she can become dependent on the estate planning attorney. The relationship of extreme trust combined with increasing dependence may cause the client to view the attorney as a possible object of bounty in gratitude for the years of advice and counsel. The attorney is then in a particularly awkward position because the client expects the attorney to prepare the necessary documents. The attorney must not do so. Any gift made by the client to the attorney in a trust or other instrument drafted by the attorney is "void" and passes as if the attorney had predeceased the client. Prob C §§21350, 21353.

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§2.39 B. Attorney as Trustee

For at least two reasons, the attorney who drafts a revocable trust should rarely, if ever, name him- or herself as sole trustee. First, it is the attorney's duty to ensure that every client considers all of the alternative candidates for trustee, and when the attorney is a candidate, the client must be fully informed of the pros and cons of the attorney in this role. The client must fully understand the attorney's qualifications for the position (a good lawyer is by no means per se a good trustee), the potential conflicts of interest if the attorney is the trustee, whether vis-à-vis the client in the event of incapacity or vis-à-vis beneficiaries who have also been clients of the attorney. For discussion, see California Estate Planning §2.21 (Cal CEB 2002).

The second reason the attorney should rarely be named as trustee stems from Prob C §§15642(b)(6) and 15687. Under §15642(b)(6), the beneficiaries of a trust of which a "disqualified person" is the sole trustee can remove the disqualified person-trustee without cause. If the trustee can show that it was the settlor's intent that the attorney serve as trustee and this intent was not the product of fraud, menace, duress or undue influence (the burden of proof rests on the attorney-trustee), the court can permit the trustee to continue. If the court finds to the contrary, it can impose all costs of the proceeding, including attorney fees, on the attorney. Prob C §15642(d).

If the drafting attorney is related to the settlor by blood, marriage, or cohabitation, §15642(b)(6) does not apply. Prob C §15642(b)(6)(A).

The use of a Certificate of Independent Review can eliminate the impact of Prob C §15642(b)(6). Prob C §15642(b)(6)(B). But see *Estate of Winans* (2010) 183 CA4th 102, 107 CR3d 167, discussed in §2.37, on counseling and confidentiality requirements for an effective certificate and questioning the independence of the reviewing attorney in the case involving an alleged invalid donative transfer to a care custodian under Prob C §21350(a).

The drafting attorney who serves as trustee should also keep in mind the dual compensation restrictions of Prob C §15687.

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§2.40 C. Attorney as Executor of Will

If the attorney drafts a will in conjunction with the revocable trust, the better practice is that the attorney not be the executor. See *State v Gulbankian* (Wis 1972) 196 NW2d 733. An attorney who routinely names him- or herself as an executor in wills that the attorney drafts renders a disservice to the client who prefers another person to be executor but may assume that the executor must be an attorney, or that estate expenses will be reduced by having an attorney serve as executor. The client should be informed that the executor need not 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.

By naming him- or herself as executor, the attorney expands potential exposure to malpractice liability and professional discipline. An attorney must follow 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 an attorney in the capacity of executor.

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§2.41 D. Attorney as Attorney for Estate

The same ethical issues that arise when an attorney who drafts a will names him- or herself executor (see §2.40) are also present when the drafting attorney is designated attorney for the estate. This conflict situation, however, is eased somewhat by the fact that the executor is not bound by the will on this matter and may select his or her own attorney. *Highfield v Bozio* (1922) 188 C 727, 207 P 242.

An attorney who serves as executor and elects to act as his or her own counsel cannot receive both executor's commissions and attorney fees unless the court approves them in advance. 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. If the attorney who is named executor retains a partner as attorney for the estate, the estate must pay both executor's commissions and legal fees only if the attorney-executor does not share in the fees paid to the partner. 200 C at 137. This prohibition against double compensation applies even when the attorney's secretary is named executor. If the attorney's secretary serves as executor and is paid commissions, the attorney cannot be paid fees for legal services rendered to the executor. LA Bar Ass'n Formal Ethical Opinion No. 382 (Dec. 11, 1979).

This general rule may be reversed by an express provision in the will. Prob C §10804; *Estate of Thompson* (1958) 50 C2d 613, 328 P2d 1. However, the propriety of assessing fees both as executor and estate attorney even when authorized by the will has been questioned. See *Estate of Miller* (1968) 259 CA2d 536, 66 CR 756.

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§2.42 VIII. PREPARING FOR 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 revocable trust that carries out the client's wishes to the letter can appear to a disappointed beneficiary to be contrary to the settlor'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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§2.43 A. File Memorandums and Letters to Clients

An attorney may avoid being placed in a difficult position after the client's death by anticipating and 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 §2.9. If specialists will be consulted, this fact 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. Even though the memorandum is self-serving, it may be admissible evidence in future proceedings as a business record (Evid C §1271) and will at least be useful for refreshing recollection (see Evid C §§771, 1237).

In addition, the cautious practitioner may send the client a letter that reiterates the client's wishes and decisions and explains how the revocable trust helps accomplish them. Such a letter serves the additional purpose of explaining the trust in lay terms, making it easier for both the lawyer and the client to review quickly at a later date what was done. 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 client signs or initials the letter or memorandum, 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 revocable trust by neglecting to provide the attorney with necessary information or feedback. The letter should inquire whether the client wishes assistance in completing the trust 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 trust. However, the attorney should not withdraw from representation until he or she has taken the necessary steps to avoid reasonably foreseeable prejudice to the client's rights. Cal Rules of Prof Cond 3-700(A)(2).

NOTE: One precautionary measure that cannot be taken is an agreement with a client limiting the attorney's liability. Under Cal Rules of Prof Cond 3-400, an attorney cannot prospectively contract with a client to limit the attorney's liability for professional malpractice.

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§2.44 B. Colleague Review of Draft of Trust

In some firms, the attorney drafting the trust routinely submits the finished document to a partner or an associate for review. This is an excellent, albeit expensive, practice. A careful reading by a colleague may uncover omissions or ambiguities. The author of a complex document often fails to detect flaws that are obvious to another person. Drafting a comprehensive letter to the client describing the plan can often serve the same purpose.

An attorney's obligation to protect confidences does not preclude disclosing the client's affairs to firm members (see Evid C §952; but see discussion in §2.19) unless the client directs otherwise.

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§2.45 C. Documenting Client's Unusual Decisions

Sometimes a client decides to structure a revocable trust in a way that does not minimize the overall tax burden on the estate by not taking full advantage of tax-exemption, -deduction, or -deferral opportunities. This decision is typically made when personal or family considerations outweigh tax saving considerations and can be entirely appropriate. The attorney should confirm the decision in a writing to the client in enough detail to foreclose any later argument that the client was not adequately advised of adverse tax consequences.

NOTE: The attorney should be aware that any argument about the trust is likely to come from beneficiaries who had no relationship with the attorney and were not a part of the process. Arguments may arise years after the attorney performed the work, when the client is gone and memories have faded. Copies of documents, letters, and notes may be the only tangible record of the decedent's understanding and intent.

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§2.46 D. Notifying Former Client of New Law

There is no authority in California imposing on the estate planning attorney a duty to keep clients apprised of changes in the law that might affect the client's estate plan. Nonetheless, commentators have occasionally suggested that such a duty might be imposed, and the cautious attorney may wish to define in the engagement letter the extent to which the client can expect the attorney to provide ongoing advice about future changes. Many attorneys specifically state in the engagement letter that it is the client's obligation to contact the attorney for future review of the plan, the lawyer will not notify the client of changes in the law, and sometimes that once the documents are signed representation ceases.

To protect themselves until this issue is resolved, some attorneys send form letters to past clients, informing them of the possible impact of a new tax reform act on their revocable trusts and recommending that clients 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 trust arrangements. These communications do not violate the advertising and solicitation prohibitions of the California Rules of Professional Conduct. Cal Rules of Prof Cond 1-400(C).

Attorneys should consider what to recommend to clients about a subsequent review of their trusts and other estate planning documents. The attorney might suggest that clients review their revocable trusts every 5 years or so, or on the birth of a child or the death or incapacity of a family member, the acquisition (or loss) of valuable property, a move to another state, a serious health problem, or a dissolution of marriage. If, under the terms of legislation already enacted, there will be a significant change in the tax law in a future year (*e.g.,* the return of the estate tax in 2011), and the trust will be affected by that change, the client should be instructed to have it reviewed by an attorney before the tax change takes effect. In giving advice on the effect of tax changes, the attorney also must consider the effect of Circular 230. See §2.46A.

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§2.46A E. 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), which promulgates practice standards applicable to attorneys, CPAs, and other persons who represent taxpayers in dealings with 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, 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. 31 CFR §10.34(a), (e). The "substantial authority" standard is consistent with tax return preparer penalty provisions in IRC §6694(a)(2). See Notice 2009-5, 2009-3 Int Rev Bull 309, discussed in 30 CEB Est Plan Rep 91 (Feb. 2009). See also *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. 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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IX. MENTALLY IMPAIRED CLIENT

§2.47 A. Estate Planner's Dilemma

The duties to communicate with the client (Cal Rules of Prof Cond 3-500) and to provide competent representation (Cal Rules of Prof Cond 3-110) can be particularly problematic for attorneys drafting revocable trusts for an older population. Diminishing mental capacity, greater susceptibility to undue influence, or a combination of the two can make competent representation impossible if the client cannot understand and intelligently evaluate the advice being given.

The attorney confronts a difficult problem when faced with a client with impaired or questionable mental capacity. On one hand, the attorney does not want to stand in the way of a person's effectuating his or her lifetime and testamentary donative desires. In *Moore v Anderson Ziegler Disharoon Gallagher & Gray* (2003) 109 CA4th 1287, 135 CR2d 888, the court held that an estate planning attorney does not owe a duty to takers under an earlier will or trust to ascertain and document a client's competence when the client makes amendments. 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 who was taking morphine and subject to hallucinations did not owe a duty of care to individuals who were entitled to receive the testator's estate under a prior will. On the other hand, the attorney does not want to assist the client to do something he or she would not have done with undiminished capacity. This problem is particularly acute when the attorney knows that the client's proposed course of action diverges from past practices, differs widely from that customarily done by people in similar circumstances, or seems suspiciously like the product of undue third party influence.

Case law protects the attorney in the latter situation. See *Chang v Lederman* (2009) 172 CA4th 67, 90 CR3d 758, in which the court held that a disappointed prospective heir cannot 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, citing *Garcia v Borelli* (1982) 129 CA3d 24, 180 CR 768, and *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, discussed in §2.21. See also *Radovich v Locke-Paddon* (1995) 35 CA4th 946, 41 CR2d 573, in which the court held that a disappointed potential beneficiary did not have a cause of action against an attorney who (a) did not send his seriously ill client a draft of a new will for 3 months after the will was requested; and (b) thereafter, did not follow up with the client during the 2 months before the client's death.

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§2.48 B. Assessing Client Competence and Possibility of Undue Influence

The initial client meeting provides an opportunity for the attorney to assess the client's competence and to learn more about medical issues that may affect his or her situation or planning considerations. The attorney should inquire about family medical history generally and be alert to possible medical issues.

The attorney should also be aware of signs of fraud or undue influence. It is not uncommon for a client—typically an elderly client or one with physical impairments—to come to the meeting accompanied by a family member or friend. However, the attorney generally should conduct all dealings directly with the client and, depending on the circumstances, meet alone with the client to ensure that the client has the opportunity to discuss his or her wishes without the presence of the third party.

In addition, the attorney should watch for "red flags," such as proposals to change the client's estate plan disproportionately to favor the person accompanying the client or his or her relatives or friends, to prepare a durable power of attorney for financial matters naming that person as attorney-in-fact, or to place assets in joint tenancy with that person or make other title changes "for convenience." Although these requests are warranted in many situations, they can also be the means by which an unscrupulous person can take advantage of the client. For further discussion of potential "predators" and techniques for guarding against them, see California Estate Planning §§3.6, 3.8 (Cal CEB 2002).

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§2.49 C. Protecting Client With Diminished Capacity From Elder Abuse

During the course of a representation, the attorney may become concerned either that the client can no longer handle personal and financial affairs or that there are one or more third parties who are a threat to the client's financial, or even physical, well-being. What does the attorney do? It is one thing to refuse to participate in the preparation of documents to change the client's estate plan; it is another to take action to protect the client from his or her impairments or from third party predations. How does the attorney reconcile the various ethical duties to the client: the duty of loyalty, the duty to maintain the client's confidences, and the duty to avoid conflicts of interest? When these duties are irreconcilable, which duty trumps the others?

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§2.50 1. California Authority

California has no rule that specifically addresses the obligation (or options) of an attorney representing a mentally impaired client. Such California authority that exists on the subject in the form of ethics opinions takes a position contrary to that in most jurisdictions in the United States. Counsel navigating the ethical rules on representing a mentally impaired client should recognize that (1) there is no controlling California authority on the subject, (2) ABA Model Rules of Prof Cond 1.14 is directly on point and is followed by over 40 states, and (3) local probate court practices should be ascertained before proceeding.

There are four California ethics opinions that deal with this subject:

- California State Bar Standing Committee on Professional Responsibility and Conduct (COPRAC) Formal Opinion No. 1989-112;
- LA County Bar Ass'n Ethics Opinion No. 1988-450;
- San Diego Bar Ass'n Ethics Opinion No. 1978-1; and
- Bar Ass'n of San Francisco Ethics Opinion No. 1999-2.

The first three opinions elevate the duty of confidentiality above all others. These opinions place California in a small minority of jurisdictions having ethics opinions purporting to prohibit an attorney from seeking appointment of a guardian or conservator for an apparently impaired client or even seeking the consultation of a physician. What the attorney (or any other objective observer) deems to be in the best interests of the client is irrelevant.

The San Francisco opinion (the most recent of the four) concludes that the duty of confidentiality should not always trump all other duties to the client, and states that an attorney who reasonably believes that a client cannot manage his or her own financial resources or resist fraud or undue influence may take protective action, including recommending appointment of a trustee, conservator, or guardian ad litem. The attorney has implied authority to make disclosures necessary in the best interests of the client. Bar Ass'n of San Francisco Ethics Opinion No. 1999-2.

The weight of current California authority seems to exalt confidentiality over all other interests of an impaired client, including the interest to be free from financial and physical abuse and predation. Of serious concern is the fact that the attorney may apparently choose only between slavishly following the client's directions (even if capacity to give directions is uncertain), regardless of likely detriment to the client, or withdrawing from the representation, leaving the individual at the mercy of his or her own failings and possible abuse by third parties. Until further statutory or judicial guidance is propounded, a California attorney who takes affirmative action to protect a client from harm against the client's wishes does so at the attorney's own peril.

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§2.51 2. National Authority

Unlike California, the ABA Model Rules specifically address the situation of a mentally impaired client. See ABA Model Rules of Prof Cond 1.14, reprinted in California Estate Planning §2.34 (Cal CEB 2002). This rule bolsters an attorney's right to take protective action on the client's behalf. It provides that an attorney who reasonably believes that a client has diminished capacity or is at risk of harm may take protective measures, including consulting with family members, using durable powers of attorney, consulting with support groups or adult-protective agencies, or seeking appointment of a guardian ad litem, conservator, or guardian. The lawyer is implicitly authorized to make any necessary disclosures to protect the client, even if the client directs otherwise.

Until California clarifies the rules governing attorneys in this area, many attorneys may reasonably be reluctant to follow the ABA's lead.

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3

Drafting Considerations

CEB Staff

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I. USING THIS BOOK

§3.1 A. Overview of Trust Drafting

The forms in the appendixes of this book reflect a variety of choices made by the authors and editors on desirable ways of structuring typical revocable trust documents. The book has been designed around the forms. The chapters of the book present and explain the forms used in the appendixes as well as a wide variety of alternatives.

To a great extent the chapter organization of the book corresponds to the organization of Appendix A—a joint revocable trust intended for a married couple that has sufficient assets to present possible federal estate tax problems. However, complete correspondence between form organization and book organization would be impractical. For example, many trusts divide into multiple trusts over time. A joint revocable trust for a married couple may be divided on the first death of a settlor into a survivor's trust, a QTIP trust, and a bypass trust. Each of these new trusts will have its own distribution provisions. It would makes little sense to repeat similar possible distribution provisions in multiple parts of the book merely because they may appear in multiple parts of Appendix A.

This chapter begins with an overview of the considerations that a drafter encounters in designing trust forms. The overview is followed by an explanation of the particular design decisions that were made in developing the appendixes and suggestions on drafting techniques that may help practitioners who wish to develop their own forms.

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§3.2 B. Trust Design Objectives

There is no single correct way to draft trust documents. There are few statutory requirements for a valid trust, and drafting practices vary considerably by locality, practitioner taste and philosophy, demands of the practitioner's drafting system, and the demands of the practitioner's firm. Nevertheless, most practitioners would agree that there are some obvious objectives—not all of which are obtainable, and some of which may be mutually exclusive—particularly when the need for precision generates increased complexity at the expense of reader comprehension. In deciding these matters, the drafter should consider the issues discussed in §§3.3-3.4.

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§3.3 1. Document Audience

The purpose of a trust instrument is to convey information to the members of its intended audience. That audience potentially includes the settlor, the trustee, the beneficiaries, the family CPA, the Internal Revenue Service, the local superior court judge, and third parties who may conduct business with the trustee. Typically, this group is very disparate in its education in general and in its knowledge of trusts and taxes in particular. Drafting a document that can be understood by each person is a challenging task. Indeed, it is not rare to encounter an experienced practitioner who claims to have abandoned the task in favor of simply making sure that the document will not be misinterpreted by the IRS or the courts, reasoning that other interested parties can be informed in separately stated explanations.

For those not willing to abandon the effort of drafting an understandable document, however, these suggestions may be helpful:

- Keep the document short. Doing so helps both the reader and the drafter.
- Organize the document by logical topics.
- Put the most important information near the beginning of the document.
- Use informative headings (and do not nullify them with a boilerplate provision that says to ignore them).
- Separate less substantive boilerplate from the more substantive clauses.
- Include one or more clauses near the beginning of the document that state the purpose of the trust and any special intended tax consequences.
- Avoid overly subtle cross-references to provisions determining rights to receive distributions. For example, if a trust will contain a custom definition of "issue," the definition should usually be placed in the portion of the trust containing the distribution provisions, and references to "issue" should alert the reader that the term has a specific definition in the document. Particularly with lengthy documents, the often-encountered drafting technique of putting all definitions in one place, usually amidst boilerplate at the end of the document, is burdensome for the reader and may create doubt about whether the settlor (or even the drafter) was fully aware of the definition each time the word was used.
- Do not hide important provisions in the boilerplate. For example, a distribution power should not be inserted in the middle of a list of routine administration powers.
- Have a table of contents. Both Microsoft Word and WordPerfect provide methods of automating this task.

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§3.4 2. Flexibility and Safety

Within the realm of document drafting, the estate planners who provide the more valuable services to their clients are those who can tailor a complex trust document to meet the varying needs of their various clients. To provide customized trusts, drafters must overcome a range of challenges. True custom drafting is expensive and increases the risk of drafting error—particularly when dealing with long documents. When working with a trust that is intended to accomplish tax savings, the drafter must make sure that a change in one part of a document will not have negative consequences in another part. (Unfortunately, it is fairly common to see trust documents in which this problem is addressed by a half-dozen or more provisions beginning, "Notwithstanding any other provision of this trust….")

Strategies for addressing these concerns include the following:

- Isolate provisions that seldom need to be customized, and try to state them in a way that minimizes the risk of conflict with provisions that change more frequently. (Example: Don't put a significant distribution power in the middle of a long list of the trustee's more general powers to carry out such acts as sell property and borrow money.) Although this approach will not shorten the document, it will shorten the portion of the document that must be carefully reviewed when custom drafting occurs.

- Build choices into a master document and flag the provisions of the document that must be consistent with each choice. (Example: Some estate plans use an IRC §2606(b)(7) qualified terminable interest (QTIP) trust and some do not. If the trust document refers to a QTIP trust at several locations, the drafter's basic form should flag those locations in a way that reminds the drafter of the need to either include all the references or delete all of them. The more options that are built into a form the more likely the drafter will use the choices most appropriate for a particular client even when documents are drafted in a hurry.

- Flag high-risk options. (Example: As a rule, a "sensitive trustee" should not be given a discretionary power to distribute property to the trustee unless the trustee's discretion is subject to an ascertainable standard related to health, education, maintenance, or support. Treas Reg §20.2041-1(c)(2).) See §4.9. If the drafter's master form contains a distribution option that creates the risk of accidentally giving a sensitive trustee an unwanted power, the option should be flagged.

- Use the same basic form structure for all trusts. For example, the forms in the appendixes all place the revocation clause at the end of the document. A practitioner may choose to place the revocation clause somewhere else, but in the absence of a reason to do otherwise, the practitioner should follow a consistent practice. Doing so will maximize the drafter's knowledge of his or her forms and will facilitate updating the drafter's forms when updating becomes necessary. Consistency is particularly important when more than one person is involved in form drafting.

PRACTICE TIP: Even basic word processing programs provide a variety of methods for inserting flags and other instructions in master forms. "Hidden text" provides a method of including text in a form that can be turned on and off. Some drafters flag instructions and text options with unique identifiers, such as $[or]$. They then use their word processing program's "macro" feature to construct macros that facilitate searching for these markers, removing the markers and the bracketed text, and/or removing the markers but preserve the bracketed text. Far more sophisticated options are available with document assembly programs, but such programs may not be cost efficient for drafters who do not create a significant volume of documents.

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II. FORMS IN THE APPENDIXES

§3.5 A. Emphasis on Distribution Provisions

The forms in the appendixes attempt to address many of the considerations described in §§3.3-3.4. Considerable effort was made to minimize the need for the client to wade through complex provisions before getting to the distribution provisions. For example, the long section on revocation and amendment was moved to the end of the document. Although it is common to see revocation and amendment provisions placed early in a trust document, the client invariably already knows that the document is a revocable trust.

For the same reason, the document splits the provisions on the trustees' identity. The names of the initial trustees and more immediate successor are stated early, but further details are relegated to later in the document. For marital deduction formula trusts, the same strategy is used with the marital deduction formula. In many trust instruments the complex formula clause is one of the first distributions provisions. This format forces the client to wade through an exceptionally sophisticated and complex clause in order to get to the remaining distribution provisions. The forms in the appendixes seek to ameliorate this problem by using a short form clause that incorporates a second, more detailed clause by reference. The second clause is placed later in the document.

The forms in the appendixes also contain a Division on "Additional Distribution Provisions." This "Division," although somewhat unconventional, provides a location for provisions that are too important to be scattered around the boilerplate of the document, but cannot be placed earlier without interfering with even more important provisions or without forcing repetition. (If the document establishes a Survivor's Trust, a QTIP trust, and a Bypass Trust, it would be undesirable to repeatedly state a provision that applies to all three.)

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§3.6 B. Common Structure and Subsets

Considerable effort has been made to make the various appendixes as similar as possible. The basic sequence of "Divisions" is essentially identical, and in many ways the provisions of the less complicated trusts are subsets of the more complicated trusts. Although individual drafters may choose to organize their trust documents differently, it remains the case that using a consistent approach will increase the drafter's familiarity with the documents and save time and money. When the client calls with a question about a 40-page document that was drafted five years earlier, it is helpful to know almost instinctively where the answer can be found. (And if the worst happens, it is nice to be able to give a deposition without needing a 10-minute recess to find the provisions that are "in here somewhere.") Consistent structure also facilitates updating forms.

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§3.7 C. Consolidation of Subtrust Provisions

Many estate plans for married couples establish multiple trusts on the first death. These trusts make one set of distributions during the life of the survivor and other distributions on the survivor's death. The drafter may organize these provisions in either of two ways—chronologically or by trust. If the organization is chronological, all distribution provisions applicable during the survivor's lifetime appear in one cluster, and all provisions for distributions after the survivor's death appear in the other. If the organization is by trust, all provisions for a particular trust, such as the bypass trust, will be stated in one cluster, with all provisions of another trust, perhaps a QTIP trust, being stated in another. The forms in the appendixes adopt the latter approach because it moderately simplifies drafting—making it easier, for example, to add or delete a QTIP trust.

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§3.8 D. Document Length

Although it is possible to draft a legally sufficient one-page trust document and some practitioners draft trusts that significantly exceed 50 pages in length, typical trust documents range from 15 to 35 pages. The forms in the appendixes are in that range. Although there is little professional consensus about appropriate document length, choices are influenced by the factors discussed in §§3.9-3.13.

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§3.9 1. California Statutes

California has a detailed trust law. See Prob C §§15000-19403. Many provisions of this law provide default rules that apply in the absence of a contrary provision in the trust document. See, *e.g.,* Prob C §§16200-16249, on the powers of trustees. California also has general provisions that apply both to trusts and to wills and related documents. These general provisions also provide many default rules that apply in the absence of contrary provisions in the trust document. See, *e.g.,* the proration of transfer tax rules in Prob C §§20100-20225 and the "Compliance With Internal Revenue Code" provisions in Prob C §§21500-21541. These rules create the possibility of using relatively short documents.

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§3.10 2. Desire to Override State Law

An express trust provision is clearly necessary when the settlor desires to establish a rule that is contrary to the default rule provided by state law. For example, California law generally requires that trustees account to beneficiaries on an annual basis (Prob C §16062), but the settlor may wish to waive this requirement to the extent permitted by Prob C §16064. See §§17.54-17.55. Similarly, when family members will act as trustees without compensation, settlors frequently choose to reduce the trustees' risk of being sued for breach of trust by including an exculpation clause. See Prob C §16461 and §16.23.

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§3.11 3. Desire to Evidence Settlor Intent

Even when a default state law rule is perfectly acceptable, it is often desirable to restate that rule in the trust document as a means of assuring beneficiaries that the settlor was aware of the rule that would apply. For example, Prob C §§20100-20225 on apportionment of estate taxes may have an a major impact on trust distributions: Assume that a trust provides for a distribution of $1 million to *X* but is silent on whether that gift is to bear its proportionate share of federal estate taxes. Even if the settlor is satisfied with the result under Prob C §20110, which will reduce the net gift to *X* by a prorated share of the taxes, the trust document should confirm this. Such a confirmation not only avoids the kind of beneficiary hostility that commonly arises when different views exist about the intentions of a deceased loved one, but it may also remind the settlor of the original decision at a later date—possibly causing the client to amend the trust if the choice is no longer desired.

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§3.12 4. Out-of-State Contacts

Generally, the need, or at least the desirability, for express trust provisions increases if the settlor may leave California, if trust real property is located outside of California, if banks or other holders of trust property are located outside of California, if beneficiaries are located outside of California, or if the situs of administration may change for some reason. Consider, for example, the practicality of completing transactions that raise issues concerning trustee powers. Under California law, persons dealing with trustees do not have an obligation to inquire into the extent of the trustees' powers and are generally fully protected in business dealings with the trustee—particularly if the person obtains a certificate of trust under Prob C §18100.5. Prob C §18100. See §17.6. Not all states provide this much protection for third parties dealing with trustees, and it may be unclear as to which state's law applies in situations involving interstate transactions. Accordingly, the drafter may choose to provide a more detailed listing of trustee powers when there are many out-of-state contacts than when all contacts are local.

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§3.13 5. Trust Duration

Many revocable trusts operate for very short periods of time. A terminally ill settlor may execute a trust that leaves the trust property outright to adults on the settlor's death, while some trusts will remain in effect indefinitely. In fact, several states have now repealed the rule against perpetuities or have very extended perpetuity periods. If a trust will operate for a prolonged period, it is usually less certain that the situs of administration will remain in California. There is also less certainty about the content of future California law, and it will become burdensome to prove what laws were in effect at the time the trust was created—and thus more burdensome to prove testator intent when it is necessary to determine those laws in order to establish client expectations. Accordingly, a long trust term probably justifies a longer trust document. If nothing else, long trust terms typically create the need for more detailed provisions concerning successor trustees.

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§3.14 E. Paragraph Headings

We have made heavy use in the appendixes of headings for the "Divisions," "Paragraphs," and "Subparagraphs" in the forms. Good headings facilitate understanding, make it easier to find desired provisions, and may be incorporated into tables of contents. They also facilitate cross-referencing by permitting such references as "the paragraph of this Division on Formalities." Cross-referencing by division number or letter creates the need to make changes each time the target provision location changes as a result of additions or deletions in the form, although the process can be automated to some degree with word-processing software. For reasons explained in §18.12, we do not recommend using a construction clause that provides that headings are to be ignored in construing the provisions of the document.

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4

Tax Considerations

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§4.1 I. OVERVIEW OF TAX ISSUES DIRECTLY RELATED TO TRUST DRAFTING

Taxes that have an impact on estate planning include federal and state income taxes, federal estate and gift taxes, the generation-skipping transfer (GST) tax, out-of-state inheritance taxes, and real property taxes. A significant discussion of those taxes is beyond the scope of this book. This chapter is primarily intended as a quick reference guide of the tax issues most directly related to trust drafting. Tax issues that may be relevant to particular trust provisions are discussed throughout the book. For more detailed discussions of the taxes discussed in this chapter, see California Estate Planning (Cal CEB 2002).

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II. TAX CONSIDERATIONS UNIQUE TO REVOCABLE TRUSTS

§4.2 A. Tax Neutrality

As a rule, revocable trusts are tax neutral. The use of a revocable trust as an estate planning device will neither save nor increase taxes. This tax neutrality results primarily from the fact that the sources and destinations of property transfers have greater tax significance than the specific method of accomplishing those transfers. If property passes from Grandfather to Grandchild, the transfer will be a generation-skipping transfer for GST tax purposes regardless of whether it passes by will through a probate estate, by revocable trust, or by the beneficiary designation on a life insurance policy or financial institution account. It is, of course, true that *irrevocable* trusts can have significant tax consequences, but it is generally irrelevant whether property is transferred to an irrevocable trust using a trust or a will. These distinctions frequently confuse clients, particularly those who have attended estate planning seminars that leave the impression that revocable trusts save taxes.

To a lesser extent, general tax neutrality of revocable trusts is the result of legislation that has been enacted for the specific purpose of promoting that neutrality. For example, IRC §645 provides an election that permits a revocable trust to be taxed as part or all of a decedent's estate.

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§4.3 B. Transfer Tax Exception: Powers of Appointment

Trust property that is held in a revocable trust is generally treated as owned by the settlor who holds the power to revoke the trust and thereby receives the property free of trust. A notable exception applies when a transfer is made to the trust by someone other than the holder of the revocation power. In that event, the holder of the power is treated as having a general power of appointment as defined in IRC §2041. In the context of a typical revocable trust, the distinction is important when a deceased settlor's property passes to a "Survivor's Trust." In contemporary California estate planning jargon, a Survivor's Trust is a trust that can be revoked or terminated by a surviving spouse or domestic partner with the consequence that the trust property is then delivered to the survivor. The trust is the functional equivalent of a revocable trust prepared for a single person and serves the general purposes of avoiding probate of the survivor's estate and avoiding conservatorship. However, despite the survivor's complete control of the Survivor's Trust, it is not necessarily true that a transfer to a Survivor's Trust for a surviving spouse will qualify for the federal estate tax marital deduction. See §4.138. Further, a QTIP trust may fail to qualify for the marital deduction if the trust income is paid to the Survivor's Trust rather than to the surviving spouse, and a Treas Reg §20.2056(b)-5(f) "estate trust" will not qualify for the marital deduction if it is to be distributed to a Survivor's Trust rather than the survivors' estate.

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C. Income Tax

§4.4 1. Grantor Trust Status

During the period that a trust is revocable, the trust property is treated as "owned" by the settlor for income tax purposes. IRC §§671, 676. A trust that is taxed under §671 is often referred to as a "grantor trust," even though the term is essentially meaningless in the sense that all trusts have grantors. A revocable trust is a grantor trust because the trust assets can be used for the benefit of the settlor. IRC §674. When a trust is a grantor trust, the settlor computes his or her taxable income by taking into account the income, deductions, and credits attributable to the trust. Essentially, the settlor is taxed "as if the trust were not in existence." Treas Reg §1.671-3(a)(1).

With a revocable trust, there is usually no requirement to file trust income tax returns (IRS Form 1041) for income taxable during the lifetime of the settlor(s). Treas Reg §1.671-4(b)(1). Payors of income are given the social security numbers of the settlor(s), who directly report the income on their personal income tax return. The trustee has the option, seldom used by family member trustees, of obtaining a taxpayer identification number for the trust, giving that number to payers of income, and filing an IRS Form 1099 in order to report that the income is taxable to the settlors. Treas Reg §1.671-4(b)(2).

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§4.5 2. Termination of Grantor Trust Status at Death

The death of a settlor generally terminates grantor trust status as to the property of that settlor. See Rev Rul 75-267, 1975-2 Cum Bull 254. If the trust was funded with property of two spouses or domestic partners, the trust remains a grantor trust with respect to the portion of trust property contributed by the survivor until the survivor's death. If the survivor acquires the right to unilaterally withdraw the property of the deceased spouse or partner, the income from that property may be taxed to the surviving spouse under the grantor trust rules. IRC §§671, 678. This tax treatment results when the decedent's property passes to (or remains part of) a "Survivor's Trust" or other trust conferring an unlimited unilateral withdrawal right. As noted in the following sections, it may also occur as to portions of a trust if the survivor has more limited powers.

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§4.6 3. Persons Treated as Owners

Under IRC §678, a surviving settlor or other beneficiary may be deemed the owner of trust property for income tax purposes, and therefore taxed on the income derived from the property regardless of whether the income is actually distributed to the beneficiary. The statute applies when a beneficiary has (or previously had) a unilateral withdrawal right.

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§4.7 a. Right to Take Corpus or Income

If a person has the power, exercisable alone, to vest trust principal or income in herself, she is treated as the owner of the portion of the trust subject to the power. IRC §678(a)(1); Treas Reg §1.678(a)-1(a). Thus, for example, a beneficiary's right to require the trustee to distribute all trust income to her will make that beneficiary the owner of the income portion of the trust, as will occur if a beneficiary who is the sole trustee has the power to sprinkle the trust income among a group that includes him- or herself. For a discussion of a power limited by an ascertainable standard, see §4.9. If the power granted an unrestricted trustee-beneficiary also includes the power to withdraw principal, she will be treated as the owner of the entire trust. See *Ella E. Russell* (1941) 45 BTA 397. Another, perhaps more common, example of the right to take corpus or income is that of a trust beneficiary who has the right to withdraw the greater of $5000 or 5 percent of the trust assets each year. In this situation, the beneficiary is treated as owning a fractional portion of the trust's income and corpus. Rev Rul 67-241, 1967-2 Cum Bull 225. As might be expected, if a beneficiary has the right to withdraw all or some lesser part of the trust, as often occurs with marital deduction power of appointment trusts (IRC §2056(b)(5); Treas Reg §20.2056(b)-5), the beneficiary will be treated as the owner of the entire trust or of the lesser portion subject to that power. See *Emery v U.S.* (1st Cir 1946) 156 F2d 728.

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§4.8 b. Sole Right to Exercise

To avoid ownership under IRC §678, assuming that that result is desired, one need only have another acting with the holder (*i.e.,* a joint holder of the power). Rev Rul 67-268, 1967-2 Cum Bull 226 (cotrustee with power to take income not owner under IRC §678). This will be true even if the power holder is a minor (Rev Rul 81-6, 1981-1 Cum Bull 385) or if the income cannot be withdrawn until the end of the calendar year (see *Grant v U.S.* (5th Cir 1949) 174 F2d 891).

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§4.9 c. Ascertainable Standard

Although IRC §678 is phrased in absolute terms of the *power* to take possession of principal or income, at least one court has interposed a fiduciary standard requirement and has held that when state law limits a life tenant's power to consume the principal solely for maintenance and related needs, the requisite absolute ownership of the corpus is absent and IRC §678(a)(1) does not apply. *U.S. v DeBonchamps* (9th Cir 1960) 278 F2d 127. See Rev Rul 61-102, 1961-1 Cum Bull 245. Conversely, where the power to consume is unlimited, the holder has been treated as the owner. *Hirschmann v U.S.* (2d Cir 1962) 309 F2d 104 (life estate with "unrestricted possession and enjoyment"). But see *Ella E. Russell* (1941) 45 BTA 397.

No ascertainable standard rule has yet been imposed on the power to withdraw ordinary income, although the portion owned has been limited in cases under prior law to the amounts necessary for the powerholder's support. See *Funk v U.S.* (3d Cir 1950) 185 F2d 127 (trustee beneficiary not owner of all income when income could be distributed only in accordance with husband and wife's respective needs, of which trustee was sole judge); *Eva V. Townsend* (1945) 5 TC 1380, acq 1946-1 Cum Bull 4 (beneficiary not taxable on amounts in excess of amounts she deemed necessary for her support).

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§4.10 d. Support Obligations

A person, other than a grantor, who holds a *fiduciary* power to apply the income of a trust for the support of someone whom the person is obligated to support is treated as an owner only to the extent that such support distributions are actually made. IRC §678(c); Treas Reg §1.678(c)-1(a). If distributions that satisfy the support obligation are made from accumulated income or corpus, the trustee/power holder is not treated as an owner but as a beneficiary.

A person, other than a grantor, who holds a *nonfiduciary* power to apply the income or principal of a trust to the support of someone whom the person is obligated to support is treated as an owner of the portion of the trust subject to the power. Treas Reg §1.678(c)-1(b). Internal Revenue Code §678 does not apply to income that is required to be distributed in support of a person's dependents: those distributions are taxable to the obligor as if the obligor were a beneficiary. Treas Reg §§1.662(a)-4, 1.678(c)-1(c).

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§4.11 D. California Property Taxes

Under California law, there is normally a reassessment of real property when there is a change of ownership. Because the reassessment commonly results in a tax increase, it is important to structure property transfers in a manner that avoids undesirable reassessments. Fortunately, property held by a revocable trust is treated as held by the person having the power to revoke the trust. See §4.226. When the trust becomes irrevocable on the settlor's death, the property is treated as transferred to the trust beneficiaries. Often, real property will be sold on the death of a sole settlor, in which case the use of a revocable trust has no negative consequences. If the property is to be sold on the death of a surviving spouse, negative consequences are avoided if the surviving spouse is the only person with a present interest in the property during the interval between the death of each settlor because the transfer to the survivor is excluded. See §4.225. Planning becomes more complex when clients' assets include a farm or other real property that will remain in the family after the death of the settlor(s). See §§4.235-4.240.

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§4.12 III. INCOME TAXATION OF ESTATES, IRREVOCABLE TRUSTS, AND DISTRIBUTEES

If a trust a portion of a trust is not subject to the grantor trust rules and therefore taxed to the grantor or a beneficiary under IRC §671, the manner of taxing trust income is significantly different. The rules applicable to such a trust are also generally applicable to probate estates. Although corporations and their shareholders are separate taxable entities that each pay tax, and partnerships are conduits that pay no tax, Part I of Subchapter J of the Internal Revenue Code (IRC §§641-685) places trusts and estates in a middle ground: the conduit principle applies to distributions to beneficiaries, but the trust or estate is treated as an entity as to undistributed income. Thus, tax liability is allocated between the estate or trust and its beneficiaries according to the amount of income received or retained by each, as measured by a special formula called "distributable net income" or "DNI." DNI determines the amount and character of income that must be taken into account by the trust or estate and its beneficiaries. It is a concept unique to subchapter J.

As always, there are exceptions. Charitable remainder trusts are nontaxable entities with special taxation rules for distributions to beneficiaries. Electing small business trusts (ESBTs) turn the rules around, taxing all the trust's S corporation income at the highest marginal rate, with no tax on the amounts distributed to beneficiaries.

Historically, estates and trusts were treated differently because estates were perceived as temporary custodians of a decedent's property while trusts were perceived as continuing entities that invest and distribute over a longer period of time. Because trust administration now often replaces probate administration on the death of the revocable trust grantor, recent changes to subchapter J eliminate those differences when a trust elects to be treated as an estate. IRC §645.

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§4.13 A. Taxable Income

The Internal Revenue Code applies the same formula to the taxation of estates and nongrantor trusts that it applies to individuals: Gross income minus allowable deductions equals taxable income. See IRC §§63(a), 641(b); Treas Reg §§1.641(a)-2, 1.641(b)-1. However, the tax-deferral benefits of annuities are not available if the owner is not a natural person or an agent for a natural person. IRC §72(u). While a revocable trust would certainly qualify as an agent, at least during the lifetime of the settlor, and the IRS has been liberal in its rulings on annuities that are owned by irrevocable trusts (see, *e.g.,* IRS Letter Ruling 200449011), the tax treatment of an annuity owned by the trust may change if the contract is retained in a portion of the trust that becomes irrevocable. Thus, it is probably best not to name the trust as the owner of the contract. Gross income, of course, is all income derived from whatever source. IRC §61(a). Subchapter J describes the modifications to a trust's or estate's gross income necessary to arrive at its taxable income. Subchapter J makes a further distinction between *taxable income* and *fiduciary accounting income*, the latter being the "income" that is to be distributed to the beneficiaries entitled to income under applicable trust law. In subparts A-D of subchapter J (concerning estates and nongrantor trusts), the unmodified word "income" means fiduciary accounting income. IRC §643(b); Treas Reg §1.643(b)-1. Conversely, the regulations under subpart E (dealing with grantor trusts), when attributing "income" to the grantor or another, mean taxable income, not fiduciary accounting income; the regulations use the phrase "ordinary income" when referring to fiduciary accounting income. Treas Reg §1.671-2(b).

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§4.14 B. Income Tax Rates

Internal Revenue Code §1(e) imposes steeply graduated rates on the income of trusts and estates, the practical effect of which is to encourage distribution of income and discourage accumulation of income. The statutory rates are adjusted for inflation. The rates for tax years beginning in 2010 are as follows:

15 percent of the first $2,300 of taxable income;

25 percent of the next $3,050 of taxable income;

28 percent of the next $2,850 of taxable income;

33 percent of the next $3,000 of taxable income; and

35 percent of the amount exceeding $11,200.

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§4.15 C. Income Tax Deductions

Estates and trusts are allowed most of the deductions allowed to individuals, with some important exceptions. Most significant is that estates and trusts are allowed a deduction for distributions of income to beneficiaries. IRC §§651, 661. The scope of this deduction is discussed in §4.26. Also, a trust is not allowed a standard deduction. IRC §63(c)(6)(D). See §§4.16-4.18 for other deductions.

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§4.16 D. Deduction in Lieu of Personal Exemption

Estates and trusts get no personal exemption deduction. Instead, estates (including trusts electing to be treated as estates) get a $600 deduction; simple trusts (those that must distribute all of their income annually) get, under IRC §645, a $300 deduction; and complex trusts (those that accumulate income, distribute principal, or make distributions to charity) get a $100 deduction in lieu of the personal exemption. IRC §642(b).

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§4.17 E. Charitable Deduction

Despite the fact that an estate or trust is, ostensibly, to be taxed in the same manner as an individual, there are substantial differences between IRC §642(c), governing estates and trusts, and IRC §170, governing individuals. For example, there are no limitations on the deductible amount for an estate or trust. Compare IRC §642(c)(1) with IRC §170(b). An estate or a trust may not take a deduction for amounts distributed to charity unless the distribution is made from gross income "pursuant to the terms of the governing instrument." IRC §642(c)(1); Treas Reg §1.642(c)-1(a). Section 642(c)(1) has been interpreted to require that the governing instrument must both mandate or authorize distributions to charity and provide that the distributions are to be made from gross income. In *Brownstone v U.S.* (2d Cir 2006) 465 F3d 525, no deduction was allowed for assets of a general power of appointment marital deduction trust distributed to charity by the surviving spouse's estate that was the appointee of trust principal because the will of the deceased spouse did not express a charitable intent but rather allowed the surviving spouse to distribute the trust principal in any way she saw fit. In *United States Trust Co. v IRS* (5th Cir 1986) 803 F2d 1363, 1365, the court stated that trust distributions "could not qualify for a deduction as distributions to a charitable organization under section 642(c) because [decedent's] will did not direct that the distributions come from gross income."

An estate or a qualified revocable trust treated as an estate or part of an estate under IRC §645 may deduct amounts permanently set aside for future distribution to or to "be used exclusively" for charity, in addition to amounts actually paid to charity. IRC §642(c)(2); Treas Reg §§1.642(c)-2(a), 1.645-1(e)(2)(i), (e)(3)(i). For the amount set aside to be considered permanently set aside for charitable purposes, the possibility that the amount will not be devoted to such purposes must be so remote as to be negligible. Treas Reg §1.642(c)-2(d). Estates or trusts may deduct amounts paid during a taxable year and amounts paid after the close of a taxable year, but may not carry forward unused deductions. Compare IRC §642(c)(1) and Treas Reg §1.642(c)-1(b) with IRC §170(d) and Treas Reg §1.170A-10. While the nature of the property contributed or of the recipient organization affects an individual's deduction, an estate or trust is limited only in that its deduction cannot exceed the amount of its "gross income." IRC §642(c)(1); Treas Reg §1.642(c)-1(a); Rev Rul 2003-123, 2003-2 Cum Bull 1200. Note that distributions for charitable purposes include distributions to foreign as well as to domestic charities. Treas Reg §1.642(c)-1(a)(2).

A trust or an estate cannot satisfy a general pecuniary charitable gift with a distribution of income and obtain a deduction. Treas Reg §1.663(a)-2. See *Mott v U.S.* (Ct Cl 1972) 462 F2d 512, cert denied (1973) 409 US 1108, 34 L Ed 2d 688, 93 S Ct 902. See also IRS Legal Memorandum 200644020 (funding pecuniary charitable gifts with shares of decedent's IRA resulted in distributing trust recognizing income). However, case law and rulings suggest that the deduction may be allowed for residuary gifts. See *Bowers v Slocum* (2d Cir 1927) 20 F2d 350; IRS Letter Ruling 200252032. See also IRS Letter Rulings 200652028, 200633009 (assignment of interests in an IRA to charity in satisfaction of the charity's right to receive a fractional share of the residue of an estate did not result in recognition of income). Likewise, no deduction is allowed for distributions of amounts other than "gross income," such as tax-exempt income or corpus. Treas Reg §1.642(c)-3(b)(1); Rev Rul 68-667, 1968-2 Cum Bull 289. See also *Mott v U.S., supra*. This is not to say that no charitable deduction will be allowed for distributions that are required by the governing instrument that consist of tax-exempt income when the trust or estate has gross income. Because all income is fungible, the deduction is simply reduced proportionally by the amount of the tax-exempt income. Treas Reg §1.642(c)-3(b). Thus, if a trust's income consists of 80 percent dividends and taxable interest and 20 percent tax-exempt interest, and it must distribute $20,000 from income to charity each year, the amount allowable under IRC §642(c) is $16,000. See Treas Reg §1.662(c)-4, Example (c).

Because items of income in respect of a decedent (IRD) enter into gross income, items of IRD distributed to charity qualify for the deduction. Treas Reg §1.642(c)-3(a). See *Estate of Freund v Commissioner* (2d Cir 1962) 303 F2d 30 (deduction only for amount of IRD actually received by estate). In IRS Letter Ruling 200336020, the IRS ruled that an estate could deduct IRA distributions and interest elements of Series HH savings bond redemptions received after distribution of all noncharitable bequests, because all residuary amounts were permanently set aside for charitable purposes.

A trust or an estate that realizes capital gains and that must make distributions to charity poses a different problem. Clearly the capital gains are part of gross income, but were *they* distributed? The answer depends on whether those gains enter into the computation of distributable net income. See §4.22. A related problem arises when a trust or an estate makes a distribution in kind of appreciated assets in satisfaction of the charity's right to income. In *Crestar Bank v IRS* (ED Va 1999) 47 F Supp 2d 670, the court disallowed a charitable deduction for a specific bequest of stock to a charitable foundation. The court noted that none of the reported income was generated by the donation of the stock. In Rev Rul 83-75, 1983-1 Cum Bull 114, the IRS allowed the deduction for the amount of gain recognized from the distribution of appreciated securities in satisfaction of a charitable annuity when the terms of the trust directed that an annuity be paid from the trust's income, but also authorized the payment out of capital gains and trust corpus if the income was insufficient.

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§4.18 F. Limits to Deductions

As with deductions available to individuals, some deductions available to estates or trusts are limited by reference to adjusted gross income. The overall limitation on the amount of deductions, however, does not apply to trusts and estates. IRC §68(e).

Miscellaneous itemized deductions may be deducted only if the aggregate of such deductions exceeds 2 percent of the trust or estate's "adjusted gross income." IRC §67(a). An estate or a trust computes its adjusted gross income in the same manner as does an individual, except that the trust or estate is granted (1) a deduction in lieu of the personal exemption, (2) a deduction for distributions to beneficiaries, and (3) a deduction for "costs which are paid in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." IRC §67(e)(1). Costs incurred in connection with administration are relatively easy to ascertain. What costs would not have been incurred if the property were not held in the trust or estate has been the subject of dispute between the IRS and taxpayers. Certainly, statutory executors' commissions and attorney fees meet the "would not have been incurred" criteria.

Management expenses, generally chargeable to the income account, such as those for investing, preserving, and maintaining estate or trust assets, have been the crux of the dispute. In *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782, the U.S. Supreme Court held that trust expenses are subject to the 2-percent floor unless it would be "uncommon (unusual, or unlikely)" for a hypothetical individual to incur the expense. In the absence of proof that investment advisor fees incurred by the trust satisfied that standard, the court held that the fees were subject to the floor. The IRS had issued proposed regulations providing that trust expenses were subject to the floor unless they "could not" be incurred by an individual. The IRS has issued temporary guidance in response to the *Knight* decision concerning the reporting of previous payments of bundled fiduciary fees when the parties did not distinguish between those costs that are subject to the 2-percent floor and those that are not. Notice 2010-32, 2010-16 Int Rev Bull 594. While the amounts at issue often are modest, the dispute may have significant alternative minimum tax (AMT) implications. See §4.19.

Some expenses allowable when determining taxable income are also deductible for estate tax purposes under IRC §2053. Most of these are "deductions in respect of a decedent," *i.e.,* items paid by the estate that would have been deductible by the decedent had he or she lived. See IRC §691(b). Prime examples are fees, commissions, and tax liens on real property deductible under IRC §212.

Interest on amounts borrowed to pay estate tax is deductible on the estate tax return, but IRC §163(h)(2)(E) specifically limits the income tax deduction to interest incurred under IRC §6163 (deferral of estate tax on remainder interests). Similarly, interest on delayed bequests, while taxable to the beneficiary receiving it (Rev Rul 77-322, 1977-2 Cum Bull 44), is not deductible by the estate, because it is "personal interest." IRC §163(h)(2). Most allowable deductions, however, may be taken either on the federal estate tax return or on the estate's income tax return, but not both. IRC §642(g).

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§4.19 G. Alternative Minimum Tax

The Internal Revenue Code imposes an additional tax on estates and trusts called the "alternative minimum tax" or "AMT," but only to the extent that the AMT exceeds the estate's or trust's regular income tax. IRC §55(a). The Code defines the AMT as the amount of "tentative minimum tax" that is the sum of 26 percent of the "taxable excess" for the year below $175,000, plus 28 percent of the taxable excess exceeding $175,000, reduced by the alternative minimum tax foreign tax credit. IRC §55(b)(1)(A)(i). The "taxable excess" is the amount of taxable income that exceeds the "exemption amount." IRC §55(b)(1)(A)(ii). The "exemption amount" for estates and trusts is $22,500 (IRC §55(d)(1)(D)), reduced by 25 percent of the amount by which the alternative minimum taxable income exceeds $75,000 (IRC §55(d)(3)(C)). Thus, for estates or trusts that have alternative minimum taxable income in excess of $165,000, the tentative minimum tax is simply 26 percent of the first $175,000 of alternative minimum taxable income, plus 28 percent of the balance.

A beneficiary's share of an estate's or trust's alternative minimum taxable income is determined by the beneficiary's share of the alternate minimum taxable distributable net income received by the beneficiary. An estate or a trust calculates its alternative minimum taxable income and net distributable alternative minimum taxable income in the same manner as it calculates its regular taxable income and DNI, but with the adjustments required by IRC §§56 and 58 and the addition of the tax preference items required by IRC §57.

The AMT rarely applies to trusts. Simple trusts distribute all their income, and complex trusts that do not distribute all their income are usually in the maximum regular income tax bracket so that their regular tax will exceed their tentative minimum tax. However, the AMT may apply if the trust has substantial expenses that are subject to the 2-percent floor on itemized deductions and the trust distributes all its regular income. 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. See §4.18. 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. For further discussion, see 29 CEB Est Plan Rep 15 (Aug. 2007).

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§4.20 H. Distributable Net Income (DNI)

Distributable net income is the measure of the *amount* of income that the trust or estate may deduct for distributions to beneficiaries, as well as of the amount of income that beneficiaries must include in their gross income. The DNI calculation also determines the *character* of amounts retained by the entity or distributed to the beneficiary. Because DNI measures both the amount and the character of income distributed or retained, it includes taxable *and* nontaxable items. IRC §643(a). Thus, the fact that an item is included in DNI does not mean that it is taxable as ordinary income, or even taxable at all—its original nature determines its tax consequences.

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§4.21 1. Computation of DNI

The computation of DNI starts with the taxable income of the trust or estate. IRC §643(a). Tax-exempt income (adjusted for a prorata share of deductible expenses) is added to the taxable income, as are extraordinary dividends, taxable stock dividends, and capital gains distributed as or allocated to income or used in determining income. IRC §643(a)(3)-(5). No adjustment is made for the personal exemption or for distributions to beneficiaries (which come later when determining the entity's taxable income). IRC §643(a)(1)-(2). Note, however, that deductions chargeable to principal under state law are taken into account when calculating DNI. See Treas Reg §1.652(b)-3(b).

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§4.22 2. Capital Gains and Losses

Capital gains pose some of the more difficult conceptual problems in determining DNI. The Internal Revenue Code states that gains from the sale or exchange of capital assets are not included when determining DNI if allocated to principal and (1) not paid, credited, or required to be distributed to any beneficiary, or (2) paid to, set aside for, or used for charity. IRC §643(a)(3). See §§4.32-4.33.

The regulations, however, are more restrictive than the Code, stating that capital gains do not enter into DNI unless they are (1) allocated to income pursuant to the terms of the instrument or local law or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with local law, such as the trustee adjustment power under Prob C §16336; (2) allocated to principal but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (3) allocated to principal but actually distributed to beneficiaries during the taxable year or utilized under the terms of the governing instrument or the practice of the fiduciary in determining the amount that is distributed or required to be distributed. Treas Reg §1.643(a)-3(b).

The first instance is fairly self-evident; if capital gains are actually allocated to income and distributed, they clearly should enter into the computation of DNI. The second instance obligates the trustee to continue to follow a reporting practice of treating discretionary distributions of principal as being paid first from capital gains, once that practice is established. See Treas Reg §1.643(a)-3(e), Examples (2)-(5). The third instance is limited to distributions required by the terms of the governing instrument on the happening of a specified event, such as a partial termination of the trust. See Treas Reg §1.643(a)-3(e), Examples (6)-(7).

PRACTICE TIP: With the diminution in dividend and interest yield, the advent of the prudent investor rule, and the use of total return investing (and the use of noncharitable unitrusts), distribution of capital gains has become more common. Because most trusts give the trustee the power to allocate between principal and income, and the law now allows equitable adjustments to be made between those accounts to achieve fairness, trustees commonly realize and distribute capital gains to income beneficiaries.

Capital losses, like most capital gains, are excluded from DNI unless they affect the amount of capital gain paid, credited, or required to be distributed. IRC §643(a)(3); Treas Reg §1.643(a)-3(d). See *Sylvan Agatstein,* TC Memo 1964-14. Because capital losses always affect the amount of capital gains if there are capital gains to net against them, the limitation applies in practice as an adjunct to the capital gains problems described above. However, if there are no capital gains and only capital losses, the effect of the limitation is to forbid taking those losses into account when determining DNI. The capital losses may still be carried forward. IRC §1212. In the final year of the estate or trust, capital losses may be passed to the beneficiaries. IRC §642(h)(1); Treas Reg §1.642(h)-1. Moreover, the estate or trust may offset up to $3000 of excess capital losses against its taxable income each year. IRC §1211(b).

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§4.23 3. Tax-Exempt Income

Tax-exempt interest is taken into account in calculating the DNI of an estate or a trust. However, IRC §643(a)(5) requires that the tax-exempt interest be reduced by a proportionate share of expenses, as described in IRC §265. The regulations under §265 direct that expenses be allocated between exempt and nonexempt income in "reasonable proportion." Treas Reg §1.265-1(c). The regulations under IRC §643 are more detailed, requiring reduction of general expenses in exactly the same proportion that the amount of tax-exempt interest bears to total fiduciary accounting income (after reducing other income by direct expenses). Treas Reg §1.652(b)-3(b). However, the examples in Treas Reg §§1.652(c)-4, 1.661(c)-2, and 1.662(c)-4 use a different formula:

$$\frac{\text{gross tax-exempt interest}}{\text{gross fiduciary accounting income}} \times \text{general expenses} = \text{allocable portion}$$

This approach apparently values simplicity over accuracy, because if a direct expense is greater than the income against which it is applied, that item ought to be eliminated from the computation. Either way, the end result is that the expenses attributable to tax-exempt income do not reduce taxable income; instead, they reduce the amount of tax-exempt income included in DNI. IRC §643(a)(5); Treas Reg §1.643(a)-5(a). Note that the general expenses of a trust or estate are allocable only to items entering into DNI, such as nontaxable and taxable interest, not to capital gains allocable to principal. IRC §652(b); *Tucker v Commissioner* (2d Cir 1963) 322 F2d 86.

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§4.24 4. Allocation of Expenses to DNI

Simply subtracting the trust's or estate's expenses from its gross income is not sufficient to determine the net amounts of the various items of income composing DNI. For example, expenses allocable to the production of tax-exempt interest are not deductible. IRC §265(a)(1). However, state income taxes are not "allocable to the production of income," so state income taxes attributable to tax-exempt income *are* deductible and thus reduce DNI. See Rev Rul 61-86, 1961-1 Cum Bull 41. Generally, deductible items attributable to one class of income are allocable to that class. Treas Reg §1.652(b)-3(a). Deductible items not attributable to one class of income are allocable in any reasonable fashion. Treas Reg §1.652(b)-3(b). If the allocable deductions of one class exceed the income of that class, they may be reasonably allocated to other classes, except for excess tax-exempt deductions, which are not usable. Treas Reg §1.652(b)-3(d). Excess deductions directly attributable to a class of regular income may be allocated to another class of regular income and need not be allocated to tax-exempt income. See Treas Reg §1.652(b)-3(d).

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§4.25 5. Separate Shares

Solely for the purpose of allocating DNI among beneficiaries of a trust or an estate, IRC §663(c) treats separate shares as if they were separate trusts or estates when a trust or estate has more than one beneficiary and those beneficiaries have substantially separate and independent shares. IRC §663(c); Treas Reg §1.663(c)-1. The separate share rule attempts to achieve essential fairness when allocating DNI among multiple beneficiaries. For example, if all trust income must be distributed equally to A and B, and the trustee distributes property with a value of more than half the trust's income to A, fairness decrees that the excess over A's half of the trust income be treated as a distribution of principal. The separate share rule does just that.

In general, the separate share rule requires calculating each share's DNI based on its ratable portion of gross income and deductions taken into account. Treas Reg §1.663(c)-2(b)(1). Gross income in this case is gross *taxable* income. Treas Reg §1.663(c)-2(b)(2). Thus, income in respect of a decedent (IRD) is included in the separate share calculation, even if the IRD is allocable to principal under state law or the terms of the instrument and if the IRD is allocated among the separate shares that "potentially" could be funded. Treas Reg §1.663(c)-2(b)(3). See Treas Reg §1.663(c)-5, Examples (6), (9)-(10). Noncash DNI items (such as original issue discount or undistributed partnership or S corporation income) are allocated in the same manner. Treas Reg §1.663(c)-2(b)(4). Deductions or losses attributable to one share remain with that share and are not allocated to other shares. Treas Reg §1.663(c)-2(b)(5).

The separate share rule applies only for the purposes of allocating DNI between the trust or estate and its current beneficiaries; it does not allocate income between successive beneficiaries, require filing additional returns, or generate additional personal exemption deductions. Treas Reg §1.663(c)-1(b). Because the separate share rule does not produce an additional run up the narrow tax brackets or additional deductions, most trust documents require that substantially separate and independent shares be treated as separate trusts, and the separate share rule infrequently affects trusts. However, wills and qualified revocable trusts (*i.e.,* trusts electing to be treated as estates) generally do not establish separate trusts during the period of estate administration, resulting in more frequent application of the rule because they often do create separate economic interests. See Treas Reg §1.645-1(e)(2)(iii). Separate economic interests include income attributable to a specific gift of property or to a family allowance, and even the qualified revocable trust itself, but not the actual specific gifts of money or property themselves. Treas Reg §1.663(c)-4(a). Family (or other) allowances that are not entitled to a share of income, as well as pecuniary formula bequests, which are not specific gifts of money or property and, unless specified otherwise in the trust or will, are entitled to interest after one year and not a share of income, are also treated as separate shares. Treas Reg §1.663(c)-4(b).

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§4.26 I. Taxation of Distributions

Distributions by the estate or trust are deductible by the entity and represent income to the beneficiary to the extent of DNI distributed. If distributions exceed DNI, the excess has no effect on the taxable income of the trust, estate, or beneficiary. IRC §§651(a), 652(a), 661(a), 662(a). Thus, DNI imposes a quantitative limitation on taxable distributions. DNI also acts as a qualitative conduit: items such as tax-exempt interest or distributed capital gains retain their character in the hands of the beneficiaries. IRC §§651(b), 652(b), 661(b), 662(b). The calculation of the exact amount and character of the distribution deduction and inclusion amount for beneficiaries depends on whether a trust is classified as simple (IRC §§651-652) or complex (IRC §§661-663).

Beneficiaries who have a mandatory right to current income are the first taxed, whether they actually receive the income or not, but only to the extent of available DNI. See IRC §§652(a), 662(a)(1). Discretionary distributions *may* carry out income, once again only to the extent of available DNI. See IRC §661(a)(2).

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§4.27 J. Tier System

Allocation of DNI ratably is permitted as long as all beneficiaries occupy the same position—for example, all as mandatory recipients of income. Ratable allocation between mandatory and discretionary recipients, however, runs afoul of IRC §102, which excludes property acquired by gift, bequest, or inheritance from treatment as income, *but not* the income from such property or a *gift or bequest of income* from such property. To avoid this conflict, subchapter J establishes a tier system to allocate DNI among classes of beneficiaries whenever total distributions exceed total DNI. The tier system first allocates DNI to those beneficiaries to whom distribution of fiduciary accounting income is mandatory, then to other recipients. If distributions to other recipients exceed remaining DNI, these distributions are identified as tax-free distributions of property under IRC §102(a).

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§4.28 1. 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(c). 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). First-tier distributions also include amounts required to be paid under a court order, such as a family allowance, to the extent that such amounts are paid from trust accounting income. IRC §662(a)(1); Treas Reg §1.661(a)-2(c).

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), 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), tier one beneficiaries must include in gross income a ratable portion of DNI, the end result being that the charitable deduction is of no benefit to first-tier beneficiaries. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example (2).

If an estate or trust distributes appreciated (or depreciated) 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.

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§4.29 2. 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), (d). "Other amounts distributed" do not, however, include specific gifts payable in fewer than three installments, or distributions that qualify for the charitable deduction. IRC §663(a); Treas Reg §§1.663(a)-1(a), 1.663(a)-2.

A complex trust or estate receives a deduction for, and a second-tier beneficiary takes into account, only those amounts "properly paid or credited." Thus, beneficiaries do not take into account the amount overpaid by mistake of fact or law, but 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 *DuPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332. A distribution to a beneficiary who immediately loans 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* (1951) 10 CCH TCM 1251. 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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§4.30 3. Intermediate Tier

As discussed in §4.28, 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 called 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, 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 (computed without taking the charitable deduction into account) minus first-tier distributions, 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). The result is that the charitable deduction is of no benefit to first-tier beneficiaries.

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§4.31 4. Variable Tier

Annuities may be first-tier or second-tier distributions. If the annuity amount may only be paid from trust accounting income, it is a first-tier distribution. Treas Reg §1.662(a)-2(c). If the annuity amount may only be paid from principal, it is a second-tier distribution. Treas Reg §1.662(a)-3(b). If the annuity amount may be paid from either income or principal, it is a variable-tier distribution 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 FAI available for distribution. See Treas Reg §1.662(a)-2(e), Examples (1)-(2).

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§4.32 K. Distribution of Appreciated Property

Distribution of appreciated property in satisfaction of a beneficiary's right to a specific dollar amount (including a pecuniary formula gift), 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), 1.1014-4(a)(3); *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217 (right to receive $5 million on attaining age 40); IRS Letter Ruling 200848009 (distribution of "an amount equal to [decedent's remaining] GST exemption" to trust for decedent's issue). 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. 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.

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§4.33 L. Distribution of Depreciated Property

The distribution of assets that have declined in value in satisfaction of a beneficiary's right to a fixed amount causes the estate or trust to realize a nondeductible loss, unless the distribution by an estate (or electing revocable trust) is in satisfaction of a pecuniary bequest. IRC §267(b)(6), (b)(13).

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§4.34 M. Property Representing IRD

Assuming that a distribution does not satisfy a beneficiary's right to a specific dollar amount, a distribution of property that includes the right to income in respect of a decedent (IRD) does not cause immediate recognition of the IRD but puts the beneficiary in the decedent's shoes and requires recognition of the income as collected. IRC §691(a)(1); Treas Reg §1.691(a)-2(a). The estate, trust, or other person acquiring the IRD item from the decedent takes over the decedent's basis; the basis of the IRD asset is not stepped up (or down) under IRC §1014(a). IRC §691(a)(2); Treas Reg §1.691(a)-3(a). The estate, trust, or person acquiring the IRD item recognizes gain in the amount of the difference between the then fair market value of the IRD item and the basis that it would have had in the hands of the decedent if he or she had disposed of the IRD item in any way other than by leaving it to someone else at his or her death. IRC §691(a)(3); Treas Reg §1.691(a)-4(a). In determining the amount of gain recognized, the estate, trust, or person acquiring the IRD item from the decedent receives an income tax deduction for the portion of estate tax paid by the decedent's estate attributable to the IRD item. IRC §691(c). Nonrecognition applies only to IRD items received from a decedent. If the estate or trust sells property using the installment method and takes back a note, distribution of that note triggers immediate recognition of all deferred gain. IRC §453B(a).

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§4.35 N. Interest or Income on Gifts

There are two types of "specific" gifts: specific gifts of property other than cash and gifts of fixed sums of money (called general pecuniary devises). The former usually carry with them the income that they earn during administration, while the latter are not entitled to a share of income, but only to statutory interest commencing one year after the decedent's death, unless the will or trust provides otherwise. Prob C §§12002-12003.

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§4.36 O. Interest on Pecuniary Gifts

Interest on a pecuniary gift may or may not be covered by IRC §663(a)(1). If interest payable is truly interest, IRC §163 governs the trust's deduction (which is zero because it is personal interest under IRC §163(h)), and the recipient takes it into account under IRC §61(a)(4). Internal Revenue Code §§661 and 662 imply otherwise because the interest is certainly an amount "properly paid." The IRS's position is that interest is interest, not a distribution. See Treas Reg §1.663(c)-5, Example (7); Rev Rul 73-322, 1973-2 Cum Bull 44. Without a contrary provision in the trust, pecuniary gifts subject to California law generally bear interest after 1 year. Prob C §§12003, 16340(b).

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§4.37 P. Income Generated by Specific Gifts

Although a specific gift of property other than cash, if payable from principal in three installments or less, does not carry out income because of IRC §663(a)(1), the income generated by the specific gift is part of the gross income of the estate or trust and is not covered by §663(a)(1) because the generated income is not received by gift or inheritance. California law provides that a specific gift carries with it the income earned on the devised property, less expenses attributable to that property. Prob C §§12002(b), 16340(a). Unless the trust specifies otherwise, the income earned by the specific gift property is not required to be distributed currently, and the recipient is a second-tier beneficiary.

For purposes of allocating DNI, the specific gift constitutes a "separate share" of the estate or trust (see discussion in §4.25), and a portion of the estate's or trust's DNI will be attributed to that separate share based on its gross income and any applicable deductions or losses. Treas Reg §1.663(c)-2(b)(1). This usually means that dividends earned by a specific gift of stock or net rental income attributable to a specific gift of real property will be used to calculate the gift's share of gross income entering into DNI. See Treas Reg §1.663(c)-5, Example (8). A similar rule applies to noncash items of gross income, such as undistributed partnership income or S corporation income attributable to a specific gift. Treas Reg §1.663(c)-2(b)(4).

If a distribution, other than of the specific gift property, is made to the recipient, he or she will include a portion of the current year's DNI in income *as a second-tier beneficiary*. Thus, if first-tier distributions use up available DNI, the recipient takes no taxable income into account. If DNI exceeds first-tier distributions, the recipient takes into account his or her separate share's ratable portion of the excess DNI. For a discussion of the tier system, see §§4.27-4.31.

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§4.38 Q. Taxable Year of Inclusion

An estate (including a qualified revocable trust), but not a trust, may elect a fiscal year. IRC §§641(b), 645. An estate or a qualified revocable trust adopts a fiscal year by filing a federal income tax return for that taxable year even if income is otherwise insufficient to require a return. Treas Reg §1.441-1(c)(1). If a qualified revocable trust is to be treated as part of an estate (or as the entire estate if no executor has been appointed), the trust (and the executor, if any) must file an election on IRS Form 8855, Election to Treat Qualified Revocable Trust as Part of an Estate, at the same time. Treas Reg §1.645-1(c). Selection of a fiscal year other than the calendar year might be made to reduce the number of fiduciary income tax returns necessary to be filed by an estate, depending on the decedent's date of death and anticipated length of administration.

Internal Revenue Code §§651(a) and 661(a) determine when the trust's or estate's distribution deduction is to be taken, and IRC §§652 and 662 govern inclusion by the beneficiary. For simple trusts, the deduction and inclusion occur during the tax year in which the income is required to be distributed. The same rule applies for first-tier distributions by complex trusts. For second-tier or variable-tier distributions (*i.e.*, other amounts properly paid or credited or required to be distributed) made by complex trusts, the phrase "for such taxable year" must be read as "during such taxable year." Note that amounts distributed in the first 65 days of an estate's or complex trust's taxable year may be treated as having been distributed in the preceding taxable year if the fiduciary properly elects to do so. IRC §663(b); Treas Reg §1.663(b)-1.

If the tax year of an estate and that of the beneficiary differ, IRC §§652(c) and 662(c) direct that the amount includable by the beneficiary is based on the DNI of the estate for the year ending with or within the beneficiary's tax year. Treas Reg §1.662(c)-1; *Hay v U.S.* (ND Tex 1967) 263 F Supp 813 (1962 income distributed during fiscal year ending in 1963 was includable in beneficiary's 1963 return). Because trusts other than qualified revocable trusts and charitable remainder trusts must adopt a calendar year (IRC §644(a)) and almost all individuals have calendar years (IRC §441(g)), the different taxable year rule is inapt for trusts except in the year of the beneficiary's death. For trusts that have corporate or other beneficiaries with fiscal years, the rule is the same as for estates. The election also affords a further opportunity for tax deferral because an estate enjoys a two-year holiday from estimated tax payments under IRC §6654(l)(2). Distributions often can be timed so that no estimated tax payments will be required by the trust or the beneficiaries for at least 3 years after death. See Dennett & Moseley, *Maximizing the Benefits of the Section 645 Election*, 31 Est Plan 546 (Nov. 2004).

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§4.39 R. Terminating Estate or Trust

In the final year of a trust or estate, all its assets (and liabilities) are distributed to the beneficiaries. All ordinary income received and capital gains realized during that year enter into DNI and are also distributed to the beneficiaries. IRC §643(a)(3). Consequently, the final return shows a second-tier distribution, in addition to any required first-tier distributions, that carries out all income. An estate is deemed terminated when all its assets have been distributed save for a reasonable amount set aside for contingencies. Treas Reg §1.641(b)-3(a). A trust is deemed terminated after the expiration of a reasonable period for the trustee to complete the administration of the trust. Treas Reg §1.641(b)-3(b).

Internal Revenue Code §642(h) allows a carryover of net operating losses, capital losses, and excess deductions to the "beneficiaries succeeding to the property of the estate or trust" on termination of the estate or trust. IRC §642(h); Treas Reg §1.642(h)-1(a). The beneficiaries succeeding to the property are those who bear the burden of the carryover loss or excess deductions. Treas Reg §1.642(h)-3(a). For an intestate estate, the beneficiaries succeeding to the property are the heirs; for an insolvent estate, the beneficiaries are those who would have taken if the estate had not been insolvent. Treas Reg §1.642(h)-3(b). In the case of a will or trust, the beneficiaries succeeding to the property are usually the residuary beneficiaries, but if a gift is determined with reference to the carryover, then that devisee also qualifies. Treas Reg §1.642(h)-3(c)-(d).

Each beneficiary succeeding to a portion of the property treats the loss carryover in the same manner as the trust or estate would have for purposes of computing taxable income, adjusted gross income, and any minimum tax, except that in the unusual case that a corporation is the beneficiary succeeding to the property, the loss is treated as a short-term loss. Treas Reg §1.642(h)-1(b). The carryover is first usable in the taxable year of the beneficiary in which the trust's or estate's year ends, but for purposes of determining any limitation on loss carryovers, the last year of the trust or estate and the beneficiary's year of receipt are each deemed to be one year. Treas Reg §1.642(h)-1(b). If the loss carryover expires in the year of termination, it is treated as an excess deduction. See Treas Reg §§1.642(h)-1(b), 1.642(h)-2(b).

It is not unusual for an estate to have excess deductions in the year of termination because most assets have been distributed previously and the bulk of fees and commissions are usually paid in the final year. The excess deductions are allowed only in computing taxable income, not in computing adjusted gross income (Treas Reg §1.642(h)-2(a)), and thus are subject to the 2 percent floor of IRC §67. See IRC §67(b). For a discussion of the 2 percent floor, see §4.18. The deduction is allowable only in the year in which the beneficiary receives it (*i.e.,* the year of the trust's or estate's termination) and may not be carried forward.

Distribution of a trust's or estate's assets on termination will bring IRC §469(j)(12) into play, increasing the basis of the distributed property and foreclosing use of the suspended losses. However, IRC §469(g)(1), relating to complete disposition of an interest, will apply if the termination is a taxable transaction of an estate, such as the funding of a pecuniary marital deduction trust.

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IV. INCOME TAX BASIS OF TRANSFERRED PROPERTY

§4.40 A. Importance of Basis Considerations

An important factor in planning for transfers of property, whether at death or during lifetime, is the income tax basis that the property will have in the hands of the transferee. That basis will establish the gain or loss that the transferee will realize on a subsequent sale or other disposition of the property. In some circumstances, basis considerations will be crucial to the discussion of whether to transfer an asset during lifetime or at death. Basis is also a crucial consideration when an estate plan provides for distributions of pecuniary amounts from a trust. If property must be sold in order to provide the cash for making the distribution, a forced recognition of gain by the trust may occur. An attempt to avoid that result by distributing property in kind in satisfaction of the obligation to pay the pecuniary amount will produce the same result. Rev Rul 66-207, 1966-2 Cum Bull 243. See §§4.32-4.33.

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B. Basis Rules for Transfers at Death

§4.41 1. Date-of-Death Basis Adjustment

Under the current law that applies to estates of decedent dying in years in which federal estate taxes are imposed, basis of property acquired from a decedent is generally the fair market value of that property on the date of the decedent's death. IRC §1014(a)(1). If the alternate valuation date is selected on the federal estate tax return for the decedent's estate, the basis will be the fair market value on that date. IRC §1014(a)(2). If an election is made to apply special use valuation under IRC §2032A, the basis of the property will be its value as determined under that section. IRC §1014(a)(3).

When the fair market value of the property at the date of death is greater than its basis in the hands of the decedent, the result will be a "stepped up" basis. However, a fair market value less than the decedent's basis causes a "step down" in basis at the date of death.

NOTE: Under Treas Reg §1.1014-3(a), the estate tax valuation of inherited property is prima facie evidence of fair market value. Although the regulation does not preclude rebutting the presumption that results from this prima facie evidence, the duty of consistency can make the presumption conclusive. See *Janis v Commissioner* (9th Cir 2006) 461 F3d 1080 (beneficiaries who inherited art gallery must use "blockage" discounted estate tax value of individual artworks as "cost of goods sold" when determining profit and loss on later sales of the works).

The categories of property that are treated as acquired or passing from a decedent are enumerated in IRC §1014(b). Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, qualifies as passing from the decedent. IRC §1014(b)(1). Also listed among the categories are community property of surviving spouses and property includable in the surviving spouse's gross estate under IRC §2044, *i.e.,* property for which a marital deduction was previously allowed. IRC §1014(b)(6), (b)(10).

The category does not include the community property of same-sex surviving domestic partners. The category also does not include the community property of same-sex surviving spouses who married in California before November 4, 2008, or married in another jurisdiction such as Connecticut, Iowa, New Hampshire, Massachusetts, and Vermont or the District of Columbia and are treated as surviving domestic partners under Fam C §308(a). Although the IRS generally relies on state law for its definitions of spouse and community property, the federal Defense of Marriage Act (DOMA) (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 surviving partners as surviving spouses. Section 3 of DOMA provides that "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." 1 USC §7. (Note: This provision was declared unconstitutional with respect to the right of same-sex spouses to file a joint return in *Gill & Letorneau v Office of Personnel Management* (D Mass, July 8, 2010, Civil Action No. 09-2013-JLT) 2010 US Dist Lexis 67874. The district court decision is expected to be appealed, and the application of the holding to the basis rules in IRC §1014(b) is uncertain.)

However, the community property of same-sex surviving spouses and domestic partners may be entitled to a step-up in basis for California income tax purposes. See §4.45.

Property is deemed to pass from a decedent if it is acquired by reason of death, form of ownership, or other condition and is thus required to be included in the decedent's gross estate. IRC §1014(b)(9). Property can be transferred either by will or by intestate succession. Treas Reg §1.1014-2(a)(1).

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§4.42 2. Exceptions to Basis Adjustment Rule

Several types of property are not subject to the basis adjustment rule of IRC §1014. Transferees of this property inherit the same basis that the property had in the hands of the decedent. See §§4.42-4.43.

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§4.43 a. Income in Respect of Decedent (IRD)

Income in respect of a decedent (IRD) is income that a decedent was entitled to receive that was not properly includable in his or her taxable income before death. IRC §691; Treas Reg §1.691(a)-1. Income on installment obligations, deferred or unpaid compensation, and distributions from IRAs and qualified retirement plans are examples of IRD. Assuming that IRD property is not distributed in satisfaction of a beneficiary's right to a specific dollar amount (see §4.32), the basis of IRD property in the hands of its eventual recipient is the same as the decedent's basis. IRC §1014(c).

For property on which no income tax has been previously paid, such as distributions from IRAs or qualified retirement plans, this rule ordinarily results in a zero basis for income tax purposes. For installment obligations, it means that, for purposes of calculating gain or loss on the payments, the transferees will use the same inclusion ratio as the one used by the decedent. Treas Reg §1.691(a)-5(a).

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§4.44 b. Appreciated Property That Decedent Acquired by Gift

If appreciated property is acquired by a decedent by gift within one year before death and that property passes on the decedent's death, directly or indirectly, to the donor or the donor's spouse, no basis adjustment is permitted. The basis of the property is its basis in the hands of the decedent immediately before death. IRC §1014(e).

"Appreciated property" is defined as property with a fair market value greater than its basis on the date it was transferred to the decedent. IRC §1014(e)(2)(A). This rule prevents a donor from obtaining a stepped-up basis by transferring property that has appreciated in value to a terminally ill donee and then inheriting the property from the donee at his or her death.

It is uncertain whether IRC §1014(e) would preclude a basis adjustment for assets that a surviving spouse had transmuted from separate to community property within a year before the donee spouse's death. Equally unclear is the question of whether the problem would be resolved by transfer of the property to a QTIP or other trust for the benefit of the surviving spouse. See Price & Donaldson, Price on Contemporary Estate Planning §3.35.5 (2007).

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§4.45 3. California Rules for Transfers at Death

In general, California's rules on adjustment to the tax basis of property acquired from a decedent parallel the federal provisions. With only minor exceptions, IRC §1014 has been incorporated by reference in California. Rev & T C §18031. The exceptions pertain to basis in certain foreign personal holding company stock and stock in a domestic international sales corporation (DISC) acquired from a decedent. Rev & T C §17024.5(b). However, while a surviving domestic partner is not entitled to a step-up in basis for the survivor's share of community property for federal income tax purposes (see §4.41), the survivor's share of community property may be entitled to the step-up in basis for state income tax purposes. Although IRC §1014(b)(6) is incorporated by reference in Rev & T C §18031, registered domestic partners will be "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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4. Application of Basis Rule to Particular Forms of Ownership

§4.46 a. Joint Tenancy

Joint tenancy property included in the decedent's estate receives a new basis at the time of the decedent's death. IRC §1014(b)(9). The basis adjustment applies to the portion of the property that is included in the gross estate for tax purposes. Therefore, if the surviving joint tenant has made a contribution to acquisition of the joint tenancy, with the result that only a portion of the property is includable in the decedent's gross estate, only that portion is deemed to be acquired from the decedent and eligible for the basis adjustment.

If the joint tenancy is a qualified joint interest between spouses, only half the interest is included in the decedent's estate. IRC §2040(b). The basis adjustment is then limited to the decedent's one-half interest. This rule does not apply if one of the spouses is a noncitizen (IRC §2056(d)(1)(B)) or if the joint tenancy was created before 1977 (*Therese Hahn* (1998) 110 TC 140). This rule also does not apply to same-sex domestic partners treated as spouses under California law. See §4.41.

For the purpose of dividing property on dissolution of marriage or domestic partnership, property acquired by spouses or partners during the marriage or domestic partnership as joint tenants is presumed to be community property. Fam C §2581. This presumption, which is rebuttable (see, *e.g.*, *Marriage of Delaney* (2003) 111 CA4th 991, 4 CR3d 378), does not apply at death. Most revocable trusts for married persons expressly provide that any joint tenancy property transferred to the trust ceases to be joint tenancy property. See §5.22.

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§4.47 b. Community Property

Both halves of property held by spouses as community property receive a step-up in basis at the death of the first spouse. The surviving spouse's half interest in the community property is regarded as property acquired from the decedent and is therefore eligible for the adjustment. IRC §1014(b)(6). However, this rule does not apply to same-sex domestic partners treated as spouses under California law. See §4.41. This rule was originally enacted in an attempt to treat residents of community property states in the same manner as residents of common law states. Based on the stereotypes of the time, the assumption was that the husband in the common law state would acquire all of the family property and die first, leaving a surviving widow who would have a new basis in all of the property, whereas, without §1014(b)(6), the same scenario in a community property state would leave the widow with a new basis only in the half of the community property that belonged to the deceased husband. The opportunity to obtain a new basis for both halves of community property can be extremely valuable when a couple owns appreciated assets, and the planner must exercise care to protect it. Frequently, property held by married couples as joint tenants should be retitled as "community property" or "community property with right of survivorship." See §4.48. Most revocable trusts for married persons expressly provide that any joint tenancy property transferred to the trust ceases to be joint tenancy property.

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§4.48 c. Community Property With Right of Survivorship

Civil Code §682.1 authorizes creation of community property with right of survivorship. The intent of this statute is to provide a form of title for real property that combines the benefits of both joint tenancy and community property. The interest of the deceased spouse can be terminated by affidavit after the death of the first spouse, and the basis step-up available for community property under IRC §1014(b)(6) is preserved.

Although section 682.1 does not apply to accounts in banks or other financial institutions, functionally the same form of title is created under the Uniform TOD Security Registration Act (Prob C §§5500-5512). The Act allows securities and securities accounts to be registered as community property with ownership to pass on death to designated beneficiaries. Prob C §5502.

The IRS has made no definitive statement that community property with right of survivorship will qualify for the basis adjustment under IRC §1014(b)(6). Other community property states (Nevada, Alaska, Arizona) have had similar statutes, and the IRS appears not to have raised any challenges to the basis issue in those jurisdictions. However, the basis adjustment will not apply to community property of same-sex domestic partners treated as spouses under California law. See §4.41.

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§4.49 d. Tenancy in Common

A tenancy in common is a co-ownership interest in which there is no right of survivorship. CC §685. The cotenancy interests may e unequal and each cotenant may devise his or her interest in the property by will or otherwise. To the extent that the cotenant's interest is includable in his or her gross estate at death, that interest is eligible for a basis adjustment under IRC §1014.

For the purpose of dividing property on dissolution of marriage or domestic partnership, property acquired by spouses or partners during the marriage or domestic partnership as tenants in common is presumed to be community property. Fam C §2581. This presumption, which is rebuttable, does not apply at death. However, to the extent that a surviving spouse can prove a transmutation of the property to community property, IRC §1014(b)(6) would allow an adjustment in the basis of the entire property on the death of the first spouse, although this rule does not apply to same-sex domestic partners treated as spouses under California law (see §4.41).

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§4.50 e. Separate Property

Any property that an individual owns before marriage or domestic partnership registration or acquires subsequent to marriage or domestic partnership registration by gift, devise, or bequest is separate property. Fam C §297.5, 770. Separate property that passes to a beneficiary or heir on the owner's death, and that is includable in the owner's gross estate for estate tax purposes, is eligible for a basis adjustment under IRC §1014. No basis adjustment is allowed on the death of the first spouse or partner for separate property owned by the surviving spouse or partner.

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§4.51 f. Basis Adjustment Planning Considerations

The fact that property receives a stepped-up basis at death is usually a reason to consider reserving appreciated property for transfer at death rather than by inter vivos gift. This strategy permits the transferee of the property to avoid income tax on the appreciation at the time of a subsequent sale. However, as discussed below, there are circumstances in which a lifetime transfer of appreciated property to a donee in a lower income tax bracket may be appropriate. See §4.56.

If the property has depreciated so significantly in value that the owner's basis is greater than the fair market value, it may be sensible for the property to be sold before death so that the loss can be realized. This assumes the owner can benefit from the recognition of the loss—perhaps using it to offset current capital gains. If the property is transferred at death, the basis will be stepped down to the fair market value, with the result that any opportunity for recognition of the loss will be eliminated.

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C. Basis Rules for Lifetime Transfers

1. Federal Provisions

§4.52 a. Carryover Basis for Lifetime Transfers

When property is transferred by inter vivos gift, either outright or in trust, the donee's basis is the same as the donor's adjusted basis at the time of the gift. However, if the basis is greater than the fair market value of the property at the time of the gift, the basis for purposes of determining loss on a subsequent disposition of the property is limited to its fair market value at the time of the gift. IRC §1015(a). Therefore, separate rules apply for computing gain and loss.

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§4.53 b. Increase in Basis for Gift Tax Paid

The donee's basis is increased, but not above fair market value, by the amount of the gift tax paid. For gifts made before 1976, the increase in basis is equal to the total amount of the gift tax paid. IRC §1015(d)(1). For gifts made after 1976, the increase in basis is limited to the amount of the gift tax attributable to the net appreciation in the value of the gift. IRC §1015(d)(6)(A). Net appreciation is the amount by which the fair market value of the gift exceeds the donor's adjusted basis. IRC §1015(d)(6)(B). The tax attributable to the net appreciation is computed by multiplying the gift tax paid on the transfer by a fraction, the numerator of which is the net appreciation in the value of the gift and the denominator of which is the amount of the gift. IRC §1015(d)(6)(A). The amount of the gift is determined after deduction of the gift tax exclusion under IRC §2503(b).

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§4.54 c. Part Gift/Part Sale

If a transfer of property is part gift and part sale, the transferee's basis is the greater of (1) the amount paid by the transferee for the property or (2) the transferor's adjusted basis at the time of transfer. Under either alternative, the basis may be increased for gift tax paid. Treas Reg §1.1015-4(a). For purposes of determining loss, however, the basis cannot be greater than the fair market value of the property. Treas Reg §1.1015-4(a).

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§4.55 2. California Lifetime Transfers Provisions

The California rules for the basis of property transferred during lifetime are the same as federal law. California has incorporated by reference IRC §1015. Rev & T C §18031.

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§4.56 3. Lifetime Gift Planning Considerations

In general, the income tax basis rules support lifetime gifts of appreciated rather than depreciated property. Particularly if the donee is in a lower income tax bracket than the donor, it may be advantageous to transfer to him or her property that has a significant amount of built-in gain. In addition to the benefit of the lower brackets, the donee will receive an increase in basis for the gift tax paid on the transfer. That increase will further lessen the gain recognized on a sale of the property.

PRACTICE TIP: If the donor is elderly or in poor health, a gift of appreciated property may not be an appropriate plan. It may be more sensible for the donor to retain the property so that it is transferred at death with a stepped-up basis.

It is ordinarily not good strategy to transfer property that has depreciated significantly in value so that the donor's basis exceeds the fair market value. If such property is transferred, the donee's basis for determination of loss on sale will be limited to fair market value. Because there is no net appreciation, no adjustment can be made for gift tax paid. IRC §1015(d)(6). Therefore, the full benefit of the depreciation is lost. The better plan is for the donor to sell the property, realize the loss, and gift the proceeds or some other property.

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D. Basis Rules After Repeal of Estate Tax

§4.57 1. Carryover Basis for Transfers at Death

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), the step-up in basis is eliminated for decedents dying after December 31, 2009. IRC §1022(a). This change coincides with repeal of the estate tax, which is effective for decedents dying in 2010. Because the gift tax remains in effect, EGTRRA-2001 makes no modifications to the basis rules of IRC §1015 for lifetime transfers.

EGTRRA-2001 provides that, except for certain allowable adjustments, property transferred at death will have a carryover basis determined in the same manner as the basis for property transferred during lifetime under IRC §1015. Therefore, property acquired from a decedent will usually have a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property at date of death.

WARNING: Because of a sunset provision in EGTRRA-2001, the rules applicable before repeal of the federal estate tax may be reinstated for estates of persons dying after 2010. See §4.72.

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§4.58 2. Increases to Carryover Basis

Internal Revenue Code §1022 provides for certain increases to the basis of assets acquired from a decedent after 2010. These increases cannot cause the basis of an asset to exceed its fair market value at the time of the decedent's death. IRC §1022(d)(2).

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§4.59 a. Basis Increase of $1.3 Million

The basis of property in a decedent's estate is entitled to an aggregate increase of $1.3 million, adjustable for inflation. IRC §1022(b)(2), (d)(4). This amount is increased by any capital loss carryover under IRC §1212(b), any net loss carryover under IRC §172 that would, but for the death of the decedent, be carried from the decedent's last tax year to a later tax year, and any losses that would have been allowable under IRC §165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. IRC §1022(b)(2)(C). This latter adjustment is referred to as a "built-in" loss.

In the case of a nonresident alien, the basis increase is limited to $60,000. IRC §1022(b)(3). This amount is adjusted for inflation, but is not increased by loss carryovers or built-in losses. IRC §1022(b)(3), (d)(4).

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§4.60 b. Spousal Basis Increase of $3 Million

An additional basis increase of $3 million, adjustable for inflation, is available for qualified spousal property. IRC §1022(c), (d)(4). "Qualified spousal property" is property that passes outright to the surviving spouse from the decedent or is qualified terminable interest property. IRC §1022(c)(3). "Qualified terminable interest property" means property that passes from the decedent and in which the surviving spouse has a qualifying interest for life. IRC §1022(c)(5).

The surviving spouse has a qualifying income interest if the surviving spouse is entitled to all income for life payable annually or at more frequent intervals and no one other than the surviving spouse has a power to appoint any part of the property to anyone other than the surviving spouse. IRC §1022(c)(5). In some cases a unitrust interest may satisfy the income requirement. See §13.5. Under these rules, a QTIP trust would be eligible for the basis increase, but the (rarely used) marital deduction estate trust would not. Moreover, it is arguable that property passing to a typical survivor's trust would not be eligible for the basis increase. The $3 million basis increase is only available for property passing in an "outright transfer" to the surviving spouse or passing to a QTIP trust. IRC §1022(c)(3). It is not clear that a transfer to a survivor's trust is an "outright transfer" under the statute, particularly if the survivor's trust permits distributions to persons other than the surviving spouse during the survivor's lifetime. Particularly in the context of smaller estates, where the federal estate tax marital deduction is not an issue, it is not unusual to encounter a survivor's trust that gives the trustee discretion to make distributions to or for the benefit of others, particularly in the event of the survivor's incapacity. Similarly, a transfer to a survivor's trust may fail QTIP requirements, either because of the spouse's power to appoint to others during the spouse's lifetime or, again, because of provisions permitting trust distributions to others. However, these rules do not apply to same-sex spouses or domestic partners treated as spouses under California law (see §4.41).

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§4.61 c. Executor Discretion to Allocate Basis

The executor has the authority to allocate the basis increases among the assets of the decedent's estate. IRC §1022(d)(3)(A). The executor determines whether a basis adjustment will be made and, if so, the amount of the adjustment. In estates that do not involve a formal probate, this authority would presumably devolve on the trustee or other person responsible for administration of the decedent's estate.

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§4.62 d. Property Eligible for Increases to Basis

Property acquired from a decedent is eligible for an increase in basis as long as the decedent owned the property at the time of death. IRC §1022(d)(1)(A).

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§4.63 (1) Property Acquired From Decedent

Property acquired from a decedent is specifically defined and includes the following (IRC §1022(e)):

- Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.
- Property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC §645(b)(1), *i.e.* any trust treated under IRC §676 as owned by the decedent.
- Property transferred by the decedent during his or her lifetime to a trust in which the decedent reserved the right to make any change in the enjoyment of the trust through exercise of a power to alter, amend, or terminate the trust.
- Any other property passing from the decedent by reason of death to the extent that the property passed without consideration, *e.g.,* property held as joint tenants with right of survivorship.

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§4.64 (2) Property Owned by Decedent

To qualify for the basis increase, property must be owned or treated as owned by the decedent at the time of death. IRC §1022(d). Ownership is specifically defined. Not all property acquired from a decedent as identified in §4.62 satisfies the ownership requirements. For example, it appears that assets in a QTIP trust would not be considered as owned by the surviving spouse for purposes of the $1.3 million basis increase in the surviving spouse's estate.

The following rules establish ownership (IRC §1022(d)(1)(B)):

- For property held as joint tenants or tenants by the entirety with the surviving spouse, the decedent is treated as owner of a 50 percent interest. See §4.46.
- For property held in a nonspousal joint tenancy or tenancy by the entirety for which the decedent furnished consideration, or she is treated as owner of a share of the property proportional to the consideration provided. See §4.90.
- For property held in a nonspousal joint tenancy acquired by the parties by gift, bequest, or inheritance (and the interests in which are not otherwise specified or fixed by law), the decedent is treated as owner to the extent of a fractional part determined by dividing the value of the property by the number of joint tenants.
- The decedent is treated as owner of property transferred (by the decedent) to a qualified revocable trust as defined in IRC §645(b)(1), *i.e.,* any trust that is treated as owned by the decedent under IRC §676 (another reason to take property out of a survivor's trust and put it back in).
- The surviving spouse's one-half share of any community property is treated as owned by and acquired from the decedent, provided that at least one-half of the community interest in the property is treated as owned by and acquired from the decedent. Therefore, like the rule under existing IRC §1014(b)(6), both the decedent's and the surviving spouse's one-half interests would be eligible for a basis increase. However, this rule does not apply to same-sex domestic partners treated as spouses under California law. See §4.41.

The decedent will not be treated as the owner of property by reason of holding a power of appointment over the property. IRC §1022(d)(1)(B)(iii). Because the statute makes no distinction between them, this rule apparently applies to both general and special powers of appointment.

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§4.65 e. Property Ineligible for Increases to Basis

An increase to basis is available only for property that was acquired from and owned by the decedent. The following categories of property are not considered owned by the decedent and are therefore not eligible for a basis increase:

- Property acquired by the decedent within 3 years before death by gift or inter vivos transfer for less than adequate and full consideration. IRC §1022(d)(1)(C). This rule does not apply to property the decedent received from his or her spouse unless, during the 3-year period, the spouse acquired the property in whole or in part by gift or inter vivos transfer for less than adequate and full consideration. IRC §1022(d)(1)(C). This exception clearly permits deathbed transfers between spouses and the resulting opportunity to maximize the available basis increases in the decedent's estate. However, this exception does not apply to same-sex domestic partners treated as spouses under California law. See §4.41.

- Stock or securities of a foreign personal holding company; stock of a domestic international sales corporation (DISC) or former DISC; stock of a foreign investment company; and stock of a passive foreign investment company, unless the company is a qualified electing fund with respect to the decedent. IRC §1022(d)(1)(D).

- Income in respect of a decedent under IRC §691. IRC §1022(f). This rule parallels IRC §1014(c), which disallows any basis increase for IRD items.

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§4.66 f. Treatment of Liabilities in Computing Gain and Basis

Under current law, when property subject to liabilities is sold or otherwise disposed of, the transferor realizes gain on the amount of the liabilities. Therefore, when property with liabilities in excess of basis is transferred by gift, the donor recognizes gain equal to the amount of the excess. *Malone v U.S.* (ND Miss 1971) 326 F Supp 106. The rationale is that assumption of the indebtedness constitutes an economic benefit to the donor.

The step-up basis rule of IRC §1014 generally provides that the basis of encumbered property that is acquired from a decedent is the fair market value of the property. Any liability is disregarded in computing the basis.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) modifies these provisions for decedents dying after December 31, 2009. Under IRC §1022(g)(1), liabilities in excess of basis are disregarded in determining whether gain is recognized on acquisition of property from a decedent. Therefore, gain is not recognized at the time of death when the estate or heir acquires property that is subject to a liability greater than the decedent's basis in that property. Similarly, no gain is recognized on the distribution of that property to a beneficiary of the estate (other than a tax-exempt beneficiary). IRC §1022(g)(1). With the exception of a tax-exempt beneficiary, liabilities in excess of basis are disregarded in determining the adjusted basis of property acquired from a decedent.

For purposes of §1022(g)(1), a tax-exempt beneficiary includes:

- The U.S., any state or possession of the U.S., and any organization that is exempt from income tax (IRC §1022(g)(2)(A));
- Any foreign person or entity within the meaning of IRC §168(h)(2), *i.e.*, a foreign government or organization and any person who is not a U.S. citizen (IRC §1022(g)(2)(C)); and
- To the extent provided in regulations, anyone to whom property is transferred for the principal purpose of tax avoidance (IRC §1022(g)(2)(D)).

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§4.67 g. Basis Reporting Requirements

The carryover basis system will include new reporting requirements for transfers at death. For estates of decedents dying after December 31, 2009, a return must be filed if the fair market value of noncash assets acquired from the decedent exceeds $1.3 million, as adjusted for inflation but not as increased by loss carryovers or unused built-in losses under IRC §1022(b)(2)(C). IRC §6018(b). The reporting requirement also applies to appreciated property that was received by a decedent within 3 years before death if this property was ineligible for a basis adjustment due to the 3-year rule under IRC §1022(d)(1)(C) and the property was required to be included on a gift tax return. IRC §6018(b).

The return must be filed with the decedent's final income tax return or at a later date specified in the regulations. IRC §6075(a). The report must include the following information (IRC §6018(c)):

- The name and taxpayer identification number of the recipient of the property;
- An accurate description of the property;
- The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;
- The decedent's holding period for the property;
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- The amount of basis increase allocated to the property under IRC §1022(b) or (c); and
- Any other information that the IRS may require by regulation.

Significant monetary penalties are imposed for failure to comply with the reporting requirements. IRC §6716. The penalties do not apply to any reporting failure from reasonable cause. IRC §6716(c).

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§4.68 h. Basis Planning Considerations

Implementation of the carryover basis system requires additional recordkeeping by clients and will inevitably generate some uncertainty about the basis of assets. Although the change will not take effect until 2009, it would be prudent for clients with estates that will exceed the amount covered by the allowable basis increases to begin assembling basis information about the assets that they currently own. They should maintain good records of assets that they acquire in the future.

In planning for the change, it is important to recognize that the $1.3 million and $3 million basis adjustments apply not to the value of the assets but to an increase in value. These amounts are increases to the carryover basis, although they cannot cause the basis to exceed the assets' fair market value. Therefore, to take full advantage of the basis adjustments, the assets to which they are allocated should have appreciation in the amount of $1.3 million, or $3 million for spousal property.

A significant part of the planning process is to ensure that the first spouse to die leaves sufficient assets to the surviving spouse to take maximum advantage of the basis adjustments, whether the $3 million or the entire $4.3 million. The spousal basis adjustment is available for property that passes outright to the surviving spouse or to a QTIP trust. As discussed in §4.64, some trusts that qualify for the marital deduction are not eligible for the basis increase.

Despite the fact that the QTIP trust satisfies the requirements for use of the basis adjustment at the first spouse's death, it is not an optimal strategy for maximizing use of the basis adjustment at the death of the surviving spouse. Apparently a QTIP trust does not qualify as property owned by the surviving spouse for the purpose of using the $1.3 million basis adjustment in his or her estate. See §4.63. The only solution to this dilemma, which has limited applicability, is to distribute the QTIP trust assets to the surviving spouse before death.

If the spouses' estates are unequal in value, transfers can be made before the first death to correct the situation. Gifts made to a spouse within 3 years before death are eligible for the basis adjustments as long as the donor spouse did not receive them as a gift during that period. IRC §1022(d)(1)(C). See §4.64. In contrast to current law, the transferred property qualifies for the basis adjustment even if the deceased donee spouse leaves the same property to the donor spouse on death. Although effective, this strategy raises the usual risks and difficulties connected with deathbed planning. However, this strategy is not available to same-sex domestic partners treated as spouses under California law. See §4.65.

The effective use of basis adjustments may be complex and difficult. The problems will be mitigated if the marital and nonmarital shares of the estate are distributed to the same beneficiaries. If these shares have different beneficiaries, *i.e.,* a current spouse and children by a prior marriage, conflicts are possible. For example, the spouse may prefer to have the $3 million increase allocated to the less highly appreciated assets so that a larger number of assets are affected. This design may be at odds with the plan of the children, who would prefer that more highly appreciated assets are allocated to the spouse so that fewer assets are affected.

One issue of continuing concern is the amount of discretion that should be given to the executor or trustee to make decisions regarding basis allocation. The options range from leaving the entire decision in the hands of the fiduciary to providing in the planning documents specific directions regarding the method and priority of the allocations. A middle ground provides broad guidance to the fiduciary, *e.g.*, allocating assets in a manner that results in the surviving spouse receiving the largest aggregate value so as to maximize use of the spousal property adjustment. If the document is silent, the fiduciary has an obligation under law to make the allocations fairly. The question of what is fair in this context, however, remains open. Does "fairness" demand a prorata allocation based on the fair market value of the assets? Or a prorata allocation based on the proportional shares of the beneficiaries? Or something else entirely?

Regardless of the approach adopted, it is prudent to include in the planning document a provision that exculpates the fiduciary from liability for allocation decisions. That provision can be very broad, basically protecting the fiduciary with respect to any basis allocation decision. In some circumstances, the provision should be more narrowly drafted to except from protection only conduct that is intentional or grossly negligent.

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V. ESTATE AND GIFT TAXES

§4.69 A. Impact of Transfer Taxes

At one time, the primary purpose of most estate plans was to minimize federal and state transfer taxes. As a result of the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), those taxes face an uncertain future. EGTRRA-2001 significantly increased estate tax exemption amounts and provided for complete repeal of the estate tax in 2010. The act has a sunset provision that causes the act to expire at the end of 2010, but most observers believe that Congress will at least enact legislation that will fully shield estates of less than $2 million or perhaps $3.5 million from the tax. Even in the latter event, there will be a significant reduction in the number of clients with significant estate tax concerns. Nevertheless, drafters of revocable trusts need a working knowledge of estate and gift taxes. Because revocable trusts are devices for passing property at death, the following discussion focuses on transfers at death. For a broader discussion, see California Estate Planning, chap 10 (Cal CEB 2002). For a discussion that focuses on lifetime transfers, see Drafting California Irrevocable Trusts, chap 2 (3d ed Cal CEB 1997).

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§4.70 1. Unified Estate and Gift Tax System

The unified system applies a combined progressive rate schedule against a cumulative tax base that includes the taxable estate and post-1976 taxable gifts. IRC §§2001, 2502. A unified credit equal to the applicable credit amount applies against the cumulative federal estate and gift tax incurred by an individual on transfers during his or her lifetime and at death. IRC §§2010(c), 2505. The applicable credit amount is the tentative tax determined under the rate schedule in IRC §2001(c) for the "applicable exclusion amount" determined under the table in IRC §2010(c) for a given year. Until 2011, the applicable exclusion amounts are different for estate and gift taxes. The gift tax applicable exclusion amount remains $1 million in 2010 while the estate tax applicable exclusion amount was $3.5 million in 2009, decreasing to $1 million in 2011. IRC §§2010(c), 2505.

A separate estate tax schedule in IRC §2201 applies lower-than-normal rates to estates of the following decedents:

- Persons killed in action in combat zones or dying as a result of wounds, illness, or injury suffered in a combat zone;
- Astronauts who die in the line of duty; and
- "[A]ny specified terrorist victim (as defined in section 692(d)(4))."

Under IRC §692(d)(4)(B), the definition of "specified terrorist victim" includes any person who dies "as a result of wounds or injury incurred as a result of the terrorist attacks against the United States on April 19, 1995, or September 11, 2001." In *Estate of Kalahasthi* (CD Cal 2008) 630 F Supp 2d 1120, the court held the reduced rates did not apply to the estate of a woman who committed suicide just over a month after her husband's death at the World Trade Center on September 11, 2001. (April 19, 1995 was the date of the Oklahoma City bombing that destroyed the Alfred J. Murrah Federal Building.)

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§4.71 2. Repeal of Estate Tax in 2010

The estate tax is repealed for the estates of decedents dying after December 31, 2009. IRC §2210(a). The gift tax is not repealed, but the unified rate schedule will be replaced by a separate gift tax schedule that effectively imposes a single 35 percent tax rate. IRC §2502(a)(2). However, the repeal will sunset in 2011, and the 2001 unified estate and gift rates will be revived.

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§4.72 3. Sunset of Estate Tax Repeal in 2011

EGTRRA-2001 is scheduled to sunset for all taxable years beginning after December 31, 2010. EGTRRA-2001 §901. Thus, unless there is further legislative action, all provisions of EGTRRA-2001 will cease to apply after that date and the rates as they existed in the year 2001 will be in effect (with a $1 million applicable exclusion amount, because the pre-EGTRRA law provided that the applicable exclusion amount is $1 million after 2005). Many practitioners believe that further legislative changes to the transfer tax laws are likely to occur before that date.

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§4.73 4. Table: Maximum Transfer Tax Rates and Applicable Exclusion Amounts

YEAR	*MAXIMUM ESTATE TAX RATE*	*MAXIMUM GIFT TAX RATE*	*ESTATE TAX APPLICABLE EXCLUSION AMOUNT*	*GIFT TAX APPLICABLE EXCLUSION AMOUNT*
2004	48%	48%	$1,500,000	$1,000,000
2005	47%	47%	$1,500,000	$1,000,000
2006	46%	46%	$2,000,000	$1,000,000
2007	45%	45%	$2,000,000	$1,000,000
2008	45%	45%	$2,000,000	$1,000,000
2009	45%	45%	$3,500,000	$1,000,000
2010	0%	35%	unlimited	$1,000,000
2011	55%	55%	$1,000,000	$1,000,000

NOTE: In 2011, an additional tax of 5 percent applies to amounts of more than $10,000,000 and less than $17,184,000 (the amount at which the average tax rate is 55 percent). IRC §2001(c)(2).

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§4.74 5. Calculating Estate and Gift Taxes

Under the unified system of estate and gift taxation, the decedent's death causes the decedent's last transfer to be subject to taxation except in 2010, when the estate tax is repealed. The estate tax is calculated (see §4.75) on the basis of the total of previous transfers subject to the gift tax (see §4.76) and the transfer at death.

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§4.75 a. Estate Tax Calculation

The estate tax, before taking into account appropriate credits, is calculated as follows (IRC §2001(b)):

- The decedent's taxable estate is calculated by reducing the gross estate (see §4.77) by appropriate exclusions and deductions (such as the marital and charitable deductions, debts, and expenses, or losses of administration as discussed in §§4.117-4.138).
- The decedent's estate tax base is then calculated by increasing that taxable estate by the aggregate value of those adjusted taxable gifts made after December 31, 1976, which are not required to be included in the decedent's gross estate under the rules discussed in §§4.78-4.90, 4.109 (IRC §§2035-2038, 2040, 2042).
- A "tentative tax" is then calculated with respect to the resulting total by applying the rate table in IRC §2001(c).
- The tentative tax is then reduced by the amount of gift tax payable on lifetime taxable gifts made after December 31, 1976, using the rates in effect at death, not those in effect when the gifts were made.
- Finally, the tentative tax is then reduced by the remaining IRC §2010 applicable credit amount not used by taxable gifts.

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§4.76 b. Gift Tax Calculation

The gift tax due in any calendar year is calculated as follows (IRC §2502(a)):

- The tentative tax is calculated on the sum of the taxable gifts made by the donor during the current taxable year, plus the value of all previous taxable gifts, using the current estate and gift tax rate schedule in IRC §2001(c). For gifts in 2010, when the estate tax is repealed, a separate gift tax schedule is provided in IRC §2502(a)(2).

- The tentative tax on previous gifts alone is calculated using the same schedule, even though current rates may differ from the rates originally used to tax those gifts.

- The tentative tax on previous gifts is subtracted from the tentative tax on the sum of current gifts and previous gifts to arrive at the tentative gift tax.

- Any remaining portion of the IRC §2505 applicable credit amount that has not been used for gifts in prior years (but not exceeding the amount needed to reduce the tax to zero) is subtracted. Then any credit for foreign gift taxes is subtracted to arrive at the gift tax payable by the donor.

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B. Estate Tax

§4.77 1. Scope of Estate Tax

Federal estate taxes are imposed on the "taxable estate" of every decedent who is a citizen or resident of the United States. IRC §2001(a). The taxable estate is calculated by subtracting certain deductions in IRC §§2053-2058 from the decedent's "gross estate" as determined under IRC §§2031-2046. IRC §2051. See §§4.117-4.138. The gross estate includes the worldwide assets of U.S. citizens and residents. Treas Reg §20.2031-1(a). Valuation is discussed in §§4.113-4.116F. Credits against the tax are found in IRC §§2011-2016. See §§4.139-4.145. Filing the estate tax return and payment of tax are discussed in §§4.146-4.153.

Nonresident aliens are taxed on U.S. situs property. IRC §§2101, 2103. Situs rules for estate tax purposes are in IRC §§2104-2105, and are not necessarily the same as the situs rules for income tax purposes or for ancillary probate. These rules may be modified by tax treaties. Estate tax credits under IRC §§2011-2013 are generally allowed. IRC §2102(a)-(b). A special unified credit applies to estates of nonresident aliens under IRC §2102(c).

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§4.78 2. Property Included in Gross Estate

As a rule, the gross estate of a U.S. citizen or resident includes all of the decedent's property, real or personal, tangible or intangible, wherever situated. IRC §2031(a). This includes property in which the decedent had an interest at the time of death. IRC §2033. See §4.79. An exception to this rule is that a portion of real property subject to a qualified conservation easement may be excluded from the gross estate. IRC §2031(c). See §4.112.

In addition to property interests owned at death, the gross estate includes the value of certain lifetime transfers under IRC §§2035-2038. Joint interests in property are included as provided in IRC §2040. Property subject to a general power of appointment is included under IRC §2041. Under IRC §2042, proceeds of a life insurance policy on the decedent's life may be included. Generally, the gross estate does not include certain interests that terminate at the decedent's death, such as an annuity payable only during the decedent's life. IRC §2039. However, the gross estate includes other interests that terminate at death, such as QTIP property for which the estate of a predeceased spouse took a marital deduction. IRC §2044. See §§4.80-4.90.

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§4.79 a. Property in Which Decedent Had an Interest (IRC §2033)

The gross estate includes all property in which the decedent had a beneficial interest at the time of death. IRC §2033; Treas Reg §20.2033-1(a). A partial ownership interest in property that the decedent can transfer at death, such as a community property or tenancy-in-common interest, may be included under §2033.

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§4.80 b. Gifts Made Within Three Years Before Death (IRC §2035)

The gross estate includes the value of any property transferred, or with respect to which a power was relinquished, by the decedent within 3 years before death if such property would have been included in the decedent's gross estate under IRC §2036 (transfers with retained life estate), §2037 (transfers taking effect at death), §2038 (revocable transfers), or §2042 (proceeds of life insurance) if the decedent had retained the property or power. IRC §2035(a). See §§4.81-4.88, 4.109. The gross estate is increased by the amount of any gift tax paid by the decedent or by the decedent's estate on any gift made by the decedent or the decedent's spouse within 3 years before the decedent's death. IRC §2035(b). In *Brown v U.S.* (9th Cir 2003) 329 F3d 664, the court held that when the decedent gave the spouse money equal to the gift tax owed because of the decedent's inter vivos gift to a trust, the decedent was treated as having paid the tax even though the spouse was under no legal obligation to apply the funds to the tax and the spouse was jointly liable for the tax because of an IRC §2513 split-gift election. Section 2035(a) does not apply to a bona fide sale for adequate and full consideration in money or money's worth (*i.e.,* when there is no gift). IRC §2035(d).

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§4.81 c. Transfers With Retained Life Estate (IRC §2036)

When a decedent makes a lifetime transfer of property and retains certain interests or rights in the property for life or for a period not ascertainable without reference to, or that does not in fact end before, the decedent's death, the property is included in the gross estate under IRC §2036. The retained interest can be for the benefit of the decedent, such as a retained income interest in the property, or for the benefit of others, such as a power to decide who shall enjoy the property. An interest is treated as retained if, at the time of the transfer, an express or implied understanding was made that the interest or right would be reserved. IRC §2036(a); Treas Reg §20.2036-1. There are three ways that property will be brought back into a decedent's gross estate under §2036 (see §§4.82-4.86).

Section 2036 does not apply to a bona fide sale for an adequate and full consideration in money or money's worth. IRC §2036(a). See *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8; *Estate of Harry R. Michelson,* TC Memo 1978-371. In *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257, the court held that a transfer of assets to a family limited partnership (FLP) in exchange for a proportionate interest in the FLP is a bona fide sale for adequate and full consideration, provided that the exchange is not a sham transaction under the "objective facts" of the case, including the existence of non-tax reasons for the transaction, such as management of business interests or creditor protection. However, some courts have held that a transfer to an FLP was not a bona fide sale for full and adequate consideration, especially when the court found an express or implied agreement (often based on the fact that the transferor did not retain enough assets for support) that the partnership assets would be used to support the decedent. See *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955; *Estate of Korby v Commissioner* (8th Cir 2006) 471 F3d 848; *Estate of Erma V. Jorgensen,* TC Memo 2009-66; *Estate of Concetta H. Rector,* TC Memo 2007-367; *Estate of Lea K. Hillgren,* TC Memo 2004-46; *Estate of Ida Abraham,* TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26; *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd sub nom *Turner v Commissioner* (3d Cir 2004) 382 F3d 367; *Estate of Morton B. Harper,* TC Memo 2002-121. In *Estate of Wayne C. Bongard* (2005) 124 TC 95, the Tax Court purported to establish the following test for determining when the creation of a business entity will be immune from IRC §2036 attack. The assets transferred for business entity interests will not be brought back into the transferor's estate if:

- There is a "legitimate and significant nontax reason" for creating the entity; and
- The transferors receive entity interests proportionate to the value of the property transferred.

In *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468, the court of appeals held that the Tax Court did not clearly err in finding that the estate failed to satisfy the "bona fide sale" requirement because it failed to prove that there was a "substantial business [or] other non-tax" purpose for the formation of the partnership. In *Estate of Lillie Rosen*, TC Memo 2006-115, the Tax Court held that the decedent's transfer of cash and securities to a family limited partnership (FLP) was not a bona fide sale for adequate consideration because there was no legitimate and significant nontax reason for creation of the FLP. In *Estate of Hilde E. Erickson*, TC Memo 2007-107, the court held that use of partnership funds to pay estate taxes was evidence of an implied agreement that the decedent retained enjoyment of property transferred to an FLP. In *Estate of Charles Porter Schutt*, TC Memo 2005-126, however, the court held that the decedent's desire to influence the future investment decisions of trusts established by deceased family members provided a sufficient nontax motive for jointly creating two Delaware Business Trusts, each of which was to passively hold a single issue of publicly traded stock. See also *Estate of Valeria M. Miller*, TC Memo 2009-119 (assets transferred a year before death not included in decedent's estate because purpose of transfer was to obtain active management of the securities using a specific investment strategy). In *Estate of Eugene E. Stone,* TC Memo 2003-309, the court held that assets transferred to a partnership shortly before death were not includable in the decedent's estate under IRC §2036. On the facts of the particular case, involving the settlement of long-standing disputes within the family, there was no "mere recycling of value." See also *Estate of Anna Mirowski*, TC Memo 2008-74 (transferred assets not included in decedent's estate when decedent retained sufficient assets to pay gift tax and the need to pay estate tax was not anticipated because decedent's death was unexpected). For further discussion, see Estate of Anna Mirowski: *Estate Wins the Latest Round in the FLP/IRC §2036 Drama,* 29 CEB Est Plan Rep 129 (Apr. 2008). See also California Estate Planning, chap 18 (Cal CEB 2002).

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§4.82 (1) Right to Income, Possession, or Enjoyment

If a decedent retains a right to possession or enjoyment of, or a right to the income from, property the decedent has transferred during his or her lifetime, it will be included in the decedent's estate under IRC §2036(a)(1). Possession or enjoyment of gifted property is retained when there is an express or implied understanding to that effect among the parties at the time of transfer. Treas Reg §20.2036-1(a). See, *e.g., Estate of Charles E. Reichardt* (2000) 114 TC 144 (property included); *Estate of Floyd G. Paxton* (1986) 86 TC 785 (same); *Estate of Concetta H. Rector,* TC Memo 2007-367 (same); *Estate of Hilde E. Erickson*, TC Memo 2007-107 (same); *Estate of Lillie Rosen*, TC Memo 2006-115 (same); *Estate of Morton B. Harper,* TC Memo 2002-121 (same); *Estate of Gizella Wells,* TC Memo 1981-574 (property not included). Retained interests commonly arise from reciprocal trusts or retained interest trusts and gifts of residences with a continued right of occupancy. See §§4.83-4.84A.

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§4.83 (a) Reciprocal Trusts

Internal Revenue Code §2036(a)(1) applies to reciprocal trusts. For example, assume that Greg creates a trust for the benefit of his spouse, Geraldine, for life with the remainder to their children. At the same time, Geraldine sets up a trust with the same terms and of equal value benefiting Greg for life with the remainder to their children. Under the reciprocal trust doctrine, the grantors of the reciprocal trusts are switched and both Greg and Geraldine are treated as if they each created a trust for themselves with a retained life interest. Consequently, the corpus of their respective trusts would be included in each of their gross estates at death under IRC §2036(a)(1). See *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730; *Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575; *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168. In IRS Letter Ruling 200426008, however, the IRS ruled that the reciprocal trust doctrine will not cause assets of life insurance trusts created by a husband and wife to be included in each other's estate. The husband's trust provided for discretionary distributions to the wife, and the wife's trust provided for distributions to the husband. Both trusts provided for distributions to the couple's son. Based on the decision in *Estate of Herbert Levy,* TC Memo 1983-453, the IRS ruled that the reciprocal trust doctrine did not apply because of differences in the terms of the two trusts. As a consequence, neither spouse will be treated as the settlor of the trust established by the other spouse. As a result of the ruling, the parties need not be concerned that each of them would later be treated as having been the settlor of a trust established for his or her own benefit. Further, neither will be deemed to have incidents of ownership in a life insurance policy on his or her own life that would result in inclusion of policy proceeds under IRC §2042.

NOTE: Despite the implications of IRS Letter Ruling 200426008, practitioners cannot be certain that modest (or even fairly significant) differences in trusts executed at the same time by closely related parties will prevent the application of the reciprocal trust doctrine. Under *Lehman v Commissioner* (2d Cir 1940) 109 F2d 99, it remains clear that trusts established by different settlors for the benefit of each other can be "uncrossed" if each trust was established in consideration of the other.

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§4.84 (b) Right to Occupy Residence

If a donor gifts a residence to donees but continues to live in the residence without paying fair market value rent, the court may find that there was an implied agreement that the donor retained "possession or enjoyment" of the property within the meaning of IRC §2036(a)(1), which means that the residence will be included in the donor's estate. See, *e.g., Estate of Maxwell v Commissioner* (2d Cir 1993) 3 F3d 591; *Estate of Adrian K. Rapelje* (1979) 73 TC 82; *Estate of Margot Stewart,* TC Memo 2006-225; *Estate of Lorraine C. Disbrow,* TC Memo 2006-34; *Estate of Timothy J. Tehan,* TC Memo 2005-128; *Estate of Eleanor T. R. Trotter,* TC Memo 2001-250. This may occur if the donor transfers the residence to a qualified personal residence trust (QPRT) and then continues to live in the residence after the trust term. QPRT property also may be included in the donor's estate if the donor dies during the trust term. See §4.84A.

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§4.84A (c) Retained Interest Trusts

If the donor creates an irrevocable trust with a retained interest for a term of years such as a grantor retained income trust (GRIT) or annuity trust (GRAT), a qualified personal residence trust (QPRT), or a charitable remainder annuity trust (CRAT) or unitrust (CRUT) and then dies during the trust term, a portion of the trust property will be included in the donor's estate under IRC §2036(a)(1). The portion included is the portion needed to produce an annual income equal to the retained interest, calculated using the IRC §7520 interest rate for the date of death. Treas Reg §20.2036-1(c). In the great majority of cases, the death of the donor during the trust term will result in 100-percent inclusion of the trust property in the estate of the donor. In the case of a GRIT or QPRT, there will always be 100-percent inclusion because the portion of the trust property needed to produce 100 percent of the trust income is always 100 percent.

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§4.85 (2) Right to Designate Possession or Enjoyment

If a decedent has the power, either alone or in conjunction with another person, to designate who shall possess or enjoy, or have the right to income from, property transferred by the decedent during his or her lifetime, the entire property will be included in the decedent's estate, not merely the affected interest. IRC §2036(a)(2). In *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468, the Tax Court held that since a limited partner can act together with other general and limited partners to liquidate the limited partnership, the limited partner could, with other persons, control who could enjoy the property, thereby invoking IRC §2036(a)(2). As a result, the retention of even a 1-percent limited partnership interest could cause the entire partnership, if previously transferred by gift, to be included in the donor's estate. However, the rule of inclusion in the donor's estate is subject to the exception for bona fide sales for adequate and full consideration, as discussed in §4.81. (The Fifth Circuit decision in *Strangi* does not discuss IRC §2036(a)(2) because of its conclusion that the decedent retained the right to enjoyment of the partnership property under IRC §2036(a)(1).) Powers over property that do not affect enjoyment of income during the decedent's lifetime are governed by IRC §2038. Treas Reg §20.2036-1(b)(3). See §4.88.

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§4.86 (3) Retained Voting Rights in Controlled Corporation

The retention of the right to vote, directly or indirectly, shares of a "controlled corporation" transferred by the decedent is considered a retention of enjoyment of the transferred shares, which are included in the decedent's gross estate. IRC §2036(b)(1). For purposes of §2036(b)(1), a corporation is treated as a controlled corporation if, after the transfer of the shares and within 3 years before the decedent's death, the decedent owned (with the application of the constructive ownership rules of IRC §318) or had the right to vote (alone or with others) at least 20 percent of the voting power of the corporation. IRC §2036(b)(2). For purposes of IRC §2035, the relinquishment or cessation of such voting rights will be treated as a transfer of property made by the decedent. IRC §2036(b)(3).

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§4.87 d. Transfers Taking Effect at Death (IRC §2037)

Property transferred in trust or otherwise is included in the transferor's gross estate under IRC §2037(a) to the extent that:

- Possession or enjoyment of the property by a transferee can be obtained only by surviving the transferor (IRC §2037(a)(1)); and
- The transferor retained a reversionary interest in the property whose value is greater than 5 percent of the property immediately before the transferor's death (IRC §2037(a)(2)).

"Reversionary interest" is defined in IRC §2037(b) as including the possibility that the property transferred by the decedent may return to the decedent or the decedent's estate or may be subject to a power of disposition by the decedent. A reversionary interest may arise either under the express terms of a trust or by operation of law. Thus, the applicability of IRC §2037(a) is determined at the decedent's death.

EXAMPLE: Before his death, a husband transfers property to a trust with income payable to his wife for life and with the remainder to himself if he is then living or, if not, to his daughter or her estate. The daughter cannot receive the property without surviving her father. Therefore, assuming that the husband's reversionary interest exceeds 5 percent of the value of the property at his death, the value of the property, less the wife's remaining life estate, would be included in his gross estate. Treas Reg §20.2037-1(e), Example (3).

Estate planners should consider all potential reversionary interests when drafting an estate plan for a client. In valuing the decedent's reversionary interest, the IRS disregards the grantor's actual health and uses mortality and actuarial tables to determine value. Treas Reg §20.7520-3(b)(3)(ii). See *Estate of Allen v U.S.* (Ct Cl 1977) 558 F2d 14; *Robinson v U.S.* (9th Cir 1980) 632 F2d 822; *Estate of Dwight B. Roy, Jr.* (1970) 54 TC 1317.

Internal Revenue Code §2037 does not apply to transfers that are bona fide sales for adequate and full consideration in money or money's worth. IRC §2037(a). See *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8.

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§4.88 e. Revocable Transfers (IRC §2038)

The gross estate includes the value of an interest in property transferred by the decedent, in trust or otherwise, when the decedent could change the enjoyment of the interest by exercising a power to alter, amend, revoke, or terminate the interest, or when the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. IRC §2038(a)(1). The power may be held as a trustee. As a consequence, property held in a revocable trust is included in the settlor's estate for estate tax purposes.

The power may be held alone or in conjunction with third parties, even if the other party is adverse. Internal Revenue Code §2038 does not apply, however, when a decedent holds a power requiring the consent of all interested persons and the power adds nothing to the parties' rights under local law. Treas Reg §20.2038-1(a)(2).

Section 2038 does not apply to transfers that are bona fide sales for adequate and full consideration in money or money's worth. Treas Reg §20.2038-1(a)(1). See *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8; *Estate of Harry R. Michelson,* TC Memo 1978-371.

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§4.89 f. Annuities (IRC §2039)

The gross estate includes the value of an annuity or other payment, receivable by any beneficiary under a contract or agreement by reason of surviving the decedent, if the annuity was payable to the decedent or if the decedent had the right to receive the annuity either alone or with someone else, for the decedent's life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's death. IRC §2039(a).

The gross estate includes only the value of the annuity or other payment receivable that is proportionate to the decedent's contribution toward the purchase price. Contributions made by the decedent's employer or former employer are considered to be contributed by the decedent. IRC §2039(b). However, specified benefits paid to family members by statute are not included under IRC §2039. See Rev Rul 2002-39, 2002-2 Cum Bull 33.

Section 2039 does not apply to life insurance policies, even though they are payable in the form of an annuity. Treas Reg §20.2039-1(d). These proceeds would be includable under IRC §2042. See §4.109. Section 2039 also does not apply to certain trusts in which the decedent had a retained interest, even though the interest is in the form of an annuity. Treas Reg §20.2039-1(e). These trusts would be includable to the extent provided by IRC §2036(a). See §4.84A.

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§4.90 g. Joint Interests (IRC §2040)

The gross estate includes the value of a decedent's interest held jointly with another person that expires at the decedent's death. IRC §2040. Section 2040 covers joint tenancies and tenancies by the entirety, but it does not cover tenancies in common or community property interests. Treas Reg §20.2040-1(b). Tenancies in common and community property interests are included under IRC §2033. See §4.79.

Generally, the amount included in the gross estate is the amount the decedent paid to acquire his or her interest in the property. IRC §2040(a). A special rule applies to spousal joint tenancies. IRC §2040(b). See §4.46. There is a rebuttable presumption, however, that the decedent furnished all the consideration for the jointly held property, unless the executor can present evidence of the surviving joint owner's contributions. Treas Reg §20.2040-1(a)(2). Thus, joint property owners should keep records of their contributions. If the property was received by the joint owners as a gift from a third party, the amount each owner received as a gift is included in that person's gross estate. If the decedent made a gift to the other joint tenants of the consideration used to purchase the jointly owned asset, that consideration is attributable to the decedent for purposes of §2040(a). Treas Reg §20.2040-1(c).

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§4.91 h. Powers of Appointment

A power of appointment is a power to direct the disposition of property that is held by a person who is not the outright owner of the property. The power may be created by will, deed, trust, or other instrument. Depending on the nature of the power, the holder (also called the power donee) of the power may be treated as the owner of the property for estate and gift tax purposes. Revocable trusts frequently create powers of appointment. These powers can be used to accomplish many objectives, including the following:

- To enable the power holder to make a later decision about the ultimate disposition of the property subject to the power, taking into account the beneficiary circumstances and tax laws as they exist at some time in the future;
- To allow the power holder to accomplish his or her own dispositive objectives as opposed to those of the donor; and
- To save taxes.

Powers of appointment are particularly useful for long-term (dynasty) trusts that exploit the generation-skipping transfer (GST) exemption and try to keep property outside of the transfer tax system as long as possible. Powers generally increase flexibility, something that will be important as these trusts age.

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§4.92 (1) Significance in Revocable Trust Drafting

The tax laws pertaining to powers of appointment are exceptionally important in the context of revocable trust drafting because of the potential consequences for trustees and beneficiaries of trusts that have become irrevocable. If a trustee or beneficiary is deemed to have a general power of appointment, the trust property will be taxable in the estate of that trustee or beneficiary under IRC §2041. That result is generally undesirable from an estate tax point of view, but it can be beneficial from an income tax viewpoint because the property will receive a new income tax basis under IRC §1014. See §4.41. For a discussion of the drafting techniques used to avoid an inadvertent creation of general powers, see chap 7.

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§4.93 (2) Basic Appointment Power Rules

With certain exceptions, a general power of appointment is a power over property that is exercisable by the powerholder in favor of him- or herself, his or her estate, his or her creditors, or the creditors of his or her estate. IRC §§2041(b), 2514(c). A nongeneral or limited power of appointment is a power of appointment that is not a general power. The rules for distinguishing between general and limited powers of appointment are discussed in §§4.96-4.100.

Property subject to a general power of appointment held by the powerholder at death is included in the estate of the powerholder. IRC §2041(a)(2). The exercise or release of a general power of appointment during the powerholder's lifetime is a transfer of the property subject to the power. IRC §2514(b). The exercise or release of a power subject to estate and gift tax also causes the powerholder to become the transferor of the property for generation-skipping transfer tax purposes. IRC §2652(a).

Property subject to a general power of appointment is generally treated as owned by the powerholder for income tax purposes if the power is held by a single individual who is currently able to vest income or principal in that individual. IRC §678.

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§4.94 (3) Powers Created on or Before October 21, 1942

Special rules apply in the case of powers created on or before October 21, 1942, and practitioners must review those rules closely if clients have any such powers. IRC §2041(a)(1). Some of the following discussion applies equally to these powers, but this chapter focuses on powers of appointment created after October 21, 1942. IRC §2041(a)(2).

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§4.95 (4) Retained Powers Excluded

This discussion is limited to powers created by anyone other than the powerholder, which are governed by IRC §§2041 and 2514. It generally does not address powers that have been retained by a settlor of a trust, which are governed by different rules. See IRC §§2036-2038. Retained powers are not governed by IRC §§2041 and 2514. Treas Reg §§20.2041-1(b)(2), 25.2514-1(b)(2).

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§4.96 (5) General Power of Appointment

Under IRC §§2041(b)(1) and 2514(c), a power to appoint property that may be exercised in favor of the powerholder (or the estate, creditors, or creditors of the estate of the powerholder) is a general power of appointment, unless the power satisfies one of the following conditions:

- The power is limited by an ascertainable standard;
- The power is held jointly with the creator of the power; or
- The power is held jointly with an adverse party.

If a power may be exercised in favor of any one of the four categories of potential beneficiaries, it is a general power of appointment. *Estate of Rebecca Edelman* (1962) 38 TC 972. Except for the powers listed above, jointly held powers are not excluded. Powers held in a fiduciary capacity are also not excluded. Therefore, a general power may be created if a potential beneficiary of a trust is able to exercise trustee powers.

Any power that excludes all four categories of potential beneficiaries is not a general power. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1). Therefore, a power exercisable in favor of the powerholder's issue (unless the powerholder owes them a duty of support) is not a general power. Indeed, a power exercisable in favor of anyone else is not a general power, even though many clients might consider it exceedingly broad.

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§4.97 (a) Power to Discharge Support Obligation

Although exclusion of the listed beneficiaries should suffice to avoid creation of a general power, there is some danger that a power could still be considered general if the powerholder owes a duty of support to the potential beneficiary and may exercise the power in order to discharge that duty. A power exercisable for the purpose of discharging a legal obligation of the powerholder constitutes a power exercisable in favor of the powerholder or his or her creditors. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1). To avoid accidental creation of a general power, revocable trusts documents routinely prohibit use of a discretionary distribution power for the purposes of discharging a support obligation. See §§7.22-7.25.

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§4.98 (b) Power to Remove Trustee

A potential beneficiary of a trust may be considered to have a general power of appointment over trust property if the beneficiary has the power to remove the trustee and the trustee has the power that would be a general power if held by the beneficiary. See §4.98. It is understandable that, if a person has power to remove a trustee and take over the job himself or herself, that person is deemed to have the same powers as the trustee. Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1). The IRS has ruled that even the power to remove a trustee and fill the vacancy with someone other than oneself may cause the powers held by the trustee to be attributed to the powerholder unless the vacancy can be filled only by a third party who is not related or subordinate to the powerholder. Rev Rul 95-58, 1995-2 Cum Bull 191; IRS Letter Ruling 9831005.

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§4.99 (c) Power Held Jointly With Nonadverse Party

A power held jointly with someone other than its creator or a person with a substantial, adverse interest is a general power, and the powerholders who are permissible beneficiaries will be treated as joint owners of the subject property. Therefore, if only one powerholder is a permissible beneficiary, his or her general power applies to all of the property.

PRACTICE TIP: When the client wants an individual to have a general power for tax purposes without giving him or her too much real power, the drafter might consider giving that person and a nonadverse party a joint power (requiring the concurrence of both holders) to appoint in favor of that individual's estate.

With multiple powerholders, if the subject property may be appointed in favor of more than one of the powerholders, and if the power does *not* continue after the death of one of them, each permissible beneficiary who is also a powerholder has a general power over his or her aliquot share of the property. Treas Reg §§20.2041-3(c)(3), 25.2514-3(b)(3). If the power continues, the powerholders are adverse parties.

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§4.100 (d) Power to Allocate Between Principal and Income

Special care should be taken in giving a trustee who is also a beneficiary broad powers to allocate principal and income items because such powers easily cross the line from being merely administrative to giving the trustee the power to change beneficial interests. For this reason, the statutory power to make an adjustment between principal and income does not extend to trustees who are beneficiaries. Prob C §16336(b)(*7*).

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(6) Nongeneral Powers

§4.101 (a) Power Limited by Ascertainable Standard

A power to consume, invade, or appropriate property for the benefit of the powerholder is not a general power of appointment if it is limited by an ascertainable standard relating to the health, education, support, or maintenance of the powerholder. IRC §§2041(b)(1)(A), 2514(c)(1).

A power is limited by an ascertainable standard if the extent of the powerholder's duty to exercise and not to exercise the power is reasonably measurable in terms of his or her needs for health, education, or support (or any combination of those), with support and maintenance being synonymous. Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2).

The standard allowed by the regulations is quite broad. Support can be in reasonable comfort or in a person's accustomed standard of living and is not limited to the bare necessities of life. Moreover, it is immaterial whether the powerholder is required to exhaust other resources before exercising the power. Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2). For a discussion of drafting considerations, see chap 7.

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§4.102 (b) Power Jointly Held With Adverse Party

A power is not a general power as long as it is held jointly with a person who has a substantial interest in the property subject to the power and that interest is adverse to the exercise of the power by the first powerholder. IRC §§2041(b)(1)(C)(ii), 2514(c)(3)(B). Estate planners rarely create such powers. The key words are "substantial" and "adverse."

Of course, if the adverse party predeceases the first powerholder, who continues alone to hold the power, the power may become general. The adverse party may be making a gift if he or she consents to the exercise of the power in a way that reduces his or her benefits from the trust. See §4.103.

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§4.103 (7) Estate and Gift Taxation of Powers

The exercise or release of a general power at death results in the inclusion of the subject property in the estate of the powerholder. IRC §2041(a)(2). The exercise or release of a general power during the powerholder's lifetime also results in the inclusion of the subject property in the powerholder's estate if the powerholder has a retained interest in the resulting transfer under IRC §§2036-2038.

A powerholder need not exercise or knowingly release a general power for the subject property to be included in his or her estate; mere possession of the power at death will suffice. IRC §2041(a)(2).

The exercise, release, or lapse of a general power of appointment during the powerholder's lifetime is a transfer subject to gift tax. IRC §2514(b). See §4.104. Of course, exercising the power in favor of oneself should not itself be a gift.

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§4.104 (a) Release or Lapse of Power

The lapse of a power is generally considered a release of the power, with certain exceptions. IRC §§2041(b)(2), 2514(e). See §4.105.

NOTE: It may be hard to recognize a release when taking action that may affect property subject to a general power. In Rev Rul 86-39, 1986-1 Cum Bull 301, the IRS ruled that a recapitalization of stock that resulted in shifting value from the remainder of one trust, over which the income beneficiary had a general power, to the remainder of another trust, over which the same beneficiary had no power, was effectively a release of the general power to the extent of the shifted value. Also, the exercise of a nongeneral power may cause the release of a related general power. See IRS Letter Ruling 199909016.

A general power subject to a condition precedent that has not yet occurred is known as a "hanging" power. A partial release of a general power, leaving the powerholder with only a nongeneral power, is not a completed gift, assuming that the powerholder retains control over the ultimate disposition of the subject property. Treas Reg §25.2514-3(c)(1). However, a later exercise or complete release of the power will be subject to the gift tax, and retention of the partially released power until death will cause inclusion of the subject property in the powerholder's estate. Treas Reg §§20.2041-3(d)(1), 25.2514-3(c)(3).

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§4.105 (b) Exception for "Five or Five" Powers

During any one year, a lapse of a general power is not a release to the extent that, at the time of the lapse, the subject property does not exceed the greater of $5000 or 5 percent of the aggregate value of the property from which the exercise of the lapsed power could have been satisfied. IRC §§2041(b)(2), 2514(e). A general power that comes entirely within this safe harbor is often called a "5 or 5" power. Spouses are often given such powers in bypass trusts, and the same powers may be given to domestic partners.

Although the lapse of a "five or five" power does not have taxable consequences, the property subject to the power will be included in the powerholder's estate if the powerholder dies during the period in which the power may be exercised. See, *e.g., Estate of Floy M. Christensen,* TC Memo 2000-368.

For further discussion of "five or five" powers and a form, see §§7.90-7.92.

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§4.106 (c) Treatment of Limited Powers Distinguished

Because only property subject to a general power at death is included in the powerholder's estate (see §4.103), the release or lapse of a limited power is not a taxable gift of the property subject to the power. See Treas Reg §25.2514-3(e), Example (2). The exercise of a limited power may result in a gift, however, if the powerholder also has an income interest in the property (see §4.107), or if the limited power is used to create a general power (see §4.108).

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§4.107 (d) Gift of Income Interest

According to the Internal Revenue Service, an income beneficiary who exercises a lifetime nongeneral power to appoint principal to a third party makes a gift of the income that the powerholder otherwise would have received from that principal. Rev Rul 79-327, 79-2 Cum Bull 342. The IRS's position seems reasonable, but a contrary result was reached in *Self v U.S.* (Ct Cl 1956) 142 F Supp 939. Thus, unless the powerholder's beneficial interest is incapable of valuation (*e.g.,* he or she may receive income or principal in the trustee's discretion), the powerholder must be careful in exercising a lifetime power.

PRACTICE TIP: One way to avoid making a gift by exercising a limited power is for the powerholder to have no other interest in the trust that is not itself a limited power. Instead of giving anyone a beneficial interest in income or principal, payable either mandatorily or at the discretion of the trustee, consider giving him or her nothing but the power to withdraw subject to an ascertainable standard and the power to appoint among a limited class of beneficiaries, both during life and at death. Exercise of any of these powers should cause no gift tax problems. See chap 7. See Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 107 (Feb. 1998).

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§4.108 (e) The Delaware Trap

Under former Delaware law, an exercise of nongeneral power of appointment starts a new perpetuities period. Out of concern that this rule would make it possible to keep property out of the transfer tax system forever, Congress enacted IRC §§2041(a)(3) and 2514(d), which provide that the exercise of a power that creates a second power that can be exercised in a way that starts a new perpetuities period will be treated as a transfer by the person exercising the first power.

Although the creation of a second *nongeneral* power in states other than Delaware does not restart the perpetuities period, the creation of a presently exercisable *general* power of appointment does.

Therefore, exercising a nongeneral power by creating a presently exercisable general power effectively turns the initial nongeneral power into a general power for tax purposes. More specifically, the powerholder can cause the conversion by appointing property to a new trust that gives the primary beneficiary an immediate unlimited withdrawal power for a specified time. The conversion can be accomplished on a fractional share basis. The name "Delaware Trap" reflects the concern that such a conversion might occur by accident, but the conversion is important in generation-skipping transfer (GST) tax planning because it offers a way for the powerholder to cause property to be subject to estate tax in the holder's estate rather than to GST tax. This can be important if the estate tax will be lower.

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§4.109 i. Proceeds of Life Insurance (IRC §2042)

The proceeds of an insurance policy on the decedent's life are included in the decedent's gross estate if the proceeds are (1) receivable by or for the benefit of the decedent's estate or (2) receivable by other beneficiaries and the decedent had any incidents of ownership in the policy at death. IRC §2042. Generally, when a client owns a large life insurance policy, the client should consider transferring the policy to the beneficiary or an irrevocable life insurance trust while the value of the policy is still low. See Drafting California Irrevocable Trusts, chap 11 (3d ed Cal CEB 1997).

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§4.110 j. Transfers for Insufficient Consideration (IRC §2043)

If a decedent transfers property with retained rights under IRC §§2035-2038 (see §§4.80-4.88), or makes a taxable transfer by the exercise or release of a general power of appointment under IRC §2041, and the transfer is not a bona fide sale for adequate and full consideration in money or money's worth, the gross estate includes the excess of the date of death value of such property over the value of the monetary consideration received. IRC §2043(a).

EXAMPLE: The grantor of the trust reserves a life income interest in a trust, naming his children as the remainder beneficiaries. The grantor then sells his income interest to his children based on his actuarial life expectancy. Had the grantor not sold his life interest, the entire trust would have been included in his or her estate under IRC §2036(a). If the sale were a bona fide sale for full and adequate consideration, none of the trust would be included in the grantor's estate; only the sale proceeds would be included. When there is not a bona fide sale for full and adequate consideration, the value of the trust as of the date of death is included in the grantor's gross estate, reduced only by the monetary consideration received from the sale of the income interest, under IRC §2043(a).

Relinquishment of marital rights such as dower or curtesy is generally not treated as consideration. IRC §2043(b). Relinquishment of a half interest in community property, however, is consideration that is deductible for purposes of IRC §2043(a). *Estate of Christ v Commissioner* (9th Cir 1973) 480 F2d 171.

In cases involving transfers of remainder interests for consideration, there is a conflict among the circuits over whether the consideration received must be measured against the value of the actual interest transferred or the total value of the property that would have been included in the decedent's estate. (These cases are primarily of interest when the transfer of the remainder interest occurred before the enactment of IRC §2702, which may treat a transfer of a remainder interest as a transfer of the entire property for purposes of valuing the gift resulting from the transfer.) Courts in the Third, Fifth, and Ninth Circuits have held that adequate and full consideration is measured by the value of transferred interest, not by the full value of the property. *Estate of Magnin v Commissioner* (9th Cir 1999) 184 F3d 1074; *Wheeler v U.S.* (5th Cir 1997) 116 F3d 749; *Estate of D'Ambrosio v Commissioner* (3d Cir 1996) 101 F3d 309, cert denied 520 US 1230, 137 L Ed 2d 1030, 117 S Ct 1822. Courts in the Federal Circuit and the Tenth Circuit have held that consideration received must equal the full value of the property. *Gradow v U.S.* (Fed Cir 1990) 897 F2d 516; *U.S. v Allen* (10th Cir 1961) 293 F2d 916.

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§4.111 k. Certain Property for Which Marital Deduction Was Previously Allowed (IRC §2044)

The gross estate includes the value of property transferred to a decedent from a predeceased spouse, which qualified for the marital deduction as qualified terminable interest (QTIP) property under IRC §2056(b)(7) or §2523(f).

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§4.112 l. Qualified Conservation Easement Exclusion

A portion of real property subject to a qualified conservation easement may be excluded from the gross estate. IRC §2031(c). The exclusion is in addition to the reduction in value of the property as a result of the easement. The property must be located in the United States or in a U.S. possession. The definition of "qualified conservation easement" is similar to the definition of "qualified conservation contribution," which is eligible for an income tax deduction under IRC §170(h), with certain additional restrictions. The easement may be created during life or at death. The easement may also be created after death by family members or by an executor or trustee, although no income tax deduction is available for an easement created at death or after death. See IRC §2031(c)(9). For further discussion, see §§4.132-4.137.

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§4.113 m. Valuation of Property in Gross Estate

Property included in a decedent's gross estate is generally valued as of the decedent's date of death. IRC §2031(a). If certain requirements are met, the executor may instead elect to value all property in the gross estate as of six months after the decedent's date of death. IRC §2032(a). This date is called the "alternate valuation date." See §4.114. Property is generally valued at its fair market value under the "willing buyer, willing seller" test, which may result in discounts or premiums relative to the decedent's percentage ownership interest in real property or closely held businesses. Treas Reg §20.2031-1(b). See §4.115. Other rules apply to specific kinds of property. Real property used in a farm, trade, or business may be eligible for a reduced "special use" valuation under IRC §2032A. See §4.116. The value of estate property also may be determined from the sale of the property (or similar property) after the decedent's death. See §§4.116A-4.116F.

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§4.114 (1) Alternate Valuation Date Election

The alternate valuation date is generally the date 6 months after the date of the decedent's death. Property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date of its distribution, sale, exchange, or other disposition. IRC §2032(a)(1); Treas Reg §20.2032-1(c).

To use the alternate valuation date, the executor must make an election on a timely filed estate tax return. The election will not be allowed if it is made on a return that is more than a year late, including extensions. IRC §2032(d). See *Estate of Loree* (D NJ 2008) 2008-1 USTC ¶60,555, 101 AFTR2d 698. However, this limitation applies only when no estate tax return is filed within that time period. If a return is filed within the period and does not make the election, the estate may apply for an extension of time to make the election under Treas Reg §§301.9100-1, 301.9100-3, even after the 1-year period expires. Treas Reg §20.2032-1(b)(1), (3). The executor also can make a protective election. Treas Reg §20.2032-1(b)(2). In *Estate of Kenneth R. Mapes* (1992) 99 TC 511, for example, the court approved a protective election that would be valid only in the event the estate failed to qualify for a special use valuation under IRC §2032A.

The election must decrease the value of the gross estate and the sum of federal estate tax and generation-skipping transfer tax payable. IRC §2032(c). Therefore, the election may not be used to increase the basis of estate assets in a zero-tax estate under IRC §1014.

If the change in value is the result of a mere lapse of time, the property will be valued as of the decedent's date of death with adjustment for any difference in its value as of the subsequent valuation date not due to a mere lapse of time. IRC §2032(a)(3). Patent, life estates, remainders, or similar interests are examples of such assets. Treas Reg §20.2032-1(f); Temp Treas Reg §20.2032-1T(f)(1). Proposed regulations provide that postdeath changes in property other than changes in "market conditions" must be disregarded when determining alternate valuation date values. Events that will be disregarded include corporate reorganizations and the impact of transferring some interests in property while retaining others. Prop Treas Reg §20.2032-1(f)(1), (3). For purposes of determining the aggregate value of assets included in the gross estate, postdeath earnings on corporate stock may be deemed "included" property owned by the decedent at death if the earnings are not "severed" from the stock as a result of a declaration of dividends. Treas Reg §20.2032-1(d)(4). See IRS Letter Ruling 200343002.

The election is irrevocable. IRC §2032(d). It must be made on the entire property in the gross estate, not merely a portion of the assets. IRC §2032(a); Treas Reg §20.2032-1(d).

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§4.115 (2) Fair Market Value

Property in a decedent's gross estate is generally valued at its fair market value at the decedent's date of death (or alternate valuation date). "Fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas Reg §20.2031-1(b). The fair market value of the decedent's property interest may be less than the value of the underlying assets.

For example, courts have allowed valuation discounts in several cases in which the asset to be valued was stock in a close corporation having assets with a basis substantially lower than fair market value. In such cases, the buyer would be disadvantaged by potential tax consequences of low basis assets and would therefore pay less for the stock. See, *e.g., Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, acq 1999-1 Cum Bull xix; *Estate of Artemus D. Davis* (1998) 110 TC 530; *Estate of Marjorie deGreeff Litchfield*, TC Memo 2009-21 (assumes appreciation of assets during projected holding period). See also *Estate of Jelke v Commissioner* (11th Cir 2007) 507 F3d 1317, cert denied (2008) 172 L Ed 2d 43, 129 S Ct 168 (assumes immediate sale of assets); *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339. Despite differences in methodology, both *Jelke* and *Litchfield* effectively allow a valuation discount for virtually the entire amount of potential capital gain taxes due as of the date of death regardless of estimated future turnover rates based on historical asset sales.

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§4.116 (3) Special Use Valuation (IRC §2032A)

The executor may elect to value qualified real property in a farm, trade, or business based on its qualifying use rather than on its highest and best use. IRC §2032A(a). The election must be made on the estate tax return, and a recapture agreement signed by each person with an interest in the property must be filed with the return. IRC §2032A(a)(1)(B), (d); Treas Reg §20.2032A-8(a), (c). A protective election may be made on the return pending the final determination of value. Treas Reg §20.2032A-8(b).

The estate tax benefits of a special use valuation are lost and tax is imposed if the family-member heir receiving the property disposes of it within 10 years. IRC §2032A(c). A qualified conservation contribution under IRC §170(h) is not considered a disposition for these purposes, but the IRS has ruled that the statute does not apply to the sale of a conservation easement for consideration. IRS Letter Ruling 200840018. The unfortunate consequence of this ruling is that owners of specially valued property must wait until the end of the 10-year recapture period before selling conservation easements for either full fair market value or a reduced "bargain sale" gift value.

To qualify for IRC §2032A treatment, the following requirements must be met:

- The decedent must have been a U.S. resident or citizen and the qualified real property must be in the United States. IRC §2032A(a)(1)(A), (b)(1).
- The property must pass to a qualified heir of the decedent. A "qualified heir" is a member of the decedent's family, defined as a spouse or an ancestor of the decedent, a lineal descendant of the decedent or of the decedent's spouse or parent, or a spouse of any such lineal descendant. IRC §2032A(b)(1), (e)(1)-(2). For these purposes, same-sex domestic partners treated as spouses under California law are not qualified heirs. See §4.41.
- The property was used for a qualified use by the decedent or a member of the decedent's family on the date of the decedent's death. IRC §2032A(b)(1).
- At least 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property that was (i) being used for a qualified use by the decedent or a member of the decedent's family on the date of the decedent's death and (ii) acquired from or passed to a qualified heir of the decedent. IRC §2032A(b)(1)(A).
- At least 25 percent of the adjusted value of the gross estate consists of the adjusted value of such real property. IRC §2032A(b)(1)(B).
- During at least 5 of the 8 years preceding the decedent's death (i) the property was owned by and used for a qualified use by the decedent or a member of the decedent's family and (ii) there was material participation by the decedent or a member of the decedent's family. IRC §2032A(b)(1)(C). For the definition of "material participation," see IRC §2032A(e)(6) and Treas Reg §20.2032A-3.

The aggregate decrease in the value of qualified real property may not exceed $750,000, plus cost-of-living adjustments. IRC §2032A(a)(2)-(3). For estates of decedents dying in 2009, the aggregate decrease may not exceed $1,000,000. Rev Proc 2008-66, 2007-45 Int Rev Bull 1107.

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§4.116A (4) Valuation of Property Sold After Death

Personal representatives and trustees often sell homes, businesses, and other estate assets after the decedent's death. Sometimes, cash is necessary to pay estate taxes. Sometimes, the beneficiaries would rather have liquid assets than hold property as co-owners. In many cases, asset sales are made at prices that differ from the values shown on appraisals that purport to provide an estate tax valuation date appraisal—values that may or may not be shown on an already filed estate tax return. When the difference between the appraised value and the sale value is significant, the personal representative or trustee may confront difficult questions: Does the subsequent sale require amending the estate tax return if it has already been filed? Is the sale price the equivalent of fair market value at the date of death? Is the initial appraisal, with its reliance on comparables, rendered useless? Is there a need for a new appraisal? Is there a safe harbor time period after which a subsequent sale can be ignored? What about appreciation between the date of death (or the IRC §2032 alternate valuation date) and an actual sale?

The critical question is how the courts balance and weigh evidence of comparable sales, appreciation, and other variables when there is a postdeath sale. The answer turns on the particular facts of each case, as illustrated by the cases discussed in §§4.116B-4.116F. For a more detailed discussion of these cases, see Soskin, *Estate Tax Valuation of Property Sold After Death*, 26 CEB Est Plan Rep 5 (Aug. 2004).

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§4.116B (a) Valuation Based on Postdeath Events

For federal estate tax purposes, property included in the gross estate is usually valued as of the date of death. Fair market value is defined in the federal estate tax regulations as the estimated price at which property would be sold in an arm's-length transaction between a willing buyer and a willing seller, neither being under any compulsion to buy or sell the property and both having a reasonable knowledge of the relevant facts. Treas Reg §25.2512-1. A rule has developed that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable on the valuation date. However, courts have not been reluctant to admit evidence of prices received for sales occurring after the date of death as long as the sale occurred within a reasonable time after death (see §4.116C) and no intervening events drastically changed the value of the property (see §4.116D). Postdeath offers (see §4.116E) and postdeath sales of similar properties (see §4.116F) also may be considered.

Further, evidence of the price of a later sale of the actual property included in the estate is generally admitted without any discussion of the supposed general rule against admission of postvaluation date events. Cases justifying such admission have treated the admission of postdeath sales price as an issue of relevance. See *First Nat'l Bank v U.S.* (7th Cir 1985) 763 F2d 891. A sale of the subject property itself, proximate in time to the relevant valuation date, is often described as the "best evidence" of fair market value. See, *e.g., Estate of Manuel Stanton,* TC Memo 1989-341. Some other courts are not as emphatic, instead stating that "the price set by a freely negotiated agreement made reasonably close to the valuation date is persuasive evidence of fair market value." *Estate of Emil S. Spruill* (1987) 88 TC 1197, 1233.

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§4.116C (b) Reasonable Time for Subsequent Sale

As discussed in §4.116B, for a subsequent sale to be considered, the transaction must have occurred within a reasonable time before or after the valuation date. But what is a reasonable time? This question is resolved on a case-by-case basis by considering the amount of activity in a particular market, trends of the market, and overall changes in economic conditions. In *Estate of Max Krischer,* TC Memo 1973-172, the court determined that a sale price obtained seven years after the date of death was not reflective of the date-of-death value. In *Estate of Helen M. Noble,* TC Memo 2005-2, however, the court held that the actual sale price of small bank stock was the best evidence of value even though the sale occurred 14 months after death. In *Gettysburg Nat'l Bank v U.S.* (MD Pa 1992) 92-2 USTC ¶60,108, 70 AFTR2d 6229, a sale 16 months after death was accepted. A price received for a building seven months after death was accepted in *Estate of Aslan Ballas,* TC Memo 1975-103. In *Estate of Jessie E. Bond,* TC Memo 1966-21, a price received for a house one year after death was also accepted. In *Estate of Thomas L. Kaplin,* TC Memo 1986-167, rev'd on other grounds (6th Cir 1987) 815 F2d 32, the court determined the value of a shopping center to be the price of a sale that took place two years after the property was donated to a local government by the surviving spouse shortly after the decedent's death. In *Estate of Max Shlensky,* TC Memo 1977-148, the court held that the sale price of a building, 15 months after death, should be used to determine value as of the date of death.

Most of these cases concerned sales of real property. The same rule, however, is equally applicable to sales of business property. In *Estate of Fitts v Commissioner* (8th Cir 1956) 237 F2d 729, the court held that sales of stock 3 or more years before the valuation date and 5 years after the critical date were too remote to be useful. In *Nathan P. Morton,* TC Memo 1997-166, the court admitted evidence relating to a sale of stock ten months after the valuation date. In *Estate of Mildred Herschede Jung,* TC Memo 1990-5, in which the sale took place 27 months after the valuation date, the court noted that evidence related to the sale of corporate stock is not inadmissible simply because the sale occurred after the valuation date; rather, the remoteness of the sale from the valuation date may be a factor in determining what weight to give the evidence.

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§4.116D (c) Appreciation Adjustment to Sale Price

A critical but difficult question is whether a subsequent sale price should be adjusted to take into consideration market appreciation occurring between date of death and the actual sale. There is no clear-cut rule that can be gleaned from a review of the cases. Each case turns on its own facts. The courts look at the nature of intervening events as well as how long after the valuation event an actual sale occurs.

In *Estate of Frederick J. Keitel,* TC Memo 1990-416, a motel was sold 13 months after the date of death. The court ignored the taxpayer's appraiser and relied on the actual sale price, but allowed a discount to reflect the appreciation in local property values of between 5 and 10 percent during the period in question. In *Estate of Manuel Stanton,* TC Memo 1989-341, discussed above, a sale took place ten months after death. The court made a slight downward adjustment in the sale price to reflect greater development potential and to adjust for ten months of appreciation. However, in *Estate of Aslan Ballas,* TC Memo 1975-103, the court used the price of a sale occurring seven months after death, without adjustment, because it concluded that the taxpayer had not provided evidence that abnormal market conditions prevailed, resulting in an inflated price.

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§4.116E (d) Postdeath Events Other Than Completed Sales

Postdeath events other than completed sales are often considered by the courts. Although offers to purchase property are not considered persuasive evidence of fair market value, they are not disregarded. If an offeror is knowledgeable or acted on the advice of experts, an offer may be accorded substantial weight. Hood, Valuation: General and Real Estate, 830-2d Tax Management Portfolios A-14 (2003). Rejected offers are considered by the courts and can support a value higher than the initial appraisal. See *Julius Long Stern* (1953) 21 TC 155, rev'd on other grounds (3d Cir 1954) 215 F2d 701. See also *Estate of Ernest A. Obering,* TC Memo 1984-407. Of course, an offer may have little probative value if it is subject to rezoning or other contingencies that significantly affect value.

In valuing businesses, courts also consider confidential private placement memorandums, reports prepared by banks for financing, and analyses by accounting firms regarding valuation of noncontrolling interests. See, *e.g., Nathan P. Morton,* TC Memo 1997-166. In *Estate of Paul Mitchell,* TC Memo 2002-98, aff'd sub nom *Fujieki v Commissioner* (9th Cir 2003) 2004-1 USTC ¶60,475, 93 AFTR2d 362, the court rejected typical valuation methodologies and determined value on the basis of several arm's-length offers made after death. In *First Nat'l Bank v U.S.* (7th Cir 1985) 763 F2d 891, the value of a business was determined by reference to a limited partnership agreement signed 21 months after death, which the court characterized as an unexercised option to purchase the property.

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§4.116F (e) Postdeath Sales of Similar Properties

Courts give sales of similar real estate great weight, even when the subject property is sold after the valuation date. In *Estate of Paul J. Moss,* TC Memo 1982-85, the court determined date-of-death value by looking at comparable sales that occurred as late as 3½ years after death, although the court then stated that there had to be an adjustment to the comparables to reflect an increase in value to local farm properties between the date of death and the date of the comparable sales. In *First Nat'l Bank v U.S.* (7th Cir 1985) 763 F2d 891, a case involving valuation of business property sold more than 15 months after death, the court stated that evidence of sales of comparable property is persuasive evidence of market value.

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§4.117 3. Deductions From Gross Estate

In determining the value of the taxable estate, the estate may deduct certain amounts from the value of the gross estate. IRC §§2053-2058. See §§4.117-4.124.

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§4.118 a. Expenses, Indebtedness, and Taxes (IRC §2053)

The estate may deduct from the value of the gross estate amounts allowable by local law for funeral expenses, administration expenses, claims against the estate, unpaid mortgages or property indebtedness, and other administrative expenses. IRC §2053. See §§4.119-4.123. Amounts allowed as deductions under §2053 for estate tax purposes are not allowed to the estate as deductions for income tax purposes. IRC §642(g). Deductions generally are not allowable without actual payment except that a deduction may be allowed for "estimated amounts" when the exact amount is unknown, provided that the amount is ascertainable with reasonable certainty and will be paid. Treas Reg §20.2053-1(d)(1), (d)(4). When a claim is resolved by settlement, the claim must be enforceable, and the settlement may be relied on to establish the amount of the claim only if the settlement resolves a bona fide issue in a genuine contest and is the product of arm's-length negotiations by parties having adverse interests with respect to the claim. Treas Reg §20.2053-1(b)(3)(iv). A deduction is not allowed when the expense or claim is or could be compensated by insurance or otherwise reimbursed. Treas Reg §20.2053-1(d)(3).

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§4.119 (1) Funeral Expenses

Funeral expenses for a "reasonable" amount may be deducted. These expenses include the cost of the funeral and burial ceremonies as well as related expenses such as the casket, flowers, food for mourners, clothing for the decedent, and the cost of transporting the body to the burial site. In *Estate of Sarah M. Davenport*, TC Memo 2006-215, the court denied a deduction for a claimed $3639 expense for a "funeral luncheon." The decision is a warning that the trustee should be prepared to provide some evidence establishing that a claimed funeral expense is a normal and customary part of a "funeral" under the circumstances. See also *Estate of Silverstein* (1984) 159 CA3d 221, 226, 205 CR 294 (funeral expenses include "accustomed forms and ceremonies"). A reasonable amount may also be deducted for expenses related to the burial site such as a tombstone or landscaping. Treas Reg §20.2053-2.

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§4.120 (2) Administration Expenses

Administration expenses are generally the expenses actually and necessarily incurred in administering the decedent's estate. These expenses include executors' commissions and attorney fees actually paid or reasonably expected to be paid and miscellaneous administration expenses such as court costs, appraiser fees, accountant fees, notary fees, and costs of sale if a sale is necessary to pay debts, expenses of administration, or taxes; to preserve the estate; or to effect distribution. Treas Reg §20.2053-3(a). These expenses may be deducted on either the estate tax return or the income tax return, but not both. IRC §642(g). For deduction of administrative expenses not subject to claims, see §4.123.

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§4.121 (3) Claims Against Estate

Claims against the decedent's estate are the decedent's personal obligations existing at the date of death. Treas Reg §20.2053-4(a)(1). Only enforceable claims may be deducted, and unless "estimated amounts" are ascertainable with reasonable certainty under Treas Reg §20.2053-4(d)(4), the estate generally does not get a deduction for enforceable claims unless there is actual payment. Treas Reg §20.2053-4(a)(1). Deductions are not allowed for "potential" or "unmatured" and contested claims. Treas Reg §20.2053-4(d)(1)-(2). However, counterclaims against the estate that are integrally related to claims or causes of action included in the estate may be deducted. Treas Reg §20.2053-4(b). In an important de minimis exception, Treas Reg §20.2053-4(c) provides that the current value of claims totaling not more than $500,000 may be deducted on Form 706 even though payment has not been made. See 31 CEB Est Plan Rep 53 (Dec. 2009) for a detailed discussion of the regulations adopted in TD 9468, 2009-44 Int Rev Bull 570. Because the regulations will often make it necessary to file protective refund claims, the IRS has stated that it will limit its examination of Form 706 to evidence relating to the claimed deduction when such a timely-filed claim for refund ripens after the expiration of the period of limitations on assessments. Notice 2009-84, 2009-44 Int Rev Bull 592.

An estate may deduct the decedent's unpaid subscriptions and charitable pledges made before death, but otherwise a claim based on a promise or agreement is deductible only if the promise or agreement was bona fide and in exchange for adequate and full consideration in money or money's worth. IRC §2053(c)(1)(A); Treas Reg §§20.2053-4(d)(5), 20.2053-5(a). There is a presumption that claims by family members of the decedent, related entities, and beneficiaries of the decedent's estate are not bona fide. Treas Reg §20.2053-1(b)(2).

Deductions are allowed for "noncontingent" recurring payment obligations which may include spousal support subject to termination on death or remarriage of the recipient. Treas Reg §20.2053-4(d)(6).

Taxes accrued and enforceable at a decedent's death are deductible only as claims against the estate, except to the extent that excise taxes may be allowable as administration expenses. Treas Reg §20.2053-6(a), (e). See Treas Reg §20.2053-6(f) for the determination of taxes deductible if spouses file a joint income tax return. Post-death adjustments increasing an accrued tax liability and refunds determined to be due to and received by the estate with respect to taxes deducted by the estate will increase or reduce the amount of the deduction available or taken for that tax liability. Treas Reg §20.2053-6(g).

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§4.122 (4) Unpaid Mortgages or Property Indebtedness

The full amount of an unpaid mortgage or any other indebtedness on any property of the gross estate may be deducted. The deduction is allowed only for the amount of the liability that was contracted bona fide and for adequate and full consideration in money or money's worth. Treas Reg §20.2053-7.

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§4.123 (5) Other Administrative Expenses

A deduction is allowed for amounts representing expenses incurred in administering property not subject to claims (generally property of an inter vivos trust) if they would have been allowed as deductions if the property being administered were subject to claims against the estate (see §4.121) and were paid before the period of limitation for assessment expires under IRC §6501. Treas Reg §20.2053-8.

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§4.123A (6) Property Taxes

Under IRC §2053(c)(1)(B), property taxes are not deductible by an estate unless the taxes are an enforceable obligation of the decedent at the time of death. Treas Reg §20.2053-6(b). In *Estate of Margot Stewart*, TC Memo 2006-225, the court held that an estate could not deduct property taxes paid by the executor after the decedent's death on property included in the decedent's estate because the decedent did not have outstanding property tax obligations relating to her interest in the property.

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§4.123B (7) Interest on *Graegin* Loans

Some court decisions and rulings have allowed an administration expense deduction for the interest expense on funds borrowed to pay estate taxes. See, *e.g.,* Rev Rul 84-75, 1984-1 Cum Bull 193 (expense of loan obtained to avoid a forced sale of assets was reasonably and necessarily incurred). In *Estate of Cecil Graegin*, TC Memo 1988-477, the Tax Court allowed a deduction for future interest payments on funds borrowed by the executor from a corporation in which the estate had a substantial interest. The promissory note had a term of 15 years, all principal and interest was to be paid at the end of the term, and the note could not be prepaid. The court upheld the deduction, concluding that on the facts of the case the interest obligation was "actually and necessarily" incurred. For district court decisions allowing substantial deductions for *Graegin* loans, see *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703, and *Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015. In *Klein v Hughes* (Apr. 24, 2004, A103940) 2004 Cal Unpub Lexis 3788, 2004 WL 838198, the court of appeal approved a similar "*Graegin*" transaction for which the deduction was apparently allowed by the IRS involving a loan from a limited liability company controlled by the decedent's revocable trust to a partnership controlled by the family of the trustees' tax attorney which then loaned the money to the trust. See *Klein v Hughes* (2005) 133 CA4th 121, 34 CR3d 613, on equitable adjustment issues raised by the income tax consequences of the transaction for some beneficiaries of the trust.

In *Estate of Samuel P. Black* (2009) 133 TC No. 15, however, the Tax Court disallowed a claimed deduction for interest to be paid on a loan to the decedent's revocable trust from a family limited partnership (FLP) when the court concluded that, on the facts of the case, the loan did not accomplish anything other than create an estate tax deduction because the estate had no means to repay the loan other than by having the FLP sell stock the FLP was intended to preserve and redeem some of the estate's FLP interests.

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§4.124 b. Losses (IRC §2054)

The estate may deduct from the value of the gross estate losses incurred during the settlement of the estate arising from fires, storms, shipwrecks, or other casualties, or from theft, when such losses are not compensated by insurance or otherwise. IRC §2054. If the loss is partly compensated, the executor may deduct the uncompensated amounts. Treas Reg §20.2054-1. Amounts allowed as deductions under IRC §2054 for estate tax purposes are not allowed to the estate as deductions for income tax purposes. IRC §642(g).

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§4.125 c. Charitable Deduction (IRC §2055)

A charitable deduction may be claimed for estate tax purposes for interests passing to or for the use of qualified recipients for public, charitable, and religious uses as described in IRC §2055(a). Note that the deduction for works of art is limited to "qualified contributions" to a qualified organization, which requires that the art work's use be related to the purpose or function constituting the basis of the organization's income tax exemption. IRC §2055(e)(4).

Property received under a power of appointment and included under IRC §2041 is considered as having passed from the decedent. IRC §2055(b). If estate tax or other death taxes are payable from the amount passing to charity under a decedent's will or state law, then the charitable deduction is reduced by the amount of such taxes. IRC §2055(c). The deduction is limited to the value of the transferred property required to be included in the gross estate. IRC §2055(d).

The estate tax value of fractional shares in artwork included in the estate is limited by the total value of the property used to calculate earlier fractional share gifts. IRC §2055(g). The gift tax value of the property used to calculate subsequent fractional share gifts is similarly limited. IRC §2522(e)(2). Note that the fractional share gift is an undivided interest and not a partial interest. See §4.126. The donor of fractional share gifts must contribute all retained interests in the property by the time of the donor's death or 10 years after the initial contribution of the property, whichever comes first, or the gift tax deductions will be disallowed. IRC §2522(e)(3)(A). Recapture of deductions also occurs if the donee fails to exercise its possession rights or does not use the gifted property for its exempt purposes. IRC §2522(e)(3)(A). The disallowance of gift tax deductions may generate taxable gifts that reduce the available unified credit and increase the donor's estate tax liability.

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§4.126 (1) Nondeductibility for Partial Interests

A charitably minded donor often may wish to establish a gift that initially provides distributions to one or more noncharitable beneficiaries, with a charity receiving the balance of the property at some future time—frequently at the death of the last named noncharitable beneficiary. Rarely, a donor may wish to make a gift that benefits the charity first with the remainder passing to noncharitable beneficiaries. Because of the potential for abuse, particularly the possibility that the deduction for the present value of the charitable interest might exceed the real value of what the charity actually receives, the ability to claim a charitable deduction for these types of gifts is heavily regulated by statute.

Although there are statutory exceptions (see §4.127), the general rule is that no deduction is allowed when the taxpayer gives a charity some but not all of the taxpayer's interests in property. IRC §2055(e). Overlooking this rule or failing to carefully design a transaction in a way that will satisfy a statutory exception can be expensive for the client and raise malpractice issues for the drafter.

EXAMPLE: Under the undivided share rule, a deduction may be allowed for the donation of a tenant-in-common fractional share of property, but no deduction is allowable for the right to use property for a specified period of time or after a specified period. For example, no deduction would be allowed for a building owner's contribution of office space for a term of 1 year.

For federal estate tax purposes, the charitable contribution deduction for an allowable partial interest in property equals its fair market value on the date of death or on the alternate valuation date. Treas Reg §20.2055-2(f).

Because of the general rule, tax advisers must be careful in structuring transactions that simply provide income interests to noncharitable beneficiaries, with remainder to charity. For example, such provisions are commonly seen in wills that provide that a certain noncharitable beneficiary is to receive all trust income for life with remainder to a charity. Although IRC §2055 contains provisions for reforming such trusts into qualifying charitable remainder annuity trusts and charitable remainder unitrusts, reformation is not always possible. Similar reformations provisions are available for inter vivos transfers. See IRC §170 on the income tax charitable deduction, and IRC §2522 on gift tax deductions.

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§4.127 (2) Exceptions to Nondeductibility

The major exceptions to the general rule of nondeductibility for partial interest gifts to charity allow deductions for:

- Qualified charitable remainder trusts (see California Estate Planning, chap 24 (Cal CEB 2002));
- Remainder interests in farms and residences (see §4.128);
- Conservation easements (§§4.132-4.137);
- Charitable lead trusts that pay annuity and unitrust amounts (see Estate Plan, chap 23A); and
- Contributions of undivided shares of property (see IRC §170(f)(3)(B)(ii)).

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§4.128 (3) Remainder Interests in Personal Residences and Farms

When a nontrust inter vivos or testamentary gift of an irrevocable remainder interest in a personal residence is made to a charity, with the donor retaining an estate for life or for a term of years, a charitable deduction will be allowed for federal income and estate tax purposes covering the value of the remainder interest. IRC §§170(f)(3)(B)(i), 2055(e)(2). In this context, "personal residence" means any property the donor used as a personal residence even if it is not the donor's principal residence. A vacation home qualifies. A tenant-stockholder's shares in a cooperative housing corporation (as defined in IRC §216(b)(1)-(2)) qualify if the dwelling the taxpayer is entitled to occupy as such a tenant-stockholder is used as his or her personal residence. Treas Reg §§1.170A-7(b)(3), 20.2055-2(e)(2)(ii). A charitable deduction for the remainder interest in a residence may be allowed even when the testator directs that the residence be sold on the death of the life tenant and the proceeds distributed to charity. *Estate of Eliza W. Blackford* (1981) *77* TC 1246.

Similarly, a deduction is allowed for the value of a nontrust contribution to charity of a remainder interest in a farm. IRC §§170(f)(3)(B)(i), 2055(e)(2). In this context, a "farm" means any land used by the donor or his or her tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. A farm includes the improvements on it. Treas Reg §§1.170A-7(b)(4), 20.2055-2(e)(2)(iii).

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§4.129 (4) Charitable Remainder Following Qualified Terminable Interest Property (QTIP) Trust

Sometimes a donor wishes to establish a trust for the benefit of a spouse with remainder to charity. This can be accomplished by creating a standard charitable remainder trust. The entire transfer is deductible for estate tax purposes because it qualifies for both a marital deduction and a charitable deduction. See IRC §§2056(b)(8), 2523(g).

An alternative to a charitable remainder trust is to create a qualified terminable interest property (QTIP) trust that initially qualifies for a full marital deduction under IRC §2056(b)(7)(B). The trust will later be included in the estate of the surviving spouse under IRC §2044, but it will qualify for an IRC §2055 estate tax deduction when it passes to charity at that time. A QTIP trust provides considerably more flexibility than a charitable remainder trust because the QTIP trust is not deemed a charitable trust for tax purposes during the spouse's lifetime. Accordingly, the trust terms can permit invasion of principal if the spouse needs additional funds. These strategies are not available to same-sex spouses or registered domestic partners treated as spouses under California law. See §4.41.

PRACTICE TIP: Before making a final decision on which device to use, the planner needs to consider that inclusion of the QTIP in the survivor's estate changes the composition and magnitude of that estate. This may have either a positive or negative impact on the ability of the survivor's estate to qualify for certain tax benefits under IRC §§303 (redemption of stock to pay tax), 2032A (special use valuation of real property), and 6166 (installment payment of estate tax).

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§4.130 (5) Pooled-Income Funds

A pooled-income fund is a trust maintained by a public charity to which a donor may contribute property while reserving a life income interest to him- or herself. See IRC §642(c)(3)-(5). The value of the life interest is based on the property transferred and the beneficiary's life expectancy. Typically, large public charities have established pooled-income funds and make available to potential donors all required transfer and other legal forms so that donors need not have any documents prepared. The property of all donors contributing to the pooled-income fund is commingled, and the fund is generally managed by the public charity. Unlike a charitable remainder trust, a pooled-income fund cannot invest in tax-exempt securities. Treas Reg §1.642(c)-5(b)(4). The charitable remainder beneficiary of a pooled-income fund must be a public charity or other qualifying IRC §170(b)(1)(A) organization. IRC §642(c)(5)(A).

PRACTICE TIP: Use of a pooled-income fund may be preferable to a charitable remainder trust for gifts of modest size because assets given to the fund are administered as part of the fund, along with transfers from other donors, either by the charity that created the fund or by a trustee. A separate trust must be created if property is given to a charitable remainder trust. To justify the cost of creating and administering a separate trust, the assets to be transferred to it must usually be substantial.

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§4.131 (6) Charitable Gift Annuities

A charitable gift annuity involves a transfer of property to a charity in exchange for an annuity—normally an annuity for the benefit of the donor or a joint and survivor annuity for the donor and the donor's spouse. The amount transferred will exceed the value of the annuity (as valued under IRC §7520). An immediate income tax deduction is allowed for the excess value. The obligation to pay the annuity is a general obligation of the issuing charity; the payment is not made from a specified fund as in a charitable remainder trust or a pooled-income fund. See §4.130. The annuity can be immediate or deferred. Some charities issue annuities in exchange for a remainder interest in a residence or farm.

Most charities that issue charitable gift annuities offer annuities based on rates provided by the American Council on Gift Annuities. This is a practice protected by the Charitable Donation Antitrust Immunity Act of 1997 (15 USC §§37-37A). Many states, including California, regulate the issuance of gift annuities. See Ins C §§11520-11524. For detailed information, see the website of American Council on Gift Annuities at http://www.acga-web.org.

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§4.132 d. Conservation Easements

The Internal Revenue Code provides substantial tax benefits for owners of real property who impose certain use restrictions on the property by making a transfer of interests in it to a qualified organization (generally, public charities having conservation objectives and government entities). The easement must have a conservation purpose under IRC §170(h)(4), meaning that it preserves land for outdoor recreation or education, protects the natural habitat of plants or animals, or preserves open space. 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 residential 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). 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 the number of units allowed under the deed was already the likely maximum number that would be allowed by zoning authorities. 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, among other things, 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 an historically important land area will qualify. See Treas Reg §1.170A-14(d)(5). The conservation purpose must be protected in perpetuity. IRC §170(h)(5)(A). See *Gordon Kaufman* (2010) 134 TC No. 9 (façade easement not protected in perpetuity because building was subject to a mortgage).

If applicable requirements are met, the donor may qualify for an income tax deduction under IRC §170(h), or, if the transfer is made at death (or even after death), it may qualify for an estate tax deduction under IRC §2055. See §§4.133-4.134.

In addition, if somewhat more rigorous requirements are met and the easement qualifies for reasons not involving historical importance of the property, an estate also may be able to *exclude* a portion of the value of the property subject to a qualified conservation easement for purposes of computing estate taxes. IRC §2031(c). This exclusion benefit is something of a "double dip" because it is in addition to the benefit of the reduced estate tax value of the property resulting from the creation of the easement during life, or the IRC §2055 charitable deduction for creation of the easement at death. See §§4.135-4.137.

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§4.133 (1) Income Tax Deduction

As discussed in §4.126, no income tax deduction is allowed for a transfer of a partial interest in property. A significant exception to the rule allows an income tax deduction for a transfer of a qualified conservation contribution. IRC §170(f)(3)(B), (h). To encourage donations of conservation easements, the otherwise applicable 30-percent limit for contributions of capital gain property by individuals is increased to 50 percent (100 percent if the donor is a "qualified farmer or rancher") and the deduction may be carried over for up to 15 years (rather than the usual 5 years) for donations made before January 1, 2010. IRC §170(b)(1)(E). See Notice 2007-50, 2007-25 Int Rev Bull 1430. In Rev Rul 2003-123, 2003-2 Cum Bull 1200, however, the IRS ruled that a trust was not allowed an income tax deduction under IRC §642(c) for a contribution of a conservation easement, because the contribution was not made from income. A qualified conservation contribution requires a contribution of a "qualified real property interest" to a "qualified organization" exclusively for "conservation purposes." See §4.132.

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§4.134 (2) Estate Tax Deduction

An estate tax deduction is permitted under IRC §2055(a) for the contribution of a qualified conservation easement. The requirements to qualify for the deduction are generally the same as for the income tax deduction. Treas Reg §20.2055-2(e)(2)(iv). See §4.133.

The estate tax deduction rules for qualified conservation easements are unusual in that it is sometimes possible to claim an estate tax deduction for an easement created by the decedent's heirs. IRC §2031(c)(9). See §4.137.

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§4.135 (3) Estate Tax Exclusion

Under IRC §2031(c), an estate tax exclusion (somewhat similar to a deduction; see §4.134) is permitted for a portion of the value of real property that is subject to a qualified conservation easement. The maximum exclusion is the lesser of (IRC §2031(c)(1)(A)-(B)):

- A fixed-dollar exclusion limitation; or
- The "applicable percentage" of the value of the land subject to the easement.

The fixed-dollar exclusion limitation is $500,000. IRC §2031(c)(3).

The applicable percentage is 40 percent, reduced (but not below zero) by 2 percentage points for each percentage point (or fraction of a percentage point) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of the easement and reduced by the value of any retained development right (as defined)). IRC §2031(c)(2). The values taken into account in this computation are the values in effect when the easement was established. IRC §2031(c)(8)(B).

EXAMPLE: The decedent owns a small vineyard in the Napa Valley with a date of death value of $2 million. Five years before death, when the property was worth $1.5 million, the decedent granted a conservation easement limiting development of the property, which reduced the value of the property to $1.2 million. Because the easement when created reduced the value of the property by only 20 percent (from $1.5 million to $1.2 million), rather than 30 percent, the applicable percentage will be 20 percent (40 percent reduced by 2 percentage points for each percentage point difference between 20 percent and 30 percent). The estate tax exclusion is 20 percent of the $2 million date-of-death value of the property, or $400,000.

For purposes of making the required reduction for development rights, a development right means "any right to use the land subject to the qualified conservation easement in which such right is retained for any commercial purpose which is not subordinate to and directly supportive of the use of such land as a farm for farming purposes." IRC §2031(c)(5)(D).

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§4.136 (a) Special Requirements

To qualify for the estate tax exclusion, the land must be located in the United States or any U.S. possession. IRC §2031(c)(8)(A)(i). In addition, the land must be owned by the decedent or a member of the decedent's family at all times during the 3-year period ending before death. IRC §2031(c)(8)(A)(ii). The definition of "family member" for these purposes is set forth in IRC §2032A(e)(2). IRC §2031(c)(8)(D).

Generally, eligibility for an IRC §2031(c) estate tax exclusion for a conservation easement is more limited than for an income tax deduction under IRC §170(h), although the §170(h) requirements must also be met (see §4.132). For example, an income tax deduction is allowed for an easement for the preservation of an historically important land area or a certified historical structure, but those easements do not qualify for an estate tax exclusion. IRC §§170(h)(4)(A)(iv), 2036(c)(8)(B).

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§4.137 (b) Postmortem Imposition

The IRC §2031(c) estate tax exclusion for conservation easements is available even if the easement is created by the decedent's executor or a member of the decedent's family. See, *e.g.,* IRS Letter Ruling 200014013 (estate of majority shareholder of corporation entitled to conservation easement resulting from postmortem agreement between corporation and shareholders to extinguish previously retained recreation and subdivision rights). The easement must be created before the deadline for making the election on the estate tax return. See IRC §2031(c)(6), (c)(8)(A)(iii). In such situations, it is also possible to obtain an estate tax deduction, but the heirs cannot also claim an income tax deduction. See §§4.133-4.134. In IRS Letter Ruling 200418005, the IRS ruled that a postdeath contribution of a scenic easement qualified for the estate tax exclusion provided that no persons claimed an income tax deduction.

PRACTICE TIP: Generally, it is preferable to convey the easement before the decedent's death. Doing so provides an income tax deduction and makes the estate tax deduction a moot point because the value of the easement will not be included in the estate. Nevertheless, the combination of an estate tax deduction and an estate tax exclusion can provide a significant tax benefit. Normally, the agreement to create or amend the easement must be accomplished within 9 months after death. This time limit is not extended by an application to extend the time for filing an estate tax return.

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§4.138 e. Marital Deduction (IRC §2056)

An unlimited marital deduction is generally allowed for transfer from a decedent to the decedent's surviving spouse. IRC §2056(a). The deduction is not allowed for transfers to same-sex surviving domestic partners treated as spouses under California law. See §4.41. For transfers to noncitizen spouses, the deduction is allowed only for property transferred to a qualified domestic trust. IRC §§2056(d), 2056A. For terminable interests, the deduction is allowed only if the transfer is in the form of a qualified terminable interest property trust or other qualifying trust. IRC §2056(b). See chap 9.

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§4.139 f. Deduction for State Death Taxes Paid (IRC §2058)

Beginning in 2005, the IRC §2011 state death tax credit (see §4.141), is repealed and replaced by a deduction for state death taxes paid. IRC §2058. In states with a pick-up tax, such as California, repeal of the credit results in zero state death taxes.

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§4.140 4. Estate Tax Credits

In addition to the IRC §2010 unified credit, which shields a portion of a decedent's estate and lifetime gifts from tax (as discussed in §§4.69-4.76), the Code provides for credits against estate tax otherwise payable for various taxes paid on the decedent's property. IRC §§2011-2016. See §§4.141-4.145.

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§4.141 a. State Death Tax Credit (Repealed) (IRC §2011)

For estates of persons dying before 2005, a credit is allowed under IRC §2011 for any state death taxes actually paid with respect to property included in the decedent's gross estate and with respect to the decedent's estate. The credit is limited based on the amount of the adjusted taxable estate. In a state with a pick-up tax, such as California, the credit has the effect that a portion of the estate tax that would have been paid in any event under IRC §2001 is paid to the state. Repeal of the tax, effective in 2005, will result in zero state death taxes in those states, including California, that limit the state tax to the amount of the allowed credit.

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§4.142 b. Credit for Gift Tax Paid (IRC §2012)

A credit is allowed for gift tax paid on the decedent's lifetime transfers if the transferred property is included in the decedent's estate. IRC §2012. Inclusion of gifted property may occur if the decedent retained certain interests in the property under IRC §§2035-2038. See §§4.80-4.88.

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§4.143 c. Credit for Tax on Prior Transfers (IRC §2013)

To provide relief from the imposition of estate taxes on deaths that occur in quick succession, IRC §2013 provides a credit for estate tax paid with respect to a transfer of property to the decedent by another person, the transferor, who died within ten years before, or two years after, the decedent. The credit is 100 percent of the amount determined under IRC §2013(b) if the deaths occur within two years of each other, and the credit is reduced as the deaths occur further apart. IRC §2013(a). The credit is the amount that bears the same ratio to the estate tax paid with respect to the transferor's estate as the value of the transferred property bears to the taxable estate of the transferor, with certain modifications. IRC §2013(b). The credit cannot exceed the tax attributable to the transferred property included in the decedent's gross estate. IRC §2013(c). The credit will not be allowed for the surviving spouse's estate if the estate of the first spouse to die paid no estate tax on the transferred property because a marital deduction was allowed under IRC §2056. IRC §2013(d).

In some cases, better tax savings may be achieved by using the IRC §2013 credit than by using the IRC §2056 marital deduction. If the surviving spouse is in poor health, it may be advisable to disclaim a portion of the marital deduction property under IRC §2518 to produce an estate tax so that the spouse's estate can receive the §2013 credit for property passing to the spouse, or the executor of the decedent's estate may choose not to make a qualified terminable interest property (QTIP) election under IRC §2056(b)(*7*) with respect to property in which the surviving spouse has a qualifying life income interest. Making a disclaimer or not making a QTIP election may become desirable if the surviving spouse dies unexpectedly. Therefore, the estate of a deceased spouse should generally request an automatic six-month extension to file the return. However, this strategy is not available to same-sex domestic partners treated as spouses under California law. See §4.41.

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§4.144 d. Credit for Foreign Death Taxes (IRC §2014)

To remedy some of the effects of double taxation that may occur because the United States taxes a decedent's worldwide assets, a credit is allowed for foreign death taxes on property in the foreign country and included in the decedent's gross estate. IRC §2014(a). The credit is limited to the lesser of the amount of foreign death tax attributable to foreign property or the amount of estate tax attributable to foreign property. IRC §2014(b). The foreign death taxes must actually have been paid and the credit claimed within 4 years after the decedent's federal estate tax return was filed, unless a petition for redetermination is pending under IRC §6213(a) or an extension has been granted under IRC §6161. IRC §2014(e). For discussion of extensions, see §4.149. If the U.S. has entered into an estate tax treaty with the country to which an IRC §2014 credit applies, the estate may apply the credit allowed under either the treaty or §2014. Treas Reg §20.2014-4(a).

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§4.145 e. Credit for Death Taxes on Remainders (IRC §2015)

A credit is available for state or foreign death taxes on a reversionary or remainder interest in property in the decedent's gross estate for which a credit would be allowable under IRC §2011 or IRC §2014, respectively. IRC §2015. For estates of decedents dying after 2004, when the state death tax credit will not apply, the credit will be available only for foreign death taxes under §2014. See §§4.141, 4.144. The §2015 credit applies only if an election is made to postpone the time for payment of the part of the federal estate tax attributable to a reversionary or remainder interest under IRC §6163. See §4.149.

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§4.146 5. Recovery of Taxes Claimed as Credits (IRC §2016)

If any tax claimed as a credit for state or foreign death taxes under IRC §2011 or IRC §2014, respectively, is recovered from the state or foreign country, the executor or other person receiving the recovery must notify the IRS, which will redetermine the estate tax liability. IRC §2016. For estates of decedents dying after 2004, when the state death tax credit will not apply, the notification will be required only for foreign death taxes recovered. See §§4.141, 4.144.

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§4.147 6. Filing Estate Tax Return

The estate tax return, IRS Form 706, must be filed within 9 months after the date of the decedent's death (*e.g.,* the day in the ninth calendar month after the decedent's death numerically corresponding to the day the decedent died), unless an extension is obtained. IRC §6075(a). If there is no numerically corresponding day in the ninth month, the return is due on the last day of the ninth month. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is the next succeeding day that is not a Saturday, Sunday, or legal holiday. Treas Reg §20.6075-1. An automatic 6-month extension to file the return under IRC §6081(a) may be obtained by filing IRS Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, before the due date of the return as provided in Treas Reg §20.6081-1(b). Under Treas Reg §20.6081-1(a), Form 4768 must include an estimate of the amount of the tax liability. However, an extension of time for filing the return does not extend the time for payment of tax. If no extension of time to pay tax is obtained, the estate will be subject to applicable late payment penalties. Treas Reg §20.6081-1(e). See §4.149.

In *Estate of Prooke* (D NJ 2010) 2010-1 USTC ¶60,594, 105 AFTR2d 2613, the court held that the IRS abused its discretion under Treas Reg §20.6081-1(c) in denying a late application for an extension of time to file the return and pay tax. The court accepted the executor's contention that the estate could not file a timely Form 4768 because it lacked sufficient information to make a reasonable estimate of the tax due. Practitioners should not rely on this decision. Form 4768 should always be filed before the due date of the return. If the form is timely filed, the extension of the filing deadline is automatic and there is no need to justify the application. With respect to the portion of the form requesting an extension of time for paying the tax, it is better to make an estimate of the amount of tax due than to make a late request. Attachments can be used to explain uncertainties.

Failure to timely file an estate tax return and pay tax may result in penalties despite a tax professional's representations that extensions have been obtained. IRS Letter Ruling 201015003. The timely filing of a tax return is not excused by the taxpayer's reliance on an agent. See *U.S. v Boyle* (1985) 469 US 241, 83 L Ed 2d 622, 105 S Ct 687. See also *Estate of Josephine Spowart Hinz*, TC Memo 2000-6 (there may be reasonable cause for failure to file if qualified professional has actually given erroneous advice concerning due date, but erroneous advice was not given until extended due date had already passed and executor improperly delegated duty to timely file to attorney by not timely inquiring about extension).

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§4.148 7. Payment of Estate Tax

The estate tax must be paid at the time fixed for filing the estate tax return, without regard to extensions. IRC §6151(a). If no extension of time for payment is available under IRC §6161 or §6163, and installment payments are not available under IRC §6159 or §6166, a late-payment penalty of 0.5 percent per month not to exceed 25 percent of the amount of the tax due will apply. IRC §6651(a)(2). For discussion of extensions and installment payments, see §§4.149-4.153.

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§4.149 a. Extension of Time for Payment

In general, the IRS may extend the time to pay the tax for a reasonable period not to exceed 12 months. IRC §6161(a)(1). The IRS may also extend for up to 14 years the time to pay the estate tax, or any part of an installment payment under IRC §6166 (see §4.152), for "reasonable cause." IRC §6161(a)(2). This extension must be requested on IRS Form 4768 and usually requires a showing of undue hardship. Treas Reg §20.6161-1(a)(2). The sale of property at the current market price is not ordinarily considered an undue hardship. In *Estate of Antoinette Hartsell,* TC Memo 2004-211, for example, the court upheld the imposition of penalties for failure to pay tax when the executor failed to liquidate estate assets more than 3 years after the decedent's death. The IRS granted the estate two 1-year extensions and denied a request for further extension when the executor provided no substantiation for reasonable cause. In *Baccei v U.S.* (ND Cal 2008) 2008-2 USTC ¶60,562, 102 AFTR2d 5801, the court held that the penalty for failure to pay tax was properly assessed because the Form 4768 filed by an accountant seeking an automatic 6-month extension to file the estate tax return did not explicitly request an extension of time to pay (see §4.147) and the cover letter that requested an extension of time to pay did not specify the period of the extension sought. If an extension is granted, the estate must pay interest on the tax liability during the extension period. IRC §6601(a); Treas Reg §20.6161-1(c)(2).

The executor may elect to postpone the payment of tax on a remainder or reversionary interest included in the decedent's gross estate until 6 months after the termination of the precedent interest or interests in the property. IRC §6163. Interest that accrues on estate tax during the 6-month extension may be deducted for income tax purposes under IRC §163(h)(2)(E). However, there is no comparable provision treating interest that accrues during an IRC §6161 extension as nonpersonal interest; accordingly, interest that accrues during the extension is not deductible. IRS Letter Ruling 200836027.

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§4.150 b. Installment Payments for All Taxpayers

The Internal Revenue Service may enter into a written agreement with a taxpayer to pay taxes through installment payments, if the IRS believes that the agreement will facilitate tax collection. IRC §6159(a). The IRS may terminate the agreement if inaccurate information is provided. IRC §6159(b)(2). The IRS may also alter, modify, or terminate the agreement if payment is not made, or if a significant change occurs in the taxpayer's financial situation. IRC §6159(b)(3)-(4). However, the IRS may not alter, modify, or terminate the agreement with less than 30 days' notice unless it believes that collection of the tax is in jeopardy. IRC §6159(b)(5). Further, the IRS is generally required to enter into an agreement if the aggregate liability does not exceed $10,000 and the agreement requires full payment of the liability within 3 years. IRC §6159(c). Installment payment of estate tax is available as a matter of right for estates that include closely held business interests under IRC §6166. See §4.151.

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§4.151 c. Installment Payments for Closely Held Business Interests

If an estate includes an interest in a closely held business whose value exceeds 35 percent of the adjusted gross estate, the executor may elect to pay a proportionate part of the estate tax due in ten equal installment payments. The first payment can be deferred for 5 years after the estate tax is due. IRC §6166(a). In some cases, 5-year deferral does not apply, and in some cases the tax must be paid in five installments. IRC §6166(b)(8), (b)(10). To qualify for the extension, the decedent must have been a U.S. citizen or resident at death. IRC §6166(a). Special rules apply to interest on deferred payments and acceleration of payment on deferred tax. See §§4.152-4.153.

An interest in a closely held business is defined as (IRC §6166(b)(1)):

- An interest as a proprietor in a proprietorship;
- An interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in the partnership is included in determining the decedent's gross estate, or the partnership had 45 or fewer partners; or
- Stock in a corporation carrying on a trade or business if 20 percent or more in value of its voting stock is included in determining the gross estate of the decedent, or the corporation had 45 or fewer shareholders.

If neither the 45-owner test nor the 20-percent 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).

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 operated by a management company in which the decedent had no ownership interest (passive asset) from one in which the decedent owned 20 percent of the stock of the management company (asset used in a trade or business).

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§4.152 (1) Interest on Deferred Payments

In addition to the advantage of deferred payment, a special 2-percent interest rate applies to the estate tax attributable to the first $1 million (plus inflation adjustments) in value of closely held business interests in excess of the applicable exclusion amount. IRC §6601(j). The amount for estates of decedents dying in 2008 is $1,280,000. Certain interests not eligible for 5-year deferral are also ineligible for the 2-percent rate. IRC §6166(b)(8). Interest applies to the balance of the estate tax at 45 percent of the regular rate for underpayment of tax under IRC §6601(a). IRC §6601(j). Interest paid is not deductible for income tax purposes. IRC §163(k). Nor is interest deductible for estate tax purposes (IRC §2053(c)(1)(D)), with the result that the net cost of deferred payments for closely held business interests in excess of the 2-percent portion is about the same (slightly less at the current estate tax rate of 45 percent) as it would have been with regular interest minus the deduction, without the need to file a return and recalculate the value of the estate every year.

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§4.153 (2) Acceleration of Deferred Tax

Payment of deferred tax may be accelerated if the closely held business interest is distributed, sold, exchanged, or otherwise disposed of, or if money is withdrawn from the business, which in aggregate is at least 50 percent of the value of the interest. IRC §6166(g)(1). Failure to make an interest or principal payment will also accelerate the date of payment, as well as disqualify the payment for the special interest rate. IRC §6166(g)(3). Acceleration precludes an action for refund based on recalculation of the tax under IRC §7422(j). *Hansen v U.S.* (8th Cir 2001) 248 F3d 761.

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§4.153A (3) Lien Imposed and Bond Required

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 unless 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 bond that may be required by the IRS under IRC §6165. As a practical matter, a special lien usually must be provided because a bond is unavailable. 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 advance of regulations stating that it will now determine on a case-by-case basis whether security will be required when a qualifying estate elects to pay taxes in installments under IRC §6166. The notice states that the IRS is in the process of establishing standards to be applied to identify those estates making an election "in which the government's interest in the deferred estate tax and the interest thereon is deemed to be sufficiently at risk to justify the requirement of a bond or special lien." Notice 2007-90, 2007-46 Int Rev Bull 1003.

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C. Gift Tax

§4.154 1. Purpose of Gift Tax

The federal gift tax closes the transfer tax loophole created by the federal estate tax. It also serves to discourage transfers of property for income-shifting purposes. The gift tax is imposed on lifetime transfers of property for less than adequate and full consideration in money or money's worth. IRC §§2501(a), 2512(b). The gift tax applies to a broad range of transfers. See §§4.155-4.166. A transfer is subject to gift tax once it becomes a completed gift. See §§4.167-4.169. Most transfers incident to divorce are not included in gifts. See §4.170.

The total amount of gifts includes all transfers subject to gift tax less annual exclusions gifts, payments for educational and medical expenses, and certain loans of artwork. IRC §2503(b)-(c), (e), (g); Treas Reg §25.2503-1. See §§4.171-4.177. Taxable gifts include the total amount of gifts made in a calendar year less charitable gifts under IRC §2522 and marital deduction gifts under IRC §2523. IRC §2503(a). See §§4.178-4.179. Spouses may elect to split gifts under IRC §2013. See §4.180. Disclaimers are discussed in §4.181. Valuation of gifts is discussed in §4.182. Filing the gift tax return and paying the tax are discussed in §4.183.

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§4.155 2. Transfers Subject to Gift Tax

The gift tax applies to transfers of property by gift whether in trust or otherwise, whether directly or indirectly, whether real or personal property, tangible or intangible property. IRC §2511(a). Examples of taxable transfers are the creation of a trust, the forgiving of a debt, and the assignment of insurance benefits. Treas Reg §25.2511-1(a).

For a nonresident alien, the gift tax applies only to transfers of real and tangible property in the United States. Although transfers of intangible property by a nonresident alien are not subject to gift tax, this exception does not apply to expatriates who lost their U.S. citizenship within 10 years before the transfer who had a net worth of at least $2 million on the date of loss of citizenship or who had an average annual net income *tax* of $124,000 per year plus cost-of-living adjustments ($145,000 in 2009) for the 5 years preceding that date (except for certain narrowly defined classes of dual citizens and minors), or who fail to certify under penalty of perjury that they have met the requirements of the tax law during that five-year period or fail 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.

The transferor's donative intent is not essential for gift tax purposes; application of the gift tax is based on the objective facts of the transfer and the circumstances under which the gift is made, rather than the donor's subjective motives. Treas Reg §25.2511-1(g)(1). Particular transactions that may result in a taxable gift are discussed in §§4.156-4.166.

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§4.156 a. Below-Market Interest Rate Loans

Internal Revenue Code §7872 provides for imputed transfers between the lender and the borrower of the forgone interest on loans with below-market interest rates. The term "loan" covers any extension of credit. Prop Treas Reg §1.7872-2(a). Any loan with a below-market interest rate when the forgoing of interest "is in the nature of a gift" is treated as a gift loan. IRC §7872(f)(3). There are two types of gift loans: demand loans and term loans. The imputed transfers are characterized differently for each type of loan for income and gift tax purposes. See §§4.157-4.158. Exceptions to gift loan treatment are discussed in §4.159.

Section 7872 does not apply to loans that are debt instruments given for the sale or exchange of property to which IRC §1274 applies, deferred interest payments to which IRC §483 applies, or loans from foreign trusts to which IRC §643(i) applies. IRC §7872(f)(8).

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§4.157 (1) Demand Loans

A below-market demand loan is a loan fully payable on demand in which interest on the loan is payable at a rate less than the applicable federal rate (AFR). IRC §7872(e)(1)(A), (f)(5). The AFR for a demand loan is the short-term rate in effect under IRC §1274(d) for the period for which the interest is being determined, compounded semiannually. IRC §7872(f)(2)(B). The forgone interest on demand loans between the borrower and the lender during any calendar year is treated as though it was transferred from the lender to the borrower as a gift and retransferred from the borrower to the lender as income on the last day of such calendar year. IRC §7872(a).

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§4.158 (2) Term Loans

A below-market term loan is any loan other than a demand loan in which the amount lent exceeds the present value of all payments due under the loan. IRC §7872(e)(1)(B), (f)(6). "Present value" is the amount of the payments discounted at the applicable federal rate (AFR) in effect under IRC §1274(d) as of the date of the loan, compounded semiannually. IRC §7872(f)(1), (f)(2)(A). The AFR is the short-term, mid-term, or long-term rate, depending on the loan terms. IRC §1274(d).

For gift tax purposes, on the day the loan is made, the lender is treated as transferring, and the borrower is treated as receiving, cash in the amount of the excess of the amount lent over the present value of all payments required under the loan. IRC §7872(b)(1), (d)(2).

The loan also is treated as having original issue discount in the amount of the imputed transfer, which is treated as income under IRC §1272. IRC §7872(b)(2).

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§4.159 (3) Exceptions to Gift Loan Treatment

There is a de minimis exception to the imputed transfer rule for gift loans between individuals for any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000. IRC §7872(c)(2)(A). This exception does not apply to any gift loans attributable to the purchase or acquisition of income-producing assets. IRC §7872(c)(2)(B). A de minimis exception also applies for compensation-related and corporate-shareholder loans in which the aggregate outstanding amount of loans between the borrower and lender does not exceed $10,000. IRC §7872(c)(3).

For gift loans made on any day on which the aggregate outstanding amount of loans between the borrower and the lender does not exceed $100,000, the amount treated as retransferred for income tax purposes in a loan directly between individuals will not exceed the borrower's net investment income for the year, unless tax avoidance is a principal purpose of the loan. IRC §7872(d).

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§4.160 b. Exercise or Release of General Power of Appointment (IRC §2514)

The exercise or release of a general power of appointment created after October 21, 1942, is treated as a property transfer by the powerholder for gift tax purposes. IRC §2514(b). The lapse of a power during the powerholder's lifetime is treated as a release to the extent that the property subject to the power exceeds the greater of $5000 or 5 percent of the value of the assets from which the lapsed power could have been exercised. IRC §2514(e). A general power of appointment is defined as a power to appoint property exercisable in favor of the individual holding the power, his or her estate, his or her creditors, or the creditors of the estate. IRC §2514(c). A power is not a general power of appointment, however, if the exercise of the power is subject to an ascertainable standard relating to the health, education, support, or maintenance of the powerholder, or the power can be exercised only in conjunction with the creator of the power or a person with a substantial, adverse interest. IRC §2514(c). For further discussion of powers of appointment, see §§4.91-4.108.

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§4.161 c. Payment of Generation-Skipping Transfer Tax (IRC §2515)

Payment of generation-skipping transfer (GST) tax on a direct skip is a gift of the amount of the tax. IRC §2515. The combined gift tax on the amount of the direct skip and the GST tax simulates the double gift tax that would be paid in the event of a gift to a child followed by a gift from the child to a grandchild. For discussion of the GST tax, see §§4.184-4.221.

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§4.162 d. Discharge of Indebtedness

In a family context, a discharge of indebtedness or a legal obligation for no consideration generally constitutes a gift by the creditor to the debtor at the time of discharge. Treas Reg §25.2511-1(a). This rule does not apply to discharge of the tax liability on jointly filed income tax returns when one spouse pays the entire tax. Treas Reg §25.2511-1(d). In a business context in which there is no donative intent, a discharge of indebtedness may result in the debtor's being deemed to receive taxable income.

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§4.163 e. Transfers to and From Corporations and Partnerships

The gift tax is imposed on individuals. IRC §2501(a); Treas Reg §25.0-1(b). A gift from a corporation is treated as a gift from the shareholders to the donee. If the donee also is a shareholder, there is a gift from the other shareholders, but only to the extent it exceeds the donee's interest in such amount as a shareholder. A gift to a corporation is treated as a proportionate gift from the donor to the shareholders. If the donor is a shareholder, the proportion of the transfer that corresponds to the portion of the corporation owned by others will be subject to gift tax. Treas Reg §25.2511-1(h)(1). Similarly, a gift to a partnership may be treated as a gift to the other partners. See *Shepherd v Commissioner* (11th Cir 2002) 283 F3d 1258. In *Mark W. Senda,* TC Memo 2004-160, aff'd (8th Cir 2006) 433 F3d 1044, the Tax Court determined that contributions of stock to a newly formed partnership were gifts of stock to the limited partners because the donor failed to prove that he contributed stock to the partnership before making gifts of limited partnership interests. But see *Thomas H. Holman* (2008) 130 TC 170, in which the court distinguished *Shepherd* and *Senda* on the grounds that capital contributions were allocated to the capital account of the contributing partner in *Holman* and the funding of the partnership and transfers of partnership interests occurred almost a week apart. See also *Bianca Gross*, TC Memo 2008-221 (donor's capital account credited with value of transferred securities 11 days before gifts). The appellate court in *Senda* further suggested that a transfer of property to a partnership followed by a gift of partnership interests can be recharacterized as a gift of the transferred property in any event if the two actions were "integrated steps of a single transaction." *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044. The Eighth Circuit rejected the donor's attack on the application of the step-transaction doctrine in gift tax cases, noting that the application of the reciprocal trust doctrine was not limited to identifying the transferor or transferee but also applied to determining the nature of the transferred property. See §4.83.

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§4.164 f. Payment for Services to Third Party

Gift taxes apply to the transfer of property, not to services. However, if a person makes a payment of money or transfers property to another as consideration for the performance of services for a third party, the amount of consideration is a gift to the third party. Treas Reg §25.2511-1(h)(3).

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§4.165 g. Joint Bank Accounts

There may be a gift for tax purposes when money is withdrawn from a joint bank account. For example, if Aaron creates a joint bank account for himself and his daughter Betsy, there is a taxable gift by Aaron when Betsy withdraws from the account for her own benefit. The same result occurs when Aaron purchases a savings bond registered as payable to Aaron or Betsy and Betsy surrenders the bond for cash without any obligation to give Aaron part of the proceeds. Treas Reg §25.2511-1(h)(4).

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§4.166 h. Community Property Life Insurance Proceeds

A gift may occur when community property is used to purchase life insurance on the life of an insured with a spouse or domestic partner but a third party rather than the spouse or partner is designated as beneficiary of that policy. The survivor is entitled to half of the proceeds on the decedent's death, because the policy was purchased with community funds. If all proceeds pass to a third party beneficiary, the survivor is treated as making a gift of half of the insurance proceeds, as long as state law considers the decedent's death as making the transfer by the survivor absolute. Treas Reg §25.2511-1(h)(9). This result does not occur when the surviving spouse or partner receives at least half of the community property. *Kaufman v U.S.* (5th Cir 1972) 462 F2d 439.

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§4.167 3. Completed Gifts

A transfer is not subject to gift tax unless it is a completed gift. A gift is completed when the donor has so parted with dominion and control of the property transferred as to leave the donor no power to change its disposition, whether for the donor's benefit or the benefit of another. Treas Reg §25.2511-2(b). For example, if the donor delivers a properly endorsed stock certificate to the donee or the donee's agent, the gift is a completed gift on the date of delivery; but if the donor delivers a stock certificate to the donor's own agent, the gift is completed on the date the stock is transferred on the corporation's books. Treas Reg §25.2511-2(h).

NOTE: In 2010, when the estate tax is repealed, any transfer in trust will be treated as a taxable gift unless the trust is a grantor trust treated as owned by the donor or the donor's spouse under IRC §§671-679. IRC §2511(c).

If the donor reserves a power of appointment over property transferred to a trust for the benefit of others, the gift is incomplete. Treas Reg §25.2511-2(c). See §4.167. A donor may also reserve the power to revoke a gift made while he or she was a minor or an incompetent, making the gift incomplete. See §4.168.

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§4.168 a. Gifts With Retained Powers

If the donor retains the power to change beneficiaries, even if the donor cannot receive the property, the gift is incomplete. Treas Reg §25.2511-1(c). If the donor can exercise the power only with a nonadverse party, the donor is treated as holding the power alone and the gift is incomplete. Treas Reg §25.2511-2(e).

Certain powers can be retained that do not render a gift incomplete. For example, a gift is completed if the donor merely reserves the power to change the manner or time of enjoyment of a gift, such as the power to decide whether trust income shall be distributed or accumulated for the benefit of the beneficiary. Treas Reg §25.2511-2(d). However, completed gifts are made when the amounts are actually paid out to the beneficiaries or when the donor either relinquishes or terminates the power to change beneficiaries. Treas Reg §25.2511-2(f).

PRACTICE TIP: Occasionally, a donor may wish to make a transfer to a trust for the benefit of others that is a completed gift but remain the owner of the trust for income tax purposes. This result may be achieved by retaining certain powers under IRC §§671-679. See §§4.4-4.10 (grantor trust status). For example, a completed gift occurs if the donor retains the power to substitute assets of equivalent value (Rev Rul 2008-22, 2008-16 Int Rev Bull 796) or if the trust allows a nonadverse party to add a beneficiary. The grantor may then decrease the size of his or her estate by paying the income tax for the trust beneficiaries without incurring additional gift tax. For a detailed discussion of grantor trusts, see Drafting California Irrevocable Trusts §§3.22-3.44C (3d ed Cal CEB 1997).

Generally, if the donor transfers property to an irrevocable trust and retains an income interest, there is a completed gift of the remainder but not the income interest. If the exercise of the trustee's power in favor of the donor is limited by an ascertainable standard, the gift is incomplete to the extent of the ascertainable value of the rights retained by the donor. Treas Reg §25.2511-2(b).

If an independent third party trustee has discretionary power to distribute income to the donor, and the trust assets cannot be reached by the donor's creditors under state law, there is a completed gift of the entire transfer. See Treas Reg §25.2511-2(g). See *Estate of Vak v Commissioner* (8th Cir 1992) 973 F2d 1409; *Estate of Leon Holtz* (1962) 38 TC 37, acq 1962-2 Cum Bull 4; Rev Rul 77-378, 1977-2 Cum Bull 347.

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§4.169 b. Transfer by Minor or Incompetent

The effect of a transfer by a minor depends on whether local law gives the minor a power to revoke the gift. If a minor can disaffirm a gift until he or she reaches the age of majority, the gift is incomplete until the minor reaches majority. *Commissioner v Allen* (3d Cir 1939) 108 F2d 961, cert denied (1940) 309 US 680, 84 L Ed 1082, 60 S Ct 718. Family Code §6710 states that a minor can disaffirm a contract.

A transfer by someone adjudicated incompetent is not a gift if state law requires a donor's competency to contract in order to make a valid gift. See *Estate of Mona E. Bettin,* TC Memo 1974-102, aff'd (9th Cir 1976) 543 F2d 1269. A guardian, however, may make a valid gift on behalf of an incompetent by judicial decree. *Commissioner v Greene* (9th Cir 1941) 119 F2d 383, cert denied (1941) 314 US 641, 86 L Ed 514, 62 S Ct 80; Rev Rul 73-612, 1973-2 Cum Bull 322; Rev Rul 67-280, 1967-2 Cum Bull 349. An agent under a durable power of attorney can also have the power to make a valid gift if specifically authorized to do so. Prob C §4264(c); *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345.

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§4.170 4. Transfer Incident to Divorce (IRC §2516)

Transfers of property or interests in property under a written agreement entered into by a husband and wife relative to the settlement of their marital or property rights, or to provide a reasonable allowance for the support of children of their marriage during minority, are considered to be made for full and adequate consideration in money or money's worth, and are therefore exempt from gift tax. However, this rule does not apply to same-sex spouses or registered domestic partners treated as spouses under California law. See §4.41. The spouses must obtain a final divorce decree within the period starting one year before and ending two years after the agreement is made, although it is not necessary that the property be received within that 3-year period. IRC §2516; Treas Reg §25.2516-1.

With property transferred for the benefit of children, only amounts necessary for their support during minority will qualify for the gift tax exemption. Other ways may be available, however, to exclude amounts transferred in excess of that amount from gift tax, such as payments for educational or medical expenses under IRC §2503(e) or by contributions to IRC §529 plans. See §4.175.

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§4.171 5. Annual Exclusion Gifts (IRC §2503(b))

Under IRC §2503(b), the first $12,000 (plus further cost-of-living adjustments after 2007) of gifts to any person, other than gifts of future interests in property, made during a calendar year are not included in the total amount of gifts made during such year. Annual exclusion gifts do not reduce the donor's IRC §2010 applicable exclusion amount for gift or estate tax purposes.

The annual exclusion is not cumulative. Unused amounts may not be carried over to another year. For this reason, an estate planner should regularly communicate early each year with clients who are in a position to make gifts. The exclusion applies to the first $12,000, as adjusted, of gifts made each year. If a client is going to make more than $12,000, as adjusted, worth of gifts in a particular year to a particular individual, and the donor has a preference about which gifts should qualify for the annual exclusion, then those gifts should be made first.

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§4.172 a. Present Interest Requirement

The annual exclusion applies to gifts of present interests and does not apply to gifts of future interests. IRC §2503(b)(1). A present interest is defined as an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)." Treas Reg §25.2503-3(b). A future interest is defined as "a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." Treas Reg §25.2503-3(a). See *Fondren v Commissioner* (1945) 324 US 18, 89 L Ed 668, 65 S Ct 499.

EXAMPLE: Under the terms of a trust, the trustee is directed to distribute trust income to the beneficiary but has discretion to withhold a payment and add such income to trust corpus. The beneficiary's interest is not a present interest, and no annual exclusion is allowable. Treas Reg §25.2503-3(c), Example (1).

Although an outright gift generally constitutes a gift of a present interest, some outright gifts may be gifts of future interests if substantial restrictions are imposed on the donee's ability to enjoy the benefits of the transferred property. See, *e.g.,* Rev Rul 76-360, 1976-2 Cum Bull 298 (gift of non-income-producing stock); *Stinson Estate v Commissioner* (7th Cir 2000) 214 F3d 846 (gift to corporation).

Similarly, gifts of limited partnership interests may not be gifts of present interests if too many restrictions are imposed on the limited partners' rights to obtain economic enjoyment of the partnership interest. See *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664.

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§4.173 b. No Limit on Number of Transferees

There is no limit to the number of annual exclusion gifts a donor may make each year. Thus, a donor with numerous objects of his or her bounty may significantly reduce his or her estate with tax-free transfers. Planning for the systematic use of the annual exclusion can go a long way in reducing transfer taxes for a client, but care must be exercised in designing transactions.

EXAMPLE: A client has four children and six grandchildren to whom the client would like to make gifts. The client could give a total of $120,000 (10 × $12,000) per year free of gift tax. If the client is married, and the client's spouse consents to split gifts under IRC §2513 (see §4.180), the client and spouse could give away $240,000 per year and incur no gift tax. The gifted amount would pass out of the client's estate without gift or estate taxes.

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§4.174 c. Trusts Qualifying for Annual Exclusion Gifts

Gifts to trusts that postpone the beneficiary's enjoyment to a future time usually do not qualify for the annual exclusion. There are three types of trusts, however, that can be used to qualify some or all of the transfers to a trust for the annual exclusion: the "income trust," the "minor's trust" under IRC §2503(c), and the *Crummey* trust under *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. Each one has different features and limitations that must be considered when planning a transfer. See Drafting California Irrevocable Trusts, chap 12 (3d ed Cal CEB 1997).

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§4.175 6. Exclusion for Education and Medical Expenses

Under IRC §2503(e), certain qualified payments made on behalf of an individual for tuition or medical care are excluded from gift tax. This exclusion is not limited in amount. It is available in addition to the annual gift exclusion and without regard to the relationship between the donor and the donee. Treas Reg §25.2503-6(a). For the definition of education and medical expenses, see §§4.176-4.177.

To qualify for the education and medical expenses exclusion, payments must be made directly to the educational or medical institution or service provider. IRC §2503(e)(2). For example, a donor's payment of tuition directly to a university as described in IRC §170(b)(1)(A)(ii) is exempt from gift tax. Treas Reg §25.2503-6(c), Example (1). In contrast, a transfer by a donor to a trust with provisions to use the funds for tuition expenses for a donee is a taxable gift not within the exclusion for education expenses, because the payment was made to the trust rather than directly to the educational institution. Treas Reg §25.2503-6(c), Example (2).

Payments of medical expenses must be paid directly to the medical service provider, not as a reimbursement to an individual who previously paid a medical service provider. Treas Reg §25.2503-6, Example (4).

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§4.176 a. "Education Expenses" Defined

Qualified education expenses include only the tuition expenses of full-time or part-time students paid directly to the qualifying educational institution. Not included are amounts paid for books, supplies, dormitory fees, board, and similar expenses that are not direct tuition costs. IRC §2503(e)(2)(A); Treas Reg §25.2503-6(b)(2). Alternatively, tuition and other expenses may be covered by making annual exclusion gifts to IRC §529 qualified tuition programs.

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§4.177 b. "Medical Expenses" Defined

Qualified medical expenses include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, for the purpose of affecting any structure or function of the body, for transportation primarily for and essential to medical care, and for medical insurance on behalf of an individual. Treas Reg §25.2503-6(b)(3). Medical expenses include payments for acupuncture, and possibly homeopathic treatment, and some forms of cosmetic surgery as long as the surgery also improves the function of the body or has some other medical function such as the diagnosis, cure, mitigation, treatment, or prevention of disease. IRC §§213(d), 2503(e)(2)(B).

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§4.178 8. Marital Deduction (IRC §2523)

An unlimited marital deduction is available for gift transfers of property between spouses who are U.S. citizens under IRC §2523(a). The deduction is not available for gift transfers between same-sex domestic partners treated as spouses under California law. See §4.41. The deduction does not apply to a noncitizen donee spouse, but the annual exclusion amount for gifts under IRC §2503(b) is increased from $10,000 to $100,000, plus cost-of-living adjustments. IRC §2523(i). For taxable years beginning in 2009, the first $133,000 of gifts each year to a spouse who is not a U.S. citizen are excluded from gift tax. Rev Proc 2008-66, 2007-45 Int Rev Bull 1107. The unlimited marital deduction does not apply to transfers of life estates or other terminable interests, unless the transfer is in the form of qualified terminable interest property (QTIP). IRC §2523(b). For a discussion of inter vivos QTIP trusts, see Drafting California Irrevocable Trusts §§2.39-2.39C (3d ed Cal CEB 1997).

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§4.179 9. Charitable Deduction (IRC §2522)

An unlimited gift tax deduction is provided for gifts made to qualified charitable organizations as described in IRC §2522(a). This deduction is similar to the deduction provided for estate taxes under IRC §2055, but organizations to which the transfer can be made and still qualify for the deduction differ.

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§4.180 10. Split-Gift Election (IRC §2513)

If an election is made under IRC §2513, a gift made by a husband or wife to a third party may be considered as made one half by each. This method allows one spouse to use both IRC §2503(b) annual exclusions and IRC §2505 applicable exclusion amounts. The election is not available to same-sex domestic partners treated as spouses under California law. See §4.41. An election covers all gifts made during the calendar period to third parties while the parties are married. Treas Reg §25.2513-1(b). Thus, it is not possible to select some gifts for the election and exclude others made during the same calendar year.

PRACTICE TIP: The split-gift election is not necessary for gifts of community property, because these transfers are treated as coming from each spouse equally. The election is important to consider when a spouse wishes to make a transfer of separate property or in non-community-property jurisdictions.

To qualify for the split-gift election, both spouses must be U.S. citizens or residents and be married when the gift is made. IRC §2513(a). Both spouses must consent to splitting the gift, and the nondonor spouse must sign the donor spouse's gift tax return. IRC §2513(b); Treas Reg §25.2513-2. The election does not apply to gifts made after the consenting spouse's death. IRS Letter Ruling 200408014.

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§4.181 11. Qualified Disclaimers

Qualified disclaimers are a useful estate planning tool to keep assets that the transferee does not want or need out of the transferee's estate and avoid a second taxable transfer of the disclaimed assets. If a qualified disclaimer is made, the person making the disclaimer is treated as if the disclaimed interest had never been transferred to that person. IRC §2518(a). To make a qualified disclaimer, the disclaimer must be in writing and be received by the transferor within 9 months after the later of the date on which the transfer creating the interest is made or the day on which the person disclaiming attains age 21; the person making the disclaimer must not have accepted the disclaimed interest or any of its benefits after age 21; and the interest must pass without any direction on the part of the disclaiming person to someone other than the person making the disclaimer, unless the person making the disclaimer is the surviving spouse (see §14.30). IRC §2518(b). Under Treas Reg §25.2518-2(d)(1), a qualified disclaimer of property cannot be made with respect to an interest in property if the disclaimant has accepted the interest or any of its benefits, expressly or impliedly, before making the disclaimer. Merely taking delivery of an instrument of title, without more, however, does not constitute acceptance. In IRS Letter Ruling 200503024, the IRS permitted a surviving spouse to disclaim various assets of a securities brokerage account despite retitling the account in her own name and performing other acts of ownership. California law does not contain any provision expressly allowing an extension of time for making a disclaimer in the case of a person who is under age 21 at the time of the transfer. Under Prob C §279, the 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 nine 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 appears, 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—would be sufficient to validate a disclaimer for state law purposes even if the disclaimant accepted dividends before age 21.

For transfers made before 1977, the qualified disclaimer rules of IRC §2518 do not apply. Instead, the consequences of the disclaimer are to be determined under Treas Reg §25.2511-1(c)(2), which generally provides that "a refusal to accept ownership does not constitute the making of a gift if the refusal is made within a reasonable time" after knowledge of the transfer (as provided in Prob C §279). Nevertheless, it appears that the IRS is willing to issue rulings concerning such disclaimers based on the current regulations. See, *e.g.,* IRS Letter Ruling 200838026 (minor beneficiary of trust may disclaim interests created before 1977 despite acceptance of benefits; proposed disclaimers will be made within 9 months after attaining age 18, the age of majority). The IRS ruling took the position that a person can disclaim an interest in property without disclaiming another separate interest in the same property. The implicit consequence of that interpretation is that acceptance of discretionary distributions by the beneficiary will not prevent a disclaimer of remainder interests. That conclusion is then bolstered by effectively applying the Treas Reg §25.2518-2(d)(3) rule that "[a]ny action taken with regard to an interest in property by the beneficiary or a custodian" prior to the beneficiary's twenty-first birthday will not be an acceptance by the beneficiary of the interest."

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§4.182 12. Valuation of Gifts

A gift is valued as of the date of the gift. IRC §2512(a). Like the valuation of property for estate tax purposes, the valuation of gifted property is made under the willing-buyer/willing-seller rule discussed in §4.115. One tax advantage of lifetime gifts is that, if fractional interests in an asset are gifted to more than one donee, they are valued separately for gift tax purposes, rather than the entire interest being valued as it would be for estate tax purposes. Thus a minority discount may apply to each fractional interest gifted. *Samuel J. LeFrak,* TC Memo 1993-526. In some cases, discounts for fractional interests in real property are limited to the cost of partition. See, *e.g., Estate of William I. Busch,* TC Memo 2000-3 (10-percent discount for 50-percent interest in potential subdivision land). See also *Stone v U.S.* (ND Cal 2007) 2007-1 USTC ¶60,540, aff'd (9th Cir, Mar. 24, 2009, No. 07-17068) 2009 US App Lexis 6347 (no fractional interest discount allowed for estate's one-half interest in 19 paintings). But see *Estate of John L. Baird,* TC Memo 2001-258, rev'd on other grounds (5th Cir 2005) 416 F3d 422 (60-percent discount for 14/65 interest in Louisiana timberland); *Estate of Eileen Kerr Stevens,* TC Memo 2000-53 (25-percent discount for 50-percent undivided interests in three parcels of commercial property). See also *Temple v U.S.* (ED Tex 2006) 423 F Supp 2d 605 (60-percent discount for 76.6-percent nonmanaging membership interest in LLC that owned and operated ranch property); *J.C. Shepherd* (2000) 115 TC 376, aff'd (11th Cir 2002) 283 F3d 1258 (15-percent discount for undivided interests in real property transferred to partnership).

Special valuation rules apply to certain transfers of interests in property to family members. IRC §§2701-2704. For a discussion of the special valuation rules, see Drafting California Irrevocable Trusts §§2.25-2.30 (3d ed Cal CEB 1997).

A gift of encumbered property is generally valued at the excess of the unencumbered fair market value of the property over the outstanding debt. *Fernie C. Laughinghouse* (1983) 80 TC 425. If property is transferred for less than full and adequate consideration, only the amount that exceeds the consideration paid is included in the amount of the gift. IRC §2512(b).

To establish the value of the gift for both estate and gift tax purposes, the donor must disclose the gift on a gift tax return. The value of the gift is conclusively established if the reported valuation is not challenged by the IRS within the 3-year limitations period, provided there was adequate disclosure of valuation issues on the return. IRC §§2001(f), 6501(c). See §11.19. In some cases, it may be possible to limit the value of the gift by a formula defining the gift as a percentage interest in property with a value as finally determined for gift tax purposes that is equal to the reported valuation. See *McCord v Commissioner* (4th Cir 2006) 461 F3d 614. The donor must be careful, however, to avoid a valuation adjustment clause of the type prohibited by Rev Rul 86-41, 1986-1 Cum Bull 300. See also *Commissioner v Procter* (4th Cir 1944) 142 F2d 824, cert denied (1944) 323 US 756. But see *Estate of Helen Christiansen* (2008) 130 TC 1, suggesting that the Tax Court is now generally inclined to take a narrow view of cases such as *Procter* in which public policy is used as a ground for disregarding clauses that seek to make adjustments in the amounts of property transferred if subsequent proceedings result in findings of larger gifts than intended. For further discussion of this technique, see McCaffrey, *Transferring Hard to Value Assets—Shielding Your Client From Valuation Risk*, Estate Planning 2009, chap 7 (Cal CEB 2009).

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§4.183 13. Filing Gift Tax Return

Gift tax returns must be filed for all taxable gifts no later than April 15 of the year after the calendar year in which the gift was made, unless an extension is granted. IRC §§6019, 6075(b)(1). If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due the next succeeding day that is not a Saturday, Sunday, or legal holiday. See Treas Reg §25.6075-1(d). If the donor dies in the year the gift is made, the return must be filed on the earlier of the estate tax return due date or April 15 of the year after the calendar year in which the gift was made. IRC §§6018, 6075(b)(3); Treas Reg §25.6075-1(b)(2).

The donor has the primary responsibility for filing the return. IRC §6019; Treas Reg §25.6019-1(a). If the donor dies before filing the return, the executor or administrator is responsible for doing so. Treas Reg §25.6019-1(g).

The return must be filed even when no gift tax is payable because of marital or charitable deductions under IRC §2522 or §2523 or because of the application of the unified credit under IRC §2505. Treas Reg §25.6019-1(f). A return need not be filed for annual exclusion gifts under IRC §2503(b), but filing may be desirable to start the running of the statute of limitations on redetermination of the value of the gifts for estate or gift tax purposes. The gift tax return is filed on IRS Form 709.

The taxpayer may apply for an automatic 6-month extension to file a gift tax return by filing IRS Form 8892. IRC §6081(a); Treas Reg §25.6081-1. If an extension is granted for income tax purposes, an extension is also available for gift tax filing. IRC §6075(b)(2); Treas Reg §25.6081-1(a). The taxpayer may receive an automatic 6-month extension for both income and gift tax filing by checking the appropriate box on IRS Form 4868. An extension of the time to file does not extend the time to pay the tax. Treas Reg §25.6075-1(b)(1); Treas Reg §25.6081-1(c).

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VI. GENERATION-SKIPPING TRANSFER TAX

§4.184 A. Purpose of GST Tax

In 1986, Congress enacted the generation-skipping transfer (GST) tax (IRC §§2601-2664) in an effort to simulate the tax results that would occur if family wealth were subject to an estate or gift tax at each generation. The tax scheme identifies situations in which the estate and gift taxes fail to accomplish this objective, defines the taxable events necessary to plug the identified gaps, and then imposes a tax that simulates, with varying degrees of success, either an extra estate tax or an extra gift tax, using the maximum estate tax rate.

NOTE: Unless Congress takes further action, the GST tax will be repealed in 2010 and restored in 2011 with a $1 million inflation-adjusted exemption and rate of 55 percent under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38).

The basic features of the GST tax are discussed in §§4.185-4.188. The different types of generation-skipping transfers are discussed in §§4.189-4.191. Tax calculation and exemptions are discussed in §§4.192-4.197. Other important concepts are introduced in §§4.198-4.205. Separate trust and valuation problems are discussed in §§4.206-4.212. Fundamental GST tax strategies are discussed in §§4.213-4.221. For a comprehensive discussion of the GST tax, see Harrington, Plaine & Zaritsky, Generation-Skipping Transfer Tax: Analysis With Forms (2d ed 2001).

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§4.185 B. Second Tax on Same Transfer

The GST tax is a second transfer tax that is imposed in addition to the estate or gift tax on transfers benefiting "skip persons" (persons assigned to generations two or more below that of the transferor). IRC §§2601, 2611-2613. See §4.203. The tax is imposed when the transfer is considered to occur. See §4.186. Except in the special case of a reverse QTIP election (see §4.214), the GST tax "transferor" is the same person who last made a transfer of the property for estate or gift tax purposes, whether or not any estate or gift tax was actually payable. IRC §2652(a). See §4.202. The GST tax does not apply to transfers before the effective date of the statute. See §4.205.

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§4.186 C. Timing of GST Tax

The GST tax is imposed as soon as all persons having an "interest" in transferred property (defined for all GST tax purposes to mean a *present* interest by which the beneficiary is currently entitled or eligible to receive benefits) are "skip persons." IRC §2613; Treas Reg §26.2612-1(e)(1). Thus, the tax is imposed immediately in the case of a gift or devise to a grandchild, but in the case of a trust that may make distributions to both skip persons and nonskip persons, the GST tax is delayed until the interests of the nonskip persons cease to exist. This occurs with respect to distributed property whenever there is a distribution to a skip person and with respect to undistributed property remaining in trust whenever death or another specified event results in no nonskip persons having a present interest in the trust. See §4.187.

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§4.187 D. Taxable Events

The statute defines three taxable events: direct skips, taxable terminations, and taxable distributions. IRC §2611(a). Direct skips are transfers to skip persons, as defined in IRC §2613, on which GST taxes are imposed at the same time as the estate or gift tax because no nonskip person has a present interest in the transferred property at that time. IRC §2612(c). See §4.186. Examples of direct skips include direct gifts to grandchildren or to trusts benefiting only grandchildren. Taxable distributions occur when there is a distribution from a trust to a skip person. IRC §2612(b). The distribution may be constructive. For example, the lapse of a withdrawal power or other power of appointment may be treated as a taxable distribution. See Treas Reg §§26.2612-1(c)(1), 26.2652-1(a)(5), Example (5). Taxable terminations occur when the interest of the last nonskip person terminates. IRC §2612(a). The effective GST tax rate depends on the taxable event. See §4.188.

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§4.188 E. GST Tax Rates

Assuming that a transfer is not exempt to any extent, the GST tax rate is the maximum estate tax rate imposed on decedents dying in the year of the transfer (45 percent in 2009). IRC §§2001, 2641. If the taxable event is a direct skip, however, the method of computation simulates the imposition of a gift tax, with the rate being applied to the after-tax net amount received by the beneficiary. This "tax-exclusive" method of computation reduces the effective rate to 33.33 percent when the GST tax rate is 50 percent. See §§4.189-4.191.

In all other cases, necessarily involving the existence of a multigenerational trust or trust equivalent (*e.g.,* a legal life estate and a remainder) in which one or more nonskip persons have interests, the taxable events will consist of "taxable distributions" or "taxable terminations." The GST tax on these events simulates imposition of an estate tax, with the GST tax rate being imposed on the entire fund available for both the net gift and the payment of the tax. This "tax-inclusive" computation results in the effective rate being the full GST tax rate.

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§4.189 F. Example of Direct Skip

The points made in §4.188 can be illustrated, in a "direct skip," by the example of a transferor who makes an inter vivos gift to a grandchild or a decedent who makes a bequest to a grandchild. The transfer is subject to a gift tax imposed on a transfer made by a member of the transferor's generation, but no estate or gift tax is ever imposed for the generation of the transferor's child, because no actual transfer is made by a member of that generation. The GST tax addresses this situation by defining a taxable event known as a *direct skip* and imposing a tax that simulates the *gift tax* that would been imposed *on a transfer by the child* if the transferor had first transferred the property to the child and then the child had immediately retransferred the property to the grandchild. The tax will be imposed on the net amount received by the grandchild, which will be 33.33 percent of the fund available to make the gift and pay the tax when the GST tax rate is 50 percent. For example, the GST tax on a $100,000 direct skip is $50,000, which is 33.33 percent of the amount of the gift plus the GST tax on the gift ($150,000). The total transfer tax result depends on whether the direct skip is an inter vivos gift or a transfer at death. See §§4.190-4.191.

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§4.190 1. Inter Vivos Gift

In an inter vivos direct skip, the GST tax is applied in a tax-exclusive manner to the amount of the gift and the gift tax is applied to the amount of the gift *and* to the GST tax under IRC §2515. For example, in an inter vivos direct skip of $100,000, assuming that all exemptions and credits have been used, the total cost of the gift would be $225,000, consisting of the amount of the gift ($100,000) plus the GST tax on the gift ($50,000) plus the gift tax on the gift ($50,000) plus the gift tax on the GST tax ($25,000). This result simulates a $150,000 gift by the transferor with a gift tax of $75,000, followed by a $100,000 gift to the recipient of the direct skip with a gift tax of $50,000. This is the best-case scenario, with both the transfer tax and the GST tax applied in a tax-exclusive manner.

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§4.191 2. Transfer at Death

In a direct-skip transfer at death, the GST tax is applied in a tax-exclusive manner to the amount of the transfer and the estate tax is applied to the fund used to make the transfer and pay the estate tax and GST tax. For example, in a direct skip of $100,000, assuming that all exemptions and credits have been used, the total cost of the transfer would be $300,000, consisting of the amount of the transfer ($100,000) plus the amount of GST tax on the transfer ($50, 000) plus the estate tax on the $300,000 fund used to make the transfer and pay the estate tax and GST tax ($150,000). This result simulates a $150,000 bequest by the transferor with an estate tax of $150,000, followed by a $100,000 gift to the recipient of the direct skip with a gift tax of $50,000. The total cost of the transfer is the same as the cost of an inter vivos gift to a trust followed by a taxable distribution or taxable termination, with the transfer tax applied in a tax-inclusive manner and the GST tax applied in a tax-exclusive manner.

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G. Tax Calculation and GST Exemption

§4.192 1. Tax Calculation Formula

According to the statute, the GST tax is calculated by multiplying the "applicable rate" by the "taxable amount." IRC §2602. Taxable amounts are defined separately for the different types of GST transfers. IRC §§2621-2623. The "applicable rate" is defined as the inclusion ratio multiplied by the maximum federal estate tax rate in effect at the time of the GST transfer. IRC §2641. The next section, IRC §2642, defines "inclusion ratio."

Literally read, the statute provides a system that uses a varying tax rate in the form of an "applicable rate" equal to the maximum federal estate tax rate multiplied by the "inclusion ratio" with respect to the transfer.

Estate planners generally find that it is conceptually much easier to work with the notion that GST trusts may be wholly exempt or wholly nonexempt, or may have exempt and nonexempt fractions, and that for the nonexempt trusts or fractions, the tax is calculated by multiplying the value of the trust or fraction by the applicable tax rate (or by the lower tax-exclusive percentage, if the transfer is a direct skip). Under this conceptual scheme, the "inclusion ratio" becomes the fraction of the trust subject to tax rather than the fraction that correspondingly reduces the tax rate, after the GST exemption is applied. See §4.193.

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§4.193 2. Overview of GST Exemption

Every individual is given a GST exemption. In 2004-2009, the exemption is equal to the applicable exclusion amount ($3.5 million in 2009). IRC §2631. The GST tax does not apply to transfers in 2010. IRC §2664. The exemption functions differently from the applicable exclusion amount and corresponding applicable credit amount, which assure that no estate or gift tax is payable until an individual's transfers exceed the applicable exclusion amount, because any available applicable credit amount is automatically applied to the earliest transfers. IRC §§2010, 2505. In contrast, use of GST exemption is discretionary. IRC §2632. An overview of the exemption allocation rules is provided in §4.194.

The other notable feature of the GST exemption is that allocation of the exemption to transferred property can cause the property to be exempt on a fractional share basis. For example, allocation of the entire $2 million exemption to a $3 million trust will cause the trust to be two-thirds exempt, with the result that only one-third of the property subject to GST tax events will be subject to the GST tax. The term "inclusion ratio," in substantive effect, designates the fraction of the trust that is subject to tax. This is calculated after first computing the "applicable fraction" (or exempt fraction) and subtracting the exempt fraction from one to determine the nonexempt fraction or inclusion ratio. IRC §2642(a)(1). The numerator of the fraction is the amount of the GST exemption applied to the transferred property and the denominator is the value of the property on the effective date of the allocation. IRC §2642(a)(2). The inclusion ratio of a trust may change if property is added to the trust or more exemption is applied to the trust. See §4.198.

For reasons discussed in §4.206, the estate planner must be careful to avoid creating trusts that are only partially exempt. If the amount transferred exceeds the remaining GST exemption, separate trusts should be created so that one is fully exempt and the other is fully nonexempt. Existing trusts with an inclusion ratio of more than zero and less than one may be severed into two (or more) trusts, one with an inclusion ratio of zero and one (or more) with an inclusion ratio of one, under IRC §2642(a)(3). See §4.212.

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§4.194 3. GST Exemption Allocation Rules

The GST exemption allocation rules, which allow an individual to allocate his or her IRC §2631 GST exemption at any time on or before the due date for filing the individual's estate tax return, are included in IRC §2632. Unless an election is made not to allocate the GST exemption, a transferor's GST exemption is automatically allocated to direct skips made during life (IRC §2632(b)) and then to indirect skips to GST trusts, as defined, made during life (IRC §2632(c)) and, at death, first to direct skips occurring at the individual's death and then to trusts with respect to which the individual was the transferor and from which a taxable termination or taxable distribution could occur at or after the individual's death (IRC §2632(e)). The individual may elect automatic allocation to transfers made during life to trusts that are not GST trusts (IRC §2632(c)), and the transferor or personal representative of the transferor's estate may allocate an exemption to any transfer made during life or at death to which automatic allocation does not apply (IRC §2632(a), (d)). Relief provisions allow late timely allocations and elections before and after death. See §4.197.

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§4.195 4. Allocating Exemption to Lifetime Direct Skips

The simplest form of GST exemption allocation involves lifetime direct skips, such as outright gifts to grandchildren. Transfers to trusts may also be direct skips if the trust has no nonskip person beneficiaries. IRC §2612(c). See §4.187. To the extent the transferor has remaining GST exemption available, the law provides for automatic allocation of enough exemption to give the direct skip an inclusion ratio of zero, thereby making the transfer wholly exempt. IRC §2632(b)(1). The transferor may, however, elect out of the automatic allocation for direct skips on a timely filed gift tax return, although such elections are unusual. IRC §2632(b)(3). See §4.196. The automatic allocation to direct skips is effective on the date of the gift, and the property is valued as of that date for inclusion ratio determination purposes. Automatic allocations to direct skips and elections out of the automatic allocation are irrevocable after the due date of the gift tax return on which the transferor might have elected out of the automatic allocation or made the election. Treas Reg §26.2632-1(b)(1). The IRS may grant extensions of time to make automatic allocation elections in appropriate circumstances. IRC §2642(g)(1). See §4.197.

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§4.196 5. Allocating Exemption to Other Lifetime Transfers

Lifetime transfers that are not direct skips include (1) transfers to trusts benefiting both skip and nonskip persons (*e.g.,* children and their issue) and (2) transfers to nonskip persons for life (or term of years, etc.) with remainder to skip persons (*e.g.,* transfer of Blackacre to child for life, with remainder to grandchild). Allocations of GST exemption to lifetime transfers other than direct skips are divided into two categories: "timely" and "late." Timely applications are *always* made by appropriately completing IRS Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, including the attached notice of allocation, and filing the return on or before the date required for reporting the transfer if it were a taxable gift. Treas Reg §26.2632-1(b)(4)(ii). Form 709 is used even if the transferor dies shortly after the gift and the allocation is made by the personal representative of the transferor's estate. Allocation on a late IRS Form 709 may be accomplished by the transferor or the personal representative of the transferor's estate. The personal representative has the alternative of making the late allocation on IRS Form 706 if the personal representative is confident that it is not necessary for the allocation to be effective before the estate tax return can be filed. Treas Reg §26.2632-1(d)(1). As for a timely allocation, a late allocation can be made according to a formula that allocates the amount of exemption necessary to reduce the inclusion ratio to zero. Treas Reg §26.2632-1(b)(4)(i).

Automatic allocation may apply to transfers to trusts, which may include a life estate with remainder under IRC §2652(b), and the transferor may elect automatic allocation or elect to have automatic allocation not apply. IRC §2632(c); Treas Reg §26.2632-1(b)(1). Either election may be made on a timely filed gift tax return for the first transfer to the trust or any later transfer. Generally, the statement attached to the return must identify the trust in question (or the separate share that is treated as a separate trust for GST tax purposes), and specifically describe or otherwise clearly identify the transfers to be covered by the election. Treas Reg §26.2632-1(b)(3). Once an election is made, deemed allocation will apply or not apply to any transfer or transfers to the trust for which the election is made. Treas Reg §26.2632-1(b)(2). Choices concerning deemed allocation can be changed, but the changes will not be retroactive. Relief from late elections may be allowed under IRC §2642(g). See §4.197.

For a discussion of the applicable rules, see California Estate Planning §§11.16-11.26 (Cal CEB 2002).

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§4.197 6. Exemption Allocation Relief Provisions

Provisions in IRC §2642(g) allow relief for inadvertent late allocations or elections and statutorily introduce the concept of substantial compliance into the arena of GST exemption allocations. Internal Revenue Code §2642(g)(1)(A) directs the Treasury Secretary to issue regulations to prescribe circumstances and procedures for extensions of time to make allocations of GST exemption described in IRC §2642(b) and allocation elections provided in IRC §2632(b)(3) or §2632(c)(5). The time for making the allocations and elections will be treated as not prescribed by statute, with the result that the allocations and elections will be eligible for discretionary relief under Treas Reg §301.9100-3. IRC §2642(g)(1)(B).

Internal Revenue Code §2642(g)(2) provides:

An allocation of GST exemption under [IRC §]2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances shall be taken into account, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant.

Notice 2001-50, 2001-2 Cum Bull 189, provides that the methods generally used for seeking relief under the statute are those provided under the regulation. As a practical matter, this provision usually means that relief must be sought under Treas Reg §301.9100-3 through a procedure that combines the specific requirements of the regulation with the more general requirements for applying for a private letter ruling. The IRS has issued proposed regulations that contain rules and procedures for seeking and granting relief that more specifically address the relevant issues than the regulations on applications for extension of time. The basic application procedure will continue to be applying for a private letter ruling. Prop Treas Reg §26.2642-7; REG-147775-06, 2008-19 Int Rev Bull 916. Fortunately, the IRS has been generous in granting relief in a wide variety of circumstances. See, *e.g.*, IRS Letter Rulings 200316031, 200245018, 200243042. If no gift tax return was required for gift tax purposes for the year or years for which relief was sought because the transfers were fully excluded from taxable gifts by the IRC §2503(b) annual exclusion, the application is made by attaching a notice of allocation to a gift tax return for the year of the transfer. Rev Proc 2004-46, 2004-2 Cum Bull 142.

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H. Other Important GST Tax Concepts

§4.198 1. Changing Inclusion Ratios

Generally, the inclusion ratio for a trust can change in two ways: (1) The transferor may add property to the trust; or (2) the transferor may apply additional GST exemption to the trust. IRC §2642. See §4.193. Distributions, whether of income or principal, do *not* cause a change in the ratio. Similarly, income accumulations and changes in asset values do not affect the inclusion ratio. Treas Reg §26.2642-4. (Remember, under the literal language of the statute, the inclusion ratio actually affects the tax rate, and there is no reference to a "nonexempt" trust share. IRC §2641. See §4.192.) The rules and regulations about this are complex, but they always follow a logical pattern consistent with the following scenario.

EXAMPLE: Settlor creates a non-GST trust, funds it with $50,000, and makes an allocation of $40,000 of GST exemption to the trust on a timely gift tax return. As a result, the initial inclusion ratio is 1:5. (Literally, the inclusion ratio is one minus the applicable fraction. The numerator of the applicable fraction is $40,000 and the denominator is $50,000.) Over the next year, the trust assets appreciate 20 percent to $60,000, but the inclusion ratio does not change. As a result, the values of the exempt and nonexempt shares also increase 20 percent to $48,000 and $12,000 respectively. At that point, the settlor adds $20,000 to the trust, but does not make a timely allocation of exemption, which increases the value of the nonexempt share to $32,000 and increases the value of the total trust to $80,000. The new inclusion ratio is 2:5 ($32,000 divided by $80,000). If the settlor now wishes to make the trust fully exempt, this can be accomplished by allocating an additional $32,000 of GST exemption to the trust.

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§4.199 2. Limited Annual Gift Tax Exclusion

The gift tax provides an annual exclusion of $13,000 (plus cost-of-living adjustments after 2009) per donor per donee per calendar year. IRC §2503(b). The GST tax incorporates the annual exclusion on a limited basis by providing that the inclusion ratio for the transferred property is zero except in specified situations. Under IRC §2642(c), the annual exclusion from GST tax is available if:

- The transfer qualifies for the gift tax annual exclusion; and
- The transfer has only one beneficiary.

Satisfying the second requirement necessarily means that the transfer will be a direct skip. IRC §2612(c). See §4.187.

A transfer to a trust meets the requirement if the trust has only one beneficiary during the beneficiary's life and any trust assets remaining at the beneficiary's death must be included in the beneficiary's estate for estate tax purposes. Such a trust is often called a "vested interest trust" and most obviously includes custodianships and IRC §2503(c) trusts for minors.

The planning significance of these rules is that there is no annual exclusion for GST purposes for the typical *Crummey* trust having more than one beneficiary, including the typical life insurance trust. If the trust is not a GST trust to which an automatic allocation of the GST exemption will be made, these trusts will not be exempt from GST tax unless automatic allocation is elected or the GST exemption is allocated by filing a gift tax return. Thus, it may be necessary to file a gift tax return for GST tax purposes even if the transfers are completely excluded for gift tax purposes. For discussion of the serious problems the GST tax poses for life insurance trusts and other irrevocable trusts that rely on the use of *Crummey* clauses to multiply annual gift tax exclusions, see McCaffrey, *Drafting and Planning to Minimize the Generation-Skipping Transfer Tax*, Estate Planning 2005, chap 3 (Cal CEB 2005).

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§4.200 3. Educational and Medical Expenses Exclusion

The GST tax is not imposed on payments of educational and medical expenses that would not be treated as taxable gifts under IRC §2503(e) if made by inter vivos gift. IRC §2611(b). Thus, the GST tax exclusion for such expenses is actually broader than the gift tax exclusion, because it applies not only to inter vivos gifts but also to trust distributions. 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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§4.201 4. Broad Definition of "Trust"

Under IRC §2652(b)(1) and Treas Reg §26.2652-1(b), a "trust" includes "any arrangement (other than an estate) that has substantially the same effect as a trust." Thus, for example, arrangements involving legal life estates and remainders, estates for years, and insurance and annuity contracts are trusts. So are custodianships for minors. The regulation also provides, somewhat dubiously and by negative implication, that a testamentary transfer may create a trust if the identity of the transferee is contingent on an event that is not certain to occur within 6 months before death. Treas Reg §26.2652-1(b)(1)-(2), Examples (2)-(3).

EXAMPLE: Under the regulation, a transfer to a child, *C,* if she survives 6 months and otherwise to her issue, will result in a *direct skip* to *C*'s issue if *C* dies before 6 months; but if the contingency period exceeds 6 months, the result would be that a trust was created for the survival period and that a *taxable termination* will occur if *C* dies during that period. See §4.187.

As discussed in §4.207, it is generally best to use a 90-day survival period to meet the requirements of Treas Reg §26.2612-1(a)(2)(i), which treats a living descendant who within 90 days after the transfer as having predeceased the transferor, with the result that the predeceased ancestor rule may apply to step up a generation and avoid a direct skip.

Under the express language of IRC §2652(b)(1), an "estate" is not a trust, nor is a revocable trust that is treated as part of the estate under IRC §645.

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§4.202 5. Identifying GST Transferor

The general rule is that the GST tax "transferor" of property is the person who is treated as having most recently made a transfer of the property for purposes of the estate or gift tax. IRC §2652(a). This person includes a deceased beneficiary of a prior transfer who held a general power of appointment under IRC §2041, the spouse of a donor who consents to a split gift under IRC §2513 (Treas Reg §26.2652-1(a)(5)), or the beneficiary spouse in the case of a transfer for which a QTIP election is made under IRC §2056(b)(7).

Under this general rule, a single trust may have multiple transferors for GST tax purposes, and the transferors' identities may change from time to time. If the transferor's identity changes, no further GST taxable events can occur with respect to the original transferor under IRC §2612, and the GST exemption allocation by the original transferor under IRC §2632 expires. The new transferor may allocate the GST exemption to the new transfer, and generation assignments will be measured by reference to the new transferor. See §§4.186-4.187, 4.203. In some situations, the original transferor may be reassigned to a lower generation. See §4.204.

There is an important exception to the general transferor rule, called the "reverse QTIP election," which is relevant only in QTIP trust situations. See §4.214.

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§4.203 6. Generation Assignments

The IRC §2651 generation assignment rules used to determine whether a transfer is made to a skip person under IRC §2613 (see §4.185) are fairly straightforward:

- **Close relatives.** The generation assignments of close relatives (descendants of grandparents of the transferor and the transferor's spouse or former spouse) are measured in the usual way. IRC §2651(b). A person who marries someone on this broad family tree also joins the family tree. IRC §2651(c). For these purposes, however, close relatives do not include same-sex domestic partners treated as spouses under California law. See §4.41.

- **Other persons.** Except for close relatives, persons more than 12 1/2 years younger than the transferor are assigned to the generation one level below the transferor; persons more than 37 1/2 years younger are two generations below the transferor; and persons more than 62 1/2 years younger are three generations below. IRC §2651(d).

- **Charities.** Charities are assigned to the generation of the transferor. The unpleasant consequence is that a transfer to a trust with a charitable beneficiary cannot be a direct skip. IRC §2651(f)(3).

- **The deceased ancestor rule.** Under IRC §2651(e), if a person is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and the parent of that person who is also such a descendant is dead at the time of a transfer, that person is reassigned to the generation of the deceased parent, with each descendant of that person also moving up one generation. The rule does not apply to nieces, nephews, or their descendants unless the transferor has no lineal descendants at the time of the transfer.

- **The deceased ancestor 90-day grace period.** The scope of the deceased ancestor rule is expanded by Treas Reg §26.2651-1(a)(2)(iii), which provides that a living descendant who dies within 90 days after the transfer is treated as having predeceased the transferor. The living descendant must in fact die within the period, not merely be treated as dead under a state disclaimer statute. The 90-day grace period does not apply if the dying descendant unconditionally acquires ownership of the transferred property within that period, but a disclaimer may be used retroactively to meet this requirement. In the event a transfer is subject to estate or gift tax more than once, the relevant date for determining generation assignments under the deceased-ancestor rule is the date of the first transfer. (If, for example, a 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.) Treas Reg §26.2651-1(a)(3). Many practitioners believe that, in drafting dispositive provisions for large estates, the drafter should make transfers to issue subject to a 90-day survival requirement. They point out that the theoretical possibility of a disclaimer by the deceased descendant's personal representative will often be illusory under IRC §2518 if the disclaimer would change the recipient of the property (*e.g.*, cause the property to pass to issue rather than the deceased descendant's spouse). In this situation a disclaimer might violate the fiduciary duties the personal representative owes to the beneficiaries of the estate.

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§4.204 *7.* Multiple Skips

Although only one GST tax is imposed on direct skips for any single taxable event, regardless of the number of generations skipped, the GST tax statute generally attempts to impose a tax at each generation for which no estate or gift tax is imposed. Thus, a nonexempt trust that results in no estate or gift tax at two generations will frequently (but not always) trigger two GST taxes. The statute accomplishes this by providing that if property is still held in trust after a transfer, the GST tax still applies to subsequent transfers, but the transferor is reassigned to the first generation above the highest generation, as determined under IRC §2651 (see §4.203), of any person having an interest in the trust. IRC §2653(a).

EXAMPLE 1: Transferor, *T,* makes a transfer in trust for child, *C,* for life, remainder in trust for grandchild, *GC,* for life, with remainder to *GC*'s issue. When *C* dies there is a taxable termination, tax is paid, and *T* is reassigned to *C*'s generation. As a result, *GC* is no longer a skip person, and distributions to her after the reassignment are not taxable, but a taxable termination will occur at *GC*'s death. Better results are achieved in Example 2.

EXAMPLE 2: Transferor, *T,* makes a transfer to a trust for grandchild, *GC,* for life, with remainder to *GC*'s issue. There is an immediate GST tax on the direct skip and *T* is immediately reassigned to child, *C*'s, generation. In this scenario, distributions to *GC* are not taxable distributions, because *GC* is only one generation below *T*, but a taxable termination will occur at *GC*'s death. This result is better than the result in Example 1, because the initial transfer is a direct skip. See §4.188. Even better results are achieved in Example 3.

EXAMPLE 3: Transferor, *T,* makes a transfer to a trust for great-grandchild, *GGC,* for life, with remainder to *GGC*'s issue. In this scenario, there is immediate GST tax on the direct skip, but distributions to *GGC* are not taxable distributions and a taxable termination will not occur until *GGC*'s death, because *T* is immediately reassigned to grandchild, *GC*'s, generation. *C* and *GC* will pay no estate or gift tax on the trust, because *C* and *GC* have no interest in the trust. Thus, no further transfer tax will occur during *C*'s lifetime or at *C*'s death, or during *GC*'s lifetime or at *GC*'s death. Under the "present interest" rule, these results would also occur if the trust allows distributions only to *GGC* for the first few years and then allows discretionary distributions to *C* and *GC*.

As a practical matter, planners generally should avoid creating nonexempt trusts that will result in multiple skips. The cycle can be broken by giving grandchildren (or great-grandchildren) general powers of appointment that cause trust property to be included in their estates, thereby offering the possibility of tax rates less than the maximum federal estate tax rate applicable for GST tax purposes.

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§4.205 8. Grandfathered Transfers

The GST tax was enacted as part of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085). The legislation included transition rules that generally avoided retroactive taxation of transfers made before October 22, 1986 (September 25, 1985, for inter vivos transfers) and provided protection for later transfers under dispositive terms that could not be amended owing to incompetence of the transferor on that date. The IRS has issued regulations applying the transition rules. See Treas Reg §26.2601-1. Details of these provisions are beyond the scope of this chapter, but counsel is warned to exercise extreme care when engaging in transactions involving grandfathered trusts that are not subject to GST tax under these rules. Problems can be caused by actual or constructive additions to these trusts, amendments to trusts, and even exercises of limited (nongeneral) powers of appointment in some exceptional circumstances.

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I. Separate Trust and Valuation Problems

§4.206 1. Need for Separate Trusts

As noted in §4.193, a fundamental strategy of GST tax planning is that transferred property should always be completely exempt from GST tax (with an inclusion ratio of zero) or completely nonexempt (with an inclusion ratio of one). In ideal circumstances, the dispositive terms would provide for the exempt property to be transferred to or for the benefit of skip persons while the nonexempt property would be transferred to or for the benefit of nonskip persons.

The obvious prerequisite of this strategy is that the transfers receiving the GST exemption must be clearly separate from the other transfers. Problems one must avoid in this area are illustrated by the following examples from Treas Reg §26.2654-1(a)(5):

EXAMPLE 1: Separate shares as separate trusts. Transferor, *T,* transfers $100,000 to a trust under which income is to be paid in equal shares for 10 years to *T*'s child, *C*, and *T*'s grandchild, *GC* (or their respective estates). The trust does not permit distributions of principal during the term of the trust. At the end of the 10-year term, the trust principal is to be distributed to *C* and *GC* in equal shares. The shares of *C* and *GC* in the trust are separate and independent and are therefore treated as separate trusts. The result would not be the same if the trust permitted distributions of principal unless the distributions could be made only from a one-half separate share of the initial trust principal, and the distributee's future rights with respect to the trust are correspondingly reduced. *T* may allocate part of *T*'s GST exemption under IRC §2632(a) to the share held for the benefit of *GC*.

EXAMPLE 2: Separate share rule inapplicable. The facts are the same as in Example 1, except that the trustee holds the discretionary power to distribute the income in any proportion between *C* and *GC* during the last year of the trust. The shares of *C* and *GC* in the trust are not separate and independent shares throughout the entire term of the trust and, therefore, are not treated as separate trusts.

In Example 1, note that the IRS correctly concludes that there are really two separate $50,000 trusts. The happy result for GST tax purposes is that only $50,000 of GST exemption must be allocated to the grandchild's "trust" to produce a zero inclusion ratio. In contrast, in Example 2, there is only one trust and it will be necessary to use $100,000 of exemption to fully exempt the trust and thereby avoid GST tax on each and every trust distribution to *GC.*

The important point here is that GST tax-sensitive estate plans should be drafted so that the issues raised by these examples will not arise. Even in Example 1, which produces a favorable result, the drafter would have been much better off designing one trust for the skip person and a different trust for the nonskip person. Requirements for creation of separate trusts at death are discussed in §4.207.

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§4.207 2. Separating Transfers at Death

One of the less than fully resolved theoretical problems of the GST tax involves the question of when trusts are created for GST exemption allocation purposes when the transferred property is included in the transferor's estate. This is particularly a problem with a revocable trust, because such a trust is susceptible to the contention that it is a single trust for GST tax purposes. See Treas Reg §26.2654-1(a)(5), Examples (3)-(4). Such a contention, if successful, would result in the settlor's GST exemption being diluted by the value of the entire revocable trust estate, an obviously absurd result. Fortunately, the IRS appears to be concerned about this problem only with pecuniary gifts, as discussed in §4.208. Nevertheless, discretion being the better part of valor, readers are cautioned by the following:

- Do not structure dispositive provisions in a will or revocable trust in a way that expressly provides that the required distributions do not occur at death. This advisory prohibition includes not using the common, but unnecessary, revocable trust provision authorizing the trustee to delay distributions for a period of administration.

- Use a 90-day survival period for gifts to issue because, under Treas Reg §26.2612-1(a)(2)(i), a living descendant who dies no later than 90 days after the transfer is treated as having predeceased the transferor. See §4.203. For transfers that would not qualify for the predeceased ancestor rule, do not make a transfer to a skip person or to a trust for skip persons (or any other disposition indirectly affecting the size of such transfers) using a survival period of more than 6 months. Treas Reg §26.2652-1(b)(1)-(2), Examples (2)-(3). See §4.201.

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§4.208 3. Separate Share for Pecuniary Amount

Probably incorrectly, the separate share regulations provide that, in specified circumstances, a pecuniary amount payable out of a revocable trust may not result in the pecuniary amount's being treated as a separate share of the trust and thus not as a separate trust. Treas Reg §26.2654-1(a)(1)(ii). This would cause an additional and much more serious penalty for failure to draft and administer pecuniary gifts in the manner provided under the safe-harbor rules or another alternative allowed by the regulations. See §4.209.

For example, if a pecuniary amount generation-skipping gift was payable from a trust with a value greater than the transferor's remaining GST exemption and the pecuniary gift was not treated as a separate trust, it would be impossible to reduce the gift's inclusion ratio to zero even if the entire remaining GST exemption was allocated to the larger trust. Fortunately, none of this is a problem as long as: (1) The pecuniary amount is entitled to appropriate interest as defined in Treas Reg §26.2642-2(b)(4)(i) (see §4.211); or (2) the entire payment is made within 15 months of the transferor's death as provided in Treas Reg §26.2642-2(b)(4)(ii).

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§4.209 4. Separating and Valuing Pecuniary Gifts

Planners and the IRS have long understood that pecuniary gifts can be structured in ways that can result in the pecuniary gift having a true value that is more or less than the stated dollar amount. This in turn can result in different values for a residuary gift that follows a pecuniary gift. Thus, for example, the true value of a pecuniary gift changes depending on when it is paid and the rights of the recipient to receive interest in the event of delay.

Then there is the strategy that caused the IRS to issue Rev Proc 64-19, 1964-1 Cum Bull 682, applicable to marital deduction gifts. This manipulative strategy involved giving the executor the power to fund the pecuniary gift in kind using federal estate tax values and without requiring the executor to be fair in allocating subsequent asset appreciation and depreciation. This strategy allegedly allowed an executor to allocate asset appreciation and depreciation in a disproportionate way to favor either the pecuniary gift or the residuary gift. For example, each beneficiary might receive property with a date-of-death value of $100, but the favored gift would be funded with assets that had appreciated to $200, while the disfavored gift would be funded with assets that had no appreciation.

With the GST tax, manipulations of the values of pecuniary gifts and the residues remaining after distribution of the pecuniary gifts are restricted by penalty rules that increase the value of the *applicable fraction* denominator for the gift, thereby increasing the amount of GST exemption that must be applied to the gift in order to achieve the desired inclusion ratio of zero. See Treas Reg §26.2642-2. For example, the denominator for a pecuniary gift might be increased to the date-of-distribution value of the assets used to satisfy the gift rather than the stated pecuniary amount. Counsel should avoid such undesirable increases to the denominator value by following some simple safe-harbor rules. See §4.210.

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§4.210 5. Basic Safe-Harbor Rules

Although the regulations offer drafters additional options, it is generally sufficient to know that they permit using estate tax values when computing the inclusion ratios for pecuniary gifts and residues if these rules are followed (Treas Reg §26.2642-2(b)(2)-(3)):

- The pecuniary gift either must be paid or set aside within 15 months or must bear "appropriate interest" (see §4.211); and
- If the pecuniary gift can be satisfied in kind using something other than the date-of-distribution value, the assets distributed in satisfaction of the pecuniary gift must "fairly reflect net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made."

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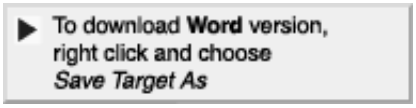
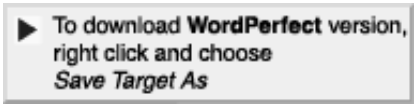
§4.211 6. Form: Appropriate Interest





4.211-1 Appropriate interest

***Appropriate Interest*. This gift shall bear interest from the date specified under applicable law (and, if none, from the date of the settlor's death) to the date of payment. The interest rate shall be at the statutory rate applicable to pecuniary bequests under state law governing the administration of this trust or, in the absence of such statutory rate, at 80 percent of the rate applicable under Internal Revenue Code §7520, or successor provision, at the date of the settlor's death.**

Comment: The "appropriate interest" requirement (see §4.210) can be satisfied in various ways, but the simplest is to pay interest on the pecuniary amount in accordance with state law. Treas Reg §26.2642-2(b)(4)(i). California requires payment of interest on distributions of pecuniary amounts made more than 1 year after death for both estates and trusts unless the will or trust provides otherwise. Prob C §§12001, 12003, 16340(b). Thus, the appropriate interest requirement will be met in any case in which California law applies to the postdeath administration of a will or trust unless the drafter inserts a provision overriding the applicable statute.

If state law does not provide an interest rate (as might happen if a client moved to another state), the instrument must provide for payment of interest of at least 80 percent of the IRC §7520 rate in effect on the date of death. Treas Reg §26.2642-2(b)(4)(i). The risk that the client will die domiciled elsewhere can be addressed either by relying on the provision that permits compliance with the "appropriate interest" rule by making the distribution within 15 months, or by adding this clause.

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§4.212 7. Trust Severance Provisions

If the governing instrument provides for the mandatory severance of a single trust into separate trusts upon the occurrence of a future event not within the discretion of the trustee or another person, and the resulting trusts are recognized as separate trusts under applicable state law, then each resulting trust is treated as a separate trust. Treas Reg §26.2654-1(a)(iii). If a client dies and it is unclear whether the dispositive instrument creates the desired separate trusts (see §4.206), it may still be possible to create them. Under IRC §2642(a)(3), a trust may be severed by any means available under the governing instrument or local law if the single trust is divided on a fractional share basis and the terms of the new trusts, in the aggregate, provide for the same succession of interests of the beneficiaries as are provided in the original trust. Detailed requirements for a qualified severance are provided in Treas Reg §26.2642-6(d). If the single trust has an inclusion ratio of more than zero and less than one, the trust must be divided into two sets of trusts, one (or more) trusts having a fractional share of the total value of the trust assets in the aggregate equal to the applicable fraction of the single trust, each of which will have an inclusion ratio of zero, and one having the rest of the trust assets, which will have an inclusion ratio of one—usually the desired outcome of trust severance. Trusts resulting from a nonqualified severance are treated after the date of severance as separate trusts each with the same inclusion ratio as the original trust. Treas Reg §26.2642-6(h). In view of this rule, it is generally desirable for revocable trusts to contain a general authorization to sever trusts into separate trusts. The same is true for wills that create trusts. For sample forms, see §17.19.

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J. GST Tax Strategies

§4.213 1. Fundamental GST Planning Strategies

Just as estate and gift tax planning involves making maximum use of gift tax exclusions and the unified credit (IRC §§2010, 2505), GST tax planning involves making maximum use of the GST tax exclusions and the GST exemption (IRC §2631).

The fundamental strategies for *maximum* use of GST exemptions are:

- **Make excluded gifts.** The client should immediately begin giving each of his or her skip person descendants maximum IRC §2503(b) annual exclusion gifts ($13,000 in 2009). These gifts can be made in trust as long as each trust has only one beneficiary, each gift qualifies for the annual gift tax exclusion, and the trust is taxable in the beneficiary's estate if he or she predeceases its final distribution. IRC §2642(c).

- **Pay tuition and medical expenses.** The client should immediately begin paying the gift-tax-excluded tuition and medical expenses of these skip persons. IRC §2611(b). See §4.200.

- **Transfer of GST exemption amount.** The client should consider the immediate creation of a GST-exempt trust in the amount of the client's remaining GST exemption, even if doing so will require immediate payment of gift tax to the extent of the difference between the client's applicable gift tax exclusion and the remaining GST exemption. In this respect it is important to remember that, under time value of money principles, apart from the hazards of investment choices, a gift today is always more valuable than a gift in the future. Of course, the advisability of making maximum use of GST exemption must be assessed in the context of the possibility of repeal of estate and GST taxes and the continuing applicability of gift taxes.

- **Do not give exempt property to nonskip persons.** To the greatest extent possible, GST tax-exempt funds should be used exclusively for the benefit of skip persons, transfers to whom would otherwise be subject to GST tax.

- **Skip more than one generation.** The GST-exempt trust should be designed in a manner that permits avoidance of transfer tax at more than one generation—not just the children's generation. This can be accomplished with flexible distribution provisions and limited powers of appointment. For example, each child or grandchild can be given a limited testamentary power of appointment that has the effect of giving the holder the choice of making outright distributions to the next generation or continuing the trust, thus making it possible to preserve the trust for the perpetuities period without forcing that result. IRC §2653(a). See §4.204.

- **Delay the interest of higher generation beneficiaries.** Because the GST tax sometimes ignores the interests of persons not having current distribution rights, it can sometimes be advantageous to create a trust that does not allow distributions to older beneficiaries during its first few years of operation. IRC §2652(c).

For clients who do not use all of their GST exemption before death, a reverse QTIP election often may be a useful strategy. See §4.214.

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§4.214 2. Reverse QTIP Election Strategy

A typical estate plan for a married couple establishes a bypass trust in the amount of the decedent's remaining applicable exclusion amount, with the value of the property passing to the bypass trust being determined by a marital deduction formula. See chap 11. In some cases, the bypass trust will be a generation-skipping trust and the value of the property passing to the bypass trust will not significantly exceed the deceased settlor's remaining GST exemption. In those cases, the deceased settlor's remaining GST exemption is allocated to the bypass trust and no further action is necessary.

But in other cases, the amount of the deceased settlor's remaining GST exemption may be significantly greater than the value of the bypass trust. This occurs, for example, when the estate plan provides for transferring a portion of the decedent's property to children or other nonskip persons. The marital deduction formula takes these transfers into account and shrinks the size of the bypass trust to the extent necessary to avoid imposition of estate tax. In the absence of further planning, the extra GST exemption is simply lost.

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§4.215 3. Effect of Reverse QTIP Election

The reverse QTIP election strategy discussed in §4.214 makes use of IRC §2652(a)(3), which provides that, if a QTIP election is made for an eligible trust under IRC §2056(b)(7) (or the gift tax equivalent in IRC §2523), the executor or donee-spouse can make a separate election to treat the QTIP property for purposes of the GST tax as if the QTIP election had not been made. If an IRC §2652(a)(3) reverse QTIP election is made, the original transferor will remain the GST tax transferor notwithstanding the fact that the trust is taxed in the estate of the beneficiary spouse. If a reverse QTIP election is made for the entire QTIP trust, the beneficiary spouse cannot apply GST exemption to any portion of the trust even if the trust is later divided into fully exempt and nonexempt trusts because the original transferor had insufficient remaining GST exemption to fully exempt the entire QTIP trust. See IRS Letter Ruling 200508001.

The result of such an election is that the surviving spouse does not later become the GST tax transferor of the trust before any generation-skipping transfers are possible (as is otherwise the case when a QTIP trust is included in the surviving spouse's estate under IRC §2044). Thus, it may become useful to apply the deceased spouse's GST exemption to the reverse QTIP trust, even though the reverse QTIP trust wastes valuable GST tax-exempt property because of the QTIP requirement that the trust pay all income to the surviving spouse. In the relatively common situation in which no large taxable gifts have been made, estate planners will need to weigh the costs of establishing a separate exempt QTIP trust to protect this amount from the GST tax, particularly if that amount is intended primarily to pass to children at the death of the surviving spouse. See §4.216.

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§4.216 4. Separating Reverse QTIP Trust

Two significant problems arise in designing reverse QTIP trusts. The first is that the reverse QTIP election must be made on an "all or nothing" basis for any particular trust. It is generally undesirable to apply the remaining GST exemption to a much larger QTIP trust, resulting in an inclusion ratio of more than zero. To avoid this result, it is necessary to create a separate trust that will have a value equal to the amount of GST exemption allocated to it. See §4.217. The second problem is the need to avoid having that trust burdened with the estate tax that will be imposed when the trust is included in the estate of the surviving spouse under IRC §2044. See §4.220.

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§4.217 5. Discretionary Reverse QTIP Trust

Creating a separate reverse QTIP trust as discussed in §4.216 is particularly difficult because it is often impossible to know in advance how much of the GST exemption will be available. The amount of available exemption will be unknown whenever there is uncertainty regarding the actual value of inter vivos gifts that received automatic allocations of the GST exemption or intentional formula allocations of "whatever it takes to produce an inclusion ratio of zero." The amount also will depend on whether administration expenses are deducted on the income tax return or the estate tax return. If they are deducted on the income tax return, the value of the bypass trust is reduced. This lowers the amount of the GST exemption needed to produce a zero inclusion ratio for the bypass trust and increases the amount available for the reverse QTIP trust. One common approach to carving out the reverse QTIP trust is simply to authorize, but not compel, an actual severance of a larger QTIP trust as allowed by IRC §2642(a)(3). See §4.212. This severance strategy can be used even when the original drafter of the estate plan failed to provide for a reverse QTIP trust. Assuming that the creation of the trust is planned, the dispositive instrument should expressly authorize the severance to avoid a reformation proceeding. For a form of authorization, see §4.218. In some situations, however, a mandatory reverse QTIP trust should be considered. See §4.219.

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§4.218 6. Form: Division of QTIP Trust

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4.218-1 Division of QTIP trust

Division of QTIP Trust. **If an election is to be made to qualify all or part of the QTIP Trust for the federal estate tax marital deduction, and if a Internal Revenue Code §2652(a)(3) reverse QTIP election is to be made, the QTIP Trust so qualified shall, if necessary, be divided and established as two separate trusts rather than one to permit the reverse QTIP election to be made with respect to one trust (the Reverse QTIP Trust), but not the other (the Nonexempt QTIP Trust). The division shall be accomplished in a manner that complies with Internal Revenue Code §2642(a)(3).**

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§4.219 7. Mandatory Reverse QTIP Trust

The advantage of the severance strategy discussed in §4.217 is its simplicity. It also provides considerable flexibility, giving great discretion to the trustee or personal representative in their ability to choose which transfers will receive the GST exemption.

Such broad discretion may be undesirable, or at least worrisome, if the planner determines that the reverse QTIP trust should have different remainder provisions than the regular QTIP. For example, the planner may want to distribute the reverse QTIP trust remainder to a multigenerational trust, with the nonexempt QTIP trust remainder passing to the children. If so, giving the personal representative or trustee great discretion with respect to the relative sizes of the two QTIPs may raise unwanted questions about fiduciary duties, conflicts of interest, and powers of appointment. This is particularly problematic if the optimum tax decision will result in the creation of a nonexempt QTIP trust that will be completely exhausted by the obligation to pay the estate taxes attributable to the reverse QTIP trust. If these issues are deemed significant in a particular case, the drafter may wish to mandate the creation of the reverse QTIP trust in the amount of the GST exemption that would otherwise be wasted. Unfortunately, doing so requires trying to devise a formula in order to specify the value of the trust, and it also requires custom drafting which usually provides, among other things, that the GST exemption is to be allocated first to the bypass trust.

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§4.220 8. Shifting Estate Tax Burden

Failure to avoid the estate tax burden on the reverse QTIP trust resulting from inclusion in the surviving spouse's estate as discussed in §4.216 will result in substantial loss of valuable GST tax-exempt funds. This problem is commonly dealt with by establishing a second QTIP trust and directing that this "nonexempt QTIP trust" pay the estate taxes imposed on the reverse QTIP trust. This tax directive must be included in the trust instrument. See IRS Letter Ruling 199927007, in which the IRS took the position that each QTIP must pay its own share of estate tax in the absence of such a provision. To avoid diminution of the reverse QTIP trust, the nonexempt QTIP trust should contain a provision similar to the one in §4.221.

The nonexempt QTIP trust must have sufficient assets at the survivor's death to pay the estate tax on both QTIP trusts. If this is unlikely because the deceased spouse's estate is too small, avoidance of an estate tax burden on the reverse QTIP trust requires that the surviving spouse be willing to pay the tax from other assets in the survivor's estate.

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§4.221 9. Form: Estate Tax Apportionment

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4.221-1 Estate tax apportionment

Taxes Resulting From Inclusion of Generation-Skipping Tax Exempt QTIP Property. **If the taxable estate of the Surviving Settlor includes a QTIP trust that is exempt from federal generation-skipping transfer taxes and another QTIP trust that is not exempt, the amount of estate taxes subject to a right of recovery under Internal Revenue Code §2207A as a result of inclusion of the trusts in the Surviving Settlor's taxable estate shall be paid from the nonexempt trust to the extent possible.**

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VII. CALIFORNIA REAL PROPERTY TAXES

§4.222 A. Property Tax Estate Planning

Historically, estate planners have devoted most of their attention to the federal transfer tax system, and typically pay somewhat less attention to income taxes and very little attention to California property taxes or the documentary transfer tax. Now, however, the first concern of many clients is the effect planning techniques will have on property taxes. For example, when the planner describes the need to transfer the family residence to a revocable trust, the client invariably asks whether the transfer will result in a reassessment for property tax purposes. Similarly, when the planner recommends transferring the family residence or vacation home to a qualified personal residence trust, the client asks whether the property will be reassessed. This chapter discusses the basic reassessment rules and exclusions that are important to planners.

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§4.223 B. Fundamental Property Tax Concepts

Real property that is not entitled to special assessment treatment or exemption is valued at the lower of (1) fair market value on the lien date of the year in question, or (2) a base-year value determined under Proposition 13 guidelines, adjusted for inflation. Cal Const art XIIIA; Rev & T C §§50-51, 110. The property tax rate is generally 1 percent of assessed value. Rev & T C §93. The assessed value cannot be increased by more than 2 percent per year. Rev & T C §51(a)(1)(B). The base-year value is the assessed value of the property on March 1, 1975, or the fair market value on a later date when a present interest in the property is transferred or improvements are newly constructed. Rev & T C §110.1. The crucial event and inquiry therefore becomes when a "change in ownership" occurs. See §4.224.

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§4.224 1. Change in Ownership

Revenue and Taxation Code §60 defines "change in ownership" broadly as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the interest." Revenue and Taxation Code §61 describes, generally, what a "change in ownership" includes. The death of an owner of real property is a change in ownership on the date of death. See 18 Cal Code Regs §462.260(c).

Because the statute employs such a broad definition, the exceptions and exclusions are crucial to its practical application. Revenue and Taxation Code §§62-69.5 specify the transfers that do not constitute a "change in ownership." See §4.225.

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§4.225 2. Excluded Transfers

Transfers excluded from "change in ownership" include:

- Transfers in which proportional ownership interests remain the same before and after transfer. Rev & T C §62(a).
- Transfers to revocable trusts. Rev & T C §62(d).
- Transfers reserving a term interest or life estate in the transferor. Rev & T C §62(e). Termination of the interest is a change of ownership unless otherwise excluded.
- Interspousal and domestic partner transfers. Cal Const art XIIIA, §2(g); Rev & T C §§62(p), 63. See §§4.232-4.234.
- Parent-child transfer of a personal residence plus $1 million of "full cash value" of other property (as defined in Rev & T C §110.1). Rev & T C §63.1. See §§4.235-4.240.
- Transfers of ownership interests in legal entities. Rev & T C §64(a). See §4.241. Exceptions to this rule include:
- Transfer of stock in a cooperative housing corporation. Rev & T C §61(i).
- Transfer resulting in a "change of control" of more than a 50 percent interest in the entity. Rev & T C §64(c).
- Cumulative transfer of more than a 50 percent interest in the entity if the transfer to create the entity after March 1, 1975, was excluded under Rev & T C §62(a). Rev & T C §64(d).
- Joint tenancy transfers among original joint tenants. Rev & T C §65(b); 18 Cal Code Regs §462.040(b)(1). See §4.231.
- De minimis transfers of interests in real property (not interests in legal entities) with a market value of less than 5 percent of the value of the total property and less than $10,000. Rev & T C §65.1.
- Base-year value transfers to replacement property for persons over age 55, and disabled persons, persons displaced by governmental action or eminent domain, and property substantially damaged or destroyed by a disaster. Rev & T C §§68-69.5. See §4.244.

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§4.226 3. Trust Transfers

For property tax purposes, trust beneficiaries are treated as the owners of real property held in trust. Transfers to or among trusts are changes in ownership unless (see Rev & T C §§61(h), 62(d), 63, 63.1; 18 Cal Code Regs §462.160(b)(5)):

- The trust is revocable;
- The transferor is the sole beneficiary or the beneficiaries qualify for an exclusion;
- The transferor retains the reversion and the beneficial interest of others does not exceed 12 years; or
- There is no change in the proportional interests of the beneficiaries.

NOTE: For property tax purposes, the trustee is never viewed as the "owner" of the trust property, even though the trustee has legal title and the power to sell. See 18 Cal Code Regs §§462.160, 462.240.

A change in ownership occurs when (1) the trustor-transferor of a revocable trust dies, and the trust becomes irrevocable, or (2) the trust is irrevocable at the time of its creation, and the beneficiaries receive present beneficial use of the property or present income from the property. See *Steinhart v County of Los Angeles* (2010) 47 C4th 1298, 104 CR2d 195; *Leckie v County of Orange* (1998) 65 CA4th 334, 76 CR2d 426 (change in ownership occurs on transfer of life income interest on death of settlor). See also *Reilly v City & County of San Francisco* (2006) 142 CA4th 480, 48 CR3d 291; *Phelps v Orange County Assessment Appeals Bd. No. 1* (review granted Sept. 9, 2009, S174418; superseded opinion at 175 CA4th 448, 96 CR3d 306) (change in ownership occurs when one sole income beneficiary dies and is replaced by another sole income beneficiary). The decision in *Steinhart* appears to support the court of appeal decision in *Phelps*. The court in *Phelps* cited the court of appeal decision in *Reilly* for the proposition that an income beneficiary of a trust has the beneficial use of real property held in trust. The court in *Reilly* had concluded that a life estate is equivalent in value to a fee interest, citing with approval the court of appeal decision in *Leckie*. Although the successor income beneficiary may not receive the equivalent of a fee interest in trust property, it remains true that the deceased settlor transferred the entire fee interest to the beneficiaries of the trust, consistent with the decision in *Steinhart*. Nothing is retained by the deceased income beneficiary, and the entire equitable estate in the property now passes collectively to the successor income and remainder beneficiaries.

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§4.227 4. Revocable Trust Property

Most transfers to or from trusts involve revocable trusts in which the trustor (settlor/grantor), the trustee, and the beneficiary are the same person. The transfer of real property by the trustor-transferor to a trust revocable by the trustor-transferor is not a change in ownership because, for property tax purposes, the present interest is not transferred. If the trustor-transferor revokes the trust, no change of ownership occurs, because the present interest is not transferred.

At the death of the trustor-transferor, either (1) the trust terminates, and the property is transferred to the remainder beneficiary, or (2) the trust continues but becomes irrevocable. In either case, there is a change in ownership subject to reappraisal unless the remainder beneficiary or the beneficiaries of the trust that has become irrevocable are persons who qualify for an exclusion, *e.g.*, a surviving spouse or child. Rev & T C §§61(h), 63-63.1; 18 Cal Code Regs §462.160(b)(2), (c).

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§4.228 5. Irrevocable Trust Property

When a trustor-transferor transfers real property to an irrevocable trust, a change in ownership occurs unless:

- The trustor-transferor retains the reversionary interest, and the beneficial interest of others does not exceed 12 years in duration. Rev & T C §62(d); 18 Cal Code Regs §462.160(b)(1)(B).
- The trustor-transferor is the sole present interest beneficiary of the trust, *e.g.*, a qualified personal residence trust (QPRT). Rev & T C §62(d); 18 Cal Code Regs §462.160(b)(1)(A).
- The present interest beneficiaries are persons other than the trustor-transferor who qualify for an exclusion from change of ownership, *e.g.*, spouse, children, or eligible grandchildren. Rev & T C §§63-63.1; 18 Cal Code Regs §462.160(b)(4).

WARNING: When a trustee has discretion to distribute income and principal to several potential beneficiaries (a "spray" or "sprinkle" trust), the property is subject to reappraisal unless all potential beneficiaries have an available exclusion, because the trustee could potentially distribute income or principal to a nonexcludable beneficiary. 18 Cal Code Regs §462.160(b)(1)(A), Examples 1-2.

Charitable trusts are discussed in §4.229. Personal residence trusts are discussed in §4.230.

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§4.229 a. Transfers to Charitable Trusts

A transfer of real property to a charitable remainder trust under IRC §642(c) will not result in a change in ownership if the trustor-transferor retains the present right to income. 18 Cal Code Regs §462.160(b)(1)(A). A transfer to a charitable lead trust is a change in ownership on the date of the transfer. 18 Cal Code Regs §462.160(a). However, the termination or distribution of the property from the charitable lead trust is not a change in ownership if the remainder beneficiaries are a spouse, children, or eligible grandchildren. Rev & T C §§63-63.1; 18 Cal Code Regs §462.160(d)(1).

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§4.230 b. Transfers to Personal Residence Trusts

A personal residence trust or qualified personal residence trust (QPRT) under IRC §2702(a)(3) is an irrevocable trust in which the trustor-transferor retains the present interest for a term of years with a gift of the remainder interest in his or her personal residence or vacation property to children or other beneficiaries. No change in ownership occurs on the creation and transfer of real property into a personal residence trust or QPRT. Rev & T C §62(d). However, at the expiration of the term (or at the death of the trustor-transferor before the expiration of the term if the property is transferred to the named beneficiaries rather than to the trustor-transferor's estate), there is a change in ownership of the real property, unless an exclusion applies. See 18 Cal Code Regs §462.160(c), (d).

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§4.231 C. Joint Tenancy Transfers

A change in ownership includes a joint tenancy interest transferred from one owner to another owner on the creation, transfer, or termination of a joint tenancy. Rev & T C §65(a). A newly created joint tenancy (*e.g., C* conveys to *A* and *B* as joint tenants) results in a change in ownership because *C* is not among the joint tenants. The creation or transfer of a joint tenancy interest is not a change of ownership if after the creation or transfer of the joint tenancy interest the transferor is among the joint tenants. Rev & T C §65(b). If *C* transfers to *A* and *C* as joint tenants, there is no change in ownership because *C* is among the joint tenants and thus becomes an "original transferor."

NOTE: Transfers between spouses qualify for the interspousal exclusion under Rev & T C §63. Accordingly, if the spouse of an original transferor is added as a joint tenant after the acquisition, the spouse becomes an original transferor. See 18 Cal Code Regs §462.040(b)(1).

Under 2003 amendments to the regulations, tenants in common can become original transferors by transferring the property to themselves as joint tenants, and joint tenants can become original transferors by transferring their interests to revocable trusts that provide for the property to go to the other on the settlor's death. Thus, a transfer from *A* to *A* and *B* as joint tenants, followed by a transfer from *B* to a revocable trust that names *A* as the recipient of the property on *B*'s death would cause *B* to become an original transferor, with the result that the property will not be reassessed on *A*'s death. See 18 Cal Code Regs §462.040(b)(1), Examples 4, 9; Letter to Assessors 2003/077 (Dec. 18, 2003); Letter to Assessors 2004/042, General Question 9 (July 6, 2004); Letter to Assessors 2010/038 (Aug. 11, 2010); Form BOE-502-A (P1) Rev 13, Item J.2 (7-10).

NOTE: Under the 2003 amendments to 18 Cal Code Regs §462.040, it is theoretically possible for successive owners to transfer property without reassessment in perpetuity, although the State Board of Equalization (BOE) has suggested that the step-transaction doctrine can be applied to avoid such results if transfers are made solely to avoid a change in ownership rather than for estate planning purposes. Letter to Assessors 2004/042, General Questions 23-24. However, the amendments appear to exceed the original transferor exception in Rev & T C §65(b). See the digest and comment for the draft form in 26 CEB Est Plan Rep 144 (Apr. 2005). The BOE has issued proposed amendments to the regulations that would eliminate the change-in-ownership exclusion for joint tenancy transfer in trust. Letter to Assessors 2007/010 (Feb. 23, 2007), reported in 28 CEB Est Plan Rep 140 (Apr. 2007). Action on the proposed regulations was postponed and has not yet occurred. Letter to Assessors 2007/025 (May 21, 2007).

On termination of a joint tenancy interest held by an original transferor, there is a change of ownership unless one of the transferees is an original transferor. Rev & T C §65(c). On termination of a joint tenancy interest held by a joint tenant other than an original transferor, there is no reappraisal if the interest is transferred to an original transferor or to all remaining joint tenants as long as one of the remaining joint tenants is an original transferor. Rev & T C §65(d).

EXAMPLE: *A* and *B* transfer their interest in Greenacre to *A*, *B*, and *C* as joint tenants. *C* is an unrelated third party. Result: No reappraisal because *A* and *B* are original transferors. *A* dies. Result: No reappraisal because *B* is a surviving joint tenant and is an original transferor. *B* dies. Result: 100 percent reappraisal because *C* is "other than original transferor."

There is a rebuttable presumption that all joint tenants holding an interest in real property on March 1, 1975, are original transferors. Rev & T C §65(e). If *A* transferred to *A* and *B* as joint tenants in 1956 and *A* dies after March 1, 1975, there is no change in ownership, because *B* is presumed to be an original transferor, unless the county assessor chooses to rely on recorded deeds, in which case a change in ownership does occur, because *B* is not, in fact, an original transferor.

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§4.232 D. Interspousal and Domestic Partner Transfers

A change in ownership does not include interspousal transfers. Cal Const art XIIIA, §2(g); Rev & T C §63. Interspousal transfers include transfers of real property, interests in real property, and transfers through the medium of a trust (see §4.233). Under Rev & T C §63, transfers of interests in real property include joint tenancy transfers, receipt of the deceased spouse's community property interest by the surviving spouse, gift of a life estate, or transfers in connection with dissolution of a marriage. Interspousal transfers may include transfers of interests in legal entities. 18 Cal Code Regs §462.220. Under Rev & T C §62(p), a change in ownership does not include any transfer of property between registered domestic partners, including transfers in trust and transfers at death. The statute was upheld by the court of appeal in *Strong v State Bd. of Equalization* (2007) 155 CA4th 1182, 66 CR3d 657.

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§4.233 1. Transfers Through Medium of Trust

Transfers through the medium of a trust require looking through the trust to ascertain the beneficial owner of the property. For example, a transfer to a revocable trust that becomes irrevocable on the death of the deceased spouse will be excluded under the trust exclusion in Rev & T C §62(d) and the interspousal transfer exclusion in Rev & T C §63 if the surviving spouse enjoys the exclusive right to trust income, regardless of the trustee's power to distribute principal. Property also will be transferred to the spouse to the extent that the spouse has a power of appointment over trust principal. See §4.234.

NOTE: The trustee's power to distribute principal among spouse and issue does not destroy the transfer exclusion, because issue do not share a present interest with the income beneficiary; the issue's interest is a "mere expectancy." See *Estate of Johnson* (1961) 198 CA2d 503, 510, 17 CR 909; *Estate of Canfield* (1947) 80 CA2d 443, 451, 181 P2d 732.

If the trustee has the power to sprinkle income to the surviving spouse and issue, the trust may not qualify if "issue" includes grandchildren who have at least one living parent, but the trust will qualify under the interspousal and parent-child exclusions if the sprinkle power is limited to the spouse and children. 18 Cal Code Regs §462.160(b)(1). In some cases a unitrust interest may satisfy the income requirement, but it may be desirable to provide that the spouse will be subject to a traditional income right with respect to residential property. See §13.5.

PRACTICE TIP: If the client is concerned about property tax increases following the death of the first spouse, when taxes could create a material financial burden, and the bypass trust will own real property, the surviving spouse should have the sole income interest in the bypass trust. This objective is inconsistent with the federal transfer tax planning goal of minimizing the survivor's estate by granting the trustee a "sprinkle" power over income. To reconcile this goal, consider allocating the real property to the QTIP trust.

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§4.234 2. Effect of "Five or Five" Power on Trust Property

A power in a bypass trust held by the surviving spouse to appoint to himself or herself the greater of $5000 or 5 percent of trust principal each year under IRC §2041(b)(2) and Treas Reg §20.2041-3(d)(3) will be deemed to be exercised every year. Thus 5 percent of the assessed value of real property held in the bypass trust shifts to the surviving spouse each year for purposes of applying the deceased spouse's parent-child exclusion. See SBE Property Taxes Law Guide, Annotations 625.0210 (Jan. 21, 1992), 625.0230 (Apr. 6, 1992), 625.0234 (Dec. 14, 1990); see §4.240 for discussion.

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§4.235 E. Parent-Child Exclusion

Each "transferor" may transfer a personal residence plus property with no more than $1 million of "full cash value" from parents to children (or from children to parents). Cal Const art XIIIA, §2(h); Rev & T C §63.1. For this purpose, "full cash value" means assessed value, not fair market value. Cal Const art XIIIA, §2(a); Rev & T C §110.1; *City & County of San Francisco v County of San Mateo* (1995) 10 C4th 554, 41 CR2d 888.

PRACTICE TIP: When donor parents (or children) have owned low base-year value property for a long time, or property values have appreciated faster than assessed values, the owners may transfer a great deal more than $2 million of fair market value property.

A claim for exemption must be filed within 3 years after the transfer or within 6 months after the mailing of a notice of supplemental or escape assessment, although a prospective claim for exemption may be filed after these dates if the property has not been transferred to a third party. Rev & T C §63.1(e). If the assessor notifies the transferee in writing of potential eligibility, the assessor may charge a fee of $175 to file the claim if a certified claim is not filed within 60 days after the date of a second notice of potential eligibility that may be sent to the transferee if a certified claim is not filed within 45 days of the original notice. Rev & T C §63.1(j).

PRACTICE TIP: Check with the county assessor to see whether certified birth certificates need to be filed with the claim for exemption. The practice among counties is not uniform. Certified birth certificates may also be necessary for grandchildren's parents as well if the exemption is claimed for transfers to grandchildren. See §4.239.

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§4.236 1. Applies Only to "Direct Interests" in Real Property

The exclusion does not apply to transfers of partnership interests, shares of stock, or membership interests in LLCs. Rev & T C §63.1(c)(8). Interests in trusts are subject to the exclusion because trusts are *not* treated as legal entities. See Rev & T C §63.1(c)(9).

PRACTICE TIP: For an example of how *not* to do a parent-child transfer—*i.e.,* transfer property to a partnership and then gift more than 50 percent of the partnership interests—see *Penner v County of Santa Barbara* (1995) 37 CA4th 1672, 44 CR2d 606. Rather, parents should gift real property interests to children, who may then contribute the interests to the partnership in exchange for proportional percentage partnership interests. See §4.238.

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§4.237 2. Nonprorata Allocation of Property

The parent-child exclusion does not apply to a sibling transfer even if the property is transferred directly to the child from the estate or trust. Generally, a devise of property to more than one person vests property in them as tenants in common. A transfer of interests among tenants in common is a change in ownership unless an exclusion applies. 18 Cal Code Regs §462.020. Therefore, nonprorata allocation of property to children may result in reassessment.

EXAMPLE 1: Decedent leaves Whiteacre to decedent's child *A*. Parent-child exclusion applies.

EXAMPLE 2: Decedent leaves Whiteacre to decedent's children *A*, *B*, and *C*. By agreement, decedent's estate (or trust) distributes Whiteacre to *A* only. The will (or trust) does not permit nonprorata allocations. Result: There is a "change of ownership" as to two thirds of the property (*B*'s and *C*'s undivided interests).

If the trust instrument permits nonprorata allocations, as long as each beneficiary receives an amount equal to the beneficiary's share of trust assets, the transfer will be treated as a direct transfer from parents to children. See 18 Cal Code Regs §462.160(d)(5).

EXAMPLE 3: Decedent leaves trust with assets worth $500,000 to decedent's four children, *A*, *B*, *C*, and *D*, "share and share alike." Each child is to receive $125,000 in assets. The trust instrument does not limit the trustee's power to distribute assets. Under Prob C §16246, the trustee has the power to distribute sole ownership of any asset or fractional interest in any asset to any of the children. The trustee deeds decedent's principal residence worth $112,500 with no outstanding loans to *A*. Result: No change in ownership under Rev & T C §63.1, because the property's net value is less than *A*'s share of the trust. If the property had been worth more than $125,000, a partial change in ownership would have occurred.

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§4.238 3. Step Transaction Doctrine Disregarded

The legislative history of Rev & T C §63.1 provides that the "step transaction doctrine" is disregarded for purposes of applying the parent-child exclusion. See Stats 1987, ch 48, §2. See also *Penner v County of Santa Barbara* (1995) 37 CA4th 1672, 44 CR2d 606.

EXAMPLE: XYZ Corporation, wholly owned by *H* and *W*, dissolves. *H* and *W* convey real property held in XYZ Corporation to themselves. They subsequently deed undivided interests in the property to children, *C1*, *C2*, and *C3*. *H*, *W*, *C1*, *C2*, and *C3* then form HW Family Limited Partnership, taking back proportional partnership interests. Result: No change in ownership. Because the "step transaction doctrine" does not apply, the parent-child exclusion (Rev & T C §63.1) would exclude the transfer of interests to *C1*, *C2*, and *C3*. The proportional interest exclusion of Rev & T C §62(a)(2) (discussed in §4.241) would exclude the transfers of interests from XYZ Corporation and into HW Family Limited Partnership.

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§4.239 4. Transfers to Grandchildren

The parent-child exclusion applies to transfers to grandchildren when parents of the grandchildren are deceased as of the date of sale or transfer. Cal Const art XIIIA, §2(h); Rev & T C §63.1(a)(3). The transfer will qualify only if all parents of grandchildren, not including stepparents married to a parent at the time of the parent's death, are deceased. Rev & T C §63.1(c)(2). The exclusion does not apply to transfers from grandchildren to grandparents. See Letter to Assessors No. 2008/018 (Feb. 29, 2008).

NOTE: The definition of "children" does not include a son-in-law or daughter-in-law whose marriage to the parent's child has been "terminated by divorce." When a daughter-in-law or son-in-law is a surviving spouse of a deceased child, the definition of "children" lasts only until remarriage. Rev & T C §63.1(c)(3).

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§4.240 5. Application to Typical Family Revocable Trust

Property interests transferred to children (or grandchildren) by a marital trust or bypass trust on the death of the surviving spouse are generally excluded by the parent-child exclusion of Rev & T C §63.1. Transfers eligible for Rev & T C §63.1 exclusion are claimed from the *deceased* spouse's estate. Property interests transferred by the surviving spouse, *i.e.,* from a survivor's trust, qualify for the surviving spouse's exclusion amount.

NOTE: The deceased spouse's parent-child exclusion applies only to property the deceased spouse owned at death. If a bypass trust bought new property during administration, the newly acquired property may not qualify for a parent-child exclusion on the death of the surviving spouse. Even though the surviving spouse's parent-child exclusion may be applied to the transfer, because the surviving spouse is considered the present beneficial owner of the property, the value of the new property combined with the surviving spouse's own property may exceed the surviving spouse's $1 million exclusion.

If the deceased spouse's property is transferred to a bypass trust and the surviving spouse possesses a "5 or 5" power (see §4.234), the surviving spouse's $1 million exclusion available for property outside the trust will be reduced by the value of property that *could have* been transferred under the power, multiplied by the number of years the surviving spouse possessed the power, because that portion of the property is treated as transferred by the surviving spouse.

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§4.241 F. Legal Entity Transfers

Generally, the transfer of interests in real property to or by a legal entity is a change in ownership unless the proportional ownership interests of the transferors and the transferees are exactly the same before and after the transfer. Rev & T C §62(a)(2); 18 Cal Code Regs §462.180(b)(2). Transfers of real property between or among affiliated corporations, however, including transfers used to achieve corporate reorganization, do not trigger reappraisal. Rev & T C §64(b).

PRACTICE TIP: The transfer of real property must be proportional as to "each and every piece of real property transferred," or a change in ownership of the disproportionally transferred property will result. *Munkdale v Giannini* (1995) 35 CA4th 1104, 41 CR2d 805.

When a transfer is excluded from reassessment under Rev & T C §62(a)(2), the holders of the ownership interests in the transferee legal entity are defined as "original co-owners" for purposes of determining whether a change in ownership has occurred on the subsequent transfer of ownership interests in the legal entity under Rev & T C §64(a). See §4.242.

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§4.242 1. Transfers of Interests in Legal Entities

Transfers of interests in legal entities generally do not result in a change in ownership of the underlying real property. Rev & T C §64(a). The general rule is subject to the following exceptions, which do result in a change in ownership (Rev & T C §64(c)-(d); 18 Cal Code Regs §462.180(d)):

- Transfers resulting in any person's obtaining, directly or indirectly, majority ownership (control) of a legal entity. See §4.242A.
- Transfers resulting in cumulative transfer of more than 50 percent of "original co-ownership" interests. See §4.243.

Form will not prevail over substance. If multiple transfers can be compressed into one transaction resulting in a change of ownership, the transfers will be ignored and a change of ownership will be found. See *Shuwa Invs. Corp. v County of Los Angeles* (1991) 1 CA4th 1635, 2 CR2d 783 (100-percent change in ownership when one partner sold its partnership interest to the buyer, the buyer and the other partner liquidated the partnership, and the other partner sold its property interest to the buyer). See also *McMillin-BCED/Miramar Ranch N. v County of San Diego* (1995) 31 CA4th 545, 37 CR2d 472.

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§4.242A 2. Change in Control

A change in control resulting in a change of ownership under Rev & T C §64(c) will occur if a corporation, partnership, LLC, or other legal entity or person obtains through indirect ownership more than 50 percent of the total capital or profits interests in a partnership or LLC. 18 Cal Code Regs §462.180(d)(1)(B).

NOTE: There is no attribution of ownership between spouses who acquire interests in a legal entity. Thus, no change in control of *XYZ* (an LLC) would occur under Rev & T C §64(c) if *A* and *B,* who are married to each other, acquire 100 percent of the ownership interests in *XYZ* as community property. See 18 Cal Code Regs §462.180(d), Example 7.

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§4.243 3. Cumulative Transfers

When a transfer results in cumulative transfers of more than 50 percent of the ownership interests in the entity under Rev & T C §64(c), there is a change in ownership of 100 percent of the real property previously excluded from a change in ownership under Rev & T C §62(a)(2), irrespective of the property interests actually transferred. Rev & T C §64(d); 18 Cal Code Regs §462.180(d)(2).

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§4.244 G. Base-Year Value Transfers

Persons over age 55 or who are severely and permanently disabled may transfer the base-year value of a residence to a replacement dwelling of equal or lesser value in the same county, or in another county if the board of supervisors of that county adopts an ordinance granting base-year value relief to replacement dwellings when the original dwelling was located in another county. Rev & T C §69.5(a). The original dwelling must have been the person's residence and must have been eligible for the homeowner's exemption (whether or not claimed) within 2 years before the purchase or new construction of the replacement dwelling. Rev & T C §69.5(b). A claim for exemption must be filed within 3 years after the replacement dwelling was purchased or new construction was completed to avoid reassessment; however, a late claim may be filed effective on the lien date of the year in which the claim is filed. Rev & T C §69.5(f). The claimant must not have been granted relief previously, except in a case involving a person over age 55 who subsequently becomes disabled. Rev & T C §69.5(b). In determining whether a new home built on land purchased years earlier qualified as a replacement dwelling "of equal or lesser value," at least one court has held that both the land and structure must be valued as of a single date, the later of the date that the property was purchased or the date that construction was complete. As a consequence, the court held that the lower assessed value of the land could not be used, and the property in question did not qualify for a base-year value transfer because the cost of the structure combined with the value of the land on the completion date exceeded the value of the original dwelling. See *Wunderlich v County of Santa Cruz* (2009) 178 CA4th 680, 100 CR3d 598.

Base-year value transfers for replacement property not limited to dwellings are available for persons displaced by governmental action or eminent domain proceedings (Rev & T C §68; 18 Cal Code Regs §462.500) and for property substantially damaged or destroyed by a disaster (Rev & T C §§69, 69.3).

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§4.245 H. Disclaimers of Transferred Interests

A disclaimed interest passes as if the beneficiary had predeceased the disclaiming party, and the date of the disclaimer relates back to the date of death of the creator of the disclaimed interest. Prob C §282(a). A disclaimer can be used to establish an exclusion from a change in ownership. For example, if a testamentary trust allows the trustee to sprinkle income and principal to the decedent's child and grandchild, both of whom are living, and the trust is funded with real property, there will be a change of ownership because a grandchild whose parent is living has been included as a trust beneficiary. See §§4.233, 4.239. If the grandchild files a disclaimer with respect to his interest in the property, and if under the terms of the trust, the property will pass to the decedent's child, the child is treated as the owner of the property as of the date of the decedent's death, and the parent-child exclusion applies, assuming that all requirements are met. See Letter to Assessors No. 98/23 (Apr. 22, 1998).

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§4.246 VIII. REPORTING REQUIREMENTS

A change in ownership statement must be filed for each transfer of real property and on the death of the owner. Rev & T C §§480-480.2. The transferee must file a preliminary change of ownership report concurrent with recordation of any document effecting a change in ownership of the property. Rev & T C §§480.3-480.4.

PRACTICE TIP: If the transfer is excluded from reassessment, explain on the preliminary change of ownership report form (using an attachment, if necessary) what transfers are occurring, and why the transfers are excluded from reassessment. Although a claim for refund based on an erroneous change of ownership can always be filed, the property tax must be paid as a condition of filing the claim for refund, and it takes one year or longer to obtain a hearing date. Consequently, a preliminary change of ownership report form that clearly states the reasons for the exclusion and convinces the assessor of the basis for the exclusion will be of substantial benefit to the client.

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§4.247 A. Transfers on Death

The personal representative must file a change in ownership statement with the county recorder or assessor in each county in which the decedent owned real property before or at the time the inventory and appraisal is filed; in all other cases, including a transfer through a trust, the form is to be filed by the trustee or transferee within 150 days after the decedent's death. Rev & T C §480(b).

PRACTICE TIP: Send a copy of the form, with the original to the assessor, with a pre-addressed, stamped envelope, and ask for a date-stamped copy.

The change in ownership statement must be filed in order to file the property tax certification required under Prob C §8800(d).

PRACTICE TIP: Whenever a document is recorded that changes who manages the trust (*e.g.*, a resignation of trustee and acceptance of nomination of successor trustee), no matter how innocuous, use a preliminary change of ownership report form. See Rev & T C §480.4. The recorder will usually insist on identification of the affected real property by assessor's parcel number and will often require a reference (by instrument number and date) to the recorded deed that places title to the property in the trustee. It is sensible to comply, because compliance is straightforward.

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§4.248 B. Statute of Limitations

The statute of limitations on supplemental assessments is 4 years (6 years for penalty assessments under Rev & T C §504) if a change in ownership statement is filed, or a preliminary change of ownership report is filed under Rev & T C §480.3, and unlimited if a statement or report is not filed. Rev & T C §75.11. The statute of limitations on escape assessments is four years if any document evidencing a change of title or ownership is recorded (eight years for penalty assessments under Rev & T C §504), and eight years for any unrecorded change for which a statement or report was not filed. Rev & T C §532.

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5

Creation of Trust

Charles A. Larson

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§5.1 I. ELEMENTS OF A TRUST

A revocable trust can be created by agreement, declaration, or exercise of a power of appointment. Prob C §15200. The essential elements of a trust are the following:

- A settlor (the owner of the property that will be subject to the trust) (Prob C §15200);
- The settlor's intent to create a trust (Prob C §15201);
- Trust property (Prob C §15202);
- A trust beneficiary (Prob C §15205); and
- A valid trust purpose (Prob C §§15203-15204).

A trust in relation to real property usually must be evidenced by a writing. Prob C §15206. In California, a trust may not be effective to accomplish its stated purposes if a beneficiary is a "disqualified person" and there is a failure to 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. See §5.18A. For a discussion of the potential consequences of naming a "disqualified person" as a trustee, see §§5.14-5.15.

A settlor may be referred to as a "grantor" or "trustor." "Settlor" is used in this book in conformity with the California Probate Code, Uniform Trust Code §103(14), and Restatement (Third) of Trusts §3 (2003).

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§5.2 A. Trust Intent

A trust is created only if the settlor demonstrates an intent to create a trust. Prob C §15201. Generally, this is not an issue with express trusts as long as the trust document contains a schedule of initial trust property. See §5.38. However, problems frequently arise concerning possible subsequent revocation of a trust with respect to property not titled in the name of the trust or otherwise clearly shown to be trust property. Similarly, problems may arise when a settlor fails to transfer after-acquired property to a trust.

This book does not cover either resulting or constructive trusts. A resulting trust is one in which the settlor's intent to create a trust is implied by law rather than expressly stated. The trust intent in a constructive trust is imposed by law regardless of actual intent. *Wells Fargo Bank v Greuner* (1964) 226 CA2d 454, 460, 38 CR 132. See CC §§2223-2225.

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.3 B. Trust Property

§5.3 B. Trust Property

No trust is created until there is an interest in property that is subject to the trust, although the interest can be a future interest. Prob C §15202. If a trust document is executed but no property is immediately made subject to the trust, the trust will come into existence when the property is later transferred to the trust. See Restatement (Second) of Trusts §26, Comment i (1959); Restatement (Third) of Trusts §16, Comment b (2003). Real property deeded to a trust before the trust document is executed also may be subject to the trust provided that (1) the deed was executed in anticipation of creation of the trust, and (2) the trust is in fact created. *Luna v Brownell* (2010) 185 CA4th 668, ___ CR3d ___.

NOTE: The typical revocable trust comes into existence immediately on execution because it identifies trust property, declaring it to be subject to the trust (if the settlor is the trustee) or transferring it to the trustee (in the case of a third party trustee). See forms in §§5.19, 5.37. Some revocable trusts are not funded until death. Although it is common in such cases to see such a trust recite the existence of a nominal and fictitious trust asset, such as $100, this is unnecessary. See, *e.g.*, Prob C §§6300, 6321, 15200(c) (transfer to trust or trustee effective on settlor's death).

Any real or personal property 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) §§40-41. The property interest may be intangible, equitable, or even contingent, but it may not be a mere expectancy. See CC §§700, 1045. See also 13 Witkin, Summary of California Law, Trusts §31 (10th ed 2005). An interest may be held in trust even if it is subject to being divested. See *Wallace v Riley* (1937) 23 CA2d 654, 666, 74 P2d 807, disapproved on other grounds in *Estate of Propst* (1990) 50 C3d 448, 268 CR 114.

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C. Beneficiary of Trust

§5.4 1. Definite Beneficiary Required

A trust fails unless there is a beneficiary or class of beneficiaries whose identity is ascertainable with reasonable certainty. Prob C §15205(b)(1). See *Chang v Redding Bank of Commerce* (1994) 29 CA4th 673, 35 CR2d 64. See also 2 Scott & Ascher on Trusts §12.10 (5th ed 2006). This requirement does not apply to charitable trusts. Prob C §15205(a). The trustee's (or other individual's) discretion to decide which members of a class of beneficiaries will take and in what proportions does not violate the requirement of definite beneficiaries as long as the class is sufficiently identified and its membership is definite. Prob C §15205(b)(2). See 2 Scott on Trusts §12.7. See §§19.10-19.11 on perpetuities savings clause.

NOTE: When the same person is sole trustee and sole beneficiary, legal and equitable titles are merged, and no trust is created. Restatement (Third) of Trusts §69 (2003). See *Nellis v Rickard* (1901) 133 C 617, 66 P 32; *Hill v Conover* (1961) 191 CA2d 171, 12 CR 522. No merger occurs, however, when the settlor is the sole trustee and sole beneficiary during his or her lifetime as long as the trust provides for one or more successor beneficiaries after the settlor's death. Prob C §15209. See Restatement §32, Comment b.

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§5.5 2. Charitable Beneficiaries

Charitable beneficiaries are usually churches, arts organizations, schools, hospitals, civil rights organizations, and other institutions that serve the general social welfare of the community at large. The requirement of definiteness (see §5.4) does not apply to charitable beneficiaries. *Estate of Bunn* (1949) 33 C2d 897, 206 P2d 635; *Estate of Clementi* (2008) 166 CA4th 375, 82 CR3d 685. For definitions of charities for tax purposes, see IRC §§170(c) (income tax), 2055(a) (estate tax), 2522(a) (gift tax).

The attorney should describe charitable beneficiaries (or the person, including the trustee, who may designate the beneficiaries) and purposes as specifically and unambiguously as possible. Because many charities have similar names, the attorney should be careful in designating the charity selected by the settlor. To ascertain the charity's proper name, the attorney may:

- Refer to the settlor's receipt for past contributions or membership card;
- 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 §170(c) of the Internal Revenue Code of 1986. If the charity has local as well as state and national chapters, the attorney should ask the settlor which chapter to designate as beneficiary.

WARNING: Great care must be exercised in drafting any trust that has both charitable and noncharitable beneficiaries if the settlor wants any part of the trust to qualify for a charitable deduction for federal estate tax purposes under IRC §2055. See chap 4.

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§5.6 D. Valid Trust Purpose

A trust must have a purpose that is neither illegal nor against public policy. Prob C §15203. For instance, trusts that encourage divorce or defraud creditors will not be enforced. However, a trust for the care of a domestic or pet animal is a trust for a lawful noncharitable purpose for the life of the animal. Prob C §15212. For a complete discussion of invalid trust purposes, see 2 Scott & Ascher on Trusts §§9.2-9.8 (5th ed 2006); Restatement (Third) of Trusts §§28-29 (2003). See also 13 Witkin, Summary of California Law, *Trusts* §36 (10th ed 2005).

Probate Code §15204 states that a trust with an indefinite purpose is not invalid "if it can be determined with reasonable certainty that a particular use of the trust property comes within that purpose." Section 15204 particularly applies to a trust with indefinite purposes that are not exclusively charitable. See Cal L Rev'n Comm'n Comment to Prob C §15204. A trust with wholly indefinite purposes will not be enforced under §15204. See, *e.g., Estate of Ralston* (1934) 1 C2d 724, 37 P2d 76 (devise to person "in trust" to distribute "as he may see fit" did not establish valid trust).

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E. Trustee of Trust

§5.7 1. Naming Original Trustee

One of the most important decisions the settlor must make is the selection of the trustee. This decision is particularly significant when the trustee will be given broad discretionary powers. See chap 16. On selecting a trustee, see §§5.8-5.18.

The trustee holds legal title to trust assets and has a duty to deal with those assets for the benefit of the trust beneficiaries. Prob C §16000. Essentially, the trustee manages the trust property for the benefit of the persons whom the settlor has chosen as beneficiaries. The trustee's duty is to fulfill the settlor's purpose in creating the trust. For a full discussion of the trustee's duties and powers, see chap 17.

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§5.8 2. Individual Trustee

In general, any adult 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, 268 CR 114. Typically, the settlor is the original trustee of a revocable trust. See §5.10. If the settlor is in poor health, then a relative, friend, professional trustee, or corporation may be the trustee. Some settlors prefer the personal relationship between trustee and beneficiary that exists when a family friend or relative acts as the fiduciary. Disadvantages of individual trustees are the potential for the individual to lose interest or feel overly burdened as time passes after the death of the settlor, the unwillingness of the surviving spouse or domestic partner or other beneficiaries to hold a family friend or relative accountable, and the individual trustee's own mortality.

Because individuals cannot provide the permanence of institutional trustees, a trust naming an individual as trustee should name or provide for designation of a cotrustee or one or more successor trustees (see chap 16) if the individual trustee becomes incompetent or dies before the termination of the trust. See forms in §§5.19, 5.37.

The settlor should carefully consider the proposed trustee's ability to comply with reporting, recordkeeping, and ongoing administrative requirements, as discussed in chap 17. Delegating these administrative details to an individual who lacks the training or temperament to observe formalities and maintain records is a potential source of trouble. Formalities must be observed and records maintained in order for administration to be transferred smoothly when a settlor dies. If these steps are not taken, finding a responsible successor trustee may be impossible or unduly expensive. Using a professional trustee from the outset may be advisable to assure proper administration, even though this increases the trust expenses during the settlor's lifetime.

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§5.9 3. Corporate Trustee

Settlors may choose a corporate trustee, such as a bank or trust company. A corporation or an association (*e.g.,* a bank or a trust company) authorized to conduct a trust business in California may act as trustee in the same manner as an individual, but is not required to be licensed as a professional fiduciary under Bus & P C §§6500-6592. See Prob C §§83 (defining "trust company"), 300 (trust company may be appointed trustee); Bus & P C §6501(f)(4)(A) (trust companies exempted from licensing requirement). See also Fin C §§106-107, 1580. No foreign corporation or association, except a national banking association or foreign (other state) state bank authorized to do trust business in California, may act as a trustee. Fin C §1503. A nonprofit corporation may act as a trustee when the trust is incidental to the corporation's principal objectives. Corp C §5140(k). Whether a California corporate fiduciary may deal with out-of-state real property depends on the law of the state in question. Often, corporate fiduciaries are unwilling to administer out-of-state real property because they thereby become subject to service of process on all matters in that state.

The advantages of having a corporate trustee are permanence, continuity of administration, professional management (and a likely greater understanding of the rules of the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) and the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375), financial accountability, and (because of its status as an independent trustee) greater latitude in administering the trust without triggering undesirable tax consequences. See §§4.26-4.34 (see chaps 4, 7) for discussion of the tax-sensitive trustee. The disadvantages include substantially greater administrative costs, turnover of personnel, clients' fears about lack of personal attention, a more conservative investment philosophy, and occasional delays in making decisions because corporate procedures frequently require action by committees.

PRACTICE TIP: Before selecting a corporate trustee, the attorney should determine whether the value of the trust estate meets the institution's minimum requirements and warrants the fee charged by the institution. If the value of the estate is not sufficiently high, the institution may decline to act or may later resign. For discussion of corporate and individual trustee as cotrustees, see chap 16.

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§5.10 4. Settlor as Trustee: Advantages

A settlor is not prohibited from acting as trustee. See *Hill v Conover* (1961) 191 CA2d 171, 12 CR 522. Indeed, most settlors choose to act as their own trustees in order to maintain control over the management of their assets.

The advantages of having the settlor act as trustee include lower administration costs and greater flexibility in investment and other trust decisions. If the settlor serves as trustee or if the husband and wife who file joint returns are the settlors, a separate tax identification number is not needed for the trust, and a separate trust tax return does not have to be filed. Treas Reg §§1.671-4(b), 1.6012-3(a)(9), 301.6109-1(a)(2). See Rev & T C §17731. See chap 4.

If the settlor is the trustee, there is a significant risk that the settlor will not always handle trust assets and personal assets in ways that make it easy to distinguish whether a particular asset is subject to the trust. For a trust that is intended to transfer the bulk of a client's assets on death, this risk should be addressed by using a "pourover will" that will transfer the settlor's nontrust assets to the trust on death. This strategy usually deprives family members and other beneficiaries of a reason to contend that some items did not belong to the trust at the time of death. If the value of the assets "outside the trust" do not exceed $100,000, all that is needed to change title is a declaration or affidavit under Prob C §13100; probate will not be necessary.

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§5.11 5. Spouse or Partner as Trustee: Possible Disadvantages After First Death

Typically, both spouses or registered domestic partners will be the initial trustees of a joint revocable trust. Even if this is not the case, both spouses or partners have control of the community property assets of the trust during their joint lifetimes in the sense that either can revoke the trust with respect to those assets. This arrangement poses few problems as long as both are living and competent, but problems may arise at death or if a spouse or partner becomes incompetent. For example, a spouse or partner may lack the experience and skills necessary to administer the irrevocable trusts that come into being on the first death. Also, the survivor will be coping with the trauma of the loss of a spouse or partner at the same time that complex trustee duties must be carried out, *e.g.,* accounting, division of assets, and dealing with a multitude of tax laws and regulations. Conversely, not naming a surviving spouse or registered domestic partner as trustee after the first death often generates ill will and resentment. Sometimes trusts provide for administration by cotrustees, including the survivor, after the first death. On creation of a trust for married settlors, see §§5.20-5.37. On creation of a trust for registered domestic partners, see §5.37A.

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6. Attorney as Trustee

§5.12 a. Ethical Considerations

Significant ethical issues confront an attorney who considers taking on the role of trustee, including professional rules on conflicts of interest and engagements adverse to a client or former client (*e.g.,* a trust beneficiary), the duty to maintain client confidences, and the duty to act competently. See *Layton v State Bar* (1990) 50 C3d 889, 268 CR 845 (standard of care not lessened when attorney is acting in fiduciary capacity). If a beneficiary is also a client, the attorney must reconcile the duties he or she owes to a client under the California Rules of Professional Conduct with the trustee duties under Prob C §§16001-16105, including the duties to deal impartially with all beneficiaries and to avoid conflicts of interest. See House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust, and Probate Counsel §4.3.3 (2d ed 2008).

The attorney trustee is particularly susceptible to removal if the trust was drafted by that attorney or by someone from that attorney's firm. Prob C §15642. See §5.14.

For a complete discussion of ethical considerations, see chap 2.

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.13 b. Restrictions on Dual Compensation

§5.13 b. Restrictions on Dual Compensation

Unless the trust document provides otherwise, an attorney who is trustee may receive either the trustee's compensation or compensation for legal services performed for the trustee, but not both. Prob C §15687(a). This restriction does not apply if the trustee is related by blood or marriage to, or a cohabitant with, a settlor (Prob C §15687(c)), or if approval is obtained by court order or by no objection after notice from persons entitled to notice (Prob C §15687(d)). See also Prob C §15687(b) (restrictions against compensation for legal services performed for trustee by specified close relatives of trustee or law partnership or corporation in which trustee has specified interests).

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7. "Disqualified Person" as Sole Trustee

§5.14 a. When Disqualified Person Is Subject to Removal

If a sole trustee is a "disqualified person" as described in Prob C §21350(a), and no exception applies, the trustee is subject to removal. Prob C §§15642(b)(6), 23151. See chap 16. The statute does not apply if the trustee is related by blood or marriage to the settlor, cohabitates with the settlor, or is the settlor's California-registered domestic partner. Prob C §21351(a).

The removal provision also does not apply if the instrument is reviewed by an independent attorney who counsels the settlor about the nature of his or her intended trustee designation and signs and delivers to the settlor and the designated trustee a certificate in substantially the form set out in §5.15. The independent review and certification may occur either before or after the instrument has been executed, but unless the law is clarified, an attorney who is named as sole trustee who prepares a restatement of a trust incorporating the same provisions that were in the document covered by the previous independent review and certification should, nonetheless, see that the client obtains a new certification from an independent lawyer. An attorney whose written engagement signed by the client is expressly limited to preparing a certificate under this subdivision, including prior counseling, shall not otherwise be considered to represent the client. Prob C §§15642(b)(6)(B), 21351(b).

For further discussion of statutorily disqualified persons, see §§2.36-2.39. See also California Trust and Probate Litigation, chap 6A (Cal CEB 1999).

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.15 b. Form: Certificate of Independent Review

§5.15 b. Form: Certificate of Independent Review

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

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

Certificate of Independent Review

I, _ _[*name of attorney*]_ _, have reviewed _ _[*name of document*]_ _ and counseled my client, _ _[*name of client*]_ _, on the nature and legal effect of the designation as trustee of _ _[*name of trustee*]_ _ in that document. I am so disassociated from the interest of the person named as trustee as to be in a position to advise my client impartially and confidentially as to the consequences of the designation. On the basis of this counsel, I conclude that the designation of a person who would otherwise be subject to removal under Probate Code §15642(b)(6) is clearly the settlor's intent, and that intent is not the product of fraud, menace, duress, or undue influence.

Date: _ _ _ _ _ _

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

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8. Beneficiary as Trustee

§5.16 a. When Beneficiary May Act as Trustee

A beneficiary may act as trustee unless he or she is the sole beneficiary and the sole trustee. In that situation, the equitable and the legal estates are merged. See *Hill v Conover* (1961) 191 CA2d 171, 12 CR 522. See §5.4.

For discussion of beneficiary as cotrustee, see chap 16.

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.17 b. Potential for Conflicts of Interest

§5.17 b. Potential for Conflicts of Interest

Under Prob C §16004, the trustee generally has a duty not to do the following:

- Use or deal with trust property for the trustee's own profit or for any other purpose unconnected with the trust; or
- Take part in any transaction in which a trustee has an interest adverse to the beneficiary.

See also Prob C §16002 (trustee's duty to administer trust solely in interest of beneficiaries).

When a beneficiary acts as trustee, conflicts of interest may arise in balancing his or her rights as a beneficiary against the rights of other beneficiaries. This situation occurs, for example, when a parent is a trustee and an income beneficiary and his or her children have remainder interests; when one sibling is trustee and all the siblings are beneficiaries; or when the trustee is a family member and runs the family business, which is a trust asset.

The risk of breaching the duty to avoid conflicts of interest when a beneficiary is a trustee may be addressed in several ways:

- The trust document may limit the trustee's duties. See chap 14.
- The trustee may receive some protection if the trust document recites the settlor's recognition of possible conflicts of interest and explicitly sanctions any of the trustee's decisions, even when they will affect the trustee's personal interest. See *Estate of Gilliland* (1977) 73 CA3d 515, 528, 140 CR 795; Restatement (Third) of Trusts §78, Comment c (2007). See form 16.28-1.
- Cotrustees or special trustees may be named and the powers divided among them, so that powers particularly affecting the beneficiary trustee are given only to other trustees. See discussion of cotrustees and special trustees in chap 16.

NOTE: The mere "potential" conflict of interest that exists when a trustee is also a beneficiary is not a bar to the individual's serving as a fiduciary. This is in contrast to the prohibition, in California, against a lawyer's being involved in a "potential" conflict with a client absent an informed written waiver. See chap 2.

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§5.18 9. Particular Trustee Requirements

Sometimes special requirements have an impact on the choice of trustee. If, for example, the trust property will include shares of a professional corporation, the trustee must hold a license for the profession in question. For further discussion of this issue, see chap 19.

If a transfer is to be made to a trust for a surviving spouse who is not a United States citizen, the trust will not qualify for the federal estate tax marital deduction unless it is made in the form of a qualified domestic trust (QDOT). IRC §§2056(d), 2056A. A QDOT must meet specific requirements, including that at least one trustee be an individual U.S. citizen or a domestic corporation. IRC §2056A(a)(1). When no trustee is such an individual or corporation, a taxable event occurs at the time of transfer. IRC §2056A(b)(4). See chap 13 for further discussion of QDOT requirements. For a form for a qualified domestic trust, see §13.33.

If a trust has a corporate trustee and owns real property in a state where the trustee does not do business, it may be necessary to name a special trustee to manage the property. A nonprofit charitable corporation may be appointed as trustee under Prob C §15604.

A trustee unrelated by blood, marriage, domestic partnership, or adoption to the settlor who serves as trustee for the benefit of more than three individuals (or who acts as trustee or as an agent under a durable power of attorney for more than three individuals) at the same time must be licensed by the Professional Fiduciaries Bureau in the Department of Consumer Affairs. Bus & P C §6501(f)(2). In counting individuals to determine whether a person is a professional fiduciary, (A) individuals related to the fiduciary are not counted; (B) individuals related to each other are counted as one individual; and (C) trustors related to each other are counted as one individual, and neither the number of trusts nor the number of beneficiaries of those trusts are counted. "Related" means related by blood, adoption, marriage, or registered domestic partnership. Bus & P C §6501(f)(3).

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.18A F. Disqualified Beneficiaries

§5.18A F. Disqualified Beneficiaries

California law imposes special requirements in connection with documents that make donative transfers to persons who are identified as "disqualified persons." Prob C §§21350-21356. Under Prob C §21350, the following persons may be "disqualified persons" unless an exception applies:

- The "drafter" of the transfer document;
- Persons and entities closely related to the "drafter," including close relatives, cohabitants, and business associates;
- Conservators and other persons having a fiduciary relationship with the transferor who transcribes the document or causes it to be transcribed; and
- Care custodians of a transferor who is a dependent adult.

These persons will not be disqualified persons if (1) they are closely related to the transferor by blood or marriage, or (2) the transferor receives advice from an independent attorney who executes a "Certificate of Independent Review." In *Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895, the court held that the statutory exception for spouses included spouses who remarried after one of them became a care custodian of the other. Other narrow exceptions apply. Prob C §21351. See discussion in §§2.36-2.39.

If a transfer is made to a drafter who is a disqualified person, the transfer fails. If a transfer is made to some other disqualified person, the consequence is that the disqualified person has the burden of proving by clear and convincing evidence that the transfer is not the product of fraud, menace, duress, or undue influence. This proof cannot be based solely on the testimony of the disqualified person. Prob C §21351(d).

Transfers made by trusts are subject to the disqualified person statutes. See definition of "instrument" in Prob C §45. As a practical matter, a certificate of independent review should be obtained whenever a trust benefits a person who might be a disqualified person. For a form, see §22.13. Particular care should be exercised whenever the settlor is elderly or infirmed, in which case a beneficiary may be a care custodian of a dependent adult. See *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248. See also *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390. On counseling and confidentiality requirements in executing the certificate, see *Estate of Winans* (2010) 183 CA4th 102, 107 CR3d 167, discussed in §2.37. An attorney who fails to advise the settlor that a certificate of independent review is needed may later be sued by the disappointed intended transferee. See *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, discussed in §2.21.

For a discussion of the problems that may arise when a disqualified person is named as a trustee, see §§5.14-5.15.

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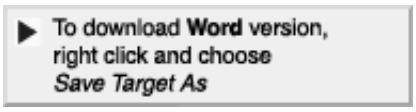
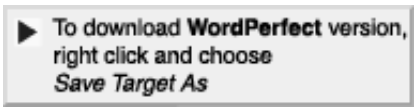
Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.19 G. Form: Creation of Trust for Sole Settlor

§5.19 G. Form: Creation of Trust for Sole Settlor





The _ _[*Name of Trust*]_ _ Trust

I, _ _[*name of settlor*]_ _, sometimes hereafter called "settlor," residing in _ _[*name of County*]_ _, California, hereby create The _ _[*Name of Trust*]_ _ Trust, declaring:

CREATION OF TRUST

***Initial Trust Property*. The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is _ _[*now held by me/hereby transferred to the initial trustee(s) named below*]_ _ in trust. This property and any other property later transferred to the trust is hereafter referred to as the "trust property" and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.**

PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. *Care of Settlor.* To provide for my care and maintenance as long as I am living;

2. *Avoid Conservatorship.* To facilitate management of the trust property in the event of my incapacity; and

3. *Transfer Property at Death.* To facilitate transfer of the trust property on my death.

B. *Initial Trustee.* _ _[*I am/_ _[Name]_ _ is*]_ _ the initial trustee of this trust.

C. *Successor Trustees.* When the initial trustee ceases to act, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.

[*If appropriate, add the following option*]

[*Option: Family information*]

D. *Family Information.* In connection with the administration of this trust, the trustee may rely on the following family information:

1. *Marital Status*. I am not married and do not have a registered domestic partner.

2. *Children*. _ _[*I have no children/The names and birthdates of my children are _ _[list names and birthdates*]_ _]_ _**.**

3. *Deceased Children*. _ _[*I have no deceased children who are survived by issue now living/My child, _ _[name*]_ _*, is deceased and is _ _[not*]_ _ *survived by issue now living*]_ _**.**

Comment: A typical trust name would be "The Mary C. Doe Revocable Trust."

This form creates a trust that is effective immediately on execution as long as care is taken to include the referenced "Exhibit A." See §5.38 for sample schedule of assets.

The optional family information declarations (1) protect the drafter by memorializing the information given by the settlor, (2) provide the possibility that the settlor will alert the drafter if the declarations are incorrect, and (3) provide information that will assist the trustee in administering the trust. For discussion of successor trustees, see chap 16. For

an alternative form designating successor trustees, see §16.48. For a provision authorizing a trustee to nominate the trustee's successor, see Alternative 1 in §16.55.

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II. CREATION OF TRUST FOR MARRIED SETTLORS

A. Trust Property Characterization

§5.20 1. Married Settlor Property Transfer

When married settlors transfer property to a revocable trust, questions arise concerning the consequences of the transfer with respect to the settlors' legal rights in the transferred property: Does community property remain community property inside the trust even though the trust provides management rules that are different from the community property management rules under the Family Code? See §5.21. Does joint tenancy property stop being joint tenancy property? If so, what does it become? See §5.22. The answers to these questions may have important consequences in property distribution rights, taxes, and creditors' rights.

Questions also arise about the possible desirability of identifying property as community property, separate property, and separate property that may be classified as quasi-community property if the settlors are domiciled in California at the time of death or dissolution of marriage. See §5.24. This is particularly true when the trust terms for management and distribution of separate property are significantly different from the terms for management and distribution of community property.

Finally, a preliminary identification of the character of property may reveal reasons that the settlors should "transmute" the character of that property, *e.g.*, to increase the basis of both halves of community property under IRC §1014(b)(6) or a desire to resolve a potential dispute over the character of property while both parties are alive and competent.

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2. Basic Trust Marital Property Provisions

§5.21 a. Preservation of Community Property Character

Unless the trust document or the transfer document expressly provides otherwise, community property that is transferred in trust remains community property during the marriage, regardless of the identity of the trustee, if the trust, originally or as amended before or after the transfer, provides that (Fam C §761(a)):

- The trust is revocable with respect to that property during the marriage; and
- The power, if any, to modify the trust with respect to the rights and interests in that property during the marriage may be exercised only with the joinder or consent of both spouses.

The revocation and amendment clauses in this book meet the requirements of this statute. See §20.3. Nevertheless, it is generally desirable to expressly provide that community property transferred to the trust remains community property. See form in §5.23.

If property is community property (presumably including community property with right of survivorship under CC §682.1 (real estate) or Prob C §5502 (securities)), it is usually the case that the property will receive a new date of death value income tax basis *for both halves of the community property* on the death of whichever spouse dies first. IRC §1014(b)(6). If the same property is owned as shares of separate property, whether as joint tenants, tenants in common, or otherwise, only the separate property interest of the deceased spouse receives a new basis at that time. Accordingly, it is generally important to ensure that community property transferred to a trust will remain community property. Exceptions to this generalization abound. Sometimes property has lost value, with the result that a new date of death value basis will actually lower the income tax basis. Sometimes concerns about creditors' rights will be significant. But as a rule, the drafter simply desires to be sure that the transfer to the trust does not result in losing a tax benefit that would exist without the transfer.

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§5.22 b. Severing and Transmuting Joint Tenancies

When property is transferred to a revocable trust, the settlors generally intend that it will be distributed as provided in the trust document. Trust distribution provisions are usually inconsistent with the survivorship right of a joint tenant, with the apparent consequence that making the joint tenancy property subject to the trust should sever the joint tenancy. *Estate of Powell* (2000) 83 CA4th 1434, 100 CR2d 501. To remove any doubt, particularly during the period before title to a joint tenancy asset is changed to the trustees, it is helpful to include an express provision in the trust document declaring that making property subject to the trust severs the joint tenancy. See form in §5.23.

Severance of a joint tenancy raises questions about the character of the property after the severance. The initial joint tenancy title created a presumption that the property was owned as equal shares of separate property. The Fam C §2581 presumption that joint tenancy property acquired during the marriage is community property does not apply if there is no dissolution of marriage proceeding. A characterization that the property is held as equal shares of separate property is usually undesirable because of the possible loss of the IRC §1014(b)(6) new basis on death for both halves of the community property on the first death. To protect this treatment, the trust should usually provide that a transfer of joint tenancy property to the trust severs the joint tenancy and transmutes the property into community property.

Because joint accounts in a financial institution do not have to be owned equally (CC §683(c); see Prob C §5305), the drafter may wish to minimize the risk of an unintended gift by providing that there is a transmutation into community property only to the extent the parties' interests are equal. This limitation seems sufficient to avoid an implication that there is a waiver of any Fam C §2640 right of reimbursement for separate property contributions to community property if the parties' marriage is later dissolved. See form in §5.23. In the less common case when it is desirable to provide that former jointly owned property is to be treated as shares of separate property, the form can be modified accordingly.

Some practitioners believe it is better practice not to rely completely on the trust instrument to characterize or transmute the property. Instead, they advocate using a separate agreement, signed by the husband and wife, addressing these issues (such as the Fam C §2640 issue).

NOTE: The ethical issues facing the attorney who represents both spouses on property characterization and transmutation should not be ignored. See chap 2, §5.25.

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§5.23 c. Form: Character of Trust Property

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A. *Property Retains Character*. Except as expressly provided in this document, all property becoming subject to this trust shall retain its character as community property, quasi-community property, or separate property after becoming trust property.

B. *Exception: Joint Tenancy Property*. No property now or hereafter subject to this trust is joint tenancy property or community property with right of survivorship. Any property that was joint tenancy property or community property with right of survivorship before becoming trust property shall become community property as a result of becoming trust property to the extent that the settlors' interests in the property were previously equal.

Comment: This clause preserves the character of community property transferred to the trust, severs any joint tenancies transferred to the trust, and provides for a limited transmutation of separate property into community property for interests in the former joint tenancies or community property with right of survivorship. See §§5.21-5.22. If a particular asset, perhaps a "dot.com" stock, has a market price below basis, it may be desirable to hold that particular asset as equal shares of separate property rather than as community property. See §5.21. This form can be modified accordingly.

Appendix A places the clause regarding character of trust property in the Miscellaneous Division in keeping with the general strategy of minimizing the number of technical clauses that appear before the trust disposition clauses. See chap 3.

See the discussion in §5.30 on options for including further clauses characterizing property transferred to the trust to make the characterization either nonbinding or binding.

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B. Character Identification Issues

§5.24 1. Desirability of Characterization

When married settlors contribute property to a trust, issues arise about the desirability and feasibility of identifying the trust property as community property, separate property, and separate property that may be classified as quasi-community property. The issues are complex and require case-by-case evaluation. Expressly stating the character of property can assist the trustee in the administration of the trust both before and after death, particularly with respect to property distribution and proper tax reporting.

Conversely, characterizing property can generate unnecessary disputes between clients, significantly increase planning expenses, and expose the planner to malpractice claims that may or may not be justified. If, *e.g.,* the estate planner identifies an apparent separate property business as separate property with insufficient consideration of the possibility that personal services during the marriage may have created a community property interest, the estate planner may end up being sued for malpractice if the clients' marriage dissolves. The planner might similarly be sued for suggesting a transmutation of quasi-community property into community property if the planner knew that the clients might not remain domiciled in California and their marriage is later dissolved. On conflicts of interest in planning for married couples, see §5.25. On the duty of competence, see §5.26. For further discussion of characterization issues, see California Estate Planning, chap 4 (Cal CEB 2002).

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/ 2. Ethical Issues in Characterizing Trust Property/§5.25 a. Conflicts of Interest

2. Ethical Issues in Characterizing Trust Property

§5.25 a. Conflicts of Interest

Although planning estates for married couples poses various potential conflicts of interest, a typical joint revocable trust does not constitute a contract between the parties. Each party is free to revoke the trust at any time and in many cases each party retains a general power of appointment, which permits that party to unilaterally change the disposition of that party's share of the trust property at any time. If, however, the trust purports to identify the character of marital property, the trust may be a binding contract to that extent. It may also result in the transfer of property interests from one party to another. The contract and agreement may be important if the marriage is dissolved as well as changing the amounts of property that each party can transfer at death. As a consequence, an attempt to characterize that property heightens concern about Cal Rules of Prof Cond 3-310, which reads in part:

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

Even if the trust does not expressly characterize property, litigation may result if the trust contains a provision that arguably has the same consequence. In *Marriage of Starkman* (2005) 129 CA4th 659, 28 CR3d 639, for example, the court held that separate property stock transferred to a revocable trust was not transmuted into community property by a trust provision stating that the property transferred to the trust was community property unless identified as the separate property of either settlor. Therefore, the nontransferor spouse was not entitled to a share of the property on dissolution. See also *Marriage of Lund* (2009) 174 CA4th 40, 94 CR3d 84; *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385 (agreements that purported to transmute separate property to community property for estate planning purposes and subject to a specified revocable trust disposition on death resulted in division of property on dissolution). At a minimum, an attorney who chooses to document a characterization of the property interests of husband and wife must obtain both parties' informed written consent. Because the consent must be "informed," the consent must disclose the "relevant circumstances" and the "actual and reasonably foreseeable adverse consequences" of joint representation. Cal Rules of Prof Cond 3-310(A)(1).

In most instances, the engagement letter will address the husband/wife conflict issues, but the attorney must be certain that is the case. For discussion of conflicts in joint representation, see chap 2.

If the characterization of property changes the surviving spouse's share of community property or quasi-community property, query whether Prob C §§140-147 (waiver of rights) would apply. It is unclear whether someone other than a spouse (*e.g.*, his or her children after his or her death) may use Prob C §§140-147 to void an agreement the spouse made during his or her lifetime. If the provisions do apply, joint representation creates the additional risk that the agreement will be unenforceable because the surviving spouse did not have independent counsel. Prob C §143(a)(2). Assuming that the surviving spouse was properly advised to obtain independent counsel, however, a waiver of the right to receive property as an omitted spouse in a premarital agreement is enforceable if the agreement made a fair and reasonable disposition of the rights of the surviving spouse at the time of signing and the surviving spouse had adequate knowledge of the property and financial obligations of the decedent, as required by Prob C §144(a), even if the agreement did not satisfy all the requirements for a premarital agreement under Fam C §1615. See *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502.

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§5.26 b. Duty of Competence

An attorney has a duty to perform legal services competently. Cal Rules of Prof Cond 3-110. See chap 2. Some estate planning attorneys have considerable family law experience; others do not. Often, the character of the clients' assets is relatively obvious. In others, the task of characterizing property presents complex issues resulting from multiple domicile changes, exceptionally difficult tracing issues, or the use of community property services in connection with the development of a separate property business. In such situations, attorneys who do not have family law experience should consider associating qualified counsel. For an excellent discussion of family law/estate planning cross-over issues, see Moore, *Your Client is Getting a Divorce: Selected Family Law Issues for Estate Planning Lawyers*, Estate Planning 2004, chap 3 (Cal CEB 2004); Moore, *Transmutation of Separate Property to Community Property: Family Code Section 2640 Lays a Trap for the Unwary*, 5 Cal Trusts & Estates Q 11 (Summer 1999).

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§5.27 3. Cost of Determining Character

The expense of determining the character of property can vary considerably. In some situations it will be obvious that all property is community property, except perhaps for a recent inheritance that has not been commingled. But consider the situation of a husband and wife who lived in New York until moving to California following retirement. Only one spouse was employed during the marriage. That spouse also inherited property. Before that spouse arrived in California all of that spouse's property was separate property and there was no reason to segregate property that would be quasi-community property in the event of death while domiciled in California. Even if financial records are sufficient to trace the quasi-community property, it is quite possible that the clients will be unwilling to incur the legal and accounting expenses necessary for the tracing—particularly if there is no assurance that they will still be domiciled in California at death.

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§5.28 4. Potential Disputes Between Clients

The effort to characterize a particular asset may sometimes be more trouble than it is worth because of the potential for creating a dispute. For example, if the revocable trust provides that all tangible personal property will pass to the survivor, it may not be necessary to decide whether the husband's gift of an expensive piece of jewelry to the wife converted the community property purchase money into the wife's separate property. (For an example of the possible complexity of the issue, see *Marriage of Steinberger* (2001) 91 CA4th 1449, 111 CR2d 521, construing Fam C §852(c). This statute provides that the usually applicable writing requirement for a valid transmutation does not apply to certain gifts of personal property that are "not substantial in value taking into account the circumstances of the marriage." Fam C §852(c). For these purposes, the term "marriage" should be read to include a domestic partnership under Fam C §297.5.)

Similarly, the often sensitive issue of whether there is a community property interest in a separate property business may eventually disappear if the property will pass to the spouse. In these situations, it is often best to leave the characterization issue unresolved. Insistence on characterization may result in the clients' failing to complete the estate plan, or it may result in one spouse or registered domestic partner acquiescing in a settlement of the issue, which has the effect of making a gift that the spouse or partner did not want to make. Furthermore, if a dispute later arises (either before or after a spouse's death), there is a possibility that the "agreement" concerning character will be unenforceable if the spouse or partner challenging the characterization did not have independent counsel. Prob C §143(a)(2).

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C. Character Identification Strategies

§5.29 1. Planning Alternatives

The practitioner can adopt various strategies to deal with the identification issues discussed in §§5.24-5.28. No particular approach is always correct. In each case it is necessary to weigh the benefits of property characterization against the problems presented.

No provisions characterizing property. Often a drafter makes no effort to memorialize the character of property. This approach may be appropriate when all or most of the property will pass to the surviving spouse, the separate property is negligible, the cost of characterizing property is high, the risk of dispute is high, and the provisions for distribution of the trust estate in the event of incompetence do not distinguish between separate property and community property. Even then, practitioners might instead consider a hybrid solution in which the character of some assets is identified in either the trust or a separate document.

Nonbinding characterization. Another strategy is to make a tentative identification of the character of property, but to expressly provide that the identification is not binding and does not transmute the character of any property. The tentative identification protects the trustee—particularly a third party trustee—allowing the trustee to administer the trust in accordance with the identification. This approach minimizes both the risk of an unintended gift and the risk of a characterization mistake by the attorney. For a form of nonbinding characterization, see Alternative 1 in form 5.30-1.

Binding characterization. Whether included in the trust document or in a separate document, or both, a binding agreement that characterizes trust property and complies with the Fam C §852 transmutation statute can provide various benefits, depending on the relevance of the characterization in the particular circumstances. These benefits may include:

- Reduction in the potential for future disputes between the settlors or among trust beneficiaries;
- Reduction in the potential for future disputes with the IRS on the tax consequences involving trust property; and
- Protection of the trustee when distribution rights or tax planning decisions depend on the character of trust property.

The attorney must be careful to avoid unintended gifts or putting one spouse into a situation in which he or she feels pressured to make a gift that he or she does not wish to make merely because the attorney has suggested possible tax benefits. Under Fam C §852, a written "express declaration" is usually required for a valid transmutation of property other than certain tangible property of a personal nature. While courts have held that no particular form of words is required by the statute, it is often preferable to use the word "transmute" to avoid potential litigation. See *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153; *Estate of Bibb* (2001) 87 CA4th 461, 104 CR2d 415. See also *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471. For a form of binding agreement, see Alternative 2 in form 5.30-1.

Hybrid strategies. It is often appropriate to combine strategies. For example, it may be absolutely clear that a large block of stock is separate property, but it may be unclear whether any of the dividends from that stock are traceable. It may well be appropriate to confirm that the stock is separate property, but not address the tracing issue.

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§5.30 2. Form: Characterization of Trust Property in Exhibit A

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5.30-1 Characterizing trust property

[*Add one of the following alternatives*]

[*Alternative 1: No binding agreement*]

Character of Trust Property. **The attached listing of trust property does not constitute a binding agreement between the settlors with respect to the character of that property as community property, separate property, or quasi-community property, but the trustee may rely on any characterizations of the trust property in that listing until such time as an interested party notifies the trustee that a characterization in the listing is disputed or incorrect.**

[*Alternative 2: Binding agreement and transmutation*]

Character of Trust Property. **The settlors agree that the characterizations of trust property as community property, separate property, and quasi-community property made in the attached listing of trust property are true and correct, and the settlors hereby convey and transmute their interests in the listed property to conform with those characterizations.**

Comment: If the listing of trust property will identify the character of some or all of the trust property, the trust document should clarify the extent to which the settlors intend that the identification constitutes their binding agreement with respect to the character of the property. The forms in the appendixes use Alternative 1. If the drafter prefers to use Alternative 2, consideration should also be given to the use of a separate contract between the settlors settling their property rights. For discussion, see §5.29.

The clauses above may be appended to either form 5.37-2 (declaring that property in Exhibit A is trust property) or form 5.23-1 (declaring trust property retains previous character except for joint tenancy property). In Appendix A, these clauses are placed in Division I, Creation of Trust.

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D. Quasi-Community Property Considerations

§5.31 1. Nature of Quasi-Community Property

Separate property acquired by persons domiciled outside California may become "quasi-community property" for specified purposes if their domicile changes to California. Generally, the quasi-community property classification is relevant only in connection with dissolution of marriage (and similar) proceedings and the right to transfer property on death. Fam C §125(a); Prob C §66. A possible exception to this generalization is Fam C §912, which treats quasi-community property as community property for debt liability purposes. The constitutionality of §912 is open to debate because the state's need to infringe on the vested rights of property owners is less clear than in marital dissolutions. See *Addison v Addison* (1965) 62 C2d 558, 43 CR 97, upholding the constitutionality of quasi-community property in marital dissolutions. See also *Estate of Thornton* (1934) 1 C2d 1, 33 P2d 1, in which the court struck down a 1917 statute that purported to treat quasi-community property as community property for all purposes. For the argument in favor of constitutionality, see 17 Cal L Rev'n Comm'n Reports 1, 12 n14 (1984) and Comment to Fam C §912.

For purposes related to the treatment of property at death, Prob C §66 provides that quasi-community property includes the following:

- "All personal property wherever situated, and all real property situated in this state, heretofore or hereafter acquired by a decedent while domiciled elsewhere that would have been the community property of the decedent and the surviving spouse if the decedent had been domiciled in this state at the time of its acquisition" and;
- "All personal property wherever situated, and all real property situated in this state, heretofore or hereafter acquired in exchange for real or personal property, wherever situated, that would have been the community property of the decedent and the surviving spouse if the decedent had been domiciled in this state at the time the property so exchanged was acquired."

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.32 2. Surviving Spouse's Rights to Quasi-Community Property

§5.32 2. Surviving Spouse's Rights to Quasi-Community Property

Under Prob C §101(a), half of the decedent's quasi-community property belongs to the surviving spouse and half belongs to the decedent's estate. *This statute applies only if the decedent, at death, was both married and domiciled in California.* The decedent's half of all quasi-community *personal* property, wherever located, and half of all quasi-community *real* property in California are subject to the decedent's testamentary disposition (Prob C §6101) and, in the absence of testamentary disposition, goes to the surviving spouse (Prob C §6401).

NOTE: The division of quasi-community property on death is radically different from the division of regular community property on death. When regular community property is divided on death, the property subject to division includes the property earned by *both* spouses. When quasi-community property is divided, only the property earned by the decedent is divided and the survivor retains all property earned by the survivor. The result of a division of quasi-community property at death resembles a division of community property only when all earnings during marriage were earned by the first spouse to die. Accordingly, when identifying the character of trust property in a trust document, it is insufficient to label an item of property as "quasi-community property" without indicating which spouse is the owner of that item.

The surviving spouse is not required to make an election between the will and statutory rights to quasi-community property (see Prob C §101(a)), although he or she may be required to do so by the express provisions of the deceased spouse's will or revocable trust.

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§5.33 3. Treatment as Separate Property During Joint Lifetimes of Spouses and for Estate Tax Purposes

For federal tax purposes, quasi-community property is treated as separate property. *Estate of Frank Sbicca* (1960) 35 TC 96. If the settlors do not file joint income tax returns, income from the property is reported on the owner's return. On death, all of the decedent's quasi-community property is included in the decedent's estate, and that property is entitled to a new income tax basis under IRC §1014. A federal estate tax marital deduction is allowed for any share belonging to the surviving spouse by operation of Prob C 101(a) or otherwise passing to the spouse.

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§5.34 4. Restoration of Transferred Quasi-Community Property to Surviving Spouse

If the decedent made specified types of living transfers to a third party of quasi-community property without substantial consideration, the surviving spouse may require the transferee to restore to the decedent's estate half of that property if the transferee retains the property or, if not, half of its proceeds or (if none) half of its value at the time of transfer. Prob C §102. Apparently because of concerns about the constitutionality of limiting a person's ability to make gifts solely because of a change in domicile (see, *e.g., Estate of Thornton* (1934) 1 C2d 1, 33 P2d 1, and other authorities discussed in §5.31), this power is extremely limited, generally applying only when the decedent retained an interest in the transferred property until death.

The effect of §102 is to emphasize that, in the absence of marital dissolution proceedings, the right to a share of the other spouse's quasi-community property is a mere expectancy. It is conditioned on survival, on California domicile at death, on the absence of an outright inter vivos gift, and, possibly, on the absence of a conversion of the assets into real property in a separate property state. Nevertheless, it is generally prudent to obtain a spouse's consent when making a large gift of property that might later be subject to a claim under the statute.

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§5.35 5. Trust Drafting Issues

If one or both spouses own significant amounts of quasi-community property, as frequently occurs with mobile business executives, retired military personnel, and older couples who have recently changed their domicile to be near younger family members, the trust drafter faces several issues.

First, it may be desirable to transmute the quasi-community property into true community property—at least to the extent that the spouses are contributing equally to the property that will become community property. Such a transmutation may increase the property that will receive a new income tax basis on the first death under IRC §1014. Without the transmutation, the quasi-community property of the surviving settlor will not receive a new basis on the first death. There may, however, be nontax reasons to avoid such a transmutation. The spouse with the longer life expectancy may benefit from preservation of the status quo, which allows the survivor to retain his or her separate property while being entitled to at least half of the decedent's quasi-community property. To the extent that the values of each spouse's quasi-community property assets are different, a conversion to community property may generate a significant gift that the party with more property does not want to make. Also, the owner of the quasi-community property may be unwilling to give up inter vivos separate property benefits that may include management rights and rights to make gifts that are greater than will be enjoyed if the property is converted to community property.

Another concern of the drafter is to make sure that the trust document does not *inadvertently* provide for a distribution of quasi-community property that is contrary to Prob C §101. The forms in this book accomplish this objective by providing that the survivor's half interest in quasi-community property is to be allocated to the Survivor's Trust. If that arrangement is not acceptable to the settlor who owns the quasi-community property, he or she may choose to force the other spouse to make an election between the statutory right to half of the decedent's quasi-community property and survivor's rights under the trust. (When a forced election is involved, it is common to establish a separate trust for the settlor who intends to force the election.) For example, a settlor with children by a previous marriage might compel the survivor to choose between receiving half of the quasi-community property or receiving an income interest for life in 100 percent of that property. If there is to be an agreement waiving a spouse's quasi-community rights, the agreement is subject to Prob C §§140-147 and may therefore be unenforceable in the absence of complete financial disclosure and the advice of independent counsel.

For discussion of the ethical considerations for an attorney who is advising a couple with quasi-community property issues, see §5.25.

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§5.36 E. Separate Property in Joint Trust

When one or both settlors own a significant amount of separate property, the drafter must consider whether it would be preferable to establish a separate trust for separate property. A separate trust is usually desirable if the provisions concerning distributions in the event of incompetence during the settlors' joint lifetimes are significantly different for separate property than for community property. Similarly, a desire to have a different trustee for separate property during the owner's incompetence suggests the desirability of a separate trust. A separate trust can also be a useful device for avoiding commingling of separate and community property. A separate trust can be unilaterally amended by the settlor. Further, the owner of separate property may simply feel more comfortable having a separate trust.

For ethical considerations in advising the client about using a joint trust or a separate trust, see chap 2.

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Source: Estate Planning/Drafting California Revocable Trusts/5 Creation of Trust/§5.37 F. Form: Creation of Married Settlor Trust

§5.37 F. Form: Creation of Married Settlor Trust

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5.37-1 Opening declaration

OPENING DECLARATION

The _ _[*Name of Trust*]_ _ Trust

We, _ _[*name of settlor*]_ _ and _ _[*name of settlor*]_ _, sometimes hereafter called "settlors," residing in _ _[*name of county*]_ _, California, hereby create The _ _[*Name of Trust*]_ _ Trust, declaring:

5.37-2 Creation of trust

CREATION OF TRUST

Initial Trust Property. **The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is _ _[*now held by us/hereby transferred to the initial trustee(s) named below*]_ _ in trust. This property and any other property later transferred to the trust is hereafter referred to as the trust property and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.**

5.37-3 Purposes, trustees, and family declarations

PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. *Care of Settlors.* To provide for our care and maintenance as long as either of us is living;

2. *Avoid Conservatorship.* To facilitate management of the trust property in the event of the incapacity of one or both of us;

3. *Transfer Property at Death.* To facilitate transfer of the trust property on our deaths; and

4*. Tax Planning.* To provide opportunities for reducing or postponing taxes that might be imposed as a result of our deaths.

B. *Initial Trustee.* _ _[*We are/*_ _[*Name*]_ _ *is*]_ _ the initial trustee(s) of this trust.

C. *Successor Trustees.* _ _[*If either of us ceases to be a trustee of this trust, the other shall become the sole trustee.*]_ _ **If the trustee resigns or ceases to be trustee, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify, resigns, or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.**

[*If appropriate, add the following option*]

[*Option: Family information*]

D. *Family Information.* In connection with the administration of this trust, the trustee may rely on the following family information:

1. *Marriage*. We are husband and wife and were married in _ _[*city and state of marriage*]_ _ on _ _[*date of marriage*]_ _.

2. *Citizenship*. _ _[*We are both/We are not/*_ _[*Name of settlor*]_ _ *is a citizen of the United States.* _ _[*Name of settlor*]_ _ *is not a*]_ _ citizen(s) of the United States.

3. *Children*. The names and birthdates of our children are: _ _[*List names and birthdates*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1: No deceased children*]

4. *Deceased Children*. Neither of us has any deceased children who are survived by issue now living.

[*Alternative 2: Both settlors*]

4. *Deceased Children*. Our child, _ _[*name*]_ _, is deceased and is _ _[*not*]_ _ survived by issue now living.

[*Alternative 3: One settlor*]

4. *Deceased Children*. _ _[*Name of settlor*]_ _'s child, _ _[*name*]_ _, is deceased and is _ _[*not*]_ _ survived by issue now living.

Comment: A typical trust name would be "The John and Mary C. Doe Revocable Trust."

This form creates a trust that is effective immediately on execution as long as care is taken to include the referenced "Exhibit A." See §5.38 for sample schedule of assets.

The list of trust purposes and family information in form 5.37-3 is optional. Family information declarations protect the drafter by memorializing the information given by the settlor, provide the possibility that the settlor will alert the drafter if the declarations are incorrect, and provide information that will assist the trustee in administering the trust. Citizenship is significant because the regular IRC §2056 federal estate tax marital deduction is not available if a surviving settlor is not a United States citizen. For discussion of noncitizen settlors, see §5.18, chap 13. For discussion of successor trustees, see also chap 16. For an alternative form nominating successor trustees, see form 13.30-1. For a provision authorizing a trustee to nominate the trustee's successor, see form 16.55-1.

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§5.37A III. CREATION OF JOINT TRUST FOR DOMESTIC PARTNER SETTLORS

The considerations discussed in §§5.20-5.37 generally also apply to a jointly settled trust in which the settlors are registered domestic partners. See Fam C §297.5. Of course, considerations relating to the estate tax marital deduction do not apply to same-sex domestic partners. In addition, the IRC §1014(b)(6) new basis on death for both halves of community property does not apply to same-sex domestic partners for federal income tax purposes. See §4.41. For a detailed discussion of estate planning for domestic partners, see California Estate Planning §§4.41-4.63 (Cal CEB 2002).

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§5.38 IV. FORM: SAMPLE SCHEDULE OF ASSETS (EXHIBIT A)

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5.38-1 Schedule of assets

THE _ _[*Name of Trust*]_ _ TRUST

Exhibit A

Initial Trust Property

The initial trust estate consists of all right, title, and interest of the _ _[*settlor/settlors or either of them*]_ _ in or to any and all of the following property.

[*Edit as appropriate*]

1. The residence commonly known as _ _[*street address*]_ _.

2. The contents of that residence.

3. All other real property.

4. All bank, stock brokerage, and other financial and securities accounts of any kind.

5. All stocks, bonds, and other securities of any kind.

6. All intangible property, including any indebtedness of any person or entity.

[*Add if appropriate*]

7. Vehicles, boats, _ _[*other known tangible property*]_ _.

[8]. Small business interest: _ _[*Identify*]_ _.

Despite the foregoing, the initial trust estate does not include the following property: _ _[*Specify*]_ _.

Comment: This list is appropriate for a trust that will include substantially all of the settlor's currently transferable assets except, perhaps, tangible personal property. A client may wish to pass a particular item of property at death using an existing joint tenancy or pay on death title, in which event that property should be expressly excluded. Note that form 5.23-1 expressly severs joint tenancies. Many practitioners use far more detailed property lists than the one shown here. For settlors of a joint trust who are spouses or registered domestic partners, the list may indicate the character of some or all of the trust property as community property, each spouse's or partner's separate property, and whether a particular item of separate property is to be treated as quasi-community property. For a detailed discussion of the advantages and disadvantages of indicating the character of trust property, see §§5.24-5.28.

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6

Distributions While Trust Is Revocable

Charles A. Larson

I. LIFETIME TRUST DISTRIBUTIONS
- A. Distributions to Settlors §6.1
- B. Distributions to Third Parties §6.2

II. DISTRIBUTION TO SPOUSES
- A. Community Property
  - 1. Distributions of Community Property §6.3
  - 2. Trustee Discretion §6.4
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V. PAYMENTS TO OTHERS
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  - 1. When Consent Is Required for Payments §6.15
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  - 2. Form: Support of Individual Beneficiary When Settlor Is Incompetent §6.21

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I. LIFETIME TRUST DISTRIBUTIONS

§6.1 A. Distributions to Settlors

A typical revocable trust for a single person (including a typical "survivor's trust" that is revocable by the surviving settlor as described in chap 12) will provide for distributions to the settlor during the settlor's lifetime. A joint trust settled by spouses or domestic partners will contain provisions governing distributions during the joint lifetimes of both settlors. When a single settlor holds the revocation power and is also entitled to receive all of the trust property on revocation, the drafter's task usually is relatively simple. See §6.13.

When a joint trust is used for spouses or registered domestic partners, the issues and solutions may become more complicated—particularly if either settlor has substantial separate property. With a joint trust there is a substantial possibility that the day will come when both settlors are living but only one of them is competent. A settlor with substantial separate property and children from a prior marriage or partnership who becomes incompetent may be unwilling to allow the competent settlor to make unrestricted withdrawals of the incompetent settlor's separate property—particularly when community property is available for the competent settlor's support. Similar issues can arise even with community property, but at least for community property withdrawn from a trust, the withdrawing settlor has fiduciary obligations to use the property for the benefit of the community. See Fam C §1100(e). Because the typical joint trust permits either settlor to revoke the trust with respect to community property, joint trust distribution provisions typically permit either settlor to withdraw community property. If there is substantial separate property, custom drafting may be needed for the separate property. The drafter must address issues regarding the extent to which (see §§6.6-6.8):

- It is permissible to use separate property for support when community property is available;
- The separate property of a settlor is available to support himself or herself if the settlor becomes incompetent; and
- The separate property of a settlor is available to support the other settlor if the settlor owner becomes incompetent.

NOTE: The drafter should specifically address these separate property issues with the client in the interview, not just in the drafting process. Although it may be difficult for clients to focus on and be honest about these issues, the drafter should not resolve these drafting decisions by extrapolating what the clients would want based on other aspects of the interview.

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§6.2 B. Distributions to Third Parties

In some situations, provisions for distributions during the lifetime of the settlor will include provisions for distributions to other beneficiaries. These may include provisions for the support of dependents or members of the settlor's household.

WARNING: A provision for the support of dependents cannot be included in any trust, including a survivor's trust, that is intended to qualify for the marital deduction. Such a provision will not meet the requirements of IRC §2056(b)(5), (b)(7)(B)(ii), because it permits trust distributions to someone other than the spouse during the spouse's lifetime. For third party distributions from a survivor's trust that is intended to qualify for the marital deduction, see chap 12.

If it is otherwise desirable to have a survivor's trust that permits distributions to third parties, the power to make the distributions, if the surviving settlor becomes incompetent, should be granted to the surviving settlor's attorney-in-fact under a durable power of attorney, and the attorney-in-fact should be expressly granted the power to make withdrawals from the trust on behalf of the surviving settlor to make distributions to the third party. See Prob C §§4264-4465. The trust document also must expressly permit withdrawals by an attorney-in-fact. Prob C §15401(c). See §6.19. For marital deduction survivor's trust clause when settlors wish to provide for distributions to third parties while still qualifying for the marital deduction, see chap 12. For discussion of durable powers of attorney, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

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II. DISTRIBUTION TO SPOUSES

A. Community Property

§6.3 1. Distributions of Community Property

Several considerations affect decisions about distributions made to the settlors of a joint revocable trust during their joint lifetimes that must be specifically addressed in the client interview and in the drafting process.

- If one or both settlors have separate property, the provisions on distribution of community property must be coordinated with the provisions on distribution of the separate property.
- If the trust is intended to remain fully funded with substantially all of the settlors' assets, it is normally inappropriate to provide for mandatory distributions in excess of the settlors' current expenses.
- The distribution provisions must take into account the possibility that one or both of the settlors will become incompetent for some period before death.
- Married settlors vary considerably in the extent to which they are willing to establish property arrangements that will permit each settlor to engage in major transactions unilaterally.
- When a third party is acting as trustee, the third party needs more guidance than when the settlors are the trustees.

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§6.4 2. Trustee Discretion

In most situations, the appropriate distribution provisions will be a logical consequence of the management and control decisions that are implicit in other trust provisions regarding exercises of trustee powers and rights to distribution in the event of revocation. If these other provisions already confer on each settlor the power to act unilaterally and without notice, there is little point in having more restrictive distribution provisions. By the same token, if a third party is acting as trustee, revocation requires notice, and property is distributed on revocation to both settlors jointly if they are both competent, it would be anomalous to use distribution provisions that would allow either settlor to withdraw unilaterally any and all trust property.

As a rule, the various considerations can be addressed with a trust provision that gives the trustee discretion to make distributions for the settlors' health, education, maintenance, and support. Such a provision is generally advisable if the settlors become incompetent. Although the provision in §6.5 is limited by an ascertainable standard, if the settlors want to provide for more liberal distributions for themselves during their lifetime, form 6.5-1 can be modified to provide distributions for, *e.g.,* comfort, happiness, welfare, generous support.

The discretionary distribution power may be augmented with withdrawal rights given to the settlors. Depending on the settlors' concerns and objectives, the withdrawal rights can be made exercisable unilaterally or jointly. If the withdrawal right can be exercised jointly only, the drafter must consider the potential consequences if one of the spouses becomes incompetent. If the distribution provisions are too restrictive, the competent spouse may find it necessary to revoke the trust. A competent spouse of an incompetent person generally has the right, subject to modest restrictions, to manage community property not held in trust. See Fam C §§1100-1103; Prob C §§3051, 3071. For a provision on determination of incompetence, see §6.12.

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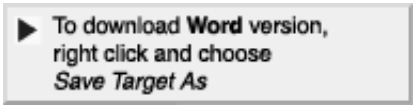
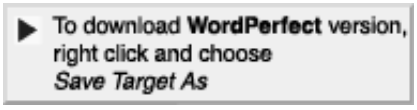
Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.5 3. Form: Distributions of Community Property

§6.5 3. Form: Distributions of Community Property





6.5-1 Distributions of community property

Distributions of Community Property. **While we are both living, the trustee shall pay to us, or apply for our benefit, as much of the community property income and principal of this trust as either of us requests plus such additional sums as the trustee in its discretion determines are appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. All distributions of community property income or principal shall be paid to us or applied for our benefit as community property.**

[*If applicable, add the following option*]

[*Option: Settlors wish to remain at home as long as possible*]

Settlors' Wishes to Remain at Home. **In exercising its discretion under this Division, the trustee shall take into account our wishes to live in our own home as long as we are physically able to do so, even if this significantly increases the cost of support. We desire to continue to live at home, despite the cost of care, as long as financial resources are available to pay for our care. Before any change is made in where either of us reside, all of our financial resources _ _**[*including any loan on the home*/*except the home and any equity in the home*]**_ _ shall be used to pay for care at home for either of us even if the financial resources are depleted in their entirety.**

Comment: For additional language that may be included describing the circumstances under which the trustee may remove the settlors from their home, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide §6.7 (Cal CEB 2003).

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B. Separate Property

§6.6 1. Distributions of Separate Property to Married Settlors

Appropriate provisions for distribution of separate property will vary greatly depending on client wishes, the nature and extent of the separate property, and the value of the separate property compared with the value of the community property. Provisions that might be appropriate if the community property is extensive and the separate property is, *e.g.*, a small amount of jewelry, obviously will be inappropriate when the community estate is small and one settlor has extensive separate property. Provisions that are suitable for separate property family heirlooms and vacation homes are likely to be inappropriate for a large amount of investment securities. In some situations, different trust provisions will be needed for the separate property of each settlor. It is often appropriate to address the possibility that a settlor will acquire a large amount of separate property at some time in the future, particularly if that settlor's attorney-in-fact might transfer after-acquired property to the trust when the settlor is no longer competent.

WARNING: Although §6.8 contains several suggested provisions for distribution of separate property, the drafter should note that no one separate property clause works for everyone and should be careful to draft provisions expressly tailored to the client's needs.

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§6.7 2. Addressing Potential Conflicts

Conflicts frequently arise with respect to distribution of separate property, and drafters must address the distribution provisions for this type of property carefully. In some situations, the potential issues will have been addressed by a prenuptial agreement. In other situations the parties' preexisting practices concerning control and use of separate property can provide a basis for drafting separate property distribution provisions that are acceptable to both spouses. Sometimes the settlors cannot agree on the use of separate property. In such instances it may be best to put the separate property in a separate trust.

NOTE: Even when the spouses agree about use of the separate property, it may be advisable to use a separate property trust when a settlor has brought a lot of inherited separate property into the marriage and is accustomed to handling it separately. Even though the spouses will have already consented to joint representation, when it is advisable to put the settlors' separate property in separate trusts, the drafter should consider again the possible need for separate counsel for each spouse. For discussion of conflicts in representing couples, see §§2.27-2.35.

Generally, a spouse trustee should not have the power to make distributions to him- or herself from the principal of the other spouse's separate property, unless the trust includes an ascertainable standard for the distribution. On the ascertainable standard, see §7.30. Otherwise, the spouse trustee may have a general power of appointment over the other spouse's separate property. A spouse who has the right to substitute him- or herself as trustee is considered to hold any power held by the trustee. Treas Reg §20.2041-1(b)(1). See §7.26. In this context, the lapse of a spouse's general power will not necessarily qualify for the marital deduction, because there is a possibility that the power will lapse before the owner of the separate property is the only possible distributee during the owner's lifetime. Also, there is a possibility the spouse will cease to be trustee before the spouse's death.

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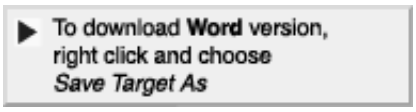
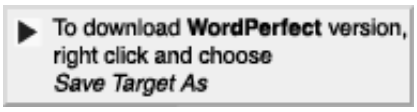
Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.8 3. Form: Distributions of Separate Property to Married Settlors

§6.8 3. Form: Distributions of Separate Property to Married Settlors





6.8-1 Distributions of separate property to married settlors

[*Add one of the following alternatives*]

[*Alternative 1: Separate property to be used in accordance with past practice*]

Distributions of Separate Property. **While we are both living, trust property that is the separate property of one of us (the "owning settlor") shall be distributed or provided for use in kind as the owning settlor requests. If at any time an owning settlor is not competent to make requests, the trustee shall pay to us or apply for our benefit as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. In exercising its discretion, the trustee shall take into account that we desire that property shall be applied for these purposes in a manner similar to the applications we made while competent. If the trustee is uncertain about our past practices, or if a particular expense is new or significantly changed in amount, the trustee shall apply property in the following order:**

1. *Income*. _ _[*Approximately proportionate shares of the income from community and the income from separate property./First from the community property income and thereafter from the separate property income.*]_ _ **For purposes of this subparagraph, "income" includes periodic receipts commonly used to pay current living expenses, including receipts from pensions, social security, and disability or long-term care insurance.**

2. *Liquid Investment Assets*. _ _[*Approximately proportionate shares of community property and separate property cash, marketable securities, and other liquid assets./First from the community property cash, marketable securities, and other liquid assets, thereafter from the separate property cash, marketable securities, and other liquid assets.*]_ _

3. *Other Property*. _ _[*Approximately proportionate shares of any remaining community property and separate property./First from any remaining community property and thereafter from separate property.*]_ _

[*Alternative 2: Liberal access to separate property by other spouse in event of owner's incompetence*]

***Distributions of Separate Property*.** **While we are both living, the portion of the trust property that is the separate property of one of us (the "owning settlor") shall be distributed, retained, or provided for use in kind as the owning settlor requests. If at any time the owning settlor is not competent to make requests, the other settlor may make requests on behalf of the owning settlor and may exercise this power for the generous health, education, maintenance, and support of both settlors. If both of us are incompetent, the trustee shall pay to or apply for the benefit of us as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in comfort. In exercising its discretion, the trustee may take into account other income and resources available for these purposes, but is not required to do so.**

[*Alternative 3: Separate property income distributed but use of principal limited*]

Distributions of Separate Property. **While we are both living, the portion of the trust property that is the separate property of one settlor (the "owning settlor") shall be distributed or provided for use in kind as the owning settlor requests. If at any time the owning settlor is not competent to make requests or direct other use of property, the trustee shall pay to or apply for the benefit of us as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. In exercising its discretion with respect to income, the trustee shall disregard other income and resources available for these purposes. In exercising its discretion with respect to principal, the trustee shall take into account other income and reasonably liquid investment assets available for these purposes.**

[*If applicable, add one or more of the following options*]

[*Option: Preservation and distribution of heirlooms*]

Distribution of Heirlooms. **The items of tangible personal property listed in Exhibit ___ are the separate property of Settlor _ _[*name*]_ _ (the "owning settlor"). While the owning settlor is living and competent, this property shall be distributed as requested by the owning settlor. Unless otherwise directed by the owning settlor, the trustee shall not administer and distribute this property in accordance with other directions for the administration and distribution of separate property, but instead shall preserve the property for distribution on the owning settlor's death in accordance with the provisions of this trust pertaining to such distributions.**

[*Option: Preservation and distribution of vacation home*]

Preservation of Vacation Home. **The vacation real property commonly known as _ _[*address*]_ _ is the separate property of _ _[*name*]_ _ (the "owning settlor"). While the owning settlor is living and competent, this property shall be distributed as requested by the owning settlor. Unless otherwise directed by the owning settlor, the trustee shall not administer and distribute this property in accordance with other directions for the administration and distribution of separate property, but instead shall preserve such property for use in kind for vacation purposes by the members of the owning settlor's family in accordance with the owning settlor's practice while competent. If at any time the owning settlor is not competent to make requests or direct other use of such property, the competent settlor and the owning settlor's children may direct the following actions with respect to the property by majority vote: (a) rentals to third parties; (b) sale and replacement; and (c) sale without replacement. If both settlors are incompetent, the trustee and the owning settlor's children may take these same actions by majority vote.**

Comment: Note that Alternative 1 provides for consuming separate property income for living expenses before invading community property principal. This provision is consistent with the spending habits of many clients but contrary to the California common-law presumption that the community property, including community property principal, is expended first. See *Beam v Bank of America* (1971) 6 C3d 12, 20, 98 CR 137.

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C. Quasi-Community Property

§6.9 1. Treated as Separate Property

For purposes of distribution provisions applicable during the joint lifetimes of both settlors, quasi-community property should be treated as separate property unless the clients wish to transmute the property to community property. Quasi-community property is defined as (Prob C §66):

> [T]he following property, other than community property as defined in [Prob C §] 28:
> (a) All personal property wherever situated, and all real property situated in this state, heretofore or hereafter acquired by a decedent while domiciled elsewhere that would have been the community property of the decedent and the surviving spouse if the decedent had been domiciled in this state at the time of its acquisition.
> (b) All personal property wherever situated, and all real property situated in this state, heretofore or hereafter acquired in exchange for real or personal property, wherever situated, that would have been the community property of the decedent and the surviving spouse if the decedent had been domiciled in this state at the time the property so exchanged was acquired.

Under this definition, quasi-community property never becomes community property. Quasi-community property differs from other separate property in ways that most significantly include:

- The quasi-community property of both parties is evenly divided if the marriage is dissolved while the parties are domiciled in California. See Fam C §§63, 2550.
- The quasi-community property of the deceased spouse is divided on the owner's death. Prob C §101. In sharp contrast to the division made on dissolution of marriage, there is no division of quasi-community property owned by the survivor. To reduce the risk that a surviving spouse's right to half of the deceased spouse's quasi-community property will be defeated by inter vivos gifts, the survivor has a modest right to recover the survivor's share of the gifts from recipients if the deceased spouse retained any interest in the gift property. See Prob C §102.
- Quasi-community is liable for the nonowner spouse's debts. Fam C §§912-913.

A settlor may sometimes have both regular separate property and quasi-community property. If so, the settlor may wish that quasi-community property be consumed first—at least to the extent that the quasi-community property is cash or investment property.

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Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.10 2. Form: Preference for Use of Quasi-Community Property

§6.10 2. Form: Preference for Use of Quasi-Community Property

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6.10-1 Preference for use of quasi-community property

[*If applicable, add the following option*]

[*Option: Preference for use of quasi-community property*]

Preference for Use of Quasi-Community Property. **When choosing the separate property to be distributed or otherwise applied for the foregoing purposes, the trustee shall make reasonable efforts under the circumstances to first resort to separate property that is potentially subject to the provisions for disposition of quasi-community property in California Probate Code §101.**

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D. Determination of Incompetence

§6.11 1. Determining Competence of Settlor

A provision to determine the competence of a settlor of a revocable trust can be important for several reasons. Most notable is that a trustee's duty to account is normally owed only to the settlor while the settlor is competent. Prob C §15800. Further, a competent settlor of a revocable rust usually has the power to direct the trustee's actions. Prob C §16001. Finally, a trust may contain provisions that provide for different distribution rules, depending on whether the settlor is competent. Accordingly, providing a method for determining whether the settlor is competent gives the trustee a way to clarify the trustee's duties.

The determination is not binding on the settlor, because the settlor retains the right to revoke the trust. If a settlor of questionable competence purports to revoke a trust, the trustee or other interested party would have to seek a court determination of competence to have the purported revocation set aside.

Drafters should not include a provision that purports to restrict the right of revocation in the event of incompetence. Such a provision can create uncertainty on a wide variety of tax issues and will not prevent the settlor from at least attempting to seek redress in the courts. Further, as a practical matter, disputes between trustees and settlors over the competency of the settlor are exceptionally rare. Disputes usually involve the trustee and other beneficiaries.

Generally the drafter should not use a provision requiring the written opinions of health care providers unless the drafter also takes steps to make sure that the providers can provide the requested written statements without violating either the Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37) or the privacy regulations under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191) (45 CFR §§164.102-164.534). See §16.45. For discussion of HIPAA, see California Powers of Attorney and Health Care Directives, chap 1 (Cal CEB 2008).

If the settlor is also the initial trustee, the trust will normally contain a provision for determining the settlor's competence for purposes of removing the settlor from the role of trustee. See §16.39. For discussion of distributions to third parties when the settlor is incompetent, see §§6.18, 6.20.

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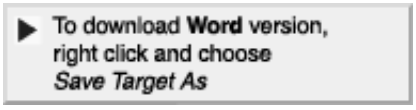
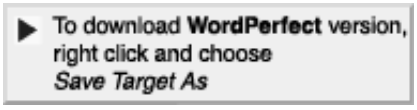
§6.12 2. Form: Determination of Incompetence





6.12-1 Determination of Incompetence

[*Add one of the following alternatives*]

[*Alternative 1: Trustee's own judgment*]

Determination of Incompetence. **For purposes of trust distributions during a settlor's lifetime, a settlor is not competent to make requests if the settlor is a person for whom a conservator of the estate could be appointed under California law. The trustee is not required to obtain a court adjudication of incompetence and may rely on the trustee's personal judgment based on the trustee's observations. The trustee shall not be liable for any such determination that is not made in bad faith and for an improper purpose.**

[*Alternative 2: Opinion of two physicians*]

Determination of Incompetence. **For purposes of making trust distributions during a settlor's lifetime, a settlor is not competent to make requests if the settlor is a person for whom a conservator of the estate could be appointed under California law. The trustee is not required to obtain a court adjudication of incompetence and may rely on the written opinion of two licensed physicians, unrelated by blood or marriage to either settlor or any beneficiary of this trust. The settlor(s) hereby requests such physicians to provide information about the settlor's competence to the trustee as a person involved with the settlor's care and payment for the settlor's care.**

[*Alternative 3: Opinion of majority of specified persons*]

Determination of Incompetence. **For purposes of making trust distributions during a settlor's lifetime, a settlor is not competent to make requests if the settlor is a person for whom a conservator of the estate could be appointed under California law. The trustee is not required to obtain a court adjudication of incompetence and may rely on the written opinions of the majority of those of the following persons who are reasonably available at the time the determination needs to be made: _ _[*names*]_ _.**

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Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.12A III. DISTRIBUTION TO DOMESTIC PARTNERS

§6.12A III. DISTRIBUTION TO DOMESTIC PARTNERS

The considerations discussed and forms provided in §§6.3-6.12 also apply to distributions from jointly settled trusts for registered domestic partners. See Fam C §297.5. For a detailed discussion of estate planning for domestic partners, see California Estate Planning §§4.41-4.63 (Cal CEB 2002).

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IV. DISTRIBUTION TO SINGLE SETTLOR

§6.13 A. Function of Distribution Provision

The main function of the distribution provision for a single settlor is to provide guidance to the trustee when the settlor is incompetent or otherwise unable to request distributions. Although the distributions in form 6.14-1 are limited by an ascertainable standard, if the settlor wants to provide for more liberal distributions for him- or herself during his or her lifetime, form 6.14-1 can be modified to provide for distributions for, *e.g.,* comfort, happiness, welfare, generous support. The distribution provision should confirm the settlor's ability to withdraw whatever the settlor wants—a right the settlor already holds in the form of the settlor's right of revocation. See Prob C §15400. See also Prob C §§16001, 16462 (generally providing that the person having power to revoke the trust can direct the trustee's actions).

The settlor also may wish to provide for distributions for other persons when the settlor is incompetent. For a distribution provision, see §6.20.

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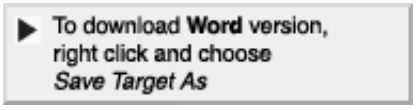
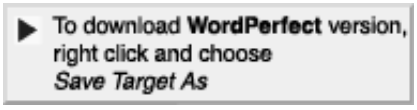
§6.14 B. Form: Distributions to Single Settlor





6.14-1 Distributions to single settlor

Distributions to Settlor. **During my lifetime, the trustee shall pay to or apply for my benefit as much of the income and principal of this trust as I request, plus such additional sums as the trustee in its discretion determines are appropriate for my health, education, maintenance, and support in accordance with my accustomed standard of living.**

[*If applicable, add the following option*]

[*Option: Settlor wishes to remain at home as long as possible*]

Settlor's Wish to Remain at Home. **In exercising discretion under this paragraph, the trustee shall take into account the settlor's wish to live at home as long as the settlor is physically able to do so, even if doing so significantly increases the cost of support. The settlor wishes to continue to live at home, despite the cost of care, as long as financial resources are available to pay for _ _**[*his/her*]**_ _ care. Before any change is made in the settlor's residence, all of the settlor's financial resources _ _**[*including any loan on the home/except the home and any equity in the home*]**_ _ shall be used to pay for the settlor's care at home even if those resources are depleted in their entirety.**

Comment: For additional language that may be included concerning the circumstances under which the trustee may remove the settlor from his or her home, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide §6.7 (Cal CEB 2003).

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V. PAYMENTS TO OTHERS

A. Married Settlors

§6.15 1. When Consent Is Required for Payments

Settlors may transfer income or principal to a child or third party. If, however, a gift of community property is made by one spouse without the written consent of the other spouse, it may be voided by the nonconsenting spouse. Fam C §1101. See Fam C §§761 (community property in revocable trust retains its character unless trust provides otherwise), 1100(b) (prohibits gifting of community personal property by one spouse without the other's consent). Therefore, when the settlors are married, both spouses should sign directions to withdraw community property for the benefit of a third party. On the annual exclusion when property is transferred from the trust within three years before the settlor's death, see §6.17.

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§6.16 2. When Consent Is Not Required

Only the settlor who has contributed separate property should sign requests for payments from that property to third parties, because they are gifts from him or her alone. A direction to make periodic payments is useful for a settlor who supports a parent or other relative.

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Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.17 3. Nonapplication of Three-Year Rule

§6.17 3. Nonapplication of Three-Year Rule

A transfer from a revocable trust (falling within IRC §676 for income tax purposes) is treated as made directly by the decedent and is therefore not included in his or her gross estate under the three-year rule of IRC §2035(a) or for any other purpose. IRC §2035(e).

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Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.18 4. Payments to Third Parties When One Settlor Is Incompetent

§6.18 4. Payments to Third Parties When One Settlor Is Incompetent

If a settlor becomes incompetent, a gift by the other settlor of trust community property to a third party (even an adult child of the settlors) is voidable unless the trust provides otherwise. Fam C §1101. See Fam C §§761, 1100(b). Therefore, if either settlor has dependents for whom he or she is providing support without any legal obligation, the trust should include a clause permitting continued payments to those persons after one spouse becomes incompetent. For a provision for determination of incompetence, see §6.12.

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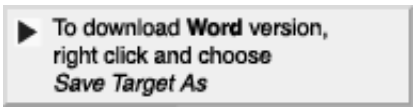
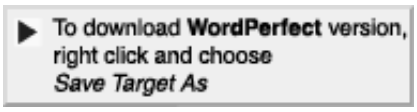
Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.19 5. Form: Payments to Others

§6.19 5. Form: Payments to Others





6.19-1 Payments to others

[*If applicable, add one of the following two options*]

[*Option 1: Power may be exercised by attorney-in-fact*]

Attorney-in-Fact. **A settlor's power to direct distributions may be exercised by an attorney-in-fact if and to the extent the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.**

[*Option 2: Power may not be exercised by attorney-in-fact*]

Attorney-in-Fact. **A settlor's power to direct the trustee to make distributions shall be personal to the settlor and may not be exercised by an attorney-in-fact or a conservator.**

[*If applicable, add the following option*]

[*Option: Continued payments to specified persons from community property after one or both spouses become incompetent*]

Continued Payments to Specified Persons. **During any period in which one or both settlors become incompetent to direct distributions or other use of property, the trustee shall** _ _[*pay/continue to pay*]_ _ **to** _ _[*name(s)*]_ _ **the sum of $**_ _[*dollar amount*]_ _ _ _[*monthly/quarterly/annually*]_ _**.**

Comment: A distribution to a third party accomplishes both a gift and a revocation of the trust with respect to the gifted assets. Accordingly, the power cannot be exercised by an attorney-in-fact unless it is authorized by both the trust document and the power of attorney. See Prob C §§4264, 15401(c). See §6.2. Routinely including Option 1 eliminates the risk that a power of attorney that expressly authorizes actions involving the trust will not be effective. The provision is not needed if the trust contains a more general provision authorizing actions by an attorney-in-fact.

Although Option 2 may be selected if desired, it is usually unwise to prohibit gift-giving by a conservator. Tax laws and circumstances change. A conservator may not make a gift without a "substituted judgment" court order. Prob C §§2580-2586. These statutes provide rigorous safeguards for gifts made by a conservator.

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§6.19A B. Domestic Partner Settlors

The considerations discussed and forms provided in §§6.15-6.19 also apply to distributions from jointly settled trusts for domestic partners. See Fam C §297.5(a). For a detailed discussion of estate planning for domestic partners, see California Estate Planning §§4.41-4.63 (Cal CEB 2002).

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C. Single Settlor

§6.20 1. Support of Individual Beneficiary When Settlor Is Incompetent

Often, a single settlor may be providing some form of economic benefit to an adult child, sibling, domestic partner, household help, some other person, or even a pet. For trusts for the care of an animal, see Uniform Trust Code §408. The settlor may or may not have a legal obligation to provide the benefits. The economic benefit may be modest (use of the family vacation home or box at the symphony or sports facility) or quite significant (use of an expensive home and motor vehicles that the settlor would want continued if the settlor were to become incompetent). It is important that the trust document state the settlor's wishes with respect to such matters. For a provision for determining incompetence, see §6.12.

If a potential beneficiary will also be a trustee, that beneficiary should not have the power to make distributions to him- or herself unless distributions are limited by an ascertainable standard. On the ascertainable standard, see §7.30. Otherwise, the beneficiary may have a general power of appointment, and trust property will be taxable in his or her estate under IRC §2041. See §§4.91-4.108.

Note that distributions to a person other than a spouse may be taxable gifts. See §6.3.

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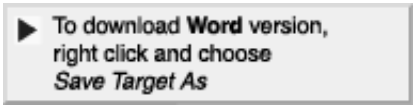
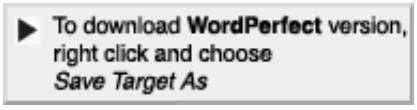
Source: Estate Planning/Drafting California Revocable Trusts/6 Distributions While Trust Is Revocable/§6.21 2. Form: Support of Individual Beneficiary When Settlor Is Incompetent

§6.21 2. Form: Support of Individual Beneficiary When Settlor Is Incompetent





6.21-1 Support of individual beneficiary when settlor is incompetent

Support of Individual Beneficiary When Settlor Incompetent. **During any period in which the settlor is incompetent to make requests or direct other use of property, the trustee shall pay to or apply for the benefit of _ _[*name*]_ _ ("beneficiary") such sums, or use of property in kind, as the trustee deems appropriate for the beneficiary's health, education, maintenance, and support in accordance with the standard of health, education, maintenance, and support provided when the settlor was competent.**

[*If applicable, add the following option*]

[*Option: Support of pets when settlor is incompetent*]

Support of Pets When Settlor Incompetent. **During any period in which the settlor is incompetent to make requests or direct other use of property, the trustee, _ _[*as directed by the special trustee*]_ _, shall distribute single sums or periodic payments out of the trust estate to support my _ _[*e.g., cats, Killer and Fluffy (collectively "my cats" or "my pets")*]_ _ in the same manner and in accordance with the same standard as the Settlor may have provided in the past (adjusted if necessary by circumstances). An attorney-in-fact under a durable power of attorney given by the Settlor may direct these distributions pursuant to authority given in the durable power of attorney.**

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7

Distributions From Continuing Trusts

Jeffrey A. Dennis-Strathmeyer
Joel A. Levine

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§7.1 I. CHOICE OF DISTRIBUTION METHOD

In many cases the death of a settlor triggers the obligation to distribute the entire trust estate free of trust, but in other cases some or all trust property will remain in trust for a prolonged term, making distributions on many occasions. This chapter discusses drafting the dispositive provisions for such continuing trusts.

The number of distribution methods is almost infinite, ranging from the outright gift to the discretionary accumulation trust for the life of the beneficiary. Ideally, the distribution method chosen by a client will fit the particular circumstances of the client and his or her chosen beneficiary. For this to occur, the practitioner must be thoroughly familiar with these factors:

- The client's purposes in making the gift (see §7.2);
- The characteristics of the beneficiary receiving the gift (see §7.3); and
- The available distribution methods and their economic and tax consequences (see §7.4).

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§7.2 A. Client Purposes in Making Gift

An understanding of the client's purposes in making a gift is crucial to choosing the appropriate distribution method or methods to use. For example, a trust that provides for an outright gift by which the beneficiary receives the entire gift on the settlor's death may be inappropriate if the client wanted to make a gift that would provide creditor protection for the beneficiary. If the client wishes to make a gift in order to provide incentives to a beneficiary to accomplish goals desired by the client, then distribution patterns should be structured to provide the desired results.

Except for an outright gift, any gift in trust necessarily involves current beneficiaries and remaindermen. The practitioner should learn to what extent the client wishes to benefit present and future interest holders. For example, if a client's sole concern is the welfare of the client's surviving spouse or domestic partner, it may not be appropriate to limit that spouse or partner to a fixed amount, annuity, or income. See §§7.69-7.71 on identifying favored beneficiaries.

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§7.3 B. Beneficiary Characteristics

To properly advise a client on the best distribution method for a particular beneficiary, the practitioner must become familiar with the nature of the intended beneficiary. For example, if the beneficiary has a history of financial improvidence, one may counsel the client to use a discretionary trust for the beneficiary's support. When the beneficiary is a minor, the client may have no idea how the beneficiary will handle money, in which case the client may wish to grant the trustee the power to accelerate or decelerate otherwise fixed distributions if there is a compelling reason to do so.

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§7.4 C. Available Distribution Methods

Distribution methods may be classified in various ways: They are either discretionary or nondiscretionary. A discretionary method allows the trustee to exercise his or her judgment on whether and when to make a distribution to the beneficiary. The trustee may be required to follow guidelines in the trust document or may have unfettered discretion to make or not make distributions to a beneficiary. See §7.5.

Nondiscretionary distribution methods require the trustee to make distributions to a beneficiary. These distributions may be either fixed or varied. A fixed method requires the trustee to distribute a set dollar amount to the beneficiary. A varied method results in distributions that change in amount because of specific events such as graduation from college or increases in the cost of living. See §7.6.

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§7.5 D. Dangers of Discretionary Distribution Powers

A power to make discretionary distributions to an individual or for the individual's benefit held by the individual alone can result in the individual's being taxed on trust income under IRC §678 even if no distributions are made to the individual and may cause trust property to be included in the individual's estate under IRC §2041 as property subject to a general power of appointment.

It is often immaterial whether the power is held in a fiduciary capacity, and sometimes the existence of the power is subtle, *e.g.,* when the holder can direct distributions to or for the benefit of the holder's own dependents in lieu of supporting them or when the individual has unlimited power to remove and replace a third party trustee that nominally holds the discretionary distribution power. See §§7.22, 7.26.

NOTE: Nondiscretionary powers to make distributions to the holder of the power also have tax ramifications, but these ramifications exist regardless of the trustee's identity and are usually unremarkable. If, for example, a trust provides for distributing all trust income to a beneficiary, the beneficiary will pay income taxes on it, and the distributed property will be included in the beneficiary's estate regardless of whether the beneficiary is the trustee.

Because of the risks associated with discretionary distribution powers, many drafters are afraid of customizing trust distribution provisions and routinely provide settlors with boilerplate canned provisions that reveal little about a particular settlor's wishes and concerns, and unnecessarily appoint independent trustees or mandate inefficient procedures. The primary objective of this chapter is to assist drafters in providing clients with highly customized documents, which may include discretionary distributions without producing undesirable tax results. See §7.2.

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§7.6 E. Fixed and Discretionary Distribution Options

A creative drafter can choose from a wide variety of distribution methods to accomplish settlor objectives.

- The trust document can direct the payment of fixed amounts. For example, the trustee can be directed to pay a beneficiary a specified dollar amount each month.
- Distributions can also be based on a formula, such as payment of a specified dollar amount per month plus cost-of-living adjustments.
- Distributions can be based on fairly objective criteria. For example, the trustee can be ordered to pay trust income or a fixed percentage of the value of the trust property at specified intervals.
- Distributions can be subject to contingencies. For example, a trust may provide for mandatory monthly payments, but provide that distributions become discretionary if the beneficiary declares bankruptcy.
- Distributions can be discretionary but subject to fiduciary duties, such as when a trustee is directed to pay a beneficiary a monthly amount that the trustee determines is appropriate for the beneficiary's support or when a beneficiary withdraws amounts that the beneficiary determines are necessary for support.
- The trust document can provide for discretionary distributions that are not subject to fiduciary duties, as when a favored beneficiary is given an unrestricted power to withdraw specified amounts at specified times or is given a power of appointment that permits the beneficiary to make gifts from the trust to the beneficiary's issue.

Drafters often use multiple distribution rules. See §7.7. Commonly used distribution rules are discussed in §§7.8-7.10.

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§7.7 1. Split-Rule Distributions

It is possible, and indeed common, to split the trust property into parts with different methods for distributing each part. It is also possible to combine multiple provisions for discretionary distributions. For example, a trust document might provide that a trustee is to make discretionary distributions for the beneficiary's support, further providing that the trustee can distribute up to a certain percentage of trust assets to the beneficiary each calendar year without taking into account the beneficiary's own assets, but that distributions cannot be larger unless the beneficiary has no liquid assets of his or her own that could be used for support.

The drafter will likely want to provide one set of distribution rules for a specified portion of the available trust assets and another set of rules for the remaining trust assets. For example, until provisions based on the classical distinction between trust principal and trust income became disfavored, it was common to see trusts that provided for mandatory distributions of "income" but discretionary "invasions" of principal.

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§7.8 2. Common Distribution Rules

There are many alternative ways to provide for distributions from a trust, but the most common involve basing distributions on specified dollar amounts (annuity amounts) and specified percentages of the value of the trust property (unitrust amounts). See §§7.9-7.10. Historically, annuity and unitrust amounts were mostly described in connection with mandatory distribution provisions, but descriptions of such amounts can be useful for other split-rule distributions as well.

PRACTICE TIP: In QTIP situations, in which it is still necessary to ensure that the spouse has a right to traditional trust accounting income in order to ensure an IRC §2056(b)(7) federal estate tax marital deduction, some drafters now provide that the spouse is to receive the *greater* of trust accounting income or a unitrust amount. The assumption is that ensuring the spouse that he or she will receive at least the unitrust amount will make the spouse more willing to permit trust investments in equity securities that may produce a high total return when capital gains are taken into account but produce low dividends and therefore low levels of trust accounting income.

Sometimes a single distribution description will refer to the greater of two different portions of a trust. For example, a "five or five" power gives the holder the unrestricted right to withdraw the greater of an annuity amount of $5000 or a unitrust amount of 5 percent of the trust assets. IRC §2514(e). See §§7.90-7.92.

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§7.9 a. Annuity Amount

An annuity amount is a specified dollar amount payable at specified intervals. The specific amount may vary. For example, many provisions describing annuities provide for cost-of-living adjustments. Also, particularly with charitable giving, the initial annuity amount may be established by a formula rather than stated as a specific dollar amount. For further discussion of annuities, see §§7.45-7.48.

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§7.10 b. Unitrust Amount

A unitrust amount is a fixed percentage of the value of the trust estate, with the assets revalued at selected intervals. Trusts mandating distribution of a unitrust amount have long been a common method of obtaining a charitable deduction for a charitable remainder trust and, less often, as a way to obtain such a deduction for a charitable lead trust. IRC §§664, 2055(e). If charitable deduction qualification is an issue, the assets must be revalued annually. See §§7.49-7.54.

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II. INCOME TAX CONSIDERATIONS

§7.11 A. Trust Income Taxed to Trust or Beneficiary

In drafting provisions for periodic distributions from trusts, the primary income tax concern is whether the trust's ordinary income (as opposed to capital gains) will be taxed to the trust or to a beneficiary. Other things being equal, it is typically desirable that income be taxed to the taxpayer with the lower tax bracket. Because trusts have very compressed income tax brackets, only a modest amount of income taxed to the trust will be taxed at a rate lower than the maximum income tax rate. IRC §1(e). If a beneficiary's tax bracket is lower, taxes can be saved by having the income taxed to the beneficiary.

NOTE: Similar issues can arise with capital gains income, although the potential tax savings are relatively modest and primarily attributable to the fact that California taxes capital gains at the same rate as ordinary income.

Trust income can be taxed to a beneficiary if the income is distributed to the beneficiary or if the trust document gives the beneficiary certain powers over the trust that result in the income being taxed to the beneficiary regardless of whether the income is distributed to the beneficiary. See §§7.11-7.17.

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§7.12 1. Beneficiary Taxed on Ordinary Income Distributed to Beneficiary

A trust's ordinary income is normally taxed to the beneficiary in a particular tax year to the extent that the income is included in the trust's "distributable net income" (DNI) under IRC §643 and distributed, or treated as distributed, to the beneficiary in the same year. The trust gets a deduction for the amounts taxed to the beneficiaries so that trust income is not taxed to *both* the trust and the beneficiaries. IRC §§651, 661. The same rule applies to distributions of annuity amounts but generally does not apply to distributions of capital gains.

Mandatory distributions of income may be deemed distributed when payment is required even if the trustee is slow in making the payment. Further, IRC §663(b) allows a trustee to elect to treat a payment made in the first 65 days of a taxable year as made in the prior taxable year, thereby giving trustees a reasonable amount of time to calculate the trust income of the prior year.

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§7.13 a. Rule Applies to Distributions of Annuity Amounts

Distributions of annuity amounts are treated as described in §7.12 despite the general rule that distributions of specific sums of money are not taxed to the beneficiary. Treas Reg §1.663(a)-1(b)(2)(ii). See chap 4.

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§7.14 b. Capital Gains Generally Taxed to Trust

Because capital gains are normally not included in distributable net income unless a distribution of gains is mandatory, they are normally taxed to the trust. Under Treas Reg §1.643(a)-3, however, distributed capital gains are taxed to distributees if the trustee consistently follows a policy of including the gains in DNI and claiming a deduction for them, in accordance with a power granted by local law or the trust document, whenever the trustee made distributions of principal. Among other things, this arrangement makes it possible for the beneficiary to be taxed on capital gains when the trust document provides for distribution of a unitrust amount.

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§7.15 2. Beneficiary Taxed Under Grantor Trust Rules

Income may be taxed to a beneficiary rather than the trust under IRC §678(a), which provides:

> (a) General Rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> (1) such person has the power exercisable solely by himself to vest corpus or the income therefrom in himself; or
>
> (2) such person has previously *partially released or otherwise modified* such a power and after the release or modification retains such *control* as would, within the principles of [IRC] sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. [Emphasis added.]

Under §678(a), a beneficiary with an unrestricted withdrawal power is taxed on income attributable to whatever portion of the trust is subject to the power. See §7.16. The statute may also apply to a solely held discretionary power to distribute trust income to the trustee. See §7.17. The statute has some importance in connection with "five or five" withdrawal powers discussed in §§7.90-7.92.

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§7.16 a. When Holder of Unrestricted Withdrawal Power Is Taxed

The statute causes the holder of the power to be taxed in the year that the withdrawal *can* be made to the holder even if the trust makes distributions only to other beneficiaries. A powerholder who does not exercise the power may continue to be taxed in later years on the income from the property that remained in the trust because of the failure to withdraw. If there are repeated lapses of annual withdrawal powers, the share of trust income taxed to the powerholder under IRC §678 keeps increasing. See IRS Letter Ruling 200022035.

NOTE: The result of this rule is not necessarily bad, because any payment of tax by the powerholder has the effect of being a tax-free gift to the trust. Normally, a holder of a withdrawal power will not allow the power to lapse unless the holder wants to benefit the other beneficiaries of the trust. The powerholder also has the option of withdrawing sufficient funds to pay the increased taxes.

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§7.17 b. Effect of Discretionary Power to Distribute Trust Income

Literally read, IRC §678 seems to provide that a trustee with a solely held discretionary power to distribute trust income to herself would also be taxed on the income that could be distributed even if no distributions were made. The IRS has never taken that view with respect to a power subject to a reasonably definite standard, including an IRC §2041 ascertainable standard, and it even appears to have taken the opposite view in *U.S. v DeBonchamps* (9th Cir 1960) 278 F2d 127. See §4.9. Some practitioners, preferring greater certainty, avoid giving beneficiaries solely held powers to withdraw property under an ascertainable standard. For discussion of discretionary distribution powers limited by an ascertainable standard, see §§7.55-7.74.

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§7.18 B. Basis Change on Death of Beneficiary

Currently, property in a decedent's taxable estate is entitled to a new date of death (or IRC §2032 alternate valuation date) value basis for purposes of future capital gain taxation. IRC §1014. See §§4.40-4.51. This rule will change when IRC §1022, providing for limited basis increases on death, is scheduled to take effect. See §§4.57-4.68.

The scheduled change is subject to the sunset provision of §901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), which may result in the restoration in 2001 of the law that existed before EGTRRA-2001 was enacted. Assuming that assets are more likely to appreciate than depreciate over long periods of time, a new basis or increased basis in property can be an important tax benefit if an estate is too small to incur estate taxes or if estate taxes do not exist at the time of death.

As a result of these issues, it is often important to give a trustee broad discretion over distributions in order to place property in the hands of persons with short life expectancies.

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III. POWER OF APPOINTMENT TRANSFER TAX PROBLEMS

§7.19 A. Discretionary Power May Result in General Power

When drafting periodic distribution provisions, the biggest tax problems are those of the estate and gift tax rules concerning powers of appointment. (See §7.20 for power of appointment terminology.) Regardless of whether a distribution power is held in a fiduciary capacity, a discretionary power to distribute property to or for one's own benefit may result in the powerholder's possessing a general power of appointment. IRC §§2041, 2514. See §§7.20-7.37.

Possession of a general power of appointment has consequences for the rights of the holder's beneficiaries. Generally, a powerholder's creditors can reach property subject to a general power of appointment to satisfy judgments against the powerholder. Prob C §682. See §7.36.

In drafting provisions for distributions from trusts having deceased settlors, the drafter should be aware that power of appointment issues may arise whenever a person, whether or not acting as trustee, has the ability to participate in an action that will cause trust property to be distributed to that person or otherwise used in a way to benefit that person. For discussion of drafting to avoid inadvertent creation of a general power, see §7.37.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.20 B. Power of Appointment Terminology

§7.20 B. Power of Appointment Terminology

Discussions of powers of appointment often use the following terminology:

- A "power of appointment" is a power created by a person (the "donor") other than the holder (or "powerholder" or "donee"), which enables the holder to dispose of property that is not owned by the holder (the "appointive property" or "property subject to the power").
- A person in whose favor the power can be exercised is a "permissible appointee" or "object" of the power.
- An "appointee" is one in whose favor the power is actually exercised.
- A "testamentary power" is a power that is exercisable only by will.

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§7.21 C. Federal Transfer Tax Definition of General Power

Under IRC §§2041(b)(1), 2514(c), a power to appoint property that may be exercised in favor of the powerholder (or the estate, creditors, or creditors of the powerholder's estate) is a general power of appointment, unless the power meets one of the following conditions:

- The power is limited by an ascertainable standard related to health, education, maintenance, or support (HEMS);
- The power is held jointly with the creator of the power; or
- The power is held jointly with an adverse party.

Except for the powers listed above, jointly held powers are not excluded. Because powers held in a fiduciary capacity are also not excluded, a general power may be created if a potential beneficiary of a trust is able to exercise trustee powers.

NOTE: Retained powers are not powers of appointment for transfer tax purposes. Treas Reg §§20.2041-1(b)(2), 25.2514-1(b)(2). Accordingly, the powers retained by a settlor who transfers property to a trust are not powers of appointment. Whether a transfer subject to a retained power will cause the retained property to be included in the transferor's estate is governed by the rules in IRC §§2036-2038.

In the context of distribution provisions of deceased settlors of a revocable trust, the exception for powers held jointly with the creator of the power will virtually never apply, and it is rare to encounter a power held jointly with an adverse party. Therefore, the single most important exception is that provided for powers limited by an ascertainable standard. See §7.30.

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§7.22 1. Power to Discharge Support Obligation

Although exclusion of the listed beneficiaries (the powerholder, the powerholder's estate and creditors, and the creditors of the powerholder's estate) should suffice to avoid creation of a general power, there is some danger that a power could still be considered general if the powerholder owes a duty of support to the potential beneficiary and may exercise the power in order to discharge that duty. A power exercisable for the purpose of discharging a legal obligation of the powerholder constitutes a power exercisable in favor of the powerholder or his or her creditors. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1).

Therefore, in addition to excluding the listed beneficiaries, it may be best to provide that the powerholder is prohibited from exercising the power in any manner that would discharge any duty of support owed by the powerholder. In other words, drafters may not want to rely exclusively on the saving provision of Prob C §16082. Inclusion of such a provision avoids disputes with the IRS and generally has minimal impact on the holder of the power. The holder of the power cannot use trust funds to directly pay child support obligations, but, assuming that the powerholder also has the power to make distributions to himself for his own support, the powerholder can take into account the fact that powerholder's own support needs are greater because of the powerholder's obligation to use his own funds for child support. A form of prohibition is provided in §7.25.

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§7.23 a. Effect of Statutory Saving Provision

California has tried to lessen the danger of an inadvertent general power being created by providing that, except as otherwise specifically provided in the trust instrument, a powerholder may not use any power to appoint or distribute income or principal to or for the benefit of others in performing his or her own legal obligations. Prob C §16082. The statute may not prevent the IRS from finding, however, that a parent has a general power of appointment over property held as a custodian. See §7.24.

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§7.24 b. Power Over Property Held as Custodian

The IRS has taken the position that parents who hold property as custodians for their minor children do hold general powers of appointment over the property if it can be used for items generally considered to be within a parent's support obligation. GCM 37299 (Oct. 21, 1977). Probate Code §3914(a) permits use of custodial funds for support, and the optional rule in Prob C §3914(d), requiring court authorization for support payments, is available only when the custodian is the transferor.

NOTE: The protection provided to powers over trust property by Prob C §16082 does not seem to extend to property held in custodianships, which is governed by a completely separate part of the statute. See Prob C §§3900-3925.

It is unclear whether the general power lapses when the child attains majority and the custodianship ends. However, there appear to be no rulings on this question, indicating no desire by the IRS to even consider it. In the context of a revocable trust, the uncertainties regarding custodianships make it preferable to use a trust instead of a custodianship to hold assets passing to minors if significant sums are to pass to minors and if the fiduciary is a wealthy person with a duty to support those minors.

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§7.25 c. Form: Prohibition Against Discharge of Support Obligation

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7.25-1 Prohibition against discharge of support obligation

***Prohibition Against Discharge of Support Obligation*. No one may exercise, alone or with others, a discretionary power conferred by this document in a manner that results in the discharge of that person's obligation to support another person. This prohibition applies to both personal powers and fiduciary powers. These restrictions do not apply to a person making distributions of property that the person could withdraw by exercising his or her power of revocation.**

Comment: Generally, this provision should be included in any trust that permits a person to participate in making discretionary distributions to that persons' spouse or domestic partner or issue. The second sentence makes it clear that the provision does not apply to a settlor having a power to revoke the trust.

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§7.26 2. Power to Remove Trustee

A potential trust beneficiary may be considered to have a general power of appointment over trust property if the beneficiary has the power to remove the trustee and if the trustee has a power that would be a general power if held by the beneficiary. Understandably, if a person has the power to remove a trustee and take over the job him- or herself, that person is deemed to have the same powers as the trustee. Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1). The IRS has ruled that even the power to remove a trustee and fill the vacancy with someone other than oneself may cause the trustee's powers to be attributed to the powerholder unless the vacancy can be filled only by a third party who is not related or subordinate to the powerholder. Rev Rul 95-58, 1995-2 Cum Bull 191; IRS Letter Rulings 9831005, 9607008.

NOTE: The concept of "related or subordinate" comes from income tax law. With respect to a trust, the phrase generally means a settlor, his or her spouse, father, mother, issue, brother, sister, or employee, a corporation, any employee of a corporation in which the stock holdings of a settlor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which a settlor is an executive. IRC §672(c).

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§7.27 3. Power Held Jointly With Nonadverse Party

A power held jointly with someone other than its creator or a person with a substantial, adverse interest is a general power, and the powerholders who are permissible beneficiaries will be treated as joint owners of the subject property. Therefore, if only one powerholder is a permissible beneficiary, his or her general power applies to all of the property.

PRACTICE TIP: When the settlor *wants* an individual to have a general power for tax purposes without giving him or her too much real power, the drafter might consider giving that person and a nonadverse party a joint power (requiring the concurrence of both holders) to appoint in favor of that individual's estate. This technique can be used when estate tax inclusion in the holder's estate is desirable in order to obtain a new income tax basis under IRC §1014 or to avoid a generation-skipping tax. IRC §2601.

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§7.28 4. Merely Administrative Powers

Although powers of appointment held in a fiduciary capacity may be treated as general powers, merely administrative powers (or the power to change them) that do not affect beneficial enjoyment do not constitute powers of appointment, nor does the mere power of management, investment, custody of assets, or allocation of receipts and disbursements between principal and income, exercisable in a fiduciary capacity, whereby the powerholder has no power to enlarge or shift any beneficial interests except as an incidental consequence of the discharge of fiduciary duties. Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1).

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.29 D. Power to Allocate Between Principal and Income

§7.29 D. Power to Allocate Between Principal and Income

Special care should be taken in giving a trustee who is also a beneficiary unusually broad powers in connection with allocations of receipts and disbursement between principal and income. If the trustee could exercise the overly broad power in a way that would increase the amount of property passing to the trustee, an overly broad power might cross the line from being merely an administrative power to being a distribution power. Hence, the statutory power to make an adjustment between principal and income does not extend to trustees who are beneficiaries. Prob C §16336(b)(7).

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§7.30 E. The HEMS Ascertainable Standard Exception

A power to consume, invade, or appropriate property for the benefit of the powerholder is not a general power of appointment if it is limited by an ascertainable standard relating to the powerholder's health, education, maintenance, or support. IRC §§2041(b)(1)(A), 2514(c)(1). A power that is not a general power because of the application of this rule is sometimes called an HEMS power—an acronym for health, education, maintenance, and support. See Treas Reg §20.2041-1(c)(2).

This rule makes it possible for a beneficiary to have or share discretionary powers to make distributions to him- or herself without the beneficiary having a general power of appointment. Such powers are frequently granted to surviving spouses or domestic partners who act as trustees of bypass trusts, when a primary objective of the trust is to avoid inclusion of the trust in the survivor's taxable estate. Similarly, children may be given such powers over trusts that benefit both children and the younger generation issue in order to avoid estate taxation on the death of the children.

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§7.31 F. Tax Consequences of General Powers

Property subject to a general power of appointment held by the powerholder at death is included in the powerholder's estate. IRC §2041(a)(2). The exercise or release of a general power of appointment during the powerholder's lifetime is a transfer of the property subject to the power for gift tax purposes. IRC §2514(b). The exercise or release of a power subject to estate and gift tax also causes the powerholder to become the transferor of the property for generation-skipping transfer (GST) tax purposes. IRC §2652(a). The lapse of a power is generally treated as a release. See §7.32. The powerholder may also be taxed on the income from the property subject to the power. See §7.33. For discussion of limited powers, see §§7.34-7.35.

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§7.32 1. Lapse of Power Treated as Release

During any one year, a *lapse* of a general power is not a *release* of the power (and therefore does not result in a taxable gift) to the extent that, at the time of the lapse, the property that could have been withdrawn or appointed does not exceed the greater of $5000 or 5 percent of the aggregate value of the property from which the exercise of the lapsed power could have been satisfied. IRC §§2041(b)(2), 2514(e). A general power that comes entirely within this safe harbor is often called a "five or five" power. Surviving settlors are often given such powers in bypass trusts. For further discussion of five or five powers, see §§7.90-7.92.

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§7.33 2. Income Tax Treatment of General Powers

Property subject to a general power of appointment is generally treated as owned by the powerholder for income tax purposes only if the power is held by a single individual who is currently able to vest income or principal in that individual. IRC §678. See §7.15.

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§7.34 3. Treatment of Limited Powers Distinguished

Because only property subject to a general power at death is included in the powerholder's estate (see §7.31), the release or lapse of a limited power is not a taxable gift of the property subject to the power. See Treas Reg §25.2514-3(e), Example (2). The exercise of a limited power may result in a gift, however, if the powerholder also has an income interest in the property. See §7.35.

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§7.35 4. Gift of Income Interest on Exercise of Limited Power

According to the IRS, an income beneficiary who exercises a lifetime nongeneral power to appoint principal to a third party makes a gift of the income that the powerholder would otherwise have received from that principal. Rev Rul 79-327, 1979-2 Cum Bull 342. The IRS's position seems reasonable, but a contrary result was reached in *Self v U.S.* (Ct Cl 1956) 142 F Supp 939. Therefore, unless the powerholder's beneficial interest is incapable of valuation (*e.g.,* he or she may receive income or principal in the trustee's discretion), the powerholder must be careful in exercising a lifetime power.

PRACTICE TIP: One way to avoid making a gift by exercising a limited power is for the powerholder to have no other interest in the trust that is not itself a limited power. Instead of giving anyone a beneficial interest in income or principal, payable either mandatory or at the discretion of the trustee, consider giving nothing but the power to withdraw subject to an ascertainable standard and the power to appoint among a limited class of beneficiaries, both during life and at death. Exercise of any of these powers should cause no gift tax problems. See Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 107 (Feb. 1998).

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§7.36 G. Creditor Rights Consequences of General Powers

The California state law definition of a general power of appointment is essentially the same as the federal tax law definition. Prob C §611. This fact has important drafting implications because creditors of a living holder of a presently exercisable general power of appointment can reach the property subject to the power. Prob C §682(a). Similarly, on the death of the holder of the general power, creditors of the deceased holder can reach the property subject to the power. Prob C §682(b).

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§7.37 H. Drafting to Avoid Inadvertent General Powers

There are several ways to avoid an inadvertent creation of a general power of appointment. The trust can name a trustee who is not a beneficiary or can divide trustee duties so that discretionary distribution powers are held by a "special trustee," "independent trustee," or "distribution trustee" who is not a beneficiary.

Alternatively, the trust can limit all discretionary distribution powers by an ascertainable standard related to health, education, support, and maintenance while prohibiting the holder from making distributions that discharge the holder's legal obligations to support others.

It is also possible to mix these approaches. A beneficiary can be given the power to make discretionary distributions limited by an ascertainable standard, and an independent trustee can be given the power to make distributions that are not limited by that standard.

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IV. INCOME, ANNUITY, AND UNITRUST DISTRIBUTIONS

§7.38 A. Disfavored Trust "Income" Distributions

Historically, trust drafters often created trusts that distinguished between income and principal in connection with distribution rights. This practice presumably reflected an assumption that trust "income" could be consumed without reducing the purchasing power of the "principal." Two major problems with distinguishing between principal and income have now caused most sophisticated drafters to abandon distinctions involving principal and income in most cases:

- The difficulty of allocating receipts and expenditures between income and principal in a manner that eventually leaves the principal account with something approximating its original purchasing power. See §7.39.
- The conflict between the need to provide a reasonable amount of "income" for the income beneficiary and the greater, long-term desirability of investing assets in a manner that produces the highest total returns (essentially, the combination of income yield and capital appreciation). See §7.40.

The second conflict may also lead to conflicts between income beneficiaries who want assets invested in assets that pay high interest and dividends, and takers of the remainder who want assets invested in securities that provide low current distributions but are likely to produce greater appreciation, with the trustee caught in the middle.

The unhappy result is that the trust distribution provisions interfere with the trustee's ability to make optimum investment decisions. Among the alternatives to trust income distributions are annuity distributions (see §§7.45-7.48) and unitrust distributions (see §§7.49-7.54). Despite these problems, certain considerations do favor income distributions in some cases. See §§7.41-7.43.

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§7.39 1. Allocation Problem

In the absence of customized provisions in the trust instrument, trust assets, receipts, and expenditures are allocated to principal or income under California's version of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375).

Even a casual review of the statute quickly leads the reader to the conclusion that applying the UPAIA will frequently not result in a division between income and principal that reflects an assumed client expectation that income is the amount that can be spent without diminishing the purchasing power of the retained principal. (Of course, the actual expectation of any particular client may be based on the client's own investment and spending practices. The overwhelming majority of clients certainly understand the impact of inflation, but this does not mean, contrary to the assumption of the statute, that the client believes that the terms "principal" and "income" in a trust instrument will take that inflation into account.)

Indeed, it is quite clear that our basic rules on interest and dividends do not result in allocations between principal and income that reflect our assumed objective of distributing income while preserving the purchasing power of the remaining fund. Under the UPAIA—as is consistent with likely client expectations in a narrower sense—interest is allocated entirely to income, even though this leads to a loss of purchasing power for the principal due to inflation. A reverse result can occur with common stocks. Under the UPAIA, stock appreciation is allocated entirely to principal even when the stock is "going through the roof" and generating increases in value at a rate significantly exceeding that needed to preserve the purchasing power of the principal.

(Ultimately, a drafter may reasonably conclude that traditional attempts to define principal and income are likely doomed to failure. At the very least, they are not worth the effort.)

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§7.40 2. Total Return Problem

The second problem with principal-versus-income distinctions—and the one that has drawn the most attention in the era of the Prudent Investor Rule (see Restatement (Third) of Trusts §§90-92 (2007))—involves the fact that marketable security investment data for the last century clearly demonstrate that, over time, equity securities (*e.g.,* common stocks) highly outperform debt instruments (bonds, mortgages, and certificates of deposit) in terms of total investment returns. We have no way of knowing whether this will be true for the next century, but a prudent trustee (and a prudent planner) should assume this, not because it is necessarily true, but because it is hard to justify any other assumption. See generally California Estate Planning, chap 24A (Cal CEB 2002).

Unfortunately, recent history indicates that common stocks typically pay rather low "trust income." Consequently, there is usually a conflict between the desirability of investing for total return and the requirement of making income distributions to the income beneficiaries at a level that is "fair" or that at least is assumed to be the level intended by the settlor.

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) attempts to resolve this dilemma by giving the trustee the power to adjust between principal and income, which in the current investment climate presumably gives the trustee an incentive to invest mainly in equity securities and then periodically allocate some principal to income. Unfortunately, this solution is not always available. The statutory adjustment power cannot be exercised by a trustee who is a beneficiary, and there are other limitations intended to avoid risks of adverse tax consequences—risks that must be dealt with even if the drafter chooses to draft a custom adjustment power that differs from the statutory power. See Prob C §16336.

These limitations are partly addressed by the unitrust conversion power in Prob C §§16336.4-16336.7. The unitrust conversion power may be used by the trustee—including a trustee who is a beneficiary of the trust—to convert a mandatory income trust into a trust providing for a unitrust payment of 4 percent of the fair market value of trust assets per year without a court order if no beneficiary objects, or by court order into a trust providing for a unitrust payment of not less than 3 and not more than 5 percent. See Prob C §16336.4. Some studies have shown that approximately 3 to 3.5 percent of trust corpus may be paid out per year without diminishing the purchasing power of the trust over time. Therefore, a unitrust conversion providing for payment of a unitrust amount of 4 percent would be expected to gradually erode the value of the trust, but this result may be acceptable if the income beneficiary, such as a surviving spouse, is the primary intended beneficiary of the trust. See §§7.49-7.54.

When court action is required, attempts by income beneficiaries to compel the trustee to exercise the adjustment power over the objections of remainder beneficiaries may confront additional obstacles. See *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129 (proposed petition would violate trust's no-contest clause). Note that the result in this case is not necessarily a good one for the remainder beneficiaries. The decision raises the question of what happens now if the income beneficiary demands that the trustee revise the portfolio to generate a higher "income component" by decreasing the investment in equity securities and increasing the investment in bonds, to comply with the trustee's duty of impartiality. History suggests that, over time, such a portfolio will have a lower return than a portfolio more heavily invested in equities.

In using the adjustment power or the unitrust conversion power to implement a total return strategy, however, the trustee should consider the intended duration of the trust and—to the extent consistent with the trust instrument—the needs of the remainder beneficiaries. If the trust is expected to terminate within a few years, and the remainder beneficiaries are expected to rely on the trust for support immediately, the beneficiaries may not have time to recover from stock market losses if the trust is invested mainly in equities. Accordingly, the trust should be invested more heavily in fixed-income securities than would be the case in a trust intended to last for many years.

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3. Considerations Favoring Income Distributions

§7.41 a. Distribution May Be Made by Using Property in Kind

A right to income is essentially the same as the right to use property in kind. For example, suppose that a trust owns Blackacre, the rental value of which is $X per year. If the beneficiary with the right to all trust income wants to live at Blackacre, the trustee can simply permit the beneficiary to use the property. There is no point in charging the beneficiary rent that will generate trust income that will be immediately transferred back to the beneficiary. Or suppose that the beneficiary wants the property leased to a third party. It makes little difference (in terms of distribution rights) whether the trustee leases the property and turns the rent over to the beneficiary or whether the trustee simply allows the beneficiary to lease the property to the third party and collect the rent directly.

In some cases, the fact that use of property has a value equivalent to the income of the property is very significant and useful, particularly if the settlor does not want the property sold during the period that income is paid to a lead beneficiary. Often, a family farm or ranch falls into this category. The expectation is that a child will lease the land from the trustee during the surviving settlor's lifetime. In this context, giving the survivor a right to trust income minimizes the risk that it might be necessary to sell or encumber some of the land in order to make distributions to the survivor—as might occur if the survivor were given a right to a unitrust amount or an annuity.

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§7.42 b. Avoiding Large Income Accumulations

Despite the disadvantages of basing distribution rights on distinctions between income and principal (see §§7.38-7.40), provisions for mandatory distribution of all trust income are usually sufficient to ensure that most taxable ordinary income will be distributed to beneficiaries rather than accumulated in the trust. Thus the income is usually taxed to the beneficiaries rather than the trust. When the distribution provisions do not mandate distribution of all income, it is generally desirable to make sure that the provisions will make it possible for the trustee to minimize the amount of income taxed to the trust itself. Because of the compressed income tax brackets applicable to trusts, accumulation of significant amounts of trust income may result in higher taxes on that income than might be imposed if the income was taxed to beneficiaries.

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§7.43 c. Qualification for Tax Deduction or Election

If a trust is intended to qualify for the marital deduction, it is normally necessary to give the spouse a right to all trust income for life. IRC §2056(b)(5), (7). In such cases there is no choice but to provide for the distribution of income. See chap 13.

Similarly, it is necessary to provide for the distribution of all income if the trust is to qualify as a shareholder of an S corporation by means of satisfying the requirements for a qualified subchapter S trust (QSST) under IRC §1361(d).

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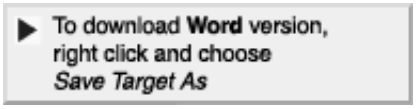
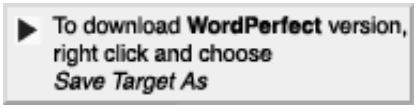
§7.44 4. Form: Mandatory Distribution of Income for Life





7.44-1 Mandatory distribution of income for life

During the lifetime of _ _[*name of beneficiary*]_ _ (the income beneficiary), the trustee shall pay to or apply for the benefit of the income beneficiary the entire net income of the trust in quarter-annual or more frequent installments. Trust income earned between the last distribution date and the date of the income beneficiary's death shall not be distributed to the income beneficiary but shall be distributed in accordance with the provisions in this instrument for distribution of the trust property following the death of the income beneficiary. If relevant, the income undistributed at the income beneficiary's death shall remain income for distribution purposes.

Comment: For a clause to be used to distribute the income of a QTIP trust, see chap 13. When relevant, the last sentence ensures that income received before the income beneficiary's death will be paid to the next income beneficiary rather than being added to principal as provided in form 7.94-1.

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§7.45 B. Annuities

An annuity amount is a specified dollar amount payable at specified intervals. The specific amount may vary. For example, many provisions describing annuities provide for cost-of-living adjustments. In addition, particularly with charitable giving, the initial annuity amount may be determined by a formula rather than stated as a fixed number of dollars. Advantages and disadvantages of annuities are discussed in §§7.46-7.47. A form of annuity is provided in §7.48.

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§7.46 1. Advantages of Annuities

The primary advantage of an annuity is that the settlor can choose a relatively precise amount for distribution to the beneficiary. Further, the amounts paid will not rise and fall as do the values of trust assets.

Annuities are particularly useful when the takers of the remainder are not the natural objects of the bounty of the annuitant. It is probably no accident that negotiated agreements for periodic payments, whether in premarital agreements, postmarital agreements, or personal injury settlements, usually provide for payments of annuities rather than trust income or unitrust amounts. As long as the value of the trust assets is clearly sufficient to fund the annuity, the interests of the annuitant and those of the remainder beneficiaries are relatively independent, and the causes for conflict are comparatively low.

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§7.47 2. Disadvantages of Annuities

The primary disadvantage of an annuity is that there is no automatic adjustment in the amount paid if the assets available to pay the annuity are much higher or much lower than originally anticipated. Problems may arise when a trust holds property that will be retained in kind. If the trust does not generate enough income to fund the annuity amount, it may be necessary to sell or encumber property to raise liquid assets for that purpose. One of the few good things to be said about a traditional income interest is that it makes it relatively easy for the trustee to provide the income beneficiary with the use of property in kind. See §7.41.

Another potential disadvantage arises when the annuity is too small to cause the distribution of all income, which may result in income being accumulated and taxed at unnecessarily high brackets because of the compressed income tax brackets applicable to trusts. IRC §1(e). See §7.11.

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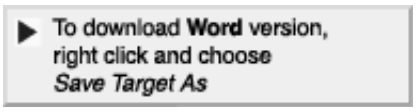
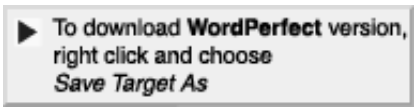
§7.48 3. Form: Payment of Annuity Amount





7.48-1 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*]_ _ increased by the increase in the cost of living between January 1, _ _[*year*]_ _, and January 1 of the year of the particular payment. The cost of living increase shall be calculated 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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§7.49 C. Unitrust Distributions

A "unitrust" is a trust that gives a beneficiary a right to periodically receive a fixed percentage of the value of the trust estate, with the assets revalued at selected intervals. Unitrusts have long been used as a method of obtaining a charitable deduction for a charitable remainder trust and, less frequently, as a method of obtaining such a deduction for a charitable lead trust. If charitable deduction qualification is an issue, the assets must be revalued annually. IRC §664(d)(2).

Advantages and disadvantages of unitrusts are discussed in §§7.50-7.53. A form of unitrust is provided in §7.54.

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§7.50 1. Advantages of Unitrusts

Unitrust advocates point out that its provisions enable the trustee to invest for "total return" without being concerned whether that return takes the form of "trust income" or appreciation. A unitrust may be particularly suitable when it is important to preserve the purchasing power of the undistributed assets. These considerations favor a unitrust over a traditional trust that distributes trust income.

Unitrusts have been the subject of considerable study in the context of the Uniform Prudent Management of Institutional Funds Act (UPMIFA) (Prob C §§18501-18510). UPMIFA allows universities and other nonprofit organizations to "appropriate for expenditure… so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established." Prob C §18504(a). The expenditure in any year of more than 7 percent of the fair market value of an endowment fund creates a rebuttable presumption of imprudence. Prob C §18504(d).

The statute has led some eligible institutions (at least for some funds) to attempt to calculate, based on historical investment data, the percentage of an endowment fund that can be withdrawn annually without diminishing the principal, taking into account the effects of inflation. Some studies indicate that this percentage is around 4 percent for a portfolio of marketable equity securities. (Other studies suggest that this percentage is only 3 to 3.5 percent.) In years of bad investment performance, a 4 percent withdrawal may deplete the principal. In better times, the purchasing power will actually increase. Supposedly, however, they will average out in the end if the endowment fund manager sticks with the 4 percent figure in good times and in bad. That figure drops quickly if there are many debt investments. These numbers will be less meaningful to the extent that the trust portfolio consists of assets other than marketable securities.

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2. Disadvantages of Unitrusts

§7.51 a. Distribution Amount Not Related to Objectives

A significant problem with unitrusts is that the amount of the mandated annual distribution often has little connection with settlor objectives other than the preservation of purchasing power. This is particularly true in small trusts. For example, if the 4 percent payout rate discussed in §7.50 is insufficient to provide the desired level of support for the primary beneficiary, there is little point in providing for payment of a unitrust amount. If by lucky happenstance the 4 percent payout is reasonable at the inception of the trust, it may quickly become unreasonable if, *e.g.,* the trust is to be divided into shares for children or grandchildren after the death of the initial lead beneficiary.

PRACTICE TIP: When an income trust is used instead of a unitrust or annuity trust, the desired level of support for the primary beneficiary should be made clear in the instrument. In *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262, the court held that trustees of a net income trust could convert a net income trust into a unitrust with a payout percentage of 4 percent under a statute similar to Prob C §16336.4 even though this had the possibly unintended effect of reducing the average annual income paid to the beneficiary from $190,000 to $70,000.

It is sometimes suggested that unitrusts are well suited for long-term dynasty trusts that remain in existence for the perpetuities period (or longer if established in one of the growing number of states having an extremely long perpetuities period or no limitation on perpetuities whatever), but their lack of flexibility makes this suggestion doubtful.

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§7.52 b. Appraisal Problems

Another disadvantage of unitrusts is the need to continually revalue the assets. Marketable securities are easily valued; most other assets are not. Appraisers are expensive. The appraisal cost issue can be mitigated by giving the trustee broad discretion with respect to valuation and estimation, but this is only a partial solution.

Valuation issues can also create tax problems and beneficiary conflicts. In a testamentary charitable remainder trust, for example, everyone wants a low valuation for estate tax purposes, but the lead beneficiary wants a high valuation for distribution purposes. See California Will Drafting, chap 14 (3d ed Cal CEB 1992).

Another version of this problem can arise when the lead beneficiary wants a high valuation, but the trust will be subject to a heavy GST tax on the lead beneficiary's death. IRC §2601. If the trustee agrees to a lead beneficiary's demands for a relatively high valuation, it will be difficult to claim a substantially lower value when it becomes time to pay the taxes on it. See §4.186.

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§7.53 c. Use of Property in Kind Problems

Problems arise when a trust holds property that is to be retained in kind, but the trust provides for payment of a unitrust amount. One of the few good things to be said about a traditional income interest is that it makes it relatively easy for the trustee to provide the income beneficiary with the use of property in kind. See §7.41.

If the trust does not generate enough income to fund the payment of the unitrust amount, property may have to be sold or encumbered in order to raise sufficient liquid assets for that purpose. Alternatively, if income exceeds the unitrust amount, taxable income may be accumulated inside the trust and therefore taxed at unnecessarily high levels owing to the compressed rate brackets applicable to trusts. IRC §1(e). See §7.11. The tax problem can be addressed by providing that the trustee is to distribute the greater of trust income or the unitrust amount. See form 7.54-1. For discussion of using a unitrust interest in place of a traditional income interest in a QTIP trust, see §13.5.

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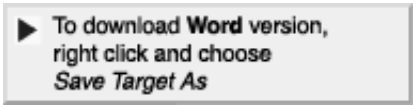
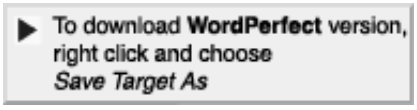
§7.54 3. Form: Payment of Unitrust Amount





7.54-1 Payment of unitrust pecuniary 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., 0.5*]_ _ percent of the fair market value of the trust property at the beginning of the accounting period. Payments shall be made on the first day of each calendar month that begins after my death and before the death of the distributee.

7.54-2 Payment of unitrust fractional share amount

The trustee shall distribute to or for _ _[*name of beneficiary*]_ _ _ _[*e.g. 0.5 percent*]_ _ of the trust assets on the beginning of each calendar _ _[*month, quarter, year*]_ _.

[*Add one of the following alternatives*]

[*Alternative 1: Excess income accumulated*]

Any trust income not distributed under this provision shall be added to principal.

[*Alternative 2: Excess income distributed*]

If in any calendar year the total amounts distributed under this provision are less than the trust income for the year, the amount of the final distribution for the calendar year shall be increased by the amount of the surplus trust income.

Comment: Clause 7.54-1 provides for distribution of an "amount" and may therefore result in the trust recognizing gain if the obligation to pay the amount is satisfied with appreciated property. *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. See §4.32. This tax result may be acceptable if the trust is small, if the trust has a short term and high basis assets, or if the distributee would be required to sell distributed property and trigger gain in any event. It may be easier to administer the trust using this clause because it is only necessary to value all of the trust property annually.

Clause 7.54-2 attempts to avoid recognition of gain, but except for prorata distributions of each asset will necessitate a determination of the total value of the trust property at the time of each distribution. This will not impose an additional burden if the trust makes only annual distributions. This clause is particularly desirable if large distributions will be made from highly appreciated property to a beneficiary that will not need to sell the distributed property until obtaining a new IRC §1014 basis for the property on death.

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§7.54A D. Conduit Trust Distributions

A "conduit trust" is a trust that is carefully designed to permit the trust to be the named beneficiary of a decedent's individual retirement account (IRA) without losing the right to utilize the life expectancy of a natural person in calculating the minimum distributions that must be made from the IRA each year. See discussion in §§7.54B-7.54C. For a form of conduit trust, see §7.54D. For additional conduit trust drafting considerations, see §7.54E.

If the right to utilize the life expectancy of a natural person is lost, it is generally the case that all assets of the IRA must be withdrawn at a much faster rate—resulting in quicker loss of the tax deferral benefits of the IRA. If the life expectancy of a beneficiary cannot be used to calculate distributions, the hypothetical life expectancy of the decedent at the time of death will be used to make the calculations, assuming the decedent survived until the required beginning date (RBD). Treas Reg §1.401(a)(9)-5, A-5. If the decedent did not survive until the RBD, all assets of the IRA must be distributed within 5 years of death. Treas Reg §1.401(a)(9)-3, A-1. Usually the RBD is April 1 of the calendar year following the year in which the decedent attained age 70 1/2. Treas Reg §1.401(a)(9)-2, A-2.

In the unusual circumstance that a qualified terminable interest property (QTIP) trust is named as a beneficiary of an IRA (despite the loss of the ability of the surviving spouse to roll over the IRA to an IRA in the name of the spouse and convert the IRA to a Roth IRA as would be possible if the spouse is named as the beneficiary of the IRA), the IRS has ruled that both the IRA and the trust must satisfy QTIP requirements—notably including the requirements that the spouse must be entitled to all income and must be entitled to compel the trustee to make the trust (and the IRA) property productive. The QTIP election must be made for both the trust and the IRA. The right to all income is satisfied if the spouse has the right to compel the trustee to withdraw the IRA income and distribute it to the spouse and the terms of the IRA permit the trustee to comply with the demand. In some cases, this may require that the trustee separately determine the trust income of the entire IRA and the trust income for the remaining portion of the trust estate. The spouse must be entitled to the combined amount. Rev Rul 2006-26, 2006-22 Int Rev Bull 939.

In theory, a conduit trust can also be used in connection with benefits from retirement plans other than IRAs, but most retirement plans do not permit a beneficiary other than a spouse to take withdrawals over a protracted period of time. In some cases retirement plan benefits can be rolled over to an IRA to circumvent retirement plan requirements for rapid distribution after the participant's death.

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§7.54B 1. The "Designated Beneficiary" Concept

The Treasury Regulations that determine whether a life expectancy of a natural person can be used to calculate minimum IRA withdrawals utilize the term "designated beneficiary." This is a term of art. The mere fact that a person or entity is named as a beneficiary on a beneficiary designation form does *not* necessarily result in the IRA having a "designated beneficiary." See Treas Reg §1.401(a)(9)-4. The designated beneficiary rules are intended to make it impossible for anyone to calculate minimum distributions using the life expectancy of someone who is not in fact the oldest possible distributee of IRA assets. The significant rules include the following:

- Only living persons have life expectancies. Therefore, there usually is no designated beneficiary if the named beneficiaries are not all living persons. Treas Reg §1.401(a)(9)-4, A-3. Charities cannot be designated beneficiaries. Estates cannot be designated beneficiaries.
- A trust cannot be a designated beneficiary, but the eldest beneficiary of the trust will be treated as the designated beneficiary if certain requirements are satisfied. Treas Reg §1.401(a)(9)-4, A-5. There is no comparable look-through rule for estates.
- In the case of a trust with multiple individual beneficiaries, the eldest is the designated beneficiary. Treas Reg §1.401(a)(9)-5, A-7(a). A possible exception to this rule may arise if the share of the benefit for each individual is a separate account. Treas Reg §1.401(a)(9)-8, A-2.
- In the case of a trust with multiple beneficiaries, the existence of any possibility of a distribution to an estate or charity will generally result in none of the beneficiaries being "designated beneficiaries."
- Unless the trust is a "conduit trust," contingent beneficiaries generally are taken into account in determining (1) the identity of the oldest beneficiary, and (2) whether the trust has a beneficiary who not a natural person. See §7.54C.

PRACTICE TIP: If a client wants to divide an IRA benefit between two (or more) beneficiaries so that each of them can take minimum distributions based on his or her own age, the division must be accomplished in the beneficiary designation of the IRA. See discussion in §7.54E. For example, the IRA beneficiary designation might state: "On the death of the participant, the beneficiaries in equal shares are the Trustee of the X trust and the Trustee of the Y trust." In the absence of such a division in the beneficiary designation, the recipient trust will be treated as a single trust for minimum distribution purposes, regardless of the terms of that trust.

Because of these rules, it will almost always be the case that a revocable trust will fail to have a "designated beneficiary" following the death of the settlor if any IRA assets might be paid to a trust that will continue in existence thereafter. It will almost always be the case that if enough people die during the postdeath term of the trust, it will be possible for IRA benefits to pass to an estate, thereby violating the fourth rule stated above.

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§7.54C 2. The Conduit Trust Safe Harbor

The regulations contain an exception to the general rule that the identities of contingent beneficiaries must be taken into account for purposes of determining (Treas Reg §1.401(a)(9)-5, A-7(b)) (1) the identity of the oldest beneficiary, and (2) whether the trust has a beneficiary who is not a natural person. Under Treas Reg §1.401(a)(9)-5, A-7(c)(1):

> A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death.

Although this language suggests that it is possible to ignore all contingent beneficiaries who could receive trust distributions only in the event of the death of another beneficiary, the remaining language of the regulation and the examples in Treas Reg §1.401(a)(9)-5, A-7(c)(3) make clear that it is also necessary that no IRA distributions can be accumulated in the trust during the lifetime(s) of the person or persons whose interests are *not* contingent on the death of other beneficiaries. In short, a contingent beneficiary will be ignored only if that beneficiary's interest is contingent on the death of other beneficiaries and the trust immediately distributes all IRA distributions until the last of those deaths occurs. The trust is a mere "conduit" in the sense that everything that comes in from the IRA immediately goes out.

EXAMPLE 1: Trust is named the beneficiary of IRA. Trust provides that during the lifetime of Child all IRA distributions are to be distributed immediately to Child. Trust is a "conduit trust" and the identities of remainder beneficiaries can be ignored for purposes of calculating minimum distributions.

EXAMPLE 2: Trust is the named beneficiary of IRA. Trust provides that during the joint lifetimes of Child 1 and Child 2 all IRA distributions are to be distributed immediately to them in equal shares. On the death of either child all IRA distributions are to be made to the surviving child. Trust is a "conduit trust" and the identities of remainder beneficiaries can be ignored for purposes of calculating minimum distributions.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.54D 3. Form: Payment of Conduit Trust Amount

§7.54D 3. Form: Payment of Conduit Trust Amount

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7.54D-1 Payment of conduit trust amount

During the period between the death of Settlor and the death of _ _[*name of beneficiary*]_ _ ("Primary Beneficiary"), the trustee shall pay to or apply for the benefit of Primary Beneficiary all amounts received by the trustee from any individual retirement account or retirement plan that is subject to the minimum distribution rules in Internal Revenue Code §401(a)(9) or a comparable provision of that Code. The distribution shall be made immediately on receipt. The trustee is required to so withdraw and distribute the amounts of any required minimum distributions and has discretion to so withdraw and distribute such additional amounts as the trustee deems appropriate to make any additional distributions to or for the benefit of Primary Beneficiary that are authorized by this trust. All expenses of administration of the trust are to be paid from other trust assets. It is the purpose of this paragraph to permit minimum distribution amounts to be calculated based on Primary Beneficiary's life expectancy.

Comment: The trust must meet the additional beneficiary designation requirements discussed in §7.54E. Drafters of conduit trusts should also make sure that the trust will have non-retirement plan assets available for paying administration expenses.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.54E 4. Additional Conduit Trust Drafting Considerations

§7.54E 4. Additional Conduit Trust Drafting Considerations

The following additional requirements must be met to calculate IRA minimum distributions based on the life expectancy of a trust beneficiary (Treas Reg §1.401(a)(9)-4, A-5(b)):

- The trust is valid under state law or would be except for the fact that there is no corpus;
- The trust is irrevocable or will become irrevocable, by its terms, on the participant's death;
- The trust beneficiaries must be individuals who are identifiable from the trust instrument within the meaning of Treas Reg §1.401(a)(9)-4, A-1; and
- The plan administrator is given documentation so that trust beneficiaries who will be treated as designated beneficiaries are identifiable to the administrator. See Treas Reg §1.401(a)(9)-4, A-6.

A trust beneficiary does not have to be specified by name as long as the individual is identifiable under the plan as of the date the beneficiary is determined under Treas Reg §1.401(a)(9)-4, A-4 (generally, the date of death if the beneficiary remains a beneficiary as of September 30 of the calendar year following the calendar year of the employee's death).

The IRS has ruled that the so-called separate account rules in Treas Reg §1.401(a)(9)-8, A-2, are not available for multiple beneficiaries of a single trust; therefore, minimum required distributions will be based on the life expectancy of the oldest beneficiary of the trust, even if the trustee establishes separate accounts for each beneficiary after the employee's death and the beneficiary designation states that the trust is to be divided into separate trusts. IRS Letter Rulings 200634068, 200349009, 200317041. If it is important that trusts for older and younger beneficiaries have separate account status, *e.g.,* because the IRA or qualified plan is large and the beneficiaries are not all from the same generation, the beneficiary designation must identify each trust, and each trust should come into existence not later than the date of the settlor's death.

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V. DRAFTING ASCERTAINABLE STANDARD HEMS DISCRETIONARY DISTRIBUTION PROVISIONS

§7.55 A. Advantages and Disadvantages of Discretionary Distributions

Provisions requiring the mandatory distribution of specified amounts from the trust, regardless of whether they are termed "trust income," an "annuity amount," or a "unitrust amount," seldom provide sufficient flexibility to meet the trust's objectives. It is usually desirable to provide for discretionary distributions, either in addition to mandatory distributions or as an alternative to them.

Well-drafted provisions for discretionary distributions can enable a trust to accomplish the settlor's objectives despite changes in beneficiary circumstances and in tax laws. For discussion of drafting challenges, see §7.56. Discretionary distributions, however, have several significant disadvantages:

- Discretionary distributions can be a source of dispute among beneficiaries whose opinions may differ on how discretion should be exercised.
- It is not always easy to find an individual or institution that can be expected to exercise discretion in the manner that the settlor desires—particularly if the trust will remain in existence longer that the life expectancy of the persons initially granted the discretionary distribution power.
- Beneficiaries often find it demeaning to be forced to ask for money.
- When discretionary powers are used for the purpose of protecting a beneficiary from his or her own folly, the beneficiary may remember the settlor with anger and resentment rather than the appreciation the settlor had presumed.

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§7.56 B. Drafting Challenges in Providing for Discretionary Distributions

As a rule, discretionary powers are given to a beneficiary or a group of beneficiaries. To avoid having the power be a general power of appointment, it must be limited by an ascertainable standard related to health, education, maintenance, or support (an HEMS power). See §§7.19-7.37. The basic description of the purposes for which distributions may be made almost invariably tracks the Treas Reg §20.2041-1(c)(2) language that is quoted in §7.57.

Unless the holder of the discretionary power is provided with additional information on the desires and goals of the settlor, the holder of the discretionary power will know little more than the fact that the settlor's attorney understood the tax law. As a result, it becomes important to know what additional guidance can be provided without risking the possibility that the additional guidance will result in the distribution provision no longer providing the limitation required by the regulations. See discussion and forms in §§7.59-7.70.

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§7.57 C. HEMS Power Requirements

The starting point for drafting HEMS powers is Treas Reg §20.2041-1(c)(2), which provides:

> *(2) Powers limited by an ascertainable standard.* A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to health, education, support, or maintenance of the decedent is, by reason of [IRC §]2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort" "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses in invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

It important to understand two things about the regulation. First, it effectively relieves the drafter of a duty to decide whether a particular standard is ascertainable. As long as the drafter uses the approved phrases, such as "support in reasonable comfort," and avoids the disapproved words such as "happiness," the standard will be considered ascertainable for purposes of the regulation—even if it proves to be totally impossible to "ascertain" the standard if the beneficiaries start litigating over whether the trustee is overly generous to herself.

Second, under the last sentence of the regulation, there is no requirement for the trustee to consider the beneficiary's financial need unless the settlor chooses to impose one. See §7.66. If desired, a trust document will still meet HEMS requirements if it permits an extremely wealthy person to withdraw amounts sufficient to maintain his or her accustomed manner of living without having to use any personal assets.

The meaning of "health, education, support, or maintenance" is further discussed in §§7.58-7.61. A basic form of HEMS power is provided in §7.62.

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§7.58 1. Meaning of "Health, Education, Support, or Maintenance"

Although construction of a trust document ultimately involves the issue of the particular settlor's intentions (see chap 18), a court facing construction issues concerning HEMS powers will quite likely be influenced by case law and authoritative legal literature. For that reason, it may be helpful for drafters to keep in mind the discussion in Restatement (Third) of Trusts §50, comment d (2003) about the terms used in an HEMS power. See §§7.59-7.61.

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§7.59 a. Support or Maintenance

According to the Restatement (Third) of Trusts §50, comment d (2003) (consistent with Treas Reg §20.2041-1(c)(2)):

> *Support or maintenance*. The terms "support" and "maintenance" are normally construed as synonyms, even when this treats the terms as redundant. Probably the most common guides used in grants of discretion, these terms are sometimes accompanied by reference to the beneficiary's accustomed standard of living or station in life. That level of intended support is normally implied from "support" or "maintenance" even without an express reference to the beneficiary's customary lifestyle. Whether this accustomed style is expressed or implied, a lower level of distributions may be justifiable if the trust estate is modest relative to the probable future needs of the beneficiary.
>
> The accustomed manner of living for these purposes is ordinarily that enjoyed by the beneficiary at the time of the settlor's death or at the time an irrevocable trust is created.... Without additional language suggesting a broader standard, however, even with extended discretion, the terms "support" and "maintenance" do not normally encompass payments that are unrelated to support but merely contribute in other ways to a beneficiary's contentment or happiness. Thus, these terms do not authorize distributions to enlarge the beneficiary's personal estate or to enable the making of extraordinary gifts.

The California Supreme Court has intimated that "travel" does not relate to "support, maintenance, and education." *Estate of Nunn* (1974) 10 C3d 799, 809, 112 CR 199. *Nunn* was an inheritance tax case, and the relevant statements are dicta. In any event, the statements are inconsistent with the regulation's language permitting "support in his accustomed manner of living" as interpreted by Restatement §50, comment *d*. See also 3 Scott & Ascher on Trusts §13.2.4 (5th ed 2007); Hess, Bogert & Bogert, The Law of Trusts and Trustees §811 (3d ed 2000).

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§7.60 b. Education

According to Restatement (Third) of Trusts §50, comment d (2003):

> [T]he term "education," without elaboration is ordinarily construed as extending to payment of living expenses as well as fees and other costs of attending an institution of higher education, or the beneficiary's pursuit of a program of trade or technical education, and the like, as may be reasonably suitable to the individual and to the trust funds available for the purpose.

This description is not very helpful except for its clarification that "education" includes some necessary "support" in the unusual instance that a trust document providing for "education" does not also expressly provide for support.

The absence of guidance suggests that trust documents should clarify whether education includes such things as private school tuition at the primary and secondary levels (which might not be true if not otherwise consistent with the beneficiary's station in life). Many drafters clarify whether "education" includes graduate school. For alternative clauses defining "education," see §§7.72-7.74.

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§7.61 c. Health and Medical Care

According to Restatement (Third) of Trusts §50, comment d (2003):

> [W]ithout more, references to "health," "medical care," and the like in the terms of a discretionary power may be useful to inform beneficiary expectations or guide an inexperienced trustee, but presumptively they provide merely for health and medical benefits like those normally implied by a support standard.

Court disputes over distributions for health are relatively rare, but it is not difficult to envision the possibility of disagreement with respect to such matters as cosmetic surgery or visits to upscale weight loss facilities, particularly when trust resources are limited and the beneficiary has not traditionally enjoyed a high station in life.

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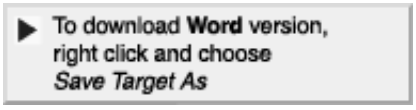
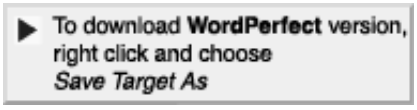
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.62 2. Form: Basic HEMS Power

§7.62 2. Form: Basic HEMS Power





7.62-1 Basic ascertainable standard HEMS power

Quarter-annually or more often, the trustee shall pay to or apply for the benefit of _ _[*name of beneficiary*]_ _ as much of the trust property as the trustee determines is appropriate for _ _[*his/her*]_ _ health, education, maintenance, and support.

Comment: This form is presented as a starting point. For alternative phrases approved by Treas Reg §20.2041-1(c)(2), see the text of the regulation in §7.57.

Normally, the discretionary distribution provision should be elaborated to provide a better understanding of the settlor's wishes. See §§7.63-7.74.

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§7.63 D. Elaboration Techniques

Various techniques are frequently used to further state settlor intentions in using a discretionary distribution power without causing the causing the holder of the power to have a general power of appointment. These techniques include the following:

- Selection of the person holding the discretionary power. See §7.64.
- Narrowing or broadening the extent of discretion of the person holding the discretionary power. See §7.65.
- Clarifying whether the trustee is to take into account the beneficiary's other assets, income, and ability to earn income. See §§7.66-7.68.
- Identifying a favored beneficiary, if any, and clarifying whether the trust property may be exhausted for the benefit of that beneficiary. See §§7.69-7.71.
- Clarifying the meaning of "education." See §§7.72-7.74.

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§7.64 1. Selection of Person Having Discretion

A discretionary distribution power may be held as a trustee or as an individual. Even if the power is held as an individual, it must be exercised reasonably and in accordance with the standard. Prob C §16081(b).

If the distribution power is conferred exclusively on the beneficiary, either as the trustee or as an individual, the document evidences the fact that the holder of the power is a favored beneficiary, because it shows that the settlor is willing to accept an arrangement that encourages discretion to be exercised in the beneficiary's favor to the maximum extent possible without violating the standard.

In contrast, giving the distribution power to an adverse party, as when a child of a former relationship is both trustee and a remainder beneficiary of a trust benefiting a surviving spouse or partner for life, suggests that the settlor is willing to accept discretionary distributions that are less generous to the person who will receive them.

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§7.65 2. Broadening or Narrowing Discretion

The degree of trustee discretion can be stated in a variety of ways. Compare the following clauses:

- "The trustee *shall* distribute such amounts as are *necessary* for support."
- "The trustee, *in its discretion*, *may* distribute such amounts as the trustee deems *appropriate* for the beneficiary's support."

Variations in terms and phrases such as "may," "shall," "necessary," "appropriate," and "in the discretion" are important in demonstrating the extent to which the settlor intends for a court to defer to the judgment of the person granted the discretionary power in the event of a dispute.

NOTE: Drafters sometimes attempt to confer "absolute discretion" on the holder of the distribution power. But doing so risks converting the discretionary power into a general power of appointment. To protect against that risk, California law provides that a trustee with an "absolute," "sole," or "uncontrolled" discretion must nevertheless act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust. Prob C §16081(a).

When particularly broad discretion is conferred on a person who is also the beneficiary, the inference that the holder may apply the standard in a manner favoring the holder is particularly strong.

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§7.66 3. Consideration of Beneficiary's Other Resources

The last sentence of Treas Reg §20.2041-1(c)(2) states:

> In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

This sentence provides the drafter with a wide range of options in determining the level of distributions to the beneficiary. For example, it is perfectly permissible to authorize a wealthy beneficiary to withdraw from the trust the amount appropriate to support that beneficiary in accordance with the beneficiary's station in life *without taking into account the fact that the beneficiary has no financial need whatever.* A drafter might very well choose to do just exactly that when the settlor would have made an outright gift to the beneficiary but for tax considerations. A generous and thoughtful settlor might also choose this approach if the beneficiary is a favored beneficiary who has only modest wealth —perhaps a small inherited nest egg.

PRACTICE TIP: Unless otherwise stated, a court would probably conclude that the holder of a discretionary distribution power should take into account other trust distributions from the same trust (including another trust established by the same settlor) such as a mandatory annuity payment or a right to withdraw trust property under a "five or five" power. If the settlor does not want those distributions considered, as may be true if the trust is established exclusively for tax reasons, the trust document should expressly say so.

Conversely, there are many situations in which the settlor will choose to require consideration of at least some other resources. Care must be taken in describing those resources. Normally, a settlor would not intend to force a beneficiary to sell a home and consume the proceeds before applying for support. Similarly, the settlor probably does not expect the trustee to consider the potential earnings of a young mother of several small children. 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, *e.g.,* the court held that the trustee of a bypass trust could consider the surviving spouse's other assets in deciding whether to invade trust principal for the spouse's support. The court cited *In re Ferrall's Estate* (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.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.67 a. Resources Taken Into Consideration

§7.67 a. Resources Taken Into Consideration

Assets and income that might be taken into consideration in exercising distribution discretion include the following:

- Other distributions from the trust.
- Other investment income known to the trustee.
- Cash and marketable securities known to the trustee.
- Real estate held for investment.
- Beneficiary-occupied real property (residence and vacation home).
- Tangible personal property.
- The beneficiary's ability to earn income without interfering with the care of family members.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.68 b. Form: Consideration of Other Resources

§7.68 b. Form: Consideration of Other Resources

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7.68-1 Consideration of other resources

[*Use one of the following alternatives*]

[*Alternative 1: No consideration*]

***Consideration of Other Resources*. In exercising its discretion to determine the amount appropriate for the beneficiary's health, education, maintenance, and support, the trustee shall not take into account other distributions from this trust or from any other income or resources.**

[*Alternative 2: No consideration except other trust distributions*]

***Consideration of Other Resources*. In exercising its discretion to determine the amount appropriate for the beneficiary's health, education, maintenance, and support, the trustee shall take into account distributions from this and from other trusts established by the settlor, but not any other income or resources.**

[*Alternative 3: Consideration of other resources left to trustee discretion*]

***Consideration of Other Resources*. In exercising its discretion to determine the amount appropriate for the beneficiary's health, education, maintenance, and support, the trustee is permitted but not required to take into account other resources readily available for these purposes.**

[*Alternative 4: Consideration of specified resources*]

***Consideration of Other Resources*. In exercising its discretion to determine the amount appropriate for the beneficiary's health, education, maintenance, and support, the trustee shall take into account distributions from other trusts established by the settlor, other sources of beneficiary income known to the trustee, other resources of the beneficiary readily available for these purposes, and, to the extent appropriate, the beneficiary's ability to earn income. In considering whether to consider the ability of the beneficiary to earn income, the trustee may consider the beneficiary's age, health, family care responsibilities, charitable work, and any other factors the trustee deems relevant.**

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§7.69 4. Identifying Favored Beneficiaries

Often the settlor wants the trustee to favor some beneficiaries more than others. This situation is commonly encountered when the trustee is permitted to "sprinkle" distributions among multiple current beneficiaries. It is also encountered when there are current beneficiaries and remainder beneficiaries. Trustees require guidance in these situations. See §§7.80-7.84.

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§7.70 a. Using Favored Beneficiary Clause

Suppose, for example, that a trust provides for discretionary distributions to support an elderly sibling for life with remainder to the sibling's issue. On one hand, the sibling may be the favored beneficiary and the settlor may not care whether the issue ever get a dime. On the other hand, the sibling's issue may be the favored beneficiaries and provisions for distributions to the sibling merely reflect the settlor's sense of duty. Although the settlor's wishes can often be inferred from other factors, express statements are helpful.

WARNING: Care should be taken to avoid completely eliminating all fiduciary duties owed to the beneficiaries other than the beneficiary's receiving discretionary distributions, because it might result in the latter's being deemed to hold a general power of appointment. See §§7.19-7.37.

Some drafters merely state that a specific beneficiary is the favored, or primary, beneficiary. That approach may provide little guidance on how far the trustee can go in favoring that beneficiary and for what purposes. Form provisions that may be helpful are provided in §7.71.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.71 b. Form: Favored Beneficiary Clause

§7.71 b. Form: Favored Beneficiary Clause

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7.71-1 Favored beneficiary clause

[*Use one of the following alternatives*]

[*Alternative 1: Lead beneficiary is favored*]

In exercising its discretion to determine the amount appropriate for _ _[*name of beneficiary*]_ _'s health, education, maintenance, and support, the trustee shall bear in mind that the primary purpose of this trust is to provide for _ _[*him/her*]_ _. The trustee may distribute the entire trust property for this purpose and may distribute the property at a rate that exhausts the trust in a shorter period than that of _ _[*his/her*]_ _ life expectancy.

[*Alternative 2: Remainder beneficiaries are favored*]

In exercising its discretion to determine the amount appropriate for _ _[*name of beneficiary*]_ _'s health, education, maintenance, and support, the trustee shall take into account the settlor's hope that a substantial portion of the trust property will remain available for distribution to the remainder beneficiaries.

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§7.72 5. Defining Education

In theory, the term "education" might include such things as preschool, private primary and secondary school, college, graduate school, vocational study, foreign travel, music lessons, and sky-diving lessons. For a fairly broad definition, see Alternative 1 of form 7.74-1.

It is sometimes desirable to be more specific—particularly when a trustee has the power to sprinkle distributions among a group of beneficiaries, with the consequence that distributions made for one beneficiary will have a direct impact on the amounts later distributed to other beneficiaries. For an example of a narrow definition, see Alternative 2 of form 7.74-1.

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§7.73 a. Including Related Expenses in Definition

Some clauses expressly provide that "education" includes such things as related living and travel expenses. See the optional language in Alternative 1 of form 7.74-1. This option is harmless, but probably not necessary inasmuch as the power to make distributions for those purposes is implied and, in any event, the beneficiary entitled to the education is normally also entitled to "support." See §7.60.

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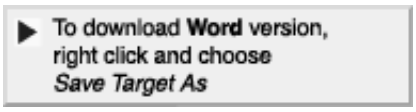
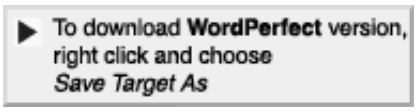
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.74 b. Form: Definition of 'Education'

§7.74 b. Form: Definition of "Education"





7.74-1 Definition of "education"

[*Use one of the following alternatives*]

[*Alternative 1: Broad definition*]

Education. **"Education" includes elementary, secondary, vocational, college, university, postgraduate study, and other specialized studies if, in the trustee's discretion, the study is being pursued to advantage by the beneficiary.**

[*If appropriate, add the following option*]

[*Option: Related expenses included*]

The trustee may pay for the beneficiary's living and travel expenses reasonably related to the beneficiary's studies.

[*Alternative 2: Narrow definition*]

Education**. "Education" includes 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.**

Comment: Alternative 2 is appropriate for a "family pot" trust with a discretionary sprinkling provision. See §§7.80-7.84. It should be modified if the attorney is drafting a separate trust for each child.

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VI. DRAFTING INDEPENDENT TRUSTEE DISTRIBUTION POWERS

§7.75 A. Independent Trustee Power Need Not Be HEMS Power

For power of appointment purposes, a trustee is an "independent trustee" (as opposed to a "sensitive trustee") if no discretionary distributions can be made to the trustee, the trustee's creditors, the trustee's estate, or the creditors of the trustee's estate. See §7.17. If all distribution discretion is vested in an independent trustee, the distribution discretion of the independent trustee will not cause the trustee or any beneficiary to hold a general power of appointment. Accordingly, if all distribution discretion is vested in an independent trustee and reasonable precautions are taken (see §7.76), it is generally unnecessary to limit that distribution discretion by an ascertainable standard relating to the health, education, maintenance, or support of the powerholder. IRC §§2041(b)(1)(A), 2514(c)(1). For discussion of drafting powers limited by an ascertainable standard (HEMS powers), see §§7.55-7.74.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.76 B. Required Precautions in Drafting Trustee Powers

§7.76 B. Required Precautions in Drafting Trustee Powers

The primary precautions that should be taken before giving a trustee a power that is not limited by an ascertainable standard (HEMS power) involve three risks:

- The drafter must be sure that the persons who would be "sensitive trustees" if they held the distribution power do not have a power to remove and replace the independent trustee. Generally, a removal and replacement power will not present a problem if a beneficiary can appoint only successor trustees that are not related or subordinate to the beneficiary within the meaning of IRC §672(c). Rev Rul 95-58, 1995-2 Cum Bull 191. See §7.26.
- It is important to ensure that no such beneficiary might end up acquiring the right to participate in exercising the distribution power in a manner that is not limited by an HEMS power. Therefore, the trust document should limit discretionary distributions to or for the trustee's benefit even though California law generally limits such distributions to those permitted by an HEMS power unless the trust document expressly provides a broader power. Prob C §16081(c). The clause limiting the exercise of the distribution power by such a beneficiary may or may not provide for the exercise of broader discretionary powers by another trustee—either a co-trustee that is independent, or a special trustee that is either named in the document or who will be chosen by a court if a need for broader distributions arises. See §7.79.
- It is important to be sure that neither the independent trustee nor any replacement will have the ability to make distributions that discharge support obligations. Assuming that the trust document already contains the provision in §7.25, no additional provision is required.

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§7.77 C. Distributions for "Comfort" and "Happiness"

Because the terms are mentioned in Treas Reg §20.2514-1(c)(2) (see §7.57), "comfort" and "happiness" are sometimes used to describe the purposes for which an independent trustee may make discretionary distributions.

NOTE: Historically, before the IRC §2056(b)(7) QTIP trust supplanted the IRC §2056(b)(5) general power of appointment trust as the marital deduction trust of choice, some drafters used "comfort" and "happiness" as code words in beneficiary withdrawal powers that would *intentionally* ensure that the surviving spouse had a general power of appointment. See chap 13.

In contemporary drafting, a power to make distributions for "happiness" may sometimes be useful in order to insulate the trustee from claims by the remainder beneficiaries that the trustee has been too generous. It does not, however, assure a specific level of distributions. Restatement (Third) of Trusts §50, comment d (2003). The term "comfort" in isolation is often ambiguous except, perhaps, when the beneficiary previously experienced a level of support that clearly fell below "comfortable."

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§7.78 D. Assessing Risks and Benefits of Not Using HEMS Power

Generally, discretionary distribution powers should be limited by an HEMS ascertainable standard unless there is a good reason *not* to limit the power. Even if the trustee appears to be independent, using an ascertainable standard HEMS power further reduces the risk that a trustee or beneficiary has a general power of appointment that the drafter has somehow overlooked. The important question is whether the settlor desires to give the trustee the power to make distributions that cannot be made under an HEMS power, as discussed in §§7.57-7.62. Generally those distributions are for purposes of the following:

- Enabling the beneficiary to make gifts, including charitable gifts;
- Accomplishing tax objectives, *e.g.*, distribution of appreciated property to the surviving spouse for the purpose of allowing the property to receive a new income tax basis under IRC §1014 (or an allocation of aggregate basis increase under IRC §1022 in 2010) on the survivor's death; or
- Possibly, making expenditures that border on the frivolous, such as lavish entertainment and yachts if such expenditures are not consistent with an existing standard of living or justifiable by the size of the trust.

The mere fact that the settlor wants the beneficiary to make frivolous expenditures, however, is not a reason to depart from use of an HEMS power. Instead, that objective can usually be accomplished by combining a beneficiary-held "five or five" power (see §§7.90-7.92) with a generous HEMS power that directs the trustee to ignore the "five or five" power and other sources of support when calculating the amount to be distributed under the HEMS power. See Alternative 1 of form 7.64-1. Accordingly, the primary purposes of giving an independent trustee a power other than an HEMS power are to facilitate tax decisions and gifts.

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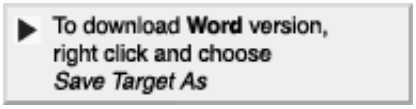
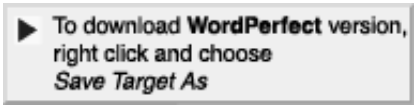
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.79 E. Form: Limitations on Discretionary Distributions to Trustee

§7.79 E. Form: Limitations on Discretionary Distributions to Trustee





7.79-1 Limitations on discretionary distributions to trustee

***Limitations on Discretionary Distributions to a Trustee*. A person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of him- or herself may exercise that power in his or her favor only for health, education, maintenance, or support within the meaning of Internal Revenue Code §§2041, 2514. Despite the foregoing and California Probate Code §15620, if a power to make discretionary distributions of income or principal is conferred on two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power; and, as long as there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary of that power, and the power may be exercised by the trustee appointed by the court. The restrictions of this paragraph do not apply to a person making distributions of property that the person could withdraw by exercising that person's own power of revocation.**

Comment: This clause is based on Prob C §16081(c), which may apply to avoid an unintended general power of appointment if the clause is inadvertently omitted from the trust document. Because the provision applies only to distribution powers exercised as a trustee or a cotrustee, it does not apply to "5 or 5" withdrawal powers or other personal powers.

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VII. DRAFTING DISCRETIONARY SPRINKLING PROVISIONS

§7.80 A. Sprinkling Provisions Used in Family Pot Trusts

The forms in this chapter generally assume that a particular trust (or at least an independent share of a trust) has only one beneficiary who is entitled to discretionary distributions at any particular time. But settlors often wish to permit discretionary distributions to multiple beneficiaries.

Assuming that the trustee has the power to make greater current distributions to some beneficiaries than to others, and that the various distributions are not charged to independent shares created for each beneficiary, such distributions provisions are called "sprinkling" provisions. Trusts using such provisions are sometimes known as "family pot" trusts. The advantages and disadvantages of sprinkling provisions are discussed in §§7.81-7.82. Drafting considerations applicable to sprinkling provisions are discussed in §7.83. A form of sprinkling provision for children is provided in §7.84.

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§7.81 1. Advantages of Sprinkling Provisions

Sprinkling provisions that place discretion in a trustee, as opposed to an appointment power that is not subject to fiduciary duties (see §§7.85-7.88), are particularly useful when a settlor wants to provide a safety blanket for multiple beneficiaries but is not sure that the assets will be sufficient to provide equal distributions. For example, a settlor may desire to ensure that sufficient assets are available to provide support and education for children and grandchildren, whose needs may vary greatly.

Sprinkling provisions can also be used to permit distributions to less favored beneficiaries if surplus funds remain after satisfying the needs of the favored beneficiary. For example, a bypass trust that benefits a surviving spouse or domestic partner might permit distributions to lower generation beneficiaries of amounts clearly not needed for the survivor's support.

Sprinkling provisions are also useful, and more or less necessary, in "dynasty" trusts that will remain in existence for a long time.

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§7.82 2. Disadvantages of Sprinkling Provisions

In deciding whether to use sprinkling provisions, the settlor should be aware that these provisions often produce friction among beneficiaries or between particular beneficiaries and the holder of the sprinkling power. Indeed, IRS letter rulings reveal a high incidence of application for rulings specifying that court petitions seeking modification of trusts will not have adverse generation-skipping transfer tax consequences. IRC §2601; Treas Reg §26.2601-1(b)(4). See Moseley, *Will Modification of a Grandfathered GST Trust End Its Exempt Status?*, 26 Est Plan 223 (1999). A great majority of these rulings involve families that are trying to convert "family pot" trusts into trusts that treat beneficiaries, or at least branches of family beneficiaries, equally. Even if no formal trust modification is sought, considerations of family harmony often result in agreements that distributions will be equal rather than sprinkled.

If a sprinkling provision is otherwise appropriate, but the settlor anticipates a beneficiary with special needs or behavior problems, the settlor should consider setting aside the share for that beneficiary as a separate share. If the difficult beneficiary is a participant in a family pot trust or sprinkle trust, the problems and issues of the difficult beneficiary become the problems and issues of all of the beneficiaries. Difficult beneficiaries are more likely to litigate with the trust. If the costs of the litigation are allocated only to the trust for that beneficiary, it is a greater disincentive to litigation than if all of the potential beneficiaries share in the costs of the litigation. It is also easier to settle litigation if there are only two parties, the difficult beneficiary and the trustee. Separate shares also allow for separate and different trustees. The skills required to deal with the difficult beneficiary may be far greater than those required for the rest of the trust. See Merritt, *Estate Planning for Difficult Beneficiaries*, Estate Planning 2004, chap 4 (Cal CEB 2004).

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.83 B. Drafting Considerations Applicable to Sprinkling Provisions

§7.83 B. Drafting Considerations Applicable to Sprinkling Provisions

Generally, the drafting considerations that apply to discretionary distribution provisions for a single beneficiary also apply to provisions for sprinkling distributions among a group, except that provisions that directly or indirectly identify favored beneficiaries become particularly important. Usually, the distribution powers should be limited by an HEMS ascertainable standard that complies with Treas Reg §20.2041-1(c)(2), although a trustee other than a particular highly favored beneficiary might be given the power to make more liberal distributions to that beneficiary.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.84 C. Form: Principal and Income Sprinkled Among Children

§7.84 C. Form: Principal and Income Sprinkled Among Children

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7.84-1 Principal and income sprinkled among children until youngest child reaches specified age

Distribution of Principal and Income. **The trustee shall pay to or for my children who survive me as much of the trust income and principal as the trustee, in the trustee's discretion, considers appropriate for their health, education, maintenance, or support. 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.

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 property 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 I have no living children under the age of _ _[*number*]**_ _.**

[*If appropriate, 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, maintenance, or support _ _[*; provided, however, that if the other parent of any child of a deceased child of mine is living and is treated as a child of mine for purposes of Article XIIIA, §2(h)(2)(A), of the California Constitution, and if an interest in real property situated in California would otherwise benefit from the grandparent-grandchild exclusion from a "change in ownership" for California property tax purposes, the trustee shall instead pay to my surviving children and to such other parent in equal shares the entire net income with respect to that interest and as much of the principal with respect to it as the trustee, in the trustee's discretion, considers appropriate for any purpose.*]**_ _.**

Comment: The optional language may be expanded to include support for the deceased child's spouse or domestic partner, particularly a spouse or partner who may be a single parent as a result of the child's death. The optional addition to the optional language contains an overriding provision designed to enable any California real property that might otherwise be subject to reassessment on the death of the settlor or on the later death of a child, with an assessed value less than its full cash or fair market value as determined for property tax purposes as of the settlor's date of death, to qualify for the grandparent-grandchild exclusion from a "change in ownership." (The parent-child exclusion is lost if the sprinkling power may be used to benefit grandchildren with respect to income from the property.) The language concerning accumulation of income is not needed if the trust document includes a separate clause providing for accumulation. See form 7.93-1.

The form sets out an "ascertainable standard." See §7.57. For broad and narrow definitions of "education," see §§7.72-7.74. For definitions of "children," see chap 18.

In addition to form 7.84-1, the drafter should include a clause expressing the settlor's intent about whether the

trustee should consider a beneficiary's other resources when making distributions. For suggested clauses, see §§7.66-7.68.

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VIII. DRAFTING PERSONALLY HELD APPOINTMENT POWERS

§7.85 A. Favored Beneficiary Given Nongeneral Power of Appointment

Sometimes the favored beneficiary is given a "nongeneral" (also called a "limited" or "special") power of appointment to periodically appoint trust property among a defined class. The power is held individually and not in a fiduciary capacity. Normally, this is done when the favored beneficiary is also being given such a power to appoint property on death, and the inter vivos power merely permits the holder to accelerate distributions to the appointees. See chap 8. For example, a bypass trust might permit the surviving settlor to appoint trust property to issue. Similarly, a trust for a child might permit the child to appoint among issue. A generic form of special power is provided in §7.88.

When such a power is conferred, the drafter must consider the fact that exercise of the power may result in a gift by the holder if the holder is entitled to distributions of income or unitrust amounts. See §7.35. This problem is avoided if the survivor's other distribution rights are either withdrawal rights limited by an ascertainable standard or rights to annuity amounts that will continue to be fully paid.

The drafter must also consider what will happen if the holder becomes incompetent and cannot exercise powers of withdrawal and appointment. One possible solution is to provide in the trust that powers can be exercised by an attorney-in-fact, then to authorize the exercise of the powers in a power of attorney.

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§7.86 B. Special Power of Appointment for Surviving Settlor

A special power of appointment may be useful when the deceased settlor would have given all assets to the surviving settlor but for the desire to reduce estate taxes. Care must be taken in exercising the power during the life of the surviving settlor because the IRS takes the position that this can result in a gift of the survivor's other rights under the trust. If, for example, the survivor is entitled to all trust income, the IRS contends that the immediate appointment of trust property to others will be a gift by the survivor of the survivor's income interest. The same argument can be applied to the survivor's other distribution rights, particularly "five or five" withdrawal power rights. Although the IRS lost the only reported case on this issue, many commentators believe the decision in that case is not persuasive. See *Self v U.S.* (Ct Cl 1956) 142 F Supp 939. The IRS has declined to follow *Self* and has stated that *Self* was effectively overruled by *Jewett v Commissioner* (1982) 455 US 305, 317, 71 L Ed 2d 170, 180, 102 S Ct 1082. See Rev Rul 79-327, 1979-2 Cum Bull 342; IRS Letter Ruling 9419007.

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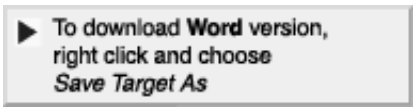
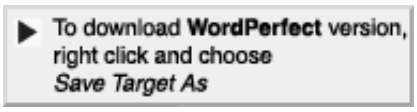
§7.87 C. Form: Exercise of Powers of Appointment





7.87-1 Exercise of powers of appointment

***Exercise of Powers of Appointment*. A power of appointment conferred by this document, other than a power held in a fiduciary capacity by a trustee, may be exercised only by an instrument that specifically refers to both this trust and the specific power being exercised. Such a power must be exercised by will, codicil, or a "qualified lifetime document." For purposes of this paragraph, a "qualified lifetime document" is a document meeting the requirements described above for revoking a trust with respect to the revoking settlor's separate property, including, if applicable under those requirements, a document executed by a conservator or an attorney-in-fact. A court may give effect to an attempted exercise that fails to satisfy the requirements of this paragraph in accordance with the criteria that would apply to a defective amendment of this document. It being a purpose of this trust to avoid probate, the trustee may distribute trust property in accordance with a will or codicil that has not been probated.**

Comment: The gift argument can be circumvented by giving the spouse no distribution right other than a *personally held* withdrawal right limited by an ascertainable standard. Such a right is a nongeneral power of appointment. The appointment of trust property to others will result in a release of that withdrawal right, but a release of a nongeneral power of appointment is not a taxable transfer. To ensure that the withdrawal right is characterized as a power of appointment, the distribution right should be held personally rather than conferred on a trustee.

If the only withdrawal powers are personally held, it is imperative that the trust document permit the powers to be exercised by the holder's attorney-in-fact and that the holder appoint an attorney-in-fact who is expressly authorized to exercise the power. Otherwise, all trust property may be trapped in the trust until the holder's death if the holder becomes incompetent. A form of special power for a surviving settlor is provided in §7.89.

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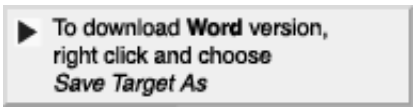
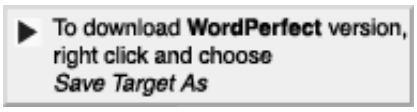
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.88 D. Form: Lifetime Special Power of Appointment

§7.88 D. Form: Lifetime Special Power of Appointment





7.88-1 Lifetime special power of appointment

***Lifetime Special Power of Appointment*. At any time and from time to time, the trustee shall distribute any or all of the trust property as _ _[*name of powerholder*]_ _ appoints.**

[*Add one of the following alternatives*]

[*Alternative 1: Broad power*]

This power to appoint property is a special power of appointment that may be exercised in favor of any appointee, outright or in trust, other than the holder of the power, the holder's estate or creditors, or the creditors of the holder's estate.

[*Alternative 2: Power in favor of specified class*]

This power to appoint property may be exercised only in favor of the settlor's issue, spouses and former spouses of those issue, _ _[*domestic partners and former domestic partners of those issue,*]_ _ and trusts for the benefit of such persons. The power cannot be exercised in favor of the holder of the power, the holder's estate or creditors, or the creditors of the holder's estate.

[*Continue*]

No exercise of this power is valid unless made in a writing signed by the holder of the power _ _[*or attorney-in-fact for the holder*]_ _ and delivered to the trustee during the holder's lifetime.

Comment: Alternative 1 essentially permits appointment of trust property to virtually anyone other than the holder of the power. This alternative is useful when the settlor would have made an outright distribution of the trust property to the holder of the power but for tax or asset protection concerns.

Alternative 2 provides an example of an appointment power limited to a more narrow class. Clients are often initially confused by provisions allowing appointment to former spouses or domestic partners, but this flexibility is often desirable to permit distributions to, *e.g.,* the surviving single parent of the settlor's young grandchildren who might otherwise be forced to seek employment outside the home or be unable to afford to reside in a neighborhood suitable for raising those grandchildren. If domestic partners are included in a class, the term should be defined. See §18.8.

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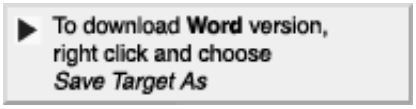
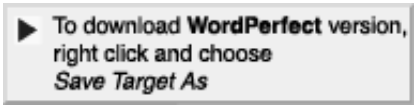
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.89 E. Form: Survivor's Special Power of Appointment

§7.89 E. Form: Survivor's Special Power of Appointment





7.89-1 Survivor's special power of appointment over bypass trust

***Survivor's Special Power of Appointment*. At any time and from time to time, any or all of the then remaining assets of the bypass trust shall be distributed as the surviving settlor appoints, outright or in trust, to, or for the benefit of any one or more "relatives" _ _[*or "charities"*]_ _. For purposes of this paragraph, a "relative" is anyone other than the surviving settlor who is (1) a descendant of any grandparent of either settlor, (2) a present or former spouse _ _[*or domestic partner*]_ _ of any such descendant, or (3) the issue of any such present or former spouse _ _[*or domestic partner*]_ _. Despite the foregoing, "relative" does not include a person qualifying as such solely by reason of a subsequent marriage _ _[*or domestic partnership*]_ _ of the surviving settlor. _ _[*For purposes of this paragraph, a "charity" is any entity, devises to which qualify for a federal estate tax deduction under Internal Revenue Code §2055.*]_ _ It is the settlors' intention that this appointment power not be a general power of appointment under Internal Revenue Code §§2041, 2514. Accordingly, the power cannot be exercised in favor of the surviving settlor, the estate of the surviving settlor, or any creditor of either. Nor may the power be exercised to discharge an obligation of the surviving settlor to support another person. An exercise of this power must be made in a writing delivered to the trustee during the surviving settlor's lifetime, but the surviving settlor's power of appointment includes the power to appoint the assets remaining in the trust at the surviving settlor's death.**

Comment: If domestic partners are included in a class, the term should be defined. See §18.8.

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IX. "FIVE OR FIVE" POWERS

§7.90 A. Exception to Transfer Taxation for Five or Five Powers

Normally, the cessation of a general power will result in a gift by the powerholder that may or may not be a completed gift at the time of the cessation. There is an important exception to this rule: During any calendar year, a *lapse* (as distinguished from a release or an exercise) of a general power is not a *release* of the power to the extent that, at the time of the lapse, the property that could have been appointed does not have a value greater than $5000 or 5 percent of the aggregate value of the property from which an exercise of the lapsed power could have been satisfied. IRC §§2041(b)(2), 2514(e). A general power that comes entirely within this safe harbor is often called a "five or five" power. Spouses are often given such powers in bypass trusts. See §7.91.

If the powerholder withdraws the property, it will be included his or her estate for transfer tax purposes. But if the powerholder lets the power lapse and the withdrawable amount was within the five or five exception, the former powerholder is treated as never having had an interest in the property for transfer tax purposes. See §§7.31-7.35.

Calculating the exact amount covered by the five or five power is not always easy, and the amount may be less than expected. If a power to withdraw from a trust is a power to withdraw from the income only, the 5 percent limitation is calculated on the value of the income. Rev Rul 66-87, 1966-1 Cum Bull 217. In Rev Rul 85-88, 1985-2 Cum Bull 201, the IRS ruled that, when a donee held a right of withdrawal in two identical trusts created by the same grantor, the amounts should have been combined for purposes of applying the $5000 limitation.

Although the lapse of a five or five power does not have adverse tax consequences, the property subject to the power will be included in the powerholder's estate if the powerholder dies during the period in which the power may be exercised. See, *e.g., Estate of Floy M. Christensen,* TC Memo 2000-368.

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§7.91 B. Uses of Five or Five Powers

Five or five withdrawal powers are often given to highly favored beneficiaries—typically those who might have been given the property free of trust but for tax considerations. The beneficiary can withdraw the allowed amount (or any lesser amount) as a matter of personal privilege without taking into account any need or distribution standard. Frequently, a surviving settlor is given a five or five power with respect to a bypass trust. See chap 14.

The five or five power may be given in lieu of other distribution rights or in addition to other rights. If the five or five power is the only distribution right, the trust document should permit the power to be exercised by the holder's attorney-in-fact. Otherwise, all trust property may be trapped in the trust until the holder's death if the holder becomes incompetent.

PRACTICE TIP: If the settlor wants to give maximum distribution flexibility to a favored beneficiary who is also the trustee, the trust document can give the beneficiary a five or five withdrawal power and further give the beneficiary the right to discretionary distributions under an ascertainable standard HEMS power that expressly provides that the trustee is not to take into account the withdrawal power or any other beneficiary resources in determining the amounts of the discretionary distributions. See §§7.66-7.68.

This flexibility may be desirable for purposes of permitting the surviving settlor to cope with issues raised by changes in tax laws. If it remains important to maximize the value of the bypass trust, the survivor can decline to make withdrawals and distributions. If, however, it would be desirable to withdraw property from the trust so that it will receive a new tax basis under IRC §1014 (or an allocation of aggregate basis increase under IRC §1022 in 2010) on the survivor's death, the survivor can withdraw substantial amounts of property.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.92 C. Form: Five or Five Withdrawal Power

§7.92 C. Form: Five or Five Withdrawal Power

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7.92-1 Lifetime power of appointment ($5000 or 5 percent limitation)

***Withdrawal Power*. In addition to receiving other distributions authorized by this document, _ _**[*name of beneficiary*]**_ _ ("powerholder") may withdraw property from the trust by delivering a written request to the trustee, subject to the following terms and conditions:**

A. The powerholder shall have no withdrawal rights under this provision during any calendar year in which the powerholder is not alive on the last day of the calendar year, but the written request may be delivered in advance.

B. 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.

C. 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 powerholder 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 the powerholder may direct, if any, and otherwise to the powerholder's estate. Any such directive must be signed by the powerholder _ _[*or attorney-in-fact for the powerholder*]**_ _ and delivered to the trustee during the powerholder's lifetime.**

Comment: Unlike an ascertainable standard HEMS power, a five or five withdrawal power is a general power of appointment, with the result that the property that may be withdrawn at the time of death is included in the powerholder's estate. IRC §1041. This clause attempts to limit the risk of death during the existence of the power by limiting the existence to the last day of the calendar year. If the powerholder does not have other distribution rights, the drafter needs to evaluate whether the powerholder should be provided with an additional source of funds to support the powerholder until the power can be exercised.

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X. DISPOSITION OF UNDISTRIBUTED TRUST INCOME

§7.93 A. Need to Direct Application of Undistributed Income

Regardless of whether a trust contains any provisions that expressly distinguish between trust income and trust principal in making trust distributions, ambiguity may result if the provisions fail to make clear what is to be done with trust income that is not expressly disposed of. See, *e.g., Estate of Robinson* (1968) 262 CA2d 32, 68 CR 420. As a precaution, most trusts contain a boilerplate provision stating that undistributed income is to be added to principal. See §7.94.

If the income is to be paid to particular 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 7.84-1 for an example of a sprinkling power.

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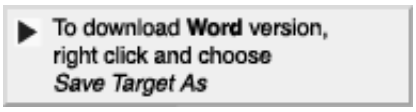
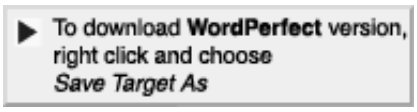
Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.94 B. Form: Accumulation of Undistributed Income

§7.94 B. Form: Accumulation of Undistributed Income





7.94-1 Accumulation of undistributed income

***Undistributed Income*. In any instance in which this document fails to expressly provide for the distribution or accumulation of any trust income, that income shall be accumulated and added to principal.**

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XI. SPECIAL NEEDS TRUST CLAUSES

§7.95 A. Purpose of Special Needs Trust

The principal purpose of a special needs trust (SNT) is to preserve public benefits for aged or disabled beneficiaries. The public benefits at issue are benefits that are "asset sensitive," *i.e.,* benefits that require the recipient to have resources and income below a certain level to qualify. A properly designed and administered SNT can provide funds to supplement a disabled or aged beneficiary's government benefits without interfering with public benefits. Although tax law frequently affects the terms of trusts discussed in the other chapters of this book, the terms of an SNT are principally controlled by public benefits law. Consequently, attorneys who prepare SNTs must be familiar with the requirements of the programs for which the beneficiary may be eligible. For further discussion, see Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008).

Most settlors creating trusts for beneficiaries with special needs use an inter vivos irrevocable SNT so that other family members can make lifetime contributions to the trust. The settlors' revocable trust can then provide for distribution of additional assets to the SNT on the death of one or both settlors. See §7.96. However, it is also possible to include SNT provisions in a revocable trust that will become irrevocable on the death of one or both settlors. See §7.97.

Assuming the revocable trust settlors wish to include provisions creating an SNT that will be funded and become irrevocable at death, this part discusses necessary and desirable provisions for such a trust. See §§7.98-7.109. A form of SNT for a sole beneficiary is provided in §7.110. Additional SNT provisions for multiple beneficiaries are discussed in §7.111. A form of SNT for multiple beneficiaries is provided in §7.112.

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§7.96 1. Using Inter Vivos or Testamentary Special Needs Trust

A third party special needs trust (SNT) is an SNT established and funded by a person other than the applicant. It is usually established by a parent for a disabled child. It may also be established by a grandparent, a sibling, or any other third party.

A third party SNT may be created by either an inter vivos or a testamentary instrument:

- An inter vivos trust is commonly used to receive gifts from several donors. For example, parents may establish an inter vivos SNT for a disabled child and then notify the grandparents of its existence. If the grandparents wish to leave assets to the disabled person, the inter vivos SNT can be used to consolidate asset management in a single entity, preserve public benefits, and obviate the need for the grandparents to establish a testamentary SNT in their wills.
- A testamentary trust is commonly used by parents, who provide in their wills for distribution of the portion of their estate intended for their disabled child to the trustee of an SNT under terms set forth in the wills.

If the inter vivos trust is likely to receive gifts from several sources, practitioners frequently prefer that it be irrevocable. Donors may feel more comfortable in transferring assets to a trust that will not be modified later. Also, the power to revoke will cause the trust assets to be includable in the settlor's estate if the settlor predeceases the beneficiary. IRC §2038. However, a third party SNT need not be irrevocable in order to preserve public benefits. As long as the trust is not required to make distributions and is not revocable by the public benefits beneficiary, the trust assets should not constitute countable resources for Supplemental Security Income (SSI) and Medi-Cal eligibility purposes. On SSI eligibility, see 42 USC §1382(a) and 20 CFR §416.1201 (trust will be counted as a resource for SSI eligibility purposes only if the beneficiary has unrestricted access to the principal). On Medi-Cal eligibility, see 42 USC §1396p(d) and 22 Cal Code Regs §§50489.1-50489.9 (restrictive trust rules applicable only to trusts established by the applicant).

For Medi-Cal eligibility purposes, some attorneys prefer SNTs established by will because they are specifically exempted from the restrictive trust rules of the Omnibus Budget Reconciliation Act of 1993 (OBRA) (Pub L 103-66, §13611, 107 Stat 622). See 42 USC §1396p(d)(2)(A). The restrictive trust provisions of OBRA, however, apply only to trusts that are considered to be established by the applicant. Because a third party SNT created under the terms of a revocable trust utilized as a will substitute is clearly not established by the applicant, it is as effective in preserving Medi-Cal benefits as a third party SNT established by will. See §7.97.

NOTE: A revocable third party SNT should not include postdeath authority to pay reimbursement claims of state agencies. This is required only when the trust is considered to be established by the applicant (*e.g.,* a litigation SNT). 42 USC §1396p(d)(1). This chapter does not discuss first party SNTs that are established by the applicant and are subject to more restrictive rules.

SSI and Medi-Cal eligibility rules and inter vivos third party SNTs are discussed in detail with sample forms in Drafting California Irrevocable Trusts, chap 13 (3d ed Cal CEB 1997). Testamentary SNTs are discussed in detail with sample forms in California Will Drafting, chap 23 (3d ed Cal CEB 1992). For a general discussion of Medi-Cal, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chaps 9-12 (Cal CEB 2003).

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§7.97 2. Advantages of Revocable Special Needs Trust

A revocable inter vivos third party special needs trust (SNT) gives the settlor the flexibility to modify the trust if the law changes or there are changes in circumstances. This flexibility allows the settlor to test the trust with public agencies by funding it, reporting it, and defending it. If the trust is found to be improper, it can be amended or revoked.

A third party SNT also may be established in a revocable trust to be operative on the death of the surviving parent. Such a trust shares the advantages of a testamentary trust (*e.g.,* it delays notification of the public agency while the parent is still able to supplement the child's public benefits during the parent's lifetime). Like the revocable third party SNT, the testamentary trust has the advantage of flexibility. Because the trust is not effective immediately, its terms may be modified if the law or circumstances change. See §7.96.

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§7.98 B. Need for Statement of Trust Purpose

The unusual nature of the special needs trust (SNT) calls for a description of the trust's specific purpose in an introductory section. To clarify the settlor'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 §7.99);
- States the intent that the trust estate be used to supplement, not supplant, public benefits 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.

For a form of introduction to a trust with a sole primary beneficiary, see Paragraph A in §7.110. Although briefer and coupled with a beneficiary identification, Paragraph B in §7.112 is intended to achieve the same goals as the introduction described above for a multiple-beneficiary trust. Because of the variation in different clients' situations, the forms obviously cannot serve in every case. The drafter should create a specific description tailored to each client.

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§7.99 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, then the appropriate state or county representative may bring a petition under CC §709.010 for reimbursement from the trust. Prob C §15306(a). See §§19.12-19.13 on spendthrift clauses.

With respect to third party special needs trusts (SNTs), Prob C §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 and does not have the right to compel distributions from the trust, then 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.

If state law creates a reimbursement obligation, even a testamentary or revocable third party SNT with a spendthrift clause may be vulnerable to claims by the state or local government if the beneficiary can require the trustee to make distributions or the beneficiary is the spouse or minor child of the settlor. However, most SNTs for disabled beneficiaries are exempt from liability for reimbursement under Prob C §15306(b). See §7.100.

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§7.100 2. Exemption from Reimbursement Liability of Most Special Needs Trusts for Disabled Beneficiaries

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 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 minimal level of support it provided.

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. The first sentence of Paragraph A in §7.110, which is intended to provide additional "spendthrift" protection, tracks the language of Prob C §15306(b).

No state laws currently require beneficiary *lifetime* reimbursements of funds received under SSI or Medi-Cal (except for overpayments). Probate Code §15306(a) should not, therefore, pose any threat of reimbursement to trusts for the disabled who receive only those benefits; the provisions of Prob C §15306(b) appear to be irrelevant to special needs trusts (SNTs) for those beneficiaries.

Probate Code §15306(b) does create the risk of SNT 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). Many of these patients receive Medi-Cal benefits 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).

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§7.101 C. Sole Beneficiary or Multiple Beneficiaries

Although the settlor usually prefers the aged or disabled beneficiary of a special needs trust (SNT) to be the sole beneficiary of the trust, some settlors 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. See form in §7.112. If the trustee is given broad discretionary power to "sprinkle" trust benefits among several parties, the interest of the government 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. See §§7.80-7.84 on sprinkling clauses.

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§7.102 D. Distribution Provisions

To preserve the beneficiary's eligibility for public benefits and to insulate the assets of the trust from claims for reimbursement of public benefits paid out, the trustee of the special needs trust (SNT) should have the widest discretion in making or not making payments from income or principal. 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 §7.96.

If a prospective trustee has no knowledge of public benefits, the settlor should consider establishing a trust advisory committee to advise the trustee regarding distributions. See Paragraph B in §7.110. The settlor also 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 §16.10 (Appointment of Special Trustee) may be adapted for this purpose.

Paragraph C in §7.110 provides for discretionary payments of both principal and income. On directions to add accumulated income to principal, see §7.93. This clause should be used only if the settlor wants the beneficiary to receive distributions of principal as well as income. This clause includes the phrase "in the trustee's discretion," so that the trust cannot be interpreted to impose a duty on the trustee to make monthly payments. See §7.103. The trust generally should include specific distribution guidelines. See §7.104.

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§7.103 1. Direction to Supplement, Not Supplant, Public Benefits

To avoid having the trust assets counted as income or a resource to the beneficiary, or as a source of reimbursement to a government agency for benefits rendered, the trust document must explicitly direct the trustee to use the trust assets to supplement, rather than supplant, public benefits. Paragraph F in §7.110 restates the trustor's intention that trust assets should supplement public benefits, not supplant them, as stated in Paragraph A. If the trust provides the trustee with maximum discretion to make distributions, guidelines for carrying out the settlor's intent are important both for trustee direction and to convince government entities that, despite the trustee's discretion, trust assets are not available to the beneficiary.

The examples of special needs in Paragraph C should be tailored to the probable supplemental needs of the beneficiary. 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 cause a reduction or even elimination of some needs-based public benefits.

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§7.104 2. Trustee Power to Supplant Public Benefits

The distribution provisions of Paragraph C in §7.110 create some flexibility to allow the trustee to forgo public benefits if determined necessary by the trustee. However, some clients will prefer more direct language authorizing the trustee to make distributions to pay for specific needs of the beneficiary. See Paragraph D in §7.110.

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 §7.108 on trust termination.

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§7.105 3. Trustee Duty to Seek Public Benefits

Alternative 1 in Paragraph E in §7.110 explicitly relieves the trustee of the duty to seek public benefits for the beneficiary. In directing the trustee to consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible, the trustee is alerted not to make distributions from the trust that may constitute unearned income to the beneficiary and cause a reduction in benefits or a loss of eligibility for SSI and other benefits.

The drafter should use Alternative 2 in Paragraph E when the trustee will take an active role in obtaining benefits for the beneficiary. 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.

The trustee's duties may be shared with a trust advisory committee (see Paragraph B) or special cotrustees. See §7.102 regarding the role of a trust advisory committee or special cotrustees in determining whether distributions should be made to the beneficiary.

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§7.106 E. Function of "Spendthrift" Clause in Special Needs Trust

A "spendthrift" clause is vital in the special needs trust (SNT) to limit the right of public 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 §§7.98-7.100 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. The last sentence of Paragraph G in §7.110 is intended to place the trust under the protection of Prob C §15306(b) by tracking the language of the section. For discussion of spendthrift clauses generally, see §§19.12-19.13.

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§7.107 F. Termination of Trust 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 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.

Paragraph H in §7.110 provides for trust termination as a solution to these problems. The clause calls for termination of the trust in the trustee's discretion 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. 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.

The drafter can soften the effect of this clause by also using Paragraph I, which directs distribution of the corpus to third parties with a request that they aid the former beneficiary. See §7.108.

NOTE: If an emergency termination might result from creditors' claims or claims for reimbursement despite a "spendthrift" clause in the trust (see §7.100), 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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§7.108 G. Remainder Distribution on Trust Termination

If the settlor fears that an emergency trust termination may leave the beneficiary destitute, the drafter may include in a precatory request that the recipients use the assets to assist the former beneficiary.

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 Paragraph I in §7.110 for a suggested clause. Before using this clause, the drafter should be certain that the settlor 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 settlor 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.

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 settlor wishes. See chap 8 for sample clauses for distributions on trust termination.

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§7.109 H. Distribution on Death of Beneficiary

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 settlor's estate plan.

Although the trust may 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 settlor 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 public agencies should be excluded from payable expenses to preserve the trust from claims for reimbursement. For a suggested clause, see Paragraph J in §7.110.

The settlor also may wish 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 class of persons nominated by the settlor. For a suggested clause, see Paragraph K in §7.110. 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). See §7.96. The device provides the beneficiary some power over the assets' disposition and assures the settlor that the trust corpus will go to appropriate recipients. On the limitation of creditors' rights to property subject to a special power of appointment, see Prob C §681.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.110 I. Form: Special Needs Trust for Sole Beneficiary

§7.110 I. Form: Special Needs Trust for Sole Beneficiary

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DIVISION _ _[*Number*]_ _
SPECIAL NEEDS TRUST

A. *Purpose of Special Needs 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 and custody and constitutes a substantial handicap. The beneficiary has been diagnosed with _ _[*name disability*]_ _ which is characterized by the following symptoms: _ _[*describe symptoms*]_ _. The purpose of this trust is to supplement, not supplant, the public benefits that would be available to the beneficiary if the trust did not exist. The beneficiary has basic living needs, such as special programs and equipment, that public benefits may not provide. It is vitally important that the beneficiary receive these services to maintain a level of human dignity and humane care. If this trust were to be invaded by creditors, subjected to any liens or encumbrances, or cause public benefits to be terminated, the trust corpus would likely be depleted before the beneficiary's death—especially because the cost of care for disabled persons (not including any emergency needs) is high. In this event, there would be no coverage for emergencies or supplementation of basic needs.

The following trust provisions should be interpreted in light of these concerns and this stated intent. 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 terminated earlier: _ _[*Name of primary beneficiary*]_ _.

B. *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.

If a TAC member is unwilling or unable, for any reason, to serve or to continue to serve as a TAC member, 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.

C. *Distribution for Special Needs*. The trustee may pay to or apply for the benefit of the beneficiary as much of the trust net income and principal as the trustee, in the trustee's discretion, considers necessary or advisable from time to time to meet the beneficiary's special needs. Any income not distributed shall be accumulated and added to principal. As used in this instrument, "special needs" are the requisites for maintaining the beneficiary's good health, safety, and welfare when, in the trustee's discretion, such requisites are not being provided by any public agency, office, or department of any city, county, or state government; the federal government; or any private agency. "Special needs" may include, but are not limited to, the following: _ _[*e.g., dental care; recreation and entertainment; special equipment; and programs of training, education, and treatment supplemental to those that the beneficiary is entitled to receive under a government assistance program*]**_ _.**

[*If appropriate, add the following option*]

[*Option: Trustee discretion to make distributions that cause reduction of public benefits*]

D. *Trustee's Absolute Discretion*. 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 of public benefits.

[*Continue*]

[*Use one of the following alternatives*]

[*Alternative 1: Trustee not required to seek public benefits*]

[E.] *Trustee to Consider Public Benefits*. The trustee is not responsible for seeking support and maintenance for the beneficiary from available public resources. In making distributions for the beneficiary's special needs as defined in paragraph _ _[*letter*]**_ _, the trustee shall, however, consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible, including SSI, Social Security Disability Insurance, Medicare, Medi-Cal, In-Home Supportive Services, Temporary Assistance for Needy Families (TANF), known in California as California Work Opportunities and Responsibility to Kids (CalWORKs), the appropriate Regional Center established under the Lanterman Developmental Disabilities Services Act, the State Department of Mental Health, county mental health services, and any other appropriate federal, state, or local agency serving disabled individuals. All references in this instrument to "Medi-Cal" shall include any other state's equivalent Medicaid program.**

[*Alternative 2: Trustee required to seek public benefits*]

[E.] *Trustee to Seek Public Benefits*. Because the beneficiary is disabled and unable to maintain and support _ _[*himself/herself*]**_ _ independently, the trustee shall, in the exercise of the trustee's best judgment and fiduciary duty, seek support and maintenance for the beneficiary from all available public resources, including, but not limited to, SSI, Social Security Disability Insurance, Medicare, Medi-Cal, In-Home Supportive Services, Temporary Assistance for Needy Families (TANF), known in California as California Work Opportunities and Responsibility to Kids (CalWORKs), the appropriate Regional Center established under the Lanterman Developmental Disabilities Services Act, the State Department of Mental Health, county mental health services, and any other appropriate federal, state, or local agency serving disabled individuals. In making distributions for the beneficiary's special needs, as defined in paragraph _ _**[*letter*]**_ _, the trustee shall consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible. All references in this instrument to "Medi-Cal" shall include any other state's equivalent Medicaid program.**

[*Continue*]

[F.] *Trust Estate to Supplement Public Benefits*. It is the intent of this trust that the trust estate shall be used to supplement public benefits, not supplant them. For purposes of determining the beneficiary's eligibility for SSI, Medi-Cal, TANF, regional center assistance, and residential and program services from the State Department of Developmental Services and any other program of public benefits, no part of the undistributed income or principal of the trust estate shall be considered an available resource to the beneficiary. However, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority to make a distribution that causes a reduction of public benefits.

[G.] *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.

[H.] *Backstop Termination Clause*. Despite any contrary provision in this trust, if the existence of this trust renders the beneficiary ineligible for Supplemental Security Income, Medi-Cal, or any other federal, state, or local program of public benefits, the trustee may, but need not, terminate this trust in whole or in part.

After paying the expenses of trust administration and termination, the trustee shall distribute the portion terminated to the persons and in the relative shares set forth in paragraph _ _[*letter*]_ _ as if the beneficiary were deceased.

In determining whether the existence of the trust may render the beneficiary ineligible for SSI, Medi-Cal, or any other program of public benefits, the trustee is granted full and complete discretion to initiate either administrative or judicial proceedings, or both, for the purpose of determining eligibility. All costs relating to such proceedings (including reasonable attorney fees) shall be a proper charge to the trust estate.

[I.] *Distribution of Remainder on Termination of Trust*. 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 to ensure that _ _[*he/she*]_ _ has sufficient funds for _ _[*his/her*]_ _ basic living needs when public benefits are unavailable or insufficient. This request is precatory, not mandatory. The trustee shall distribute the trust remainder to _ _[*name of remainder beneficiary*]_ _.

[J.] *Payment of Expenses on Death of Beneficiary*. 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. 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.

[*If applicable, add the following option*]

[*Option: Beneficiary special power of appointment*]

[K.] *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 his or her 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 _ _[*Letter*]_ _ of Division _ _[*number*]_ _.

Class: _ _[*Name of class*]_ _

Comment: The division of the trust document containing the special needs trust (SNT) provisions should be titled as a "special needs trust" because most SSI and Medi-Cal offices are familiar with the term. See discussion of this form in §§7.98-7.104.

Alternative 1 in Paragraph E is the minimal directive to the trustee of an SNT to consider public benefits in making distributions. Alternative 2 in Paragraph E requires more active participation by the trustee in obtaining public benefits. See §7.105.

On Paragraph G, see §7.106.

On Paragraph H, see §7.107.

Paragraph I should be amended if more than one beneficiary is named, both to conform articles and to describe the shares intended. On use of this clause, see §7.108.

Paragraph J excludes expenses that are the obligation of public agencies from payable expenses. See §7.109.

The blank paragraph letter in Paragraph K refers to the paragraph of the trust directing residuary gifts. The reference may be replaced by a reference to Paragraph I if the residuary beneficiary is the same as the precatory trustee on termination of the trust.

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§7.111 J. Additional Clauses for Multiple-Beneficiary Special Needs Trust

An alternative to the special needs trust (SNT) 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 SNT guidelines.

A multiple-beneficiary trust may be desirable both because the settlor 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. See §7.101.

Certain clauses of a multiple-beneficiary SNT must vary from those suggested in §§7.98-7.110:

- The beneficiaries will all be named initially, and the purpose of the trust as an SNT will be with regard to the identified disabled beneficiary only;
- The distribution clause will be a "sprinkling" clause that does not require distributions to the disabled (or any other) beneficiary;
- Any backstop clause (effective if the trust renders the disabled beneficiary ineligible for public benefits) will not terminate the trust but will provide only for cessation of distributions to the disabled beneficiary.

For sample clauses for use in a sprinkling SNT, see §7.112. For a model sprinkling clause for use in a non-special needs children's trust, see §7.84.

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Source: Estate Planning/Drafting California Revocable Trusts/7 Distributions From Continuing Trusts/§7.112 K. Form: Special Needs Trust for Multiple Beneficiaries

§7.112 K. Form: Special Needs Trust for Multiple Beneficiaries

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DIVISION _ _[*Number*]_ _
SPECIAL NEEDS TRUST

A. *Beneficiaries*. The beneficiaries of this trust are those of the following persons who survive the settlor: _ _[*Names of beneficiaries*]_ _.

B. *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 beneficiary has been diagnosed with _ _[*name disability*]_ _, which is characterized by the following symptoms: _ _[*describe symptoms*]_ _. 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, government benefits provided to that beneficiary, without disturbing government benefits that would be available to that beneficiary if this trust did not exist. The beneficiary is _ _[*name of disabled beneficiary*]_ _.

C. *Distribution of Principal and Income*. The trustee may pay to or for the then-living, above-named beneficiaries as much of the trust 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. 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.

D. *Distribution for Special Needs*. The trustee may pay to or apply for the benefit of _ _[*name of disabled beneficiary*]_ _ as much of the trust net income and principal as the trustee, in the trustee's discretion, considers necessary or advisable from time to time to meet the beneficiary's special needs. As used in this instrument, "special needs" are the requisites for maintaining the beneficiary's good health, safety, and welfare when, in the trustee's discretion, such requisites are not being provided by any public agency, office, or department of any city, county, or state government; the federal government; or any private agency. "Special needs" may include, but are not limited to, the following: _ _[*e.g., dental care; recreation and entertainment; special equipment; and programs of training, education, and treatment supplemental to those that the beneficiary is entitled to receive under a government assistance program*]_ _.

E. *Trust Estate to Supplement Public Benefits*. It is the intent of this trust that the trust estate shall be used to supplement public benefits for _ _[*name of disabled beneficiary*]_ _, not supplant them. For purposes of determining the beneficiary's eligibility for SSI, Medi-Cal, TANF, regional center assistance, and residential and program services from the State Department of Developmental Services and any other program of public benefits, no part of the undistributed income or principal of the trust estate shall be considered an available resource to the beneficiary. However, the availability of public benefits to pay for a specific need shall not deprive the trustee of the authority to make a distribution that causes a reduction of public benefits.

F. *Cessation of Distributions to Disabled Beneficiary*. Despite any contrary provision in this trust, if the existence of this trust renders _ _[*name of disabled beneficiary*]_ _ ineligible for Supplemental Security Income, Medi-Cal, or any other federal, state, or local program of public benefits, the trustee may, in the trustee's discretion, (1) notify _ _[*him/her*]_ _ that the trustee will cease making distributions to or for that beneficiary, and (2) make no distributions to or for that beneficiary.

G. *Termination of Special Needs Trust*. _ _[*Describe terminating event and distribution of remainder*]_ _.

Comment: The settlor may wish to include special instructions to the trustee to evaluate the beneficiary's needs or seek public benefits for that beneficiary. See Paragraph E in §7.110. The settlor also may wish to include a provision

creating a trustee advisory committee. See Paragraph B in §7.110.

The drafter should include language in Paragraph G limiting the duration of the trust and providing for a residuary gift of the remainder on termination of the trust. See Paragraph I in §7.110.

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8

Distributions on Terminating Event

Jeffrey A. Dennis-Strathmeyer
Kenneth G. Petrulis

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§8.1 I. TERMINATING DISTRIBUTIONS

This chapter addresses provisions for trust distributions, other than the types of periodic distributions discussed in chap 7 and the types of marital deduction distributions discussed in chaps 9-11. The distributions described in this chapter include those typically made on the death of an unmarried settlor or on the death of a surviving married settlor, including gifts of tangible personal property (see §§8.35-8.41), specific or general gifts of real or personal property and monetary gifts that may be made to the survivor of married settlors or other beneficiaries (see §§8.41A-8.45C), and the division and distribution of the residue of trust property in equal or unequal shares (see §§8.46-8.64). The chapter briefly discusses charitable gifts and charitable split-interest trusts (see §§8.65-8.65K).

Sometimes some or all of the "distributions" are not distributed at all, but are retained in further trust. Provisions for retaining property in further trust because the beneficiary is too young to manage money are included or discussed in this chapter. See §§8.21-8.30B. Provisions for retaining property in further trust in the context of marital deduction trust planning are discussed in chaps 12 (survivor's trusts), 13 (QTIP trusts), and 14 (bypass trusts). For more on charitable remainder trusts and charitable lead trusts, see California Will Drafting, chap 14 (3d ed Cal CEB 1992) and Drafting California Irrevocable Trusts, chaps 18, 18A (3d ed Cal CEB 1997). On special needs trusts, see §§7.95-7.112. See also Will Drafting, chap 23; Irrevocable Trusts, chap 13.

This chapter also discusses common disposition drafting problems (see §§8.3-8.20), as well as trustee discretionary powers concerning mandatory distributions (see §§8.66-8.72).

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§8.2 II. DISTRIBUTION TERMINOLOGY

Many distribution provisions closely resemble the corresponding will provisions. Nevertheless, there are differences: First, trusts distribute property at times other than death, which results in the need to expressly identify death as the distribution event. Second, terms such as "devise" and "bequeath" have little or no relevance in the context of trusts. Trustees "distribute" trust property. Accordingly, many of the provisions for distribution of trust property simply begin, "On the Settlor's death, the trust estate shall be distributed as follows:…."

For some purposes (particularly the abatement rules) statutory definitions of types of gifts are relevant in the trust drafting context. There are six classification of at-death transfers: specific, general, demonstrative, general pecuniary, annuity, and residuary. Prob C §21117. These can be summarized as follows:

- **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.,* "The trustee shall distribute my wedding ring to *A.*" Prob C §21117(a).
- **General gift.** A general gift is a gift from the general assets that does not give specific property. For example, a gift of "300 shares of common stock of General Motors Corporation" may be a general gift, particularly if the trust instructs the trustee to buy GMC stock on the open market for the beneficiary if the trust property does not otherwise include sufficient shares to make the distribution. (Note that an ambiguity arises if the estate's shares are insufficient and there is no direction to purchase them.) In contrast, a gift of "*my* 300 shares of General Motors Corporation stock" is a specific gift. General gifts other than general *pecuniary* gifts (described below) are relatively rare. Prob C §21117(b).
- **Demonstrative gift.** A demonstrative gift designates a particular fund or asset from which the gift is to be made, *e.g.,* "The trustee shall distribute $5000 to *X* to be paid from my credit union savings account." Demonstrative gifts are also rare, but sometimes used when a client has inherited a particular asset and desires that the particular asset be sold in order to provide gifts to persons closely related to the original owner. Prob C §21117(c).
- **General pecuniary gift.** A general pecuniary gift is a gift stated either as a fixed dollar amount or as a dollar amount determinable by the provisions of the trust. For example, "The trustee shall distribute $25,000 to *C.*" Prob C §§21117(d), 21118(b).
- **Annuity gift.** An annuity gift is a general pecuniary gift that is payable periodically, *e.g.,* "The trustee shall distribute $500 per month to *D* for the rest of her life." Prob C §21117(e).
- **Residuary gift.** A residuary gift is a gift of all that remains after all specific and general gifts are discharged, *e.g.,* "The trustee shall distribute the residue of the trust property to my issue per capita at each generation." Prob C §21117(f).

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§8.3 III. DISPOSITION DRAFTING PROBLEMS

Although the distribution provisions are the most important part of a revocable trust, they also require the greatest amount of custom drafting. Decades of litigation attest to the fact that, even ignoring tax issues, drafting distribution provisions that are both practical and unambiguous can be challenging. Problems the drafter must consider in devising a distribution plan and implementing clauses for a client are discussed in §§8.4-8.30B.

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§8.4 A. Bankruptcy of the Residue and Abatement

Sometimes individual dispositive provisions are perfect and still produce a disaster. In a classic example, the value of trust assets plunge, leaving the trust with sufficient assets to pay generous monetary gifts to friends and charities, but leaving the favored residuary beneficiaries, often the spouse and children, with virtually nothing. This consequence is sometimes called a "bankruptcy of the residue." Although the problem has been well known for years (see, *e.g.*, Leach, *Lessons from the Depression in Drafting of Wills and Trusts*, 18 Minn L Rev 27 (1933)), it is still fairly common. A bankruptcy of the residue may also occur because of unexpected debts, including large medical expenses that arise late in the settlor's life, unexpected business debts, and tort liabilities. Sometimes the residue is depleted by an ill-advised use of clauses charging all taxes and expenses to the residue, particularly when the residue is force to bear the burden of taxes on property passing outside the trust.

In extreme situations, not only are there no residuary assets, but insufficient assets to fund the preresiduary gifts. When that occurs, the preresiduary gifts must be cut back or "abated." Although it is often said that drafters should be familiar with statutory abatement rules, it is more accurate to say that drafters need to draft dispositive provisions in ways to ensure that the statutory rules never come into play.

PRACTICE TIP: When a client desires to make large preresiduary gifts, and the residuary beneficiaries are the favored beneficiaries, the trust should expressly limit the preresiduary gifts to a specified percentage of the trust estate or set a minimum value for the residue. In that event, the trust should state the manner of abating the preresiduary gifts if that becomes necessary.

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§8.5 1. Statutory Abatement Rules

California's abatement rules are in Prob C §§21400-21406. Under those rules, transfers abate in the following order (Prob C §21402(a)):

- Property not disposed of by the document—*i.e.*, by the laws of intestate succession;
- Residuary gifts;
- General gifts to persons other than the transferor's relatives;
- General gifts to the transferor's relatives;
- Specific gifts to persons other than the transferor's relatives;
- Specific gifts to the transferor's relatives.

Annuities and demonstrative gifts are considered specific gifts to the extent that they are satisfied out of the fund or asset specified in the trust, and general gifts to the extent that 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).

NOTE: For these purposes, a "relative" is very narrowly defined as a person who would be an intestate heir of the transferor if the transferor died intestate and no other person had priority. Prob C §21402(b).

WARNING: An important exception to the abatement rules concerns encumbered property. If the transferor directs that liens on specifically transferred property be exonerated, a specific transfer of other property will not abate for the purpose of exonerating the encumbered property. Prob C §21404.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.6 2. Avoiding Abatement Problems

§8.6 2. Avoiding Abatement Problems

Often the statutory abatement rules will not produce results the client desires. Normally, a client's favored beneficiaries are the residuary beneficiaries, but under the statutory scheme the gifts to the residuary beneficiaries abate before any others under the trust. Prob C §21402(a)(1). Thus, a distribution plan involving valuable preresiduary gifts must provide custom abatement provisions. Trust provisions that provide for abatement supersede the statutory abatement provisions. Prob C §21400.

Common strategies include the following:

- **Bargain sale.** Sometimes a particularly valuable item such as a residence or a business is to be distributed to a particular beneficiary. If the client wants to ensure that the assets are sufficient for other beneficiaries (typically, siblings of the beneficiary receiving the property), the plan may require the beneficiary to pay the trustee the difference between the value of the item and a dollar amount determined by a formula.
- **Specified abatement.** The trust may provide that the value of listed gifts cannot exceed a specified percentage of the value of the assets available for distribution or that the value of the residue cannot drop below a stated amount. If the limitation is exceeded, the gifts will abate in a particular order, pro rata, or a combination of both. Example: "The value of the gifts listed in paragraph X shall not exceed 25 percent of the value of the trust property available for distribution. In the event that that limitation would otherwise be exceeded, the gifts to A, B, and C abate first on a prorata basis, after which the gift to D shall abate."

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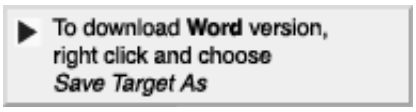
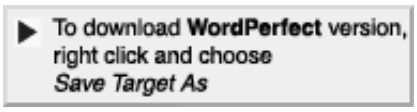
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.7 3. Form: Abatement of Gifts

§8.7 3. Form: Abatement of Gifts





8.7-1 Gifts restricted to fixed percentage of estate

***Abatement of Gifts*. If the total gifts made in paragraphs _ _[*paragraph numbers*]_ _ exceed _ _[*percent*]_ _ percent of the value of trust property available for distribution, these gifts shall be reduced on a prorata basis so that their total value does not exceed that percentage.**

Comment: As consistent with client objectives, the fraction should be set high enough that it will be unlikely that the clause is triggered. If the clause is triggered, the estate may become difficult to administer, and the administration may generate disputes because of the increased number of beneficiaries who have a direct interest in the value of the residue. See §8.13. These beneficiaries may dispute such issues as property valuations or the date the valuations are made.

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B. Ademption of Gifts

§8.8 1. Rules of Ademption

An inherent problem with any provision for distribution of a specific item is the risk of ademption. Ademption occurs when a specific item is not part of the trust estate at the time it is to be distributed. This situation may arise because the property was exchanged, sold, lost, destroyed, or given away during the transferor's lifetime. If the specific property is no longer part of the trust estate, the gift will normally adeem (fail), unless either a statutory exception applies or the gift can be construed in a manner preventing ademption.

The issue of ademption of a gift of securities often turns on a determination of whether the settlor intended a specific gift of certain securities or a general gift of the equivalent value of the securities. Under Prob C §21132, when the settlor intended a specific gift of securities, some or all of which are not part of the trust property at the settlor's death, the beneficiary of the gift 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 settlor because of actions initiated by the organization or any successor, related, or acquiring organization;
- Securities of another organization owned by the settlor 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.

Probate Code §21133 generally provides that a person who was entitled to receive specific property is also entitled to receive such things as the unpaid balance of the purchase price of the item that was sold, as well as unpaid proceeds from fire or casualty insurance for a damaged or destroyed item. Probate Code §21134 provides for a pecuniary gift in lieu of the original gift if the original gift was sold or encumbered by a conservator or attorney-in-fact after the owner became incompetent. (Interestingly, the provision does not apply to similar actions taken by the trustee of a revocable trust that has an incompetent settlor.)

Probate Code §21135 addresses the ademption issue by satisfaction. In the context of a gift of a specific item of property (*e.g.*, a specific piece of jewelry), an inter vivos transfer of the property to the same person who would take it at death under the trust will result in ademption of the gift. Prob C §21135(a)(4). For other transfers, the statute essentially establishes a presumption that an inter vivos gift does not extinguish the right to take under the trust without specified documentation confirming that the gift is intended to be a substitute for the transfer at death. Prob C §21135(a).

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§8.9 2. Avoiding Ademption Problems

An ademption of a gift of a significant asset can result in a disposition of client wealth that is radically different from that originally intended by the client. And although the ademption of a modest item of tangible personal property may seem unimportant, hard feelings can result. When a client proposes to gift specific items in the dispositive provisions, the planner should point out the risk and ascertain the client's desires. In some situations, the client's concerns can be satisfied without making an actual gift of specific property:

EXAMPLE 1: "The trustee shall distribute the trust property to my then living issue per stirpes. If the trust property includes Blackacre, the trustee shall allocate Blackacre to my daughter Jill if she is then living and requests that allocation. If the value of Blackacre exceeds the value of Jill's share, the trustee need not allocate Blackacre to her share unless she pays the trustee a sum of money equal to the excess value."

Another option is to provide an alternative pecuniary gift:

EXAMPLE 2: "The trustee shall distribute Blackacre to my daughter Jill if she survives me. If for any reason the value of this gift is less than $100,000, the trustee shall then distribute to Jill a sum of money equal to $100,000 reduced by the value of Blackacre."

Still another option is to provide for a gift based on the appraised value of Blackacre, but such a provision may pose construction and administration problems if, for example, Blackacre has been sold.

Gifts of assets such as automobiles that are likely to be disposed of and replaced during the transferor's lifetime can be drafted to allow for exchanges (*e.g.*, "the automobiles I own at the time of my death" instead of "my 2003 Acura").

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C. Exoneration of Encumbrances

§8.10 1. Expression of Settlor's Wishes

Unless the trust provides otherwise, a specific gift of encumbered property passes the property to the beneficiary subject to the encumbrance, without right of exoneration. Prob C §§21102, 21131. This rule creates a particular form of ademption problem, with the same consequences: A large gift of a specific item of property may lead to unintended results if the factual circumstances at death are significantly different from those that existed when the trust was drafted. The risk has become greater in contemporary estate planning because many clients refinance properties on a frequent basis and many have home equity lines of credit. Further, because home mortgage interest is more easily deducted for income tax purposes, clients frequently use their homes to secure loans used for purposes unrelated to the home.

In some situations, the client prefers to override the statutory rule and provide that a residence or other property pass free of encumbrances other than, perhaps, current real property taxes and assessments not yet delinquent. When this occurs, an express provision is required. The provision should clarify whether the assets that can be applied to pay the encumbrances are limited to the assets of the residue or whether other gifts can be abated for this purpose. A transferor who does not provide for abatement of other gifts will be presumed to have not desired it. Prob C §21404.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.11 2. Form: Exoneration of Encumbrances

§8.11 2. Form: Exoneration of Encumbrances

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8.11-1 Exoneration of encumbrances

[*Add one of the following alternatives*]

[*Alternative 1: Trustee to pay encumbrances on real property*]

Payment of Encumbrances. **I direct the trustee to pay any encumbrances on the property at the time of my death, including mortgages, deeds of trust, and real property taxes and assessments. These payments shall be made from the residue of the trust property.**

[*Alternative 2: No exoneration of encumbrances on real property*]

Property Includes 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: If the trust document is silent, liens and encumbrances will not be paid. Prob C §21131.

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§8.12 D. Tax Apportionment Issues

Tax apportionment provisions are discussed in chap 15. For estates large enough to be subject to substantial estate taxes, tax apportionment clauses can have almost as much effect on the values of gifts as the dispositive provisions. Accordingly, poor decisions on tax apportionment can result in asset distributions that are quite different from those the client intended. Particular care should be taken to avoid overuse of clauses that charge the trust residue with taxes on property passing outside the trust. See §§8.4-8.7, 15.1-15.2. Sometimes the assets passing outside the trust are substantial, including such things as large retirement plans, IRA interests, and life insurance. Alternatively, life insurance and other assets may be unexpectedly included in a client's estate, as when a client dies within three years after transferring an insurance policy. See IRC §§2035, 2042.

Boilerplate clauses may also create doubts about the client's intentions. Suppose, for example, that a provision charges all taxes to the residue, and the recipients of the residue are Individual and Charity in equal shares. Did the client really intend that the charitable gift would be subject to estate tax burdens even though that gift was deductible and did not contribute to the tax? If so, the amount of the allowable charitable deduction will be reduced, and total taxes will be increased. That may indeed be exactly what the client wanted because it increases the net gift to Individual, but a careful drafter will make sure that the client's intentions are stated more specifically than would a boilerplate clause, particularly in view of the fact that statutory apportionment applies except to the extent the trust "specifically directs that property be applied to satisfaction of the estate tax." Prob C §20110(b)(1). See §15.4.

This problem can arise even if the trust is not initially subject to estate tax. In *In re Menchhofer Family Trust* (Iowa App, Feb. 19, 2009, No. 8-464/07-1702) 2009 Iowa App Lexis 123, the court held that state inheritance taxes on pecuniary formula gifts in a trust created by a California settlor who later moved to Iowa were allocated to the charitable residuary beneficiaries under a boilerplate clause in the trust agreement providing for payment of all state death taxes from the residue with the apparent consequence that federal estate tax will be imposed on the portion of the residue used to pay the inheritance taxes, and additional estate tax will be imposed on the portion used to pay the estate tax. The opposite problem arises in 2010 when the estate tax is repealed and a pecuniary formula gift could result in the entire trust passing to charity. Did the client really intend that the charitable gift would *not* be reduced or limited by anticipated estate tax burdens that failed to materialize only because the estate tax did not apply to decedents dying in that year?

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.13 E. High Number of 'Interested' Beneficiaries

§8.13 E. High Number of "Interested" Beneficiaries

Most clients have had relatively little experience with postdeath trust administration. Consequently, a client's preliminary statement of dispositive wishes may present practical administration problems that the client has not considered. For example, a plan that gives small shares of the residue to a significant number of beneficiaries leads to many problems. At the time of postdeath administration, each beneficiary will have standing to object to almost anything the trustee does, *e.g.*, investment selection, decisions on liquidation of property, or eviction of relatives from the family home. The greater the number of such persons, the lower the likelihood that they will all waive an accounting by the trustee.

These kinds of problems can be minimized or avoided by using the following techniques:

- Small fractional share gifts can be replaced with gifts of specific dollar amounts;
- Survivorship clauses can be shortened to accelerate the elimination of contingent beneficiaries; or
- A single charity can be substituted for remote family members the client has never met as the taker of the residue if the client outlives the primary beneficiaries.

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F. Disclaimers of Gifts

§8.14 1. Failure to Consider Disclaimers

Disclaimers can be important tools for enabling trust beneficiaries to rearrange their inheritances in ways that may save taxes or protect assets from creditors. A "qualified disclaimer" under IRC §2518 is not treated as a gift by the disclaimant for estate and gift tax purposes. The most common example of the use of disclaimers involves the establishment of disclaimer trusts by a surviving spouse. See §§14.28-14.35.

Disclaimers can also be important in connection with dispositions to adult children.

EXAMPLE 1: Suppose that an elderly client wishes to leave her estate equally to her two middle-aged children, C1 and C2. C2 might wish to disclaim all or portion of his share to avoid exposing the trust property to taxes in his already large estate, to avoid loss of public benefits, or to prevent creditors from attaching the property.

Unfortunately, disclaimers are useful only if the person who takes in the event of disclaimer is a person the disclaimant wants to benefit. Without an express provision in the trust, disclaimed property will pass as if the disclaimant predeceased the transferor. Prob C §282. It is often desirable to provide express alternative dispositions, as in Example 2.

EXAMPLE 2: If, in Example 1, the client is aware that C2 is alienated from one of C2's children, GC1, the trust might provide that in the event of a disclaimer by C2, the disclaimed property will pass only to C2's children other than GC1.

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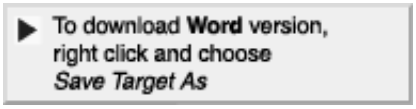
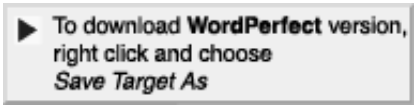
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.15 2. Form: Disposition of Disclaimed Gift

§8.15 2. Form: Disposition of Disclaimed Gift





8.15-1 Disposition of disclaimed gift

Disposition of Disclaimed Gift. **If _ _[*name*]_ _ disclaims any interest in property passing to _ _[*him/her*]_ _ under this trust, the disclaimed interest shall be distributed as follows: _ _[*Specify*]_ _.**

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G. Survivorship Issues

§8.16 1. Survivorship in Joint Trusts for Spouses and Domestic Partners

In plans for spouses and domestic partners, it may or may not be important to impose a survival requirement on transfers from a deceased settlor to a surviving settlor or to a trust for the benefit of a surviving settlor. Assuming that a spouse survives, a survival requirement in the trust will not result in the loss of the federal estate tax marital deduction unless the survival period exceeds six months. IRC §2056(b)(3)(A). See §9.18. If there is no survival requirement, the survivor may be able to decide the ultimate disposition of all trust property even if the survival period is quite short. If that possibility is unacceptable to the client, perhaps because there are children from prior relationships, the solution may be to minimize transfers to the surviving settlor or to a survivor's trust, increasing transfers to bypass trusts or QTIP trusts, rather than imposing a lengthy survival contingency. (If the client is unhappy about the prospect of the survivor deciding the disposition of the entire trust estate in the event of survival by one day, why would the client not be equally concerned about the prospect of the same result if the survivor remains alive an additional six months?)

If the clients choose an approach that makes transfers to a surviving settlor or survivor's trust contingent on a period of survival, the trust must contain alternative provisions for the disposition of the trust estate to be made if both settlors die within the survival period. It is usually not sufficient to simply provide that each settlor's property will be distributed as it would if the particular transferring settlor had been the survivor.

EXAMPLE: H and W attended Stanford University and the University of California at Berkeley, respectively. The trust provides that, on the death of the surviving spouse, each school is to receive $100,000 and the balance is to be distributed to issue. If the property of each spouse is to be distributed in this manner if the survivor does not survive for a specified period, each school will receive $200,000 rather than $100,000. The drafter could provide that, if both spouses die within the survival period, the gift from each spouse will be $50,000; however, that solution exposes the deceased spouse to the risk that the other spouse will eliminate the survivor's gift to the decedent's alma mater. A potential solution is for each spouse to provide only for the gift to that spouse's school. Similar considerations arise when the conflicting allegiances involve children from prior marriages.

It is important for the survivorship clause to specify the beginning of the survival period. In *Burkett v Capovilla* (2003) 112 CA4th 1444, 5 CR3d 817, litigation resulted when a trust survivorship clause provided that distributees must "survive for sixty (60) days before entitlement to such gifts." The court held that the clause required distributees to survive 60 days after the settlor's death—not 60 days after execution of the trust. For an unambiguous form of survivorship clause, see §10.12.

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§8.17 2. Simultaneous Death

In the context of a jointly settled trust, the drafter needs to consider the possibility that the settlors will die under circumstances in which it cannot be determined which party is the surviving settlor. Under the Uniform Simultaneous Death Act (Prob C §§220-234), when it is impossible to prove that one person survived another, each person's property will be disposed of as if he or she had survived the other. Prob C §220. The will or other dispositive document, however, may contain different provisions. Prob C §221.

As a rule, the trust will already provide that outright dispositions are contingent on survival for a specified period such as 30 days. In such situations, it is still helpful, although not necessary, to specify which settlor will be deemed the surviving settlor merely to avoid the difficulty of construing a trust when both settlors meet the definition of "deceased settlor." For a trust provision that specifies the surviving settlor in the event of simultaneous death, see §9.7.

WARNING: 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).

PRACTICE TIP: When federal estate taxes are a concern and one spouse has little wealth, the estate planner should consider the possible benefits of having the wealthy spouse establish an irrevocable inter vivos QTIP. Such a trust will make it possible to shift wealth to the estate of the less wealthy spouse even if he or she dies first. See Drafting California Irrevocable Trusts §§2.39-2.39D (3d ed Cal CEB 1997).

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/ 3. Lapse of Gifts/ §8.18 a. Disposition of Distribution If Initial Beneficiary Fails to Survive

3. Lapse of Gifts

§8.18 a. Disposition of Distribution If Initial Beneficiary Fails to Survive

When a beneficiary fails to survive the settlor, or fails to survive until a future time required by the trust, the gift 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 §8.19), to the beneficiary's issue (Prob C §21110(a); see Prob C §240);
- If (1) the failed gift is a share of the residue (or "all") or of a future interest, (2) the residue or future interest is transferred to two or more persons, (3) the antilapse statute does not apply, and (4) the trust does not express a contrary intention, then the gift passes to the other beneficiaries of the residue or future interest in proportion to their other interests 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 as of the date the interest was to take effect in enjoyment (see *Estate of Stoddart* (2004) 115 CA4th 1118, 1131, 9 CR3d 770) as provided in Prob C §21114 (Prob C §21111(d));
- If there is no residuary clause or if a residuary gift fails and none of the above apply, to the transferor's estate passing to the heirs at law under intestate succession (Prob C §21111(a)(3)).

PRACTICE TIP: The careful trust drafter does not rely on the statutory lapse rules. Instead, the trust should be drafted to provide expressly for substitute takers in place of beneficiaries who do not survive the transferor.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.19 b. Antilapse Statute

§8.19 b. 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 settlor;
- The beneficiary is kindred either of the settlor or of the settlor's surviving, deceased, or former spouse or domestic partner; or
- The trust does not express an intention contrary to the provisions of the antilapse statute.

Section 21110 provides that such a gift should be distributed to the issue of the deceased beneficiary as provided in Prob C §240. Prob C §21110(a). For example, unless the trust provides otherwise, a gift to a deceased child of the settlor who leaves children who survive the settlor will pass to those children (the settlor's grandchildren). See also *Estate of Tolman* (2010) 181 CA4th 1433, 104 CR3d 924 (will provision that expressed an intention not to provide for unmentioned heirs or relatives did not sufficiently manifest an intention to prevent the operation of the antilapse statute with respect to the issue of named transferees). The antilapse statute is designed to reflect most settlors' intentions when they are not expressed in the trust. See *Estate of Sowash* (1923) 62 CA 512, 515, 217 P 123. For these purposes, the personal representative of a deceased beneficiary has the burden of proving by clear and convincing evidence that the beneficiary survived the settlor under Prob C §220. *Estate of Lensch* (2009) 177 CA4th 667, 99 CR3d 246.

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. For these purposes, a parent-child relationship may exist between a person and that person's natural parent, adopting parent, foster parent, or stepparent. See Prob C §§6450-6455.

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. A man is presumed to be the natural father of a child if he was married to the child's natural mother and the child was born during the marriage or within 300 days after the marriage was terminated. Fam C §7611(a). See *Scott v Thompson* (May 26, 2010, G041060) 2010 Cal App Lexis 753. 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, 6453(c). 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 met mother when she was pregnant and provided home for mother and child for several years). See also *Estate of Burden* (2007) 146 CA4th 1021, 53 CR3d 390 (decedent's grudging recognition of paternity in personal letter was sufficient evidence that he "openly held out the child as his own" even though decedent never lived with or supported child). Such presumed parents may include a second parent of the same sex as the biological parent or other natural parent. See *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46 (presumed mother lived with and supported biological mother and child; "[i]nsofar as practicable," provisions applicable to father and child relationship apply in determining existence of mother and child relationship under Fam C §7650(a)). 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 second parent of child). In some cases, the determination may depend on presumptions concerning the paternity of a child of a natural parent born during a marriage. See Fam C §§7540-7547.

The presumption of paternity also should apply to the natural child of a woman cohabiting with a registered domestic partner. 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 the 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.

PITFALL: "Kindred" means relationship by blood and not by affinity. Thus, spouses and 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 settlor's spouse but does cover gifts to kindred of, *e.g.,* the settlor's former spouse.

Adopted children are generally kindred of the adopting parent and not of the natural parents. Note, however, that in certain circumstances an adopted child also may be considered a child of the child's natural parent. 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. See §8.53.

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 trust and the settlor 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.

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§8.20 c. Avoiding Survivorship and Lapse Issues

Normally, issues concerning failure to survive and possible application of the lapse statute arise because of a lack of drafting precision.

EXAMPLE: Client has three children, *C1*, *C2*, and *C3*, all of whom have children of their own. The trust states, "On my death the trustee shall distribute my diamond necklace to *C1*," without further clarification. *C1* fails to survive the settlor. The residuary clause provides for distribution to issue then living. Under the statutes, the diamond necklace will pass to the *C1*'s issue. Prob C §21110. That may be exactly what the settlor would have wanted if the trust makes comparable gifts to *C2* and *C3*, or it may be the last thing the settlor wanted if the gift was motivated by the fact that *C1* had a particular attachment to the necklace that was not shared by other family members. In any event, none of the family members will be happy to have the disposition issue resolved by a state statute that the settlor probably never read rather than by an express provision in the trust.

Generally, dispositive provisions should expressly provide in every instance *either*:

- That the gift lapses if the beneficiary fails to survive, or
- That the gift goes to a specified alternative taker if the beneficiary fails to survive.

The following are two examples of these two types of dispositive provisions:

Gift lapses. "The trustee shall distribute my diamond necklace to *C1* if she survives me. If she fails to so survive, this gift shall lapse."

Specified alternative taker, then lapse. "The trustee shall distribute my diamond necklace to *C1* if she survives me. If she fails to so survive, my diamond necklace shall be distributed to *C2* if she survives me. If she also fails to survive me this gift shall lapse."

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§8.20A d. Avoiding Gift to Deceased Beneficiary

Sometimes class gifts are phrased in a manner that simply avoids the creation of a gift if one of the primary beneficiaries is deceased. Example: "The trustee shall distribute the residue of the trust estate in equal shares to the members of a class consisting of *X*, *Y*, and *Z* who survive me." Even then, the careful drafter will expressly indicate whether issue of a deceased member of the class will take the gift of the deceased member. Example: "The trustee shall divide the residue of the trust property into equal shares, creating one share for each member of a class consisting of *X*, *Y*, and *Z* who survives me or leaves issue surviving. Each share created for a surviving class member shall be distributed to the class member and each share created for a class member who failed to survive me shall be distributed to the issue of that class member per stirpes."

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.21 H. Dispositions to Young Persons

§8.21 H. Dispositions to Young Persons

In varying degrees, typical trust distribution provisions pose the risk that substantial property could pass to a minor or young adult. Unless the value of the property in question is exceptionally small, it is common for trusts to provide that dispositions that would otherwise pass to such persons are to be retained in further trust until they reach specified ages. Alternatively, the trust provisions can provide for distribution to a custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). See §§8.27-8.28.

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§8.22 1. Managing Minor's Property in Absence of Express Trust Provisions

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. Further, 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, chap 2 (Cal CEB Annual); 4 Witkin, Summary of California Law, *Sales* §233 (10th ed 2005); 12 Witkin, Summary, *Real Property* §206; on minors, 1 Witkin, Summary, *Contracts* §§28-30; on incompetents, 1 Witkin, Summary, *Contracts* §§51-56.

There are several devices for distributing property to a minor in the absence of a specific trust provision addressing the issue. See §§8.23-8.30. All of them suffer from the fact that the minor will be entitled to outright ownership of the property at age 18. There are other problems as well.

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§8.23 a. Guardianship of Estate

If the property to be distributed to a minor is substantial, distribution normally requires the appointment of a guardian of the minor's estate. A guardianship of the estate is a legal relationship in which the court appoints an adult to manage a minor's estate. See Prob C §§1500-1517. The guardianship terminates when the minor dies, attains majority, or is emancipated under Fam C §7002. Prob C §1600. In the interim, the guardian operates under court supervision. Guardianships incur court fees and legal fees. Quite aside from the desire to avoid outright distribution at age 18, few clients who have chosen a revocable trust in order to avoid California's probate court system will be interested in using that system to manage the minor's property.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.24 b. Transfer to Custodianship Without Trust Authorization

§8.24 b. Transfer to Custodianship Without Trust Authorization

Probate Code §3906 specifies the circumstances in which a trustee may distribute property to a custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) without express authorization in the trust. Generally, the amount to be distributed is limited to $10,000 unless the custodian is the trustee or a trust company. Although a court can raise the $10,000 limit, it may be reluctant to effectively waive the protections of a guardianship. Inasmuch as a trust that does not authorize distribution to a custodianship will almost certainly have no provision allowing the custodianship to remain in effect past age 18, the minor will be entitled to the property at that age. Prob C §3920.5(f).

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§8.25 c. Gift Delivered to Parent of Minor With Small Estate

The trustee can deliver 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 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 usually avoid guardianship. The attorney should alert the donor that the assets must be relinquished to the minor when he or she reaches age 18. Prob C §3300.

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§8.26 d. 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," as long as the money belonging to the minor is $20,000 or less. 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 (CUTMA) (Prob C §§3900-3925). Prob C §3412(b).

Because custodianships provide considerably less protection for the minor than does a guardianship, it is unlikely that a court would permit transfer of a large sum to any custodian other than a bank. In any event, all these options result in the property passing to minor at age 18.

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2. Trust-Authorized Distributions to Custodianships

§8.27 a. CUTMA Requirements

A custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) is a legal arrangement in which property transferred to a minor is managed and expended for the minor's benefit by an adult (the custodian) selected by the settlor (or by the trustee in the absence of an effective selection by the settlor). Normally, a custodianship terminates at age 18, but the trust can expressly delay termination to a selected age not exceeding age 25. Prob C §3920.5(c).

A custodianship cannot have multiple minor beneficiaries. Only one adult may be named as custodian. Prob C §3910. The settlor or trustee 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 settlor's designation of successors takes precedence over a designation by a custodian. Prob C §3918(b). A trustee may select a custodian if none is nominated by the settlor or if all those nominated are unable to act. Prob C §3905(c).

There are no limitations on the types of property that may be transferred 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.

When investing custodial property, the custodian must abide by the standard of care that would be followed by a prudent person dealing with another person'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 transferor. 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).

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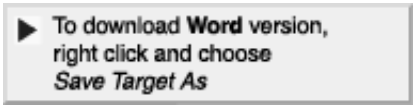
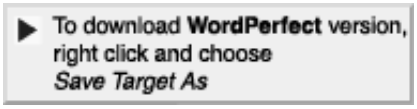
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.28 b. Form: Distribution to CUTMA Custodian

§8.28 b. Form: Distribution to CUTMA Custodian





8.28-1 Distribution to CUTMA Custodian

Distribution to Custodian. **If any person otherwise entitled to a distribution from this trust is under the age of** _ _[*number 18 to 25*]_ _ **at the time distribution is to be made, the trustee is authorized to make the distribution to a custodian named by the trustee under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) or a comparable statute of another state. The custodianship shall remain in effect until the beneficiary reaches age** _ _[*number 18 to 25*]_ _**.**

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3. Retention in Further Trust

§8.29 a. Advantages Compared to Custodianship

To some extent, a custodianship established under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) is a trust with statutory terms. The biggest disadvantage of a custodianship is its rigidity: A settlor cannot structure its terms to suit the beneficiary's particular needs or the settlor's estate planning objectives. There can be only one custodian and only one beneficiary. The age of termination cannot exceed age 25. Further, the settlor cannot specify the distribution to be made of the custodial property if the beneficiary fails to survive until the specified distribution age. Because of these considerations, most drafters provide that property that would otherwise pass to a person under a specified age will continue to be held in trust—either as a consequence of retention by the trustee making the distribution or by transfer to a new trustee. See §8.30.

Drafters also may provide that property that might otherwise pass to younger generation beneficiaries such as children or grandchildren will continue to be held in trust without regard to the age of the beneficiary on the terminating event. See §§8.30A-8.30B.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.30 b. Form: Retention in Further Trust Until Specified Age

§8.30 b. Form: Retention in Further Trust Until Specified Age

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8.30-1 Retention in further trust until specified age

Distributions to Young Persons. **If any person otherwise entitled to outright distribution of any property from any trust created by this document is under the age of _ _[*age*]_ _ at the time the right to distribution vests, the trustee shall not make the distribution, but shall, instead, retain the property that would otherwise be distributed in a separate trust for the benefit of the underaged person ("Beneficiary"). 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 then-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 in accordance with the provisions of this document for exercising a power of appointment. 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 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 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 order of death occurs. When outright distributions to young persons are likely to occur, *e.g.,* because distributions will be made to skip persons on the death of the settlor (or surviving settlor) and the settlor's GST exemption will be applied to the distributions, the trust document may provide for distribution to a family pot trust (see §8.30A) or separate trusts (see §8.30B). If the trust document does not otherwise contain a spendthrift clause, the drafter should consider adding one. On spendthrift clauses, see §§19.12-19.13.

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§8.30A 4. Distribution to Family Pot Trust

A family pot trust may be used when the terminating distribution will be made to a set of beneficiaries that may include young persons or when, for whatever reason, the settlor does not wish to make outright distributions. For a form of family pot trust, adaptable to a single settlor trust, to be included in the survivor's trust, see §12.18.

The form is appropriate for a trust that will be made exempt from the generation-skipping transfer (GST) tax as a result of allocation of the settlor's GST exemption. The trust may work especially well when all or most of the terminating distribution can be shielded by the settlor's GST exemption. For example, a single settlor with two children and a $5 million estate might give an amount equal to the settlor's remaining GST exemption ($3.5 million in 2009) to a family pot trust on the settlor's death and leave the residue outright in equal shares to the children. For settlors with larger estates, separate trusts for individual beneficiaries may be more appropriate than a family pot trust. See §8.30B.

Similarly, married settlors with a community property estate of $8 million might provide that the survivor's trust will give $3.5 million to the family pot trust on the death of the surviving settlor. This assumes that the deceased settlor's GST exemption has been applied to the bypass trust and that the survivor's GST exemption will not be applied to the marital trust. For further discussion and alternative family pot trust clauses adaptable to a revocable trust, see California Will Drafting §§22.49-22.52 (3d ed Cal CEB 1992).

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§8.30B 5. Distribution to Separate Trusts

Separate trusts for individual beneficiaries may be used when the terminating distribution will be made to a set of beneficiaries that may include young persons or when, for whatever reason, the settlor does not wish to make outright distributions. For a form, adaptable to a single settlor trust, to be included in the survivor's trust, see §12.19.

The form may be used whenever the intended beneficiaries may include young persons but a family pot trust would be inappropriate, as might occur if the amount to be distributed far exceeds the amount that can be shielded from the generation-skipping transfer (GST) tax by the application of the settlor's GST exemption. In that case, the settlor may prefer not to waste GST exemption by applying it to a trust that has both skip-person and non-skip-person beneficiaries. This form allows the trustee to create separate trusts for each beneficiary so that the settlor's GST exemption may be applied only to trusts for the settlor's grandchildren (or great-grandchildren) or other skip persons.

Separate trusts also have the advantage that IRC §2503(b) annual exclusion gifts can be made to each trust by other senior relatives such as great-aunts and great-uncles, or by children who are grandparents of the settlor's great-grandchildren. The gift tax annual exclusion does not apply to gifts in trusts for GST tax purposes if the trust has more than one beneficiary. IRC §2642(c). Such gifts may be especially desirable when most of the estate will pass outright to children who will then have taxable estates of their own. For example, a settlor with two children, four grandchildren, and four great-grandchildren who has a $10 million estate might give an amount equal to the settlor's remaining GST exemption ($3.5 million in 2009) to separate trusts for the great-grandchildren and the residue to the children. The children can then make annual exclusion gifts to the trusts and outright annual exclusion gifts (or gifts in trust) to the settlor's grandchildren.

The form also may be used to create separate trusts for children when the settlor does not wish to make outright distributions to them. In that case, the testamentary power of appointment ensures that the child will become the GST transferor of the trust on that child's death. Accordingly, the settlor's GST exemption need not be allocated to the trusts and may be used to exempt other transfers to separate trusts for grandchildren or great-grandchildren. For further discussion and alternative clauses adaptable to a revocable trust, see California Will Drafting §§22.53-22.58 (3d ed Cal CEB 1992).

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IV. PARTICULAR DISPOSITIONS

§8.31 A. Organization of Dispositive Provisions

A typical set of dispositive provisions begins with gifts of particular items of tangible personal property. See §§8.35-8.39. This set is followed by a provision for disposition of the residue of the tangible personal property. See §§8.40-8.41. The drafter usually provides that estate taxes attributable to these items in the taxable estate are to be paid from the residue of the trust estate.

PRACTICE TIP: The basic drafting strategy is to get tangible personal property out of the way. Doing so may be particularly desirable when the residue of the trust property will pass in fractional shares, inasmuch as distributions of tangible personal property in such shares can lead to disputes with beneficiaries concerning valuation. However, caution is required. Tangible personal property used in a trade or business should normally be distributed to the takers of the business. If the trust property includes a vacation home, the client usually wishes furniture and recreation equipment at the home to pass to the distributees of the home. Sometimes clients own art works or other valuable items. In each situation, custom provisions will be needed.

The provisions for disposition of tangible personalty are normally followed by whatever other preresiduary distributions the client desires. They may dispose of particular property such as a farm or vacation home, or they may provide for gifts of money. See §§8.41A-8.45C. They are followed by the provisions that dispose of the residue of the trust property. This disposition may be relatively simple, *e.g.*, a disposition to "my then surviving issue per stirpes."

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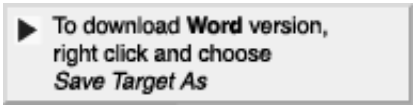
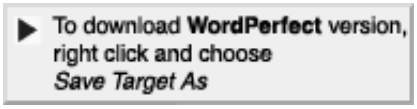
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.32 1. Form: Introduction to Dispositive Provisions

§8.32 1. Form: Introduction to Dispositive Provisions





8.32-1 Introduction to dispositive provisions

Distribution on Death. **On the death of the _ _[*person whose death triggers disposition*]_ _, the trustee shall distribute the remaining trust property in accordance with the following provisions of this _ _[*division/chapter/section*]_ _.**

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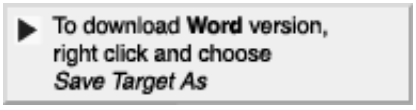
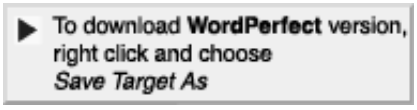
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.33 2. Form: Introduction to Dispositive Provisions With Power of Appointment

§8.33 2. Form: Introduction to Dispositive Provisions With Power of Appointment





8.33-1 Introduction to dispositive provisions with power of appointment.

Distribution on Death. **On the death of the _ _**[*person whose death triggers disposition*]**_ _, the trustee shall distribute the remaining trust property as _ _**[*person entitled to dispose of property*]**_ _ appoints, in accordance with the provisions of the division of this document on Exercise of Appointment Powers. The permitted appointees of this power are _ _**[*unlimited and include the estate of the power holder/limited to descendants of a parent of either settlor, spouses or domestic partners (including former spouses and domestic partners) of such descendants, and organizations satisfying the definition of "charity" in the division of this document concerning Additional Distribution Provisions, and trusts exclusively benefiting such persons and/or organizations*]**_ _. If the power of appointment is not effectively exercised with respect to any trust, the property not effectively appointed shall be distributed in accordance with the following provisions of this _ _**[*division/chapter/section*]**_ _.**

Comment: If the trust creates a power of appointment, the document should normally include provisions concerning procedures for exercising that power. See §7.87.

On the benefits of giving married settlors powers of appointment, see §9.34-9.36. In many situations, it is desirable to give a beneficiary a power of appointment. For example, a trust that has made periodic distributions to a beneficiary until death might give that beneficiary the ability to appoint the disposition on the beneficiary's death. On powers of appointment and their tax consequences, see §§7.16-7.34. If domestic partners are included in a class, the term should be defined. See §18.8.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.34 3. Form: Exercise of Power of Appointment [Deleted]

§8.34 3. Form: Exercise of Power of Appointment [Deleted]

This form was deleted as duplicative of form 7.87-1. See comment to form 8.33-1.

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§8.35 B. Tangible Personal Property

The nature and value of the tangible personal property clients own varies greatly. In addition, clients vary greatly in the extent they wish to make particular dispositions of personal property. There is frequently no connection between the value of the property and the degree to which a client desires to make detailed provisions for its disposition. Indeed, a client who has little else may be particularly interested making many gifts of specific items. When this occurs, the list of gifts may require frequent updating. A potential solution for this problem is a power of appointment. See §8.39.

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§8.36 1. Administrative Expense Issues

If it appears that unusual expenses may be incurred in safeguarding or transporting particular items of property, the trust should state whether the trust or the distributee pays for those expenses. For example, a caretaker may be needed to look after the settlor's stable of horses. The settlor must decide whether the estate or the beneficiary of the horses should pay for the caretaker's services.

The settlor may not wish to burden the beneficiary of tangible personal property with the expense of transporting it. Accordingly, if the beneficiary lives more than a short distance from the settlor's home, an express provision should be included that requires the trust to pay transportation expenses.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.37 2. Form: Gift of Single Item of Personal Property

§8.37 2. Form: Gift of Single Item of Personal Property

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8.37-1 Specific gift of single item of personal property

Gift of Personal Property. **If the property of the trust at the time of my death, including property passing to the trust as a result of my death, includes _ _[*item of tangible personal property*]_ _, the trustee shall distribute it, together with any insurance on it, to _ _[*name of beneficiary*]_ _. Any estate or inheritance taxes imposed on this gift, and the reasonable costs of delivering the property to the distributee's residence, shall be paid from the residue of the trust property. If _ _[*he/she*]_ _ fails to survive me, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: The reference to insurance is optional because this result is provided by Prob C §21133(c).

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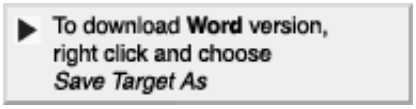
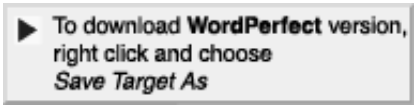
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.38 3. Form: List of Gifts of Personal Property Included in Trust

§8.38 3. Form: List of Gifts of Personal Property Included in Trust





8.38-1 List of gifts of items of personal property

Gifts of Personal Property. **The trustee shall distribute each of the following items to the person whose name appears next to that item. Any estate or inheritance taxes imposed on these gifts, and the reasonable costs of delivering the property to the distributee's residence, shall be paid from the residue of the trust property. If any item of property is not then included in the trust property, the gift of that item shall fail. If any distributee does not survive _ _**[*me/the settlor/the surviving settlor*]**_ _, the gift to that distributee shall lapse and the item shall become part of the residue of the trust property.**

_ _[*List each item of personal property and the beneficiary who will receive it, e.g., Settlor's Rolex watch: Settlor's son, George.*]_ _

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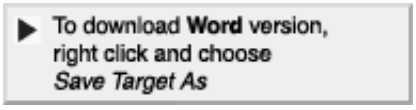
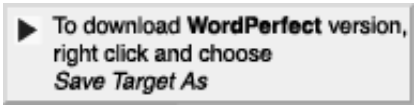
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.39 4. Form: Settlor to Give Trustee Separate List of Gifts of Personal Property

§8.39 4. Form: Settlor to Give Trustee Separate List of Gifts of Personal Property





8.39-1 Separate list of gifts of personal property

Settlor May Appoint Disposition of Personal Property. **The Settlor shall have the power to appoint the disposition of any or all items of the Settlor's tangible personal property included in the trust. This power may be exercised in a dated writing signed by the Settlor and delivered to the trustee. The writing need not expressly refer to this trust, and any additional formalities otherwise required by this document for exercising a power of appointment shall not apply. Unless otherwise provided in the exercise of the power, the appointment of any item of property that is not trust property at the Settlor's death and does not pass to the trust as a result of the Settlor's death shall fail, and any gift appointed to a person who fails to survive the Settlor shall lapse.**

8.39-2 Payment of estate taxes on personal property

Payment of Estate Taxes on Personal Property**. Any estate or inheritance taxes imposed on the Settlor's tangible personal property, and the reasonable costs of delivering the property to the distributee's residence, shall be paid from the residue of the trust property.**

Comment: One advantage of using a trust rather than a will to dispose of property is the fact that a trust can confer a power of appointment that permits a settlor to dispose of trust property in a document that is executed after the date of execution of the trust. The foregoing provision may be useful for a client who frequently desires changes in provisions for disposing of tangible personal property.

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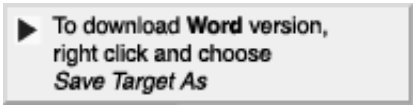
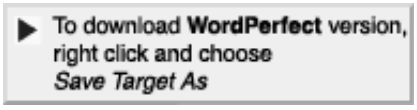
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.40 5. Form: Gift of Tangible Personal Property Not Otherwise Disposed of

§8.40 5. Form: Gift of Tangible Personal Property Not Otherwise Disposed of





8.40-1 Gift of tangible personal property to individual

Gift of Personal Property Not Otherwise Disposed of. **The trustee shall distribute all my jewelry, clothing, household furniture and furnishings, automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of in any other manner, together with any insurance on the property, to _ _[*name of beneficiary*]_ _. Any estate or inheritance taxes imposed on these gifts, and the reasonable costs of delivering the property to the distributee's residence, shall be paid from the residue of the trust property.**

Comment: The drafter should review with the settlor 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 S2d 1217 (litigation over whether gold coins are "tangible personal property").

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41 6. Form: Gift of Tangible Personal Property to Children

§8.41 6. Form: Gift of Tangible Personal Property to Children

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8.41-1 Gift of tangible personal property to children; trustee divides if children cannot agree

Gift of Personal Property to Children. **The trustee shall distribute all my jewelry, clothing, household furniture and furnishings, automobiles, books, and other tangible articles of a personal nature not otherwise specifically disposed of 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. Any estate or inheritance taxes imposed on these gifts, and the reasonable costs of delivering the property to the distributee's residence, shall be paid from the residue of the trust property. If any of my children fail to survive me, the gift to that child shall lapse. If my children are unable to agree on a division of the tangible personal property, the trustee shall make the division.**

Comment: This clause intentionally cuts off issue of deceased children in the interests of administrative convenience.

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C. Specific Gifts of Corporate Stock and Business Interests

§8.41A 1. Specific Gift Drafting Considerations

It is usually prudent to avoid specific gifts of publicly traded stock as defined in Prob C §21117 (see §8.2) because the stock holdings of the trust may be altered in some manner or sold after execution of the trust instrument. The settlor should consider providing for the beneficiary of the proposed specific gift of stock by making a general pecuniary gift as defined in Prob C §21118 (see §§8.45A-8.45C) or a percentage gift of the residue of the trust property.

If the settlor insists on making a specific gift of publicly traded stock, the trust should specify whether and how the gift should be adjusted for changes in the capital structure of the corporation made after execution of the trust instrument. If it does not, Prob C §21132 will control. See §8.8. The settlor also may wish to specify what is to happen if the specifically gifted stock is sold by the trustee before the settlor's death. See §8.9 for discussion of ademption issues.

Because closely held stock is often subject to buy-out agreements (*e.g.,* a stock redemption agreement), the 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).

These considerations also apply to specific gifts of partnership interests, limited liability company (LLC) membership interests, and sole proprietorships that will be transferred to the trust or become trust property on the death of the settlor by operation of the pourover will. When the settlor wishes to specifically give his or her interest in a partnership or LLC, the drafter should review the terms of the partnership or operating agreement to determine its impact on the settlor's estate plan. The drafter should also discuss with the settlor what he or she wants done with income attributable to the interest and debts associated with it.

When the settlor's spouse or domestic partner has an interest in a professional partnership or corporation that can be transferred only to a licensed member of the profession, an outright gift of the settlor's interest in the partnership or corporation should be made to the spouse or domestic partner to prevent many potential postdeath administration problems. See §19.17.

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 settlor 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 trustee to deliver possession of the business to the beneficiary as soon as possible if the trustee is an individual who is unable or unwilling to operate the business during estate administration. See form 8.41G-1.

For suggested clauses for making specific gifts of stock, see forms 8.41B-1, 8.41C-1. For suggested clauses for making specific gifts of partnership interests, see forms 8.41D-1, 8.41E-1. For a suggested clause for making specific gifts of LLC membership interests, see form 8.41F-1. For a suggested clause for making a specific gift of a sole proprietorship, see form 8.41G-1.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41B 2. Form: Specific Gift of Publicly Traded Stock

§8.41B 2. Form: Specific Gift of Publicly Traded Stock

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8.41B-1 Specific gift of publicly traded stock

***Specific Gift of Property*. The trustee shall distribute _ _[*number of shares*]_ _ of _ _[*type of stock*]_ _ stock of _ _[*name of corporation*]_ _ to _ _[*name of beneficiary*]_ _. If, between the date of execution of this document and the date of death of the Settlor, an adjustment is made in the capital structure of that corporation, 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 death of the Settlor, the number of shares of stock given in this paragraph. If the total number of shares of the class of stock given in this paragraph (adjusted for changes in capital structure) exceeds the number of shares included in the trust property at the death of the Settlor, this gift of stock shall be reduced so that the total number of shares of stock given will be the number of shares included in the trust property at the date of death of the Settlor. If _ _[*he/she*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

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 §8.41A.

When the settlor'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 settlor 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 §8.45C.

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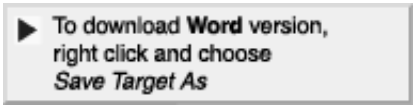
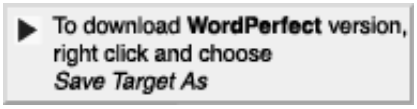
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41C 3. Form: Specific Gift of Closely Held Stock

§8.41C 3. Form: Specific Gift of Closely Held Stock





8.41C-1 Specific gift of closely held stock

***Specific Gift of Property*. The trustee shall distribute to _ _[*name of beneficiary*]_ _ all capital stock in _ _[*name of corporation*]_ _ or its successors included in the trust property on the date of death of the Settlor, _ _[*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, the trustee shall give the net proceeds of the sale of this stock to _ _[*name of beneficiary set forth above*]_ _. If _ _[*he/she*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: See discussion in §8.41A. 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 settlor.

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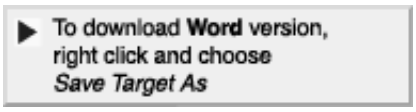
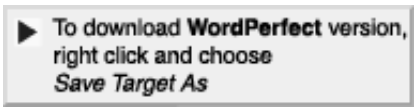
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41D 4. Form: Specific Gift of General Partnership Interest

§8.41D 4. Form: Specific Gift of General Partnership Interest





8.41D-1 Specific gift of general partnership interest

***Specific Gift of Property*. The trustee shall distribute to _ _[*name of beneficiary*]_ _ the entire interest in the partnership doing business under the name of _ _[*name of business*]_ _, or any successor to it, included in the trust property subject to any option given to the surviving partners under the partnership agreement either to purchase the interest or to liquidate the partnership. If the option is exercised, the trustee shall distribute the net proceeds of the sale or liquidation to _ _[*name of beneficiary set forth above*]_ _. If _ _[*he/she*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: See discussion in §8.41A. The drafter should modify this clause to accommodate the partnership 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 settlor.

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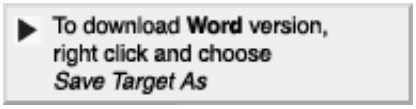
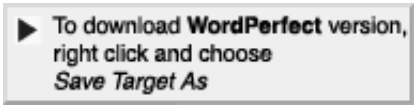
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41E 5. Form: Specific Gift of Limited Partnership Interests

§8.41E 5. Form: Specific Gift of Limited Partnership Interests





8.41E-1 Specific gift of limited partnership interests

***Specific Gift of Property*. The trustee shall distribute all the limited partnership interests in _ _[*name of partnership*]_ _ included in the trust property at the death of the Settlor to _ _[*name of beneficiary*]_ _. If _ _[*name of beneficiary set forth above*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: See discussion in §8.41A. The drafter should not use the second sentence of the clause if the trustee is an interested beneficiary. See also §§8.8-8.9 on ademption.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41F 6. Form: Specific Gift of LLC Membership Interest

§8.41F 6. Form: Specific Gift of LLC Membership Interest

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8.41F-1 Specific gift of LLC membership interest

***Specific Gift of Property*. The trustee shall distribute to _ _[*name of beneficiary*]_ _ the entire membership interest in _ _[*name of limited liability company*]_ _ included in the trust property, subject to any option given to the surviving members under the operating agreement either to purchase the interest or to liquidate the company. If the option is exercised, the trustee shall distribute the net proceeds of the sale or liquidation to _ _[*name of beneficiary set forth above*]_ _. If _ _[*he/she*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: See discussion in §8.41A. The drafter should modify this clause to accommodate the operating 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 settlor.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.41G 7. Form: Specific Gift of Sole Proprietorship

§8.41G 7. Form: Specific Gift of Sole Proprietorship

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8.41G-1 Specific gift of sole proprietorship

***Specific Gift of Property*. The trustee shall distribute to _ _[*name of beneficiary*]_ _ the business known as _ _[*name of business*]_ _, which the Settlor has conducted as a sole proprietor at _ _[*address*]_ _, together with _ _[*accounts receivable, cash on hand, and*]_ _ all the tangible personal property used in connection with the business. This gift is 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 the death of the Settlor, except liabilities for federal and state income taxes. The trustee shall 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. If _ _[*he/she*]_ _ fails to survive the Settlor, this gift shall lapse and be distributed as part of the residue of the trust property.**

[*If applicable, add the following option*]

[*Option: Trustee may require security deposit*]

The trustee has discretion to require _ _[*name of beneficiary*]_ _ to deposit security as a condition of delivery of the business, in form and amount that the trustee considers necessary to protect the trustee from incurring liability for debts, claims, and other liabilities incurred in operation of the business.

Comment: See discussion in §8.41A. 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 settlor's intent clear.

The clause calls for treating income taxes differently from other liabilities arising from the operations of the business. If the settlor does not desire to treat taxes differently, the word "except" can be changed to "including."

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.42 D. Form: Gift of Residence to Survivor or Other Individual

§8.42 D. Form: Gift of Residence to Survivor or Other Individual

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8.42-1 Gift of residence

Gift of Residence. **The trustee shall distribute my primary personal residence at _ _[*address*]_ _, or the replacement of that residence included in the trust at my death, to _ _[*name*]_ _. This gift shall be made free of any encumbrances other than real property taxes and assessments that will not be delinquent if still unpaid six months after my death. If the trust property does not include such a residence, the trustee shall instead distribute to _ _[*name*]_ _ a sum of money equal to $_ _[*dollar amount*]_ _ increased by the percentage increase in the median sales prices for single family residences in _ _[*name*]_ _ County between the calendar month of the execution of this trust and the calendar month immediately preceding the calendar month of my death. All estate and inheritances taxes on this gift shall be paid from the residue of my estate and, if necessary, by abating other gifts. This gift has priority over all other distributions to be made on my death and shall not abate until all other gifts have abated. If _ _[*name*]_ _ fails to survive me by 30 days, this gift shall lapse and the residence shall be distributed as part of the residue.**

Comment: This clause is an example of a clause that addresses issues of property description, replacement, ademption, the risk that the property will not exist, exoneration of encumbrances, disposition of the property if the distributee fails to survive, tax apportionment, and order of abatement. Different choices can be made with respect to any of these issues.

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§8.43 E. Beneficiary Indebtedness to Settlor

A client often may be owed money by a beneficiary of the trust. The client may have lent the beneficiary money to purchase a home or a business, or for another reason. If the client will not need the money, it is often wise to cancel these obligations before death, taking additional appropriate action to provide comparable wealth distributions to the siblings of the debtor. When the client will not forgive debts inter vivos, it is usually desirable for the drafter to address the disposition of the indebtedness in the trust. The drafter must take care, however, to avoid unintended results inasmuch as the debt situation at death may be quite different from the current situation. It is also important to consider the consequences of a forgiveness of debt on co-debtors as well as on the owners of property encumbered by the security for the debt.

EXAMPLE: Husband and Wife purchase a home using funds borrowed from Husband's Mother. Husband dies. Husband's Mother dies, and her trust provides for distributing the original promissory note to Husband—a gift that lapses because Husband has failed to survive.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.44 1. Form: Forgiveness of Indebtedness

§8.44 1. Form: Forgiveness of Indebtedness

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8.44-1 Forgiveness of indebtedness

Forgiveness of Debt. **The trustee shall take such actions as are necessary to cancel the indebtedness evidenced by that certain promissory note executed by _ _[*name of debtor*]_ _ on or about _ _[*date*]_ _. Any estate or inheritance tax attributable to this gift shall be charged to the residue of the trust property.**

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.45 2. Form: Allocation of Indebtedness

§8.45 2. Form: Allocation of Indebtedness

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8.45-1 Allocation of indebtedness

Allocation of Indebtedness. **If anyone who is entitled to a share of the residue of the trust property is indebted to me or to the trust at my death, the trustee shall, to the extent possible, allocate that indebtedness to the trust property to be distributed in satisfaction of the person's share of the residue.**

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§8.45A F. 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 §8.2.

Because general gifts can distort the settlor's dispositive plan, the trust drafter should counsel sparing use of them. On the one hand, cash gifts that were generous when the trust 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 trust property, dissipating the residue typically left to the settlor's principal beneficiaries. Even when the trust property has not diminished in value, general pecuniary gifts may deplete the available cash, forcing the trustee to sell other assets to pay taxes, claims, and expenses. On abatement problems when general gifts are involved, see §§8.4-8.7.

The beneficiary of a general pecuniary gift is entitled to interest on the gift beginning one year after the settlor's death. See §8.71. The Probate Code does not provide for interest or income on nonpecuniary general gifts.

For a form for general pecuniary gifts, see §8.45B. For a form for general gift of stock, see §8.45C.

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§8.45B 1. Form: General Pecuniary Gifts

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8.45B-1 General pecuniary gifts

Monetary Gifts. **The trustee shall distribute 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 the trust property. If any listed person fails to survive _ _**[*me/the settlor/the surviving settlor*]**_ _ by 30 days, the gift to that person shall lapse and be distributed as part of the residue of the trust property.**

_ _[*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 the trust property. 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: Attempts to determine values of assets distributed under a residuary clause can be troublesome, particularly if the values are changing. This clause expressly states a fixed dollar amount, making it a general pecuniary gift under Prob C §21117. See definition in §8.2. 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/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.45C 2. Form: General Gift of Stock

§8.45C 2. Form: General Gift of Stock

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8.45C-1 General gift of stock

***General Gift of Property*. The trustee shall distribute _ _[*number*]_ _ shares of _ _[*type of stock*]_ _ in _ _[*name of corporation*]_ _ to _ _[*name of beneficiary*]_ _. If the trust property does not include sufficient shares of this stock at the death of the Settlor, the trustee shall purchase additional shares to satisfy this gift. If _ _[*he/she*]_ _ fails to survive the Settlor by 30 days, this gift shall lapse and be distributed as part of the residue of the trust property.**

Comment: This clause clearly states the settlor's intent that the trustee purchase shares on the open market for the beneficiary if the trust does not have sufficient stock to cover the gift at the settlor's death, making it a general gift under Prob C §21117. See definition in §8.2. See forms 8.41B-1, 8.41C-1 for clauses relating to specific gifts of stock. Because of the uncertainties concerning future stock values, these types of gifts are not recommended.

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§8.46 G. Residuary Gifts

In most situations, the provisions for the disposition of the residue will dispose of the bulk of the trust. These provisions should be drafted in a manner that avoids any possibility of a failure to dispose of all remaining trust property. If a gift may lapse, it is imperative to provide what will happen to the lapsed gift.

Not all dispositions on a terminating event will terminate the trust. See, *e.g.,* the provisions for retaining property in further trust for a minor in §8.30, and the provisions for allocating property among a survivor's trust, a QTIP trust, and a bypass trust in chap 10.

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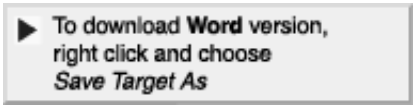
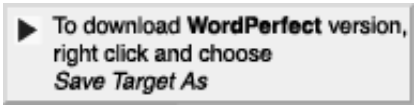
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.47 1. Form: Introduction to Disposition of Residue

§8.47 1. Form: Introduction to Disposition of Residue





8.47-1 Introduction to disposition of residue

Residue. **The residue of the trust property, including any lapsed gifts not otherwise disposed of, shall be distributed as follows:** _ _[*Specify residuary dispositions.*]_ _

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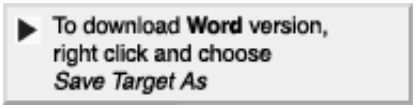
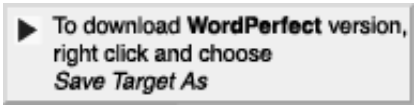
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.48 2. Form: Disposition of Residue to Specified Individual

§8.48 2. Form: Disposition of Residue to Specified Individual





8.48-1 Disposition of residue to specified individual

Residue. **The residue of the trust property, including any lapsed gifts not otherwise disposed of, shall be distributed to _ _[*name*]_ _ if _ _[*he/she*]_ _ survives the settlor. If _ _[*he/she*]_ _ fails to survive, this gift shall lapse and instead be distributed to _ _[*name*]_ _ if _ _[*he/she*]_ _ survives the settlor. If _ _[*name*]_ _ also fails to survive, this gift shall lapse and instead be distributed to _ _[*specify*]_ _.**

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/ H. Class Gifts/§8.49 1. Class Gift Drafting Considerations

H. Class Gifts

§8.49 1. Class Gift Drafting Considerations

Although "class gifts" are not used exclusively for dispositions of residues, they are commonly used for that purpose. Consider the following example of a residuary gift:

The residue of the trust property, including any lapsed gifts not otherwise disposed of, shall be distributed to my issue who survive me per stirpes.

Historically, class gifts have generated a considerable amount of litigation concerning the identity of the takers. Most controversies are easily avoided by making sure that the trust document is clear with respect to the identity of potential class members (see §8.49A), when class members are determined (see §8.49B), alternate takers for deceased class members (see §8.49C), and whether class members take equal shares (see §8.49D).

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§8.49A a. Identifying Potential Class Members

The members of a class are usually defined by a term of relationship, such as "children," "grandchildren," "issue," "next of kin," or "nieces and nephews." However, classes can be defined in other ways, *e.g.*, "the members of a class consisting of *X*, *Y*, and *Z* who survive me." That description might be used if *X*, *Y*, and *Z* are children of the settlor and the settlor intends to exclude other children from the gift.

Problems arise when class descriptions are ambiguous. Does "issue" include adopted persons? Does it matter whether they were adopted as children or as adults? State statutes often govern the result of such problems if the settlor's intentions cannot be ascertained. On class member identification issues, see §§8.50-8.56.

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§8.49B b. When Class Members Determined

For an *outright* distribution made on a settlor's death, the answer is usually clear absent unusual language in the trust document: Because of the survival requirement in Prob C §21109, the class members are established on the date of death unless another date is specified, *e.g.*, as in a disposition "to my grandchildren who survive me by sixty days." (Even this provision is slightly ambiguous, however, because of the possibility of a grandchild being conceived during the 60-day period.)

Ambiguity about the date of determining class membership occurs more often in future interests. For example, suppose that a clause provides "Income to Son for life, remainder to his issue." Who takes the remainder? The son's issue living at the death of the settlor or those living at the son's death? This problem can be avoided by simply specifying "remainder to his issue *then living*." On the time for ascertaining class membership, see §8.57.

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§8.49C c. Alternate Takers for Class Members

Consider a disposition to "my nieces and nephews who survive me." Read literally, the surviving issue of a deceased class member would not take in the place of the deceased class member (who literally is not even a member of the class anymore), but a prudent drafter will more directly confirm this result in the trust document: "Issue of a deceased niece or nephew are not entitled to a share." This language initially assures the drafter that the settlor understands the disposition and has the opportunity to reconsider it. Later, such language helps to assure beneficiaries that the settlor understood what she was signing. It also ensures that the question of whether issue can take a share is not determined by an antilapse statute that the settlor has probably never read. See Prob C §21110, discussed in §8.19.

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§8.49D d. Equal Shares for Class Members

Generally, there is a presumption that class members take equally in the absence of a contrary indication. Terms such as "per stirpes" and "by representation" provide contrary indications. State statutes provide construction rules for provisions that simply provide for disposition "to my issue [or heirs or next of kin]." On statutory distribution patterns and proportions to be taken by class members, see §§8.58-8.61.

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2. Class Member Identification Issues

§8.50 a. Class Gift Versus Gift to Named Individuals

A disposition may become ambiguous if it both describes a class and names its members. For example, if the disposition states: "in equal shares to my grandchildren, Mary, Joe, and Mike, who survive me," who are the takers if Mary, Joe, and Mike are the only grandchildren when the trust is executed, but additional grandchildren are born before the settlor's death? A similar issue arises if the disposition states: "in equal shares to my three grandchildren." (These particular dispositions also raise lapse issues if a grandchild fails to survive but leaves surviving issue. See §§6.18-6.20.)

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b. Gifts to Children and Issue

§8.51 (1) Statutory Definitions of "Children" and "Issue"

Settlors frequently wish to make gifts to "children" or "issue." Because the ambiguity of these terms often leads to litigation, they may need clarification. The statutes discussed in this section can be applied to construe these terms. They do not apply, however, if the trust clearly indicates the settlor's intentions. Prob C §21102.

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 trust, 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 or relationship in accordance with the rules for determining relationship and inheritance rights for purposes of intestate succession.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.52 (a) Children Born Out of Wedlock, Foster Children, Stepchildren

§8.52 (a) Children Born Out of Wedlock, Foster Children, Stepchildren

The rules for determining relationship and inheritance rights for purposes of intestate succession are in Prob C §§6406, 6450-6455. These rules state that a gift to "children" usually includes children born out of wedlock. Prob C §6450(a). 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.

The same rules generally apply to inheritance rights of parents for purposes of intestate succession. In *Estate of Shellenbarger* (2008) 169 CA4th 894, 86 CR3d 862, the court held that decedent's natural father was entitled to take one-half of decedent's estate by intestate succession under Prob C §6402 even though he never saw decedent during decedent's lifetime and allegedly did not pay child support to decedent's mother whom he abandoned during pregnancy.

For these purposes, a "stepparent" may include a registered domestic partner of a child's natural parent. See Fam C §297.5. 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. In *Estate of Ford* (2004) 32 C4th 160, 8 CR3d 541, the court held that an adult foster child was not entitled to a share of the decedent's estate, because there was no legal barrier to adoption after the age of majority. The court also rejected a claim of equitable adoption. See §8.53.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.53 (b) Adopted Children

§8.53 (b) Adopted Children

Adopted children are generally included in class gifts to "children." Prob C §6450(b). Litigation about "children" or "issue" has frequently concerned adoptees. In particular, such litigation has usually concerned whether a transferor intended to include in class gifts:

- Adoptees who were adopted as adults. See *Abramovic v Brunken* (1971) 16 CA3d 719, 94 CR 303; *Williams v Ward* (1971) 15 CA3d 381, 93 CR 107 (transferor did not intend to include adult adoptees). See also *Ehrenclou v MacDonald* (2004) 117 CA4th 364, 12 CR3d 411 (persons adopted as adults in Colorado by beneficiary of California trust were not beneficiary's issue under Colorado law). 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 transferor'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.

California law preserves the judicial doctrine of equitable adoption. Prob C §6455. In *Estate of Ford* (2004) 32 C4th 160, 8 CR3d 541, however, the court held that there must be a direct expression of intent by the decedent to adopt the child or the decedent must actually hold the child out as adopted. In addition, the claimant must show that the decedent acted consistently with that intent by forming a close and enduring familial relationship. The court further held that these facts must be established by clear and convincing evidence.

Adoptees 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 domestic partner of either of the natural parents or after the death of either of the natural parents.

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§8.54 (c) Grandchildren

Occasionally, it may be unclear whether a class gift to "children" includes grandchildren. Unless the trust 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 (court acknowledged rule but found that will at issue, when read as whole and in light of extrinsic evidence, led to conclusion that deceased had intended "children" to include grandchildren).

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.55 (2) Alternative Definitions of Children and Issue

§8.55 (2) Alternative Definitions of Children and Issue

Sometimes a drafter will choose to provide definitions of "children" and "issue" that differ from the statutory definitions. Doing so should usually be done on a custom basis. For example, if the client wishes to exclude a particular branch of descendants, the trust might state:

For purposes of this document, the term "my children" refers only to W, X, Y, and any persons hereafter born to or adopted by me. I have intentionally omitted Z from this definition. The term "issue" refers to my children as so defined and their issue.

Some drafters attempt to develop boilerplate clauses that provide definitions of children and issue that are different from those in Prob C §21115 and the intestate succession rules. Unfortunately, these clauses tend to reveal more about the biases of the drafter than the dispositive wishes of the settlor.

WARNING: In view of the difficulty of educating a client about the wide variety of situations in which the definitions have been litigated and the reasons for the statutory choices, the drafter should be careful in using boilerplate clauses. In particular, he or she should avoid narrow definitions in the context of provisions for distributions of future interests many years in the future. In addition, the drafter should define classes very broadly in provisions identifying the permissible appointees under a power of appointment. Most thoughtful clients will agree that Granddaughter, currently age 2, will be in a better position than the settlor to decide 40 years from now whether it is appropriate for her to appoint a trust remainder to any of her issue who were born out of wedlock.

For a clause defining terms of relationship in a manner substantially identical to Prob C §21115 except for slightly more stringent provisions on acknowledging children born out of wedlock, see §18.5.

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§8.56 c. Gifts to Heirs

Unless the trust states otherwise, a gift made to "heirs," "relatives," "family," "next of kin," or similarly described persons is considered to be made to those who would take under the laws of intestate succession. Prob C §21114(a). See Prob C §§6400-6455. If the designated person's surviving spouse or registered domestic partner is living but in a marriage or domestic partnership with another person when the transfer takes effect, the survivor is not an heir of the designated person. Prob C §21114(a); Fam C §297.5(c). In *Estate of Lahey* (1999) 76 CA4th 1056, 91 CR2d 30, the court held that a spouse who obtained a judgment of legal separation was not a surviving spouse for intestate succession purposes. 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" is 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 an action for dissolution that was dismissed for lack of prosecution). These takers are determined on the date the gift to them will take effect under California's statutes of intestate succession of property not acquired from a predeceased spouse in effect at that time. Prob C §21115(d).

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§8.57 3. Time for Ascertaining Class Membership

The time for ascertaining the membership of a class is determined by the intent of the transferor as expressed in the instrument. Prob C §21102(a). A disposition may be ambiguous if it provides, for example, that income is to be paid to *A* for life and distributed to *A*'s issue on *A*'s death. California law no longer creates a presumption that future interests vest on the transferor's death. Most often, the settlor intends that the remainder will pass to the issue living when the remainder takes effect in enjoyment at *A*'s death, but some trusts intentionally provide for immediate determination of the takers of the remainder in order to make it easier for the beneficiaries to modify the trust by unanimous agreement. The trust should expressly clarify the settlor's wishes. Example: "On my wife's death the remaining trust property shall be distributed to my *then living* issue."

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§8.58 4. 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, common-law rule is that the transferor's intent establishes the manner of distribution. *Lombardi v Blois* (1964) 230 CA2d 191, 40 CR 899. If the transferor'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 common-law rule when the class involved consists of issue or descendants. When the trust does not specify the manner in which issue or descendants are to take, the distribution pattern described in Prob C §240 (distribution by representation; see §8.59) will be used. Prob C §245.

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a. Statutory Patterns for Distributions to Issue or Descendants

§8.59 (1) Descriptions of Statutory Patterns

California law provides three statutory distribution patterns that may apply to a disposition to the issue or descendants of the settlor. They are as follows:

(1) The first pattern (the intestate succession pattern) applies when the trust document does not indicate a different intention, when the pattern is expressly incorporated by reference, or in the event of intestate succession. See Prob C §§240, 245.

(2) The second pattern (the per stirpes pattern) applies when an instrument calls for a distribution "per stirpes," "by representation," "by right of representation," or "in the manner provided in Probate Code §246." Prob C §246(a).

(3) The third pattern (the per capita at each generation pattern) applies when an instrument calls for distribution "per capita at each generation" or "in the manner provided in Prob C §247." Prob C §247(a).

The statutory wording of the distribution patterns is set forth in §8.60. The differences in the statutes are primarily the result of two factors. First, only Prob C §246 (the per stirpes pattern) makes a division into shares at the first generation of issue even if that generation has no living members. Second, only Prob C §247 (the per capita at each generation pattern) recombines the shares of the members of a generation that are deceased but leave issue with living members. See, *e.g.,* Example 4 in §8.61, in which the shares of X and Y were combined and then distributed to the issue of both even though Z is alive.

NOTE: Sometimes practitioners encounter wills and trusts that amusingly and inconsistently provide for a disposition "in equal shares per stirpes" or "in equal shares by representation."

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.60 (2) Wording of Statutory Patterns

§8.60 (2) Wording of Statutory Patterns

Under Prob C §240 (the intestate succession pattern), which may be incorporated by reference in a trust (see 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.

Under Prob C §246 (the per stirpes pattern), applicable if incorporated by reference in a trust or if the trust provides for distribution "per stirpes," "by representation," or "by right of representation," 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.

Under Prob C §247 (the per capita at each generation pattern), applicable if incorporated by reference in a trust or if the trust provides for distribution "per capita at each generation," the property in a "per capita at each generation" disposition scheme 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 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.

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§8.61 (3) Examples of Differences Among Patterns

The most relevant distinctions among the patterns set forth in §§8.59-8.60 are best explained by example.

EXAMPLE 1: Suppose that Settlor's trust provides for distributions to Spouse for life with remainder to Settlor's then living issue. Settlor has two children, *X* and *Y*. *X* has one child, Tom. *Y* has four children, Dick, Harry, Mary, and Susie. Under all three statutory patterns, *X* and *Y* will take equally if both are living at Spouse's death.

EXAMPLE 2: Similarly, under all three statutory patterns, if one of the children dies before Spouse, the surviving child will take one half, and the deceased child's issue will share the other half.

EXAMPLE 3: The statutory patterns produce different results only if both *X* and *Y* fail to survive Spouse. In that event, Prob C §245 (the per stirpes pattern) will leave half of the trust property to Tom (only child of *X*) and the other half equally to Dick, Harry, Mary, and Susie. In contrast, both Prob C §240 (the intestate succession pattern) and Prob C §247 (the per capita at each generation pattern) would give all five grandchildren equal shares.

NOTE: Advocates of Prob C §240 (the intestate succession pattern) and Prob C §247 (the per capita at each generation pattern) point out that it is highly unlikely that the settlor will love Tom four times as much as the settlor loves Dick, Harry, Mary, and Susie. Such advocates also contend that in an era of birth control and children who delay producing grandchildren or fail to produce them altogether, few clients are concerned that deviation from a classic per stirpes pattern will somehow encourage excessive and irresponsible propagation.

EXAMPLE 4: The distinction between Prob C §240 (the intestate succession pattern) and Prob C §247 (the per capita at each generation pattern) becomes relevant if Settlor has a third child, *Z*, and *Z* survives Spouse. Under §247 (the per capita at each generation pattern), the two-thirds of the trust property not passing to *Z* will still be distributed to the five grandchildren equally if *X* and *Y* survived, whereas under §240 (the intestate succession pattern), the distribution will be the same as under Prob C §246 (the per stirpes pattern).

EXAMPLE 5: The distinction between Prob C §240 (the intestate succession pattern) and Prob C §247 (the per capita at each generation pattern) also becomes relevant if Dick is deceased leaving one child and Harry is deceased leaving two children. Under §247 (the per capita at each generation pattern), the two-fifths of the trust property not passing to Tom, Mary, and Susie will be distributed to the three great-grandchildren equally, whereas under §240 (the intestate succession pattern), the distribution will be the same as under Prob C §246 (the per stirpes pattern). The distinction also applies to more remote descendants in multiple generations. See *Estate of Beckel* (2009) 174 CA4th 93, CR3d 890 (property passing by intestate succession divided among decedent's first cousins and first cousins once, twice, and thrice removed).

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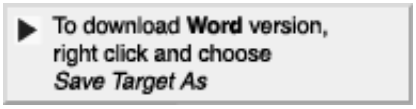
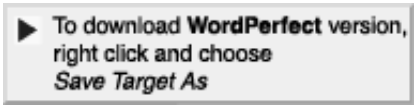
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.62 b. Form: Manner of Making Distribution Per Capita at Each Generation

§8.62 b. Form: Manner of Making Distribution Per Capita at Each Generation





8.62-1 Manner of making distribution per capita at each generation

***Distribution Per Capita at Each Generation*. In making a per capita distribution at each generation, the trustee shall divide the property to be distributed 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.**

Comment: This clause incorporates the language of Prob C §247.

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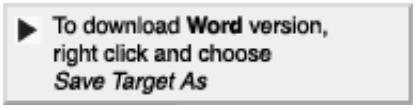
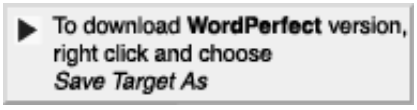
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.63 5. Form: Class Gift to Issue

§8.63 5. Form: Class Gift to Issue





8.63-1 Gift in equal shares to children who survive settlor

Residue. **The residue of the trust property, including any lapsed gifts not otherwise disposed of, shall be distributed to my issue _ _[*who survive me/then living*]_ _, per capita at each generation.**

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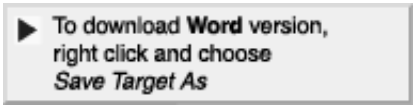
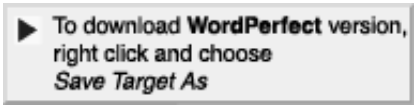
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.64 6. Form: Class Gift to Named Person and His or Her Descendants

§8.64 6. Form: Class Gift to Named Person and His or Her Descendants





8.64-1 Class gift

Residue. **The residue of the trust property, 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 are then living and deceased persons named in that list who leave issue then living. Each living listed person shall receive one share and the then living issue of each deceased listed person shall receive one share by right of representation. The named persons are: _ _[*List*]_ _.**

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§8.65 V. CHARITABLE GIFTS

A revocable trust may provide for a charitable gift on a terminating event such as the death of the settlor or surviving settlor. The trust may provide for an outright gift to charity, or the trust may provide for a split-interest gift to a trust for the benefit of charity and one or more individual beneficiaries. In the case of a split-interest gift to a trust, the charitable gift for estate tax purposes is the present value of the remainder interest (in a charitable remainder trust) or the lead interest (in a charitable lead trust) on the terminating event.

A detailed discussion of charitable gifts that qualify for the federal estate tax deduction (see IRC §2055) is beyond the scope of this book. The rules are complex, and failure to qualify for the deduction can be costly. See California Will Drafting, chaps 13-14 (3d ed Cal CEB 1992). See also California Estate Planning, chaps 23-24 (Cal CEB 2002). On the statutory framework for and forms of inter vivos charitable remainder trusts and charitable lead trusts, see Drafting California Irrevocable Trusts, chaps 18-18A (3d ed Cal CEB 1997). This part of the chapter provides a basic discussion of the charitable deduction and charitable split-interest trusts, with sample forms for basic charitable remainder trusts with one individual beneficiary and sample clauses for charitable lead annuity trusts.

Owing to increases in the applicable exclusion amount (see IRC §2010) and repeal of the estate tax in 2010, the federal estate tax deduction may be irrelevant to many clients. The drafter should keep in mind, however, that the sunset provision in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) will restore former exclusion amounts and rates in 2011 unless Congress takes further action before then.

When it is certain that the estate tax deduction is unimportant, forms for making gifts of specific property or amounts of money to individuals may be adapted for making gifts to charities.

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§8.65A A. Basic Requirements for Charitable Deduction

To qualify for an estate tax charitable deduction, a gift in trust that becomes irrevocable on the death of the settlor must meet the IRC §2055 requirements. Generally, that section restricts the deduction to gifts passing only to certain organizations (see §8.65B) 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 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.

PRACTICE TIP: The drafter should take considerable care to correctly identify the chosen legal entity. Many national charities have separate local affiliates, and many charities have similarly sounding names.

It is traditional to provide that, if a charity is not an organization described in IRC §2055 at the time the distribution will be made, then the trustee is to select an alternative distributee as described in that section. If deductibility is not relevant, however, such a clause is unnecessary and might be undesirable if the client wishes to benefit the named organization in any event.

In some instances, the settlor may give an individual a power of appointment that includes charities within the class of potential appointees. If so, it may be appropriate to include a definition of "charity." See form in §18.15.

If a charity is to receive a remainder interest under a trust created by the donor, all three statutes (IRC §§170(f), 2055(e), 2522(c)) 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 all charitable remainder trusts. See §8.65C. However, different rules apply to charitable lead trusts. See §8.65G.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.65B B. Organizations Qualifying for Charitable Deduction

§8.65B B. 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.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.65C C. Charitable Remainder Annuity Trusts and Unitrusts: Similarities and Differences

§8.65C C. Charitable Remainder Annuity Trusts and Unitrusts: Similarities and Differences

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)(v)) or a unitrust amount (Treas Reg §20.2055-2(e)(2)(vi)) at least annually, for life or a term of years, and must be alive on the date on which the decedent dies.
- 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).

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 fixed percentage is generally preferred because a fixed dollar amount may be less than 5 percent if the trust is larger than expected. If the annuity amount turns out to be less than 5 percent, it may be possible to reform the trust by increasing the annuity amount and providing that the increase portion of the annuity amount is paid to charity. IRC §2055(e)(3); IRS Letter Ruling 200726007. 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 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). The IRS has provided sample forms for both unitrusts and annuity trusts. See §8.65D.

No deduction is permitted when more than a 5-percent probability exists that a 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. 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.

Furthermore, the unitrust amount may be limited to trust income, 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 instrument, but the terms of the annuity trust must expressly prohibit additions. However, the basic forms of unitrust (see §8.65E) and annuity trust (see §8.65F) provided in this chapter both prohibit additional contributions.

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.

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§8.65D D. Sample Clauses for Charitable Remainder Trusts

To qualify as a charitable remainder unitrust, a trust must meet all the requirements of IRC §664 and Treas Reg §1.664-3. To qualify as a charitable remainder annuity trust, a trust must meet the requirements of Treas Reg §1.664-2. 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 in a series of revenue rulings and revenue procedures.

In 2003, the IRS issued Rev Procs 2003-53—2003-60, 2003-2 Cum Bull 230, containing sample forms of annuity trusts. In 2005, the IRS issued Rev Procs 2005-56—2005-59, 2005-34 Int Rev Bull 383, containing sample forms of unitrusts. 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, the revenue rulings and revenue procedures.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.65E E. Form: Charitable Remainder Unitrust

§8.65E E. Form: Charitable Remainder Unitrust

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8.65E-1 Purpose of trust

DIVISION _ _[*NUMBER*]_ _
CHARITABLE REMAINDER UNITRUST

A. *Purpose of Trust*. The property of the Charitable Remainder Unitrust shall be held and administered as provided in this Division. This trust is intended to be a charitable remainder unitrust within the meaning of Revenue Procedure 2005-56 and Internal Revenue Code §664(d)(2).

8.65E-2 Payment of unitrust amount

B. *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 the Settlor's 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 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 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.

8.65E-3 Proration of unitrust amount

C. *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 B.

8.65E-4 Deferral of payment during probate administration

D. *Deferral Provision*. The obligation to pay the unitrust amount described in Paragraph B shall commence with the date of the Settlor'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 (in the case of an underpayment) or receive from the Recipient (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.

8.65E-5 Additional contributions prohibited

E. *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 the Settlor's death.

8.65E-6 Remainder to qualified charity

F. *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(c) 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(c) and 2055(a) as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.

8.65E-7 Prohibited transactions

G. *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).

8.65E-8 Investment restrictions on trustee

H. *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.

8.65E-9 Trustee's powers

I. *Governing Law*. Subject to all limitations stated elsewhere in this trust instrument, 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 the corresponding regulations.

8.65E-10 Distributions in kind authorized

J. *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.

8.65E-11 Limited power of amendment

K. *Limited Power of Amendment*. This trust becomes irrevocable on the death of the Settlor. 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).

8.65E-12 No investment restrictions

L. *Investment Restrictions*. Nothing in this document 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.

Comment: This form of charitable remainder unitrust has one individual beneficiary as provided by the revenue procedure cited in Paragraph A and does not include optional provisions that can give unitrusts additional advantages over annuity trusts, such as provisions permitting additional contributions and provisions limiting the unitrust payment to trust income. The trust is to be funded on the death of the settlor under the distribution provisions in another division of the trust, but may be funded on some other terminating event.

The authors have modified the Internal Revenue Service sample clause in Paragraph B 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.

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 Paragraph C is based on the sample clause offered by the Internal Revenue Service as satisfying this requirement.

Paragraph D is based on sample clauses included in Rev Proc 2005-56, 2005-2 Cum Bull 383. Under Treas Reg §1.664-1(a)(5), the charitable remainder unitrust is considered to have been created on the date of the settlor'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, the IRS has ruled that the trust must provide that the obligation to pay the unitrust amount begins on the date of death. Rev Rul 92-57, 1992-2 Cum Bull 123.

Paragraph E prohibits additional contributions. 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 forms in Rev Procs 2005-56—2005-59, 2005-2 Cum Bull 383, prohibit additional contributions.

The wording of Paragraph F 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.

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. Although Prob C §§16102-16104 seem to make Paragraph G redundant because they impose all the required restrictions on the trustee as provided by Treas Reg §1.508-3(d), 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.

Although not required, Paragraph H 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 Treas Reg §1.664-1(a)(3).

Paragraph I is similar to the sample language in the declaration of trust in Rev Proc 2005-56, 2005-2 Cum Bull 383. The trustee's powers are enumerated in Prob C §§16200-16249.

Paragraph J is based on the sample clause offered in Rev Rul 72-395, §7.05, 1972-2 Cum Bull 340. 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.

Paragraph K 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."

Paragraph L recognizes that 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).

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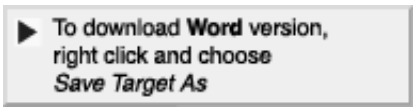
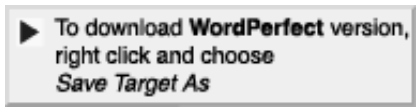
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.65F F. Form: Charitable Remainder Annuity Trust

§8.65F F. Form: Charitable Remainder Annuity Trust





8.65F-1 Purpose of trust

DIVISION _ _[*NUMBER*]_ _
CHARITABLE REMAINDER ANNUITY TRUST

A. *Purpose of Trust*. The property of the Charitable Remainder Annuity Trust shall be held and administered as provided in this Division. This trust is intended to be a charitable remainder annuity trust within the meaning of Revenue Procedure 2003-57 and Internal Revenue Code §664(d)(1).

8.65F-2 Payment of annuity amount

B. *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 the Settlor's 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.

8.65F-3 Proration of annuity amount

C. *Proration of Annuity Amount*. The trustee shall prorate the annuity amount described in Paragraph B on a daily basis for any short taxable year. 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. The taxable year of the trust shall be the calendar year.

8.65F-4 Deferral of payment during probate administration

D. *Deferral Provision*. The obligation to pay the annuity amount described in Paragraph B shall commence with the date of the Settlor's 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 underpayment) or receive from the Recipient (in the case of an overpayment) 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.

8.65F-5 Additional contributions prohibited

E. *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 the Settlor's death.

8.65F-6 Remainder to qualified charity

F. *Distribution to Charity*. At the death of the Recipient, 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(c) 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(c) and 2055(a) as the trustee shall select, and in the proportions as the trustee shall decide, in the trustee's sole discretion.

8.65F-7 Prohibited transactions

G. *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).

8.65F-8 Investment restrictions on trustee

H. *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.

8.65F-9 Trustee's powers

I. *Governing Law*. Subject to all limitations stated elsewhere in this trust instrument, 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 the corresponding regulations.

8.65F-10 Distributions in kind authorized

J. *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.

8.65F-11 Limited power of amendment

K. *Limited Power of Amendment*. This trust becomes irrevocable on the death of the Settlor. 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).

8.65F-12 No investment restrictions

L. *Investment Restrictions*. Nothing in this document 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.

Comment: This form of charitable remainder annuity trust has one individual beneficiary as provided by the revenue procedure cited in Paragraph A and does not include various optional provisions that are seldom used, such as provisions permitting distributions to charity before trust termination. The trust is to be funded on the death of the settlor under the distribution provisions in another division of the trust, but may be funded on some other terminating event.

Paragraph B 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 trust must require that the annuity 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 Paragraph C is based on the sample clause offered by the Internal Revenue Service as satisfying this requirement. The last sentence 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.

Paragraph D is based on sample clauses included in Rev Proc 2003-57, 2003-2 Cum Bull 257. Under Treas Reg §1.664-1(a)(5), the charitable remainder annuity trust is considered to have been created on the date of the settlor's death. Because the charitable deduction is computed as of the date of death, the IRS has ruled that the trust must provide that the obligation to pay the annuity trust amount begins on the date of death. Rev Rul 80-123, 1980-1 Cum Bull 205.

Paragraph E prohibits 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. For testamentary charitable remainder annuity trusts, all property passing to the trust at death is considered to be one contribution. Treas Reg §1.664-2(b).

The wording of Paragraph F is based on the sample clause offered by the IRS as meeting the requirements of Treas Reg §1.664-2(a)(6)(i). See Rev Proc 2003-57, 2003-2 Cum Bull 257.

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. Paragraph G is identical to the sample clause offered by the IRS as meeting the requirements in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274.

Although not required, Paragraph H 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 Treas Reg §1.664-1(a)(3).

Paragraph I is similar to the sample language in the declaration of trust in Rev Proc 2003-57, 2003-2 Cum Bull 257. The trustee's powers are enumerated in Prob C §§16200-16249.

Paragraph J is based on the sample clause offered in Rev Rul 72-395, §5.05, 1972-2 Cum Bull 340. Under Treas Reg §1.664-2(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.

Paragraph K is similar to the sample clause offered by the IRS in Rev Proc 2003-57, 2003-2 Cum Bull 257, and Rev Proc 2003-60, 2003-2 Cum Bull 274.

Paragraph L recognizes that 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).

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§8.65G G. Overview of Charitable Lead Trusts

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 §8.65C.

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. For further discussion of income tax issues, see California Will Drafting §14.82 (3d ed Cal CEB 1992).

This discussion devotes 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 §8.65H. On CLAT planning considerations, see §8.65I. On CLAT drafting requirements, see §8.65J. For sample CLAT form provisions, see §8.65K.

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§8.65H 1. GST Rules for Charitable Lead Trusts

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. 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).

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 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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§8.65I 2. CLAT Planning Considerations

When compared to the alternative of making outright gifts to both charities and family members, 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.

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, 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, 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.

In assessing 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 settlor 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 settlor 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.

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§8.65J 3. CLAT Drafting Requirements

Generally, the requirements for drafting a CLAT are somewhat simpler than for a CRAT. The fundamental requirements are that the charitable interests must be a guaranteed annuity interest (see Treas Reg §1.170A-6(c)(2)(i)) and that all of these payments must be made before payments can be made to noncharitable beneficiaries. 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 §8.65H. 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.

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. 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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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.65K H. Form: Required and Desirable Provisions for CLAT

§8.65K H. Form: Required and Desirable Provisions for CLAT

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

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

8.65K-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 the Settlor's death and terminates _ _[*number of years of the lead term*]_ _ thereafter. The "annual annuity amount" is 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 the Settlor's 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 the Settlor's 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. 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.**

8.65K-2 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.**

8.65K-3 Charitable deduction saving clause

***Purpose of Trust*. The Settlor(s) _ _[*intends/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.**

***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 the Settlor's death.**

Comment: The trust could provide instead for payment of a fixed annuity amount or an annuity amount based on a fixed percentage of trust assets. The trust should then provide for the disposition of the trust estate following conclusion of the charitable term. This may include retention of the assets in trust.

In the rare case that the present value of the lead interest at the inception of the trust will be 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).

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. 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 of testamentary CLAT in Rev Proc 2007-46, 2007-29 Int Rev Bull 102.

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VI. TRUSTEE DISCRETIONARY POWERS CONCERNING "MANDATORY" DISTRIBUTIONS

A. Nonprorata Funding

§8.66 1. Nonprorata Funding of Shares

It is customary to expressly authorize the trustee to distribute property in cash or in kind and either prorata or nonprorata, even though the trustee has this power under Prob C §16246 in the absence of a contrary provision in the trust document. On including an express authorization, see §§11.48-11.50.

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§8.67 2. Nonprorata Division of Community Property

When spouses or registered domestic partners have a joint trust, it is desirable to clarify that the division of community and quasi-community property on the first death can be made nonprorata. See form in §8.68. In the absence of an agreement, each spouse or partner has a one-half interest in each item of community property. *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240; *Estate of Wilson* (1986) 183 CA3d 67, 227 CR 794. Spouses or registered domestic partners may agree in writing to divide their community or quasi-community property on the basis of a nonprorata division, and a transfer of community or quasi-community property to a revocable trust is presumed to represent such an agreement with respect to the transferred property. Prob C §§100(b), 101(b), 104.5; Fam C §297.5. For a form providing for a nonprorata division of community property taking into the account the effect of such an agreement on property passing outside the trust, see §10.8A.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.68 3. Form: Nonprorata Division of Community Property

§8.68 3. Form: Nonprorata Division of Community Property

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8.68-1 Nonprorata division of community property

Nonprorata Division of Community Property. **Community property and quasi-community property may be divided on the basis of a nonprorata division of the aggregate value of the property, or on the basis of a division of each individual item or asset, or partly on each basis.**

Comment: This form adopts the language in Prob C §§100(b), 101(b).

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/ B. Delayed Distributions/§8.69 1. Power to Delay Distributions

B. Delayed Distributions

§8.69 1. Power to Delay Distributions

The literal language of most trust distributions tends to imply that the trustee must make distribution immediately on the death of a settlor or the occurrence of some other distribution event, without making any express provision for the delays that occur while the trustee performs administration tasks similar to those in the administration of a decedent's estate. Some drafters, concerned that beneficiaries will have unrealistic expectations about the speed of distributions, expressly authorize delays. Such a clause should clarify that it does not authorize any actions that might result in loss of the marital deduction or charitable deduction, which might occur if the clause effectively denied a surviving spouse his or her right to all income for life from a QTIP trust. See form in §8.70.

This power to delay distributions should be distinguished from a power that intentionally converts an apparent mandatory distribution right into a discretionary right. For example, a trust for a young person might be drafted in a manner that appears to provide for delivery of the balance of trust property to the beneficiary at a specified age, but then provides that the trustee can deviate from that arrangement by delaying distribution in specified circumstances such as imprisonment, insolvency, or drug addiction.

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Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.70 2. Form: Power to Delay Distributions

§8.70 2. Form: Power to Delay Distributions

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8.70-1 Power to delay distributions

Power to Delay Distributions. **When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it, and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after the trustee receives the income. This provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. Nor does this provision authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.**

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§8.71 3. Interest on Delayed Pecuniary Gift

The beneficiary of a pecuniary gift is entitled to interest on the gift beginning on the first anniversary of the settlor's death. Prob C §§12003, 16340(b). The interest rate is 3 percentage points less than the legal rate on judgments (currently 10 percent) in effect 1 year after the date of the settlor's death. Prob C §12001.

A fiduciary must pay the interest provided by a will, a trust, or by the provisions governing administration of a decedent's estates when the will is silent, from net income (see Prob C §16340(c)), or from principal if net income is insufficient (Prob C §16340(b)), *i.e.,* when the trust provides for interest on a pecuniary amount, the interest is chargeable first to trust income. There is no statute indicating the source of interest on a pecuniary gift when the trust is silent. This problem affects the rights of beneficiaries and may create GST tax problems in connection with regulations that establish when a pecuniary gift is treated as a separate share for GST tax purposes. See Treas Reg §§26.2654-1(a)(1)(ii), (b)(1)(ii)(C)(2), 26.2642-2(b)(4)(i). However, the GST tax problem does not arise if the pecuniary amount is paid within 15 months of the settlor's death. Treas Reg §26.2642-2(b)(4)(ii). See §4.208.

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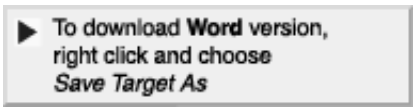
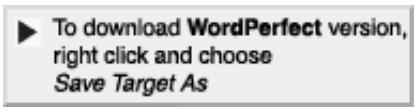
Source: Estate Planning/Drafting California Revocable Trusts/8 Distributions on Terminating Event/§8.72 4. Form: Interest on Delayed Distribution of Pecuniary Amount

§8.72 4. Form: Interest on Delayed Distribution of Pecuniary Amount





8.72-1 Interest on pecuniary amounts

Interest on Pecuniary Amounts. **When a beneficiary is entitled to receive payment of a pecuniary amount or an annuity, the beneficiary shall be entitled to receive interest on delayed distributions to the extent provided by California law. If California law has no provision expressly applicable to trusts, interest shall be paid in accordance with California law applicable to a decedent's estate.**

Comment: California law currently provides for payment of interest on pecuniary gifts at a rate of 10 percent beginning 1 year after the settlor's death. See §8.71.

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9

The Marital Deduction

Marc M. Stern

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V. LIMITATION APPLICABLE TO SOME MARITAL TRANSFER INSTRUMENTS DRAFTED BEFORE 1982 §9.42

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§9.1 I. MARITAL DEDUCTION QUALIFYING TRANSFERS

This chapter describes the requirements common to all marital deduction gifts (see §§9.3-9.22) and then provides an overview of the various forms of transfers that qualify for the marital deduction (see §§9.23-9.41). The most widely used forms of transfers are discussed in detail in the chapters on survivor's trusts (see chap 12) and on qualified terminable interest property (QTIP) trusts and qualified domestic trusts (QDOTs) (see chap 13). The related issue of determining the *value* of the marital deduction transfer is discussed in chap 11.

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§9.2 II. OPERATION AND EFFECT OF MARITAL DEDUCTION

Under IRC §2001(a) (after 2010), the estate tax is imposed on the "taxable estate," which is determined by making certain deductions from the gross estate. IRC §2051. One of the deductions is the IRC §2056 marital deduction. This deduction is allowed for property that passes or has passed from the decedent to the surviving spouse and is part of the decedent's gross estate. IRC §2056(a). The estate tax marital deduction does not apply to same-sex domestic partners treated as spouses under California law, although it may apply to same-sex spouses under case law. See §4.41.

From a tax-policy perspective, the marital deduction is not intended to provide a married couple with a permanent exemption from estate tax but merely to allow them the opportunity to defer tax liability until the death of the surviving spouse. The statutory requirements for qualifying a transfer for the marital deduction are designed to ensure that the transferred property will be treated as owned by the surviving spouse for purposes of future imposition of estate and gift taxes when the property is later transferred by the surviving spouse.

The complexity of the rules intended to ensure this objective vary with the type of transfer. An unconditional outright transfer of property to a surviving spouse is subject to relatively few requirements, whereas transfers to trusts are greatly restricted to ensure that the trust corpus is included in the survivor's estate for tax purposes even though the survivor is not the actual owner of the trust property. Because an outright transfer to a spouse often does not satisfy a client's estate-planning objectives, the benefits and burdens of the alternative methods of qualifying a transfer for the deduction must be evaluated during the estate planning process.

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§9.3 III. REQUIREMENTS FOR MARITAL DEDUCTION GIFT

There are four indispensable requirements necessary for a transfer to qualify for the marital deduction (IRC §2056(a)):

(1) The decedent must be survived by a spouse who is a citizen of the United States (see §§9.4, 9.8; see chap 13 on the use of QDOTs when the surviving spouse is not U.S. citizen);

(2) The interest must pass to the surviving spouse (see §§9.9-9.11);

(3) The interest must be includable in the decedent's gross estate (see §9.13); and

(4) The interest must not constitute a nondeductible terminable interest (see §§9.15-9.21).

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§9.4 A. Marriage of Decedent and Survivor

To qualify for the marital deduction, the decedent and the survivor must have been married. Marital status is generally determined under state law at the decedent's death. See S Rep No. 1013, 80th Cong, 2d Sess (1948). Thus, as long as the marriage was not terminated before the decedent's death, the marital deduction is available even if the parties were legally separated or subject to dissolution proceedings short of a final decree. Rev Rul 57-368, 1957-2 Cum Bull 896. The burden of proving marital status is on the decedent's personal representative. Treas Reg §20.2056(a)-1(b)(1). However, federal law also precludes a determination that the decedent and the survivor were married if they were of the same sex. See §4.41.

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§9.5 B. Survival of Recipient Spouse

To qualify for the marital deduction, one spouse (the recipient of the gift) must survive the other. Treas Reg §20.2056(a)-1(b)(1)(i). The decedent's personal representative has the burden of proving survival. Treas Reg §20.2056(a)-1(b)(1).

Even a brief period of survival is sufficient if it can be proved. If the order of deaths of the decedent and the spouse cannot be proved, under California law, each settlor will be considered to have survived the other. See Prob C §220, discussed in §9.6. However, a presumption in the trust document that the spouse survived will be respected. Treas Reg §20.2056(c)-2(e). For a form of simultaneous death provision, see §9.7.

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§9.6 C. Need for Simultaneous Death Provision

The simultaneous death provision in §9.7 is necessary in a husband-wife revocable trust so that one of them will be the "deceased settlor" and the other will be the "surviving settlor" for purposes of implementing an estate plan requiring the establishment of subtrusts on the death of the deceased spouse. See chap 10. If neither settlor survives the other, each will be considered to have predeceased the other (Prob C §220), and it may be impossible to implement the division into separate trusts on the deceased settlor's death because there will be no "deceased settlor," as defined in such a multitrust estate plan.

Because the settlors' combined estate taxes can often be reduced by paying tax on the first death and receiving an IRC §2013 prior transfer property (PTP) credit on the second death if both settlors die within a short period of each other, it is generally advisable for the settlor with the greater amount of separate property to be considered to have predeceased the other. The PTP credit is not available, however, for the presumed survivor's interest in the presumed predeceased settlor's trust property if both settlors die in a common accident. For a discussion of the PTP credit, see §9.29.

Additionally, in the infrequent situations in which a close order of deaths is intended to have substantive dispositive effects, the settlors may wish to specify who will be treated as the survivor if it cannot be conclusively determined.

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§9.7 D. Form: Simultaneous Death Provision

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9.7-1 Simultaneous death provision

***Simultaneous Death*. If the order of the settlors' deaths cannot be ascertained, _ _**[*name of deemed survivor*]**_ _ shall be deemed to be the Surviving Settlor for purposes of this Division.**

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Source: Estate Planning/Drafting California Revocable Trusts/9 The Marital Deduction/§9.8 E. Surviving Spouse Citizenship

§9.8 E. Surviving Spouse Citizenship

The marital deduction is not allowed unless the transferee spouse is a United States citizen or the property is transferred to a qualified domestic trust (QDOT) as described in IRC §2056A. IRC §2056(d). A spouse is treated as a citizen if he or she becomes a citizen before the estate tax return is filed and is a resident of the United States at all times from the date of death until becoming a citizen. IRC §2056(d)(4).

NOTE: The rules applicable to the creation and effect of QDOTs are significantly different from those for other marital deduction transfers. On creating QDOTs, see chap 13.

In contrast, the decedent does not need to be a citizen. Assuming that the other requirements for the marital deduction are satisfied, the marital deduction is allowed for property in the United States that is owned by a nonresident who is not a citizen if the property is included in the decedent's United States gross estate. IRC §2106(a)(3).

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§9.9 F. Property Must Pass From Decedent to Surviving Spouse

Under IRC §2056(a), the marital deduction is allowed for the

> value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

The property must pass from the decedent to the surviving spouse. Thus, the deduction may not be claimed when property is actually transferred by someone other than the decedent for estate and gift tax purposes, which may occur, *e.g.,* when property passes to the spouse through the decedent's special power to appoint property transferred in trust by the decedent's parent.

Whether property passes to the surviving spouse is a simple question in most situations involving outright transfers to the spouse. If a transfer is in trust, the property is deemed to pass to the spouse if all trust distributions must be made to the spouse or the spouse's estate. See Treas Reg §20.2056(c)-2(b)(1). See also the description of the estate trust in §§9.37-9.39. In other situations, the question of whether property transferred to a trust is treated as passing to the surviving spouse depends on the application of the terminable interest rule (see §§9.15-9.21) and express provisions in IRC §2056(b) under which property is "considered as" or "treated as" property passing to the surviving spouse if other statutory requirements are met. For example, QTIP property must be treated in this manner. See IRC §2056(b)(7). The same issues are raised in situations involving legal life estates. See §9.33.

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§9.10 1. Net Value Rule

For purposes of the marital deduction, the value of an interest in property is the net value, applying the same principles that are used to value a gift. Treas Reg §20.2056(b)-4(a). The value of encumbrances must be deducted. Treas Reg §20.2056(b)-4(b). This rule can arise in situations involving taxes or mortgaged real property. For example, if the interest passing to the surviving spouse must bear part of the estate tax imposed on the decedent's estate, only the net value of the interest qualifies for the marital deduction. IRC §2056(b)(4)(A).

NOTE: If the decedent owned a majority interest in property and only a portion of the decedent's interest passes to the spouse, the value of that interest may be greater or less than a proportionate share of the value of the decedent's interest, depending on whether the interest passing to the spouse represents a majority or minority interest in the property. See *Estate of Dean A. Chenoweth* (1987) 88 TC 1577; *Estate of Frank M. DiSanto*, TC Memo 1999-421.

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§9.11 2. Property Passing to Spouse Under Will Contest

Property that passes to the surviving spouse when a will contest or similar litigation is settled qualifies for the marital deduction if the settlement is "a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate." Treas Reg §20.2056(c)-2(d)(2). If the surviving spouse, however, assigns or surrenders property that would otherwise qualify for the deduction in settlement of a will contest brought by a third party, the interest assigned or surrendered will not qualify for the marital deduction. Treas Reg §20.2056(c)-2(d)(1).

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§9.12 G. Interest Must Be Deductible

To qualify for the marital deduction, the interest passing to the surviving spouse must be "deductible." Any interest is deductible unless it falls into one of the three categories of nondeductible interests. Treas Reg §20.2056(a)-2(b). These are discussed in §§9.13-9.15.

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§9.13 1. Interest Must Be Includable in Decedent's Gross Estate

The first category of nondeductible interest is interests that are not includable in the decedent's gross estate. To be deductible, and therefore qualify for the marital deduction, an interest must be includable in the decedent's gross estate. Treas Reg §20.2056(a)-2(b)(1). The decedent's gross estate is defined as the value, at the decedent's death, of all property, real and personal, tangible and intangible, wherever situated, described in Subtitle B, Chapter 11A, Part III of the Internal Revenue Code. IRC §2031.

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Source: Estate Planning/Drafting California Revocable Trusts/9 The Marital Deduction/§9.14 2. Interest Must Not Be Subject to Double Deduction

§9.14 2. Interest Must Not Be Subject to Double Deduction

The second category of nondeductible interests is interests that are deducted under another section of the Internal Revenue Code. To qualify for the marital deduction, an interest may be deducted only once. IRC §2056(b)(9). Thus, an interest does not qualify for the marital deduction if it is also deducted under IRC §2053 (expenses, indebtedness, and taxes) or IRC §2054 (losses).

EXAMPLE 1: When a bona fide debt is owed by the decedent to the surviving spouse, repayment of which is deducted under IRC §2053 as a claim against the estate, that amount does not qualify for the marital deduction. Treas Reg §20.2056(a)-2(b)(2).

EXAMPLE 2: An amount deducted under IRC §2053 for commissions allowed to the surviving spouse as executor is a nondeductible interest that does not qualify for the marital deduction. Treas Reg §20.2056(a)-2(b)(2).

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§9.15 3. Interest Must Not Be Nondeductible Terminable Interest

The third category of nondeductible interests, and the most troublesome, includes those that fall within the terminable interest rule. Under that rule, if the interest passing to the surviving spouse is a "nondeductible terminable interest" it will not qualify for the marital deduction. IRC §2056(b)(1); Treas Reg §20.2056(b)-1. No deduction is allowed for an interest that will terminate or fail on the lapse of time or the occurrence of an event, and, after termination, passes to a third party. The interest that passes to the surviving spouse therefore must generally be includable in his or her gross estate to the extent that he or she does not consume or dispose of it while alive. This is because the intended effect of the marital deduction is to permit deferral of the estate tax only until the death of the surviving spouse. See §9.2.

Terminable interests include any interest that will terminate or fail either on the mere passing of time or on the occurrence or nonoccurrence of some event. A terminable interest can include life estates, terms of years, annuities, patents, copyrights, and all interests that may terminate if a contingency occurs. Treas Reg §20.2056(b)-1(b). However, a bond, note, or similar instrument, the discharge of which would not have the effect of an annuity or term for years, is not a terminable interest. IRC §2056(b)(1).

Whether an interest is terminable is determined as of the decedent's death. See Treas Reg §20.2056(b)-1(e)(3). There are several statutory exceptions to the terminable interest rule. See §§9.17-9.21.

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§9.16 a. Examples of Nondeductible Terminable Interests

The following are examples of transfers for which no marital deduction is allowed because they are nondeductible terminable interests:

- A transfer of Blackacre in trust for the surviving spouse, but on the death or remarriage of the surviving spouse, remainder to children. See Treas Reg §20.2056(b)-1(g), Example (1).
- A transfer of Blackacre to the surviving spouse for a term of ten years with remainder to a child. See Treas Reg §20.2056(b)-1(c).
- A transfer of Blackacre to spouse as a trustee for the benefit of a third party (assuming that trust cannot benefit spouse). See Treas Reg §20.2056(c)-2.

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b. Exceptions to Terminable Interest Rule

§9.17 (1) No One Other Than Spouse Will Have Interest in Property

By the express terms of the general rule, an interest is a terminable interest only if no person other than the spouse (or the spouse's estate) may possess or enjoy any part of such property after termination or failure of the interest passing to the surviving spouse. IRC §2056(b)(1)(A). Therefore, even though it is otherwise an impermissible "terminable interest," a term of years, for instance, will qualify for the marital deduction if it is unconditionally transferred to the spouse and if the decedent did not own any other interest in the property that passes to someone else. However, note that, if the executor or trustee is directed to acquire terminable interest property for the spouse (*e.g.,* to buy an annuity), the transfer does not qualify for the marital deduction despite the fact that no interest in the purchased property will pass to another person.

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§9.18 (2) Survival Contingencies Not Exceeding Six Months

Internal Revenue Code §2056(b)(3) permits transfers that require the spouse to survive the decedent by a limited period not exceeding six months. The spouse must in fact survive the period. The terms of the trust cannot change the actual order of death if the "surviving spouse" in fact dies first. *Estate of Kwang Lee*, TC Memo 2007-371. Homespun survival provisions with requirements such as survival "until distribution" do not satisfy the requirement. See Prob C §21525 for a savings provision designed to ameliorate the effects of a survivorship requirement of greater than six months.

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§9.19 (3) Life Estate Plus General Power of Appointment

Internal Revenue Code §2056(b)(5) provides a statutory exception to the terminable interest rule for a general power-of-appointment trust and the legal life estate equivalent. See §§9.33-9.36. This statutory exception is permissible because the surviving spouse's general power of appointment will cause inclusion of the trust property in the surviving spouse's estate under IRC §2041. Internal Revenue Code §2056(b)(6) provides a similar exception for annuities paid under life insurance policies.

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Source: Estate Planning/Drafting California Revocable Trusts/9 The Marital Deduction/§9.20 (4) Qualified Terminable Interest Property (QTIP)

§9.20 (4) Qualified Terminable Interest Property (QTIP)

Internal Revenue Code §2056(b)(7) provides a statutory exception to the terminable interest rule for a QTIP trust and the legal life estate equivalent. The surviving spouse must be given a life income interest, and the deceased spouse's executor must make an election causing inclusion of the trust corpus in the survivor's estate under IRC §2044. For an overview of QTIP trusts, see §§9.26-9.32. For a detailed discussion and forms for QTIP provisions, see chap 13.

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Source: Estate Planning/Drafting California Revocable Trusts/9 The Marital Deduction/§9.21 (5) Charitable Remainder Trusts

§9.21 (5) Charitable Remainder Trusts

Internal Revenue Code §2056(b)(8) allows a marital deduction for the value of the spouse's interest in a qualified charitable remainder trust. See §§9.40-9.41B.

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§9.22 4. Reduction for Nonqualifying Assets

If a pool of assets available to satisfy a marital deduction gift includes particular assets that do not qualify for the marital deduction, the value of that gift is reduced by the aggregate value of the nonqualifying assets. IRC §2056(b)(2). The marital deduction is reduced if a particular asset could be used to satisfy the marital gift, regardless of whether the asset is actually so distributed, unless the decedent's will provides that the survivor's bequest cannot be satisfied with a nondeductible interest. Treas Reg §20.2056(b)-2(d). For a form provision designed to obviate any unidentified asset issues, see §13.21 (marital deduction savings clause).

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§9.23 IV. ADVANTAGES AND DISADVANTAGES OF DIFFERENT MARITAL DEDUCTION QUALIFYING TRANSFERS

Under IRC §2056, a variety of different types of transfers may qualify for the marital deduction, including transfers outright, transfers of certain life estates, and transfers to several types of trusts. The standard marital deduction estate plan requires using one or more of these types of transfers. Each type has its own advantages and disadvantages in terms of tax planning, convenience, expense, and various other client needs.

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§9.24 A. Outright Transfers to Surviving Spouse

An outright transfer is a transfer that meets the following requirements (see IRC §2056(b)(1); Treas Reg §20.2056(a)-2(b)(4)):

- The transfer is made directly to the spouse rather than in trust;
- The property interest transferred is not an annuity, a life estate, a term of years, or an interest otherwise limited in duration; and
- The transfer is unconditional.

Outright transfers are convenient and often emotionally satisfying for the surviving spouse. The survivor has full power to use and dispose of the property in any manner. Outright transfers do not, however, protect the deceased spouse's testamentary intent with regard to disposition of the estate on the death of the surviving spouse. The significance of the decedent's lack of control over ultimate disposition depends on the settlors' circumstances, *e.g.,* whether their family life is harmonious, whether both intend to leave trust assets after the death of the second spouse to their children, or whether either spouse has children from a former marriage.

Other disadvantages of outright transfers include the following:

- They do not eliminate the need for a conservatorship for an incompetent surviving spouse;
- They may require a formal probate administration of the survivor's estate;
- They provide no protection from the surviving spouse's creditors; and
- They may shift assets from the deceased spouse to the surviving spouse, creating adverse estate tax consequences.

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§9.25 B. Transfers to Qualifying Survivor's Trusts

A typical estate plan for a married couple often includes a survivor's trust for the surviving spouse, the purpose of which is to avoid probate of his or her property. The trust is typically funded with the surviving spouse's separate property, half share of the community property, and half share of any quasi-community property. The trust may also receive some of the deceased spouse's property. A standard survivor's trust generally contains provisions substantially similar to those in a trust prepared for an unmarried person, *i.e.*, the survivor retains unlimited power to revoke or amend the trust and is entitled to withdraw whatever he or she wishes.

Although not all survivor's trusts qualify for the marital deduction, if the trust will receive some of the deceased spouse's property, it is crucial that the trust qualify for the deduction. The trust will not qualify for the marital deduction if the surviving spouse's right of withdrawal ceases during his or her lifetime or if there is a gift to a third party. For example, the trust may not qualify for the marital deduction if it provides that the spouse cannot make withdrawals if he or she becomes incompetent. See §12.2.

The survivor's trust may also be used to implement nonprorata distribution of community property in an estate plan requiring the establishment of subtrusts—*e.g.,* a survivor's trust, marital trust, and bypass trust—on the death of the first spouse. See §§8.66-8.68. For example, it may be desirable to allocate both community property halves of the settlors' personal residence to the survivor's trust, with a balancing transfer of both community property halves of other assets, *e.g.,* a securities account to the bypass trust or marital trust.

Two additional advantages of a survivor's trust over an outright transfer are that the transfer to the survivor's trust (1) eliminates the need to appoint a conservator for the surviving spouse in the event of his or her incapacity and (2) minimizes the risk of having to conduct a formal probate administration of the survivor's estate.

For a detailed discussion of the survivor's trust, see chap 12.

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C. Transfers to Qualified Terminable Interest Property (QTIP) Trusts

§9.26 1. Characteristics of QTIP Trust

Assuming a trust is not an "estate trust" that will distribute all remaining assets to the surviving spouse's probate estate (see §9.37), the trust will not qualify for an estate tax or gift tax marital deduction unless the spouse is entitled to all "income" for the spouse's lifetime. Trusts that have this characteristic are QTIP trusts, and general power of appointment trusts (see §9.34). In a QTIP trust, all the trust income is paid to the surviving spouse at least annually for his or her lifetime and, during the surviving spouse's lifetime, no distributions may be made to anyone else. The deceased spouse's executor must make a timely QTIP election. IRC §2056(b)(7)(B)(i)(III). In some cases a unitrust interest may satisfy the income requirement. See §13.5.

If the QTIP election is made, the trust property will be treated as belonging to the surviving spouse for estate and gift tax purposes even if the surviving spouse is not the true owner. If the survivor does not attempt to make an inter vivos transfer of the right to trust income, the trust property will be included in the survivor's estate under IRC §2044. However, the trust property will not be aggregated with other property owned by the survivor as a single consolidated interest in determining whether the survivor's estate is entitled to fractional share or minority interest discounts. *Estate of Harriet R. Mellinger* (1999) 112 TC 26, acq 1999-35 Int Rev Bull 314.

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§9.27 2. Use of QTIP Trust

The QTIP trust is widely used in estate planning because it is the only form of marital deduction transfer that gives the first spouse to die control over the disposition of the trust property after the death of the surviving spouse. In addition, the balance remaining in a QTIP trust on the death of the surviving spouse is not subject to probate administration or to the claims of the surviving spouse's creditors. For a discussion of QTIP trusts, see chap 13.

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a. Advantages of QTIP Trust

§9.28 (1) Postmortem Tax Planning

The QTIP trust offers unique postmortem tax planning opportunities because the availability of the marital deduction and resulting inclusion of the QTIP in the surviving spouse's taxable estate depend on the decedent's executor making a QTIP election. In some situations, particularly those involving a terminally ill surviving spouse, substantial tax advantages may be gained by not making the election or making a partial election. See §§9.29-9.30.

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§9.29 (2) Prior Transfer Property (PTP) Credit

Not making a QTIP election may generate an IRC §2013 prior transfer property (PTP) credit. For PTP credit purposes, the survivor is deemed to receive a transfer of the income interest. Because PTP rules do not provide for tracing the transferred property, it is irrelevant that the survivor's early death results in the survivor's receiving little if any income from the trust. Getting the PTP credit may produce a sizeable tax savings.

EXAMPLE: A married couple owns $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 x $4,000,000).

This strategy is of limited use if the surviving spouse was 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. See Treas Reg §20.7520-3(b)(3)(iii); *Estate of Judith I. Harrison* (2000) 115 TC 161.

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§9.30 (3) Fractional Share Election

The QTIP election may be made for only a fractional share of the QTIP trust. See chap 13. The fractional share election (or no election at all) is particularly desirable if the surviving spouse has a short life expectancy and the surviving spouse's estate will be allowed an IRC §2013 previously taxed property credit for a portion of the estate taxes paid by the deceased spouse's estate. See §9.29. A fractional share election may also be useful if the bypass trust provides the surviving spouse with a qualifying income interest and estate taxes can be reduced to zero in both estates if a portion of the QTIP trust is not included in the deceased settlor's estate. For a discussion of such a "QTIP-able bypass trust," see chap 14.

The IRS has ruled that the gross amount passing to the survivor in a partial election is (1) the full value of the property for which the QTIP election is made, plus (2) the value of the life income interest for the portion of the trust for which the QTIP election is not made, reduced by the marital deduction allowed for the QTIP election property, with the net result that the portion of the deceased spouse's estate deemed to pass to the survivor and eligible for the PTP credit is the value of the income interest in the non-QTIP election portion. IRS Legal Memorandum 200218003.

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§9.31 (4) Reverse QTIP Election

A QTIP trust benefit results from IRC §2652(a)(3), which allows a "reverse QTIP" election. This section, relevant only for purposes of the generation-skipping transfer (GST) tax, permits the deceased spouse's executor to elect that a QTIP trust will continue to be treated as property transferred by the deceased spouse for GST tax purposes even though the trust property is otherwise treated as belonging to the surviving spouse for estate and gift tax purposes. For a detailed discussion of reverse QTIP elections, see chap 4.

No comparable elections are available for other types of marital deduction transfers.

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§9.32 b. Disadvantages of QTIP Trust

The primary disadvantages of a QTIP trust are a direct result of its primary advantage. See §9.27. Because the surviving spouse is often given little if any ability to control disposition of the remainder interest, use of a QTIP trust may cause conflict between the spouse and the remainder beneficiaries over investment strategy, tax strategy, adequacy of accountings, and related trust administration problems. Much depends on such factors as the relationship between the settlors and the designated remainder beneficiaries and whether the surviving spouse will have substantial other assets.

QTIP trusts may also discourage the surviving spouse from making inter vivos gifts to the next generation even when the gifts could be made without imposition of gift tax because of the IRC §2503(b) annual gift tax exclusion. Although the marital deduction requirements for QTIP trusts do not prohibit giving the spouse powers to withdraw principal, the typical QTIP trust does not grant liberal withdrawal powers that might be exercised to defeat the objective of ensuring that the remainder interest passes according to the wishes of the deceased spouse. Thus, use of a QTIP trust may deprive the surviving spouse of funds needed to make tax-advantageous gifts. This consideration may be inconsequential, however, if the surviving spouse has access to other assets.

Some of the possible disadvantages of a QTIP trust may be mitigated by using the trust in combination with other forms of marital deduction transfers. For example, a plan could provide for transferring some of the deceased spouse's assets to the survivor's trust with only the remaining assets being included in the QTIP trust. This strategy may be used to provide the spouse with additional liquidity or the ability to control assets likely to cause disputes between the spouse and the remainder beneficiaries, *e.g.,* valuable jewelry, family heirlooms, yachts, racehorses.

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§9.33 D. Legal Life Estate QTIP Trusts

If state law entitles a life tenant to receive all income produced by property, a QTIP election may be made with respect to a legal life estate because it will satisfy the IRC §2056(b)(7)(B)(ii) qualifying-income-interest-for-life requirement. Thus, the marital deduction is allowed for a transfer of property to the surviving spouse for life, with the remainder going to the decedent's designees.

PRACTICE TIP: As a practical matter, such dispositions are rarely included in revocable trust estate plans. Legal life estates are difficult to manage if a sale is required or if a spouse becomes incompetent. Further, separate arrangements must be made to provide a source of funds for paying property taxes, related expenses, and the estate tax imposed on the property at the surviving spouse's death by IRC §2044. The QTIP trust is far better suited to addressing these problems. Because use of a revocable trust estate plan evidences a client's willingness to use trusts, it is difficult to imagine a situation in which a legal life estate disposition would be appropriate.

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E. General Power-of-Appointment Trusts

§9.34 1. Characteristics of GPA Trust

Internal Revenue Code §2056(b)(5) expressly allows a marital deduction for a transfer that gives the surviving spouse the right to all income from the property for life plus the right to appoint the property to the surviving spouse or the surviving spouse's estate (whether or not the power may also be exercised in favor of others). The required power of appointment may be either a testamentary or an inter vivos power, but it must be exercisable by the surviving spouse alone and in all events. Accordingly, a general power-of-appointment (GPA) trust gives the surviving spouse the power to control ultimate distribution of the trust property. Unlike QTIP trust property (see §§9.26-9.32), GPA trust property is aggregated with the surviving spouse's property for valuation purposes. *Estate of Aldo H. Fontana* (2002) 118 TC 318.

If the surviving spouse is given a testamentary power to appoint to his or her estate, the power must be exercisable effective on the surviving spouse's death for the trust to qualify for the federal estate tax marital deduction. See Rev Rul 76-446, 1976-2 Cum Bull 295; *Gardner v U.S.* (CD Cal 1980) 80-1 USTC ¶13,355, 46 AFTR2d 6139 (exercise of testamentary general power of appointment did not immediately terminate trust; trust held not to qualify for federal estate tax marital deduction).

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§9.35 2. Use of GPA Trust

General power-of-appointment trusts were commonly used before the 1981 enactment of IRC §2056(b)(7) (which allows the marital deduction for QTIP trusts)—particularly when the transferor did not want the surviving spouse to have the power to manage the trust assets. The trust was also useful if the transferor wanted to minimize the survivor's ability to dispose of the trust property during life. These objectives are now better served by use of the QTIP trust, which gives the transferor the ability to retain control over the disposition of the property after survivor's death.

In a technical sense, a survivor's trust may be viewed as a form of general power-of-appointment trust. Referring to the survivor's trust as a GPA trust is likely to cause confusion, however, because the surviving spouse's rights with respect to a GPA trust are commonly more limited than they are with respect to a survivor's trust.

The typical GPA trust authorizes the trustee to make distributions of principal to the surviving spouse for health, support, maintenance, or education. The spouse may also be given powers of invasion. Because the spouse is intentionally given a general power of appointment, there is typically no significant tax reason for placing limits on these invasion and withdrawal powers. Such powers may affect whether capital gain is taxed to the trust under IRC §641 or to the spouse under IRC §678, but in most situations the bulk of such gains will be taxed at the maximum capital gains rate, currently 15 percent. See IRC §1(h).

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§9.36 3. Form: General Power-of-Appointment Trust

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9.36-1 General power-of-appointment trust

General Power of Appointment Trust. **During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor all the trust income in convenient installments at least annually. Despite any other provision of this trust, the Surviving Settlor shall have the power to require that the trustee make unproductive property productive or convert it to productive property within a reasonable time. In addition to the net income, the trustee may pay or apply for the benefit of the Surviving Settlor as much of the principal as the trustee considers necessary for the Surviving Settlor's health, support, maintenance, and education in accordance with the Surviving Settlor's standard of living on the death of the Deceased Settlor. After the death of the Surviving Settlor, the trustee shall distribute any remaining balance of the trust, including principal and accrued or undistributed income, to one or more persons and entities, including the Surviving Settlor's own estate, and on any terms and conditions (either outright or in trust) and in any proportion that the Surviving Settlor shall appoint by will or codicil specifically referring to and exercising this power of appointment.**

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F. Estate Trusts

§9.37 1. Characteristics of Estate Trust

An estate trust may be described as a trust that can never make any distributions other than to the surviving spouse or the surviving spouse's estate. The estate trust qualifies for the marital deduction because the surviving spouse does not receive a "terminable interest" owing to the fact that no other person has any interest in the trust. IRC §2056(b)(1); Rev Rul 72-333, 1972-2 Cum Bull 530. The most significant feature of an estate trust is that it does not require the trustee to make distributions to the surviving spouse during the spouse's lifetime.

The following are examples of estate trusts (Treas Reg §20.2056(c)-2(b)(1)):

- Trust income is payable to the surviving settlor for life and on his or her death, the corpus is distributable to his or her executors or administrators;
- The surviving settlor is entitled to the trust income for a term of years, after which the corpus will be paid to the surviving settlor or his or her estate;
- The trust income is to be accumulated for a term of years or for the surviving settlor's life and the augmented fund paid to the surviving settlor or his or her estate.

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§9.38 2. Use of Estate Trust

The estate trust is rarely used in contemporary estate planning, primarily because of a series of amendments in the IRC §1(e) income tax rates applicable to trusts, which have eliminated the tax advantages of accumulating income in trusts. Indeed, the rates often have the effect of penalizing the accumulation of trust income. See chap 1.

Another disadvantage of the estate trust is that the trust must ultimately be distributed to the survivor's estate. The term "estate" must be taken literally. It is not sufficient to provide for ultimate distribution to the survivor's trust. Nor is it sufficient to give the survivor a general power of appointment. Rev Rul 75-128, 1975-1 Cum Bull 308. Accordingly, use of an estate trust usually requires a formal probate administration on the surviving spouse's death.

Nevertheless, the estate trust may occasionally solve an estate planning problem, particularly if the trust is funded with assets that do not produce taxable income (*e.g.,* municipal bonds, stock of corporations not paying dividends) and if the ultimate disposition of the property is known because the surviving spouse is not competent to execute or modify a will.

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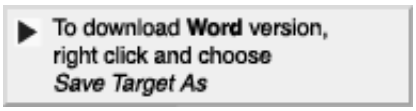
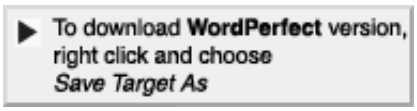
Source: Estate Planning/Drafting California Revocable Trusts/9 The Marital Deduction/§9.39 3. Form: Estate Trust

§9.39 3. Form: Estate Trust





9.39-1 Estate trust

Estate Trust. **During the Surviving Settlor's lifetime, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the trust income and principal as the trustee considers necessary for the income beneficiary's health, maintenance, support, and education in convenient installments at least annually. Such distributions shall be charged first to income. Any undistributed income shall be added to principal. On the Surviving Settlor's death, the entire remaining trust property shall be distributed to the Surviving Settlor's estate.**

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G. Qualified Charitable Remainder Trusts

§9.40 1. Characteristics of Charitable Remainder Trust

Internal Revenue Code §2056(b)(8) allows a marital deduction for the value of the spouse's lead annuity or unitrust interest in a qualified charitable remainder annuity trust or unitrust. These trusts are described in IRC §664. A remainder interest passing to a qualified charity is ordinarily deductible under IRC §2055(e)(2)(A) only if the trust is one of these trusts. (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 trust contest. See *Burdick v Commissioner* (9th Cir 1992) 979 F2d 1369.) This rule is strictly construed. 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. 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. 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 §9.41A. For a form of qualified charitable remainder trust, see §9.41B. The tax result of using such a trust is that a marital deduction is allowed for the value of the surviving spouse's lead interest, and the charitable deduction is allowed for the value of the charity's remainder interest. Thus, the value of the entire trust is deductible.

As a practical matter, the same result can be achieved by using a qualified terminable interest property (QTIP) trust that distributes its remaining assets to charity on the surviving spouse's death. The QTIP trust provides a marital deduction for the full value of the trust. When the surviving spouse dies, the entire value of the trust is included in the spouse's estate under IRC §2044, but the survivor's estate will be able to claim an IRC §2055 charitable deduction for the full amount. The QTIP election must be made for the full value of the 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 §13.23. In IRS Letter Ruling 200540003, the estate lost both the marital deduction and the charitable deduction for the value of the remainder interest that passed to the charity when the executor claimed the marital deduction only for the actuarial value of the spouse's interest in each asset passing to the trust.

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§9.41 2. Factors in Deciding Whether to Use QTIP or Charitable Remainder Trust

In deciding whether a qualified charitable remainder trust or a QTIP trust is desirable, the attorney should consider the following factors:

- A QTIP trust, unlike a qualified charitable remainder trust, may contain a provision permitting invasion of principal for the benefit of the surviving spouse.
- A QTIP trust must pay capital gains tax whereas a qualified charitable remainder trust is exempt from tax. Thus, no capital gains tax is paid except to the extent that gains must be distributed to the spouse if the trust's income is insufficient to make the annuity or unitrust payment. IRC §664(b). This consideration is mitigated by the fact that the trust assets will usually have received a new basis under IRC §1014 or §1022 as a result of the death of the deceased spouse.
- A qualified charitable remainder trust is less likely to produce conflict between the surviving spouse and the charity with respect to investment decisions. This is particularly true for a charitable remainder annuity trust that pays the spouse a fixed amount.
- The choice between a QTIP and a qualified charitable remainder trust may affect whether the survivor's estate will qualify for special benefits available for estates owning substantial business interests under IRC §§303 (redemption of stock to pay estate taxes), 2032A (special use valuation), and 6166 (installment payment of estate tax). See chap 4. The availability of benefits under these statutes depends on the percentage of the estate that is composed of specified business property interests. The choice between a QTIP trust and a qualified charitable remainder trust may affect those percentages because a QTIP trust is treated as part of the surviving spouse's estate but qualified charitable remainder trust property is not.

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§9.41A 3. Requirements of Charitable Remainder Trust

To qualify a charitable remainder annuity trust or unitrust for an estate tax charitable deduction under IRC §2055 and a marital deduction under IRC §2056, the trust must meet all requirements of Treas Reg §§1.664-2 or §1.664-3 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 the surviving spouse. Treas Reg §§1.664-2(a)(1)(i), 1.664-3(a)(1)(i). That amount, called the annuity or unitrust 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, or a fixed percentage of the net fair market value of trust assets determined annually. Treas Reg §§1.664-2(a)(1)(ii)-(iii), §1.664-3(a)(1)(ii)-(iii). See discussion in §8.65C.

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§9.41B 4. Form: Qualified Charitable Remainder Trust

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9.41B-1 Qualified charitable remainder trust

DIVISION _ _[*Number*]_ _
CHARITABLE REMAINDER TRUST

A. *Purpose of Trust*. The property of the Charitable Remainder Trust shall be held and administered as provided in this Division. This trust is intended to be a charitable remainder _ _[*annuity trust/unitrust*]_ _ within the meaning of Revenue Procedure _ _[*2003-57/2005-56*]_ _ and Internal Revenue Code §664 _ _[*(d)(1)/(d)(2)*]_ _. The _ _[*annuity/unitrust*]_ _ interest is intended to qualify for the federal estate tax marital deduction under Internal Revenue Code §2056(b)(8) and the remainder interest is intended to qualify for the federal estate tax charitable deduction under Internal Revenue Code §2055(e)(2)(A).

Comment: This form is the opening paragraph of a form intended to satisfy the requirements for a qualified charitable remainder trust, as discussed in §§9.41-9.41A. Paragraphs B through L of the form may be found in §8.65E (unitrust) or §8.65F (annuity trust). When using those forms, "Surviving Settlor" should be substituted for "Recipient" and "Deceased Settlor" for "Settlor" throughout the form.

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§9.42 V. LIMITATION APPLICABLE TO SOME MARITAL TRANSFER INSTRUMENTS DRAFTED BEFORE 1982

Before 1982, the allowable marital deduction could not exceed the greater of $250,000 or half of the taxable estate with certain adjustments for community property. This limitation continues to apply in any case in which a will executed before September 12, 1981, provides for a marital gift in the amount of the maximum amount of property qualifying for the marital deduction under federal law, unless the will is later amended to "refer specifically to an unlimited marital deduction." Pub L 97-34, §403(e)(3), 95 Stat 172.

The transition rule does not expressly apply to revocable trusts. Nevertheless, marital deduction formula clauses in trusts executed before September 12, 1981, should be amended to clarify that the clause refers to the unlimited marital deduction. Amendments to other provisions of the trust will probably not be sufficient to avoid the rule.

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10

Distributions on First Spouse's Death

CEB Staff

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I. DISTRIBUTION OF TRUST ON DEATH OF FIRST SPOUSE

A. Third Party Dispositions

§10.1 1. Making Gifts to Third Parties

When clients with spouses or registered domestic partners dispose of their property by will, there is a disposition of property on the death of each of them as provided in their respective wills. The will of the first to die (the "decedent") usually provides for gifts to third parties and gifts to the surviving spouse. In the case of married clients, however, if the couple has significant property, and therefore estate tax concerns, much of the residue of the decedent's estate may be divided between a "bypass trust" and a marital-deduction-qualifying distribution to, or trust for the benefit of, the survivor. For an explanation of marital deduction planning, see chap 11.

WARNING: For decedents dying in 2010, a typical reduce-to-zero marital deduction formula estate plan could result in the deceased settlor's entire share of trust property passing to the bypass trust. The drafter should consider trust amendments or new trust language that would be effective only in 2010 if the consequences of conventional planning document provisions would be undesirable. See chap 14.

A typical joint revocable trust estate plan preserves these same dispositive rights for each spouse or partner and provides for the disposition of the property of each on death. Often, the dispositive rights of the first to die are preserved only by means of a unilateral right to revoke the trust. If revocation is the only method of unilaterally changing the disposition of property, the estate of the first to die may need to be probated. For a strategy for preserving unilateral disposition rights without the need for revocation, see §10.2.

The dispositions made at each death under a joint revocable trust will essentially be the same as if property was being transferred by will, except that transfers to the survivor are generally made in the form of a transfer to a "survivor's trust" rather than outright to the survivor. This is done to avoid probate of the transferred property on the survivor's death, while giving the survivor the substantive equivalent of outright ownership by means of an unrestricted right of withdrawal. For a discussion of survivor's trusts, see chap 12.

NOTE: Some trust forms do not identify a separate "survivor's trust" or expressly provide for transfers to that trust. Instead, they attempt to simulate that result by providing, in the form, that the property that would otherwise be allocated to the survivor's trust will be "retained" in further trust, with the survivor having rights that are the same as under a survivor's trust. This drafting style tends to obscure the actual legal transfers and changes in rights that are taking place and is not recommended.

The provisions for disposing of trust property on the first death should begin by distributing the survivor's own property to the survivor's trust. This can be done on a nonprorata basis. See chap 8. The remaining property will accordingly be the decedent's share of the property, which can then be disposed of as desired. Some or all of this property may also be allocated to the survivor's trust. Under the forms in this book, property transferred to the survivor's trust need not be retitled to reflect that transfer. See §10.5.

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Source: Estate Planning/Drafting California Revocable Trusts/10 Distributions on First Spouse's Death/§10.2 2. Deceased Settlor's Power of Appointment

§10.2 2. Deceased Settlor's Power of Appointment

It may be desirable to grant each settlor the power to appoint the disposition of his or her property if he or she is the first to die. A typical survivor's trust that is revocable by the survivor already grants this privilege with respect to the survivor and his or her property in the survivor's trust. See chap 12. The benefit of such a power arises when a competent settlor is concerned that he or she may want to make changes to the trust during lifetime and might predecease an incompetent settlor. Normally the trust instrument will not permit unilateral amendment with respect to community property assets of the trust, with the result that the competent settlor must revoke the trust and execute a new will in order to change the disposition of the competent settlor's share of community property. This in turn typically results in the need to probate both settlors' estates at death.

WARNING: If the trust instrument gives the deceased settlor a general power of appointment, it is important that the planner carefully advise each settlor that each of them may be able to appoint that settlor's share of the trust estate without the other's knowledge. This is also true when spouses or domestic partners make dispositions by will, but their testamentary power is limited by statutory protections allowing for court-awarded family allowances and probate homesteads. See Prob C §§6500-6615; Fam C §297.5(c). Such protections are not available for living trusts.

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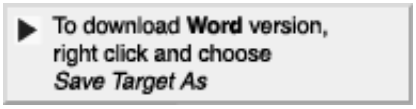
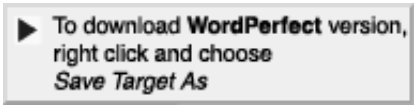
§10.3 3. Form: Distribution of Decedent's Property as Appointed by Deceased Settlor





10.3-1 Decedent's property; power of appointment

***Decedent's Property; Power of Appointment*. The trustee shall distribute the remaining property as the Deceased Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Deceased Settlor's estate.**

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§10.4 B. Administration of Entire Trust as Survivor's Trust

If the estate is too small to warrant a bypass trust to shelter the deceased settlor's exemption equivalent amount, there may be no need for multiple trusts. Both settlors can simply distribute their respective interests in trust property to the survivor's trust. Note that although this practice is not inefficient from a transfer tax perspective, the deceased settlor loses control over the disposition of his or her assets following the survivor's death.

This practice may become a model for many settlors if proposals for portability of the deceased settlor's exemption equivalent amount become law. These proposals would allow the trustee to elect to apply the deceased settlor's exemption credit in addition to the survivor's exemption credit on the second death. The deceased settlor's interest in trust property would be sheltered from estate tax by the unlimited marital deduction on the first death. If portability is adopted, there will be no need for a bypass trust on the first death whenever the trust property is unlikely to exceed the combined exemption credits of both settlors on the second death, allowing for possible appreciation or depletion of trust property in the meantime.

The trust can provide that, if the survivor's trust is the only trust established on the death of the deceased settlor, a transfer to that trust need not be evidenced by a transfer in title.

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§10.5 C. Form: Distribution of Both Settlors' Trust Property to Survivor's Trust

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10.5-1 Distribution to survivor's trust

On the death of whichever of us is the first to die (the "Deceased Settlor") the property of the survivor of us (the "Surviving Settlor") shall be distributed to the trustee of the Survivor's Trust described in the next Division and the property of the Deceased Settlor shall be allocated and distributed in accordance with the wishes of the Deceased Settlor, as follows:

A. *Survivor's Property*. The trustee shall distribute to the trustee of the Survivor's Trust the Surviving Settlor's separate property, half interest in community property, and any share of the separate property of the Deceased Settlor that the Surviving Settlor would be entitled to receive under the laws of the Deceased Settlor's domicile at death, including, if applicable, any share of quasi-community property or other forced share.

B. *Decedent's Property; Power of Appointment*. The trustee shall distribute the remaining property as the Deceased Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Deceased Settlor's estate.

C. *Decedent's Property That Is Not Effectively Appointed*. The trustee shall distribute any of the Deceased Settlor's property that was not effectively appointed by the Deceased Settlor under the preceding paragraph to the trustee of the Survivor's Trust.

D. *Survivor's Trust as Only Trust.* If the Survivor's Trust is the only trust established on the death of the Deceased Settlor, a transfer to that trust need not be evidenced by a change of title.

Comment: Gifts are often made to third parties on the first death. These gifts may be distributed under paragraph C, with the residue passing to the survivor's trust. Frequently, these gifts vary, depending on which settlor dies first, necessitating alternative disposition provisions.

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II. DIVISION OF TRUST

§10.6 A. Division Into Three Trusts

When estate tax planning is a factor for married clients, on the first spouse's death, that spouse's separate property, interest in quasi-community property, and interest in the community property remaining after specific gifts and the exercise of any power of appointment are often divided between a "bypass trust" and a marital deduction trust. The marital deduction trust will usually be either a "QTIP trust" or a "survivor's trust." The community property share and any separate property belonging to the surviving spouse usually remain in a separate revocable trust, designated in this book as the "survivor's trust." This book avoids the common practice of referring to the survivor's trust, bypass trust, and QTIP trust as Trust A, Trust B, Trust C, or the like. Occasionally, trust documents that use such nondescriptive terms may inadvertently reverse the gifts to the QTIP trust and the bypass trust. See IRS Letter Ruling 200043036. See App A for a form of a three-trust marital estate plan.

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§10.7 B. Division Into Two Trusts

If the settlors do not wish to preserve all the assets of the first to die for ultimate distribution to beneficiaries other than the survivor, the trust can be divided into only two trusts. Under this plan, the applicable credit amount in the estate of the first to die is placed in the bypass trust. The remaining property (the marital deduction amount, if any, as well as the survivor's community property interest) passes into the survivor's trust. See the description for App A for the actions needed to divide the trust into two trusts.

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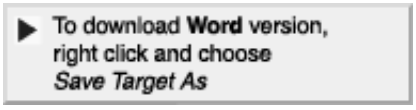
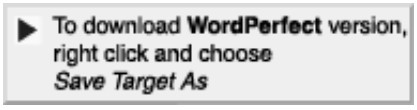
Source: Estate Planning/Drafting California Revocable Trusts/10 Distributions on First Spouse's Death/§10.8 C. Form: Division of Trusts

§10.8 C. Form: Division of Trusts





10.8-1 Division of trusts

On the death of whichever of us is the first to die (the "Deceased Settlor"), the property of the survivor of us (the "Surviving Settlor") shall be distributed to the trustee of the Survivor's Trust described in the next Division and the property of the Deceased Settlor shall be allocated and distributed in accordance with the wishes of the Deceased Settlor, as follows:

A. *Surviving Settlor's Property.* The trustee shall distribute to the trustee of the Survivor's Trust the Surviving Settlor's separate property, one-half interest in community property, and any share of the separate property of the Deceased Settlor that the Surviving Settlor would be entitled to receive under the laws of the Deceased Settlor's domicile at death, including, if applicable, any share of quasi-community property or other forced share.

B. *Decedent's Property; Power of Appointment*. The trustee shall distribute the remaining property (the "Deceased Settlor's property") as the Deceased Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee including the Deceased Settlor's estate.

C. *Decedent's Property That Is Not Effectively Appointed*. The trustee shall distribute any of the Deceased Settlor's property that was not effectively appointed by the Deceased Settlor under the preceding paragraph as follows:

1. *To the Trustee of the Survivor's Trust*: _ _[*Specify, e.g., all furniture, furnishings, clothing, personal effects, private papers, jewelry, motor vehicles, tools, and recreation equipment.*]_ _

2. *To the Trustee of the* _ _[*QTIP/Survivor's*]_ _ ***Trust*:** _ _[*Specify, e.g., a fractional share of the residue of the Deceased Settlor's property that is the smallest fractional share of the Deceased Settlor's property 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 the Deceased Settlor's death, as further explained in the Division of this document titled "Additional Distribution Provisions."*]_ _

3. *To the Trustee of the Bypass Trust*: _ _[*Specify, e.g., the other fractional share of the residue of the Deceased Settlor's property.*]_ _

Comment: This clause may be modified to designate only two trusts: the survivor's trust (including the marital deduction amount, if any, and the survivor's community and separate property interests) and the bypass trust.

Often gifts are made to third parties on the first death. These gifts may be inserted before the gift to the survivor's trust in subparagraph 1 of paragraph C, with the residue passing to subtrusts, as specified. Frequently these gifts vary, depending on which settlor dies first, necessitating alternative disposition provisions.

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§10.8A D. Form: Additional Language for Nonprorata Division of Community Property

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10.8A-1 Nonprorata division of community property

The trustee shall take into account any written agreement between the Settlors providing for a nonprorata division of their community property _ _[*and quasi-community property*]_ _ **and the effect of such agreement on community property** _ _[*and quasi-community property*]_ _ **passing outside the trust.**

Comment: This clause may be added to paragraph A of form 10.8-1 in cases in which the settlors have agreed that the surviving settlor will become the owner of certain nontrust community property with the consequence that less than half of the trust community property will be allocated to the survivor's trust. See discussion in §10.8B.

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Source: Estate Planning/Drafting California Revocable Trusts/10 Distributions on First Spouse's Death/§10.8B E. Purpose of Additional Language for Nonprorata Division of Community Property

§10.8B E. Purpose of Additional Language for Nonprorata Division of Community Property

Some practitioners have recommended the use of additional language similar to the form provided in §10.8A in connection with an "aggregate theory" community property agreement designed to preserve the ability of the spouse to roll over retirement plan benefits when trust property is insufficient to allow the trustee to both fully fund the bypass trust and allocate half of the trust community property to the survivor's trust. The contemplated agreement would provide that the nonemployee spouse named as the designated beneficiary of a retirement plan will become the sole owner of retirement plan benefits as part of the survivor's share of community property if the employee spouse dies first and the decedent's share of community property will include other assets equal in value to the retirement benefits. Agreements providing for nonprorata division of community property and quasi-community property are specifically authorized by Prob C §§100(b), 101(b). See §8.67. For a detailed sample form of agreement, see Trytten, *Aggregate Theory Agreements: Don't Get "Bogg'ed" Down*, 5 Cal Trusts & Est Q 4 (Fall 1999), available on the members-only page of the Trusts and Estates Section of the California State Bar on the state bar website at http://www.calbar.ca.gov.

NOTE: In the editor's view, such an agreement may not be needed to make a nonprorata division of community property taking into account property passing outside the trust. Arguably, the deceased spouse's community property interest in nontrust property is an intangible asset of the estate that passes to the trust under the pourover will. In effect, the trustee allocates the decedent's interest in nontrust property to the survivor's share of the trust. This allows the trustee to allocate other assets of equivalent value to the decedent's share of the trust. As stated in Prob C §§100(b), 101(b): "Nothing in this subdivision shall be construed to require this written agreement in order to permit or recognize a non pro rata division of community property."

Readers are cautioned that the IRS has not ruled on the question of whether a nonprorata division of community property that includes both trust and nontrust property will result in a taxable sale or exchange of the deceased spouse's interest in the nontrust property for the survivor's interest in trust property notwithstanding the agreement. Generally, the IRS has not treated distributions from a revocable trust as involving a sale or exchange unless the fiduciary did not have the power to make a nonprorata distribution. Most trust instruments give the trustee the power to fund on a nonprorata basis without the agreement of the beneficiaries, as provided by the forms in this book, and Prob C §16246 already authorizes this if the instrument is silent. However, the IRS might rule differently if property passing outside the trust causes a greater portion of the community property inside the trust to be allocated to the deceased spouse's share. Furthermore, it is not altogether clear that a sale or exchange problem would be eliminated just because there is an advance agreement to permit the sale or exchange following death.

EXAMPLE 1: Married Settlors have $1 million of community property in a joint revocable trust (including a $500,000 residence and $500,000 in financial assets) and $1 million of community property in an IRA. The nonemployee spouse is the designated beneficiary of the IRA. On the death of the employee spouse, the trustee allocates the decedent's interest in the IRA to the survivor's trust, taking into account the survivor's community property interest in the financial assets and the residence ($250,000 + $250,000 = $500,000), and the trustee allocates the residence and the financial assets to the bypass trust, taking into account the decedent's community property interest in the financial assets, the residence, and the IRA ($250,000 + $250,000 + $500,000 = $1,000,000).

Readers are strongly cautioned that such agreements are advisable only with respect to nonqualified plan benefits such as individual retirement accounts (IRAs) and non-matching 403(b) or 457 plans. Under the decision in *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754, the deceased spouse's community property interest in a defined contribution plan such as a 401(k) plan is preempted by the Employee Retirement Income Security Act (ERISA) (29 USC §§1001-1461). Accordingly, an unequal allocation of trust community property intended to accomplish an even division of community property that includes nontrust qualified plan benefits would require a valid waiver and consent by the nonemployee spouse to receive less than the entire plan benefit to which the spouse is entitled under federal law. Such a waiver appears to represent a taxable gift by the surviving spouse to the remainder beneficiaries of the bypass

trust that is not sheltered by the marital deduction and is not reduced by the value of the spouse's retained interest in the trust.

EXAMPLE 2: Married Settlors have $1 million of community property in a joint revocable trust (including a $500,000 residence and $500,000 in financial assets) and $1 million in a qualified retirement plan. The nonparticipant spouse is the designated beneficiary of the retirement plan. On the death of the participant spouse, the trustee allocates the residence to the survivor's trust, taking into account the survivor's community property interest in the financial assets and the residence ($250,000 + $250,000 = $500,000), and the trustee allocates the financial assets to the bypass trust, taking into account the decedent's community property interest in the financial assets and the residence ($250,000 + $250,000 = $500,000). The result is different from Example 1 because the decedent's interest in the qualified plan is preempted by ERISA.

When there is insufficient trust property to fully fund the bypass trust by equal division of community property in these circumstances, cautious practitioners might advise the settlors to name the revocable trust as the designated beneficiary of an IRA or other nonqualified plan and provide for allocation of plan benefits to the survivor's trust with the likely consequence that plan benefits must be paid out over the lifetime of the nonemployee spouse. This will allow the trustee to allocate other assets of equal value to the bypass trust, and there is still some chance that the IRS might allow the surviving spouse to roll over the plan benefits as trustee of the survivor's trust. See California Estate Planning, chap 21 (Cal CEB 2002).

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§10.9 F. Deferral of Division or Distribution of Assets

As discussed in chap 4, the personal representative sometimes may elect to value all assets at their fair market value on the date of death or on an alternate valuation date. The alternate valuation date is the date 6 months after the decedent's date of death or, if an asset was disposed of within that period, the date on which the asset was disposed of. See IRC §2032. A trustee's allocation of a decedent's assets to subtrusts may constitute a disposition for purposes of §2032, but a distribution of a surviving spouse's share of the community property to a survivor's trust would not constitute a disposition. See Rev Rul 78-431, 1978-2 Cum Bull 230. To avoid a disposition in connection with the deceased settlor's property, the trust might give the trustee discretion to defer distribution until at least 6 months after the settlor's death. See §4.114.

There may be other reasons for deferring distribution beyond 6 months, *e.g.,* to ensure payment of estate and income taxes or to determine when contingent liabilities and guaranties will become payable.

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Source: Estate Planning/Drafting California Revocable Trusts/10 Distributions on First Spouse's Death/§10.10 G. Form: Deferral of Division or Distribution of Trust Assets

§10.10 G. Form: Deferral of Division or Distribution of Trust Assets

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10.10-1 Power to delay distribution until resolution of claims or liability

***Power to Delay Distributions*. When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after income is received by the trustee. This Provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. This provision does not authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.**

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III. SURVIVORSHIP OF SPOUSE

§10.11 A. Surviving Settlor's Failure to Meet Survivorship Conditions

If the surviving settlor fails to satisfy a specified survivorship condition, *e.g.*, surviving the deceased settlor by at least 30 days, the trust will need to specify the manner of distribution of the deceased settlor's property.

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Source: Estate Planning/Drafting California Revocable Trusts/10 Distributions on First Spouse's Death/§10.12 B. Form: Distribution of Deceased Settlor's Property If Spouse or Partner Does Not Survive

§10.12 B. Form: Distribution of Deceased Settlor's Property If Spouse or Partner Does Not Survive

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10.12-1 Distribution if spouse or partner fails to survive

If the Surviving Settlor fails to survive the Deceased Settlor by thirty (30) days, the trustee shall distribute the Deceased Settlor's property as follows: _ _[*Specify, e.g., in accordance with the provisions for the distribution of the Bypass Trust on the death of the Surviving Settlor.*]_ _

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§10.13 C. Simultaneous Death Provision

A simultaneous death provision may be necessary to avoid questions concerning the identities of the deceased settlor and the surviving settlor in an estate plan using that nomenclature. Normally the spouse with the smaller estate should be named as the deemed survivor as this specification may make it possible to use disclaimers or partial QTIP elections, or both, to balance the two estates for federal estate tax purposes. For a form of simultaneous death provision, see chap 9. For a discussion of disclaimers, see chap 14.

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§10.14 IV. NOTIFICATION BY TRUSTEE ON FIRST DEATH

When the trust or any portion of it becomes irrevocable on the death of the first spouse or domestic partner (or any settlor), the trustee must serve the statutory "Notification by Trustee" on the beneficiaries of the irrevocable trust and on the heirs of the deceased settlor within 60 days after the date of the settlor's death. The notification must contain the information prescribed by statute. See Prob C §16061.7; *Harustak v Wilkins* (2000) 84 CA4th 208, 100 CR2d 718. See also Prob C §16061.8 (statute of limitations for persons receiving notification by trustee). The trustee is responsible for all damages, attorney fees, and costs caused by failure to serve the notification unless the trustee makes a reasonably diligent effort to comply. Prob C §16061.9. The trustee must also provide a copy of the terms of the trust or irrevocable portion of the trust to any beneficiary of the trust or heir of the deceased settlor who requests it. Prob C §16061.5. However, "terms of the trust" does not include documents that were intended to affect the disposition of the trust only while the trust was revocable. Prob C §16060.5.

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11

Marital Deduction Formulas and Funding

Marc M. Stern

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I. MARITAL DEDUCTION PLANNING

§11.1 A. Marital Deduction Planning Considerations

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 applicable exclusion amount available in that spouse's year of death, clients typically want some of the deceased spouse's property to pass in a manner qualifying for the marital deduction in order to avoid unnecessary imposition of estate tax on the death of the first spouse. Property passing in a manner qualifying for the marital deduction, however, increases the wealth that may be subject to estate tax on the death of the surviving spouse. Generally, excess marital deduction transfers (*i.e.,* transfers in excess of the amount needed to reduce the tax in the first estate to zero) should be avoided. One exception to this rule is when it is relatively certain that the surviving spouse's estate will be too small to trigger an estate tax liability. Another exception may arise with respect to decedents dying in 2010 when the absence of an estate tax may result in no marital deduction transfer under a typical reduce-to-zero marital deduction formula estate plan. This could have unintended consequences unless the nonqualifying transfer is made to a trust in which the surviving spouse has a beneficial interest. Fortunately, it is possible to provide fairly generously for the surviving spouse without causing inclusion of the trust property in the survivor's estate. Alternatively, the distribution provision on the first death could be amended or drafted to limit the nonqualifying transfer. See chap 14. Property included in the survivor's estate will receive a new date-of-death value tax basis under IRC §1014, or basis increase can be allocated to the property under IRC §1022 in 2010 (see chap 4). Assuming that assets appreciate between the two deaths, the higher date-of-death basis can result in lower capital gains taxes being incurred by the heirs on the disposition of those assets.

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§11.1A 1. Need for Planning Flexibility

Because of changing applicable exclusion amounts and considerable uncertainty as to future legislation concerning a single year of estate tax repeal that would also change income tax basis on death rules (see chap 4), it is often quite difficult for planners to determine whether death 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 the potential hazards of estate tax liability, *i.e.*, that 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 20.

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§11.1B 2. Typical Marital Estate Plan

When the value of a couple's total property is large enough to create a risk of estate tax liability on the death of the second spouse, a typical marital estate plan will provide that the part of the property sheltered by the deceased spouse's available applicable credit amount will be set aside in a manner that avoids estate tax on the second death. Setting this property aside (a "credit shelter" disposition) can be accomplished in several ways:

- An outright transfer to persons other than the surviving spouse;
- A trust that becomes irrevocable on the death of the first spouse, providing lifetime benefits for the surviving spouse (referred to in this book as a "bypass trust" but also commonly referred to as a "B" trust, an "exemption" trust, a "credit shelter" trust, a "credit" trust, a "family" trust, or a "nonmarital" trust; see chap 14); or
- An irrevocable trust funded via disclaimer by the surviving spouse (a "disclaimer" trust; see chap 14).

In a typical estate plan for a married couple, because of the marital deduction and applicable credit amount, no death taxes are payable on the first spouse's death. As discussed in chap 14, the assets in a properly drafted bypass trust or disclaimer trust will be excluded from the surviving spouse's gross estate even though the surviving spouse may be entitled to trust income and principal.

EXAMPLE: A couple residing in California owns community property worth $2 million. The applicable credit amount against the estate tax shields $1 million from taxes in 2011. The husband dies in January 2011; the wife dies in December 2011. If the husband leaves all his property to his wife, the unlimited marital deduction will eliminate any federal estate tax on his death. If the net value of the wife's estate remains constant until she dies and her taxable estate at death is $2 million, her estate will owe $435,000 in federal estate taxes. Had the husband used his applicable credit amount by creating a $1 million bypass trust, representing his entire community property interest, no estate tax would have been owed at either spouse's death, and the couple's beneficiaries would have received approximately $435,000 more.

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§11.2 B. Determining Marital Deduction; Formula Clauses

Once the client and attorney have decided that the marital deduction will be available on the death of the first settlor to die (the deceased spouse), the amount of marital deduction that can be claimed and the manner of determining the property used to satisfy the marital deduction gift must be determined. The client might wish to do one of the following:

- Leave a fixed fraction (*e.g.,* 50 percent) of his or her share of the trust property to the marital or nonmarital gift.
- Leave specific assets (*e.g.,* a residence) to the marital deduction gift, with the balance of the deceased spouse's share of the trust property passing to the nonmarital gift. The desire to designate specific percentages or assets for the marital gift often arises in second marriages, in which the client seeks to accommodate the interests of children of a first marriage with the interests of the spouse and children of the second marriage.
- Leave specific assets (*e.g.,* a business interest) to the nonmarital gift, with the balance of his or her share of the trust property passing to the marital gift.

For maximum estate tax savings, however, both settlors 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 applicable credit amount, which is subject to change by action of Congress, and (2) the amount that can pass tax free on the deceased spouse's death, which depends on the value of taxable gifts made by the deceased spouse during his or her lifetime. See §11.4.

The purpose of a formula clause is to determine how much of the deceased spouse's property should be allocated between the marital and nonmarital gifts or shares. Although the marital share can be left outright to the surviving spouse, or to a revocable trust established for the surviving spouse's benefit (the "survivor's" trust; see chap 12), the marital share will often pass to a trust called the marital trust or marital deduction trust (or share), and the nonmarital share will usually pass to a bypass trust or similarly titled trust. These shares may be further divided into subshares for administrative convenience (if allowed under the trust instrument or by court order). On the marital deduction and various kinds of marital trusts, see chap 11. On bypass trusts, see chap 14.

The trust instrument 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.

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Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.3 C. Division of Trust Assets on Death of First Spouse

§11.3 C. Division of Trust Assets on Death of First Spouse

The formula clause is generally preceded by a clause stating that the trust property will be divided into a survivor's trust, marital trust, or bypass trust. See §§10.6-10.8. These trusts are discussed in chaps 12, 13 (QTIPs and QDOTs), and 14, respectively. Other kinds of marital trusts are discussed in chap 9.

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§11.4 II. MARITAL DEDUCTION FORMULAS AND FUNDING ISSUES

If the settlors wish to achieve the optimum amount of marital deduction that will benefit their estates, the trust should contain a marital deduction formula clause. Formula clauses allocate the deceased spouse's interest in trust assets between two shares: One is usually called the marital trust (or share) or the marital deduction trust (or share); the other is called the bypass trust or the nonmarital trust (or share). Formula clauses minimize present estate taxes by using the deceased spouse's applicable credit amount. Such clauses produce the same estate tax result regardless of the value of the deceased spouse's gross estate or the value of taxable gifts previously made by the deceased spouse. On types of formula clauses, see §11.5. On complexities of formula clauses, see §11.8.

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§11.5 A. Types of Formula Clauses

The amounts passing to the marital deduction trust and bypass trust at the first spouse's death can be computed in several ways, as discussed below.

There are two basic types of marital deduction formula clauses: pecuniary amount (see §11.6) and fractional share (see §11.7).

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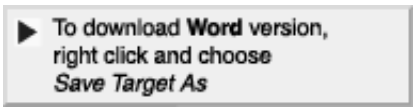
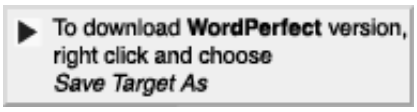
Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.6 1. Form: Pecuniary Amount Formula Clause

§11.6 1. Form: Pecuniary Amount Formula Clause





11.6-1 Pecuniary amount formula clause

***Pecuniary Gift*. The trustee shall distribute to the QTIP 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 the Deceased Settlor's death, after taking into account allowable credits.**

Comment: A pecuniary amount formula clause provides an amount of dollars that will produce the optimum 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" as discussed in §§11.9-11.36) or the amount of the nonmarital share (called a "pecuniary bypass," sometimes referred to as a "reverse pecuniary formula" as discussed in §§11.37-11.43). A simple version of a pecuniary marital formula would read as above (assuming that a QTIP trust is the form of marital trust selected; see chap 13 for a discussion of QTIP trusts).

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Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.7 2. Form: Fractional Share Formula Clause

§11.7 2. Form: Fractional Share Formula Clause

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11.7-1 Fractional share formula clause

***Fractional Share Gift*. The trustee shall distribute to the QTIP Trust the smallest fractional share of the Deceased Settlor's interest in the trust property that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable on the Deceased Settlor's death, after taking into account allowable credits.**

Comment: A fractional share formula clause is phrased in terms of the fractional share of the trust property that will produce the optimum marital deduction, as discussed in §§11.44-11.50. This form is a simple version of such a clause.

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§11.8 B. Complexities of Formula Clauses

A variety of complications occur in particular formula clauses:

- Because a complex formula 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. (Note that IRC §2032 requires a resulting decrease in tax as a prerequisite to election of alternate valuation; the marital formula clause is frequently designed to produce no tax on the deceased spouse's death.) The formula amount will also be affected by whether the allowable deductions for costs of administration are claimed as deductions against the estate tax or the trust's income taxes.
- If the value of the estate property changes during the period of administration following the deceased spouse's death, complex income tax issues may 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 trust property after the deceased spouse'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 trust early in the planning stages of drafting. Although the consequences of the choice of clause may not be realized until the deceased spouse's death, which could occur many years after the trust is drafted, delaying this choice until his or her death occurs could leave the deduction amount totally within the trustee's discretion, thereby resulting in loss of the marital deduction. Some flexibility can nevertheless be preserved at the drafting stage by anticipating strategies involving disclaimers. See chap 14.

For an in-depth treatment of formula clauses, see Pennell, *Estate Tax Marital Deduction*, Tax Management Portfolios 843-2d (2005).

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§11.9 III. PECUNIARY MARITAL FORMULA

If a pecuniary amount marital deduction formula is used, several funding clauses may be used to determine how trust 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," "fairly representative," and "minimum worth" funding plans.

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§11.10 A. 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 or to the survivor's trust.) The date of distribution value, fairly representative, and the minimum worth funding plans may all be used to govern the allocation of trust assets when funding the marital gift calculated under the formula.

Because the marital gift is a pecuniary amount under the formula, it will not share in trust income earned during the period of administration following the deceased spouse's death unless the instrument affirmatively provides that the pecuniary amount be treated as a residuary bequest solely for the purpose of allocation during the administration or predivision period. At most, if the marital gift is not made within one year after the deceased spouse's death, as a general pecuniary gift it bears interest thereafter at a rate equal to 3 percent below the legal rate on judgments in effect one year after the deceased spouse's death. Prob C §§12001, 12003, 16340. A clause in the trust instrument overriding the state law interest requirement may result in either a reduction of the amount of the marital deduction or in the marital gift's 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 deceased spouse's generation-skipping transfer tax exemption to the residual bypass trust because of the requirement that pecuniary formula gifts carry appropriate interest. See Treas Reg §26.2642-2(b)(3); California Will Drafting §15.39 (3d ed Cal CEB 1992).

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Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.11 B. Form: Pecuniary Marital Formula (Bypass Trust as Residue)

§11.11 B. Form: Pecuniary Marital Formula (Bypass Trust as Residue)

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11.11-1 Pecuniary marital formula (bypass trust as residue)

***Distribution to QTIP Trust and Bypass Trust*. When the residue of the Deceased Settlor's property is distributed to the QTIP Trust and the Bypass Trust, as provided above, the shares of the trusts and the allocations between them shall be determined and accomplished as follows:**

1. *Distribution to QTIP Trust*. The trustee shall distribute to the QTIP 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 the Deceased Settlor's death, after taking into account all factors relevant to this estate tax objective, including but not limited to:

(a) All deductions claimed and allowed in determining the estate tax payable by reason of the Deceased Settlor's death.

(b) The net value of all other property (whether or not it is given under this instrument and whether or not it passes at the time of the Deceased Settlor's death or has passed before the Deceased Settlor's death to or in trust for the Surviving Settlor) that is included in the Deceased Settlor's gross estate and qualifies for the federal estate tax marital deduction. If the Surviving Settlor disclaims any property that would otherwise qualify for the federal estate tax marital deduction, the disclaimer shall be disregarded.

(c) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for (1) taxes paid in the estate of one whose death occurs after the death of the Deceased Settlor or (2) any state inheritance or estate tax unless, and to the extent that, the tax would be payable to the state or states regardless of the federal credit.

2. *Distribution to Bypass Trust*. The trustee shall distribute to the trustee of the Bypass Trust the balance of the Deceased Settlor's interest in the trust property. It is understood that the share of the Bypass Trust as determined under this formula may be 100 percent. Also, if the federal estate tax is repealed or is otherwise not in effect at the time of the Deceased Settlor's death, the share of the residue of the Deceased Settlor's property that will be allocated to the Bypass Trust will be 100 percent.

3. *Satisfaction of Pecuniary Amount*. The trustee shall satisfy the minimum pecuniary amount distributed to the QTIP Trust as so determined in cash or in kind, or partly in each. When distributing the Deceased Settlor's property because of the Deceased Settlor's death, the trustee, to the extent possible, shall use property qualifying for the federal estate tax marital deduction in making distributions to the Surviving Settlor or to the Survivor's Trust, any QTIP Trust, or other trust that otherwise qualifies for the federal estate tax marital deduction.

[*Add one of the following alternatives*]

[*Alternative: 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 QTIP trust.

[*Alternative: 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. The trustee shall select property to satisfy this amount so that any appreciation or depreciation that has occurred in the value of trust property between the applicable valuation date and the date of allocation shall be fairly apportioned between the QTIP Trust and the Bypass Trust.

[*Alternative: 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 total value of such assets on the date or dates of allocation to the QTIP Trust be less than this pecuniary amount.

Comment: In form 11.11-1, if there is no QTIP trust and the marital deduction amount will be allocated directly to the surviving spouse or to the survivor's trust, the words "surviving settlor" or "survivor's trust" rather than "QTIP trust" should be used, as appropriate. If a marital trust other than a QTIP trust is used, the words "marital trust" should be substituted for "QTIP trust."

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 §11.38. For a discussion of special use valuation, see chap 4.

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 subparagraph 2. For suggested language and discussion, see chap 9.

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§11.12 C. Factors Included in Pecuniary Marital Formula

The pecuniary marital formula requires that several factors 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 deceased spouse's applicable credit amount. In determining the appropriate amount of the marital deduction gift to minimize taxes, the formula does, however, take into account gifts to or for the surviving spouse both under the governing trust instrument (*e.g.,* specific gifts) and from other sources (*e.g.,* insurance).

Although it may not be possible to eliminate taxes on the deceased spouse's death in certain circumstances (*e.g.,* when there are taxable bequests, joint tenancies with persons other than the surviving spouse, or life insurance proceeds passing to others), the formula nevertheless yields the smallest amount necessary as a marital deduction to minimize the taxes due.

Note that the formula requires disregarding any disclaimer by the surviving spouse. Without this language, the formula would adjust for the disclaimer and defeat the purpose of making the disclaimer.

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§11.13 1. Federal Estate Tax Deductions

The deductions allowed on the deceased spouse's federal estate tax return are 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 deceased spouse'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 deceased spouse has a gross estate valued at $5,000,000, deductions totaling $1,500,000 will be required to obtain a taxable estate of $3,500,000, the maximum amount that can be sheltered by the unified credit in 2009. If no other deductions were claimed or allowed on the deceased spouse's federal estate tax return, a $1,500,000 marital deduction would be required (and will be computed under the formula) to achieve the desired result. If, instead, administration expenses totaling $100,000 are allowed on the deceased spouse's estate tax return, a marital deduction of only $1,400,000 would be required (and computed under the formula) to achieve the desired result.

The word "allowed" is used instead of "taken" in the formula because a deduction taken 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 §11.40 on deduction of administration expenses.

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§11.14 2. Other Property Passing to Surviving Spouse

The second factor to consider under the pecuniary marital formula is that less marital deduction is required with respect to trust property (that will be allocated between the marital and nonmarital gifts), to the extent that other gifts required to be made under the trust instrument or outside the trust (*e.g.,* through joint tenancies, life insurance, or other trusts) are includable in the deceased spouse's gross estate and qualify for the marital deduction.

EXAMPLE: In the example discussed in §11.13, the formula yielded a marital gift of $1,400,000, assuming that administrative expenses were allowed as an estate tax deduction. If the deceased spouse's gross estate consists of $4,500,000 of trust property and $500,000 of life insurance payable to the surviving spouse and qualifying for the marital deduction, then a marital deduction under the formula of only $900,000 will be required with respect to trust property (and computed under the formula) to achieve the desired result. Under this assumption, the value of trust property is $4,500,000, $100,000 of administration expenses will be paid, and a marital deduction gift of $900,000 will be made, leaving $3,500,000 for the bypass trust.

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§11.15 3. Federal Estate Tax Credits

The third factor of the formula requires that all credits available to the deceased spouse's estate be taken into account in making the calculation under the formula. This includes the IRC §2010 applicable credit amount, the IRC §2012 credit for gift taxes paid, the IRC §2013 credit for prior transfers, and the IRC §2014 foreign death tax credit. The IRC §2011 state death tax credit is taken into account, however, only to the extent that doing so does not cause a tax to be paid to a state when that tax could otherwise be avoided.

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§11.16 a. 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.

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" (Rev & T C §13302) results in no state death tax after the credit is repealed. 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.

The following table shows the maximum amount of the gross estate (before payment of and credit for state death taxes) that would be shielded from federal estate taxes for the years 2006-2011, and the California estate taxes that would apply. (See chap 4 for a discussion of applicable exclusion amounts for these years.)

Year	*Maximum Gross Estate Shielded From Estate Tax*	*Amount of State Tax*
2006, 2007, 2008	$2,000,000	$0
2009	$3,500,000	$0
2010	(repealed)	$0
2011	$1,093,786	$38,452

Without including the qualifying language in the formula, the settlors' desire to have no estate taxes paid on the deceased spouse's death could be frustrated because, even though no federal estate taxes would be paid, a state estate tax could 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 state estate tax to be paid. The qualifying language should always be used to achieve a no-tax result for individuals whose entire assets have a situs in California and other states with pick-up taxes. If the individual 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.

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§11.17 b. Prior Transfer Property Credit

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 ten-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 deceased spouse) occurs within two years after the death of the transferor. The credit is reduced by 20 percent for each additional two-year period.

If the deceased spouse dies within two 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 deceased spouse dies more than two 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 the deceased spouse's 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 PTP credit is available in situations in which the transferor dies *after* the deceased spouse (as would be relevant if, for example, the transferor made an inter vivos gift to the deceased spouse that was later included in the transferor's estate for some reason), the formula provides for ignoring the credit in these circumstances to preclude a contention by the Internal Revenue Service, however dubious, that a portion of the marital deduction distribution was subject to a prohibited contingency.

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§11.18 c. 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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§11.19 4. 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 deceased spouse during his or her lifetime). Although the gross estate does not include adjusted taxable gifts, they 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 deceased spouse's adjusted taxable gifts.

PRACTICE TIP: 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 gift tax exclusions when computing the estate tax. See Treas Reg §20.2001-1(b). Under Treas Reg §301.6501(c)-1(f), the requirements for adequate disclosure can require highly detailed information and legal analysis. Separate adequate disclosure requirements apply to transactions involving the special valuation rules under IRC §§2701 (transfers of business interests when the transferor retains other interests in the same business) and 2702 (transfers to retained-interest trusts).

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§11.20 5. 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.

Insurance on the surviving spouse's life is likely to increase substantially in value from the date of the deceased spouse's death (when it will be valued at its interpolated terminal reserve value or its lesser replacement cost) to the date of the surviving spouse's death (when it will be valued at its face amount).

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D. Funding Issues When Pecuniary Marital Formula Is Used

§11.21 1. 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 surviving spouse's death.

The pecuniary formula only minimally addresses the issue of funding the marital trust. Although requiring that the gift be satisfied in cash is one way to fulfill the requirement of Rev Proc 64-19, 1964-1 Cum Bull 682, 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 trust property, with attendant income tax consequences (if the assets appreciate in value after the decedent'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.

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 property. Because true fractional share formula clauses give a fraction of each asset to the marital gift, they are not affected by Rev Proc 64-19, except that it is unclear whether gifts labeled as "fractional shares" are pecuniary gifts when the instrument requires or allows selection of assets to satisfy the gift.

Revenue Procedure 64-19 does not apply when:

- A fractional share formula is used;
- A pecuniary amount may be satisfied solely in cash;
- The fiduciary has no discretion in selecting the assets that must be distributed in kind in satisfaction of a pecuniary amount;
- The assets selected for distribution in kind in satisfaction of a pecuniary amount are valued at their respective dates of distribution; or
- The fiduciary is required to satisfy a pecuniary gift with assets fairly representative of the postdeath appreciation or depreciation of all property available for satisfying the gift.

EXAMPLE: In the example discussed in §11.14, the deceased spouse's gross estate was valued at $5,000,000, including $500,000 of life insurance. The deceased spouse's share of the trust property was valued at $4,500,000. Assume further that the trust consists of $2,100,000 in cash (from which $100,000 in administrative expenses are paid) and two assets: (1) Blackacre, with a federal estate tax value of $1,500,000, which has increased in value to $1,600,000 on the date of distribution; and (2) Whiteacre, with a federal estate tax value of $900,000, but which has decreased in value to $800,000 on the date of distribution.

At the date of distribution, there will have been no net appreciation in the trust assets (although administration expenses will have been paid). The effect of Rev Proc 64-19 is to preclude the allocation of only Whiteacre in full satisfaction of the $900,000 marital gift determined under the formula. Such an allocation would have left Blackacre and the remaining $2,000,000 in cash (assets having an aggregate value of $3,600,000) for allocation to the bypass trust, thereby shifting $100,000 from the marital trust to the bypass trust.

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§11.22 2. "Date-of-Distribution Value" Funding

"Date-of-distribution value" funding is sometimes known 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 trustee is directed to distribute assets to the surviving 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 trust 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 trust assets appreciate or depreciate during the administration of the trust following the deceased spouse's death, the appreciation or depreciation will be borne by the residual bypass trust.

EXAMPLE: In the example discussed in §11.21, if Whiteacre is allocated in satisfaction of the marital gift when date-of-distribution value funding is used, it will be valued at only $800,000, its date-of-distribution value. An additional $100,000 of cash or a 1/16 interest in Blackacre (having a date-of-distribution value of $100,000 or 1/16 of $1,600,000) will also need to be allocated to the marital gift to make up for the loss in value of Whiteacre.

PRACTICE TIP: Because of IRC §267(a), which disallows losses on sales or other transactions between related taxpayers, there may be gain but no loss recognized on funding when the date-of-distribution formula is used in a revocable trust. In general, therefore, the drafter should not use this formula when the trust property includes assets that may be subject to volatile depreciation and appreciation (*e.g.,* sports teams, racehorses, certain kinds of stock investments).

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§11.23 3. "Fairly Representative" Funding

The "fairly representative" funding clause directs the trustee 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.

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 deceased spouse's death should be valued at its income tax basis.

EXAMPLE: In the example discussed in §11.21, because there was no appreciation or depreciation in the trust property as a whole, the assets chosen for distribution to the marital trust 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 interest in Blackacre that includes an equivalent amount of appreciation must also be allocated to the marital gift in a manner that achieves 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 3/8 (having a date of distribution value of $300,000 and depreciation of $37,500), with a 3/8 share of Blackacre (having a date-of-distribution value of $600,000 and appreciation of $37,500) also being distributed to the marital trust.

NOTE: Under Prob C §21118, if an instrument permits the fiduciary to value property selected to satisfy a pecuniary gift as of a date other than the date of distribution, that property must fairly reflect net appreciation and depreciation between the valuation date and the date of distribution, unless the instrument expressly provides otherwise. The "fairly representative" funding clause for the pecuniary marital formula is consistent with this provision.

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§11.24 4. "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), if an asset is included in the deceased spouse's estate, the asset's value for estate tax purposes becomes its income tax basis.)

EXAMPLE: In the example discussed in §11.21, any amount of cash can be used to satisfy the marital gift. Whiteacre would be valued at its lesser value of $800,000 on the date of distribution, and Blackacre would be valued at its lesser federal estate tax value of $1,500,000. Thus, a 60-percent interest in Blackacre (having a date-of-distribution value of $960,000) could be allocated in complete satisfaction of the $900,000 marital gift. If Whiteacre is used to satisfy the marital gift, an additional $100,000 in cash or a 1/15 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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§11.25 5. Consequences of Funding Plan

The most obvious effect of the chosen funding plan concerns allocation of appreciation or depreciation in the value of trust assets during the administration of the trust following the deceased spouse's death. When the marital trust is the pecuniary gift trust, date-of-distribution value funding allocates all appreciation of the assets to the bypass trust. The appreciation will thus not be subject to federal estate tax on the surviving spouse's later death—an obviously favorable result. When the assets depreciate, 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. See §§11.30-11.31.

Because too many factors are unknown when the trust instrument is drafted (*e.g.,* the nature of future assets, the deceased spouse's date of death, and future economic conditions), the drafter is unlikely to be able to ascertain whether the trust property will appreciate or depreciate during administration. Although the conservative approach of the fairly representative funding plan does not produce favorable results 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 unfavorable results when the assets depreciate (because a proportionate share of the depreciation will be allocated to the marital gift). See §§11.32-11.34.

When trust assets depreciate in value during 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 to satisfy the marital gift at their lower date-of-death values, thereby causing some of the appreciation to be allocated to the marital trust. Thus, whereas minimum worth funding produces the same unfavorable result as date-of-distribution value funding when the assets depreciate, it does not produce the same favorable result when the assets appreciate. See §§11.35-11.36.

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§11.26 6. Income Tax Issues

A number of income tax issues arise in connection with funding that are also affected by the chosen funding plan. These include gain and loss considerations (see §11.27), income in respect of a decedent (IRD) (see §11.28), and distributable net income (DNI) (see §11.29).

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§11.27 a. Gain and Loss

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. See *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. Thus, gain is realized when property that has appreciated in value during the period of administration following the deceased spouse's death is distributed in kind in satisfaction of the pecuniary marital gift. The amount of gain is equal to the fair market value of the property less its income tax basis, which is usually the date-of-death value. If property has depreciated during administration, however, no loss can be recognized under IRC §267 with respect to a distribution from a revocable trust. Because any loss is disallowed when depreciated property is distributed in satisfaction of the pecuniary marital gift, IRC §267(d) provides that the recipient of the marital gift (either the surviving spouse or the marital trust) will not recognize gain on the sale of the depreciated asset to the extent of the loss disallowed. Note that, in contrast, loss can be recognized under §267 on distribution of depreciated property from a probate estate in satisfaction of a pecuniary gift. If, however, the trustee (and executor, if there is a probate estate) makes the election under IRC §645 to have the trust treated as part of, and taxed as part of, the probate estate, the trust's loss can be recognized.

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Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.28 b. Income in Respect of a Decedent (IRD)

§11.28 b. Income in Respect of a Decedent (IRD)

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 (see IRC §691(a)(2)), the trustee'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.

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§11.29 c. Distributable Net Income (DNI)

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 trust property. 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 deceased spouse's federal estate tax return, as discussed in §11.40; see Treas Reg §1.663(a)-1(b)). Therefore, a distribution under a pecuniary marital formula will carry out DNI unless the marital gift is a separate share under IRC §663(c). The marital gift is a separate share if date-of-distribution funding is used, because the marital gift does not share in appreciation or depreciation. The marital gift is not a separate share if fairly representative or minimum-worth funding is used. See Treas Reg §1.663(c)-4(b).

On the principles of fiduciary income tax generally, see Drafting California Irrevocable Trusts, chap 3 (3d ed Cal CEB 1997). For a discussion of testamentary trust taxation applicable to revocable trusts, see California Will Drafting, chap 23A (3d ed Cal CEB 1992).

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E. Comparison of Funding Plans Used With Pecuniary Marital Formula

1. Date-of-Distribution Value Funding

§11.30 a. Advantages of True 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 trustee may choose the assets that will be distributed to satisfy the pecuniary amount from all the assets under the trustee's control, the trustee will be able to satisfy various goals and desires. For example, a 100 percent interest in the settlors' residence may be distributed in satisfaction of the marital gift or assets may be allocated among various beneficiaries to facilitate efficient management of the deceased spouse's business. One consideration is that an asset with large growth potential will be taxed on the surviving spouse's death unless it is put in the bypass trust. On the disadvantages of this flexibility, see §11.31.
- **Protection of value of property passing for the surviving spouse's benefit.** Although the trustee'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 settlors 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 trust assets as a whole 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 settlors' intention to protect the surviving spouse will be carried out.
- **Allocation of appreciation to bypass trust.** In an appreciating market, any rise in value of trust assets as a whole during administration and before funding the marital gift will be allocated solely to the bypass trust. As discussed in §11.2 and chap 14, property allocated to the bypass trust is subject to estate tax on the deceased spouse's death and escapes estate taxation on the death of the surviving spouse to the extent that it passes to third parties. The fact that the pecuniary marital gift does not receive a share of the appreciation of the trust property as a whole does not jeopardize the marital deduction unless the funding of the gift is delayed beyond a reasonable time. IRS Letter Ruling 8746003; *Connecticut Nat'l Bank v U.S.* (D Conn 1990) 90-2 USTC ¶50,526, 66 AFTR2d 5852, rev'd on other grounds (2d Cir 1991) 937 F2d 90.
- **DNI.** When date-of-distribution value funding is used, it may not draw out distributable net income (DNI; defined in IRC §643(a)) from the funding entity. See §11.29.
- **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 the administration of the trust following the deceased spouse's death. If, however, the marital gift is not satisfied within one year after the deceased spouse's death, the marital gift will bear interest thereafter at a rate equal to 3 percent below the legal rate on judgments in effect one year after the deceased spouse's death. Prob C §§12001, 12003, 16340. Nonetheless, doing a simple interest calculation is usually substantially easier than allocating income, gains, and losses.

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§11.31 b. Disadvantages of True Value Funding

The disadvantages of the pecuniary marital formula with date-of-distribution value funding include:

- **Recognition of gain.** Gain is 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 trustee 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 distributing trust entity realizes gain on the difference between the asset's basis (generally date-of-death value) and its appreciated value as of the date of distribution. Loss is generally not recognized, so the distributee will have a basis in a depreciated asset equal to its basis before the distribution. (For a discussion of when loss can be recognized, see §11.27.) Recognition of gain can be especially problematic in large estates because a high proportion of the assets will be allocated to the marital trust. To minimize the potential gains, disallowed losses, and imposition of interest on the pecuniary marital gift, many fiduciaries try to fund the pecuniary gift soon after the deceased spouse's death.
- **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 deceased spouse'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 impatient beneficiaries and trustees who have already endured one appraisal for the estate tax return 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 surviving 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 surviving spouse to the bypass trust; the IRS may treat overfunding as a gift by the beneficiaries of the bypass trust to the surviving 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 surviving spouse.
- **IRD problems.** In choosing assets for distribution in kind, the fiduciary will need to identify trust 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. See §11.28. 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 drafter of the trust may avoid the IRD trap by making a specific, preresidual gift 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 second spouse's death or in a harmonious family situation.)
- **Conflicts of interest.** A trustee 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 §11.52.

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2. Fairly Representative Funding

§11.32 a. 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 trust 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.
- **Sharing burden of depreciation.** If, in the aggregate, the value of assets depreciates following the deceased spouse's death, the residual bypass trust alone will not bear the economic burden of the decrease in value; instead, the burden will be shared proportionately by the marital gift and the bypass trust.

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§11.33 b. 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 the marital gift defeats 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 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* noncash 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 trustee 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 trustee'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 §11.21, in which Blackacre has appreciated $100,000 (6.7 percent) and Whiteacre has depreciated $100,000 (11 percent), if an interest in Whiteacre (which includes depreciation) is allocated to the marital gift, an interest in Blackacre that includes an equivalent amount of appreciation must also be allocated to the marital gift in a manner that achieves 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 3/8 (having a value of $300,000 and depreciation of $37,500), with a 3/8 share of Blackacre (having a value of $600,000 and appreciation of $37,500) also being distributed to the marital trust.
- **DNI.** When a pecuniary formula other than date-of-distribution value funding is used, 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 §11.29. The trustee of the revocable trust should advise the surviving spouse or the trustee of the marital trust (who in turn will 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).

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§11.34 c. Overcoming Disadvantages

Many fiduciaries feel that the easiest way to comply with the fairly representative 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 administration and the marital portion's share of the appreciation or depreciation, the trustee can choose among the trust 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 §11.52.

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3. Minimum Worth Funding

§11.35 a. Advantages of Minimum Worth Funding

The advantages of the pecuniary marital formula with minimum worth funding include:

- **No recognition of gain.** 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 will be no recognition of gain. Unlike the situation with a probate estate, if the fair market value of an asset allocated to the marital trust has depreciated on the date of distribution to a value less than its basis, the loss will be disallowed by the related party transaction rules of IRC §267. To recognize the loss, the fiduciary must sell the asset and instead distribute the proceeds of sale.
- **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 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 is required—at least when it is clear that a given asset has appreciated.

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§11.36 b. 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 deceased spouse'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.
- **DNI.** When a pecuniary formula other than date-of-distribution value funding is used, 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 §11.29. The trustee of the revocable trust should advise the surviving spouse or the trustee of the marital trust (who in turn will 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).

The trustee 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 settlors' family or families disagree about asset distribution, the trustee must exercise great care in choosing assets for funding under this plan. For discussion of conflicts of interest in funding, see §11.53.

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IV. PECUNIARY BYPASS MARITAL FORMULA

§11.37 A. Overview of Pecuniary Bypass 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 deceased spouse'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 §§11.26-11.29.

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 may be easier to find assets worth $3.5 million (the IRC §2010 estate tax applicable exclusion amount for 2009) that have not appreciated than it will be to find assets worth $6.5 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 trustee to overfund the bypass trust and correspondingly underfund the marital gift, thus violating 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 trust income earned during the period of administration following the deceased spouse's death, unless the trust instrument provides otherwise. At most, if the nonmarital gift is not made within one year after the deceased spouse's death, as a general pecuniary gift it bears interest thereafter at a rate equal to 3 percent below the legal rate on judgments in effect one year after the deceased spouse's death. Prob C §§12001, 12003, 16340. A trust clause 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 deceased spouse's generation-skipping transfer tax exemption to the residual marital trust, if a reverse qualified terminable interest property (QTIP) election is made, because of the requirement that formula gifts carry appropriate interest. See Treas Reg §26.2642-2(b)(3); California Will Drafting §15.39 (3d ed Cal CEB 1992). For discussion of reverse QTIP elections, see chap 9.

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 deceased spouse'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 first spouse's death, thereby causing an estate tax to be paid. The formula does, however, take into account taxable gifts made under the governing trust instrument (*e.g.,* specific gifts) and from other sources (*e.g.,* joint tenancy property) in determining the appropriate amount that can pass to the bypass trust to maximize use of the deceased spouse's unified credit.

In some circumstances (*e.g.,* when nontrust gifts exceed the applicable credit amount that can be sheltered) it is not possible to have zero tax on the deceased spouse's death, and the formula will therefore yield a bypass trust value of zero.

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Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.38 B. Form: Pecuniary Bypass Formula (Marital Trust as Residue)

§11.38 B. Form: Pecuniary Bypass Formula (Marital Trust as Residue)

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11.38-1 Pecuniary bypass formula (marital trust as residue)

***Distribution to QTIP Trust and Bypass Trust*. When the residue of the Deceased Settlor's property is distributed to the QTIP Trust and the Bypass Trust, as provided above, the shares of the trusts and the allocations between them shall be determined and accomplished as follows:**

1. *Distribution to Bypass Trust*. The trustee shall distribute 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:

(a) All deductions claimed and allowed in determining the estate tax payable by reason of the Deceased Settlor's death.

(b) The net value of all other property included in the Deceased Settlor's gross estate, whether or not it is given under this instrument and whether or not it passes at the time of the Deceased Settlor's death or has passed before the Deceased Settlor's death to or in trust for any person or entity, so that it is included in the Deceased Settlor's gross estate and does not qualify for the federal estate tax marital deduction. If the Surviving Settlor disclaims any property that would otherwise qualify for the federal estate tax marital deduction, the disclaimer shall be disregarded.

(c) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for (1) taxes paid in the estate of one whose death occurs after the death of the Deceased Settlor or (2) any state inheritance or estate tax unless, and to the extent that, the tax would be payable to the state or states regardless of the federal credit.

2. *Distribution to QTIP Trust*. The trustee shall distribute to the QTIP Trust the balance of the Deceased Settlor's interest in the trust property.

It is understood that the share of the Bypass Trust as determined under this formula may be 100 percent. Also, if the federal estate tax is repealed or is otherwise not in effect at the time of the Deceased Settlor's death, the share of the residue of the Deceased Settlor's property that will be allocated to the Bypass Trust will be 100 percent.

3. *Satisfaction of Pecuniary Amount*. The trustee shall satisfy the maximum pecuniary amount distributed 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. When distributing the Deceased Settlor's property due to the Deceased Settlor's death, the trustee, to the extent possible, shall use property qualifying for the federal estate tax marital deduction in making distributions to the Surviving Settlor or to the Survivor's Trust, any QTIP Trust, or any other trust that qualifies for the federal estate tax marital deduction.

[*Add one of the following alternatives*]

[*Alternative: 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: 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. The trustee shall select property to satisfy this

amount so that any appreciation or depreciation that has occurred in the value of trust property between the applicable valuation date and the date of allocation shall be fairly representative between the QTIP Trust and the Bypass Trust.

Comment: In form 11.38-1, if there is no QTIP trust and the marital deduction amount will be allocated directly to the surviving spouse or to the survivor's trust, the words "surviving settlor" or "survivor's trust" rather than "QTIP trust" should be used, as appropriate. If a marital trust other than a QTIP trust is used, the words "marital trust" should be substituted for "QTIP trust."

If the estate includes qualifying special use valuation property, the pecuniary marital formula in §11.11 should be used rather than the pecuniary bypass formula in this section. For a discussion of special use valuation, see chap 4.

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 subparagraph 3. For suggested language and discussion, see chap 9.

Note that the formula requires disregarding any disclaimer by the surviving spouse. Without this language, the formula would adjust for the disclaimer and defeat the purpose of making the disclaimer.

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§11.39 C. Factors Included in Pecuniary Bypass Formula

The factors included in the pecuniary bypass formula are essentially the same as the factors set forth in the marital pecuniary formula, as discussed in §§11.12-11.19, except that the minimum-worth funding plan may not be used with the pecuniary bypass formula. See §§11.9, 11.24.

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§11.40 D. 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 the marital deduction regulations provide that charging such expenses to the marital deduction qualifying gift reduces 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 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 that 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 to make up for the loss of the estate tax administration expense deduction.

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E. Funding Issues When Pecuniary Bypass Formula Is Used

§11.41 1. Date-of-Distribution Value Funding

Under the date-of-distribution method of funding, the trustee 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 trust assets will therefore 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 trust assets appreciate or depreciate during the administration of the trust after the deceased spouse's death, the appreciation or depreciation will be borne by the marital trust.

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§11.42 2. Fairly Representative Funding

The fairly representative funding clause directs the trustee 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 deceased spouse'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 §11.23.

NOTE: Under Prob C §21118, if an instrument permits the fiduciary to value property selected to satisfy a pecuniary gift as of a date other than the date of distribution, that property must fairly reflect net appreciation and depreciation between the valuation date and the date of distribution unless the instrument expressly provides otherwise. The "fairly representative" funding clause for the pecuniary bypass marital formula is consistent with this provision. See form 11.38-1.

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§11.43 3. 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 trust's assets appreciate or depreciate during administration, the appreciation or depreciation will be allocated 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 underfunding may appear to create a troublesome problem with respect to the availability of the marital deduction in the deceased spouse'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 174. See also Rev Rul 81-20, 1981-1 Cum Bull 471. This result is sound because, even if all of the deceased spouse's property is left to the surviving spouse, the property could depreciate during administration, with the result that the surviving spouse receives less than the date-of-death value of the trust property.

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. See *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. Therefore, the use of appreciated assets to satisfy the gift to the bypass trust under a date-of-distribution value funding plan will result in the recognition of gain to the extent of the appreciation. 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. See IRC §691(a)(2).

Underfunding of the marital gift will result to the extent that the residuary marital gift pays the capital gains taxes resulting from funding the bypass trust with appreciated assets. However, because use of appreciated assets to fund the bypass trust will result in a relative increase in the size of the marital gift, the net marital gift in these circumstances will be greater than the allowed deduction, and the IRS is unlikely to challenge the marital deduction.

Distributions to the bypass trust will also carry out distributable net income (DNI; defined in IRC §643(a)) unless the pecuniary gift is a separate share under IRC §663(c), because the amount determined under the pecuniary bypass 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 deceased spouse's federal estate tax return, as discussed in §11.40; see Treas Reg §1.663(a)-1(b)). The pecuniary gift is a separate share if date-of-distribution funding is used because the pecuniary gift does not share in appreciation or depreciation. See Treas Reg §1.663(c)-4(b). In IRS Letter Ruling 200210002, the amount of a formula pecuniary gift to a bypass trust was not ascertainable; accordingly, the IRS ruled that properly timed distributions in satisfaction of the gift will carry out the estate's DNI and be taxed to the beneficiaries. The assets of the trust included portions of the decedent's retirement account taxed as IRD.

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V. FRACTIONAL SHARE MARITAL FORMULAS

§11.44 A. Overview of Fractional Share Marital Formulas

As its name implies, the fractional share marital formula directs the trustee to divide the deceased spouse's share of the trust 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 asset value reductions.

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 giving the trustee the flexibility to avoid distribution of a fractional share of each 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 trustee to satisfy the gift.

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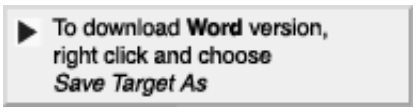
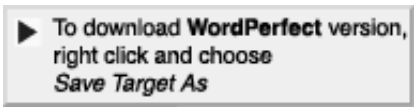
§11.45 B. Form: Fractional Share Marital Formula





11.45-1 Fractional share marital formula

***Distribution to QTIP Trust and Bypass Trust*. When the residue of the Deceased Settlor's property is distributed to the QTIP Trust and the Bypass Trust, as provided above, the shares of the trusts and the allocations between them shall be determined and accomplished as follows:**

1. *Distribution to QTIP Trust*. The share of the QTIP Trust shall equal the smallest fractional share of the Deceased Settlor's property 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 the Deceased Settlor's death, after taking into account all factors relevant to this estate tax objective, including but not limited to:

(a) All deductions claimed and allowed in determining the estate tax payable by reason of the Deceased Settlor's death.

(b) The net value of all other property (whether or not it is given under this instrument and whether or not it passes at the time of the Deceased Settlor's death or has passed before the Deceased Settlor's death to or in trust for the Surviving Settlor) that is included in the Deceased Settlor's gross estate and qualifies for the federal estate tax marital deduction. If the Surviving Settlor disclaims any property that would otherwise qualify for the federal estate tax marital deduction, the disclaimer shall be disregarded.

(c) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for (1) taxes paid in the estate of one whose death occurs after the death of the Deceased Settlor or (2) any state inheritance or estate tax unless, and to the extent that, the tax would be payable to the state or states regardless of the federal credit.

(d) The value of assets as finally determined for estate tax purposes.

2. *Distribution to Bypass Trust*. The Bypass Trust share shall equal the remaining share of the trust property. It is understood that the share of the Bypass Trust as determined under this formula may be 100 percent. Also, if the federal estate tax is repealed or is otherwise not in effect at the time of the Deceased Settlor's death, the share of the residue of the Deceased Settlor's property that will be allocated to the Bypass Trust will be 100 percent.

3. *Qualification for Marital Deduction*. When distributing the Deceased Settlor's property due to the Deceased Settlor's death, the trustee, to the extent possible, shall use property qualifying for the federal estate tax marital deduction in making distributions to the Surviving Settlor or to the Survivor's Trust, any QTIP Trust, or other trust that otherwise qualifies for the federal estate tax marital deduction.

Comment: In form 11.45-1, if there is no QTIP trust and the marital deduction amount will be allocated directly to the surviving spouse or to the survivor's trust, the words "surviving settlor" or "survivor's trust" rather than "QTIP trust" should be used, as appropriate. If a marital trust other than a QTIP trust is used, the words "marital trust" should be substituted for "QTIP trust."

Note that the formula requires disregarding any disclaimer by the surviving spouse. Without this language, the formula would adjust for the disclaimer and defeat the purpose of making the disclaimer.

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 subparagraph 2. For suggested language and discussion of reverse QTIP trusts, see chap 9.

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C. Comparison With Pecuniary Funding Formulas

1. Fractional Share Formula With Prorata Funding

§11.46 a. Prorata Funding Not Advised

Under current law, it is not 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 trusts should authorize nonprorata funding of distributions. Nonprorata funding is also authorized by statute in California. See Prob C §16246. For a form of authorization, see §11.50. For additional language providing for nonprorata division of community property to be used in connection with "aggregate theory" community property agreements in certain circumstances, see §10.8A.

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§11.47 b. 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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2. Fractional Share Formula With Nonprorata Funding

§11.48 a. Advantages of Nonprorata Funding

Use of the fractional share marital formula with nonprorata funding eliminates many of the problems associated with pecuniary marital formulas and fractional share marital formulas with prorata funding:

- **Flexibility.** Unlike prorata funding, nonprorata funding offers the trustee the flexibility of choosing the assets to satisfy the distribution.
- **Nonrecognition of gain.** Assuming that the distributing fiduciary has the power to distribute on a nonprorata basis without obtaining the approval of the beneficiaries (a power conferred by Prob C §16246), a nonprorata allocation of assets to fractional shares does not result in recognition of gain or loss. IRS Letter Rulings 200334030, 199925033, 199912040. See Rev Rul 69-486, 1969-2 Cum Bull 159, in which the fiduciary did not have such a power, with the consequence that the beneficiaries were deemed to have made a taxable exchange.
- **Administrative ease.** Nonprorata funding will be administratively simpler to implement than prorata funding. For example, use of nonprorata funding may result in more than one distribution with successive distributions funding a portion of the determined amount. If an audit reveals a change in values, the result of the revaluation of assets and recomputation under the formula will alter the fraction, which in turn will change the amount passing to the marital trust (the fraction multiplied by the date-of-distribution value of the assets available for distribution). The adjustment can easily be made with a reallocation of assets at their date-of-reallocation values. The nonprorata formula eliminates the administratively cumbersome need to change the prorata share of each asset allocated to the marital trust when there is a change in values on audit.

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§11.49 b. 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 trust 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 §11.21.
- **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 solely to the bypass trust or have depreciation solely borne by the marital gift, which would in either case reduce the estate tax on the death of the surviving spouse.
- **Conflicts of interest.** A trustee 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 §11.52.

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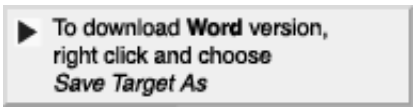
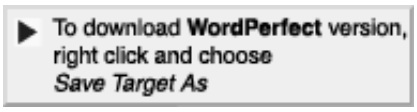
Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.50 c. Form: Power to Make Nonprorata Distribution

§11.50 c. Form: Power to Make Nonprorata Distribution





11.50-1 Power to make nonprorata distribution

***Nonprorata Distributions*. 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 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 appropriate to accommodate such distributions.**

Comment: Form 11.50-1 authorizes nonprorata funding of distributions. Even without this clause, Prob C §16246 authorizes nonprorata funding.

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VI. SELECTING FORMULA AND FUNDING OPTIONS

§11.51 A. Selection Considerations

In advising settlors about which formula and funding option to choose, the attorney should analyze the nature and value of the assets, the personalities of the settlors and beneficiaries, and the tax goals to be achieved through the estate plan. Balancing the interests of the settlors' family or families may be difficult, especially for extended families with antagonistic members, but the settlors' 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 on funding;
- Allocation and possible acceleration 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 (DNI; 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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§11.52 B. Conflicts in Funding

In many of the formula clauses, the trustee has the discretion to allocate various assets entirely to one trust to the exclusion of the other. Because each trust may have different beneficiaries (either current or remainder), exercising this discretion can have significant effects. The trustee is placed in a position of conflict between the beneficiaries of each trust in allocating assets of the trust. When a trustee is also a beneficiary, he or she may ultimately decide on an allocation that is personally beneficial. Language either absolving the trustee of liability in making funding decisions or giving the trustee guidance is therefore recommended in the administrative provisions of the trust instrument.

In some cases, such as when a marital pecuniary formula with minimum worth funding is used, the trustee's exercise of discretion will affect even the date-of-distribution value of the property passing to the residual bypass trust. In effect, the trustee has the power to manipulate the values of the marital trust and the bypass trust. This is also true when the trustee 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 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 IRD is accelerated when used to satisfy a pecuniary gift, the residual gift will be decreased by the tax attributable to IRD.)

If, however, the surviving spouse is the income beneficiary of both the marital trust and the bypass trust, and the deceased spouse's share of the trust contains sufficient other property to fully fund a 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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§11.53 C. Timing of Distributions

Unlike the external constraints and delays imposed on the funding process when there is a court-supervised probate proceeding, the preliminary allocations from a revocable trust can frequently be accomplished shortly after the deceased spouse's death and without the need to obtain the approval of any other party, such as a judge. Prompt funding may alleviate issues relating to recognition of gain, allocation of income, and fairness to the various beneficiaries.

Even when there is no probate proceeding, however, California creditor laws and the federal tax laws may cause delays in making allocations. Determining the values of the deceased spouse's assets, filing a federal estate tax return, and paying any estate taxes due must still be done. Because IRC §6324 makes a trustee in possession of property included in the deceased spouse's gross estate personally liable for any estate taxes due but not paid, a trustee will often want to delay distribution until an estate tax closing letter has been received from the Internal Revenue Service, especially when allocations will cause the trustee to lose control over property (*i.e.,* when property goes outright to another beneficiary rather than to the bypass trust or outright to the trustee in his or her capacity as a beneficiary).

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VII. DECEASED SPOUSE'S ESTATE TAXES AND OTHER EXPENSES PAYABLE

§11.54 A. Equitable Tax Allocation

In drafting the revocable trust tax allocation clause, the drafter should bear in mind how much of the settlors' property is to be held in the trust. Because typically all or most of the settlors' property is held in the trust, form 11.57-1 assumes that this is so. If only a small portion of the decedent's property is held in the trust, it would be inequitable to force the trust beneficiaries to bear the burden of all death taxes and expenses and allow the residue of the probate estate to pass tax free to the other beneficiaries.

Because of the marital deduction (see chap 9), substantial estate taxes are often payable only on the surviving spouse's death. Therefore, the drafter must focus on the tax burden on the surviving spouse's death, particularly the relationship between estate taxes and expenses attributable to the surviving spouse's own estate and those attributable to the property that qualified for the marital deduction and that is taxable in the surviving spouse's estate. Tax allocation is especially important if the two spouses have different beneficiaries, because payment of taxes from the surviving spouse's own estate (*e.g.,* from his or her survivor's trust or probate estate) benefits the deceased spouse's beneficiaries to the detriment of the surviving spouse's beneficiaries. See *Estate of Armstrong* (1961) 56 C2d 796, 17 CR 138.

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§11.55 B. Trust From Which Taxes and Expenses Should Be Payable

The payment of the deceased spouse's taxes, if any, should be charged to the bypass trust and expenses should be charged to the bypass trust to the extent that the marital deduction regulations provide that charging expenses to the marital trust reduces the allowable marital deduction. The importance of not using a contrary provision is illustrated by Rev Rul 79-14, 1979-1 Cum Bull 309, in which the trustee was directed to pay death taxes from the nonmarital trust but had discretion to pay them from the trust intended to qualify for the marital deduction. The Internal Revenue Service ruled that the marital deduction would be reduced by taxes that could have been paid from the marital share, even though all were in fact paid from the nonmarital share.

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§11.56 C. Avoiding General Power of Appointment Over Surviving Spouse's Share of Community Property

The direction to pay the decedent's debts, expenses, and taxes must be carefully drafted to avoid any estate or gift tax problems. If the trust instrument requires that debts, expenses, and death taxes that are properly chargeable against the deceased spouse's community share be charged to both the deceased spouse's and the surviving spouse's share, the deceased spouse might be considered to have a general power of appointment over the surviving spouse's share of the community property. In addition, an excess allocation made against the survivor's trust may constitute a gift by the survivor to beneficiaries of the bypass trust. See §§4.91-4.93.

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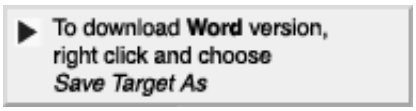
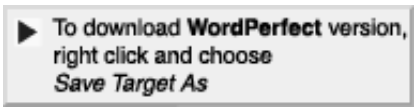
Source: Estate Planning/Drafting California Revocable Trusts/11 Marital Deduction Formulas and Funding/§11.57 D. Form: Deceased Spouse's Expenses

§11.57 D. Form: Deceased Spouse's Expenses





11.57-1 Deceased spouse's expenses

***Deceased Spouse's Expenses*. After the Deceased Settlor's death, the trustee may pay out of the trust property the Deceased Settlor's funeral expenses, last-illness expenses, debts, and the expenses of administration of the deceased settlor's probate estate. The burden of debt payments shall be allocated and charged to the separate and community property of each settlor under California Probate Code §§19320-19326, with no funeral or last-illness expenses being paid from the community property of the Surviving Settlor. The burden of any expenses of administration of the deceased settlor's probate estate shall be allocated and charged to property of the Deceased Settlor. Despite the foregoing, the trustee shall make no such payments from funds received from qualified retirement plans that are excludable, in whole or in part, from the Deceased Settlor's gross estate for federal estate tax purposes under the transition provisions applicable to the exclusions formerly provided under Internal Revenue Code §2039.**

Comment: This clause assumes that most, if not all, of the decedent's property is in the revocable living trust. The prohibition against the survivor's community property being used to pay funeral and last-illness expenses is found in Prob C §19326. The prohibition against using funds received from qualified plans is designed to protect the estate tax exclusions for such plans that may still be available if the deceased settlor was in a pay status before January 1, 1985. See Temp Treas Reg §20.2039-1T. The exclusion is generally not available if the plan benefits could be used for the benefit of the decedent's estate. The prohibition can be deleted if neither settlor has a retirement plan interest qualifying for the exclusion.

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12

Survivor's Trust

CEB Staff

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§12.1 I. QUALIFYING FOR MARITAL DEDUCTION

In a typical plan for a married couple's estate that may be subject to federal estate tax, the surviving spouse's separate property, half share of the community property, and half share of any quasi-community property are allocated to a "survivor's trust." A survivor's trust accomplishes the same purposes as a standard revocable trust for an unmarried person. It avoids probate on the survivor's death and provides a vehicle for managing property in the event of the survivor's loss of capacity. A survivor's trust will not necessarily qualify for the marital deduction, but good practice suggests that the trust should be drafted so that it does qualify if it will receive property from the first settlor to die (the "deceased spouse"). For marital deduction qualifying provisions, see §§12.2-12.3A. For introductory provisions, see §§12.4-12.9. For dispositive provisions, see §§12.10-12.19.

For decedents dying in 2010, provisions allowing disposition of trust property to third parties during the lifetime of the surviving spouse could make a deceased settlor's property passing to the survivor's trust ineligible for the additional $3 million basis increase for property passing to a surviving spouse under IRC §1022. Accordingly, practitioners should be cautious in using such provisions in a survivor's trust (including a survivor's power to appoint to others) until uncertainty about the application of the basis increase provisions is resolved, unless it is fairly certain that none of the deceased settlor's property will be allocated to the trust or the built-in gain on the deceased settlor's property will not exceed $1.3 million. See §4.60.

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Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.2 A. Required Provisions

§12.2 A. Required Provisions

A survivor's trust may qualify for the marital deduction under the general power-of-appointment trust exception to the terminable interest rule. See IRC §2056(b)(5), discussed in chap 11. Normally this is accomplished by giving the survivor an unlimited right to withdraw any or all trust property at any time and giving the survivor a power to appoint the property to anyone, including the survivor's estate, at death. An unrestricted power to amend the trust is sufficient to confer these rights. The ability to withdraw all of the property is sufficient to give the surviving spouse the qualified income interest for life that is required by IRC §2056(b)(5). Treas Reg §20.2056(b)-5(f)(6). The withdrawal power also provides the spouse with the required general power of appointment exercisable in all events. Because the spouse is *entitled* to all of the income by virtue of the revocation power, the trust need not provide for actual distribution of the income. Treas Reg §20.2056(b)-5(f)(8).

WARNING: The spouse's right to all income must continue until death even if he or she becomes incompetent, and there must be no provisions for third party transfers. It is easy to inadvertently destroy the right to all income, and thus lose the marital deduction, by providing that (1) the withdrawal right terminates if the surviving spouse becomes incompetent, or (2) the trustee can make distributions to or for someone other than the surviving spouse during the surviving spouse's lifetime. The drafter must not include trust provisions that might cause the revocation power to terminate before the surviving spouse's death. In particular, the instrument should not attempt to eliminate the possibility of revocation by a court-appointed conservator in the event of the survivor's incompetence. See *Estate of Dorothy M. Walsh* (1998) 110 TC 393.

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§12.3 B. Third Party Distribution Provisions

Although a survivor's trust may fail to qualify for the marital deduction if it provides for third party distributions in the event that the surviving spouse becomes incompetent (see §12.2), there may be many reasons for the settlors' inclusion of provisions for such distributions, including, *e.g.*, annual exclusion gifts, continuance of charitable giving, providing for a dependent child who stays home to take care of the incompetent spouse, or preservation and use of the family vacation home or the family box at the symphony or sports stadium. If the settlors wish to include third party distribution provisions in the survivor's trust to accommodate the possibility of the surviving spouse's becoming incompetent, there are three possible drafting solutions that will preserve the marital deduction:

(1) Give an attorney-in-fact the express power to exercise the surviving spouse's withdrawal power for the purpose of making the desired third party gifts;

(2) Provide for distribution to the spouse and then attempt to ensure that the spouse or his or her durable power holder makes a postdeath assignment of the distribution back to the trust; or

(3) Provide for a temporary split of the survivor's trust. The first survivor's trust is funded with the survivor's own property and authorizes third party gifts. The second survivor's trust does not authorize gifts, thereby qualifying for the marital deduction, and is funded with transfers from the deceased spouse. Immediately after the deceased spouse's death, the survivor can transfer the assets of the marital deduction qualifying trust to the survivor's trust. This approach minimizes the risk of needing a probate if the postdeath transfer contemplated in (2), above, is never accomplished.

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§12.3A C. No Marital Deduction for Domestic Partners

A jointly settled revocable trust for domestic partners may include both community and separate property because registered domestic partners have the same rights and obligations as spouses under California law. See Fam C §297.5. In a plan for an estate that may be subject to federal estate tax, the surviving partner's separate property and one-half share of community property may be allocated to a "survivor's trust." However, a survivor's trust for same-sex spouses or domestic partners treated as spouses under state law need not qualify for the marital deduction, because the estate tax marital deduction does not apply to same-sex spouses. See §4.41.

In most other respects, the remainder of this chapter applies equally to jointly settled revocable trusts for spouses and domestic partners.

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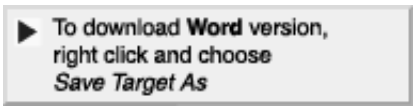
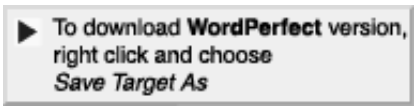
II. INTRODUCTORY PROVISIONS

§12.4 A. Form: Distribution to Survivor's Trust





12.4-1 Distribution to survivor's trust

***Distribution to Survivor's Trust*. The trustee shall distribute to the trustee of the Survivor's Trust the Surviving Settlor's separate property, one-half interest in community property, and any share of the separate property of the Deceased Settlor that the Surviving Settlor would be entitled to receive under the laws of the Deceased Settlor's domicile at death, including, if applicable, any share of quasi-community property or other forced share.**

Comment: If a settlor intends to make a forced election concerning quasi-community property, the language concerning quasi-community property or other forced-share property should be deleted and the terms for disposition of the property of the deceased settlor should expressly state that an election is being forced.

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§12.5 B. Purpose of Survivor's Trust

It may be useful to state the purpose of the Survivor's Trust. Although doing so is primarily for the clients' benefit, it could conceivably aid in the interpretation of the trust if future questions arise. See form in §12.6.

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Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.6 C. Form: Purpose of Survivor's Trust

§12.6 C. Form: Purpose of Survivor's Trust

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12.6-1 Purpose of survivor's trust

***Purpose of Survivor's Trust*. This trust is established to hold property that would belong to the Surviving Settlor following the death of the Deceased Settlor but for the provisions of this trust. It is established to provide for the care and maintenance of the Surviving Settlor, to facilitate management of the trust property in the event of the Surviving Settlor's incompetence, and to facilitate transfer of the trust property to beneficiaries chosen by the Surviving Settlor on the Surviving Settlor's death. The Surviving Settlor may revoke the Survivor's Trust with respect to any and all assets at any time as more particularly set forth in the Division of this document concerning Revocation, Amendment, and Exercise of Powers. In the event of such a revocation, the trustee shall deliver the trust property to the Surviving Settlor.**

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§12.7 D. Revocability of Survivor's Trust; Irrevocability of Bypass Trust and QTIP Trust

In the case of a typical survivor's trust, the surviving settlor is given the right to revoke or amend the survivor's trust at any time. See §12.2. The forms in this book include that provision in the portion of the document that more generally addresses issues of revocation and amendment. See the form in §20.3.

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Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.8 E. Marital Deduction Qualification If Third Party Distributions

§12.8 E. Marital Deduction Qualification If Third Party Distributions

A typical survivor's trust will not qualify for the marital deduction if the trust provides for distributions during the life of the surviving spouse that are not made to or for the benefit of the surviving spouse. IRC §2056(b)(5). See §12.3. In many cases it is important for the trustee to be able to make distributions to other persons—particularly in the event the survivor lacks capacity. It may be desirable to make gifts for tax reasons or provide for the support of another family member or provide for family members to use particular property in kind. The following form can be used in such cases. It essentially prohibits third party distributions from those assets passing from the deceased spouse until the surviving spouse effectively makes those assets her own by withdrawing them from a separate trust that keeps those assets isolated. It is contemplated that this withdrawal will be a mere paper transaction in which the surviving spouse directs the trustee to transfer the isolated assets to the regular survivor's trust. This cannot be done until after death. A durable power of attorney can be used to assure that this directive can be given if the surviving settlor then lacks capacity.

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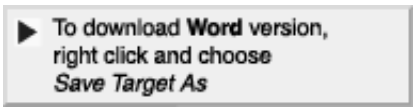
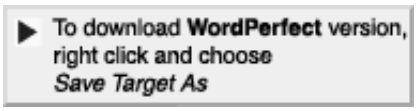
§12.9 F. Form: Marital Deduction Survivor's Trust





12.9-1 Marital deduction survivor's trust

***Marital Deduction Survivor's Trust*. If property included in the taxable estate of the Deceased Settlor passes to the Survivor's Trust by reason of the death of the Deceased Settlor, that property shall be held as a separate trust, called the Marital Deduction Survivor's Trust, to be administered and distributed in the same manner as the regular Survivor's Trust, except that during the lifetime of the Surviving Settlor, distributions may be made only to or for the benefit of the Surviving Settlor. It is contemplated but not required that the Surviving Settlor will eliminate the need for this separate trust after the death of the Deceased Settlor by directing that all assets of the Marital Deduction Survivor's Trust be distributed to the regular Survivor's Trust.**

Comment: This marital deduction survivor's trust clause is for use when the settlors wish to provide for distributions to third parties while still qualifying for the marital deduction. On use of this approach of temporarily splitting the survivor's trust in order to preserve the marital deduction when providing for distributions to third parties, see §§12.3, 12.8. For sample language to use in the survivor's trust that provides for third party distributions, see chap 6.

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III. DISPOSITIVE PROVISIONS

A. Payment of Principal and Income of Survivor's Trust

§12.10 1. No Negative Tax Consequences

Because the survivor's trust typically continues to be revocable, no negative tax consequences arise from the drafter's failure to use an ascertainable standard for distribution. See chap 7 on ascertainable and nonascertainable standards. Nevertheless, some practitioners use an ascertainable standard for the survivor's trust because of a general desire to minimize the presence of forms that might cause transfer tax problems in other contexts. If the survivor's trust will be the recipient of the marital gift, the survivor must have the right to all income during the survivor's lifetime in order to qualify for the marital deduction. It is not necessary to require the distribution of the income, but there cannot be any restriction on the survivor's right to demand it, and there cannot be any provisions for making distributions benefiting other persons during the survivor's lifetime. Treas Reg §20.2056(b)-5(f)(8). See chap 11.

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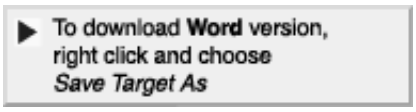
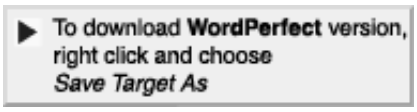
Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.11 2. Form: Payment of Income and Principal

§12.11 2. Form: Payment of Income and Principal





12.11-1 Distribution of income and principal

***Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the income and principal of the Survivor's Trust as the Surviving Settlor requests, plus such additional sums as the trustee, in the trustee's discretion, determines are appropriate for the Surviving Settlor's health, maintenance, support, or education.**

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B. General Power of Appointment

§12.12 1. Use of General Power of Appointment

Because the survivor's trust represents the survivor's own property, there is no tax reason for the survivor not to have a general power of appointment over it. Giving the settlor a power of appointment makes it possible for the settlor to unilaterally determine the disposition of the survivor's trust in a document executed while both settlors are still living. See chap 7. For a form conferring a power of appointment for tangible personal property, see chap 8.

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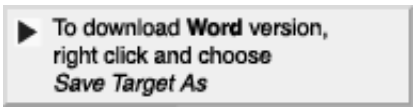
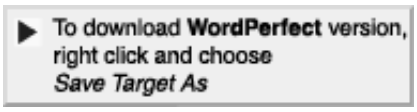
Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.13 2. Form: General Power of Appointment

§12.13 2. Form: General Power of Appointment





12.13-1 General power of appointment

***Distribution on Death—General Power of Appointment*. On the death of the Surviving Settlor, the trustee shall distribute the remaining trust property as the Surviving Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Surviving Settlor's estate.**

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C. Termination When Survivor Does Not Hold or Has Not Exercised Power of Appointment

§12.14 1. Pourover Into Bypass Trust

The survivor's trust must provide for the disposition of the trust property on the survivor's death. If the surviving spouse is given a general power of appointment, these provisions will apply to the extent the surviving spouse does not exercise the power. When consistent with the distribution objectives of the surviving spouse, it is sometimes desirable to provide that distribution will be made to the bypass trust. This can be particularly useful if the bypass trust contains lengthy provisions for future management of property in trust after the survivor's death and it is undesirable to create a separate duplicate trust. The approach of transferring all property to the bypass trust and using it as the only trust with distribution provisions usually should *not* be used in any case in which it is important to know which spouse's property is intended to fund a particular gift. If, for example, there is to be a gift to charity on the survivor's death, placing the provision for the gift in the bypass trust will result in the survivor's estate not being able to claim the charitable deduction that would have been available if the gift had been made from the survivor's trust. Similarly, when the settlors have children from multiple marriages, it is generally not appropriate to create a bypass trust benefiting all children of each of them, while at the same time leaving the survivor free to divert the survivor's trust to only the survivor's children.

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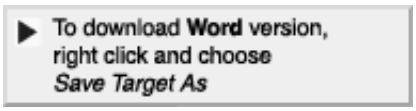
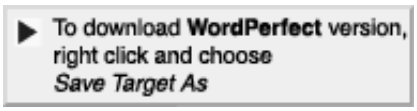
Source: Estate Planning/Drafting California Revocable Trusts/12 Survivor's Trust/§12.15 2. Form: Pourover Into Bypass Trust

§12.15 2. Form: Pourover Into Bypass Trust





12.15-1 Pourover into bypass trust

***Distribution on Death—Property Not Appointed*. Any trust property not effectively appointed by the Surviving Settlor under the preceding paragraph shall be distributed to the trustee of the Bypass Trust.**

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§12.16 3. Separate Dispositive Clauses for QTIP Trust and Survivor's Trust

If the husband and wife have different natural objects of their bounty (*e.g.,* if each have children from a prior marriage), they might prefer to have only the QTIP trust pour over into the bypass trust after the surviving spouse's death (because both such trusts contain only the deceased spouse's property), with different dispositive clauses governing the survivor's trust afterwards. In this situation, the unappointed property in the survivor's trust will pass to the surviving spouse's beneficiaries or to a new trust for such beneficiaries, while the marital trust and bypass trust are combined and held for or distributed to the deceased spouse's beneficiaries.

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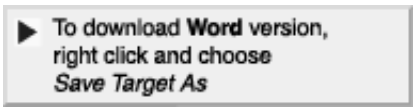
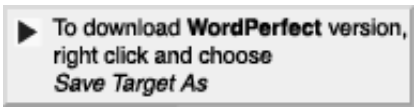
§12.17 4. Form: Specified Distribution of Survivor's Trust





12.17-1 Specified distribution of survivor's trust

***Distribution on Death—Property Not Appointed*. On the death of the Surviving Settlor, any property not effectively appointed by the Surviving Settlor shall be distributed as follows:** _ _[*Specify*]_ _.

Comment: Terminating distributions are discussed in chap 8. Among the possibilities are outright gifts to named beneficiaries or an outright class gift to, *e.g.,* children, some of which may be retained in trust until the beneficiaries reach a certain age. See §8.30.

Other possibilities include a residuary gift to a family pot trust (see §12.18) or to separate trusts for individual beneficiaries (see §12.19). See also discussion of special needs trusts in chap 7.

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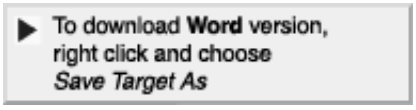
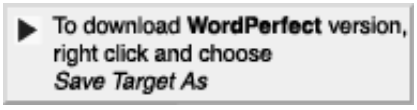
§12.18 5. Form: Distribution to Family Pot Trust





12.18-1 Distribution to family pot trust

***Distribution on Death—Property Not Appointed*. Any trust property not effectively appointed by the Surviving Settlor under the preceding paragraph shall be retained in a separate trust for the benefit of the Surviving Settlor's issue and their spouses. The separate trust shall be administered as follows:**

1. *Name of Trust*. The trust created by this paragraph may be referred to as _ _[*e.g., The John and Mary 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 the settlors' 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 the settlors' 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 the settlors living at the death of the Surviving Settlor are deceased. On termination, the trust estate shall be distributed to the then-living issue of the settlors, per capita at each generation.

5. *Distribution to Charity if No Issue*. If at any time before full distribution of the trust estate all the settlors' issue are deceased and no other disposition of the property is directed by this instrument, 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 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 paragraph.

Comment: This form may be used as an alternative to outright gifts on the death of the surviving settlor. See discussion in §8.30A.

The form also can be included in the bypass trust if the survivor's trust will pour over into the bypass trust. See §§12.15, 14.27.

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§12.19 6. Form: Distribution to Separate Trusts for Children or Grandchildren

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12.19-1 Distribution to separate trusts for children or grandchildren

***Distribution on Death—Property Not Appointed*. Any trust property not effectively appointed by the Surviving Settlor under the preceding paragraph shall be retained in separate trusts for the benefit of the Surviving Settlor's _ _[*e.g., grandchildren*]_ _. The separate trusts shall be administered as follows:**

1. *Name of Trusts*. The trusts created by this paragraph may be referred to collectively as the _ _[*e.g., The John and Mary Doe Grandchildren Trusts*]_ _. Each separate trust established under this paragraph may be referred to by adding the name of its beneficiary to that name.

2. *Additions to Trust*. Other property acceptable to the trustee may be added to any trust created by this instrument by any person. Any transfer to the trustee that does not specify a different allocation shall be allocated in equal shares among the trusts then being administered under this agreement for the benefit of their original beneficiaries.

3. *Discretionary Distributions*. As long as the original trust beneficiary is under age 21, the trustee shall pay to or apply for the beneficiary's benefit as much of the net income and principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers appropriate for the beneficiary's support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee. Any income not distributed shall be accumulated and added to principal. Income or principal of the beneficiary's trust shall not, however, be used to discharge in whole or in part any person's legal obligation to support the beneficiary.

4. *Distribution of Income*. After a beneficiary has attained age 21, the trustee shall pay to or apply for the benefit of the beneficiary the entire net income of the beneficiary's trust, quarterly or at more frequent intervals. In addition, the trustee shall pay to or apply for the benefit of the beneficiary as much of the principal of the beneficiary's trust as the trustee, at the trustee's discretion, considers appropriate for the beneficiary's support, health, maintenance, and education, after taking into consideration to the extent the trustee considers advisable any of the beneficiary's other income or resources known to the trustee.

5. *Distribution of Principal*. When the beneficiary attains age _ _[*25/30/35*]_ _, the trustee shall distribute to the beneficiary _ _[*e.g., one-half*]_ _ of the principal of the beneficiary's trust as then constituted. When the beneficiary attains age _ _[*30/35/40*]_ _, the trustee shall distribute to the beneficiary the undistributed balance of his or her trust.

6. *Beneficiary's Power of Appointment*. If a beneficiary dies before becoming entitled to receive distribution of his or her entire trust, the trustee shall distribute the entire balance then remaining, if any, of the beneficiary's trust to the one or more persons and entities, including the beneficiary's estate, on terms and conditions (either outright or in trust) appointed by the beneficiary in a will or codicil specifically referring to and exercising this power of appointment. In the event this power is not exercised, the remaining trust estate shall be distributed, free of trust, to the beneficiary's then-living issue per capita at each generation. If there are no issue, the trust estate shall be distributed to the settlors' then-living issue per capita at each generation. However, if any part of the balance to be distributed would otherwise be distributed to a person for whose benefit a trust is then being administered under this instrument, that part shall instead be added to that trust and shall thereafter be administered according to its terms, except that any addition to a partially distributed trust shall augment proportionally the distributed and undistributed portions of that trust.

7. *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 the 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 paragraph.

Comment: This form may be used as an alternative to outright gifts on the death of the surviving settlor. See discussion in §8.30B.

The form also can be included in the bypass trust if the survivor's trust will pour over into the bypass trust. See §§12.15, 14.27.

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13

QTIPs and QDOTs

Marc M. Stern

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I. QTIP TRUSTS

§13.1 A. Uses of QTIP Trust

As noted in chap 9, the qualified terminable interest property (QTIP) trust is widely used in estate planning because it is the only form of marital deduction transfer that gives the first spouse to die control over the disposition of the trust property after the death of the surviving spouse. In addition, the balance remaining in a QTIP trust on the death of the surviving spouse is not subject to probate administration or to the claims of the surviving spouse's creditors.

A QTIP trust can be especially effective in generation-skipping transfer (GST) tax planning. By using GST-exempt and GST-non-exempt QTIP trusts and a "reverse QTIP election," a QTIP trust can be employed to use a deceased settlor's remaining GST exemption following allocation of GST exemption to the bypass trust. See chap 4.

The introductory portion of the QTIP trust should state the purpose of the trust, and the trust's relation to the election specified in IRC §2056(b)(7)(B). For a discussion of this election, see chap 4.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.2 B. Form: QTIP Trust Purpose

§13.2 B. Form: QTIP Trust Purpose

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13.2-1 QTIP trust purpose

Purpose of QTIP Trust. **The property of the QTIP trust shall be held and administered as provided in this Division. This trust is intended to qualify for the federal estate tax marital deduction to the extent that an Internal Revenue Code §2056(b)(7)(B) election is made for that purpose.**

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.3 C. Qualifying-Income-Interest-for-Life Requirement

§13.3 C. Qualifying-Income-Interest-for-Life Requirement

To obtain a marital deduction for a qualified terminable interest property (QTIP) trust, the trust must satisfy the specific requirements of IRC §2056(b)(7). This statute includes the requirement that the surviving spouse have a qualifying income interest for life, defined as follows (IRC §2056(b)(7)(B)(ii)):

> (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has an interest for life in the property, and
>
> (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.
>
> Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

Thus, to obtain the deduction, the QTIP trust must satisfy two requirements:

(1) All trust income must be paid to the spouse at least annually; and

(2) There must be no circumstances under which property can be appointed by anyone to any person other than the surviving spouse during the surviving spouse's lifetime.

Even the spouse cannot hold a power to distribute to others.

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§13.4 1. What Constitutes Requisite Income Interest

The determination of whether the spouse has the required income interest is made by applying the principles of Treas Reg §20.2056(b)-5(f). This regulation addresses IRC §2056(b)(5) requirements for qualifying a trust for the marital deduction by giving the spouse all income for life combined with a general power of appointment.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.5 a. Degree of Enjoyment

§13.5 a. Degree of Enjoyment

The required income interest for a QTIP trust is present if the trust document as a whole gives the surviving spouse "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." Treas Reg §20.2056(b)-5(f)(1). This requirement is strictly construed. In *Davis v Commissioner* (9th Cir 2005) 394 F3d 1294, for example, the court held that no marital deduction was allowed for a residuary trust giving the spouse a discretionary income interest based on "health, education, or support, maintenance, comfort and welfare" in accordance with her accustomed standard of living. The required income interest may be satisfied by a unitrust interest. See §13.5A.

The trust document will not satisfy this requirement if "the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment." Treas Reg §20.2056(b)-5(f)(5). On the spouse's power to compel the trustee to make trust property productive of income, see §13.5B.

Because of these limitations, investment power clauses and clauses specifying the determination of income and principal should be reasonably restricted so that they do not evidence "the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute." Treas Reg §20.2056(b)-5(f)(4). Among the powers that, if subject to reasonable limitations, will not disqualify the interest passing in trust are the power to:

- Determine the allocation or apportionment of receipts and disbursements between income and corpus;
- Apply the income or corpus for the spouse's benefit;
- Retain the assets passing to the trust, subject to the requirement of prudence in the exercise of these powers; and
- Retain a residence or other property for the spouse's personal use (see Treas Reg §20.2056(b)-5(f)(4)).

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.5A (1) Qualifying Unitrust Interest

§13.5A (1) 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 settlor a 4-percent interest unless the survivor and the remainder beneficiaries agree to provide a different amount, but a drafted unitrust can give the survivor a greater or lesser unitrust interest. For QTIP trusts funded with equity securities, the converted unitrust will often pay the survivor a larger amount than trust accounting income. Comparable results in terms of support can be achieved by giving the survivor a "5 or 5" withdrawal power (see §§7.90-7.92) in addition to an income interest, but a unitrust interest may be easier for the survivor 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.

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 survivor 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 survivor's right to use trust property in kind—property that cannot be appointed to anyone other than the survivor—combined with the survivor'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 survivor 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. Since 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 survivor a unitrust interest, see form 13.14A-1.

CAUTION: In a converted unitrust, the spouse presumably retains the income interest provided by the converted trust in the residential property and tangible personal property excluded from the unitrust calculation. While the form provision in §13.14A is intended to give the spouse an equivalent interest in the property, cautious practitioners may wish to use a separate QTIP trust with a traditional income interest for residential property and tangible personal property until there is further guidance from the IRS.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.5B (2) Power to Compel Trustee to Make Trust Property Productive of Income

§13.5B (2) Power to Compel Trustee to Make Trust Property Productive of Income

The trustee's power to retain non-income-producing property may also interfere with the surviving spouse's right to the beneficial enjoyment of all the income. Treasury Regulation §20.2056(b)-5(f)(4) indicates, however, that a trustee's power to hold unproductive property will not disqualify the trust if the surviving spouse is permitted to require that the trustee make the property productive or convert it within a reasonable time. Qualified terminable interest property trusts should always include such a provision. In IRS Letter Ruling 200339003, the IRS ruled that the spouse's power to compel the trustee to convert trust assets into productive assets qualified closely held corporation stock for the marital deduction, even though the stock had never paid dividends. Note, however, that the important provision giving the spouse power to compel the trustee to convert the trust assets to productive assets will not be sufficient to ensure marital deduction qualification if stockholder agreements or other arrangements effectively deprive the trustee of the power to comply with the spouse's demand.

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§13.6 b. Payable at Least Annually

To qualify as a required income interest, income from the trust must be "payable annually or at more frequent intervals." IRC §2056(b)(7)(B)(ii)(I). This regulation may be satisfied merely by giving the spouse the right to withdraw income annually and by allowing the trustee to add the income to principal if the power is not exercised. Treas Reg §20.2056(b)-5(f)(8).

WARNING: This option should not be used for QTIP trusts. If the surviving spouse does not have a power of appointment over the remainder, the spouse's failure to withdraw income from the trust may result in a gift to the trust, depending on the amount of the income and whether it exceeds the $5000 threshold applicable to releases of general powers of appointment under IRC §2514. This may necessitate paying gift taxes (or at a minimum filing a gift tax return), valuing the gift under the special valuation rules of IRC §2702, and separately accounting for a share of a trust that has become a grantor retained income trust rather than a true QTIP trust.

The actual tax impact of these consequences may be minimal. Problems may be avoided by having the trustee maintain a separate account for accumulated income and having the spouse retain a withdrawal power over the account so that no completed gift occurs. It is usually preferable, however, to avoid these issues. If the settlors wish, the income can be paid to a survivor's trust that gives the surviving spouse the unrestricted right to withdraw all trust assets during the survivor's lifetime.

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§13.7 c. Distributions "for the Benefit" of Spouse

To qualify as a required income interest for marital deduction purposes, all income must be paid to the surviving spouse. IRC §2056(b)(7)(B)(ii)(I). This requirement is not violated by an administrative clause allowing the trustee to "apply the income or corpus to or for the benefit of the spouse." Treas Reg §20.2056(b)-5(f)(4). The qualifying alternative language "pay to or apply for the benefit of" is used in form 13.14-1 (QTIP trust income provision). The same language may be used in a clause providing for payment of a unitrust amount between 3 and 5 percent instead of trust accounting income as provided by Prob C §16328 and the definition of "income" in Treas Reg §1.643(b)-1. See §13.14A.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.8 d. Income Unpaid at Death

§13.8 d. Income Unpaid at Death

An income interest will not fail to qualify as an income interest for life "solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse." Treas Reg §20.2056(b)-7(d)(4).

PRACTICE TIP: As permitted by this provision, the QTIP trust should normally provide that the income earned between the last distribution date and the date of death will not be paid to the surviving spouse's estate, because such a distribution would usually be inconsistent with the purposes of a QTIP trust. The trust terms applicable to trust distributions after the spouse's death should be examined to ensure that it will be possible to distribute this income rather than accumulate it if accumulation would be subject to onerous tax brackets for trust income. See IRC §1(e).

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.9 e. Income From Specific Portion of Trust

§13.9 e. Income From Specific Portion of Trust

For QTIP purposes, a "specific portion" of property is treated as separate property. IRC §2056(b)(7)(B)(iv). Therefore, a deduction may be claimed for the transfer of a specific portion of property. The term "specific portion" includes only a portion determined on a fractional or percentage basis. IRC §2056(b)(10). A fractional or percentage share is one that reflects increases or decreases in value of the property as a whole. Treas Reg §20.2056(b)-5(c)(2).

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.10 f. No Contingent Continuation of Income Interest

§13.10 f. No Contingent Continuation of Income Interest

The required income interest for QTIP purposes cannot be subject to termination on the occurrence of some event other than the death of the surviving spouse. In particular, the interest cannot be subject to termination in the event of remarriage. Treas Reg §20.2056(b)-7(d)(3).

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§13.11 g. Income Interest May Be Contingent on QTIP Election

A qualifying income interest for QTIP purposes may be contingent if the *only* contingency is the executor's QTIP 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).

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 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 in order to generate a large IRC §2013 credit for tax on prior transfers when the tax is computed on the survivor's estate. See §9.29.

Second, if the income interest is contingent on the executor's election and the spouse is the executor, it is arguable that the spouse makes a gift of the income interest if the spouse does not make the election.

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2. No Appointment of Property to Persons Other Than Spouse

§13.12 a. Prohibition Against Third Party Distributions

To qualify as an income interest for life for QTIP purposes, no person may have a power to appoint any part of the property to anyone other than the surviving spouse during the spouse's lifetime. IRC §2056(b)(7)(B)(ii)(II). This rule is a necessary corollary of the rule that all income must be paid to the spouse. See IRC §2056(b)(7)(B)(ii)(I). A distribution of income to a third person would directly violate the rule, and a distribution of corpus would deprive the spouse of the future income from that corpus. Aside from logical consistency, the prohibition against distributions to persons other than the spouse supposedly ensures that no property can be removed from the trust in a way that might result in avoidance of estate or gift taxes. Even the spouse is prohibited from holding the prohibited power. See IRS Letter Ruling 200919003.

The rule prohibiting appointment of property to a person other than the spouse is not violated, however, by a provision permitting the trustee to apply trust principal for the spouse's benefit. Treas Reg §20.2056(b)-7(d)(6).

The statute permits granting appointment powers exercisable only on or after the surviving spouse's death. See IRC §2056(b)(7)(B)(ii). Depending on the clients' wishes, the surviving spouse may be given a limited power to appoint property among a defined class of remainder beneficiaries, *e.g.,* the issue of the marriage or anyone except the surviving spouse, his or her estate, his or her creditors, or the estate's creditors. See form in §13.19.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.13 b. Consequences of Distribution by Surviving Spouse

§13.13 b. Consequences of Distribution by Surviving Spouse

If the surviving spouse makes an inter vivos transfer of all or any part of his or her right to income, he or she is deemed to make a transfer of the entire trust, reduced by the value of any portion of the income interest retained after the gift that is a "qualified interest." IRC §§2511, 2519, 2702; Treas Reg §25.2519-1(a), (g), Examples (4)-(5). A tax under IRC §2519 is imposed on the value of the QTIP assets, less the value of the income interest, which is taxable under IRC §2511. To offset the imposition of the gift tax, the QTIP assets are no longer taxable in the surviving spouse's estate. IRC §2044(b).

If the entire income interest is transferred, the result is not inequitable. The transferees are liable for the gift tax, and the gift tax paid by the transferees is consideration for the transfer that reduces the amount of the gift. IRC §2207A(b); Treas Reg §25.2519-1(c)(4). 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 and remainder interests computed separately under IRC §7520 because transferees were to pay gift tax attributable to the remainder but not the income interest). If the surviving spouse had made a qualified disclaimer, the QTIP trust assets would have been subject to estate tax in the decedent's estate. 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)(1). See IRS Letter Ruling 200230017. 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).

The gift will trigger a deemed gift of the entire remainder interest even if the spouse retains a portion of the income interest. IRC §2519. As a consequence, the total gift is the value of the trust reduced by the value of any retained income interest. If a portion of the income interest is retained by the surviving spouse, an equivalent portion will be included in the survivor's estate under IRC §2036. This does not result in double taxation of the §2036 portion because gifts of property later included in the estate are ignored when computing the estate tax. IRC §2001(b). However, the deemed gift uses up the survivor'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 survivor's estate. This may unfairly benefit the remainder beneficiaries of the QTIP. Furthermore, if the remainder beneficiaries are the spouse's children, the gift of a portion of the income interest will trigger a gift equal in value to the entire trust estate because the retained income interest will be valued at zero under the special valuation rules in IRC §2702. Treas Reg §25.2519-1(g), Examples (4)-(5). The impact of IRC §2519 can be further mitigated in these cases by dividing the QTIP trust into multiple trusts before assigning the income interest in one of them. See IRS Letter Rulings 200530014, 200250033, 200137022, and 200044034.

EXAMPLE: On the decedent's death, an $11 million joint revocable trust is divided into a $3.5 million bypass trust, a $2 million QTIP trust, and a $5.5 million survivor's trust. The survivor 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 survivor's death, the second QTIP trust is included in the survivor's estate. In the meantime, both QTIP trusts and the survivor's trust have doubled in value. The survivor's gross estate is $13 million ($11 million survivor's trust plus $2 million QTIP trust) and the survivor's taxable estate is $10,500,000 after application of the $2,500,000 remaining unused applicable exclusion amount to the survivor's trust. After payment of $4,725,000 in estate taxes ($3,825,000 paid by the estate and $900,000 paid by the QTIP beneficiaries, assuming the estate tax rate is 45 percent), the QTIP beneficiaries receive $3,100,000 and the survivor's beneficiaries receive $7,175,000, for a total of $10,275,000. If the gift of the QTIP income interest were not made, the survivor's gross estate would be $15 million ($4 million QTIP trust plus $11

million survivor's trust) and the survivor's taxable estate would be $11,500,000. After estate taxes of $5,175,000 ($3,375,000 paid by the estate and $1,800,000 paid by the QTIP beneficiaries), the QTIP beneficiaries would receive $2,200,000 and the survivor's beneficiaries would receive $7,625,000, for a total of $9,825,000.

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 $450,000 in estate tax on $1 million of appreciation. Note, however, that the amount received by the survivor's beneficiaries is reduced. This may be important if the survivor's beneficiaries and the QTIP beneficiaries are not the same.

In IRS Letter Ruling 200324023, the division of a QTIP trust and renunciation of the spouse's interest in one of the shares caused that share to become a charitable remainder unitrust under the terms of the QTIP remainder, resulting in a gift by the spouse that qualified for a gift tax charitable deduction. If the survivor purchases the QTIP remainder interest, the survivor is deemed to make a gift equal to the greater of the value of the remainder or the amount of consideration paid. Rev Rul 98-8, 1998-1 Cum Bull 541.

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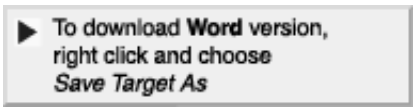
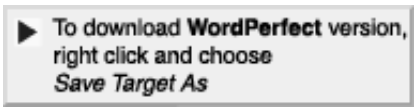
Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.14 3. Form: QTIP Trust Income Provision

§13.14 3. Form: QTIP Trust Income Provision





13.14-1 Income to surviving settlor for life; traditional income interest

Income to Surviving Settlor for Life. **During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor the entire net income of the QTIP 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 the Surviving Settlor. Despite the foregoing, trust income earned between the last distribution date and the date of the Surviving Settlor's death shall not be distributed to the Surviving Settlor or the Surviving Settlor'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 the Surviving Settlor. Regardless of any other provision of the trust, the Surviving Settlor shall have the power to require that the trustee make unproductive property productive or convert it to productive property within a reasonable time.**

Comment: For discussion of QTIP trust income requirements, see §§13.2-13.10. Under Treas Reg §20.2056(b)-7(d)(4): "An income interest does not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse."

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.14A 4. Form: QTIP Unitrust Provision

§13.14A 4. Form: QTIP Unitrust Provision

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13.14A-1 Income to surviving settlor for life: unitrust amount

Income to Surviving Settlor for Life. **During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor 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 QTIP 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 the Surviving Settlor, 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. _ _**[*The Surviving Settlor 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 the Surviving Settlor's death shall not be distributed to the Surviving Settlor or the Surviving Settlor'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 the Surviving Settlor. No person shall have the power to appoint any part of the trust property to any person other than the Surviving Settlor. This provision is intended to satisfy the right of the Surviving Settlor 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 the Surviving Settlor in quarter-annual or more frequent installments the entire net income of the QTIP 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: This form provides a unitrust alternative to the traditional income interest provided by form 13.14-1. The form is intended to satisfy the unitrust requirements for a qualifying income interest for life discussed in §13.5.

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 settlor 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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D. Distribution of Principal

§13.15 1. Distribution of Principal to Surviving Spouse Permitted

A qualified terminable interest property (QTIP) trust may contain clauses for distributing principal to the surviving spouse (but no one else) during the surviving spouse's lifetime. See IRC §2056(b)(7)(B)(ii)(II). Thus, the trustee may be authorized to make discretionary distributions to the spouse.

PRACTICE TIP: The drafter should avoid unrestricted principal distribution clauses that may supply more funds to the surviving spouse than is necessary for consumption, thereby undermining the typical nontax objective of ensuring that the QTIP remainder passes to the persons chosen by the deceased settlor. For this reason, as well as to avoid giving an inadvertent general power of appointment to a surviving spouse trustee, the drafter should limit withdrawal powers by an ascertainable standard. See form 13.17-1.

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§13.16 2. Avoiding General Powers of Appointment

The QTIP requirements expressly forbid giving anyone the power to appoint qualified terminable interest property to anyone other than the surviving spouse during the surviving spouse's lifetime. See IRC §2056(b)(7)(B)(ii)(II). There is no restriction against permitting distributions of principal to the spouse during the spouse's lifetime, however, and there are no prohibitions on distributions after the spouse's death. Nevertheless, it is important to ensure that any such provisions do not result in the surviving spouse's having a general power of appointment over the QTIP trust either during life or on his or her death for the following reasons:

- Under a QTIP trust, the executor has the option of deciding against a QTIP election in whole or in part, thereby avoiding inclusion of all or part of the trust in the surviving spouse's estate. This advantage is lost if the trust must be included in the survivor's estate under IRC §2041 as a result of the survivor's general power of appointment.
- For generation-skipping transfer (GST) tax purposes, IRC §2652(a)(3) permits a "reverse QTIP" election under which QTIP trust property is not treated as transferred by the surviving spouse. This benefit is probably lost if the trust is included in the survivor's estate under IRC §2041. On reverse QTIP elections, see chap 4.
- Inclusion of the trust in the surviving spouse's estate under both IRC §2041 (property subject to a general power of appointment) and IRC §2044 (QTIP) may raise questions about the applicability of IRC §2207A rules of tax recovery, which apply to property included under §2044 but do not apply to property included under §2041. Accordingly, form 13.17-1 is properly limited by an ascertainable standard. See Reg §20.2041-1(c)(2).

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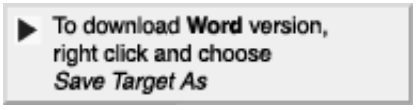
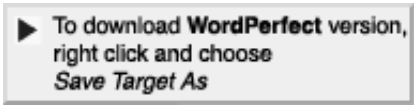
§13.17 3. Form: Discretionary Distribution of Trust Principal to Spouse





13.17-1 Distribution of trust principal: ascertainable standard

Distribution of Trust Principal. **If the trustee considers the _ _**[*net income/unitrust amount/net income or unitrust amount*]**_ _ to be insufficient for such purposes, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the principal of the trust property as the trustee considers appropriate for the Surviving Settlor's health, support, maintenance, and education in accordance with the Surviving Settlor's standard of living on the death of the Deceased Settlor. In exercising this discretion, the trustee may take into consideration other income or resources of the Surviving Settlor held free of this trust.**

Comment: This clause limits the trustee's discretion by an ascertainable standard, meeting the requirements of Reg §20.2041-1(c)(2). Accordingly, the clause may be used even when the surviving spouse is the trustee, without giving the surviving spouse a general power of appointment. For a discussion of alternative provisions concerning the consideration of other resources, see chap 7.

If the bypass trust also permits discretionary distributions to the spouse, the invasion-of-principal provisions should be coordinated, which can usually be accomplished by inclusion of suitable clauses in the bypass trust.

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E. Termination of QTIP Trust

§13.18 1. When Surviving Spouse Holds Limited Power of Appointment

As discussed in §13.16, the surviving spouse should not be given a general power of appointment over a QTIP trust, because such a power could frustrate both the tax and nontax objectives of the trust. The surviving spouse may still be given a limited power of appointment (also referred to as a special power of appointment) over the trust remainder, however. Such a limited power excludes the surviving spouse or the estate of the surviving spouse as appointees. Accordingly, the power does not cause the property to be included in the surviving settlor's estate under IRC §2041.

The limited power of appointment may allow the surviving spouse to make adjustments for events that occur after the deceased spouse's death. Although increased flexibility is often beneficial in theory, giving the surviving spouse a limited power of appointment allows the surviving spouse to direct the distribution of the QTIP on his or her death in a manner that could be contrary to the deceased spouse's desires.

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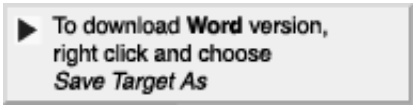
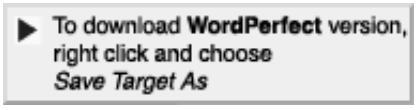
Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.19 2. Form: Limited Power of Appointment Exercisable at Death

§13.19 2. Form: Limited Power of Appointment Exercisable at Death





13.19-1 Limited power of appointment

[*Use one of the following alternatives*]

[*Alternative 1: Power of appointment limited by class*]

Distribution on Death—Limited Power of Appointment. **On the death of the Surviving Settlor, the trustee shall distribute any remaining balance of the QTIP trust property to _ _**[*specify class of beneficiaries, e.g., one or more of the settlors' issue and their spouses, including widows and widowers*]**_ _ on any terms and conditions, either outright or in trust, and in any proportion that the Surviving Settlor shall appoint in accordance with the provisions of this document for exercising a power of appointment.**

[*Alternative 2: Limited power of appointment (broadest type)*]

Distribution on Death—Limited Power of Appointment. **On the death of the Surviving Settlor, the trustee shall distribute any remaining balance of the QTIP trust to any persons or entities other than the Surviving Settlor, his or her estate, his or her creditors, and the creditors of his or her estate, on any terms and conditions, either outright or in trust, and in any proportion that the Surviving Settlor shall appoint in accordance with the provisions of this document for exercising a power of appointment.**

Comment: Because the permissible appointees do not include the surviving spouse's estate or its creditors, the power to appoint the trust remainder is a special power of appointment rather than a general power of appointment. See §13.16.

Some practitioners do not limit the document that can exercise the appointment power to wills only, and some require that any document exercising the power be delivered to the trustee during the surviving spouse's lifetime.

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§13.20 3. Termination When Surviving Spouse Does Not Hold or Has Not Exercised Power of Appointment

If the surviving spouse's power of appointment has not been exercised before his or her death, the survivor's trust and the QTIP (or other form of marital trust, except an estate trust) may pour over into the bypass trust, thus eliminating the requirement of three sets of dispositive clauses following the surviving spouse's death. For discussion of and form for pouring over assets of the survivor's, marital, or disclaimer trusts into the bypass trust, see chap 12.

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§13.21 F. Form: Marital Deduction Savings Clause

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13.21-1 Marital deduction savings clause

Satisfaction of Marital Deduction Distributions. **When distributing the Deceased Settlor's property due to the Deceased Settlor's death, the trustee, to the extent possible, shall use property qualifying for the federal estate tax marital deduction in making distributions to the Surviving Settlor or to the Survivor's Trust, any QTIP Trust, or other trust that otherwise qualifies for the federal estate tax marital deduction.**

Comment: This clause is strongly recommended. The statement of intent effectively triggers application of California statutes that add to trusts holding marital deduction gifts the provisions necessary for the trusts to qualify as marital deduction trusts under federal law. See Prob C §§21520-21526. Further, courts may rely heavily on such clauses in finding that a particular trust qualifies for the marital deduction. See *Estate of Ellingson v Commissioner* (9th Cir 1992) 964 F2d 959; *Estate of Bert B. Rapp,* TC Memo 1996-10, aff'd (9th Cir 1998) 140 F3d 1211 (estate not entitled to marital deduction, because no intent to qualify for deduction was evident from decedent's estate planning documents).

The clause also forestalls any problems with unintentionally triggering the "unidentified asset" rule. See chap 9.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/ G. Division of QTIP Trusts/ 1. Making QTIP Election/§13.22 a. Potential Conflict of Interest in QTIP Election Decision

G. Division of QTIP Trusts

1. Making QTIP Election

§13.22 a. Potential Conflict of Interest in QTIP Election Decision

The QTIP election decision is made by the executor of the estate, if any, and otherwise by the trustee. See Treas Reg §20.2056(b)-7(b)(3). This decision may (1) raise conflict-of-interest issues if the trustee is the spouse or a remainder beneficiary or (2) confront a neutral trustee with conflicting demands. For example, the corpus of the QTIP is often taxed at lower estate tax rates in the estate of the deceased spouse if the full QTIP election is not made. This strategy benefits the remainder beneficiaries by increasing their ultimate distribution, but it reduces the benefits available to the spouse. Form 13.24-1 seeks to provide the trustee with reasonable latitude without suggesting that the trustee's discretion is free from fiduciary constraints.

Because of confusion regarding the QTIP election on earlier versions of the form, IRS Form 706 provides that the executor is deemed to have made the election with respect to any property that:

- Satisfies the QTIP requirements;
- Is listed on Schedule M of the return; and
- Is not expressly identified as being excluded from the election.

Thus, in most situations, simply listing property satisfying the QTIP requirements on Schedule M is sufficient to make the QTIP election.

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§13.23 b. Consequences of Unnecessary QTIP Election or Failure to Make Election

Sometimes 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 such situations, the Internal Revenue Service will disregard the election and treat it as null and void for purposes of IRC §§2044, 2056(b)(7), and 2519. See, *e.g.,* IRS Letter Rulings 200729028, 200535026. Thus, the property will not be included in the surviving spouse's estate, and the spouse will not be treated as making a gift of the property if he or she disposes of the income interest 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 124.

NOTE: In a case involving an erroneous allowance of a marital deduction for a defective QTIP trust, the court held that the QTIP trust was not included in the estate of the surviving spouse and allowed a refund claim for estate tax paid, but the government was allowed to equitably recoup a portion of the estate taxes not paid by the decedent's estate. The decision noted that if the QTIP election had been ruled on and allowed by an earlier court decision that refused to consider the issue, the refund claim by the surviving spouse's estate would be barred by res judicata. *Estate of Buder v U.S.* (ED Mo 2005) 372 F Supp 2d 1145, aff'd (8th Cir 2006) 436 F3d 936. However, the court in another case rejected a claim that an allegedly defective QTIP trust should not be included in the survivor's estate. Although the trust did not expressly state that income was to be paid at least annually, the court held that the decedent's intent that income was to be paid at least annually could be inferred. *Warner v U.S.* (CD Cal 2006) 98 AFTR2d 6136.

In other situations, 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 situations, the IRS may grant an extension of time to make the election. See IRS Letter Ruling 200215025. The problem may be avoided, however, 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).

Under Treas Reg §20.2056(b)-7(b)(3), the personal representative of the estate is the person authorized to make a QTIP election. If there is no personal representative, the trustee of a revocable trust can make the election. Although not necessary, an express provision authorizing the trustee to make the election is included by many drafters of QTIP trusts—particularly when the surviving settlor will be the trustee. See form in §13.24.

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.24 c. Form: Authorization to Make QTIP Election

§13.24 c. Form: Authorization to Make QTIP Election

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13.24-1 Authorization to make QTIP election

Authorization to Make QTIP Election. **The person permitted by Treasury Regulation §20.2056(b)-7(b)(3) to make the Internal Revenue Code §2056(b)(7)(B) election is authorized and encouraged to make that election and thereby qualify the trust for the federal estate tax marital deduction. Nevertheless, the election need not be made, and the authorized person should consider the possible advantages of a partial election or no election, taking into account all relevant factors, including the health and life expectancy of the Surviving Settlor and the impact of the Internal Revenue Code §2013 prior transfer property credit.**

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2. Partial QTIP Election

§13.25 a. When Partial Election Permissible

It may be advisable for the executor to make the QTIP election for only a portion of the QTIP trust. This alternative is permitted as long as the portion is a fractional share. Treas Reg §20.2056(b)-7(b)(2). On when a partial election is advisable, see chap 9.

If a partial election is made, it is generally desirable to divide the QTIP trust into separate trusts for the elected and nonelected portions, rather than to try to administer a single trust for an extended period that is partly QTIP and partly non-QTIP. Aside from administrative simplicity, a division into two trusts permits the trustee to pursue different investment strategies for each trust. Finally, if the trustee has discretion to invade principal for the surviving settlor's benefit, the distributions should be made only from assets that will be included in the surviving spouse's taxable estate. This cannot be accomplished if the QTIP is not divided into two trusts.

Accordingly, the trust document should authorize the division in a manner that satisfies regulation requirements that division be accomplished on a fractional share basis, with the assets being allocated between trusts based on fair market value at the time of division. Treas Reg §20.2056(b)-7(b)(2)(ii)(B)-(C).

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.26 b. Form: Division of Trusts Reflecting Partial Election

§13.26 b. Form: Division of Trusts Reflecting Partial Election

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13.26-1 Division of trusts reflecting partial election

Division of Trusts Reflecting Partial Election. **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 chap 9.

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II. QUALIFIED DOMESTIC TRUSTS (QDOT) FOR NONCITIZEN SPOUSES

§13.27 A. Use of QDOT to Qualify for Marital Deduction

The statutory plan for the marital deduction is much more restrictive if the surviving spouse is not a United States citizen and does not become a citizen by the time the estate tax return is filed. See chap 9. In that situation, no marital deduction is allowed unless the property is transferred to a qualified domestic trust (QDOT) that meets the requirements of IRC §2056A. IRC §2056(d)(2)(B). Any property that passes to a surviving noncitizen spouse, outside the decedent's probate estate, will be treated as having passed to the surviving spouse through a QDOT if the property is transferred by the surviving spouse to a QDOT before the decedent's estate tax return is filed. IRC §2056(d)(2)(B). The IRS may grant an extension of time to file a supplemental return within 1 year after the due date. See IRS Letter Rulings 200910019, 200821030, 200712010.

A QDOT is the only vehicle by which a decedent's estate can claim a marital deduction if the surviving spouse is not a United States citizen. IRC §2056(d)(1). 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 their assets or interests in assets whether within or outside of the country. IRC §§2001(a), 2511(a). In contrast, nonresident noncitizens are subject to transfer tax only on their assets or interests in assets that are situated or deemed situated within the United States. IRC §§2101(a), 2103, 2511(a). Requiring a QDOT is intended to prevent the situation in which a United States citizen's property escapes estate taxation by first qualifying for the marital deduction and then having the noncitizen surviving spouse move to a foreign country and die.

NOTE: Lifetime gifts to or in trust for noncitizen spouses in any form do not qualify for the marital deduction, but there is a $100,000 (plus cost-of-living adjustments) annual exclusion for those gifts. IRC §2523(i)(2). Any gift to a noncitizen spouse must qualify both under the present interest rules of IRC §2503(b) and under the marital deduction rules. See *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664 (gifts of membership units in LLC were gifts of future interests that did not qualify for annual gift tax exclusions).

PRACTICE TIP: A variety of planning options are available to couples when one or both of them are not United States citizens. Electing to qualify a trust as a QDOT is not always the preferred strategy. For full discussion, see California Will Drafting §19.39 (3d ed Cal CEB 1992).

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§13.28 B. Requirements to Qualify Trust as QDOT

A trust must meet the following requirements to qualify as a QDOT (IRC §2056A(a)):

- The trust document must provide that at least one trustee of the marital trust is a United States citizen or a domestic corporation. (It is preferable not to use a member of the spouse's family as a trustee.) Using a United States bank as trustee is one way to meet the security requirements for a QDOT. Treas Reg §20.2056A-2(d)(1)(i)(A). See Alternative 1 in §13.33.
- The trust document must provide that no distribution (other than a distribution of income) may be made from the trust unless the trustee who is a United States citizen or a domestic corporation has the right to withhold from distribution the estate tax imposed under IRC §2056A.
- The trust must comply with regulations issued by the Secretary of the Treasury to ensure the collection of any tax. See Treas Reg §§20.2056A-1—20.2056A-13. For detailed provisions on United States bank, bond, or letter of credit security requirements for a QDOT, see Treas Reg §20.2056A-2(d)(1)(i)-(ii). Special rules apply to incompetent settlors. See Treas Reg §20.2056A-2(d)(6)(ii). For anti-abuse rules, see Treas Reg §20.2056A-2(d)(1)(v).
- Applicable rules for marital trusts for United States citizen surviving spouses must be satisfied before a QDOT election is made. See Treas Reg §20.2056A-2(b)(1).
- A QDOT election must be made on the last estate tax return filed before the due date or, if a timely return is not filed, on the first return filed within 1 year after the due date. Treas Reg §20.2056A-3(a); IRS Letter Ruling 200352005.
- The surviving spouse must agree to pay the estate tax due on the corpus portion of the trust under IRC §2056A(b)(1) (see §13.31) and the executor must file the agreement to pay tax and a prescribed information statement with the estate tax return. See Treas Reg §20.2056A-4(c)(4)-(6); Temp Treas Reg §20.2056A-4T(c)(4)(ii)(B).
- The executor must make an irrevocable election on the estate tax return to treat the trust as a QDOT. IRC §2056A(d).

PRACTICE TIP: A QDOT can be created or fine-tuned by use of a reformation to qualify a trust that would otherwise not have met the tests for a QDOT. Treas Reg §20.2056A-4(a)(1). See form 13.33-1, Alternative 2. Court reformation is also possible. Treas Reg §20.2056A-4(a)(2).

NOTE: Some foreign countries prohibit trusts or prohibit them from having a United States trustee. In either situation, 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 permit exceptions to the usual requirements for qualifying as a QDOT. See, *e.g.*, IRC §§2056A(a)(1) (requirement of at least one United States trustee subject to regulatory exception), 2056A(c)(3) (to extent provided in regulations, "trust" includes other arrangements that have substantially the same effect as a trust). However, any such regulations may only permit a marital deduction for nontrust arrangements or for trusts without a United States trustee under circumstances in which 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. 105-220, 105th Cong, 1st Sess, 719 (1997), reprinted in 1997 US Code Cong & Ad News 1129, 1531.

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§13.29 C. When Noncitizen Spouse Becomes Citizen

The conventional marital deduction is available for transfers to a noncitizen if he or she 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).

In addition, the transfer may qualify for the conventional marital deduction if the surviving spouse becomes a citizen after the estate tax return is filed and either of the following sets of requirements are met (IRC §2056A(b)(12); Treas Reg §20.2056A-10):

- The surviving spouse was a resident of the United States at all times between the date of the decedent's death and the date citizenship was obtained (or no QDOT tax was imposed before the spouse became a citizen) and the United States trustee notifies the IRS of the surviving spouse's citizenship by filing final Form 706-QDT on or before April 15, plus extensions, of the year following the year in which the spouse became a citizen and certifies in writing that the spouse is a citizen (Treas Reg §20.2056A-10(a)); or
- The spouse elected to treat any taxable distribution from the QDOT as part of his or her tax base for determining the rate of gift and estate tax on future transfers by the surviving spouse (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 Rulings 200451024 and 200719002, the IRS granted an extension of time to satisfy the notice requirement when the spouse's attorney or 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 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.

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§13.30 D. Effect of QDOT on Estate Tax

A QDOT preserves the marital deduction property as a separate fund. The QDOT plan for estate taxation involves a recalculation of the estate taxes of the *deceased* spouse. Each time principal is distributed from the QDOT, an estate tax is imposed measured by the deceased spouse's top estate tax bracket, taking into consideration prior principal distributions from the QDOT, with the balance of the QDOT principal being taxed in the same manner on the death of the surviving spouse. Thus, the marital deduction provided by a QDOT, like any marital deduction, is only temporary. However, the estate tax does not apply to mandatory distributions of income from the QDOT. Thus, it may be possible to minimize subsequent taxation of the marital deduction property by providing for payment of the maximum allowable unitrust amount (5 percent) in satisfaction of the surviving spouse's right to trust income. For many types of trust property, the net income of the trust with respect to the trust property will be less than this amount. See discussion in §13.5.

This method of recalculation of the taxes of the deceased spouse does not exist for marital deduction transfers to citizen spouses, with the result that proper marital deduction planning for noncitizen spouses involves considerably more analysis than substituting a QDOT for another form of marital deduction transfer. This is because the requirements applicable to transfers to surviving spouses who are United States citizens do not include any provisions for tracing the transferred property or providing security for the payment of future estate taxes. Thus, a citizen surviving spouse is free to minimize subsequent taxation by, *e.g.,* making annual exclusion gifts.

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§13.31 E. When QDOT Property Is Subject to Estate Tax

Qualified domestic trust (QDOT) property is subject to estate tax in the following three situations:

(1) Any distribution from the QDOT to the surviving spouse, other than a distribution of income, is subject to the estate tax. IRC §§2056A(b)(1)(A), (b)(3). The tax applies to distributions of principal in 2010, when the estate tax is repealed. IRC §2210(b)(1). There is no tax, however, on distributions made on account of hardship. IRC §2056A(b)(3)(B). "Hardship" refers to an immediate and substantial need for health, maintenance, and support of the spouse, or a person whom the spouse is legally obligated to support, with no other sources reasonably available to the spouse. Treas Reg §20.2056A-5(c).

PRACTICE TIP: If the QTIP trust does not otherwise include a discretionary power to distribute principal to the spouse, it may be advisable for the trustee to have the power to make "hardship" distributions to the spouse within the meaning of IRC §2056A(b)(3)(B).

(2) The surviving spouse's death causes the remaining property in the QDOT to be subject to the estate tax as if it were included in the estate of the first spouse to die. IRC §2056A(b)(1)(B). The tax does not apply after December 31, 2009. IRC §2210(b)(2).

(3) If the QDOT ceases to meet the requirements imposed by the regulations, an estate tax 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).

Internal Revenue Service Form 706-QDT should be used to report taxable distributions from QDOTs, or taxable events resulting from trusts that no longer meet the requirements of a QDOT, or from the death of the surviving spouse.

On how to calculate the amount of the estate tax due on a QDOT, see California Will Drafting §19.38 (3d ed Cal CEB 1992).

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Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.32 F. Successor Domestic Trustees

§13.32 F. Successor Domestic Trustees

As discussed in §13.28, a QDOT must provide that at least one trustee is a United States citizen or a domestic corporation. If there is only one domestic trustee, provision should be made for a successor domestic trustee to take over if the first ceases to act. To accomplish this task, the attorney should ensure that one of the following steps is taken:

- A domestic corporation should be appointed as the final successor;
- The other trustees should be given the power to appoint a domestic successor; or
- A series of United States citizens should be appointed.

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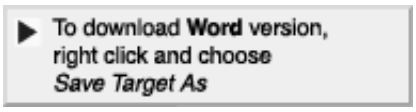
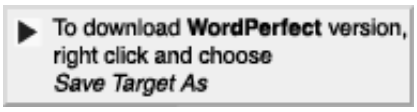
Source: Estate Planning/Drafting California Revocable Trusts/13 QTIPs and QDOTs/§13.33 G. Form: Qualifying Trust as QDOT

§13.33 G. Form: Qualifying Trust as QDOT





13.33-1 Qualifying trust as QDOT

[*Use one of the following alternatives*]

[*Alternative 1: Provisions qualifying trust as QDOT*]

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.

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 settlors intend that the QTIP Trust will qualify for the marital deduction under Internal Revenue Code §§2056(d) and 2056A. The trustee shall comply with all Treasury Regulations pertaining to such qualification. If necessary, the trustee may amend the trust for this purpose.

4. The trustee must comply with all security arrangements for qualified domestic trusts as set forth in Treasury Regulation §20.2056A-2(d)(1)(i) or (ii).

5. These provisions shall not apply or shall cease to apply if trust distributions are no longer subject to the tax imposed by Internal Revenue Code §2056A and if all such taxes already imposed by that section have been paid.

[*Alternative 2: Power to reform trust to qualify as QDOT*]

Power to Reform Trust to Qualify as QDOT. **In the event 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: Alternative 1, subparagraph 5 makes the qualified domestic trust (QDOT) provision inapplicable in certain circumstances, *e.g.,* when the surviving spouse becomes a United States citizen. See §13.29.

In Alternative 2, the trustee may reform the trust unilaterally to qualify as a QDOT without the need for a costly court-ordered reformation. See Treas Reg §20.2056A-4(a)(1).

On the possibility of regulatory exceptions to the usual rules for QDOT qualifications when a foreign country prohibits trusts or prohibits trusts from having a United States trustee, see §13.28.

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14

Bypass and Disclaimer Trusts

Marc M. Stern

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I. PURPOSE OF BYPASS TRUST

§14.1 A. Basic Zero-Tax Strategy

In 1981, Congress amended IRC §2056 effective for estates of persons dying after that year, eliminating the former cap on the maximum allowable federal estate tax marital deduction. As a result of the unlimited marital deduction, it became possible to avoid paying estate tax on the death of the first spouse to die (deceased spouse). Avoiding tax on the first death greatly appealed to clients, and it became standard practice to write trusts that achieved that objective. Estate planners recognized, however, that any property given to the spouse or the marital deduction trust would increase the value of property that would be subject to estate tax on the death of the survivor. Accordingly, it was desirable for the deceased spouse to give the survivor or marital deduction trust no more property than was necessary to reduce the first tax to zero.

These arrangements left open the question of what disposition should be made of the residue of the deceased spouse's estate. If the deceased spouse was quite wealthy, the residue could be left directly to children or other selected beneficiaries. But if the deceased spouse's assets were more modest, the surviving spouse might need (or at least desire) access to the residue of the estate. In the latter situation, standard planning provided for disposition of the residue to a "bypass trust," which would make the assets available for the survivor's use but would not give the survivor rights to the trust property that would cause any undistributed trust property to be included in the taxable estate of the survivor on the survivor's death—the undistributed assets of the decedent's estate would "bypass" the survivor's estate. See §14.2.

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§14.2 B. Three Approaches to Bypass Trust

There were, and remain, three common approaches to carving out the assets of the bypass trust.

- **Marital deduction formula clause.** This approach, which is the most common and flexible, involves using a marital deduction formula clause to split the property of the deceased spouse between a marital deduction gift and a gift passing to the bypass trust. See §14.3.
- **QTIPable bypass trust.** The second approach involves establishment of a qualified terminable interest property (QTIP) trust that will qualify for a marital deduction under IRC §2056(b)(7) to the extent that the executor or trustee makes a QTIP election on the federal estate tax return. See §14.4.
- **Disclaimer trust.** The third approach involves leaving all property to the spouse or a marital deduction trust, but also providing that, if the spouse makes a qualified disclaimer of any property under IRC §2518, the disclaimed property will pass to a "disclaimer trust." See §14.5. Disclaimer trusts are not available to registered domestic partners. See §14.5A.

Each approach has its strengths and weaknesses. Using the marital deduction formula clause is clearly superior if it is reasonably certain that the survivor's estate will owe estate tax or if the deceased spouse wants to limit the survivor's access to property for nontax reasons. In some situations, however, it may undesirably result in the creation of a bypass trust when the trust is either unnecessary or actually undesirable because bypass trust property does not usually receive a new IRC §1014 income tax basis on the survivor's death—except, perhaps, when the bypass trust qualifies for a QTIP election and that election is actually made. Planners must also consider the impact of EGTRRA-2001. See §§14.6-14.20A.

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§14.3 1. Marital Deduction Formula Clause

The benefits of using the marital deduction formula clause include the fact that the surviving spouse can be given considerable discretion over bypass trust distributions. Further, if the marital deduction gift is made to the survivor or a survivor's trust rather than to a QTIP trust, this approach normally accomplishes its objectives even if the federal estate tax return for the deceased spouse is prepared incorrectly or is never filed at all. For a discussion of typical bypass trust distribution options, see §§14.21-14.23A. For a detailed discussion of marital deduction formulas, see chap 11.

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§14.4 2. QTIPable Bypass Trust

The primary advantage of the QTIPable bypass trust approach is preservation of the option of making the QTIP election for *more* of the trust than is necessary to reduce the estate tax to zero. Using this approach, the executor or trustee would typically make the QTIP election for only a fraction of the trust. Under the trust document, the trust would then be split into two separate trusts—one for the fraction receiving the QTIP election and one for the remaining fraction. This result might be desirable to the extent that no estate tax will be owed on the survivor's death, because QTIP property included in the survivor's estate under IRC §2044 may be entitled to a new basis on the survivor's death under IRC §1014. See §§14.24-14.27A.

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§14.5 3. Disclaimer Trust

The disclaimer trust approach provides flexibility in the amount that will be disclaimed into the disclaimer trust, but it is essentially useless unless the remainder beneficiaries of the disclaimer trust are the persons the surviving spouse wants to benefit. Surviving spouses rarely disclaim in favor of a deceased spouse's children by a prior marriage. Even if the spouse wishes to benefit the particular beneficiaries, the spouse may fail to disclaim because the spouse is insecure, incompetent, careless, or poorly advised. Further, disclaimers must be made within 9 months after death. IRC §2518. For discussion of disclaimer trusts, see §§14.28-14.35.

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Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.5A C. Bypass Trust for Domestic Partners

§14.5A C. Bypass Trust for Domestic Partners

California registered domestic partners may own community property. See Fam C §297.5. Assuming the partners want a revocable trust estate plan and do not want to partition the community property into equal shares of separate property, the partners will need to use a joint trust. Although most marital deduction estate planning strategies will not apply to domestic partners, the concept of using a bypass trust to benefit the survivor without causing the trust property to be taxed in the survivor's estate can still be useful. In the case of domestic partners, the use of a disclaimer trust is not an option, because only a spouse can make a qualified disclaimer that results in property interests passing to the person making the disclaimer. IRC §2518(b)(4).

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II. IMPACT OF EGTRRA-2001

§14.6 A. Relevant Provisions of EGTRRA-2001

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), which provided for sharp increases in the applicable exclusion amount ($2 million in 2006-2008, and $3.5 million in 2009), no estate tax in 2010, and a sunset provision that results in the reinstatement of the estate tax with a $1 million applicable exclusion amount for estates of persons dying in 2011 and later. See §§4.69-4.75.

In addition, EGTRRA-2001 provided a new set of rules on the income tax basis of property acquired from a decedent. The new rules, described in §§4.58-4.68, apply in years in which there is no estate tax. The new rules are in IRC §1022 and replace those in IRC §1014.

NOTE: Because of the sunset provision, the new rules apply only to estates of persons dying in 2010, but they will presumably continue to apply if the estate tax repeal is extended by further legislation.

Under IRC §1014, the basis of property acquired from a decedent is the fair market value of the property on the date of death (or on the alternate valuation date—up to 6 months later—if an election is made to value the property on the alternate valuation date for estate tax purposes under IRC §2032).

Under IRC §1022, the basis of property acquired from a decedent is the basis of the property in the hands of the decedent, potentially increased by up to $1.3 million regardless of the identity of the distributee, and another $3 million for property distributed to a spouse. Property passing to a QTIP trust qualifies for the $3 million increase on the first death, but under IRC §1022(e) is not deemed to be property passing from the surviving spouse on the survivor's death and is therefore not eligible for any increase in basis on the survivor's death. See §4.60.

These changes, and the prospect of future changes, require increased awareness of flexibility planning. See §§14.7-14.20A.

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§14.7 B. Flexibility Planning Under EGTRRA-2001

As a result of EGTRRA-2001 and the changes discussed in §14.6, planners confront considerable uncertainty about the tax laws that will apply when each member of a married couple dies. Worse, strategies that produce the best results if the survivor's estate will be subject to estate tax can produce bad results if no estate tax will be owed on the survivor's death. Minimizing estate taxes on the survivor's death typically involves keeping property *out* of the survivor's estate, but making maximum use of opportunities for obtaining increases in income tax basis under current IRC §1014 or future IRC §1022 requires moving property *into* the survivor's estate. Planning is further complicated by the fact that QTIP property is considered part of the survivor's estate under §1014, but not under §1022.

An additional problem is the possibility that IRC §1014 will be deemed to apply retroactively with respect to decedents dying in 2010. There is an unresolved issue as to what happens if an individual dies in 2010 but the recipient sells inherited property in 2011 or later years, after the sunset of EGTRRA-2001. The sunset provision of EGTRRA-2001 §901 states (emphasis added): "The Internal Revenue Code of 1986… shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) *as if the provisions and amendments described in subsection (a) had never been enacted*." If EGTRRA-2001 had never been enacted, the estate assets would receive a new basis on death under IRC §1014, so it may be that the recipient will be retroactively treated as having a basis equal to the fair market value on the date of death. There are counterarguments that can be made involving the Act's focus on the date of death and the apparent intention to impose carryover basis with respect to property of decedents dying in 2010. Realistically, we simply don't know what will happen, but we are left to address the possibility that the heir will be treated as having an IRC §1022 basis, rather than an IRC §1014 basis, even if the property is sold after 2010.

Planners now confront a situation in which there is considerable uncertainty about the value of the property that will end up in the bypass trust and little certainty concerning whether the original objective of a bypass trust—keeping property out of the survivor's taxable estate—will remain a desirable objective. Consequently, planners must now design bypass trusts on a case-by-case basis, giving heavy emphasis to strategies that provide the flexibility needed to modify plans in response to future law changes. Strategies for maintaining flexibility in the initial value of the bypass trust are discussed in §§14.8-14.10. The strategy of preserving flexibility before the first death by giving an agent the power to amend the trust is discussed in §§14.11-14.13. Strategies for creating flexibility after the first death are discussed in §§14.14-14.20A.

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§14.8 1. Initial Value Flexibility Strategies

Under EGTRRA-2001, there will be more and more cases in which it will not be desirable to transfer as much property as possible from the deceased spouse to a trust that serves to keep property out of the survivor's estate. The planner must be concerned about distribution distortion—the risk that a distribution determined in accordance with a formula such as a martial deduction formula—will result in a distribution of the estate that is contrary to the client's wishes.

Distribution distortion may be a particular concern if the surviving settlor will not be the trustee of the bypass trust or if the trustee has a fairly restrictive invasion power. Conversely, distribution distortion may not matter if the surviving settlor will be the trustee of the bypass trust and the trustee has a less restrictive invasion power or the surviving settlor also has a "five or five" withdrawal power. See §14.22.

In view of the uncertainties concerning the amount that will pass to the bypass trust in the future under the marital deduction formula, drafters need ways of controlling that amount. There are two basic approaches to this problem: First, the drafter can use strategies that essentially eliminate the formula (see §14.9). Second, the drafter can modify the disposition provisions of the bypass trust to compensate for the unexpected size of the bypass trust (see §14.10).

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§14.9 a. Eliminating Formula Disposition

One method of eliminating the formula disposition is to use a QTIPable bypass trust. The trust gives the surviving settlor the right to all income from the trust for life. Assuming that it is possible to make an IRC §2056(b)(7) QTIP election even if no election is needed to reduce the estate tax to zero, the deceased settlor's executor (or the trustee in the absence of an executor) would have the ability to shift property to the estate of the surviving settlor by altering the value of the property for which the election is made. This strategy would make it possible to increase the amount of property getting a new IRC §1014 income tax basis adjustment on the survivor's death. (The strategy would also make it possible to allocate the additional $3 million basis increase for property passing to a surviving spouse under IRC §1022 to the bypass trust for decedents dying in 2010. See §4.60.) There are disadvantages to this approach: First, it is not certain that an unnecessary election is valid. Second, no distributions can be made to anyone other than the survivor during the survivor's lifetime, although it may be possible to split the bypass trust and provide QTIP terms for only a share of the trust. See §§14.24-14.27A.

Another method of eliminating the formula disposition is to use a disclaimer trust. As noted in §14.5, this approach risks the surviving settlor's failure to make the disclaimer—particularly if the remainder beneficiaries are the deceased settlor's issue of a prior marriage. Further, the surviving settlor cannot have a discretionary distribution power over a disclaimer trust that is not limited by an ascertainable standard. Treas Reg §25.2518-2(e)(2). See §§14.28-14.35.

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§14.10 b. Modifying Disposition Provisions of Bypass Trust

As an alternative to eliminating the marital deduction formula, the drafter can provide for a second formula that effectively splits the bypass trust. If this approach is used, it is probably easiest to use a fractional share formula clause because of the drafting difficulties involved in trying to divide trusts that may be funded with either a pecuniary amount, a residue remaining after a pecuniary amount, or the entire residue of an estate. See §§11.44-11.50. The clause might state, for example:

If the percentage of my estate passing to the bypass trust under the formula in paragraph _ _[*letter*]_ _ of this trust exceeds 50 percent of the residue of my estate, the bypass trust shall be divided into two shares. A 50 percent share of the residue of my estate shall be retained in the bypass trust and administered in accordance with its terms. The other 50 percent share shall be distributed to the Overflow Trust and administered as provided in accordance with its terms.

Of course, it is not necessary to have an "Overflow Trust" (a term used here for illustration, but having no standard meaning). The overflow amount might instead pass to the deceased settlor's children, the surviving settlor, or a QTIP trust.

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§14.11 2. Preserving Predeath Flexibility

Because of the uncertainties caused by EGTRRA-2001, it is important to address the risk that future plan changes will be desirable at a time when the client is incompetent. In the current tax situation, it is often appropriate to give an attorney-in-fact the power to modify the plan. See §§14.12-14.13.

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§14.12 a. Giving Agent Power to Amend Trust

Although clients and practitioners are appropriately concerned about the potential abuse of trust amendment powers by attorneys-in-fact, conservative drafting and the ready availability of court review can reduce these risks to a level that is far lower than the risks posed by an inability to respond to changing tax laws. Court determination of the validity of an agent's action affecting a trust is available under both the Trust Law (Prob C §17200) and the Power of Attorney Law (Prob C §4541), and it is even possible, although not necessarily desirable, to require a trustee to obtain court confirmation of the validity of the agent's action before making a distribution.

NOTE: It is important to remember that a trust may not be modified or revoked by an attorney-in-fact under a power of attorney unless it is expressly permitted by the trust instrument (Prob C §15401(c)), and a power of attorney may not be construed to grant authority to an attorney-in-fact to create, modify, or revoke a trust unless expressly authorized in the power of attorney (Prob C §4264(a)). See California Powers of Attorney and Health Care Directives, chap 6 (Cal CEB 2008).

Further, an agent's authority to create a revocable trust does not, without further authorization, confer power to change the persons entitled to the principal's property on the principal's death. *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285. Presumably, the same rule applies to trust amendments. For a trust clause authorizing an attorney-in-fact to exercise a settlor's powers to revoke or amend the trust if expressly permitted in the power of attorney, see §14.13.

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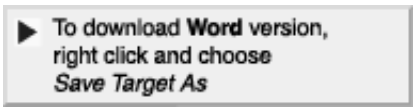
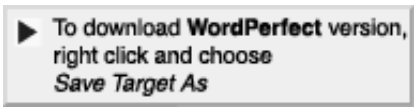
Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.13 b. Form: Agent's Power to Amend Trust

§14.13 b. Form: Agent's Power to Amend Trust





***Exercise of Power to Revoke or Amend*. A power to revoke or amend this instrument may be exercised by a settlor's attorney-in-fact to the extent that the attorney-in-fact is expressly so authorized in a provision of the instrument appointing the attorney-in-fact that specifically refers to this particular trust.**

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§14.14 3. Creating Postdeath Flexibility

EGTRRA-2001 creates situations in which the "right" planning strategy at the time of the first death may not be the right answer several years later. For example, ever-increasing estate tax exemption amounts might make it desirable to get more property into the surviving spouse's estate in order to obtain a new income tax basis under either IRC §1014 or IRC §1022. As a result, it is desirable to find ways to facilitate appropriate responses to future changes in the law. Depending on other planning concerns, it may be desirable to remove obstacles to judicial modification, facilitate implementation of beneficiary agreements, or provide the trustee or a standby special independent trustee with greater distribution discretion. See §§14.15-14.20. If the settlors decide that it is appropriate to permit the surviving settlor to purchase an interest in the family residence from the bypass trust, the drafter may wish to include language in the trust document expressly authorizing the transaction. See §14.20A.

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§14.15 a. Avoiding Restrictions on Postdeath Judicial Modification

Common drafting practices and restrictive California statutes may undesirably limit the potential remedy of judicial modification. The relevant statutes are usually Prob C §§15403 and 15409, which provide:

> 15403. (a) Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.
>
> (b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest as provided in Chapter 2 (commencing with [Prob C] Section 15300).
>
> ....
>
> 15409. (a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.
>
> (b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.

Under §15403, there are essentially three requirements for judicial modification of a trust:

- No valid restraint on alienation (*i.e.,* no spendthrift clause). See §14.16.
- Unanimous beneficiary agreement (usually requiring the consent of a guardian ad litem for contingent remaindermen, including unborn or unascertainable contingent remaindermen). See §14.17.
- No defeat of a material purpose (subject to some court discretion). See §14.18.

In considering the possibilities of modification or termination under §15409, the drafter should be concerned about the phrase "owing to circumstances not known to the settlor and not anticipated by the settlor." See §14.19.

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§14.16 (1) Omitting Spendthrift Clause

A drafter choosing to facilitate the possibility of modifying or terminating a trust under Prob C §15403 should consider whether it is possible to omit spendthrift clauses. Often, the risk of creditors is negligible compared with the risk of the tax collector—particularly when a family is confronted with a high certainty of losing most of the benefit of a possible $1.3 million IRC §1022 basis increase that is not available for assets locked in a bypass trust or QTIP trust.

There are alternative devices for reducing creditor concerns, including strategies that make distributions subject to the discretion of a trustee or the personal wishes of the holder of a power of appointment, particularly if the trustee or power holder has the option of excluding the indebted beneficiary from the class of distributees. See §§7.55-7.74.

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§14.17 (2) Facilitating Unanimous Beneficiary Agreement

If the spendthrift hurdle can be surmounted (see §14.16), it may be desirable for the drafter to facilitate a unanimous beneficiary agreement under Prob C §15403 by making it possible to eliminate contingent beneficiaries. A technique for accomplishing this objective can be illustrated by the following example.

EXAMPLE: The bypass trust provides for distributions to the spouse during life with remainder to the issue living at the spouse's death. The spouse has a nongeneral power of appointment that allows her to do at least one thing—to irrevocably appoint the remainder per stirpes to the issue of the deceased settlor living on the date of appointment. If the spouse and the children reach an agreement to modify or terminate the trust, the spouse can exercise the power of appointment, thereby eliminating all other beneficiaries of the trust and producing the necessary unanimous consent.

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§14.18 (3) Overcoming Material Purposes Limitation

In appropriate cases, the "material purposes" limitation under Prob C §15403 can be overcome by including trust terms that are more informative than are boilerplate distribution provisions. This is particularly true for a QTIP trust. Does the income interest for life mean that the decedent wanted to delay benefits to his children or to protect the children or the spouse from their own bad judgment, or was the choice of the QTIP trust just a tax-driven compromise?

To avoid judicial confusion about the settlor's "material purposes," clues about what the settlor would have done in the absence of tax considerations can be dropped into a document as long as the hints do not themselves change the trustee's duties with respect to distribution and do not have the effect of becoming virtually self-executing mandates for modification in the event of estate tax repeal.

Thus, it is permissible to say, "Although we would have preferred to leave all our property to each other, we have chosen to make it possible to save estate and GST taxes by using a combination of QTIP and bypass trusts." It is *not* permissible to say anything that would terminate a surviving spouse's qualifying income interest in a QTIP trust in the event of estate tax repeal.

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§14.19 (4) Removal of Uncertainty as a Changed Circumstance

A settlor who now executes a trust might be presumed to know of the *possibilities* raised by EGTRRA-2001, making it difficult to establish that any particular resolution of the estate tax issues by Congress would be "not anticipated." However, a future finding of changed circumstances might be facilitated by a declaration that EGTRRA-2001 creates great uncertainty about the tax laws that will be in effect at the death of each settlor and that the settlors, therefore, recognize that they are unable to know or anticipate the tax rules that will apply and be relevant to their trusts in the future. Such a declaration *should* make it easier for a court to find that later removal of uncertainty is itself a changed circumstance.

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§14.20 b. Giving Independent Trustee Broad Distribution Discretion

A relatively straightforward way to reduce the size of a trust is to give a trustee broad distribution powers. The trustee can then distribute the trust property. Because powers not limited by an IRC §2041 ascertainable standard often should not be given to a potential distributee, it is sometimes desirable to give any powers that are not so limited to a standby special trustee who will be appointed only on his or her application to the court. Of course, trustee discretion cannot be used to divide the benefits of a QTIP trust between the surviving settlor and the remaindermen, because doing so would violate the "qualifying income interest for life" requirement of IRC §2056(b)(7).

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§14.20A c. Form: Option to Purchase Residence From Bypass Trust

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***Option to Purchase Residence From Bypass Trust*. It is anticipated that all or a portion of the family home, currently located at _ _[*address*]_ _ ("said real property") may be allocated to the bypass trust. It is the settlors' intent that the Surviving Settlor shall have the option to purchase the Deceased Settlor's interest in said real property and the settlors recognize that such transaction may result in the bypass trust being funded with a note bearing below-market interest secured by a deed of trust. The settlors further recognize that such an investment may lack diversification and liquidity, may never yield a significant distribution of income to the trust, and may constitute a very large percentage, or all, of the trust estate. Nevertheless, the settlors intend that the trustee enter into such transaction and that, notwithstanding any other provision in this trust document to the contrary, the applicable Uniform Prudent Investor Act or any other rule or law that restricts a fiduciary's ability to invest is hereby waived insofar as any such rule or law would prohibit such transaction. No trustee shall be accountable to any beneficiary for any loss or depreciation sustained by reason of the exercise of such option, as follows.**

(1) *Option Granted*. If said real property is allocated to the bypass trust, the Surviving Settlor shall have the option to purchase the Deceased Settlor's interest in said real property held by the trust on the death of the Deceased Settlor, or transferred to the trust following the death of the Deceased Settlor.

(2) *Exercise of Option*. The Surviving Settlor shall provide written notice to the trustee of the intent to exercise the option. The term of the option shall begin on the date of death of the Deceased Settlor and shall terminate at midnight California time on the date that is six (6) months after the Deceased Settlor's death.

(3) *Notices*. All notices and other communications authorized or required under this paragraph shall be in writing and shall be given by (a) personal delivery, (b) mailing by certified mail or registered mail, return receipt requested, postage prepaid, or United States express mail, or (c) delivery by commercially recognized courier service.

(4) *Purchase Price*. The price at which the option may be exercised shall be the fair market value of the Deceased Settlor's interests in said real property as of the date on which the option is exercised, without applying any discounts for fractional or minority interests arising solely from joint ownership with the Surviving Settlor.

(5) *Satisfaction of Purchase Price*. The Surviving Settlor is authorized to satisfy the purchase price using a note secured by a deed of trust on said real property, with principal payable in full no more than nine (9) months after the Surviving Settlor's death, or earlier sale of said real property, to the extent permitted by law, said note to bear interest at the rate of _ _[*number*]_ _ percent per annum; but no interest shall be paid during the lifetime of the Surviving Settlor.

(6) *Nonassignability of Option*. This option is personal to the Surviving Settlor. The Surviving Settlor may not assign this option or any right under it. A named representative of the Surviving Settlor is authorized to exercise this option on behalf of the Surviving Settlor. As used in this paragraph, the term "named representative" includes a trustee, agent under a power of attorney, or conservator of the estate of the Surviving Settlor, who is then acting in his or her capacity as a representative of the Surviving Settlor, but excludes a bankruptcy trustee or any person acting on behalf of the Surviving Settlor's creditors.

(7) *Consideration for Option*. The consideration for the granting of this option is the promise of each settlor to grant the other settlor a reciprocal option on the earlier death of the settlor. Notwithstanding the foregoing, this option may be revoked by either settlor in the manner provided in the trust document for revocation of the trust, and each settlor agrees to indemnify and hold harmless the other settlor with respect to the option.

Comment: This form originally appeared in reference materials prepared for the seminar Gaw on Subtrust Funding in

April/May 2010. It is used with the permission of the presenter, David B. Gaw of Gaw, Van Male, Smith, Myers & Reynolds, Napa. The drafter should carefully review the circumstances of each case before including this form language in the trust document. For example, one issue is whether to designate a particular property as the family residence as provided in this form. It may be possible to include form language that would permit the surviving settlor to purchase an interest in an after-acquired residence. However, this could create uncertainty as to whether a particular residence was the "family residence" as opposed to a vacation home. This uncertainty can be avoided by identifying a specific property, but may leave the surviving settlor without an option unless the trust document is amended to reflect an after-acquired family residence.

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III. BYPASS TRUST DISTRIBUTION OPTIONS

§14.21 A. Overview of Distribution Options

As the amount that can pass free of estate tax under IRC §2010 increases, bypass trusts created under a marital deduction formula clause will become larger. Most often, the trust's distribution provisions will provide for the distribution of almost all of the deceased spouse's property. Thus, it may be desirable for the bypass trust to contain a mixture of provisions. For example, the bypass trust might provide for immediate distribution of gifts of tangible personal property or sums of cash to specified beneficiaries. For suitable clauses, see chap 8.

NOTE: First-death gifts of this type can also be made in the trust provisions that provide for distributions before the residue of the deceased settlor's property is divided between the bypass trust and the marital or survivor's trust using the marital deduction formula clause. Either approach is acceptable.

With large amounts passing under the distribution provisions of the bypass trust, bypass trust property will often be distributed in shares in some manner, with only a portion of the property actually remaining in the bypass trust itself. For example, a wealthy settlor with a young second family might choose to create a substantial trust for the benefit of the settlor's first family. As a rule, however, a bypass trust primarily benefits the surviving settlor. See §§14.22-14.23A.

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§14.22 1. Surviving Settlor as Trustee of Trust Benefiting Survivor

In most estates not involving significant wealth or issue of a prior marriage, the bypass trust will benefit the surviving settlor and will name the survivor as trustee. If desired, and if care is exercised, the surviving settlor can be given broad discretion over the distributions from the bypass trust without the trust's being included in the survivor's estate. The survivor might, for example, be given one or more of the following powers:

- Power to make withdrawals from the trust for the survivor's health, education, support, or maintenance without being required to take into account the survivor's own resources. See §§7.63-7.65.
- "Five or five" withdrawal power, which permits the survivor to annually withdraw the greater of $5000 or 5 percent of the trust property for any reason whatever. IRC §§2041, 2514. See §§7.90-7.92.
- Power to make distributions to other family members, either by exercising a trustee "sprinkling" power (see §§7.80-7.84) or an individually held nongeneral power of appointment (see §§7.85-7.89).
- Nongeneral power to select the recipients of the remainder of the trust at the survivor's death. See §§13.18-13.20.

For a detailed explanation of periodic trust distribution options that may and may not be used when a beneficiary is the trustee, see chap 7.

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Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.23 2. Use of Bypass Trust for Small Estates

§14.23 2. Use of Bypass Trust for Small Estates

As discussed in §§4.69-4.72, when the combined assets of both settlors are under the applicable exclusion amount, creating a bypass trust probably cannot be justified on the basis of estate and gift tax considerations (assuming that neither settlor made any taxable gifts during his or her lifetime). Even if all of the deceased settlor's property is left to the surviving settlor and includable in the survivor's estate, that property can still pass to their children after the survivor's death without any diminution for estate taxes.

Nevertheless, a bypass trust may be desirable for reasons other than tax savings:

- A bypass trust enables the deceased settlor to (1) dictate the terms on which distributions will be made from the trust to the surviving settlor or others and (2) specify the trust's remainder beneficiaries.
- The bypass trust may afford the surviving settlor and other beneficiaries a level of creditor protection that would not be available if an outright gift were made. See Prob C §§15300-15309.

The issue of control is particularly important when the settlors have conflicting dispositional objectives, *e.g.,* when each settlor has children from a previous marriage. A QTIP trust can also be used to control disposition of the remainder interest, but all income must be distributed to the surviving settlor during the survivor's lifetime, with no distributions to others during that period. See chap 13.

A significant 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 (or alternate valuation date) income tax basis or IRC §1022 basis increase allocation on the death of the surviving settlor. This disadvantage can sometimes be avoided by giving the survivor a QTIP interest in the bypass trust. See §§14.24-14.27A.

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Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.23A 3. Form: NonQTIPable Bypass Trust

§14.23A 3. Form: NonQTIPable Bypass Trust

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BYPASS TRUST

A. *Purpose of Bypass Trust*. In addition to other purposes, a primary purpose of this Bypass Trust is to avoid estate taxation of the assets of this trust on the death of the Surviving Settlor.

B. *Discretionary Distributions During Survivor's Lifetime*. The trustee shall pay to or apply for the benefit of the Surviving Settlor, at quarter-annual or more frequent intervals, as much of the income or principal of this Bypass Trust as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, support, and maintenance. In exercising its discretion, the trustee shall take into account the Surviving Settlor's income and other resources readily available for these purposes.

C. *Withdrawal Power*. In addition to receiving other distributions authorized by this document, the Surviving Settlor may withdraw property from the Bypass Trust by delivering a written request to the trustee, subject to the following terms and conditions:

1. The Surviving Settlor shall have no withdrawal rights under this provision during any calendar year in which the Surviving Settlor 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 Bypass 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 Surviving Settlor exercises the power in a calendar year but fails to survive until actual distribution, the amount withdrawn by the Surviving Settlor shall be distributed in accordance with the provisions for distribution of the remaining property of the Survivor's Trust.

D. *Distribution on Death*. On the death of the Surviving Settlor, the remaining assets of the Bypass Trust shall be distributed as follows: _ _[*Specify*]_ _.

Comment: The provision for invading principal for the benefit of the surviving settlor can be modified to make it more generous, but if the survivor is the trustee it must be limited by an HEMS ascertainable standard to avoid giving the survivor a general power of appointment. IRC §2041. See §§7.19-7.37. The "five or five" withdrawal power is intended to give the survivor a benefit comparable to a life income interest without making the benefit mandatory to the survivor and without the need to distinguish between principal and income to determine the maximum amount of the benefit. See §§7.90-7.92.

Because the spouse does not have a mandatory right to distributions of income or principal, no portion of the bypass trust will be included in the survivor's estate except delayed distributions under the withdrawal power. For this reason, there will be no step-up in basis for bypass trust assets on the survivor's death as discussed in §14.24.

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§14.24 B. QTIPable Bypass Trust

In some situations, it may be appropriate to provide a bypass trust with distribution terms that will give the executor of the estate the option of making an IRC §2056(b)(7) qualified terminable interest property (QTIP) election for all or a portion of the bypass trust. This strategy is particularly appropriate if there is a substantial possibility that inclusion of the bypass trust in the surviving settlor's estate will not result in that estate being liable for estate tax. If the facts known at death confirm that the survivor's estate will probably not pay estate tax, the deceased settlor's executor 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 (or alternate valuation date) income tax basis on the survivor's death.

WARNING: Although the IRS may disregard a QTIP election for IRC §2044 purposes if the election was not necessary to reduce the estate tax to zero, it is still uncertain whether the IRS may disregard the election for IRC §1014 basis purposes when relief is not requested by the executor or trustee. See Rev Proc 2001-38, 2001-2 Cum Bull 124. For better or worse, the Revenue Procedure does not apply if it would be necessary to make a partial QTIP election for a particular trust to reduce the estate tax to zero. Depending on the terms of the trust, a disclaimer of a few dollars by the surviving spouse may be used to cause the value of the credit shelter trust to slightly exceed the applicable exclusion amount so that a partial election is needed.

Different methods may be used to calculate the QTIP portion of the trust. See §14.25. The trust may also provide different distribution terms for the unelected portion of the trust. See §14.26. For a typical form of QTIPable bypass trust with one set of distribution provisions, see §14.27. For additional provisions, see §14.27A.

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§14.25 1. Determining QTIP Portion of Trust

If the estate plan will provide for creation of a QTIP trust in any event, the objectives of a QTIPable bypass trust can be achieved by simply creating the QTIP trust and providing that a partial election will result in dividing the trust into two trusts. See §§13.25-13.26. In such cases, it is not necessary to use a marital deduction formula to calculate 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 surviving settlor or a survivor's trust, a marital deduction formula will be used to establish the size of the bypass trust. See chap 11.

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§14.26 2. Providing Different Distribution Terms for Unelected Portion of Trust

A significant drawback to using a QTIPable bypass trust involves the difficulty of providing benefits for persons other than the surviving settlor. To qualify as a QTIP trust, the trust must provide all income to the surviving settlor for life and no person can have a power to appoint property to anyone other than the survivor during the survivor's lifetime. 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, the trust may provide different distribution terms for all or any portions of the trust for which the election is *not* made. AOD 1996-011 re *Estate of Willis Edward Clack* (1996) 106 TC 131, acq 1996-2 Cum Bull 1. See §13.10. Accordingly, the trust instrument can provide the required limited distribution terms and also provide that different distribution terms will apply to any portion of the trust for which the election is not made.

If a trust contains such an alternative disposition, the drafter should consider giving an independent person the power to decide 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 resulted in a gift. For example, if the surviving settlor is the executor of the deceased settlor's estate and gives up the mandatory income interest as a result of deciding to forgo the QTIP election, it might be argued that the survivor made a gift of that income interest. This result can presumably be avoided by naming an independent trustee/executor or by requiring the surviving settlor trustee/executor to follow the dictates of a nonbeneficiary in making the QTIP election decision. In some cases a unitrust interest may satisfy the income requirement. See §13.5.

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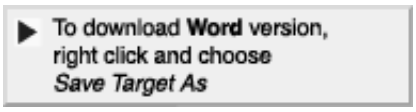

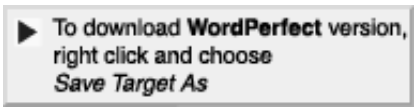

BYPASS TRUST

A. *Purpose of Bypass Trust*. In addition to other purposes, a primary purpose of this Bypass Trust is to avoid estate taxation of the assets of this trust on the death of the Surviving Settlor. Nevertheless, the trust qualifies for a qualified terminable interest property (QTIP) federal estate tax election, so that the tax treatment can be changed if it becomes appropriate to do so.

B. *Income Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor all net income of the Bypass Trust in quarter-annual or more frequent installments. Income earned between the last distribution date and the date of the Surviving Settlor's death shall be distributed to the persons entitled to distribution of income earned immediately following the Surviving Settlor's death. The Surviving Settlor, including any attorney-in-fact or Conservator authorized to act on behalf of the Surviving Settlor, may compel the trustee to invest the trust property in income-producing assets, in which event any otherwise existing trustee power to hold or retain unproductive property shall not apply.

C. *Principal Invasions During Survivor's Lifetime.* If the income is insufficient, the trustee shall pay to or apply for the benefit of the Surviving Settlor, at quarter-annual or more frequent intervals, as much of the principal of this Bypass Trust as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, support, and maintenance. In exercising its discretion, the trustee is permitted, but not required, to take into account the Surviving Settlor's income and other resources readily available for these purposes.

[*Add one of the following alternatives*]

[*Alternative 1: Power of appointment*]

D. *Distribution on Death: Special Power of Appointment*. On the death of the Surviving Settlor, the remaining assets of the Bypass Trust shall be distributed as the Surviving Settlor appoints, in accordance with the provisions of this document for exercising a power of appointment. The permitted appointees of this power are limited to descendants of a parent of either settlor, spouses (including former spouses) of such descendants, and organizations satisfying the definition of "charity" in the Division of this trust on Additional Distribution Provisions, and trusts exclusively benefiting such persons or organizations.

E. *Distribution if Power of Appointment Not Exercised*. If the Surviving Settlor's power of appointment is not effectively exercised with respect to any property of the Bypass Trust, the property not effectively appointed shall be distributed as follows: _ _[*Specify*]**_ _**

[*Alternative 2: No power of appointment*]

D. *Distribution on Death*. On the death of the Surviving Settlor, the remaining assets of the Bypass Trust shall be distributed as follows: _ _[*Specify*]**_ _.**

Comment: The provision for invading principal for the benefit of the surviving settlor can be modified to make it more generous or restrictive, but if the survivor is the trustee it must be limited by an HEMS ascertainable standard to avoid giving the survivor a general power of appointment. IRC §2041. See §§7.19-7.37. If the survivor has a general power of appointment, the property will be included in the survivor's estate even if no QTIP election is made, thus defeating the objective of using that election to determine the amount of property to be included in the survivor's estate.

If the optional provision allowing the surviving spouse to appoint trust property is not used, an alternative disposition on death should be provided. See chap 8.

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[F.] ***Surviving Settlor's Disclaimer of Income Interest in Bypass Trust*****. If the Surviving Settlor 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 the Surviving Settlor as much of the trust property as the trustee, in its discretion, determines is appropriate for the Surviving Settlor's health, education, support, and maintenance. In exercising its discretion, the trustee may consider other income and resources available to the Surviving Settlor to such extent, if any, as the trustee deems appropriate.**

[G.] ***Surviving Settlor's Disclaimer of All Rights in Bypass Trust*****. If the Surviving Settlor disclaims all rights to principal and income with respect to all or a fractional share of the Bypass Trust, the property so disclaimed shall be distributed in accordance with the provisions of the trust applicable on the death of the Surviving Settlor.**

Comment: In case the QTIP election is not made for a portion of the bypass trust, it may be desirable to provide a mechanism for the surviving settlor to disclaim the income interest in the trust to prevent the erosion of trust principal. This form, to be added to the form in §14.27, permits the surviving settlor to separately disclaim the mandatory right to income and the right to discretionary distributions of principal.

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IV. DISCLAIMER TRUST

A. Use of Disclaimer Trust

§14.28 1. Purpose of Disclaimer Trust

In the context of marital deduction planning, a disclaimer trust is a trust that will be created if the surviving settlor disclaims a transfer of property from the deceased settlor to the surviving settlor (or a survivor's trust that is revocable by the survivor). Without an express provision for such a trust, any property disclaimed by the surviving settlor typically passes immediately to younger generation beneficiaries—a fact that might discourage the survivor from making the disclaimer.

In some cases, a disclaimer trust may be used as a substitute for a marital deduction formula clause bypass trust. If so, the purpose of the trust is to use the deceased settlor's IRC §2010 applicable exclusion amount. See §§4.69-4.72.

In other cases, the disclaimer trust is used in addition to a regular bypass trust to divide the estates more evenly (although this will produce no benefit for decedents dying in 2006-2009) and, perhaps, to take advantage of the IRC §2013 prior transfer property credit. This option can be particularly useful if it becomes obvious shortly after the death of the first spouse that the second spouse will die soon. See §4.143.

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§14.29 2. Disclaimer Trust Problems

The use of a disclaimer trust in lieu of a marital deduction formula bypass trust can be an alluring option when it is uncertain whether the surviving settlor's assets will otherwise have a value in excess of the IRC §2010 estate tax applicable exclusion amount. See §§4.69-4.72. Given the uncertainties of tax laws and variations of 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 the following:

- Disclaimer trusts are relatively useless when the first spouse to die will want to benefit persons who are not the natural objects of the bounty of the surviving spouse;
- 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 (see §4.181);
- 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
- 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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§14.30 3. Surviving Settlor'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, exists if the disclaimant is the donor's spouse. The spouse (and no one else) 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). Although not statutorily limited, §2518(b)(4)(A) had a primary purpose of allowing a "cutdown" of the marital deduction by a disclaimer, even though the disclaimed property could then pass into a nonmarital trust from which the surviving spouse would receive income.

PRACTICE TIP: In some family situations, if there is no clause in the trust giving the surviving settlor benefits in the disclaimed property, the surviving settlor may be unwilling to make the disclaimer despite the estate tax savings that would result for the ultimate beneficiaries (*i.e.,* his or her children).

When the surviving settlor has a large income and wishes to reduce income taxation, the disclaimer provisions can serve the function of sprinkling income to other family members. This feature is not available in a QTIP marital trust because of the IRC §2056(b)(7)(B)(ii) requirement that all trust income be distributed to the surviving settlor during his or her lifetime.

If the settlors wish to take advantage of the surviving settlor's right to retain an interest in disclaimed property that will be kept out of his or her estate, the trust should provide that the disclaimed property passes into a trust of which the surviving settlor is a lifetime beneficiary. The trust also may contain a power of invasion for the survivor. See Prob C §282(a) (creator of interest may provide for specific disposition in event of disclaimer). Discretionary distributions, however, must be limited. See §14.31.

If no disposition of the disclaimed property is provided for, it will pass as though the surviving settlor had predeceased the deceased settlor. See Prob C §282(a).

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B. Required Elements of Disclaimer Trust

§14.31 1. Limiting Discretionary Distributions by Surviving Settlor

The surviving settlor who has disclaimed property may be the lifetime beneficiary, or one of several beneficiaries, of the disclaimer trust. The survivor may even act as trustee. For the disclaimer to qualify, however, the surviving settlor 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. See Treas Reg §25.2518-2(e)(2). Therefore, any discretionary powers held by the survivor to distribute or appoint trust property must be limited by an ascertainable standard. Treas Reg §25.2518-2(e)(2), (e)(5), Examples (4)-(6). See §14.32.

Assuming that the transfer document does not create separate income and remainder interests, the survivor 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.

PRACTICE TIP: Even with an ascertainable standard governing sprinkling powers, problems may arise when the surviving settlor is a trustee; he or she is placed in a conflict-of-interest position when the trust calls for discretionary distributions, because the surviving settlor can benefit him- or herself or the children. It is preferable to have a third party hold this power or act as trustee of the trust.

Apparently, the survivor may also retain a noncumulative "five or five" power over the disclaimed property. Treas Reg §25.2518-2(e)(5), Example (7). See §§7.86-7.88. Although the author does not recommend that such a power be used, inclusion of the greater of $5000 and 5 percent of the trust property in the surviving settlor's estate will yield a better estate tax result than including 100 percent of the property in the surviving settlor's estate if no disclaimer is made. Thus, if a five or five power is required to induce the surviving settlor to disclaim, that power should be added to the trust into which the disclaimed property will pass. Note that the surviving settlor can disclaim the five or five power.

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Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.32 2. Disclaiming Special Power of Appointment

§14.32 2. Disclaiming Special Power of Appointment

If the surviving settlor has a special (nongeneral) power of appointment over the disclaimed assets that is not subject to an ascertainable standard, the disclaimer will not qualify. If the special power of appointment is also disclaimed in a proportionate percentage to the total assets that will constitute the augmented trust, the requirements for a qualified disclaimer may be met. See Reg §25.2518-2(e)(5), Example (5).

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C. Optional Features of Disclaimer Trust

§14.33 1. Bypass Trust as Recipient of Disclaimed Property

Sometimes the bypass trust itself can be designed to be the recipient of property passing under the trust under the surviving settlor's qualified disclaimer. The bypass trust should not be designated as the recipient of such property, however, if its provisions would violate the rule that disclaimed property must pass either to the spouse or to someone other than the disclaimant without any direction from the person making the disclaimer. Treas Reg §25.2518-2.

Using the bypass trust to hold property disclaimed by the surviving settlor is thus inappropriate if the survivor is given a power to sprinkle income or principal to persons other than him- or herself during the survivor's lifetime unless the power is held in a trustee capacity and is limited by an ascertainable standard. Treas Reg §25.2518-2(e)(1)-(2). Nor should the bypass trust be used if the survivor is given a nongeneral power of appointment over the remainder. See §14.32.

PRACTICE TIP: If the settlors wish the surviving settlor to have powers over property in the bypass trust that are incompatible with the qualified disclaimer requirements, a separate disclaimer trust meeting those requirements should be provided.

There is no point in providing that disclaimed property passes to a bypass trust that benefits persons the survivor may not want to benefit. Doing so will deter the survivor from making the disclaimer regardless of tax considerations. See, *e.g., Estate of Leona Engelman* (2003) 121 TC 54.

For a clause pouring over assets from the survivor's, marital, or disclaimer trust into the bypass trust, see form 12.15-1.

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§14.34 2. Disclaimer Trust as Sole Trust After Death of Deceased Settlor

A disclaimer trust is sometimes used as an alternative to a bypass trust in order to take advantage of the deceased settlor's applicable exclusion amount and to reduce the size of the survivor's taxable estate. Generally, this approach is desirable only when it is very unlikely, given the settlors' ages and scheduled increases in the applicable exclusion amount, that their estates will pay any estate tax. Thus, the disclaimer trust is a useful protection against the possibilities that one of the settlors will unexpectedly die before the scheduled increases take effect, that the settlors will acquire enough property in the meantime to create an estate tax problem, or that the scheduled increases will not take effect.

For large estates, there are several disadvantages to using a disclaimer trust as an alternative to a bypass trust, including the risk that there will be an inadvertent failure to meet the stringent IRC §2518 requirements for a valid disclaimer. See §14.29.

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Source: Estate Planning/Drafting California Revocable Trusts/14 Bypass and Disclaimer Trusts/§14.35 D. Form: Disclaimer Trust

§14.35 D. Form: Disclaimer Trust

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DISCLAIMERS BY SURVIVING SETTLOR

A. *Purpose of Disclaimer Trust*. In this Division, a disclaimer is a Surviving Settlor's refusal to accept a transfer of property (or a particular right or interest in property) from the Deceased Settlor. Disclaimers are sometimes used to fine-tune an estate plan after the death of the Deceased Settlor, thereby saving substantial taxes. This is particularly true if family wealth has significantly increased or if it is determined that the Surviving Settlor has an unexpectedly short life expectancy. The provisions in this Division are intended to provide the Surviving Settlor with increased opportunities to use disclaimers in appropriate cases. The Settlors understand that it is important to consult a tax professional promptly after the death of the Deceased Settlor about the possible benefits of a disclaimer. The Surviving Settlor has no obligation whatever to make any disclaimers.

B. *Disclaimer of Property Passing to Surviving Settlor*. The Surviving Settlor (or the personal representative of a deceased Surviving Settlor) shall have the right to disclaim any property of the Deceased Settlor distributable to the Survivor or the Survivor's Trust. In the event of such a disclaimer, the disclaimed property shall be held and administered by the trustee as a separate trust known as the Disclaimer Trust. The trustee shall pay to the Surviving Settlor all income of the Disclaimer Trust in quarter-annual or more frequent intervals, plus as much of the principal as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, and support. In exercising its discretion, the trustee may take into account other income and resources available to the Surviving Settlor to such extent, if any, as the trustee deems appropriate.

C. *Surviving Settlor's Disclaimer of Mandatory Income Interest*. If the Surviving Settlor 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 the Surviving Settlor as much of the trust property as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, and support. In exercising its discretion, the trustee may consider other income and resources available to the Surviving Settlor to such extent, if any, as the trustee deems appropriate.

D. *Surviving Settlor's Disclaimer of All Rights in Disclaimer Trust*. If the Surviving Settlor 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, the Surviving Settlor will be deemed to have died on the date of death of the Deceased Settlor.

E. *Distribution on Surviving Settlor's Death.* On the death of the Surviving Settlor, the remaining trust property shall be distributed as follows: _ _[*Specify*]_ _

[*Add the following paragraph if the trust includes a QTIP trust*]

F. *Disclaimer of QTIP Trust Interest.* This Division does not apply to the QTIP trust. If the Surviving Settlor disclaims all rights to principal and income with respect to all or a fractional share of the QTIP trust, the property or share of that trust shall be distributed in accordance with the provisions of that trust applicable on the death of the surviving settlor.

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15

Payment of Taxes, Debts, and Administration Expenses

CEB Staff

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§15.1 I. BURDEN OF TRUST PAYMENT OBLIGATIONS

To varying degrees, the assets of a revocable trust will be burdened with obligations to pay various debts of the settlor and the settlor's estate. This chapter's particular concern is with obligations to pay federal estate taxes and state estate or inheritance taxes when applicable (see §§15.2-15.21), debts of settlors and funeral expenses (see §§15.22-15.28), and expenses of administering trusts in connection with the activities that are comparable to the activities that would be performed by an executor administering a decedent's estate (see §§15.29-15.34).

The obligations discussed in this chapter may be imposed by statute, the trust document, or a combination of both. When obligations must be paid, questions arise as to what property will be applied to satisfy those obligations. Again, this may be determined by statute, the trust document, or both.

Care must be taken in addressing these issues. Drafting errors can result in distributions of a client's wealth in a significantly different manner from that intended by the client. For example, clauses that charge all estate taxes to the residue of the trust property can result in few if any assets passing to residuary beneficiaries—a disastrous result if the client intended that they receive the bulk of the trust assets. See the discussion of abatement in §§8.4-8.7.

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§15.2 II. APPORTIONMENT OF FEDERAL TRANSFER TAXES

In the absence of express provisions in a trust or will that specify sources for paying estate and generation-skipping transfer (GST) taxes, the source of payment is generally dictated by a combination of California and federal statutes. The rules in these statutes are generally sensible, and a drafter can do worse than draft wills and trusts that contain no provisions on apportionment of such taxes—sometimes much worse. Nevertheless, it is usually appropriate to provide modest deviations from the statutory scheme—particularly with distributions of tangible personal property and gifts of specific amounts of money.

The governing statutes are discussed in §§15.3-15.12. That discussion is followed by discussion of a recommended drafting strategy for addressing tax apportionment in the context of funded revocable trusts and sample tax apportionment clauses. See §§15.13-15.16. Particular apportionment problems are discussed in §§15.17-15.21.

For a detailed discussion of tax apportionment issues that does not specifically address California statutes, see Pennell & Danforth, *Transfer Tax Payment and Apportionment*, Tax Mgmt Portfolios 834 (2001).

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Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.3 A. Equitable Proration Under California Statutes

§15.3 A. Equitable Proration Under California Statutes

Under Prob C §§20100-20125, unless the decedent has made other provisions in a written inter vivos trust or testamentary instrument disposing of property, as discussed in §15.4, federal and California estate taxes are prorated equitably among the persons interested in the estate, after taking into account the exemptions granted to them. Prob C §§20110-20112. Accordingly, charities and surviving spouses that receive gifts that qualify for an estate tax deduction under IRC §§2055-2056 are not required to bear a share of estate taxes in connection with those gifts.

Probate Code §§20200-20225 are similar provisions apportioning generation-skipping transfer (GST) taxes, generally charging them proportionately among those receiving the generation-skipping transfers. Prob C §§20210-20212.

Under this type of apportionment scheme, beneficiaries who receive specific items of property or specific amounts of money will share in the obligation to pay estate and GST taxes, based on the value of what they receive. The obligation may be enforced by the decedent's personal representative. See §15.5. The state statutes defer to the federal statutes if a conflict arises. Prob C §§20110(b)(2), 20210(b)(2). See §15.6.

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§15.4 1. Overriding Equitable Proration

Probate Code §20110(b) permits deviation from the California statutory rules for apportionment of estate taxes described in §15.3. The statute provides:

> (b) This section does not apply:
> (1) To the extent 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. As used in this paragraph, an "instrument disposing of property" includes an instrument that creates an interest in property or an amendment to an instrument that disposes of property or creates an interest in property.

A similar provision applies to the California statutory rules for apportionment of generation-skipping transfer (GST) taxes. See Prob C §20210(b).

The tax apportionment clause must normally appear in the trust and not in the settlor's will. The statutes require that the language be in the document that disposes of the property that is to be used to pay the tax. In a fully funded revocable trust, it is unlikely that any assets passing under the will to a devisee other than the trust will be suitable for paying taxes. For discussion of situations in which limited provisions in a will are desirable because of IRC §2206, concerning life insurance proceeds, and IRC §2207, concerning power-of-appointment property, see §§15.7-15.8.

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§15.5 2. Right of Recovery by Personal Representative

The California statutes described in §15.3 have enforcement provisions that give the personal representative the right to recover the money needed to pay estate and generation-skipping transfer (GST) taxes from the persons who owe them. Prob C §§20116, 20214. There is no express state law giving such a right to the trustee of a revocable trust, but IRC §2205 gives the trustee a right to recover from the executor if the trust pays more than its share of taxes. See §15.6.

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§15.6 B. Federal Apportionment Statutes

Federal statutes provide an odd assortment of apportionment rules. The federal statutes on estate tax collection are based on the somewhat dubious assumption that the executor of a decedent's estate will be the primary payer of estate taxes. Under IRC §2205, anyone other than the executor whose share of the estate is diminished by payment of estate tax is entitled to reimbursement from the estate or to equitable contribution from the persons whose interest in the estate would have been diminished if the tax had been paid before distribution of the estate. Accordingly, most of the federal statutes are concerned with tax attributable to property that would not be in the executor's control. The federal statutes are discussed in §§15.7-15.12. Apart from these rules, apportionment is generally governed by California's statutory apportionment rules, discussed in §§15.3-15.5.

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Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.7 1. Life Insurance Proceeds

§15.7 1. Life Insurance Proceeds

Under IRC §2206, the executor has the right to recover from every beneficiary of life insurance proceeds "such portion of the total tax paid as the proceeds of such policies bear to the taxable estate." The rule does not apply to insurance paid to a surviving spouse in a transfer qualifying for the IRC §2056 federal estate tax marital deduction. Inexplicably, there is no comparable exception for transfers qualifying for the IRC §2055 federal estate tax charitable deduction. Section 2206 does not apply to the extent the decedent directs otherwise in his or her will.

PRACTICE TIP: If the client owns a life insurance policy that will pay proceeds to charity, the client probably intends for the charity to receive the entire proceeds undiminished by payments for estate taxes—particularly inasmuch as the payment of proceeds to the charity does not generate any estate tax. Assuming this is so, the client's will should expressly provide that that the executor shall not recover estate taxes from the charity.

Under a literal reading of IRC §2206, a provision waiving the executor's right of recovery would be ineffective if placed only in the trust. However, in the context of a will that pours all assets into a revocable trust, a waiver of the right of recovery can be achieved in substance by directing in the trust that trust property be used to reimburse the recipient of the insurance proceeds for any estate taxes otherwise payable by the recipient of the insurance proceeds. Nevertheless, a will provision is probably preferable. In the relatively rare case in which it is desirable to override §2206, the will should expressly provide that the executor shall not exercise the §2206 right of recovery with respect to the specific policy in question rather than making the provision applicable to "all" life insurance proceeds.

Note that §2206 does not require an express reference to the particular life insurance policy. Consequently, there is a risk that a boilerplate provision charging estate taxes to the residue of the probate estate might constitute a waiver of the right of recovery even if the clause makes no mention of life insurance proceeds. Because the plan drafter has little way of knowing what life insurance might end up in the taxable estate years later—intentionally or otherwise—such a clause is unwise. For additional reasons not to use will provisions charging taxes to estate residues in the context of revocable trust estate plans, see §15.13.

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§15.8 2. IRC §2041 Power-of-Appointment Property

Under IRC §2207, the executor has the right to recover from the recipients of power-of-appointment property that was included in the settlor's estate under IRC §2041 the proportionate share of the estate taxes attributable to that property.

The statute closely mirrors IRC §2206 relating to life insurance proceeds, including the exclusion for property qualifying for the marital deduction, the failure to exclude property qualifying for the charitable deduction, and the requirement that a waiver of the reimbursement right must appear in the will—not just in the trust. See §12.7.

WARNING: Just as it is undesirable to have a blanket waiver of the IRC §2206 reimbursement right, it is undesirable to have a blanket waiver of the IRC §2207 reimbursement right. Indeed, the risks created by such waivers are greater under §2207 because of the likelihood that property included in the settlor's estate under IRC §2041 was included unexpectedly.

In the relatively rare case in which it is desirable to override IRC §2207, the will should expressly provide that the executor shall not exercise the §2207 right of recovery with respect to the specific property in question, and the revocable trust should expressly state that property of that trust is to be used to pay the estate taxes attributable to the power of appointment property. Such a clause might be appropriate when, for example, the power-of-appointment property is property of a trust that owns real estate that will remain in the family and the trust has no cash available to pay taxes.

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§15.9 3. IRC §2036 Retained Life Estate Property

Under IRC §2207B, the decedent's estate has the right to recover from the recipient of IRC §2036 property (relating to transfers with retained life estates) the proportionate share of the estate taxes attributable to that property. The statute does not apply to charitable remainder trusts. IRC §2207B(d). Unlike the reimbursement rights in IRC §§2206-2207 (see §§15.7-15.8), the reimbursement right may be waived in a revocable trust instrument—not just in a will. IRC §2207B(a)(2). It is unclear how specific the waiver needs to be. It is difficult to conceive of a situation in which it would be appropriate to have a blanket waiver of this right of reimbursement, but waivers may be appropriate for particular assets.

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§15.10 4. IRC §2044 Qualified Terminable Interest Property

If the estate of the surviving settlor includes a qualified terminable interest property (QTIP) trust established by the deceased settlor under IRC §2044, the increase in estate tax attributable to the inclusion of the QTIP trust in the survivor's estate may be recovered by the survivor's estate from the remainder beneficiaries of that trust. IRC §2207A. Unlike the proportionate reimbursement required by IRC §2207B (see §15.9), the QTIP trust bears the burden of the entire increase in tax attributable to the inclusion of the QTIP trust, on the theory that the surviving settlor has no power to control the disposition of the trust.

If the estate plan provides for establishing a generation-skipping transfer (GST) tax exempt "reverse QTIP" election trust, the statute will cause depletion of that trust unless the trust directs that the estate tax attributable to inclusion of that trust in the survivor's estate is to be paid from another source. This is generally accomplished by providing that the tax will be paid to the extent possible from a second QTIP trust that is not GST tax exempt. See §§4.112-4.120.

If the beneficiaries of both settlors are substantially identical and the survivor will wish to avoid the reduction in value of the exempt QTIP trust that would result if taxes were paid from that trust on the survivor's death, the survivor may be willing to override IRC §2207A and pay the estate taxes attributable to the QTIP trust from other assets of the survivor. To accomplish this result, the trust must specifically indicate the survivor's intent to waive the right of recovery (*e.g.,* by specific reference to QTIP, the QTIP trust, §2044, or §2207A) according to the legislative history of IRC §2207A. But see *Eisenbach v Schneider* (Wash App 2007) 166 P3d 858 (provision allocating estate taxes pro rata between QTIP trust and survivor's trust is sufficient to override IRC §2207A). For discussion of GST tax apportionment, see §15.12.

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§15.11 5. QDOT Tax Apportionment

If the surviving settlor is not a United States citizen, no federal estate tax deduction is allowed unless property passes to a qualified domestic trust (QDOT). IRC §§2056(d), 2056A(a). On the death of the surviving settlor, a delayed estate tax is imposed on remaining QDOT property, using the tax rates and exemptions that would have been applicable on the death of the deceased spouse. IRC §2056A(b). See §13.31. The tax must be paid from the QDOT with the result that the other apportionment options available in a QTIP trust are then not available. See §15.10.

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§15.12 6. GST Tax Apportionment

Under IRC §2603(b), generation-skipping transfer (GST) taxes are charged to the property constituting the transfer "unless otherwise directed pursuant to the governing instrument by specific reference to the [GST tax]." It is not clear how specific the reference needs to be. In the context of revocable trust drafting, the primary apportionment involves taxes on direct skips when property is transferred directly from the decedent to a skip person (grandchild or lower generation) or from the decedent to a trust having only skip person beneficiaries.

EXAMPLE 1: If the trust provides for a distribution of $5 million to Grandchild and the trust charges all transfer taxes to the residue without expressly mentioning the GST tax, the GST tax ($931,000 million after application of the decedent's $2 million GST tax exemption) will come out of the $5 million gift. Grandchild will receive a net amount of $4,069,000.

There may or may not be an unintended result if, for example, the trust provides that the residue is to be distributed equally between a child and a grandchild. If the trust document is silent on the subject of GST tax, any GST tax will be charged solely against the grandchild's share, with the consequence that the grandchild will receive less than the child.

EXAMPLE 2: If the residue is such that $5 million after payment of estate tax will be distributed equally to Child and Grandchild and the trust does not mention the GST tax, the GST tax ($162,000 after application of the decedent's $2 million GST tax exemption) will come out of Grandchild's $2.5 million share. Child will receive a net amount of $2.5 million, and Grandchild will receive a net amount of $2,338,000.

If this is the desired result, no additional drafting is required, but it is nevertheless desirable that the trust document indicate that the settlor intended this result. The alternative is for the trust document expressly to provide for the residue to be distributed equally *after* payment of the GST tax. This method will actually increase the GST tax because the grandchild is receiving more property, but that is simply the price of giving more to the grandchild.

EXAMPLE 3: If the residue is such that $5 million after payment of estate tax will be distributed equally to Child and Grandchild after payment of GST tax, Child and Grandchild will each receive a net amount of $2,408,000 after payment of $184,000 in GST tax (after application of the decedent's $2 million GST tax exemption) based on the net amount received by Grandchild.

GST tax apportionment problems are aggravated by the possibility that disclaimers by children will trigger GST tax as a consequence of the disclaimed property passing to grandchildren. It is often unfair to burden other beneficiaries with the additional tax. Under IRC §2603(b), the tax will be charged to the property passing to the grandchildren if the trust is silent, but not if the trust includes a provision charging transfer taxes "including generation-skipping transfer taxes" to the residue. If the trust includes such a clause, it should also include a clause charging disclaimed property with the additional taxes caused by the disclaimer. See §§15.15-15.16.

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§15.13 C. Recommended Apportionment Clause Scheme for Funded Revocable Trusts

In a more or less fully funded revocable trust estate plan that is accompanied by a pour-over will that devises almost everything to the trust, the drafter should consider the following drafting suggestions.

- **Do not use a will provision charging taxes to the residue of the probate estate.** The probate estate is unlikely to have any assets suitable for paying taxes. If there are suitable assets, they typically will pass to the trust, in which event the trust's tax apportionment provisions will apply, and no additional will provisions are needed. See discussion in §§15.3-15.5.
- **Do not include any other apportionment provisions in the will except in the rare case when it is necessary to waive a right of recovery under IRC §§2206-2207B.** For discussion of these recovery rights, see §§15.7-15.9. If the will makes a devise to a devisee other than the trust, a will provision stating that the estate taxes on that devise are to be paid from the trust may be ineffective. A provision that requires payment from trust property must appear in the trust. See §15.4.
- **Include a trust provision that provides for equitable proration under the California statute except as expressly provided.** For a sample trust clause providing for equitable proration under California law, see §15.14.
- **Include a trust provision that provides for transfer taxes caused by a disclaimer to be paid from the disclaimed property.** See discussion and form in §§15.15-15.16.
- **When drafting an exception to equitable apportionment, expressly state the source of the funds to pay the tax.** Exceptions to equitable apportionment are most frequently used in connection with distributions of specific items of property and distributions of specific dollar amounts. Often, the settlor will want the residue to bear the burden of the estate taxes attributable to these items. Generally, the directive to pay the tax from the residue should be part of the provision making the gift in question. The dispositive provisions in chap 8 use this approach, making additional apportionment clauses unnecessary. See, *e.g.*, the clause for the gift of a residence in §8.42.
- **Avoid blanket exceptions.** As a rule, providing an exception to the equitable proration rule will cause additional taxes to be charged to the residue. To avoid unexpected charges to the residue, clauses charging taxes to the residue should refer to a specific gift or a specific list of gifts. Blanket clauses that purport to charge "all" transfer taxes to the residue of the trust are extremely risky and should be avoided. See discussion in §15.1.

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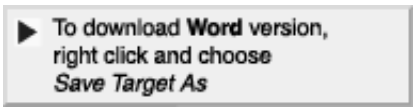
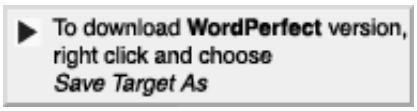
Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.14 1. Form: Equitable Proration Under California Law

§15.14 1. Form: Equitable Proration Under California Law





15.14-1 Equitable proration under California law

***Apportionment of Taxes*. Except as otherwise provided in this document, all estate, generation-skipping, and inheritance taxes, including interest and penalties, imposed on or by reason of the inclusion of any trust property in the gross taxable estate of _ _[*the/either*]_ _ settlor may be paid by the trustee and charged to, prorated among, or recovered from the trust property or the persons entitled to the benefits under the trust as provided in the California Probate Code and the Internal Revenue Code.**

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Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.15 2. Transfer Taxes Caused by Disclaimer

§15.15 2. Transfer Taxes Caused by Disclaimer

A disclaimer that is qualified under IRC §2518 may cause an increase in the estate, inheritance, or generation-skipping transfer taxes owed by an estate. For example, if the surviving settlor disclaims a transfer to the survivor with the result that it passes in a manner that disqualifies it from the federal estate tax marital deduction, the loss of the deduction may generate increased taxes. Similarly, a disclaimer by a child that results in property passing to grandchildren may result in generation-skipping transfer (GST) taxes. IRC §2601. See discussion in §12.12.

EXAMPLE: The deceased settlor has a taxable estate of $5 million in 2009. Under the trust, $3.5 million passes to the decedent's children and $1.5 million to the survivor. The survivor disclaims the gift, which passes to the survivor's children. Except for the disclaimer, the estate tax would be zero. As a result of the disclaimer, the gift ceases to qualify for the marital deduction and the decedent's estate incurs a tax of $675,000. Under equitable proration, $472,500 of the tax will be borne by the decedent's children and $202,500 by the survivor's children.

It might be unfair to require other beneficiaries to bear the tax burden caused by the disclaimer. To avoid this unfairness, a trust can provide that additional taxes resulting from disclaimers will be paid from the disclaimed property. See §15.16.

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§15.16 3. Form: Apportionment of Tax to Disclaimed Property

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15.16-1 Payment of additional taxes from disclaimed property

Transfer Taxes Caused by Disclaimer. **Any increase in estate, generation-skipping, or inheritance taxes, including interest and penalties, resulting from a qualified disclaimer shall be paid from the disclaimed property.**

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Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.17 D. Particular Apportionment Problems

§15.17 D. Particular Apportionment Problems

A variety of circumstances and tax laws can produce situations that demand special attention to tax apportionment. The more common problems are described in §§15.18-15.21.

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§15.18 1. Tax Deductible Gift Paid From Residue

A problem arises when the provisions for distribution of the residue of the trust estate provide for one or more tax deductible gifts and also provide for one or more gifts that are not deductible.

EXAMPLE 1: The trust provides that the trustee shall distribute the residue in equal shares to the settlor's spouse and the settlor's son.

EXAMPLE 2: The trust provides that the trustee shall distribute the residue in equal shares to the settlor's son and The Regents of the University of California.

In Example 1, the gift to the spouse will qualify for the IRC §2056 federal estate tax marital deduction. In Example 2, the gift to the Regents will qualify for the IRC §2055 estate tax charitable deduction. In both examples, a construction problem now arises. Did the settlor want the equal division to be made *before* or *after* the payment of whatever federal estate taxes must be paid from the residue?

EXAMPLE 3: The trust includes the provision described in Example 2 and the residue is $8 million. There are no other taxable gifts. The taxes charged to the residue will be $225,000 on a taxable estate of $4 million if the division is made *before* taking taxes into consideration. On a pretax basis, $4 million will be allocated to each beneficiary. The California apportionment statutes described in §15.3 will charge all of the estate tax payable out of the residue to the son. No tax will be charged to the transfer to the University because that transfer is tax deductible and does not contribute to the estate tax. In the end, the net amount received by the University will be $4 million and the net amount received by the son will be $3,775,000.

If instead, the division of the residue is made *after* payment of tax, the University will receive less, the son will receive more, and the estate taxes will increase (because of the lower charitable deduction resulting from the University's receiving a lower after-tax distribution). The tax increase is about $65,000, raising the total tax to $290,322 (in 2009) on a taxable estate of $4,145,161. The University and the son will each receive $3,854,839.

Which result did the settlor want? How can you tell? Yes, the second alternative produces a higher estate tax, but that is simply the unavoidable cost of giving less to charity. Despite the fact that the California apportionment statute provides an answer, a cautious drafter will make sure that the settlor's intent is expressed in the instrument even if the settlor intends the result provided by the statute. Of course, a custom provision is imperative if the settlor wants the University and son to receive equal net amounts *after* the taxes are paid.

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§15.19 2. Tax Imposed on Gift Taxes Paid

Under IRC §2035, gift taxes paid within 3 years before death are included in the decedent's estate for purposes of calculating the estate tax. Unfortunately, the gift taxes are not an actual asset of the estate or of the trust that can be used to pay the increased estate tax. Whenever a client has paid gift taxes during his or her lifetime, the trust should expressly state the source of funds that will be used to pay the additional taxes if the settlor fails to survive 3 years. The drafter must also consider whether this source will be charged with merely a prorata share of the estate taxes or with the entire increase in taxes resulting from inclusion.

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§15.20 3. Other Uncertainties Concerning Lifetime Transfers

There are many reasons why a drafter may be uncertain about the nature and extent of the property that will be included in the settlor's taxable estate. For example:

- A court might rule that property of a family limited partnership is part of the settlor's estate under IRC §2036. See §4.81.
- Life insurance proceeds might be included in a settlor's estate under IRC §2042 because of negligent drafting of a life insurance trust. See §4.109.
- Life insurance proceeds might be included in a settlor's estate under IRC §2035 because of a transfer of life insurance within 3 years before death. See §4.80.

The statutory provisions described in §§15.3-15.12 sometimes produce results that match the client's wishes, but often this does not occur. Generally, the drafter needs to identify potential issues and then calculate the apportionment results under the various possible scenarios. Because of the many uncertainties, including those related to the future of the estate tax, the drafter may need to draft custom apportionment clauses that use custom formulas to accomplish the settlor's dispositive wishes.

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§15.21 4. IRC §2032A Special Use Valuation Property

Under IRC §2032A, farms, ranches, and sometimes real property used in other businesses may qualify for special use valuation that may lower the value of the taxable estate by as much as $1,000,000 (in 2009). An election is required, and the persons receiving the ranch or farm must consent to the election. If the election is made but there is a failure to use the farm or ranch for a qualifying purpose for ten years, the benefits of the valuation reduction may be recaptured. See §4.116.

On one hand, as a practical matter, the transferees of the farm or ranch will not consent to the election unless they will be the persons benefiting from the reduction in the estate tax. On the other hand, devisees who cannot control the future use of the property do not want to be liable for the possible future imposition of recapture tax. California is one of the few states to address this issue. Under Prob C §20114, the recipients of the farm or ranch receive both the benefits and burdens of the election. When relevant, the trust should confirm that the settlor intended this result, particularly if the settlor might not be domiciled in California at death. The statute can be incorporated by reference.

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§15.22 III. PAYMENT OF DECEASED SETTLOR'S DEBTS AND FUNERAL EXPENSES

The property of a revocable trust is generally liable for a deceased settlor's debts. Under Prob C §19001:

> (a) Upon the death of a settlor, the property of the deceased settlor that was subject to the power of revocation at the time of the settlor's death is subject to the claims of creditors of the deceased settlor's estate and to the expenses of administration of the estate to the extent that the deceased settlor's estate is inadequate to satisfy those claims and expenses.
>
> (b) The deceased settlor, by appropriate direction in the trust instrument, may direct the priority of sources of payment of debts among subtrusts or other gifts established by the trust at the deceased settlor's death. Notwithstanding this subdivision, no direction by the settlor shall alter the priority of payment, from whatever source, of the matters set forth in [Prob C §]11420 which shall be applied to the trust as it applies to a probate estate.

In the context of a funded revocable trust estate plan, there is normally no probate administration, and most if not all of the assets outside the trust that would normally be subject to probate administration will be collected by the trustee under the procedures for transferring small estates without probate in Prob C §§13000-13210.

PRACTICE TIP: If the will makes small devises to devisees other than the trust, it is normally the settlor's intention that the devisees take those assets in kind without the trustee forcing creditors to first resort to those assets. Questions about that intention can be avoided by using the trust to make even small gifts.

Given these circumstances and the fact that a revocable trust provides little protection from creditors, typical revocable trust provisions concerning debts usually do little more than confirm the trustee's authority to pay debts. The trust document may confirm statutory rules for allocating debts between married settlors. See §15.23. The trust document may but normally does not provide that debts are to be paid from specific assets. See §15.24. The trust document may also attempt to address uncertainties about postdeath additions to the trust. See §15.25. Normally, the trust document does not actually *require* the payment of the debts because of the concern that this would create an obligation to seek out creditors that might not otherwise exist. See §15.26. Form trust provisions based on these principles are provided in §§15.27-15.28.

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§15.23 A. Allocation of Debts Between Married Settlors

For a married couple, the trust document may confirm the application of the statutory rules for allocating debt obligations between the deceased settlor and the surviving settlor. Prob C §§19320-19326. These rules are essentially the same as those that would apply under Prob C §§11440-11446 if the decedent's property was administered in a probate proceeding. Debts are characterized as community or separate and are charged to community and separate property accordingly. Funeral expenses are charged entirely to the property of the deceased settlor to preserve the IRC §2053(a) estate tax deduction. Prob C §19326. See §§4.118-4.119.

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§15.24 B. Payment of Debts From Specific Assets

Despite the authorization in Prob C §19001(b), quoted in §15.22, the trust document will not normally provide that debts are to be paid from specific assets but instead leaves this issue to the abatement rules, which, in effect, charge debts to the residue. Prob C §21402(a). See §§8.4-8.7. Similarly, issues of payments of real property taxes, mortgages, and other debts secured by property can be left to the implications of exoneration rules as modified by express distribution provisions that may or may not require the payment of such debts. See §§8.10-8.11.

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§15.25 C. Avoiding Uncertainties Concerning Postdeath Additions to Trusts

Under Prob C §19001(a), quoted in §15.22, revocable trust property may be liable for the settlor's debts. The statute does not address the issue of what happens to property passing to the trust on the settlor's death that a decedent's creditors would not have been able to reach if the property had passed directly to an individual beneficiary. For example, life insurance proceeds payable to an individual are at least partially exempt from levy by the deceased insured's creditors and enjoy some protection from levy by the beneficiary's creditors. CCP §704.100. For discussion of exemptions of retirement benefits and life insurance, see California Estate Planning §§26.39-26.41 (Cal CEB 2002).

There is certainly a risk that naming a revocable trust as the beneficiary of such protected property will result in loss of that protection. The forms in this book authorizing the payment of creditors from the trust attempt to avoid aggravating the risk of lower creditor protection by providing that the trustee is not to pay creditors from property that would be exempt from levy if the property had been transferred to a named individual. See §§15.27-15.28. The effectiveness of this strategy is uncertain. When creditor protection is a significant concern, a revocable trust should probably not be named as the beneficiary of life insurance or pension benefits.

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§15.26 D. Mandating Use of Optional Statutory Creditor Claim Procedure

Probate Code §§19000-19403 establish a court proceeding that the trustee of a revocable trust may use to compel a deceased settlor's creditors to file claims within a 4-month period. The trustee is not required to use the proceeding, but distribution of the trust estate without using the procedure will make each distributee personally liable for the decedent's debts to the extent of the value of the distribution received by that distributee. Prob C §19400. Distributee personal liability exists only to the extent that the creditor's claim cannot be satisfied from the trust estate and is further limited to a prorata portion of the claim "based on the proportion that the value of the property distributed to the person out of the trust estate bears to the total value of all property distributed to all persons out of the trust estate." Prob C §19402(b).

NOTE: When the trust creditor claim procedure is used, the court proceeding is substantially similar to that used in the administration of a decedent's estate. The trustee is required to publish notice in a newspaper (Prob C §19040) and actual notice must be given to known creditors (Prob C §19050). Creditors must usually file claims within 4 months. Prob C §19100(a). For further discussion, see California Trust Administration, chap 10 (2d ed Cal CEB 2001).

Trust provisions mandating use of the creditor claim procedure are generally ill advised. The procedure is rarely used for several reasons: First, CCP §366.2 provides a 1-year limitations period for filing suit on a decedent's obligation. The limitations period may not be tolled for any reason except those listed in the statute and is not tolled during periods such as the minority of a claimant in which the claimant may lack the knowledge or ability to bring a claim. *Farb v Superior Court* (2009) 174 CA4th 678, 94 CR3d 586. Accordingly, the period of time in which new creditors, such as professional malpractice victims who have newly discovered the decedent's negligence, might come forward is already relatively short. Similarly, CCP §366.3 provides a 1-year limitations period for an action alleging breach of a contract to make a will. See *Stewart v Seward* (2007) 148 CA4th 1513, 56 CR3d 651. However, an action to declare that a decedent held title to property under a resulting trust is not subject to the 1-year limitations period of CCP §366.2 but rather is subject to the 4-year limitations period of CCP §343. See *Estate of Yool* (2007) 151 CA4th 867, 60 CR3d 526. Second, the great majority of deceased settlors have relatively few debts, which the trustee can easily pay without incurring the expense of a formal proceeding. Finally, many beneficiaries, often particularly including the successor trustee, are not eager to become subject to a duty to give actual notice to creditors. The creditor claim procedure may sometimes be useful when the trust has a cash flow problem and many creditors.

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§15.27 E. Form: Payment of Debts—Single Settlor

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A. *Debts of Settlor's Estate*. On my death, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. My funeral and last illness expenses.

2. *Other Debts*. My other debts that would be properly payable by my probate estate if the trust property were included in a probate estate rather than this trust and a timely creditor's claim was filed in that estate.

3. *Probate Expenses*. Necessary and proper expenses of administration of my probate estate.

B. *Limitations on Sources of Payment*. Despite the provisions in Paragraph A, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including individual retirement account) benefits in which the trust acquires an interest as a result of the death of the settlor. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the death of the settlor in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

Comment: For discussion of the issues in this clause, see §§15.22-15.26.

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§15.28 F. Form: Payment of Debts—Married Settlors' Joint Trust

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A. *Debts of Deceased Settlor and Estate*. On the death of the Deceased Settlor, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. The Deceased Settlor's funeral and last illness expenses;

2. *Other Debts*. Debts of the Deceased Settlor, the Surviving Settlor, or both, that would be properly payable by the Deceased Settlor's probate estate if the trust property were included in the probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Deceased Settlor's probate estate.

B. *Allocation Between Deceased Settlor and Surviving Settlor*. Payments made for the purposes described in Paragraph A shall be allocated and charged to the separate and community property of each settlor as provided by California law, including Probate Code §§19320-19326, and the trustee shall take any action necessary to recover from the Surviving Settlor or the Survivor's Trust amounts paid that are chargeable to the Surviving Settlor's property. Funeral and last illness expenses shall be allocated and charged to property included in the gross estate of the Deceased Settlor for federal estate tax purposes to the extent possible.

C. *Debts of Surviving Settlor and Estate*. On the death of the Surviving Settlor, the trustee may pay from the property of the Survivor's Trust:

1. *Funeral and Last Illness Expenses*. The Surviving Settlor's funeral and last illness expenses.

2. *Other Debts*. Debts of the Surviving Settlor that would be properly payable by the Surviving Settlor's probate estate if the trust property were included in the Surviving Settlor's probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Surviving Settlor's probate estate.

D. *Limitations on Sources of Payment*. Despite the provisions in Paragraphs A, B, and C, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including an Individual Retirement Account) benefits in which the trust acquires an interest as a result of the settlor's death. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the settlor's death in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

Comment: For discussion of the issues in this clause, see §§15.22-15.26.

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§15.29 IV. TRUST ADMINISTRATION EXPENSES

Trustees necessarily incur expenses in the course of administering the trust. To varying degrees, state law and the list of trustee powers in the trust document give the trustee authority to pay these expenses, including the trustee's compensation. Sometimes this power is merely implied.

In California, Prob C §16243 authorizes the trustee to pay a wide variety of expenses, including trustee compensation, in the absence of contrary provisions in the trust document. Also, Prob C §§15684-15685 authorize the trustee to reimburse the trustee for expenditures made on behalf of the trust and grant the trustee an equitable lien securing payment of those expenditures. If the trustee conveys the trust estate to the beneficiaries without reimbursement of expenses, the equitable lien is extinguished but the trustee may be entitled to indemnity from the beneficiaries personally. Restatement (Second) of Trusts §649 (1959); *Kasperbauer v Fairfield* (2009) 171 CA4th 229, 88 CR3d 494. In some cases, issues may arise regarding the deductibility of expenses (see §§15.30-15.32), source of payment (see §15.33), and allocation of expenses between principal and income (see §15.34).

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Source: Estate Planning/Drafting California Revocable Trusts/15 Payment of Taxes, Debts, and Administration Expenses/§15.30 A. Deductibility of Expenses

§15.30 A. Deductibility of Expenses

Although it is necessary to consider each particular expense, most of the more common expenses of administering a trust are deductible for income tax purposes under IRC §212, which provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
> (1) for the production or collection of income;
> (2) for the management, conservation, or maintenance of property held for the production of income; or
> (3) in connection with the determination, collection, or refund of any tax.

If expenses paid after a settlor's death are allocable to predeath services relating to income-producing assets, they may be deductible by the estate for income tax purposes under IRC §691(b) and also for estate tax purposes. Fees for predeath services relating to non-income-producing assets do not qualify for an income tax deduction and are therefore deductible only for estate tax purposes as claims against the estate. See Rev Rul 76-498, 1976-2 Cum Bull 199. Special rules limit the deductibility of trust expenses for income tax and estate tax purposes. See §§15.31-15.32.

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§15.31 1. Two Percent Floor on Itemized Deductions

The deduction for trust administration expenses of a grantor trust are passed through to the settlors during the settlors' lifetimes and are subject to the 2-percent floor on miscellaneous itemized deductions. IRC §67(c); Temp Treas Reg §1.67-2T(b). The 2-percent floor applies at the trust level after the trust becomes irrevocable. See §4.18.

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§15.32 2. Income Tax Deduction Versus Estate Tax Deduction

In the context of postdeath administration of a trust, many trustee fees and other expenses may be deducted for either estate tax purposes or income tax purposes, but not both. Treas Reg §20.2053-3; IRC §642(g). See §§4.120, 4.123.

If an election is made to claim an income tax deduction rather than an estate tax deduction, any estate tax liability will be increased or—in administering a trust that will make distributions to a bypass trust under a marital deduction formula clause (or similar formula clause dividing the trust between a bypass trust and a charitable trust)—the bypass trust will be reduced in value because of the need to make a larger distribution to the marital deduction trust (or charitable trust) to zero out the estate tax.

There is a limited exception to this rule: The payment of "estate management" expenses (as opposed to "estate transmission" expenses) attributable to the share of trust property distributed to the marital deduction trust or charitable trust from trust income rather than principal will not reduce the marital or charitable deduction and so will not shrink the bypass trust. Estate management expenses are expenses that are incurred in connection with the investment of estate assets or with their preservation and maintenance during a reasonable period of administration. Estate transmission expenses are all other expenses incurred because of the decedent's death. Treas Reg §§20.2055-3(b), 20.2056(b)-4(d). See §11.40.

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§15.33 B. Source of Payment of Expenses

Most trust documents' provisions do not specify the source of payment of administration expenses. In the context of ordinary postdeath administration, the issue of the source of payment is left to the statutory abatement rules, which generally result in the expenses being charged to the residue of the trust property. Prob C §21402(a). See §§8.4-8.7.

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§15.34 C. Allocation of Expenses Between Principal and Income

With a continuing trust that provides for different distributions for income from those for principal, issues may arise as to whether expenses should be charged to income or principal. Most trust documents 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 incurred in 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 legal fees incurred by the trustee of a bypass trust in a dispute concerning whether the trustee 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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16

Office of Trustee

Charles A. Larson

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I. OFFICE OF TRUSTEE

§16.1 A. Choice of Trustee

The settlors' choice of trustees, including successor trustees, is critically important. The trustee or cotrustees will be responsible for managing and investing trust assets and carrying out the settlors' dispositive desires, which, in many trusts, may include deciding when to make distributions and how much to distribute.

Most settlors decide to act as their own trustees during their lifetimes to maintain control over the management of their assets. In addition, competent settlors may amend or revoke their trusts to remove any third party trustee with whom they are unhappy. Their choices of successor trustees usually become irrevocable, however, after the death of the first settlor to die—except for a trust containing the surviving settlor's property, which usually remains revocable. See chap 12.

Although the choice of trustee of a revocable trust has no tax consequences during a settlor's lifetime, the postmortem tax consequences of choosing a particular trustee must be given careful consideration. See, *e g.,* chap 4 (taxation consequences when trustee is beneficiary).

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§16.2 B. Application of Trustee Provisions

When a trust will have subtrusts, cotrustees, or special trustees, it is useful to specify that all provisions regarding the trustee as defined in the trust document (see §16.3) apply to all trusts and trustees established under the trust document (see §16.4).

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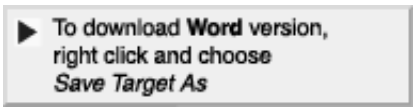
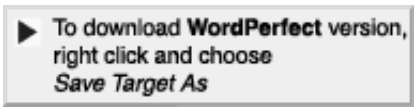
§16.3 1. Form: Definition of Trustee





16.3-1 Definition of trustee

Definition of Trustee. **The term "trustee" as used in this document usually refers to such one or more persons or entities who, alone or in combination, have the power to take action on behalf of the trust, but it may instead refer to any form of limited power or special trustee or one or more individual cotrustees, depending on context.**

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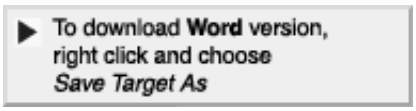
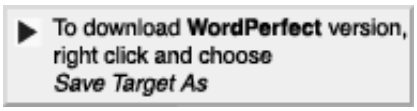
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.4 2. Form: Scope of Trustee Provisions

§16.4 2. Form: Scope of Trustee Provisions





16.4-1 Scope of trustee provisions

Scope of Trustee Provisions. **Except as otherwise provided, the provisions of this document concerning the identity of trustees apply to all trusts established by this document. Similarly, except as otherwise provided, the provisions of this document concerning trustee duties, powers, privileges, and protections from liability, apply to all trustees, including successor trustees, of all trusts established by this document.**

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C. Cotrustees

§16.5 1. Role of Cotrustee

A settlor may wish to have more than one trustee, so that the experience and different skills of each may be used in administering the trust. This often occurs when the settlor desires to combine a corporate trustee's permanence with an individual's personal familiarity with family circumstances or with family investment policy. Note, however, that a corporate fiduciary generally expects to receive the bulk of the trustee fees. If a national bank acts as a cotrustee, bank regulations require that the bank keep the trust records. See 12 CFR §§9.1-9.20.

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§16.6 2. Beneficiary Cotrustee

If a beneficiary is named as a cotrustee, and both cotrustees have the power to participate in the decision to distribute principal to the beneficiary, general power of appointment problems are not avoided unless the other cotrustee is an adverse party. IRC §§2041(b)(1)(C), 2514(c)(3). Special care should be used when both cotrustees are given the power to distribute, because the interests of cotrustees that have been found to be adverse are fairly narrow. For example, a taker in default of appointment under a power has an adverse interest. Similarly, a coholder of a power who, after the holder's death, may exercise the power in favor of him- or herself has an adverse interest. In contrast, a mere coholder of a power does not have an adverse interest merely because of the joint possession of the power, even if the coholder is a permissible appointee. See Treas Reg §20.2041-3(c); Rev Rul 79-63, 1979-1 Cum Bull 302.

On possible adverse tax consequences when a beneficiary has trustee powers, see chap 4.

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§16.7 3. Form: Cotrustees

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16.7-1 Cotrustees

Applicable Rules for Cotrustees. **The following rules apply when a trust has more than one trustee, none of whom has the power to revoke the trust:**

1. *Lack of Unanimity.* Cotrustees who are unable to reach a unanimous decision may act by majority decision.

2. Vacancy. **If a vacancy occurs in a cotrusteeship, the remaining cotrustees may act for the trust.**

3. *Disqualified Trustees.* If one or more trustees cannot participate in a decision concerning a discretionary distribution, the decision shall be made in accordance with the provisions of this document expressly addressing that circumstance.

4. *Temporary Disability.* If a cotrustee is unavailable to perform duties because of absence, illness, disqualification under other law, or other temporary incapacity, and prompt action is necessary to achieve the purposes of the trust or to avoid injury to the trust property, the remaining cotrustee or a majority of the remaining cotrustees may act for the trust.

5. *Delegation of Authority.* A trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly. Unless a delegation was irrevocable, a trustee may revoke a delegation previously made.

Comment: The provision regarding disqualified trustees could arise, for example, when a beneficiary/cotrustee must disqualify him- or herself from considering a discretionary distribution in order to avoid adverse tax consequences. The procedure for handling this should be specifically addressed in the provisions of the trust document dealing with provisional disqualification of a cotrustee from participating in a distribution decision.

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§16.8 D. Special Trustee

A trustee with limited powers, sometimes called a "special trustee," may be appointed to handle specified aspects of trust administration, without shifting the burden of the trustee's other duties and without permitting the special trustee to influence other aspects of trust administration.

The special trustee's powers can be limited to the lifetime of the surviving settlor or individual trustee who needs assistance, or the special trustee's powers can continue indefinitely. Successor special trustees should be provided for in the same manner as for regular trustees.

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§16.9 1. Management of Specified Assets

Appointment of a special trustee should be considered when the settlors want a trustee to obtain specialized assistance in managing certain trust assets or when a corporation wants to be relieved of responsibility for managing certain assets (*e.g.,* copyrights). Specialized assistance is often a concern for settlors who fund a trust with an interest in a closely held business (*e.g.,* a proprietorship or a partnership), the profitability of which depends on a particular individual's management skills. Similarly, vesting voting power over stock in a closely held corporation in a special trustee may facilitate business operations after a settlor's death.

If the settlor consistently relied on the investment or management skills of a particular individual, that person may be appointed special trustee, with powers limited exclusively to the investment or management of all or part of the trust property. Using the special trustee to handle investments permits a family member who is not a sophisticated investor to act as trustee and rely on the special trustee for investment or property management, thus avoiding the need for an institutional trustee or a cotrustee. Failure to include a provision to this effect may result in the trustee's liability for delegation of duty to that individual.

An alternative to appointing a special trustee is requiring an individual trustee to consult with an advisory committee for specific purposes, including investments or property management. It should be made clear that, after consulting the advisory committee, the trustee is free to use its own judgment and exercise its powers in any manner.

During a settlor's lifetime, the settlor may wish to appoint an agent to exercise specified asset management powers of the trustee. This may be accomplished by giving a settlor-trustee the power to name an agent to perform the desired tasks.

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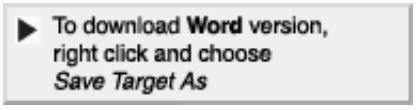
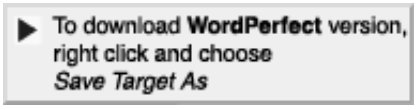
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.10 2. Form: Appointment of Special Trustee

§16.10 2. Form: Appointment of Special Trustee





16.10-1 Appointment of special trustee

[*Add one of the following alternatives*]

[*Alternative 1: Trustee names special trustee*]

Appointment of Special Trustee. **_ _**[*Name of individual trustee*]**_ _, while serving as trustee, may appoint _ _**[*an individual and one or more successor individuals/name of special trustee*]**_ _ as special trustee, who shall be vested with all the rights and powers granted to a trustee under this document exclusively with reference to _ _**[*specify special trustee's duties, e.g., management and investment of commercial real estate held in trust*]**_ _, including without limitation _ _**[*specify any specific powers*]**_ _.**

[*Alternative 2: Settlor names special trustee*]

Appointment of Special Trustee. **After the death of the _ _**[*settlor/surviving settlor*]**_ _, the person(s) listed below, in the order and priority indicated, shall be vested with all the rights and powers granted to a trustee under this document exclusively with reference to _ _**[*specify special trustee's duties, e.g., management and investment of commercial real estate held in trust*]**_ _, including without limitation _ _**[*specify any specific powers*]**_ _.**

First: **_ _**[*Name of special trustee*]**_ _**

Second: **_ _**[*Name of successor special trustee*]**_ _**

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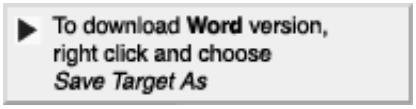
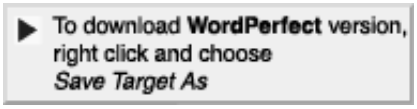
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.11 3. Form: Effect of Powers of Special Trustee on Powers of Trustee

§16.11 3. Form: Effect of Powers of Special Trustee on Powers of Trustee





16.11-1 Effect of powers of special trustee on powers of trustee

Effect of Powers of Special Trustee. **The powers granted in this document to the special trustee shall not limit in any way the power granted in this document to the trustee, except that, as long as the appointed special trustee serves as special trustee of this trust, no other trustee may exercise any powers granted in this document to the special trustee.**

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.12 4. Form: Settlor-Trustee's Power to Use and Employ Agents

§16.12 4. Form: Settlor-Trustee's Power to Use and Employ Agents

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16.12-1 Settlor-trustee's power to use and employ agents

***Power to Use and Employ Agents*. A trustee who is a settlor having a power to revoke a trust may appoint agents to exercise any asset management power of the trustee. This power includes, but is not limited to, the power to authorize any person to be an authorized signatory (either alone or with others, jointly or severally) for any financial institution account or securities account.**

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§16.13 5. Potential for Special Trustee's Conflict of Interest

Probate Code §16004 imposes a duty on the trustee to avoid conflicts of interest. For example, the trustee may not use or deal with trust property for the trustee's own profit, or for any other purpose unconnected with the trust, and may not take part in any transaction in which the trustee has an interest adverse to the beneficiary. Prob C §16004(a). See Prob C §16015 (provision of services for compensation by financial institution or its affiliate to trust of which the institution also acts as trustee is not violation of duty to avoid conflict of interest). See also *Estate of Gilliland* (1977) 73 CA3d 515, 528, 140 CR 795 (trustee designated by settlor cannot be removed merely for potential conflict of interest of which settlor was aware at time of trustee's designation).

The potential for a conflict of interest to arise when the manager of property becomes a special trustee should be specifically recognized in the trust document, and the special trustee should be absolved of liability under circumstances that the settlor will determine in consultation with his or her attorney. Otherwise, the special trustee may refuse to act for fear of incurring liability or becoming a target for removal by beneficiaries of the trust. See also Prob C §§16463 (consent of beneficiaries may relieve trustee of liability for breach), 16464 (release by beneficiary), 16465 (affirmance by beneficiary).

For an exculpatory clause for trustees or special trustees with conflicts of interest, see §16.28.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.14 6. Use of Special Trustee to Protect Beneficiary Trustee From Adverse Tax Consequences

§16.14 6. Use of Special Trustee to Protect Beneficiary Trustee From Adverse Tax Consequences

Appointing a special trustee may also solve the tax problem (discussed in §§16.1, 16.6) that arises when the trustee is a trust beneficiary. After the settlor's death, for instance, a special trustee may be designated to be the only trustee making decisions relating to the payment of income or corpus to the beneficiary trustee or to all family members, with no other powers or responsibilities. This designation eliminates the taxability of trust income to the beneficiary trustee under IRC §678(a).

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.15 7. Compensation

§16.15 7. Compensation

The trust usually provides that the special trustee receive reasonable compensation for carrying out his or her responsibilities. See form 16.10-1. Some drafters also include one of the following provisions specifying the effect of the special trustee's compensation on that of the regular trustee:

- The trustee's compensation shall not be affected by compensation owed to the special trustee; or
- The trustee's compensation shall be reduced when a special trustee has performed and is owed compensation, on the assumption that the trustee's responsibilities have been lessened accordingly.

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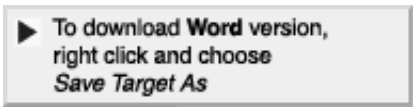
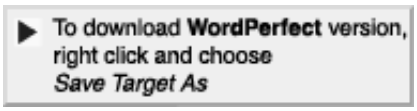
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.16 8. Form: Compensation of Special Trustee

§16.16 8. Form: Compensation of Special Trustee





16.16-1 Compensation of special trustee

Compensation of Special Trustee. **The special trustee shall receive reasonable compensation.**

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E. Trustee's Bond

§16.17 1. Bond Generally Not Required

Probate Code §15602 expressly provides that no bond is required of a trustee (who is named in the trust document) unless the trust document requires a bond or, regardless of the document, a court orders a bond on a finding that the beneficiaries' interests must be protected. Prob C §15602(a)(2). In the absence of trust provisions to the contrary, a bond's cost is borne by the trust. Prob C §15602(d). Trust companies, however, are not required to give a bond, regardless of the trust provisions. Prob C §15602(e).

Limiting the waiver of the bond to persons named in the document as trustee is prudent; requiring a bond of a court-appointed noncorporate successor is justified because the settlor will have had no opportunity to evaluate him or her. This decision, however, can be left to the court's discretion.

For discussion of the trustee's bond and when it should be used, see California Will Drafting §28.22 (3d ed Cal CEB 1992).

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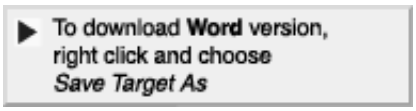
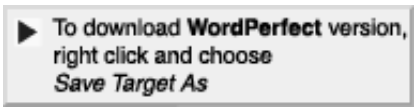
§16.18 2. Form: Trustee's Bond





16.18-1 Trustee's bond

Trustee's Bond. **No bond shall be required of anyone named in this document as trustee, or of anyone appointed as the trustee in the manner specified in this document, for the faithful performance of his or her duties as trustee.**

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/ F. Trustee Compensation/§16.19 1. When Compensation Is Allowed

F. Trustee Compensation

§16.19 1. When Compensation Is Allowed

If the trust does not provide otherwise, the trustee is entitled to reasonable compensation "under the circumstances." Prob C §15681. In the following circumstances, the court is authorized to set as compensation an amount that is greater or less than the amount fixed in the trust document (Prob C §15680(b)):

- The trustee's duties are substantially different from the duties contemplated when the trust was created;
- Compensation according to the trust terms would be inequitable or unreasonably low or high; or
- Extraordinary circumstances require it.

The court may fix compensation only prospectively. Prob C §15680(c). See also Prob C §15682 (order for prospective compensation may be of indefinite duration). Reimbursement of expenses is authorized by Prob C §15684. For further discussion, see 18 Cal L Rev'n Comm'n Reports 1201 (1986).

Unless the trust document provides otherwise, compensation set by the document is apportioned among cotrustees according to the services performed by each. Prob C §15683. Some institutional trustees do not accept apportionment of fees but prefer that they receive reasonable compensation rather than a fixed rate.

WARNING: If an attorney acts as trustee, dual compensation for trustee and legal services is not allowed. Prob C §15687(a). This restriction does not apply if the trustee is related to, or is a cohabitant with, the settlor (Prob C §15687(c)) or if approval is obtained by court order or by no objection on the part of persons entitled to notice (Prob C §15687(d)). A restriction against dual compensation also applies if the attorney performing legal services for the trustee is related to or associated with the trustee. See Prob C §15687(b). Any waiver of the statutory requirements is void as against public policy. Prob C §15687(e).

PRACTICE TIP: If a corporate trustee is appointed, the settlor or drafting attorney should provide either for compensation based on the corporate trustee's fee schedule, as it exists from time to time, or for a fixed percentage. During the drafting stage, the settlor or attorney should try to ascertain whether this provision is acceptable to the trustee.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.20 2. Form: Trustee Compensation

§16.20 2. Form: Trustee Compensation

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16.20-1 Trustee compensation

[*Add one of the following alternatives*]

[*Alternative 1: Reasonable compensation*]

Compensation of Trustees. **Trustees are entitled to reasonable compensation.**

[*Alternative 2: Reasonable compensation even if trustee has relationship with business entity included in trust estate*]

Compensation of Trustee. **The trustee may pay _ _**[*himself/herself*]**_ _ reasonable compensation for services rendered to the trust estate as trustee (even if _ _**[*he/she*]**_ _ is receiving compensation as a partner, an officer, a director, or an employee of any partnership, corporation, or business venture, an interest in which is included in the trust estate) and to reimburse _ _**[*himself/herself*]**_ _ for any expenses of the trust estate that _ _**[*he/she*]**_ _ has paid.**

[*Alternative 3: Percentage of net value of principal*]

Compensation of Trustee. **The trustee shall be paid _ _**[*e.g.*, *one half/three fifths/three fourths*]**_ _ of 1 percent of the average net value of the principal of the trust estate during each calendar year for all ordinary services rendered by _ _**[*him/her/it*]**_ _ and reasonable additional compensation for any extraordinary services. If the trustee serves for part of a calendar year, the annual compensation shall be prorated. In any event, the trustee shall be entitled to reimburse _ _**[*himself/herself/itself*]**_ _ for any expenses of the trust actually paid by _ _**[*him/her/it*]**_ _.**

16.20-2 Optional addition to 16.20-1: Cotrustee compensation

Compensation of Cotrustees. **Cotrustees shall be entitled to reasonable compensation, which shall be apportioned among the cotrustees according to the services rendered by them.**

Comment: Form 16.20-2 may either be added to form 16.20-1 or be used in place of it if cotrustees are appointed.

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II. EXCULPATING TRUSTEE

§16.21 A. Cotrustee Liability

Probate Code §16013 requires 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 specifies the circumstances in which a trustee will be liable to a beneficiary for a cotrustee's acts. These circumstances involve not only such conduct as participation or acquiescence in the breach of trust but also failure 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. If a trustee is aware of a cotrustee's breach of trust, resignation by the innocent trustee may be deemed acquiescence in the breach. See, *e.g., Blackmon v Hale* (1970) 1 C3d 548, 83 CR 194 (partner of attorney who misappropriated funds from law firm's trust account held to have breached duty as cotrustee; although he had withdrawn from firm before deposit of misappropriated funds, his name remained on firm's trust account).

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§16.22 B. Relief From Liability by Trust Provision

The trustee can be relieved of liability for breach of trust by provision in the trust document. Prob C §16461(a). However, a trust provision is not effective to relieve the trustee of liability for breaches of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the beneficiary's interest, or for any profit that the trustee derives from the breach. Prob C §16461(b). A trust provision that purports to relieve the trustee of liability if a beneficiary fails to object to an item in an interim or final account or other written report within a specified time period is not effective unless the specified period is at least 180 days (or the trustee elects to comply with the 180-day requirement), a specified form of notice is provided to the beneficiary, and other conditions are met. Prob C §16461(c)-(j). The notice states that if the beneficiary objects, the 3-year period of Prob C §16460 will apply to the objection. See generally Prob C §§16460-16465 for limitations on proceedings against a trustee and exculpation of a trustee. See also Prob C §§16500-16504 for a notice of proposed action procedure with a 45-day notice period that can be used by the trustee to bar court review of the proposed action if no beneficiary objects. Provisions relieving a trustee from liability to beneficiaries for breach of trust do not relieve the trustee from potential liability to third parties, including liability to creditors of a beneficiary for failure to make required distributions. See *Cassell v Globerson (In re Kolb)* (Bankr CD Cal, May 29, 2007, No. 97-32321) 2007 Bankr Lexis 1896 (trustees jointly and severally liable for distributions to sons of trust beneficiary who purportedly disclaimed his interest in trust property). However, a trustee is generally not liable to third parties for acts of the trustee unless the trustee either fails to reveal his or her fiduciary capacity or is personally at fault. See Prob C §§18000-18002.

Many attorneys believe that a family member or a friend acting as a trustee without compensation should not be liable for misconduct or alleged misconduct short of bad faith, gross negligence, or willful misconduct. Usually an exculpatory clause is inappropriate for a professional trustee except for particular powers, *e.g.,* retention of a family business or a request to refrain from diversifying a large holding of a particular stock. For a form of exculpation of a trustee other than a professional trustee, see §16.23. For a form shortening the time for objection to an account or other written report to 180 days, see §16.23A.

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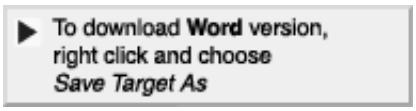
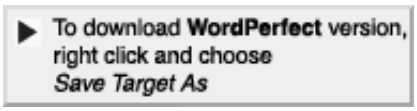
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.23 C. Form: Exculpation of Trustee

§16.23 C. Form: Exculpation of Trustee





16.23-1 Exculpation of trustee

Exculpation of Trustee. **A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, 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 previous 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 person who regularly engages in the business of acting as a trustee.**

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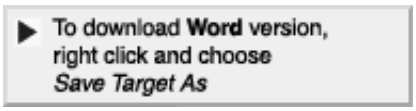
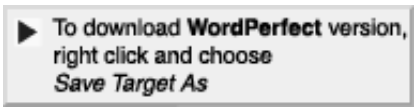
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.23A D. Form: Effect of Account

§16.23A D. Form: Effect of Account





16.23A-1 Effect of account

Limited period for objecting to trustee accounts and reports. **Subject to the provisions of California Probate Code Section 16461 or other applicable statute, if a beneficiary has received an interim or final account in writing, or other written report, that adequately discloses the existence of a claim against the trustee, the claim is barred with respect to that beneficiary unless the beneficiary delivers a written objection to the trustee within 180 days after receipt of the account or report by the beneficiary. For purposes of this paragraph, a beneficiary is deemed to have received an account or report if the beneficiary would be so deemed for purposes of applying the statutory objection period that would otherwise apply.**

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III. LIABILITY FOR ACTIONS OF OTHER TRUSTEES

§16.24 A. Trustee Duties and Liabilities

The trustee's duties are set out in Prob C §§16000-16105. The trustee's liability to the beneficiaries for breach of trust is set out in Prob C §§16400-16442. See chap 17 for a discussion of a trustee's duties and liabilities.

When there are cotrustees, each may feel better able to act if one is not liable for the others' acts, except for acts committed in bad faith or with reckless indifference to the beneficiary's interest. See Restatement (Second) of Trusts §222 (1959). See also *Corbett v Benioff* (1932) 126 CA 772, 14 P2d 1028.

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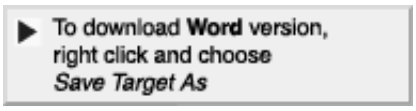
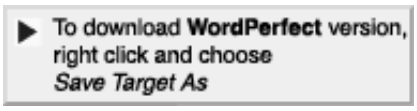
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/ B. Cotrustee Provisions/§16.25 1. Form: Cotrustee's Duty to Act

B. Cotrustee Provisions

§16.25 1. Form: Cotrustee's Duty to Act





16.25-1 Cotrustee's duty to act

***Cotrustee's Duty to Act*. A cotrustee must participate in the performance of a trustee's function unless the cotrustee is unavailable to perform the function because of absence, illness, disqualification under other law, or other temporary incapacity or unless the cotrustee has properly delegated the performance of the function to another trustee.**

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.26 2. Form: Limitation on Duty to Investigate Predecessor or Cotrustee

§16.26 2. Form: Limitation on Duty to Investigate Predecessor or Cotrustee

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16.26-1 Limitation on duty to investigate predecessor or cotrustee

***Limitation on Duty to Investigate Predecessor or Cotrustee*. A successor trustee or cotrustee has no duty to audit or investigate the administration or accounts of any prior trustee or cotrustee unless an audit or investigation is demanded in writing by a beneficiary. Each trustee shall exercise reasonable care to (1) prevent a cotrustee from committing a serious breach of trust, and (2) compel a cotrustee to redress a serious breach of trust.**

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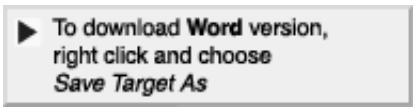
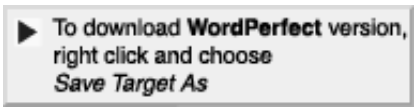
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.27 3. Form: Nonliability for Cotrustee's Acts

§16.27 3. Form: Nonliability for Cotrustee's Acts





16.27-1 Nonliability for cotrustee's acts

Nonliability for Act of Cotrustees. **No trustee shall be liable or responsible for any act, omission, or default of any other trustee** _ _[*as long as the trustee has no knowledge of facts that might reasonably be expected to put the trustee on notice of it*]_ _**.**

Comment: The optional language limits the protection given to the innocent cotrustee. See §16.22. The drafter must determine whether he or she wishes cotrustees to have some duty to keep informed about the other trustees' actions.

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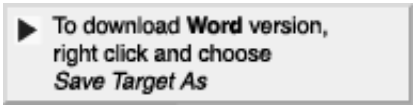
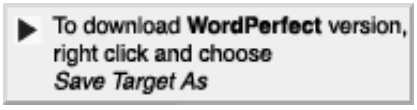
§16.28 4. Form: Nonliability of Trustee or Special Trustee for Conflicts of Interest





16.28-1 Nonliability of trustee or special trustee for conflicts of interest

Nonliability of Trustees for Conflicts of Interest. **The settlors recognize that the _ _[*trustee/special trustee*]_ _ may have current or potential conflicts of interest in the management and investment of _ _[*name of specific property or properties*]_ _ and nevertheless wish _ _[*him/her*]_ _ to serve as _ _[*trustee/special trustee*]_ _ _ _[*if designated*]_ _. The _ _[*trustee/special trustee*]_ _ shall not be liable to any beneficiary, cotrustee, or successor trustee for any acts performed in relation to management and investment in _ _[*his/her*]_ _ fiduciary capacity except for fraudulent or grossly negligent conduct.**

Comment: If the conflict of interest involves a trustee's position in a business, the clause may also state that the trustee shall be entitled to compensation both as a trustee and as an officer, director, partner, or employee of that business, and that the trustee may determine his or her own fair compensation from the business. For restrictions on dual compensation when the trustee provides legal services, see §16.18.

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5. Notice to Trustee of Births, Deaths, and Other Events Affecting Interests

§16.29 a. Purpose of Clause

Although a birth, death, or marriage may alter the beneficial interests in a trust, it is unreasonable to expect the trustee to keep track of such events (except when the death of a settlor causes any portion of the revocable trust to become irrevocable; see Note below). To encourage the trustee to make regular distributions without fear that an event may have reduced or extinguished a beneficiary's interest (*e.g.,* a remarriage), the trust should protect the trustee from liability for distributions made in ignorance of the event. See form 16.30-1.

Unless the drafter includes the option in form 16.30-1, however, the trustee may be relieved of liability for failure to pay death taxes or generation-skipping transfer taxes that may be payable by the trust on the settlor's death, a beneficiary's death, or the occurrence of some other event. The settlor may wish to include the optional clause when a professional trustee will act as trustee but not when a friend or family member will do so.

NOTE: When any portion of the revocable trust becomes irrevocable on the death of a settlor, the trustee must serve the statutory "Notification by Trustee" on beneficiaries of the irrevocable trust and heirs of the deceased settlor within 60 days after the date of the settlor's death. See Prob C §16061.7.

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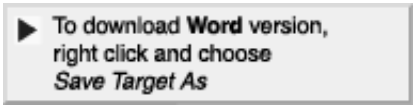
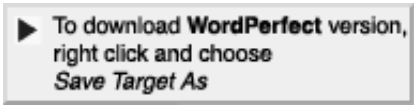
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.30 b. Form: Notice to Trustee of Births, Deaths, and Other Events Affecting Interests

§16.30 b. Form: Notice to Trustee of Births, Deaths, and Other Events Affecting Interests





16.30-1 Notice to trustee of births, deaths, and other events affecting interests

Notice to Trustee. **Unless the trustee has received actual _ _[*written*]_ _ notice of the occurrence of an event affecting the beneficial interests of this trust, the trustee shall not be liable to any beneficiary of this trust for proceeding as though the event had not occurred.**

[*If applicable, add the following option*]

[*Option: Trustee remains liable for paying certain taxes*]

This clause shall not exculpate the trustee from liability arising from nonpayment of death taxes or generation-skipping transfer taxes that may be payable by the trust on the occurrence of an event affecting the beneficial interests of this trust.

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IV. TRUSTEE VACANCY

§16.31 A. Procedures When Office of Trustee Becomes Vacant

The office of trustee shall be deemed vacant if any of the following occurs (Prob C §15643):

- The person named as trustee rejects the trust;
- The person named as trustee cannot be identified or does not exist;
- The trustee resigns or is removed;
- The trustee dies;
- A conservator or guardian of the person or estate of an individual trustee is appointed;
- The trustee is the subject of an order for relief in bankruptcy;
- A trust company's charter is revoked or powers are suspended, if the revocation or suspension is to be in effect for 30 days or more;
- A receiver is appointed for a trust company if the appointment is not vacated within 30 days.

The trust does not terminate when the office of trustee becomes vacant. If the trust document provides a practical method of appointing a trustee or names the person to fill the vacancy, the vacancy will be filled as provided in the trust document. Prob C §15660(b). If the trust document does not so provide, the vacancy may be filled by a trust company that has agreed to accept the trust on agreement of all adult beneficiaries (Prob C §15660(c)); or the court may, on petition of any interested person or any person named as trustee in the trust document, appoint a successor, taking into consideration any nomination by beneficiaries over age 14 (Prob C §15660(d)). A vacancy in the office of a cotrustee must be filled only if the trust so requires. See Prob C §15660(a). See also Prob C §§15642 (grounds for removal of trustee), 17200(a), (b)(10) (petitioning for appointment or removal of a trustee); *Stewart v Towse* (1988) 203 CA3d 425, 249 CR 622 (probate court had jurisdiction under Prob C §15409 to make modifications otherwise forbidden by trust document, including replacement of a successor trustee). See §§16.47-16.58 on appointing successor trustees.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.32 B. Duties and Powers of Former Trustee Pending Delivery to Successor

§16.32 B. Duties and Powers of Former Trustee Pending Delivery to Successor

When a vacancy occurs in the office of trustee, the former trustee who holds property of the trust must deliver the trust property to the successor trustee or a person appointed by the court to receive it. The former trustee remains responsible for the trust property until it is delivered and has the powers reasonably necessary under the circumstances to preserve the trust property until it is delivered to the successor trustee. The former trustee may also perform actions necessary to complete his or her administration of the trust. Prob C §15644.

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V. RESIGNATION OF TRUSTEE

§16.33 A. Methods of Resigning

Under Prob C §15640, a trustee who has accepted the trust may resign only by one of the following methods:

- As provided in the trust document.
- In the case of a revocable trust, with the consent of the person holding the power to revoke the trust.
- In the case of a trust that is not revocable, with the consent of all adult income beneficiaries and beneficiaries entitled to distribution of principal if the trust were terminated at the time consent is sought.
- Under a court order obtained on petition by a trustee under Prob C §17200(b)(11). The court must accept the trustee's resignation and may make any orders necessary to preserve the trust property, including appointing a receiver or a temporary trustee.

With a revocable trust, the rights of the beneficiaries and the trust itself are subject to the settlor's control. Accordingly, the trustee's resignation is accomplished by giving notice to the settlor, not the beneficiaries. Official Comment to Uniform Trust Code §705.

The liability for acts or omissions of the resigning trustee or of the sureties on the trustee's bond, if any, is not released or affected in any manner by the trustee's resignation. Prob C §15641.

If the trustee has resigned and a successor is designated in the trust document, third parties will usually transact business with the successor trustee on receipt of the prior trustee's written resignation and the successor's written acceptance. Some third parties may also require a certified copy of the trust document or a trust abstract.

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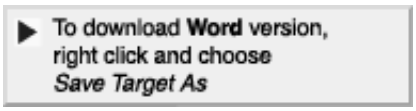
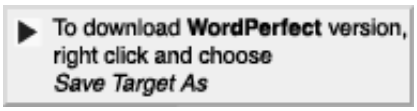
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.34 B. Form: Trustee Resignation

§16.34 B. Form: Trustee Resignation





16.34-1 Trustee resignation

[*Add one of the following alternatives*]

[*Alternative 1: Notice to persons entitled to trustee's account*]

Resignation of Trustee. **The trustee may resign at any time by mailing notice to the persons entitled by law to receive a trustee's account. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.**

[*Alternative 2: Notice to settlor*]

Resignation of Trustee. **The trustee may resign on 30 days' notice to the settlor and all cotrustees. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.**

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VI. REMOVAL OF TRUSTEE

§16.35 A. How Trustee May Be Removed

A trustee may be removed (1) as provided in the trust document; (2) by the court on its own motion; or (3) on petition of a settlor, cotrustee, or beneficiary to remove a trustee under Prob C §17200(b)(10). Prob C §15642(a).

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§16.36 1. Statutory Grounds for Removal

The statutory grounds for removal by a court include (Prob C §15642(b)):

- Breach of trust;
- Insolvency or unfitness to administer the trust;
- Hostility or lack of cooperation among cotrustees;
- Failure to act;
- Excessive trustee compensation under the circumstances;
- Substantial inability to manage the trust's financial resources or otherwise execute properly the duties of the office;
- Substantial inability to resist fraud or undue influence; or
- Other good cause.

See also Prob C §16420(a)(5) (if trustee commits breach of trust, beneficiary or cotrustee may commence proceeding to remove trustee). However, substantial inability to manage the trust's financial resources or otherwise execute properly the duties of the office may not be proved solely by isolated incidents of negligence or improvidence. Prob C §15642(b)(7)-(8).

A sole trustee may be removed if he or she is a disqualified person under Prob C §21350(a) (relating to invalidity of provision of document making donative transfers to, among others, persons who drafted the document under which the transfer is made). See §2.36. The trustee will not be removed if, based on any evidence of the intent of the settlor and all other facts and circumstances, 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. Any waiver by the settlor of this provision is void as against public policy. Prob C §15642(b)(6). The provision for removal of a sole trustee does not apply in certain situations, including when the settlor is related to the trustee or when the document is reviewed by an independent attorney. Prob C §15642(b)(6). On when the "disqualified person" provisions do not apply, see §5.14. For a form of certificate of independent review, see §5.15.

Conflict of interest may be a good cause for removal. See *Getty v Getty* (1988) 205 CA3d 134, 252 CR 342. If the settlor selected the trustee with full knowledge of possible conflicts of interest, however, the trustee may be removed only for a demonstrated abuse of power. *Copley v Copley* (1981) 126 CA3d 248, 178 CR 842. See also Restatement (Third) of Trusts §37(a), Comment f (2003) (court will not ordinarily remove an individual trustee named by settlor on a ground existing at time of trustee's appointment and known to settlor; if trustee is beneficiary, however, court will carefully scrutinize his or her conduct). For a clause of nonliability of trustee or special trustee with conflict of interest, see form 16.28-1.

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§16.37 2. Trust Provisions Authorizing Grounds for Removal

The settlor may also wish to provide for removal and replacement of a trustee for lesser reasons than those set out in Prob C §15642 (discussed in §16.36), *e.g.,* unsatisfactory but not culpable performance or deterioration of personal relationships. Provision for removal for such reasons may, however, create conflict rather than solve problems, and most settlors do not want beneficiaries to overturn their choices of trustees for other than serious reasons (for which the statute provides). The need to protect the trustee from a complaining spendthrift or otherwise unreasonable beneficiary should also be considered before a trustee's removal is authorized because of deteriorating personal relationships.

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§16.38 B. Tax Consequences Arising From Beneficiary's Power to Replace Trustee

The settlor of a revocable trust does not suffer negative tax consequences from having the power to remove and replace a trustee. The settlor's share of the trust estate is already includable in his or her gross estate for estate tax purposes, and each settlor is taxable on his or her share of trust income during a grantor's lifetime.

When the trustee has powers equivalent to a general power of appointment, a beneficiary's power to remove and replace the trustee with anyone, including the beneficiary, is considered to be a general power of appointment in the beneficiary. For example, if the trustee has the discretionary right, not limited by an ascertainable standard, to invade corpus for the beneficiary's benefit or for a group including the beneficiary, and the beneficiary has an unrestricted power to remove the trustee and appoint another, *including him- or herself,* as trustee, the beneficiary is considered to have a general power of appointment over the trust corpus. Reg §20.2041-1(b)(1). See also *Estate of Josephine R. Lanigan* (1965) 45 TC 247; Rev Rul 78-398, 1978-2 Cum Bull 237.

If the trustee's power to invade corpus is limited by an ascertainable standard, this limitation should eliminate the argument that the beneficiary has a general power of appointment for estate tax purposes. See IRC §2041(b).

If the beneficiary's power to remove a trustee without cause and to appoint a successor trustee excludes the power to appoint him- or herself, the beneficiary will not be treated as the holder of a general power. See Rev Rul 95-58, 1995-2 Cum Bull 191.

Under Rev Rul 77-182, 1977-1 Cum Bull 273, a beneficiary's power to replace a corporate fiduciary has no adverse tax consequences if the fiduciary has voluntarily resigned or been removed by judicial process. Revenue Ruling 95-58 modified Rev Rul 77-182 to hold that, even if the decedent had possessed the power to remove the trustee and appoint an *individual* or a corporate successor trustee that was not related or subordinate to the decedent (within the meaning of IRC §672(c)), the decedent would not have retained a trustee's discretionary control over trust income. Related and subordinate parties under §672(c) include the settlor's spouse, parents, issue, siblings, employees, controlled corporations, and a business executive's subordinates.

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§16.38A C. Removal of Incompetent Settlor Acting as Trustee

Most revocable trusts contain provisions concerning the removal of a trustee who is a settlor. The traditional provision provides for a determination of the settlor's inability to perform trustee duties by two physicians. This approach can be slow and expensive and also makes it necessary to include provisions in the estate plan that will waive medical information privacy protections afforded by the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191, 110 Stat 1936) and California's Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37). For a discussion of those protections and forms for drafting waivers, see §§16.45-16.46C.

A more practical alternative is for the settlor to name lay persons to make the determination. Family members and friends often have a much greater sense of a settlor's capabilities than a physician. Further, a requirement to use physicians does not provide a settlor with any protection from a possible premature assumption of trustee powers by the nominated successor trustee. Under California law, the successor trustee can prematurely exercise trustee powers in any event merely by presenting banks and other third parties with Certifications of Trust. Prob C §§18100-18108. See §§22.1-22.2. The settlor's primary protection against improper action by the settlor is the settlor's retained ability to revoke or amend the trust if the settlor in fact has sufficient capacity to do that.

PRACTICE TIP: If a clause naming lay persons is used to make the determination of the settlor's inability to perform trustee duties, the same type of clause and the same named persons should be used in the settlor's durable power of attorney to make the determination of incapacity.

Fortunately, serious disputes concerning settlor capacity to administer a trust are relatively rare. Many settlors authorize successor trustees to be signatories on financial and brokerage accounts long before fully losing capacity. Others are eventually cajoled into signing resignations. In the rare case of a bona fide dispute about settlor capacity to administer the trust, the controversy will end up in court regardless of any language in the trust document.

Although clauses providing for determination of capacity by third parties, regardless of whether they are physicians or lay persons, may provide little additional protection for the settlor, they can be useful for the purpose of protecting the successor trustee from possible later claims by beneficiaries that the successor acted improperly in assuming the position of trustee. For an example of such a clause, see §16.39.

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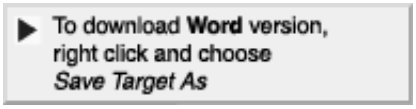
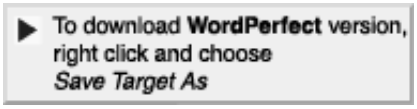
§16.39 C. Form: Removal of Incompetent Settlor Acting as Trustee





16.39-1 Removal of incompetent settlor acting as trustee

Removal of Settlor-Trustee. **A settlor may be removed from the position of trustee if the settlor can no longer effectively manage the affairs of the trust because the settlor is missing, lacks the physical ability to act, or lacks sufficient mental capacity to perform the duties of the trustee. A majority of the following named persons shall have the power to determine that a settlor is unable to act as trustee for any of those reasons: _ _[*Names of persons given the power to make the determination*]_ _. The removal power must be exercised by executing and delivering to the successor trustee an affidavit that states that the settlor cannot perform the duties of the trustee and explains the reason(s). Alternatively, if the inability to act is due to lack of physical ability or sufficient mental capacity, a settlor's inability to manage the affairs of the trust may be established by the affidavits of two physicians authorized to practice medicine in the place where the settlor then resides. In the event of a removal of a settlor from the position of trustee under this paragraph, the successor trustee must immediately give that settlor written notice that the successor has assumed the position of trustee unless the whereabouts of that settlor are unknown. A removal under this paragraph does not constitute a determination that the settlor lacks the capacity to exercise any powers of amendment or revocation, and nothing in this paragraph prevents a settlor from overriding a determination under this paragraph by exercising those powers.**

Comment: In the case of married settlors, different persons may be named to make the determination of the husband's inability to perform trustee duties and the wife's inability to perform trustee duties.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.40 D. Form: Removal of Corporate Trustee

§16.40 D. Form: Removal of Corporate Trustee

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16.40-1 Removal of corporate trustee

Removal of Corporate Trustee. **The current income beneficiary (or a legal representative of that beneficiary) of a trust created under this document may remove a current corporate trustee and substitute a successor corporate trustee if the beneficiary or representative reasonably believes that substitution will result in a significant reduction in trustee fees.**

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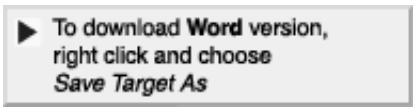
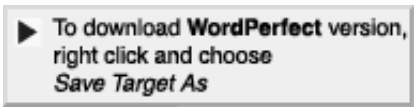
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.41 E. Form: Removal of Any Trustee

§16.41 E. Form: Removal of Any Trustee





16.41-1 Removal of any trustee

Removal of Any Trustee. **Any trustee, including a settlor, may be removed in accordance with California law.**

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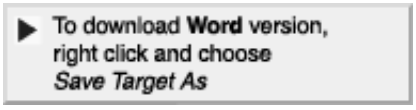
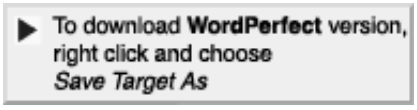
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.42 F. Form: Removal of Trustee by Beneficiary or Third Party

§16.42 F. Form: Removal of Trustee by Beneficiary or Third Party





16.42-1 Removal of trustee by beneficiary or third party

Power to Remove Trustee. **By written document delivered to the trustee, _ _**[*name of beneficiary or third party*]**_ _ may remove any trustee acting under this document with respect to a trust that is no longer revocable by _ _**[*the/either*]**_ _ settlor 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 document. 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*]**_ _.**

Comment: The beneficiary's power to remove a trustee without cause and to appoint a successor trustee is discussed in §16.38.

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G. Removal on Change of Beneficiary's Residence

§16.43 1. Need for New Trustee When Distance Makes Appointed Trustee Inaccessible

The trust may provide for removal and replacement of a trustee if, after the death of an unmarried settlor or both married settlors, the current beneficiary of a trust changes his or her residence and distance makes the appointed trustee inaccessible. Because effective trust administration does not depend on close physical proximity, however, a settlor may not want the trustee to be replaced because of the beneficiary's move. A clause for changing the trustee in such circumstances may be more appropriate for a corporate trustee rather than an individual trustee.

If a settlor wants to include such a clause in a trust with more than one beneficiary, a change of trustee may be permitted when a stated percentage of beneficiaries with a present right to income, or of beneficiaries with a right to income and principal at the trustee's discretion, has changed residences. If the beneficiaries' new residences are spread over a great distance, however, there may be little advantage in a change of trustee. Designation of a new trustee because of change of residence by beneficiaries may also be left to a majority vote of the beneficiaries.

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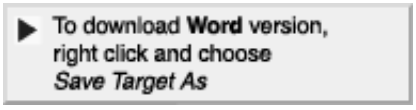
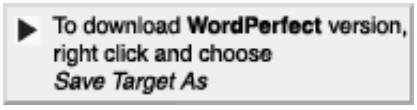
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.44 2. Form: Removal on Change of Beneficiary's Residence

§16.44 2. Form: Removal on Change of Beneficiary's Residence





16.44-1 Removal on change of beneficiary's residence

Removal of Trustee on Change of Beneficiary's Residence. **If, after the death(s) of** _ _[*the/both*]_ _ **settlor(s),** _ _[*name of beneficiary/a majority of current beneficiaries with a present right to income, or of beneficiaries with a right to income and principal at the trustee's discretion,*]_ _ **changes residence to another city or state more than** _ _[*number*]_ _ **miles from** _ _[*trustee's designated place of business*]_ _**,** _ _[*he/she/they*]_ _ **may by written document delivered to the trustee remove the trustee and appoint as successor trustee a duly authorized corporation doing business within** _ _[*number*]_ _ **miles of the residence(s) of** _ _[*name of beneficiary/a majority of current beneficiaries with a present right to income or of beneficiaries with a right to income and principal at the trustee's discretion*]_ _**. After written acceptance by the appointed corporate trustee, the removed trustee shall promptly deliver all trust assets to the successor trustee** _ _[*together with an accounting from the date of any prior accounting through the date of transfer*]_ _**.**

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/ H. Removal Owing to Trustee Incapacity/§16.45 1. Need for New Trustee When Appointed Trustee Becomes Physically or Mentally Incapacitated

H. Removal Owing to Trustee Incapacity

§16.45 1. Need for New Trustee When Appointed Trustee Becomes Physically or Mentally Incapacitated

Clauses for designating a successor trustee, or for a cotrustee to become sole trustee on the inability or unwillingness of a trustee to serve, implicitly extend to situations in which the trustee becomes physically or mentally incapacitated. The settlor may wish to include a separate clause, however, requiring that a physician certify the trustee's incapacity and that a trusted person (*e.g.,* a close friend or family physician) concur with that certification. 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 the trust document itself or in a contemporaneous document specifically authorizing the release of medical information, 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. On the other hand, if the release of medical information must be sought by an agent under a springing durable power of attorney, there is a chicken-and-egg question whether the agent is authorized to obtain the release of that information in advance of a determination that the trustee is incompetent or indeed whether the trustee can authorize the release of information if the trustee is incompetent. As of this writing, there is no consensus about how these problems should be addressed.

Planners generally want to avoid the need for an agent or 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. In the extreme case, if it turns out that the only way to obtain the release of medical information needed to determine incapacity is to initiate a conservatorship proceeding for the trustee, the purpose of creating the trust in the first place would be substantially defeated. In drafting trust documents, practitioners should consider the following alternatives to using a provision in which a physician's certificate of incapacity is required to trigger replacement of an incapacitated trustee.

- Give the incapacity determination power to someone other than a physician. The power can be given to family members, a trusted friend, or a committee of such persons.
- Give an immediately activated durable power of attorney to an agent who can then authorize the release of medical information to the successor trustee.
- Do not require a determination that the trustee is incompetent or lacks capacity. Instead require a determination that the trustee is no longer able to effectively manage the affairs of the trust.

One commentator argues that these solutions are inadequate, noting that clients are reluctant to give agents immediate powers or give nonphysicians powers to make incapacity determinations, especially without the benefit of medical information. He also argues that these solutions do not effectively deal with the need to remove successor trustees who can no longer carry out their duties, suggesting instead that the trust document should require 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 further discussion of HIPAA issues, see California Powers of Attorney and Health Care Directives, chap 1 (Cal CEB 2008). See also Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide April 2010). For a form of trustee replacement clause containing alternative provisions, see §16.46. For a form of authorization by the settlor for an agent under an advance health care directive to obtain the release of medical information under HIPAA, see §16.46A. For a form of trust provision requiring successor trustees to authorize to release of health information, see §16.46B. For a form of authorization by successor trustees for use and disclosure of health information, see §16.46C.

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.

As noted above, some settlor trustees also create durable powers of attorney for business matters that "spring" into being on the client's incapacity. The practitioner should consider coordinating trust language defining when "incapacity" is deemed established with any such language in a durable power of attorney, provided that medical privacy concerns can be addressed. For a form of springing durable power of attorney, see Powers of Attorney, chap 5.

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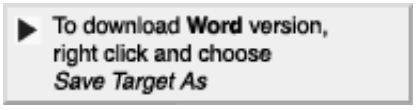
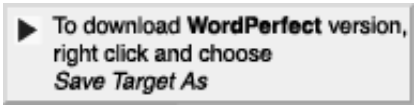
§16.46 2. Form: Replacement of Incapacitated Trustee





16.46-1 Replacement of incapacitated trustee

[*Add one of the following alternatives*]

[*Alternative 1: Determination by physicians*]

Replacement of Incapacitated Trustee. **If the trustee 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 lay persons*]

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 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. The alternative clause naming lay persons to make the determination of the trustee's inability may be customized to permit determination by a single individual.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.46A 3. Form: Grant of Authority to Health Care Agent and Authorization Under HIPAA and California Law for Release of Health Information

§16.46A 3. Form: Grant of Authority to Health Care Agent and Authorization Under HIPAA and California Law for Release of Health Information

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

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

16.46A-1 Grant of authority to health care agent and authorization under HIPAA and California law for release of health information

GRANT OF AUTHORITY TO HEALTH CARE AGENT AND AUTHORIZATION UNDER HIPAA AND CALIFORNIA LAW FOR RELEASE OF HEALTH INFORMATION

I, _ _[*Name*]_ _, grant to my agent under my advance health care directive the authority to advocate for my health care needs even if I have not been determined to lack capacity.

This release shall apply to any of my information which is governed under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), 42 USC §1320d and 45 CFR pts 160, 164, and California law. I intend my agent to be dealt with by all my health care providers, as required by HIPAA and California law, in the exact same way as I would be treated with respect to my rights regarding the use and disclosure of my identifiable protected health information or other medical records.

Pursuant to HIPAA and California law, I authorize any covered entity, including, but not limited to, any physician, health care professional, dentist, health plan, hospital, nursing home, clinic, laboratory, pharmacy, or any other covered health care provider, any insurance company, and the Medical Information Bureau, Inc., or other health care clearinghouse that has provided treatment or services to me or that has paid for or is seeking to be paid for services, to give, disclose, and release to my agent, without restriction and at my agent's request, all of my individually identifiable health information and medical records regarding any past, present, or future medical or mental health condition, including, but not limited to, any and all information relating to the diagnosis and treatment of sexually transmitted diseases, mental illness (including information contained in mental health records protected by the Lanterman-Petris-Short Act), HIV/AIDS, and drug or alcohol abuse.

I understand that:

I may revoke this authorization at any time by written notice to the covered entity;

The covered entity may not condition treatment, payment, enrollment, or eligibility for benefits on whether I sign an authorization unless the law allows conditions;

I have a right to a copy of this authorization; and

Under California law, all recipients of protected health care information may not redisclose it except as required or permitted by law.

This authority shall supersede any prior agreement that I may have made with my health care providers to restrict access to or disclosure of my individually identifiable health information. The authority given to my agent shall expire on _ _[*date*]_ _ or in the event that I revoke this authority in writing and deliver it to my health care provider.

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

Comment: This form may be used as a separate form or attached as a separate page in an advance health care directive.

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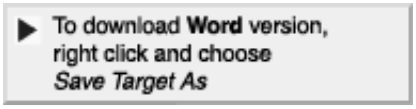
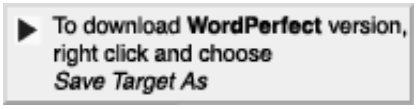
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.46B 4. Form: Trustee Required to Authorize Release of Health Information

§16.46B 4. Form: Trustee Required to Authorize Release of Health Information





16.46B-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, cotrustee, or successor trustee 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, cotrustee, or successor trustee is capable of managing the affairs of the trust.

2. *Revocation of Authorization.* Any trustee, cotrustee, 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, cotrustee, or successor trustee.

3. *Determination of Capacity.* Any individual holding or accepting the office of trustee or cotrustee 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 cotrustee, 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 cotrustee, if any, and otherwise by the next successor trustee or cotrustee, or if there is none, by any beneficiary who is currently entitled to receive income or principal distributions from this trust. A trustee, cotrustee, 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 §16.46C.

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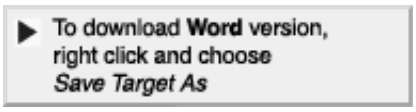
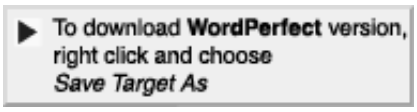
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.46C 5. Form: Authorization for Use and Disclosure of Protected Health Information

§16.46C 5. Form: Authorization for Use and Disclosure of Protected Health Information





16.46C-1 Authorization for use and disclosure of protected 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 cotrustee _ _[*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 cotrustee 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 type face not smaller than 14-point type pursuant to CC §56.11(a).

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VII. SUCCESSOR TRUSTEES

§16.47 A. Designation of Successor Trustees

One or more successor trustees should be named in the trust. The trust should also address the situation in which an incumbent trustee or cotrustee is temporarily unavailable to serve. The same considerations that affect selection of the original trustee apply when selecting successor trustees. See chap 5. Consideration should also be given to letting the acting trustee from time to time designate his or her own trustee, overriding the settlors' selection. Over time, relationships and abilities change, making what appeared to be a good selection inappropriate.

Some practitioners believe that naming a corporate trustee eliminates the requirements for a successor trustee. Although it is true that successors in interest of state and national banks become successor trustees by operation of law following a merger or sale, institutional trustees may terminate their existence as corporate entities without a successor in interest. In addition, they may resign if the trust corpus falls below institutional requirements or if they cannot work effectively with the beneficiaries. Because smaller trusts are often unprofitable for corporate fiduciaries, their resignation has become common in recent years.

Even if the trust gives the original or subsequent trustees the power to name successors, settlors should name successor trustees to provide for the possibility that a trustee will not or can not, by reason of incapacity or death, exercise his or her power to appoint a successor, or that successors appointed by the trustee will resign or be otherwise unable to serve. Naming successor trustees in the trust will eliminate the inconvenience and expense of a court-appointed successor.

If the trust both names successor trustees and gives the acting trustee the power to designate successors, the trustee's designation ordinarily takes precedence.

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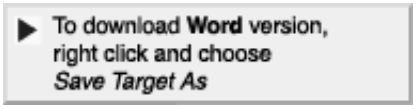
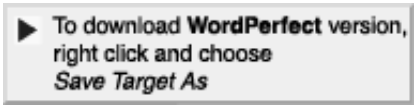
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.48 B. Form: Sole Settlor's Designation of Successor Trustees

§16.48 B. Form: Sole Settlor's Designation of Successor Trustees





16.48-1 Sole settlor's designation of successor trustees

Successor Trustees. **If the _ _[*person/institution*]_ _ named as trustee is unable or unwilling to serve in that office, the _ _[*persons/institutions*]_ _ listed below shall serve as successor trustees in the order named:**

First: _ _[*Name of first successor trustee*]_ _

Second: _ _[*Name of second successor trustee*]_ _

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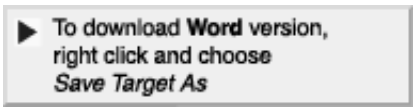
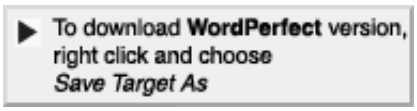
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.49 E. Form: Temporary Trustee

§16.49 E. Form: Temporary Trustee





16.49-1 Temporary trustee

***Temporary Trustee*. If an incumbent trustee or cotrustee is temporarily unable to administer the trust, the person(s) otherwise entitled to be the trustee if the incumbent resigned shall become the trustee until the incumbent can resume the duties of trustee**.

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C. When Successors to Cotrustees Must Be Named

§16.50 1. Maintaining Original Number of Cotrustees

If there are cotrustees and the settlor intends that their number not be diminished, he or she should name a successor for each trustee. There may be tax reasons for not diminishing the number of trustees. For example, if the remaining trustee is a beneficiary and holds a "sprinkling" power, he or she may be taxed on the trust's income unless the power is held jointly with a cotrustee. See IRC §678.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.51 2. Cotrustee Remains Sole Trustee

§16.51 2. Cotrustee Remains Sole Trustee

In certain circumstances, the settlor may wish a cotrustee to remain as sole trustee if the other cotrustee becomes unable or unwilling to act. For example, when an institution and individuals are cotrustees, the settlor may prefer that the institution continue to act when the individual ceases to do so but does not necessarily wish the individual to act alone if the institution ceases to act as trustee. Alternatively, the settlor may prefer that an individual continuously act with the professional trustee to add a personal touch or assuage the feelings of family members.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/ D. Institution Named as Last Successor Trustee/§16.52 1. Ensuring Availability of Successor Trustee

D. Institution Named as Last Successor Trustee

§16.52 1. Ensuring Availability of Successor Trustee

It is impossible to ensure that individual successor trustees will be alive and available when their services are needed. Thus, many settlors name an institution as the last successor trustee in order to avoid leaving that determination to the court.

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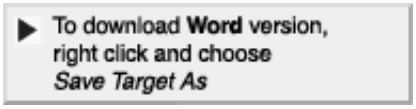
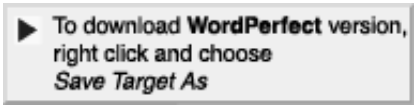
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.53 2. Form: Settlor's Designation of Institution as Last Successor Trustee

§16.53 2. Form: Settlor's Designation of Institution as Last Successor Trustee





16.53-1 Settlor's designation of institution as last successor trustee

Last Successor Trustee. **If all persons named or designated as trustees or successor trustees are unable or unwilling to serve in that office, _ _[*name of bank or trust company*]_ _ shall act as trustee of _ _[*the/all*]_ _ trust(s).**

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E. Power to Name Successor Trustees

§16.54 1. Authorizing Trustee or Beneficiary to Name Successor Trustees

The settlors may give each other as surviving settlor and subsequent trustee the power to name a successor trustee or to change or add to the designation of successor trustees in the document. This power is particularly useful if the trusts created are likely to last for a prolonged period, as when several generations will be beneficiaries in a generation-skipping transfer trust.

In this situation, it is unrealistic to expect that the settlors can name a succession of individual trustees who will be able and willing to act for the entire term of all the trusts. Even when longevity is not an issue, leaving the succession of trustees open provides greater flexibility than would be possible if every successor were irrevocably named. Moreover, even a particular corporate fiduciary may become less attractive by reason of corporate sale of a trust department or extensive turnover of its personnel or changes in its policies.

The power to name successor trustees can be given to the trustee then in office, trust beneficiaries, or third persons. Caution must be exercised if a beneficiary is given the power. If the beneficiary has the right to remove the trustee and the right to appoint a successor, including him- or herself, and if the trustee has powers that constitute a general power of appointment when held by the beneficiary, the beneficiary may be considered to hold a general power of appointment for estate and inheritance tax purposes. See §16.38 on tax consequences when the beneficiary has the power to replace a trustee.

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.55 2. Form: Power to Name Successor Trustee

§16.55 2. Form: Power to Name Successor Trustee

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16.55-1 Power to name successor

[*Add one of the following alternatives*]

[*Alternative 1: Trustee has power to name successor*]

Power to Name Successor Trustee. **A trustee of this trust shall have the power to name a person or entity who shall become that trustee's successor if a successor is required and this document makes no other provision for a successor, or if the successors named in this document are not willing to act. The power shall be exercised as provided in this document for the exercise of a power of appointment.**

[*Alternative 2: Beneficiaries have power to name successor*]

Power to Name Successor Trustee. **In the event of a vacancy in the office of trustee not otherwise provided for in this document, a successor trustee shall be appointed by a majority of the 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.**

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F. Powers and Liabilities of Successor Trustees

§16.56 1. Powers of Successor Trustee

Unless otherwise indicated in the trust, a successor trustee is endowed with all the power of the original trustee by operation of law. Restatement (Third) of Trusts §85 (2007); Restatement (Second) of Trusts §196 (1959). To avoid any dispute, the trust should expressly state that the successor trustees may exercise all powers given to the original trustee or should specify which powers the successor trustees may not exercise. In *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317, the court held that a successor trustee has a right to inspect all confidential communications between a predecessor trustee and an attorney on matters of trust administration. In *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716, however, the court limited the effect of *Moeller* to discovery of a predecessor trustee's privileged documents under Evid C §954 related to matters of day-to-day trust administration. 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 same logic should apply to successor trustees. In *HLC 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 attorney-client privilege formerly held by the decedent. It is unclear whether the result would have been different if the decedent had been the settlor of a revocable trust and the business interests in question were trust property held by a successor trustee. For a critical analysis of *Borisoff* and *Moeller* arguing that there is no such thing as an "office of trustee" for purposes of determining the holder of the attorney-client privilege for trustee communications, 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).

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Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.57 2. Liability of Successor Trustee for Acts of Predecessor Trustee

§16.57 2. Liability of Successor Trustee for Acts of Predecessor Trustee

It may be difficult to find a qualified successor trustee who is willing to act and incur possible liability for failure to discover and redress breaches committed by his or her predecessor. This problem can be alleviated or eliminated by including in the trust document a clause exonerating the successor trustee from liability in this situation. Such a clause may also eliminate substantial expense for investigations and accountings otherwise required by a successor trustee. The clause does not relieve the trustee of liability to third parties, although successor trustees are generally not liable to third parties for the acts of a predecessor. See *Haskett v The Villas at Desert Falls* (2001) 90 CA4th 864, 108 CR2d 888.

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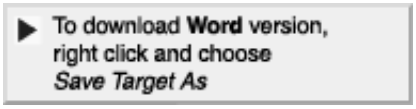
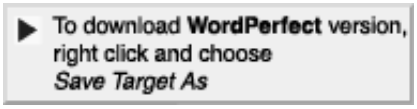
Source: Estate Planning/Drafting California Revocable Trusts/16 Office of Trustee/§16.58 3. Form: Powers and Nonliability of Successor Trustee and Cotrustee

§16.58 3. Form: Powers and Nonliability of Successor Trustee and Cotrustee





16.58-1 Powers and nonliability of successor trustee and cotrustee

Powers of Successor Trustee. **All rights, powers, duties, and discretions conferred on the original trustee shall vest in all successor trustees. No successor trustee or cotrustee shall be responsible or liable for the acts or omissions of any prior trustee or cotrustee, nor shall any successor trustee or cotrustee have a duty to audit or investigate the administration or accounts of any prior trustee or cotrustee** _ _[*unless an audit or investigation is requested in writing by an adult beneficiary*]_ _**.**

Comment: This clause applies to successor trustees named by the settlor or designated by the original trustee. It also applies to successor cotrustees. For discussion of and forms regarding trustee and cotrustee liability for their own acts, see §§16.21-16.23.

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17

Trustee Powers and Duties

Jeffrey A. Dennis-Strathmeyer

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I. DRAFTING POWERS AND DUTIES

§17.1 A. Statement of Powers

The overwhelming majority of attorney-drafted trust instruments contain one or more provisions that purport to state the trustee's "powers." These provisions typically focus on the goal of allowing the trustee to provide evidence that the settlor enabled the trustee to perform certain types of actions, such as the sale of property. In practice, these provisions seldom state all powers of the trustee, but instead emphasize the property management powers. When a power is directly and specifically related to a topic addressed in another part of the trust, it is common and appropriate to state that power as part of the more specific discussion. For example, a trustee power to make nonprorata distributions of property might be stated in the portion of the trust document on distributions, and the power of a cotrustee to act alone in a particular circumstance might be stated in the portion of the trust document on the office of the trustee. Such specific placement reduces the risk that an important power will be overlooked in a lengthy more general powers clause that may have the appearance of boilerplate. This book and the forms in the appendixes follow this approach. See particularly chap 8 (Distributions on Terminating Event) for powers related to distributions of trust property and chap 16 (Office of Trustee) for powers concerning trustee compensation, trustee succession, and co-trustees. Accordingly, the forms in this chapter emphasize more general powers, although the recommended incorporation by reference of powers stated in California statutes and the Uniform Trust Code will result in conferring powers that are specifically stated elsewhere in the trust.

This chapter also addresses problems that arise when a trust document purports to confer a "power," but it appears that the power was intended to modify a possible duty of the trustee. See §17.2. Depending on the settlor's objectives, it may be preferable to redraft the provisions in a manner that either expressly modifies the trustee's duties or modifies them by implication by stating a trust objective that is inconsistent with the trustee's duties imposed by California law in the absence of a contrary trust provision. See §§17.3, 17.27.

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§17.2 B. Probate Code §16202 Power Limitations

When drafting trust powers and when explaining them to clients, the drafter must take into account Probate Code §16202, which, consistent with common law and Uniform Trust Code §815(b) states:

> The grant of a power to a trustee, whether by the trust instrument, by statute, or by the court, does not in itself require or permit the exercise of the power. The exercise of a power by a trustee is subject to the trustee's fiduciary duties.

The purpose of §16202 is to make clear, for example, that even though the trustee has the power to sell Blackacre, the trustee may breach the trust if the trustee negligently sells the property for less than market value or leaves the primary beneficiary without housing. Similarly, the mere grant of a power to hold unproductive property would not permit a trustee to disregard a surviving spouse's power to compel the trustee to make marital deduction trust property productive of income. In one sense, §16202 and the corresponding common law greatly simplify the drafting of trust powers because they facilitate a general approach of granting the trustee broad powers in the great majority of cases, without having to impose specific detailed limits on each power. However, they also create the potential ambiguity described in §17.3.

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§17.3 C. Duty Modifications Distinguished; Potential Ambiguity

Many trust documents contain provisions that purport to grant a trustee a power, but actually attempt to limit or modify a trustee duty. A trustee duty imposes an obligation or a prohibition. A court can compel a trustee to act in accordance with trustee duties, remove a trustee that fails to comply with trustee duties, and surcharge a trustee for breach of duties.

When a trust document appears to limit a duty in language that confers a power, the provision is ambiguous, in part because of application of Prob C §16202 or its common law equivalents. For example, suppose that the trust document grants the trustee the power to retain trust property received at the beginning of the trust, a power to hold a portfolio that is not diversified, or a power not to make property productive of income. If these provisions are simply construed as granting powers, §16202 applies and the trustee may nevertheless be liable for exercising them. Conversely, if these grants of powers are construed as limitations on the trustee's duties, such as the Prob C §16007 duty to make property productive or the Prob C §16048 duty to diversify investments, the trustee arguably cannot be compelled to sell assets, diversify them, and make them productive—and cannot be surcharged for a previous failure to do so.

Because there are at least two possible interpretations of such provisions, the provisions are ambiguous. The construction issue is further complicated by a third possibility. Suppose, for example, that the trust instrument provides with unusual specificity that the trustee is not required to make the family vacation home productive of income. This provision presumably means that the trustee is not required to retain a property manager who will rent the property to vacationers when the family is not using it. It might well be that the settlor did not want rental tenants to interfere with enjoyment of the property by beneficiaries, but did not intend to protect the trustee if the trustee fails to rent the property if circumstances change—for example if the beneficiaries no longer use the property because of failing health, or increased trust income is needed because the primary beneficiary has high medical or convalescent care expenses. Or perhaps the settlor merely wanted to avoid the risk that a trustee would be undesirably eager to rent the property because of fear of trustee liability if the property was allowed to remain empty.

Whatever the settlor's intentions in such matters, the trust document should provide a clearer statement of those intentions than is provided by a boilerplate power listing of "the power to acquire and retain unproductive property." This issue is particularly important if the settlor truly desires to override Prob C §16202, however unwise that may be. For clauses expressly limiting generally applicable trustee duties, see §§17.39-17.41.

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II. TRUSTEE POWERS

§17.4 A. Evolving Presumption of Trustee Power

Modern legal developments also have an impact on decisions concerning the drafting of trustee powers. Historically, particularly in England and particularly in connection with powers to sell or encumber real property, courts were often reluctant to assume that a trustee had powers greater than those expressly stated in the trust instrument. See 3 Scott & Ascher on Trusts §18.1 (5th ed 2007). Further, third parties dealing with trustees often had little protection if they made the mistake of dealing with a trustee who was exceeding the trustee's powers—as often occurs today under laws of agency in general and laws pertaining to attorneys-in-fact in particular. See, *e.g.*, *Lindsay-Field v Friendly* (1995) 36 CA4th 1728, 43 CR2d 71 (in absence of a showing of ostensible authority, persons dealing with assumed agent are bound at their peril to ascertain extent of agent's authority). For these reasons, it became customary for trust drafters to include lengthy lists of powers in their trust instruments.

This legal landscape has significantly changed as a result of both court decisions and legislation. Generally, the legislation took the approach of providing that a trustee had specified powers unless otherwise provided in the trust instrument. See, *e.g.*, the English Trustee Act, 1925, 15 Geo. V, c. 19, and the Uniform Trustees' Powers Act (1964), adopted by the National Conference of Commissioners on Uniform State Laws in 1964. In California, statutes providing trustee powers date back to at least 1943 (see former CC §2261), but these statutes dealt with narrow issues. In 1986, these were replaced with the more organized and comprehensive powers detailed in the California Trust Law. See Prob C §§16200, 16220-16249, which are now augmented by Prob C §§16047(e), 16052. More than half of the states have adopted either the Uniform Trustees' Powers Act or another statute that similarly confers a broad range of powers on trustees. See 3 Scott on Trusts §18.1.

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§17.5 B. Uniform Trust Code

Continuing the trend, the National Conference of Commissioners on Uniform State Laws adopted a Uniform Trust Code in 2000. Copies are available at http://www.law.upenn.edu/bll/ulc/ulc.htm. The Conference used the California Trust Law (Prob C §§15000-19403) as a primary source for developing the Uniform Act. Because the Uniform Trust Code is more recent and more detailed, the form in §17.19 heavily quote (with permission) the powers listed in the Act. The Code was amended in 2005. It is uncertain whether California will adopt all or portions of the Code.

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§17.6 C. Third Party Duty of Inquiry

The law concerning the duty of a third party to inquire into the trustee's powers has also changed significantly. Under Prob C §18100, based on the Uniform Trustees' Powers Act (1964):

> With respect to a third person dealing with a trustee or assisting a trustee in the conduct of a transaction, if the third person acts in good faith and for a valuable consideration and without actual knowledge that the trustee is exceeding the trustee's powers or improperly exercising them:
> (a) The third person is not bound to inquire whether the trustee has power to act or is properly exercising a power and may assume without inquiry the existence of a trust power and its proper exercise.
> (b) The third person is fully protected in dealing with or assisting the trustee just as if the trustee has and is properly exercising the power the trustee purports to exercise.

This statute replaced former CC §2243, which provided:

> Every one to whom property is transferred in violation of a trust, holds the same as an involuntary trustee under such trust, unless he purchased it in good faith, and for a valuable consideration.

In view of the arguable difficulty of showing "good faith" in the absence of a demand for proof of the trustee's powers, the former Civil Code statute commonly inspired such demands. Whether or not as a result of the change in the law, demands for proof of a trustee's powers by a California third party are now relatively rare except in transactions involving securities and title insurance. When demands arise, they can usually be resolved by presentation of a certification of trust. See Prob C §18100.5; chap 22.

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D. Drafting Considerations

§17.7 1. Long Form Versus Short Form Powers Provisions

As a result of the changes described above, a fairly strong argument can be made that it is no longer necessary for drafters to include lengthy lists of powers in trust instruments. A simple provision incorporating the California statute or the Uniform Trust Code by reference is sufficient to confer those powers, including the Prob C §16200(c) catch-all provision that confers "the power to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in [Prob C §]16040 [prudent person standard] or 16047 [prudent investor standard]." The California Law Revision Comment for this provision explains, "Under [Prob C §16200(c)] the trustee has the powers of a prudent person, without the need to obtain prior court approval." This incorporation is certainly sufficient to enable the trustee to execute certifications of trust under Prob C §18100.5 without committing perjury. It will bind beneficiaries, and, when the existence of a power is important for tax purposes, it should suffice for the IRS.

On the other hand, an actual listing of powers provides greater assurance that the settlor fully understands the extent of the trustee powers. This list may avoid beneficiary claims that "I'm sure Mother didn't know she was doing that." It may also cause the settlor to consider whether a particular trustee should be given almost unlimited control over the trust property.

There is a law practice economics issue as well. The cost of adding a long list of powers to a trust document is meager compared with the costs of later needing to provide copies of the incorporated codes to third parties who demand further evidence of a trustee power even though there is no legal basis for the demand. The case for providing a detailed list of powers becomes stronger if the trust is likely to engage in transactions in other jurisdictions, although the Internet has now made it far easier to quickly prove California law to out-of-state transfer agents than it was formerly. Because the law continues to evolve, not always in predictable or sensible directions, express detailed provisions may be more important with "dynasty" and other trusts that will remain in effect for a long period of time.

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§17.8 2. Intentional Limitations on Trustee Powers

Because trustee powers are already limited by Prob C §16202 (see §17.2), which provides that the grant of a power to a trustee does not in itself permit the exercise of the power, and that the exercise of a power is subject to the trustee's fiduciary duties, it is generally unnecessary to include detailed provisions limiting trust powers in the trust document. Indeed, practitioners who recognize such restrictions as depression-era-inspired limitations on permitted investments tend to avoid express limitations. If trust objectives are clearly stated, limitations on powers are frequently unnecessary unless demanded by the client. If, for example, the trust states that a primary purpose of the trust is to permit a beneficiary to live at home for as long as possible, the trustee will breach the trust if the trustee attempts to defeat the objective by a premature sale, and further restrictions are unnecessary. A middle ground approach is to require the consent of an interested person (or at least the absence of an objection by the interested person after being given notice of a proposed trustee action) before specified major transactions can be conducted.

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§17.9 E. Consequences of Incorporating California Law

Probate Code §16200 provides that:

> A trustee has the following powers without the need to obtain court authorization:
> (a) The powers conferred by the trust instrument.
> (b) Except as limited in the trust instrument, the powers conferred by statute.
> (c) Except as limited in the trust instrument, the power to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in Section 16040 or 16047.

Accordingly, California's statutory powers will apply whether or not the drafter incorporates those powers by reference, unless they are limited in the trust instrument. A general construction provision that the trust is to be construed in accordance with California law will probably suffice for an express incorporation, but there is no reason not to be more specific. If the drafter elects to expressly incorporate California law, it is important to be aware of the specific powers that have been incorporated. The drafter should also be aware of potential shortcomings in the statutory list. The discussion in §§17.10-17.18 analyzes the powers conferred by California law in the absence of a contrary provision in the instrument.

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§17.10 1. Powers Without Express Limitations

As originally enacted, the California Trust Law (Prob C §§15000-19403) provided a single set of trustee powers. Additional powers were enacted in response to the Uniform Prudent Investor Act (UPIA) and the Uniform Principal and Income Act (UPAIA). An analysis of these powers reveals (1) a list of powers that are not subject to any special conditions other than the "fiduciary duty" imposed by Prob C §16202; (2) a small number of powers that are subject to specific conditions or limitations; and (3) the omission of some specific powers that are sufficiently important that a specific statement of those powers is desirable.

The following are abbreviated statements of the powers that are not expressly limited. They are presented in the order in which they appear in the Probate Code.

- **Accept additions.** The trustee may accept additional contributions to the trust. Prob C §16221. See discussion on the acceptance of additions in §17.58.
- **Buy and sell property.** The trustee may buy and sell property. Prob C §16226.
- **Manage, change character, and abandon.** The trustee has powers to "manage, control, divide, develop, improve, exchange, partition, change the character of, or abandon trust property." Prob C §16227.
- **Encumber.** The trustee can encumber, mortgage, or pledge trust property. Prob C §16228.
- **Powers regarding buildings.** The trustee may improve, repair, and raze buildings. Prob C §16229.
- **Real estate subdivision development.** The trustee may perform a variety of actions normally associated with real estate subdividing. Prob C §16230.
- **Lease.** The trustee may lease property as lessor or lessee for terms extending beyond the term of the trust. Prob C §16231.
- **Oil and mineral rights.** The trustee may perform a variety of actions normally associated with exploitation of oil and mineral rights. Prob C §16232.
- **Options.** The trustee may grant or take options for the sale or purchase of property. Prob C §16233.
- **Owner of securities.** The trustee may generally exercise voting and other rights of a securities owner and may pay calls and assessment accruing on account of securities. Prob C §§16234-16236.
- **Business reorganizations.** The trustee may consent to and participate in a variety of activities associated with business reorganizations and dissolutions. Prob C §16237.
- **Security in name of nominee.** The trustee has the power to hold a security in the name of a nominee or in "bearer" form. Prob C §16238.
- **Security depository.** The trustee may deposit securities in a securities depository licensed under Fin C §30200. Prob C §16239.
- **Insurance.** The trustee may insure trust property against loss and insure the trustee against liability with respect to third persons. Prob C §16240.
- **Borrow money.** The trustee may borrow money. With a corporate trustee, the lender may include an affiliate or subsidiary of the trustee. Prob C §16241.
- **Third party claims.** The trustee may contest, settle, and pay claims by or against the trust.
- **Taxes, trustee compensation, costs of administration.** The trustee may pay taxes, the trustee's compensation, and a variety of expenses of administering the trust. Prob C §16243.
- **Loans to beneficiaries.** The trustee may lend trust property to beneficiaries and may guarantee loans of beneficiaries. Prob C §16244.
- **Nonprorata distribution.** The trustee may distribute property on a nonprorata basis. Prob C §16246. (For discussion of this power and a form, see chap 11.)
- **Hire advisers and agents.** The trustee has the power to hire persons, including accountants, attorneys, and investment advisers. A corporate trustee may hire agents associated or affiliated with the trustee. Prob C §16247.
- **Execute instruments.** The trustee may execute any instruments needed to exercise a trustee power. Prob C

§16248. (This provision is harmless as well as unnecessary. There is little risk that a grant of a power to perform a specific act, such as sell property, would not be construed as granting the power to take the other actions necessary to accomplish the act.)

- **Litigation.** The trustee may prosecute and defend litigation to protect trust property and "the trustee in the performance of the trustee's duties." Prob C §16249.

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§17.11 2. Limited Powers

Some powers conferred by California law contain limits or qualifications that should be addressed by the drafter. See §§17.12-17.18.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.12 a. Investment in Any Kind of Property

§17.12 a. Investment in Any Kind of Property

Under the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) and Prob C §16047(e), a trustee may invest in any kind of property or type of investment or engage in any course of action or investment strategy consistent with the standards of the UPIA.

The UPIA limits the power to invest in any kind of property by requiring the trustee to manage trust assets as a prudent investor would. This includes evaluation of specific factors described in the statute. The UPIA generally requires diversification of assets. It may sometimes be appropriate to modify that duty. See §§17.14, 17.52.

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§17.13 b. Delegation of Investment and Management Functions

Probate Code §16052 provides that

> (a) A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following:
> (1) Selecting an agent.
> (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust.
> (3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation.
> (b) In performing a delegated function, an agent has a duty to exercise reasonable care to comply with the terms of the delegation.
> (c) Except as otherwise provided in Section 16401, a trustee who complies with the requirements of subdivision (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.
> (d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this state, an agent submits to the jurisdiction of the courts of this state.

The provision provides a limited exception to the common law rule that the "trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." Restatement (Second) of Trusts §171 (1959); 3 Scott & Ascher on Trusts §17.3 (5th ed 2007). This statutory delegation power is generally desirable as far as it goes. A much broader power of delegation that is not limited to investment decisions is provided by Uniform Trust Code §807. See §17.50. Compare the broader delegation power in Restatement (Third) of Trusts §80 (2007) ("trustee has a duty to perform the responsibilities of trusteeship personally, except as a prudent person of comparable skill might delegate those responsibilities to others").

The statute imposes special duties related to any delegation, requiring the trustee to exercise prudence in selecting the agent, establishing the scope and terms of the delegation, and reviewing the agent's overall performance. In some instances, if, perhaps, the trustee is an elderly surviving spouse and there are potentially litigious beneficiaries, the drafter may choose to limit those duties or include an exculpation clause. See chap 16 on exculpation of the trustee.

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§17.14 c. Retention of Property

Probate Code §16220 provides that:

> The trustee has the power to collect, hold, and retain trust property received from a settlor or any other person until, in the judgment of the trustee, disposition of the property should be made. The property may be retained even though it includes property in which the trustee is personally interested.

This provision allows retention of property only until "in the judgment of the trustee, disposition of the property should be made." More significant is that it must be read in light of Prob C §§16203 (grant of a power does not necessarily permit exercise of the power), 16007 (duty to make property productive), 16048 (duty to diversity investments), and 16049 (duty to review assets and make decisions concerning retention and disposition within a "reasonable time"). In view of these limitations, it is often necessary to expressly address asset retention issues in the trust document. For a form addressing this problem, see §14.53.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.15 d. Operation of a Business

§17.15 d. Operation of a Business

The statutory power authorizing operation of a business imposes significant limitations on that power. Probate Code §16222 provides:

> (a) Subject to subdivision (b), the trustee has the power to continue or participate in the operation of any business or other enterprise that is part of the trust property and may effect incorporation, dissolution, or other change in the form of the organization of the business or enterprise.
>
> (b) Except as provided in subdivision (c), the trustee may continue the operation of a business or other enterprise only as authorized by the trust instrument or by the court. For the purpose of this subdivision, the lease of four or fewer residential units is not considered to be the operation of a business or other enterprise.
>
> (c) The trustee may continue the operation of a business or other enterprise for a reasonable time pending a court hearing on the matter or pending a sale of the business or other enterprise.

The requirements for a court order in Prob C §16222(b) severely limit the ability of the trustee to operate a business under Prob C §16222(a) and would certainly make it difficult to convince a court that a trustee can operate a business under the general grant of trustee powers in Prob C §16200. Further, incorporation of the powers of the Uniform Trust Code may not provide desired certainty of the trustee's ability to operate a business because Uniform Trust Code §816(6) merely permits the trustee to "continue" a business. Because of these concerns, the "California Law" portion of the form in §17.19 provides a power to operate a business. More specific provisions are often desirable. See §§17.20-17.26A.

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§17.16 e. Obligations of the United States

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." This limitation on portfolio content seems to conflict with the later enacted trustee power to invest in any kind of asset under Prob C §16047(e). See §17.12. The form in §17.19 overrides the portfolio limitation in the paragraph on "California Law."

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§17.17 f. Deposit of Funds in Excess of FDIC Insurance Limits

Probate Code §16225 provides that:

> (a) The trustee has the power to deposit trust funds at reasonable interest in any of the following accounts:
> (1) An insured account in a financial institution.
> (2) To the extent that the account is collateralized, an account in a bank, an account in an insured savings and loan association, or an account in an insured credit union.
> (b) A trustee may deposit trust funds pursuant to subdivision (a) in a financial institution operated by, or that is an affiliate of, the trustee. For the purpose of this subdivision, "affiliate" means a corporation that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with another domestic or foreign corporation.
> (c) This section does not limit the power of a trustee in a proper case to deposit trust funds in an account described in subdivision (a) that is subject to notice or other conditions respecting withdrawal prescribed by law or governmental regulation.
> (d) The court may authorize the deposit of trust funds in an account described in subdivision (a) in an amount greater than the maximum insured or collateralized amount.
> (e) Nothing in this section prevents the trustee from holding an amount of trust property reasonably necessary for the orderly administration of the trust in the form of cash or in a checking account without interest.

Under Prob C §16225, a court order is required to deposit trust funds in an amount greater than the maximum insured or collateralized amount. The standard maximum deposit insurance amount (SMDIA) is $250,000. 12 USC §1821(a)(1)(E). The Federal Deposit Insurance Corporation (FDIC) has issued a rule that substantially obviates the limitation by raising the insurance limit on revocable trust accounts so that trust account owners with more than five different beneficiaries are insured for the greater of either: five times the SMDIA or the aggregate amount of the ownership interests of all the beneficiaries named in the trusts, limited to the SMDIA per beneficiary, regardless of the amount to be distributed to each beneficiary on the settlor's death (or surviving settlor's death). 12 CFR §330.10(e). If an account is established by more than one owner, the respective interest of each account owner, which are deemed equal, is insured separately, per different beneficiary, up to the SMDIA. 12 CFR §330.10(f).

This limitation on portfolio content seems to conflict with the trustee power to invest in any kind of assets under Prob C §16047(e). See §17.12. The form in §17.19 overrides this limitation in the provision incorporating "California Law."

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.18 g. Distribution to Minors and Incompetents

§17.18 g. Distribution to Minors and Incompetents

If property is to be distributed to a person who is a minor or incompetent, the trustee may instead make a distribution for the benefit of that person or transfer the property to a custodian under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). The power to transfer property to a custodian may apply only to transfers not exceeding $10,000 because the statute incorporates specified limitations in Prob C §3906. Generally, all trusts should contain distribution provisions that expressly address the issues of what actions are to be taken if the trust document otherwise provides for distribution to a minor. Otherwise, distribution will likely be required to a court-appointed guardian and the minor will receive the property at age 18. Alternatives include provisions delaying distribution if a person is under a specified age (see §§8.69-8.72) or distributions to a CUTMA custodian. If expressly authorized in the trust instrument, distributions to a CUTMA custodian can be made in unlimited amounts and the custodianship can continue up to age 25. Prob C §3905.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.19 F. Form: Statement of Broad Trustee Powers

§17.19 F. Form: Statement of Broad Trustee Powers

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***A. General Powers of Trustee*. Subject to any limitations expressly stated in this document, the trustee of each trust established under this document is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:**

1. *California Law.* The 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 insurance, or collateralization requirements otherwise applicable, and the power to operate or participate in any business without complying with any otherwise applicable requirement for a court order.

2. *Prudent Person*. The power to perform any act that a prudent person would take in order to accomplish the objectives of the trust.

3. *Prudent Investor.* The power to perform any act that a prudent investor would take in investing trust property.

4. *Owner of Property.* The power to exercise any right or privilege that an unmarried competent adult has over individually owned property.

5. *Other Powers. A*ny other powers appropriate to achieve the proper investment, management, and distribution of the trust property.

6. *Uniform Trust Code*. Any other powers conferred by the Uniform Trust Code, as revised and amended in 2001 and 2003 by the National Conference of Commissioners on Uniform State Laws.

[*If appropriate, add the following*]

B. *Specific Powers of Trustee*. The powers listed in the previous paragraph include, but are not limited to, those described in this paragraph. The trustee may:

1. Collect trust property and accept or reject additions to the trust property from a settlor or any other person;

2. Acquire or sell property, for cash or on credit, at public or private sale;

3. Exchange, partition, or otherwise change the character of trust property;

4. Deposit trust money in an account in a regulated financial-service institution;

5. Borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the duration of the trust;

6. With respect to an interest in a proprietorship, partnership, limited liability company, business trust, corporation, or other form of business or enterprise, continue the business or other enterprise and take any action that may be taken by shareholders, members, or property owners, including merging, dissolving, or otherwise changing the form of business organization or contributing additional capital;

7. With respect to stocks or other securities, exercise the rights of an absolute owner, including the right to:

a. Vote, or give proxies to vote, with or without power of substitution, or enter into or continue a voting trust agreement;

b. Hold a security in the name of a nominee or in other form without disclosure of the trust so that title may pass by delivery;

c. Pay calls, assessments, and other sums chargeable or accruing against the securities, and sell or exercise stock subscription or conversion rights; and

d. Deposit the securities with a depositary or other regulated financial-service institution;

8. With respect to an interest in real property, construct, or make ordinary or extraordinary repairs to, alterations to, or improvements in, buildings or other structures, demolish improvements, raze existing or erect new party walls or buildings, subdivide or develop land, dedicate land to public use or grant public or private easements, and make or vacate plats and adjust boundaries;

9. Enter into a lease for any purpose as lessor or lessee, including a lease or other arrangement for exploration and removal of natural resources, with or without the option to purchase or renew, for a period within or extending beyond the duration of the trust;

10. Grant an option involving a sale, lease, or other disposition of trust property or acquire an option for the acquisition of property, including an option exercisable beyond the duration of the trust, and exercise an option so acquired;

11. Insure the property of the trust against damage or loss and insure the trustee, the trustee's agents, and beneficiaries against liability arising from the administration of the trust;

12. Abandon or decline to administer property of no value or of insufficient value to justify its collection or continued administration;

13. With respect to possible liability for violation of environmental law:

a. Inspect or investigate property the trustee holds or has been asked to hold, or property owned or operated by an organization in which the trustee holds or has been asked to hold an interest, for the purpose of determining the application of environmental law with respect to the property;

b. Take action to prevent, abate, or otherwise remedy any actual or potential violation of any environmental law affecting property held directly or indirectly by the trustee, whether taken before or after the assertion of a claim or the initiation of governmental enforcement;

c. Decline to accept property into trust or disclaim any power with respect to property that is or may be burdened with liability for violation of environmental law;

d. Compromise claims against the trust that may be asserted for an alleged violation of environmental law; and

e. Pay the expense of any inspection, review, abatement, or remedial action to comply with environmental law;

14. Pay or contest any claim, settle a claim by or against the trust, and release, in whole or in part, a claim belonging to the trust;

15. Pay taxes, assessments, compensation of the trustee and of employees and agents of the trust, and other expenses incurred in the administration of the trust;

16. Exercise elections with respect to federal, state, and local taxes;

17. Select a mode of payment under any employee benefit or retirement plan, annuity, or life insurance payable to the trustee, exercise rights thereunder, including exercise of the right to indemnification for expenses and against liabilities, and take appropriate action to collect the proceeds;

18. Make loans from trust property, including loans to a beneficiary on terms and conditions the trustee

considers to be fair and reasonable under the circumstances, including imposition of a lien on future distributions for purposes of securing repayment of a loan;

19. Pledge trust property to guarantee loans made by others to the beneficiary;

20. Appoint a trustee to act in another jurisdiction regarding trust property in the other jurisdiction, confer on the appointed trustee all powers and duties of the appointing trustee, require that the appointed trustee furnish security, and remove any trustee so appointed;

21. Pay an amount distributable to a beneficiary who is under a legal disability or who the trustee reasonably believes is incapacitated, by paying it directly to the beneficiary or applying it for the beneficiary's benefit, or by:

a. Paying it to the conservator or guardian of the beneficiary's estate;

b. Paying it to the beneficiary's custodian under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) or similar statute and, for that purpose, creating a custodianship or custodial trust;

c. If the trustee does not know of a conservator, guardian, or custodian, paying it to an adult relative or other person having legal or physical care or custody of the beneficiary, to be expended on the beneficiary's behalf; or

d. Managing it as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution;

22. Resolve a dispute over the interpretation of the trust or its administration by mediation, arbitration, or other procedure for alternative dispute resolution;

23. Prosecute or defend an action, claim, or judicial proceeding in any jurisdiction to protect trust property and the trustee in the performance of the trustee's duties;

24. Sign and deliver contracts and other instruments that are useful to achieve or facilitate the exercise of the trustee's powers;

25. Combine two or more trusts into a single trust or divide a trust into two or more separate trusts;

26. On termination of the trust, exercise the powers appropriate to wind up the administration of the trust and distribute the trust property to the persons entitled to it; and

27. Appoint any person to be an authorized signer (either alone or with others, jointly or severally) for any financial institution account or securities account.

Comment: With or without the optional continuation, this form attempts to provide extremely broad property management powers. The provision incorporating California law overrides limitations on powers stated in Prob C §§16222, 16224-16225. See §§17.15-17.17. The incorporated statutes include Prob C §§16200, 16220-16249, 16047(e), and 16052. Portions of paragraph "A" incorporate Uniform Trust Code §815. Except for the last power in the list, the optional language (paragraph "B") quotes Uniform Trust Code §816. The language is optional because it has already been incorporated by reference in Subparagraph A(6). The Uniform Trust Code commentary for §816 discusses most of the listed provisions. The last power in the list permits the trustee to give other persons signature authority with respect to financial institution accounts and securities accounts. Frequently elderly settlors will want a child to be able to access such accounts in order to pay bills. Expressly conferring this authority in the trust document helps assure that the financial institution will allow a nontrustee to take actions with respect to the account. Although it is not necessary to list any of the paragraph B powers, settlors are sometimes required to prove or certify that they have certain powers. It is thus helpful for the document to expressly list, at a minimum and in addition to the power to give other persons signature authority, the powers to acquire or sell property, borrow money and give security, and enter a lease beyond the term of the trust.

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G. Amplification of Business Powers

§17.20 1. Trustee's Ability to Operate a Business

Generally, California law severely limits a trustee's ability to operate a business or even lease property as a lessor in the absence of an express provision in the trust instruments. Prob C §16222. See §17.15. Although the form in §17.21 overrides that limitation and the broad form of trustee powers in §17.19 generally allows the trustee to operate a business, the drafter may choose to provide more specific provisions when it is reasonably certain that the trustee will be operating a business. To the extent possible, these provisions should be tailored to the specific business in question. The drafter should also consider such questions as: What will be the concerns of the other principals of the business concerning the trustee's powers? What issues might be raised by beneficiaries who are unhappy about the trust participating in the business?

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.21 2. Form: Powers for Business Interests

§17.21 2. Form: Powers for Business Interests

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The trustee may continue to hold and operate, sell, or liquidate, at the risk of the trust, any business or investment activity in whatever form, including a sole proprietorship, general or limited partnership interest, trust, corporation (including a closely held corporation), limited liability company, or other entity) that the trustee receives or acquires under this trust. The trustee may 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 the business's 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 appropriate, 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 consider necessary or desirable for the management and operation of any business interest held in the trust, without liability for any loss resulting from the acts or omissions of any of the employees of the business, provided that the act or omission is not that of the trustee acting in the capacity of an employee, that the trustee uses reasonable care in selecting and supervising the employees, and that the trustee did not fail to mitigate the loss or correct the act or omission after having notice of it. The trustee shall pay the employees from the trust 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, any employee of a limited liability company, 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 from the trust for any claims, liability, losses, or damages chargeable against the trustee arising from or connected with the trustee's possession, management, or ownership as trustee of any interest in a business, regardless of its form, as long as the trustee (a) shall not be indemnified for the trustee's own acts or omissions while acting in the capacity of an employee, officer, manager, or director, (b) has used reasonable care in selecting and supervising the employees, officers, or directors, and (c) did not fail to mitigate the loss or correct the negligence after having notice of it.

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3. Corporation Powers

§17.22 a. Authority to Participate in Corporate Organizational Matters

Specific powers regarding corporate business management, such as those in §17.23, should be included. If the settlor owns a corporation and wishes to name a business associate as trustee, to avoid any charge of trustee self-dealing, the drafter should also include an optional clause permitting the trustee to serve even though the trustee personally owns shares in the corporation. See Option 1 in §17.23. See also California Will Drafting §28.42 (3d ed Cal CEB 1992).

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.23 b. Form: Corporate Business Management

§17.23 b. Form: Corporate Business Management

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The trustee may:

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 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 appropriate, 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 an account held in another fiduciary capacity or for the trustee's own account.

[*Option 2: Management and delegation (closely held corporation)*]

The settlor requests but does not require that the trustee vote the stock of the corporation to elect as directors and officers the persons actively participating in the corporation's management when the settlor dies. The corporation's management and the conduct of its operations may be delegated to persons chosen by the corporation's board of directors.

Comment: If the settlor wants to restrict the trustee's powers, the clause should be revised. If the drafter uses Option 2, a clause protecting the trustee from liability for delegating powers should be considered for inclusion in the management clauses.

The drafter may adapt any of these clauses for use in connection with a partnership or limited liability company by substituting partnership or LLC terms for the corporate terms provided in the clauses.

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4. Partnership Interest Powers

§17.24 a. Authority to Hold Partnership Interest

The issues that arise in connection with the inclusion of partnership interests in the trust and that should be addressed are:

- The potential liability to which that holding may expose the trust. On partnership liabilities, see Advising California Partnerships §4.23 (3d ed Cal CEB 1999).
- Whether to expressly empower the trustee to own a partnership interest if the settlor intends the trustee to maintain the partnership interest in the trust.
- Whether to include an optional clause to eliminate issues of trustee self-dealing, if the trustee individually owns an interest in the partnership. See chap 4 on potential for conflict of interest by special trustee; chap 16 on nonliability of trustees for conflict of interest; California Will Drafting §28.42 (3d ed Cal CEB 1992).
- Whether the settlor wants to restrict the trustee's investment powers in the business to that of a limited partner, with the protections afforded by that status (see Advising Partners §5.17), and whether the partnership agreement permits such a conversion.

The drafter should consider adapting one or more of the general business clauses in §17.21 for use in connection with a partnership interest. For instance, the trustee exculpation in Option 2 is advisable in most instances. The attorney may also want to adapt Option 2 in §17.23, recommending trustee retention of the corporate management team in place when the settlor dies.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.25 b. Form: Power to Engage in Partnership Business

§17.25 b. Form: Power to Engage in Partnership Business

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The trustee may:

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, 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 appropriate, add one or more of the following options*]

[*Option 1: Partner trustee 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 or another fiduciary account.

[*Option 2: Trustee must convert general partnership interest to limited partnership interest*]

Despite the foregoing, the trustee shall, if possible, convert any general partnership interest that the trust may hold at the time of, or because of, a settlor's death to a limited partnership interest.

Comment: Option 2 may be used with either the power to engage in a partnership business provided in §17.22 or the general grant of power to engage in business provided in §17.21. Option 2 may also be adapted for use when neither of those clauses is used. Option 2 may also be adapted to cover a limited liability company.

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5. Farming and Ranching Powers

§17.26 a. Authority to Hold Farming and Ranching Interests

Operation by the trust of farming or ranching properties is similar to the conduct of any other business enterprise. The broad form of trustee powers (see §17.19) or general business clauses (see §17.21) should be sufficient to empower the trustee to act. The settlor owner of farm or ranch property may also suggest specific powers that should be given to the trustee in addition to or in place of those found in these forms. Additional clauses that take into account the special valuation provisions of IRC §2032A should be added when the settlor is considering a gift of real property used in farming or by a closely held business. On reduced valuation of farm real property held in trust, see chap 4.

Without express authority in the trust document, 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 because of productivity and diversification concerns, although the form in §17.19 gives the trustee the power to invest in any kind of property and the power to operate a business, and the form in §17.21 gives the trustee the power to retain and operate business interests. See discussion in §§17.11-17.15, 17.20. Accordingly, if the trust estate is likely to contain an interest in a farm or ranch, the settlor may wish to 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 a form of powers for farming interests, see §17.26A.

For detailed discussion of the special problems posed by farms and ranches, see Kelley, Ludtke, & Steinmeyer, Estate Planning for Farmers and Ranchers: A Guide to Family Businesses with Agricultural Holdings (3d ed 2002); Estate Planning for Special Assets, chap 3 (Cal CEB 2004).

PRACTICE TIP: Farm or ranch property passing after the settlor's death may present special tax issues, *e.g.,* those associated with installment payment of taxes under IRC §6166 and allocation of income and expenses on allocation of business receipts. See Prob C §16352.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.26A b. Form: Powers for Farming Interests

§17.26A b. Form: Powers for Farming Interests

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17.26A-1 Powers for farming interests

***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 this document, 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 17.26A-1 gives the trustee the power to hold onto 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 settlor may not want to grant the trustee this power.

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§17.27 III. DUTIES LIMITING POWERS

Because Prob C §16202 (discussed in §17.2) provides that the exercise of a trustee's powers is subject to the trustee's duties, it is typically unnecessary to limit a trustee's powers, either by purporting to deprive the trustee of a particular power or by purporting to impose a duty not to use a power in a particular manner. Indeed, limitations on powers may be undesirable if they limit the trustee's ability to attain the trust's objectives. Nevertheless, there are many situations in which limitations on powers are useful, and clients frequently insist on them.

Clients and drafters should also understand that provisions limiting a trustee's exercise of powers will usually be ineffective if the trustee is willing to breach the trust by, for example, making an unsecured loan of money to the trustee or encumbering trust property despite an express prohibition in the trust instrument. As noted in §17.6, third parties are no longer required to inquire into the powers of the trustee and a trustee willing to risk prosecution for perjury can evidence the trustee's powers by executing a certification of trust. Prob C §§18100-18100.5. See discussion of trust certification in chap 22. When it is exceptionally important to make a power limitation enforceable, the drafter may need to consider the option of clouding the title of the trustee. If, for example, the drafter wishes to prevent the trustee from encumbering real property without the consent of a particular beneficiary, it may be possible to deed the property to both the trustee and the beneficiary, preventing unilateral sale by the trustee.

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§17.28 A. Form: Generic Power Limitation

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17.28-1 Generic power limitation

Despite the powers otherwise conferred on the trustee, the trustee _ _[*does not have the power/is prohibited from*]_ _ _ _[*e.g., selling or encumbering* _ _[*specify property*]_ _ *without the consent of* _ _[*specified beneficiary*]_ _]_ _**.**

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§17.29 B. Limitations Conferring Powers on Individuals

A trustee power is often limited by the fact that the trust instrument confers all or part of a trustee power on someone other than the trustee, either individually or as a cotrustee, special trustee, other fiduciary, or professional adviser. The forms provided in the following discussion of investment powers can be adapted to the particular power in question.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.30 1. Allocation of Investment Powers

§17.30 1. Allocation of Investment Powers

In some instances, particularly those involving corporate trustees, a trust will impose limits on the corporate trustee's investment power by conferring certain rights on a cotrustee, a beneficiary, or an adviser. The following forms provide samples of such provisions.

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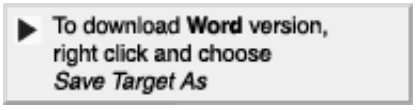
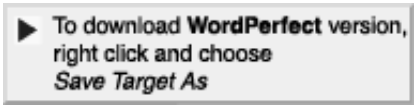
§17.31 2. Form: Corporate Trustee's Duty to Propose Purchases and Sales





17.31-1 Corporate trustee's duty to propose purchases and sales

The corporate trustee shall make periodic reviews of the investments held by the trust and, based on these reviews, shall make written recommendations to _ _[*e.g., the individual trustee*]_ _ regarding proposed purchases and sales of trust assets. Failure to notify the corporate trustee in writing of the disapproval of any proposed sale or investment within _ _[*number*]_ _ days after notice of the recommendation has been mailed to _ _[*e.g., the individual trustee*]_ _ at his or her last-known address shall be considered to be approval. The corporate trustee shall not be liable for any loss resulting from retention of any property if its sale has been expressly disapproved by _ _[*e.g., the individual trustee*]_ _, or from failure to invest any money if its investment has been expressly disapproved by said person.

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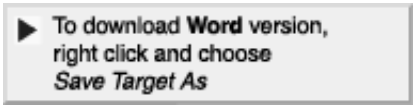
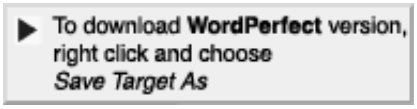
§17.32 3. Form: Investment Power Solely in Individual Trustee





17.32-1 Investment power solely in individual trustee

As long as _ _[*name of individual trustee*]_ _ acts as a cotrustee of this trust, _ _[*he/she*]_ _ shall have the power to direct the corporate cotrustee in writing, from time to time, to retain, sell, exchange, or lease any property of the trust, on specified terms and conditions and to invest funds of the trust in the manner that _ _[*name of individual trustee*]_ _ specifies. The corporate cotrustee shall comply with all written directions, shall have no responsibility to review trust investments, and shall incur no liability to any beneficiary of the trust or to any other person for following the written direction received by it from _ _[*name of individual trustee*]_ _ or for failure to act absent a written direction.

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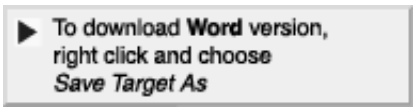
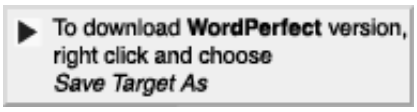
§17.33 4. Form: Special Trustee's Veto Power Over Investments





17.33-1 Special trustee's veto power over investments

The trustee may not exercise any investment power given to the trustee in _ _[*article/paragraph*]_ _ _ _[*number*]_ _ unless the trustee gives written notice to _ _[*name of special trustee*]_ _ of each proposed exercise of that power. On receipt of notice, _ _[*name of special trustee*]_ _ shall promptly notify the trustee in writing of _ _[*his/her*]_ _ approval or disapproval of the proposed action. If the trustee notifies _ _[*name of special trustee*]_ _ of any proposed action by certified mail at _ _[*his/her*]_ _ last-known address, and if the trustee has not received notice of approval or disapproval from _ _[*name of special trustee*]_ _ within _ _[*number*]_ _ days after the date of mailing, _ _[*name of special trustee*]_ _ shall be deemed to have approved the action. On the death or resignation of _ _[*name of special trustee*]_ _ or _ _[*his/her*]_ _ disability to exercise power, the trustee shall, in the trustee's discretion, notify _ _[*name of successor special trustee*]_ _, at his or her last-known address, who shall then have the power to disapprove of all such actions. On the death or resignation of both _ _[*name of special trustee*]_ _ and _ _[*name of successor special trustee*]_ _ or their disability to exercise this power, as certified in writing by two physicians, the trustee may, in the trustee's discretion, exercise the powers given to the trustee in _ _[*article/paragraph*]_ _ _ _[*number*]_ _. The trustee shall not be liable to any beneficiary of this trust for failure to take action disapproved by _ _[*name of special trustee*]_ _ or _ _[*name of successor special trustee*]_ _. _ _[*Name of special trustee*]_ _ and _ _[*name of successor special trustee*]_ _ shall hold the powers given to them in this _ _[*article/paragraph*]_ _ _ _[*number*]_ _ in trust.

Comment: For a discussion of special trustees, see chap 16. For discussion of problems with provisions requiring participation by physicians in disability determinations, see §16.45.

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IV. DUTIES AND DUTY MODIFICATIONS

§17.34 A. Duty Defined

A trustee duty is an obligation to perform or not perform a particular act. A court has the power to compel a trustee to perform the trustee's duties and may enjoin the trustee from violating duties. Prob C §16420(a)(1)-(2). A violation of a duty is a breach of the trust. Prob C §16400. In the event of such a breach, the court may remove the trustee and may compel the trustee to redress the breach by payment of money (a surcharge) or otherwise. Prob C §16420(a). A standard exculpation clause may protect a trustee from the risk of surcharge, but such a clause does not otherwise prevent enforcement of the duty.

See chap 16 for discussion of exculpation clauses and Prob C §16461(b) for a statute that prevents relieving a trustee from liability for acts committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interests of the beneficiary, or for any profit that the trustee derives from the breach of the trust.

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§17.35 B. Trust Drafting Significance

Trustee duties are necessary and important. In the absence of any trustee duties, there would be no trust. Under Restatement (Third) of Trusts §2 (2003),

> A trust, as the term is used in this Restatement when not qualified by the word "resulting" or "constructive," is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and *subjecting the person who holds title to the property to duties* to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee. [Emphasis added.]

Even relatively modest attempts to dilute or eliminate duties may result in a trustee being deemed to be the owner of property for tax purposes—perhaps causing the trustee to be deemed to hold an IRC §2041 general power of appointment over trust property or even causing the trustee to be deemed the actual owner. Conversely, the drafter does not want the trustee to be subject to duties that are inappropriate for accomplishing the settlor's objectives. Indeed, the drafter also wants to make sure that the trustee does not take actions not desired by the settlor as a result of concern that the trustee *might* have a duty to take a certain action—such as sell a family business in order to diversify investments. Unnecessary duties may also increase trust administration costs or cause a prospective trustee to decline the trust. For drafting purposes, it is useful to begin the section of the trust that deals with duties with a general statement of the trustee's duties. See form 17.36-1.

Duty issues are usually best solved by memorializing the settlor's trust objectives in the trust document, but a remarkable number of trust documents fail to do so, in part because many revocable trust provisions are tax-driven and disclose little about the settlor's wishes beyond the distribution provisions themselves. The distribution provisions are also typically stated in language that is tax-driven and uninformative, as in the case when a trustee is given distribution discretion in "ascertainable standard" language approved by Treas Reg §20.2041-1(c)(2). See chap 7.

At least to the extent that the trust document leaves uncertainty as to whether a trustee is obligated to perform or not perform a particular action, common law and statutes may supply a particular duty. The drafter needs to be aware of what duties may be supplied and draft a trust that avoids their unintended application. Of course, some duties are mandatory and will apply regardless of the settlor's wishes. See, *e.g.*, Prob C §16061.7 on the trustee's duty to serve a notice on beneficiaries and heirs when a revocable trust becomes irrevocable.

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§17.36 C. Form: General Statement of Trustee's Duties

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17.36-1 Trustee's duties

A. *Duties of Trustee*. Except as expressly provided in this document, the trustee has the duties imposed by law, including the duty to report and account to trust beneficiaries, statutory duties to give notice and copies of this document to trust beneficiaries and heirs at law on the death of a settlor, and the duty to invest property in accordance with the Uniform Prudent Investor Act.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.37 D. Duties Owed to Settlor

§17.37 D. Duties Owed to Settlor

Probate Code §15800(b) provides that the duties of the trustee of a revocable trust are owed to the person holding the power to revoke. Also, the trustee of a revocable trust must follow any written direction acceptable to the trustee given by the person then having the power to revoke the trust or by the person to whom the settlor delegates the right to direct the trustee. Prob C §16001(a). However, if a written directive given to the trustee would have the effect of modifying the trust, the trustee has no duty to follow the direction unless it meets the requirements for modifying the trust. Prob C §16001(b).

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E. California Statutory Scheme

§17.38 1. Duty to Administer Trust According to Document

Probate Code §16000 provides that

> On acceptance of the trust, the trustee has a duty to administer the trust according to the trust instrument and, except to the extent the trust instrument provides otherwise, according to this division.

The reference to "this division" refers to Division 9 of the Probate Code and therefore includes the entire "Trust Law." Probate Code §16000 is followed by a list of statutory duties that include a duty of loyalty, a duty to deal impartially with beneficiaries, a duty to avoid conflicts of interest, a duty not to undertake adverse interests, a duty to take control of trust property, a duty to make trust property productive, a duty to keep trust property separate and identified, a duty to enforce claims, a duty to defend actions, a duty not to delegate acts to others, duties concerning cotrustees, and a duty to apply any special skills of the trustee. Prob C §§16001-16015. Other statutory duties are in Prob C §§16045-16054 for prudent investing under the Uniform Prudent Investor Act (UPIA); Prob C §§16060-16064 requiring reports and accounts to beneficiaries as well as notices when a trust becomes irrevocable or the trustee changes; Prob C §§16080-16082 on the exercise of discretionary powers; and Prob C §§16100-16105 on duties concerning trustees of charitable trusts.

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§17.39 2. Limiting Statutory Duties

Under Prob C §16000, a trustee's duties are those stated in the trust instrument and, except as otherwise provided in the trust instrument, those required by statute. See also Prob C §16046, which expressly permits trust provisions that expand or limit the rules of the Uniform Prudent Investor Act (UPIA). Some duties cannot be modified, including the duty of the trustee to give specified notices on the death of a settlor of a revocable trust. See Prob C §16061.7.

When considering the desirability of overriding a statutory duty with a trust provision, the drafter should first consider the extent to which this is necessary. If, for example, a trust is created for the purpose of holding a specific asset, as is often true of a life insurance trust, it appears that the Prob C §16048 duty to diversify investments would not apply during the period before the death of the insured. That certainly appears to be the position of Uniform Trust Code §801 and Restatement (Third) of Trusts §4 (2003), both of which first look to the "terms of the trust" in defining the trustee's duties. As explained in the Restatement: "The phrase 'terms of the trust' means the manifestation of intention of the settlor with respect to the trust provisions expressed in a manner that admits of its proof in judicial proceedings." It may thus be possible to consider a significant amount of extrinsic evidence when determining the duties of the trustee, including, for example, evidence that a particular trust was executed at the same time the settlor was arranging a physical examination related to the acquisition of life insurance and the first contribution to the trust coincidentally equaled the first year's premium on the policy.

In contrast, the literal terms of Prob C §16000 appear to be more restrictive on this issue than are the Uniform Trust Code and the Restatement, and they apply statutory duties except to the extent that the trust instrument provides otherwise. Accordingly, in circumstances like those in the preceding paragraph, it is likely to be the better practice in California to expressly override the trustee's duty to diversify investments.

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F. Particular Duties

§17.40 1. Duty of Loyalty

Under Restatement (Third) of Trusts §78(1) (2007): "Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries." This rule is codified in Prob C §16002, which also specifies that the rule is not violated when there are transactions between multiple trusts having the same trustee. Some states have statutes expressly prohibiting or regulating specific self-dealing actions that may violate the more generally stated duty of loyalty. Trustee actions that may violate the duty of loyalty include purchases of trust property by the trustee personally, sale of trust property to an entity in which the trustee has an interest, a sale to the trust of the trustee's own property, a loan of trust property to the trustee personally, a deposit by a corporate trustee in its banking department, an investment by a corporate trustee in its own shares, engaging in a business that competes with a business owned by the trust, causing transactions to occur between multiple trusts with the same trustee and conflicting interests, purchase of an adverse interest, and disclosure of information acquired as trustee if disclosure would harm a beneficiary. For detailed discussions of the actions that may violate the duty, see 3 Scott & Ascher on Trusts §17.2 (5th ed 2007).

Trust documents routinely limit the duty of loyalty either expressly or by implication. (An example of a limitation by implication is a trust provision that grants the trustee a discretionary power to make distributions to the trustee personally. See Comment to Uniform Trust Code §802.) There is a similar implication that self-dealing is permitted when circumstances demonstrate that the settlor knowingly selected a trustee who would necessarily confront a preexisting conflict of interest. This would occur when, for example, a settlor names the child who leases the family farm as the trustee of a trust that includes the farm, in circumstances that suggest the intention that the lease will continue. (Despite the implication, a drafter who is aware that the trustee will have a specific conflict of interest problem should expressly address that problem in the trust instrument. See chap 16.)

The duty of loyalty protects beneficiaries but may result in inflexibility. For example, with the rising federal estate tax exclusion amounts, a surviving settlor-trustee will often administer a significant portion of the family assets in the bypass trust. It may be desirable to permit the survivor individually to engage in transactions with the bypass trust in order to borrow funds, sell or exchange assets, and jointly acquire trust property. The duty of loyalty protects the interests of the other beneficiaries, but it may also limit the survivor's options in the absence of an authorizing court order or consent of all beneficiaries. These considerations must be balanced.

Perhaps the most common limitation on the duty of loyalty is a provision authorizing the trustee to lend its own funds to the trust. If the trustee is a corporate trustee, it is common to permit the trustee to retain shares of its own stock, particularly if the family owns a significant interest in that or a related corporation. It is also common to authorize the corporate trustee to deposit funds in accounts at the bank, purchase mutual funds managed by the bank, and engage the services of itself and its affiliates for various purposes of trust administration. These and less common (and often less appropriate) limitations on the duty of loyalty are suggested by the following form.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.41 a. Form: Limitations on Trustee Duty of Loyalty

§17.41 a. Form: Limitations on Trustee Duty of Loyalty

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17.41-1 Limitations on trustee duty of loyalty

Limitations on Trustee Duty of Loyalty. **As long as the trustee does not act in bad faith or in disregard of the purposes of the trust, it is not a breach of the trust for the trustee to take any of the following actions _ _[***after giving advance written notice of the proposed action to _ _[specify selected beneficiaries or an adviser***]_ _]_ _:**

[*If applicable, add one or more of the following options*]

[*Option 1: Lend trustee's funds for trust purposes*]

1. Lend the trustee's own funds to the trust for any trust purpose, with interest at current rates;

[*Option 2: Receive security for loan*]

2. Receive reasonable security for such a loan;

[*Option 3 : Purchase trust property*]

3. Purchase trust property from the trust at fair market value, provided the purchase price is paid in full in advance;

[*Option 4 : Lease or sell trust property*]

4. Lease or sell the trustee's own property to the trust at a rent or price not in excess of its fair market value;

[*Option 5: Employ trustee, relative, or business*]

5. Employ the trustee, a relative of the trustee, or a business in which the trustee has an interest, to perform needed services for the trust or any business in which the trust has an interest and to pay compensation not exceeding fair market value;

[*Option 6: Acquire property in which trust has interest*]

6. Acquire or retain an interest in property in which the trust also has an interest;

[*Option 7: Acquire stock of corporate trustee*]

7. Acquire or retain stock of a corporate trustee or an affiliate of a corporate trustee unless the acquisition or retention would violate the trustee's duties in the case of stock of a similar corporation other than the trustee or its affiliate;

[*Option 8: Deposits in bank in which trustee has interest*]

8. Deposit funds in a bank in which the trustee has an interest;

[*Option 9: Perform action with relative or business of trustee*]

9. Perform as trustee any action described above with a relative of the trustee or a business in which the trustee has an interest;

[*Option 10: Fail to segregate trust property*]

10. Hold property of multiple trusts without segregating or dividing the property and without separately titling the property of each trust, but instead keeping accounts sufficient to identify the property of each trust.

Comment: A provision similar to Option 11, allowing the trustee to hold property of multiple trusts without segregation, is commonly included in most trusts. In other respects, the drafter should be cautious in choosing the optional provisions. Some practitioners believe that one of the greatest risks to trust property arises when a trustee borrows trust assets at a time when the trustee or the trustee's business has a cash flow problem and the trustee optimistically believes that the problem is short term. If the optimism is not justified, the trust may suffer a substantial loss. Similar problems arise if the trustee is unjustifiably optimistic about the value of individual property provided as collateral for such a loan, or the sale price of property. This can occur when the property is an interest in a business enterprise owned by the trustee individually. Nevertheless, this type of clause is often desirable when the trustee is the primary beneficiary, or if the trustee is personally involved in the operation of a family business in which the trustee may also hold an interest personally. Provisions allowing the employment of the trustee and relatives of the trustee may be helpful in situations in which the trustee and relatives will likely be providing for the personal care of a settlor who may become incompetent.

Risks can be reduced by requiring notice to specified persons or requiring the consent of a cotrustee or special trustee. The opening language "not act in bad faith or in disregard of the purposes of the trust" is taken from Prob C §16081(a), which similarly limits the authority of a trustee having "absolute" or "uncontrolled" discretion.

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§17.42 b. Custom Limitations on Duty of Loyalty for Businesses

In many situations involving businesses, the settlor will select a trustee who actively participates in the business. This person may be a business associate or, more often, a family member who will also be a beneficiary. Examples of conflict of interest problems that arise in this situation include:

- The nominated trustee leases as lessee a farm owned by the trust, will have the power to determine the periodic rental, and will not want the farm sold for purposes of diversifying investments or increasing trust income.
- The nominated trustee is a co-owner of rental real estate who receives a salary or other compensation for managing the property.
- The nominated trustee is a fellow stockholder who will be able to vote a majority of the stock of the corporation (or other entity) after becoming trustee. The nominated trustee will therefore have the indirect power to control the salary and other benefits, including stock options, that he or she receives as president of the corporation.
- The trustee is an attorney, accountant, or other professional who has been compensated as such in the past.

When these situations are known to exist at the time the trust is drafted, the drafter should discuss the issues with the settlor and devise solutions that reflect the settlor's wishes. Potential solutions in the farm lease situation, for example, might include:

- A provision requiring an independent appraisal when determining farm rent in the absence of the agreement of named family members.
- A provision permitting retention of the farm for a specified period, but compelling sale at the end of the period with the trustee having an option to purchase on favorable terms.

Comment: Addressing these kinds of issues is common practice in business succession planning.

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§17.43 2. Duty to Deal Impartially With Beneficiaries

If a trust has two or more beneficiaries, the trustee must deal impartially with them "taking into account any different interests of the beneficiaries." Prob C §16003. See also Restatement (Third) of Trusts §79 (2007). It is difficult to conceive of a situation in which it would be appropriate to limit this duty rather than simply modifying the description of the beneficial interests. For example, a trust might state that the primary purpose of a trust is to provide for the lead beneficiary and that the trustee is permitted to expend the entire trust property for that purpose. See chap 7.

In *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473, the court held that the trustees of a testamentary trust did not violate Prob C §16003 by paying the income beneficiaries an average of 1.25 percent of the net value of trust assets per year because the trust instrument specifically authorized the trustees to hold unproductive property and to retain the stock of the family corporation for as long as they saw fit.

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§17.44 3. Duty to Avoid Conflict of Interest

Under Prob C §16004(a), the trustee has a duty not to use trust property for the trustee's own profit and not to take part in a transaction in which the trustee has an interest adverse to the beneficiary. Probate Code §16004(b) bars enforcement of adverse claims acquired after appointment of the trustee. Thus, for example, the trustee cannot acquire a note and deed of trust encumbering trust property and then foreclose on that property. Probate Code §16004(c), on the relationship between the trustee and the beneficiary, creates a presumption that transactions between the trustee and the beneficiary violate the trustee's fiduciary duty—presumably out of concern that a beneficiary could be influenced to make a bad deal in order to stay on the good side of the trustee. This presumption affects the burden of proof.

To some extent, these provisions restate elements of the duty of loyalty. They appropriately address transactions with beneficiaries. In both cases, it would usually be inappropriate to draft custom provisions addressing these issues beyond those already discussed above concerning the duty of loyalty.

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§17.45 4. Duty Not to Undertake an Adverse Trust

Probate Code §16005 states: "The trustee of one trust has a duty not to knowingly become a trustee of another trust adverse in its nature to the interest of the beneficiary of the first trust, and a duty to eliminate the conflict or resign as trustee when the conflict is discovered." The statute is traceable to former CC §2232, which was adopted as part of the Field Code in 1872 and rarely cited by the courts. There are no conventional drafting responses to this provision, despite the fact that it is common for there to be transactions, such as secured loans, between, *e.g.*, a QTIP trust and a bypass trust established by the same settlor and having the same trustee, but not always identical beneficiaries.

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§17.46 5. Duty to Take Control of Trust Property

Probate Code §16006 provides that:

> The trustee has a duty to take reasonable steps under the circumstances to take and keep control of and to preserve the trust property.

At least on a theoretical level, this duty raises problems when trust property remains in the possession of a settlor of diminishing capacity. Predators separate elders from their funds in an astonishing variety of ways. The situation is complicated by the fact that the ability of a third party to act in these situations is uncertain unless the settlor is indisputably incompetent. A competent settlor will have the power to revoke or amend the trust—possibly disinheriting the trustee who desired to be helpful. Thus, the successor trustee confronts the risk that remainder beneficiaries may claim a breach of duty if there is a failure to deprive the settlor of control of property, but the successor confronts equally unfortunate alternatives. Fortunately, the duty is limited to "reasonable steps under the circumstances." There is no generally recognized drafting solution for this problem. As a matter of trust administration, some of the trustee's exposure can be reduced by maintaining adequate insurance for trust property. If the trustee is a successor trustee, the successor can sometimes decline to serve until the settlor agrees to arrangements satisfactory to the successor, but practical considerations may preclude that approach.

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§17.47 6. Duty to Make Property Productive

Probate Code §16007 provides that:

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

This section must be read in conjunction with Prob C §16220, which states,

> The trustee has the power to collect, hold, and retain trust property received from a settlor or any other person until, in the judgment of the trustee, disposition of the property should be made. The property may be retained even though it includes property in which the trustee is personally interested.

This second statute is qualified by Prob C §16200, which provides that the possession of a power does not necessarily permit its exercise. See §17.2.

In many situations these statutes can provide the basis of dispute—particularly during a period of settlor incompetence. A classic example involves a settlor's vacation home that is no longer used by the settlor—particularly an incompetent settlor. The potential for dispute is magnified if the trustee and the trustee's issue are those who most use the vacation home. The trustee can argue that the settlor's historical use of the property shows a special relationship to the property that justifies retention. Other beneficiaries may counter that the settlor's incompetence is a change of circumstance. Some of these issues can be addressed during the settlor's lifetime in the distribution provisions as long as care is taken to preserve the marital deduction for property held in a Survivor's Trust. See chaps 9, 12. Similar issues arise in connection with yachts, excessive numbers of motor vehicles, some hobby assets, and a variety of other tangible personal property assets that are depreciating or at least not likely to appreciate sufficiently to justify their retention on an economic basis.

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§17.48 7. Duty to Keep Property Separate and Identified

Probate Code §16009 provides that:

> The trustee has a duty to do the following:
> (a) To keep the trust property separate from other property not subject to the trust.
> (b) To see that the trust property is designated as property of the trust.

Many trust documents override these duties. Indeed, Prob C §16238 confers the power to hold trust property in bearer form or in the name of a nominee. The same power appears in Uniform Trust Code §816(7)(B), and is therefore expressly conferred by the form in §17.19. Many trustees do not separate and separately title the assets of various trusts created under the same document. This option is permitted by the form in §17.41.

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§17.49 8. Duties to Enforce Claims and Defend Actions

The duties to enforce claims and defend actions listed in Prob C §§16010-16111 are unremarkable and rarely require custom drafting. If the trust holds a claim against a beneficiary as a result of a loan to the beneficiary or otherwise, it may be helpful to provide the trustee with guidance on enforcement—particularly if that beneficiary is the trustee, or if the trust instrument provides for forgiveness of the note on death (or distribution as part of the share of the obligor on death), but fails to guide the trustee concerning desired action during a period of settlor incompetence.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.50 9. Duty Not to Delegate

§17.50 9. Duty Not to Delegate

Probate Code §16012 provides that:

> (a) The trustee has a duty not to delegate to others the performance of acts that the trustee can reasonably be required personally to perform and may not transfer the office of trustee to another person nor delegate the entire administration of the trust to a cotrustee or other person.
> (b) In a case where a trustee has properly delegated a matter to an agent, cotrustee, or other person, the trustee has a duty to exercise general supervision over the person performing the delegated matter.
> (c) This section does not apply to investment and management functions under Section 16052.

For a discussion of Prob C §16052, permitting delegation of investment functions, see §17.13. The trend of the law is to permit delegation of trustee functions. Under Uniform Trust Code §807:

> (a) A trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:
> (1) selecting an agent;
> (2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
> (3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.
> (b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.
> (c) A trustee who complies with subsection (a) is not liable to the beneficiaries or to the trust for an action of the agent to whom the function was delegated.
> (d) By accepting a delegation of powers or duties from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

The form in §17.19 incorporates the powers conferred by Uniform Trust Code §807 by reference and therefore confers a power to delegate.

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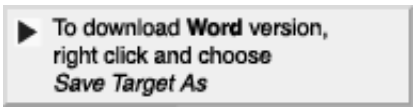
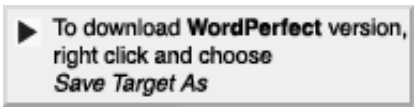
Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.51 10. Form: Delegation of Powers and Duties

§17.51 10. Form: Delegation of Powers and Duties





17.51-1 Delegation of powers and duties

The trustee may delegate duties and powers, other than discretionary distribution powers, as long as the trustee exercises reasonable care, skill, and caution in:

1. Selecting an agent;

2. Establishing the scope and terms of the delegation; and

3. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

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§17.52 11. Duty to Diversify Investments

Probate Code §16048 provides that:

> In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.

This section is part of the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054). It is rarely prudent not to diversify investments. See Restatement (Third) of Trusts §90 (2007). Nevertheless, there are various reasons why it might be appropriate to limit the duty of diversification of a particular trust. For example, a trust might be created to hold a specific asset that is only one of many assets in the total family wealth. A life insurance trust may fall into this category. Even if lack of diversification is unwise or at least debatable (as may be true with many family businesses), the settlor may intend that the trustee hold without diversification business interests that provide employment for family members or allow the family to remain in control of a business entity. Generally, a clause limiting the duty of diversification should be focused as sharply as possible, identifying the assets to be retained. Because lack of diversification is rarely prudent from an objective point of view, the clause may not accomplish its purpose if it requires the retention to be prudent or reasonable.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.53 12. Form: Continued Retention and Management of Business

§17.53 12. Form: Continued Retention and Management of Business

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17.53-1 Continued retention and management of business

A purpose of this trust is to provide for the continued retention and management of the settlor's interest in _ _[*specify name of business*]_ _ ("the Company"). The trustee has no duty to sell interests in the Company _ _[*unless requested to do so by (specify)*]_ _ and may acquire additional interests in the Company for purposes of increasing family control or other purposes, and the requirements of the Uniform Prudent Investor Act do not apply to those interests.

[*If applicable, add the following option*]

[*Option: Making trust property productive of income*]

Despite the foregoing, the trustee shall sell interests in the Company if necessary to meet a demand of the Surviving Settlor to make trust property produce income.

Comment: Regarding the identified assets, this form overrides both the duty of diversification in Prob C §16048 and the other provisions of the Uniform Prudent Investor Act (Prob C §§16045-16054). The optional language is intended to ensure that the clause does not inadvertently fail to qualify for the IRC §2056 federal estate tax marital deduction by depriving the surviving settlor of the right to income.

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§17.54 13. Duty to Report and Account

The Probate Code imposes a general duty to report to beneficiaries (Prob C §16060), a specific duty to give notice to both beneficiaries and heirs at law and to provide a copy of the terms of the trust to any heir or beneficiary who requests it when a trust becomes irrevocable (Prob C §§16061.5-16061.7), a specific duty to give notice when there is a change of trustee of a trust that has become irrevocable (Prob C §16061.7), and a general duty to account annually to beneficiaries (Prob C §16062). If a beneficiary contests the trustee's account and the court determines that the trustee's opposition to the contest was without reasonable cause and in bad faith, the court may award the contestant attorney fees and costs. Prob C §17211(b). See *Leader v Cords* (2010) 182 CA4th 1588, 107 CR3d 505 (attorney fees and costs awarded to beneficiary when trustee's account revealed that trustee had failed to distribute trust assets and trustee opposed petition to compel distribution). The duty to account annually applies only to current income beneficiaries, but at least one court has held that remainder beneficiaries may be entitled to a "particular account" under the general duty of the trustee to provide information on reasonable request (Prob C §16061). See *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538.

PRACTICE TIP: Nothing in the statute limits the general duty to report to rendering reports on request under Prob C §16061 and providing accounts routinely to income beneficiaries under Prob C §16062. A thoughtful trustee might find it far simpler and preferable to give accounts to remainder beneficiaries than to test the limits of what a court might order under Prob C §16060 or §16061.

The two specific duties to give notice cannot be waived in the trust document. Prob C 16061.7(i). Proposed legislation would apply this same limitation on waiver to the trustee's duty to report information to beneficiaries on request. See Prop Prob C §16068 in SB 202 (2010). The duty to report and account can be waived in the trust document unless the trustee is a disqualified person under Prob C §21350.5. Prob C §§16062(e), 16064(a). Subject to the exceptions listed in Prob C §21351, disqualified persons under §21350.5 include persons involved in drafting the trust document and care custodians. See §§2.36-2.39.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.55 14. Form: Waiver of Accounting

§17.55 14. Form: Waiver of Accounting

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***Waiver of Accounting*. The trustee does not have a duty to account in the absence of a demand for an account by a person entitled to an account.**

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§17.56 15. Duties Regarding Discretionary Powers

Probate Code §16080 provides that, except as provided in Prob C §16081, a discretionary power conferred on a trustee is not left to the trustee's arbitrary discretion, but shall be exercised reasonably. Section 16081 further provides that, when a trust document confers "absolute," "sole," or "uncontrolled" discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust. That section and Prob C §16082 provide additional restrictions on a trustee power that permits distributions to or for the benefit of the trustee. These additional restrictions are intended to avoid the possibility that overexuberant drafting will result in the trustee's having an unintended general power of appointment for tax purposes under IRC §§2041 and 2514. See chap 7.

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§17.57 16. Duties Regarding Charitable Trusts

Probate Code §§16100-16105 impose various duties of trustees of charitable trusts, split-interest trusts, and private foundations. These provisions are intended to ensure that such trusts qualify for tax deductions when the drafter has failed to include all necessary provisions in the trust document. The drafter of such trusts should not attempt to override or modify these duties.

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§17.58 17. Duty to Accept Additions

The trust should specify that the trustee has a duty to accept additions to the trust unless they would significantly expand the trustee's duties or expose the trustee to liability. See Uniform Trust Code §§816(1), 816(13)(C). If property is added to the trust by anyone other than the original settlor, that person becomes the settlor of the trust for income, estate, and generation-skipping transfer tax purposes, to the extent of the addition to the trust. The drafter should consider this potential tax problem when determining whether persons other than the original settlor should be permitted to make additions to the trust. See IRC §§671-677.

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Source: Estate Planning/Drafting California Revocable Trusts/17 Trustee Powers and Duties/§17.59 18. Form: Acceptance of Additions

§17.59 18. Form: Acceptance of Additions

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***Acceptance of Additions*. The trustee has a duty to accept additions to this trust unless an addition would significantly expand the trustee's duties, the transferred property is hazardous or otherwise creates a substantial increased risk of trustee liability, or the property is transferred by a competent person other than a settlor who retains the capacity to establish a trust naming a different trustee. If an addition is rejected on the ground of increased duties or liabilities and the transferor is deceased or lacks capacity, the trustee shall give reasonable notice to the persons interested in the trust.**

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§17.60 19. Duty With Respect to Cotrustees

Probate Code §16013 provides that:

> If a trust has more than one trustee, each trustee has a duty to do the following:
> (a) To participate in the administration of the trust.
> (b) To take reasonable steps to prevent a cotrustee from committing a breach of trust or to compel a cotrustee to redress a breach of trust.

The statute closely follows the language of the Restatement (Second) of Trusts §184 (1959). The statute is consistent with Uniform Trust Code §703(g), but it lacks the safeguard of §703(f), which provides that "[e]xcept as otherwise provided in subsection (g), a trustee who does not join in an action of another trustee is not liable for the action." However, this issue can usually be addressed by a trustee exculpation clause. See §16.21.

The rule that a cotrustee is required to participate in the administration of a trust is premised on the notion that the settlor had a purpose for appointing multiple trustees that will not be accomplished if a cotrustee does not actively participate. Compare the language of Restatement (Third) of Trusts §81 (2007) ("except as otherwise provided by the terms of the trust, each trustee has a duty and a right to participate in the administration of the trust"). In some cases, this assumption is incorrect. For example, a settlor might name children as cotrustees to avoid favoritism or to assure that all children have the opportunity to participate if they desire. In such cases, the power-of-delegation clause in form 17.51-1 can be modified to expressly authorize delegation to a cotrustee. Drafters may also want to consider giving different cotrustees different functions. In some cases, the investment function is assigned to only one of multiple trustees.

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§17.61 20. Duty to Use Special Skills

Probate Code §16014 provides that:

> (a) The trustee has a duty to apply the full extent of the trustee's skills.
> (b) If the settlor, in selecting the trustee, has relied on the trustee's representation of having special skills, the trustee is held to the standard of the skills represented.

Thus, if the settlor's trusts and estates attorney is named as trustee, the attorney must take care to ensure that all the other trustee duties are properly discharged.

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18

Construction of Trusts

K. Bruce Friedman
Donald J. McCubbin

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- B. When to Include Rules of Construction §18.2
- C. Where to Place Definitions of Terms §18.3

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I. INTERPRETATION OF TRUST TERMS

§18.1 A. According to Intention of Settlor as Expressed

California law provides a general rule that trust instruments, like wills, must be interpreted according to the intention of the settlor as expressed in the instrument. Prob C §21102(a). See *Newman v Wells Fargo Bank* (1996) 14 C4th 126, 59 CR2d 2. Unless ambiguous, the trust's terms are to be construed by their ordinary legal meaning, and the instrument is to be interpreted from the entirety of the writing rather than from isolated elements. Prob C §§21120-21122. Extrinsic evidence is admissible to construe ambiguous terms in the instrument. *Ike v Doolittle* (1998) 61 CA4th 51, 70 CR2d 887. Specific statutory rules of construction apply when the settlor's intentions are not expressed in the instrument. Prob C §21102(b). See §18.2.

Uniform Trust Code §112 and Restatement (Third) of Trusts §25(2) (2003) also provide that a revocable trust is subject to the rules of construction and other rules applicable to testamentary dispositions. However, Uniform Trust Code §103(17) states that "terms of a trust" means the manifestation of the settlor's intent regarding the trust provisions "as expressed in the trust instrument or as may be established by other evidence that would be admissible in a judicial proceeding" and Restatement §4 simply provides that "terms of the trust" means the manifestation of the settlor's intent with respect to the trust provisions "expressed in a manner that admits of its proof in judicial proceedings."

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§18.2 B. When to Include Rules of Construction

The settlor may provide rules of construction or definitions for any terms used in the trust document. Whenever the meaning of a term significantly affects the trust's interpretation, and a misunderstanding may lead to mistake, confusion, or dispute, the drafter should consider including special definition clauses. The term may refer to a gift, beneficiaries, or manner of distribution or trust administration. Placement of definition clauses is discussed in §18.3.

PRACTICE TIP: Cautious drafters generally include definitions when the trust document contains a technical term. Defining the term ensures that it will be properly interpreted. Without a definition, the interpretation of technical terms is governed by Prob C §21122. The definition will also ease the fiduciary's task of explaining the term to the beneficiaries and of administering the trust.

Probate Code §§21101-21140 provide rules of construction for wills, trusts, deeds, and any other instrument that apply when the settlor's intentions are not unambiguously expressed in the instrument. Prob C §§21101, 21102(b). The statutory rules of construction, however, may not reflect the settlor's intentions. For example, although the settlor might not want to include stepchildren in the class of "children," stepchildren will be included in this class under Prob C §21115(a) if the circumstances described in Prob C §6454 exist and apply to the trust. Even when the statutory rules of construction are in accord with the settlor'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 trustee and discourage arguments among beneficiaries and persons not intended to be included in the class. See §§18.4-18.5.

When a gift to a beneficiary would go to the beneficiary's spouse or domestic partner if the beneficiary predeceased the settlor, the settlor may want to include clauses specifying the time when the spousal or domestic partner relationship must be determined and that cohabitation is required as of that time. See §§18.6-18.8.

Settlors also may provide choice-of-law rules. See §§18.9-18.11. Other commonly used form definitions and construction clauses are given in §§18.12-18.16. Some traditional clauses are now widely regarded as unnecessary. See §§18.17-18.20.

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§18.3 C. Where to Place Definitions of Terms

The drafter generally has three options with respect to definitions:

- Add the appropriate clauses at different places in the trust document. For example, members of classes named in class gift clauses may be described in the portion of the trust document making class gifts, and tax terms may be defined in tax clauses.
- Place all definitions at one place in the document, usually listing them alphabetically for clarity.
- Define terms of limited application where they are used in the document and define terms of broad application in one place. Definitions that apply to the entire trust are usually placed at the end of the trust document but may be placed near the beginning.

A drafter who chooses to place definitions in a separate section of a trust must be especially careful that the defined term is used in the same way throughout the document. If the definition is important only for a particular occurrence of the term at a specific location of the trust, it may be better to place the definition at that specific location.

PRACTICE TIP: Often, settlors want different definitions to apply to different provisions. A single trust document may contain various outright gifts, provisions for trust distributions over a prolonged period, and powers of appointment. Each provision must be analyzed separately before deciding whether a single definition is appropriate.

When a definition is exceptionally significant, as when "issue" and "children" are defined (see §18.4), the clauses using the term should add a cross-reference to the definition in order to alert readers to the definition and to provide some assurance that the drafter and settlor were both aware of the definition when they used the term.

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II. TERMS OF RELATIONSHIP

§18.4 A. Purpose of Terms of Relationship Clause

Settlors frequently wish to make gifts to "children" or "issue." The question of whether the settlor intended by these terms to include children adopted in or out of the family, stepchildren, children born out of wedlock, or certain other nontraditional family configurations may become an issue. When the settlor's intent is not clear and cannot be shown by extrinsic evidence, the statutory laws of construction and intestacy will apply. See Prob C §§26 (definition of "child" governed by intestacy laws), 50 (definition of "issue"), 6450-6455 (parent-child relationship defined for intestate succession), 21112-21115 (rules of construction).

When terms like "children" or "issue" are not adequately defined in the trust document, the risk of litigation is increased. Further complications arise when the laws of intestate succession or construction change with regard to treatment of the relevant relationships after the trust has been executed. See, *e.g., Newman v Wells Fargo Bank* (1996) 14 C4th 126, 139, 59 CR2d 2 (testator's presumed intent concerning status of adopted-out children for purposes of class gift determined by laws in effect at time will was executed, not as amended after death of testator). See also *Estate of Dye* (2001) 92 CA4th 966, 112 CR2d 362 (intestate succession by adopted-out children determined by current law as amended after adoption but before death of decedent).

PRACTICE TIP: The time for ascertaining the membership of a class is controlled by the settlor's intent as expressed in the instrument. Prob C §21102(a). When drafting dispositions to classes, it is important that the drafter indicate when class membership is to be determined. Consider, for example, a trust provision that provides for making various distributions to a spouse for life and then provides that on the death of the spouse the remaining trust estate is to be distributed to the settlor's issue. The trust instrument should clarify whether the takers of the remainder are the issue living at the settlor's death or those living at the spouse's death. Generally, this should be made clear in the distribution provision—not in the Terms of Relationship provision in §18.5. See chap 8.

When the settlor's intent is not adequately shown by the instrument, Prob C §21115 governs the construction of class gifts and relationships as applied to specified familial configurations, including half-brothers and sisters, adoptees, foster children, stepchildren, and children born out of wedlock. See §§8.51-8.55.

Because technological and social changes continue to create relationships that were previously unfamiliar, *e.g.,* those arising from surrogate motherhood or posthumous conception and the adoption or conception by in-vitro fertilization of a child by a same-sex couple, the drafter may anticipate more confusion regarding the laws of intestacy and the settlor's intent regarding gifts to children. See §8.19.

In sum, special care should be taken to define terms of relationship in the trust document, according to the settlor's intent. For a form of definition, see form 18.5-1.

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§18.5 B. Form: Terms of Relationship

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18.5-1 Terms of relationship

***Terms of Relationship*. Except as expressly provided in this paragraph, half bloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons when appropriate to the class, are included or excluded in terms of class gift or relationship in accordance with California law for determining relationship and inheritance rights for purposes of intestate succession that are in effect on the date of execution of this document.**

[*If appropriate, add the following option*]

[*Option: "Children" includes those born out of wedlock and adopted children if parent-child relationship existed during minority*]

However, a person born out of wedlock to a natural parent shall not be considered a child of that person unless the person lived, while a minor, as a regular member of the household of the natural parent or of that parent's parent, sibling, or spouse; or otherwise during minority was both openly acknowledged by such a person to be the child of the parent and was involved with such a person in an active social relationship. Further, an adopted child shall not be considered the child of an adopting parent unless the adopted person lived while a minor (either before or after adoption) as a regular member of the household of the adopting parent.

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III. DEFINITION OF "SPOUSE" AND "DOMESTIC PARTNER"

§18.6 A. Purpose of Spousal Definition Clauses

In some cases it will be desirable to include definitions of "spouse" or "domestic partner" in a trust document. Such definitions are important if unnamed "spouses" or "domestic partners" may receive distributions. For example, a provision conferring a power of appointment might list "spouses" or "domestic partners" as classes of persons who are permitted appointees. Or a provision might name such persons as alternate takers in the event an intended distributee fails to survive the settlor. ("The trustee shall distribute $100,000 to each of my grandchildren who survives me. If any grandchild fails to survive me but is survived by a spouse who survives me, the spouse shall receive the gift the grandchild would have received had the grandchild survived me.")

Provisions for distributions to spouses or domestic partners raise several questions. Is the existence of the spousal or domestic partner relationship determined as of the date of execution of the trust (regardless of a later dissolution or separation) or as of the date of the settlor's death or as of some later date of distribution—such as the date of the death of some other beneficiary? Does remarriage after dissolution or death of a spouse, or entry into a new domestic partnership, change the rights of a person who was the spouse or domestic partner of a child of the settlor when the trust was executed? For forms of definitions that answer these questions, see §§18.7-18.8.

NOTE: Excluding a remarried, widowed spouse from the class of permitted appointees under a power of appointment, as provided in the optional language in form 18.7-1, may be unwise if the document creates a long-term trust. If a lineal descendant dies leaving a spouse and young children, deterring that spouse's remarriage may not be in the children's best interests. Different problems occur if no provisions are made for the surviving spouse or domestic partner of a child who is the parent of issue. The issue may end up living under less than ideal conditions because of the surviving parent's financial insecurity. In most cases it is preferable to give the holder of the power broad discretion.

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§18.7 B. Form: Definition of "Spouse"

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18.7-1 Definition of "spouse"

Spouse. **In reference to any deceased beneficiary of any trust created under this document, the term "spouse" is limited to the lawfully married spouse of the beneficiary who at the time of the beneficiary's death (1) was permanently residing with the beneficiary, (2) was not suing or being sued in any jurisdiction for limited or absolute divorce or dissolution of marriage or for separate maintenance or legal separation from the beneficiary, and (3) was not subject to an interlocutory decree of divorce or dissolution of marriage.**

[*If appropriate, add the following option*]

[*Option: Spouse considered deceased on remarriage*]

On remarriage, this spouse shall be considered predeceased for all purposes under this document.

Comment: The optional language is not recommended. See §18.6. Note that a "lawfully married spouse" would include same-sex spouses who are residents of other states (Connecticut, Iowa, Maine, Massachusetts, New Hampshire, and Vermont) in which same-sex marriage is permitted. Settlors wishing to restrict or extend this definition may need to modify the form. For a similar form of definition for "domestic partner," see §18.8.

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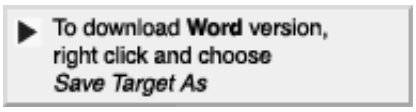
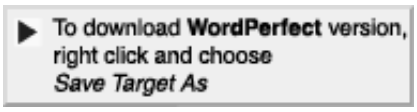
§18.8 C. Form: Definition of "Domestic Partner"





18.8-1 Definition of "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 or a person in a substantially equivalent relationship with the beneficiary under the law of another jurisdiction as defined in Family Code §299.2.**

Comment: Under the basic definition, a person is not a domestic partner unless he or she satisfies registration and other requirements described in Fam C §§297-299.6. Settlors wishing to include officially recognized same-sex partners in class gifts may need to use this form or a similar provision because California currently does not recognize same-sex marriage under the decision in *Strauss v Horton* (May 26, 2009, S168047) 2009 Cal Lexis 4626.

A legal union of two persons of the same sex other than a marriage validly formed in another jurisdiction that is substantially equivalent to a domestic partnership as defined in Fam C §§297-299.6 will be recognized as a valid domestic partnership and the partner will meet the Prob C §37 definition. Fam C §299.2. As of this writing, it appears that civil unions in New Jersey and domestic partnerships in Oregon may satisfy the requirement of equivalence.

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IV. CHOICE OF LAW

§18.9 A. Enforceability and Desirability of Choice-of-Law Provision

The drafter may eliminate doubt about the law governing the trust by specifying the law that will govern. Such a clause will be honored if the jurisdiction specified has sufficient contact with the trust and the clause does not violate public policy. See, *e.g., Hall v Superior Court* (1983) 150 CA3d 411, 416, 197 CR 757; *Shannon v Irving Trust Co.* (1937) 275 NY 95, 9 NE2d 792. California courts usually respect choice-of-law clauses. See *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330. For full discussion of choice-of-law issues, see chap 23. See also 7 Scott & Ascher on Trusts §§44.1-46.9 (5th ed 2010).

Trust documents often include a choice-of-law clause specifying that California law will govern administration of the trust. Such a clause may be undesirable, however, because a future trustee may decide that the trust should be relocated to another jurisdiction, and, in any event, the administration of the trust will be governed by California law if the trust is administered in California. See Prob C §§17002-17005. The drafter may choose to provide only that the trust shall be *construed* in accordance with California law. See form 18.10-1. That rule of construction will usually be consistent with the settlor's intent. See §18.1.

In some circumstances, a choice-of-law clause may produce different results depending on whether the clause is construed to apply substantive law or the law of conflicts. In *Eherenclou v MacDonald* (2004) 117 CA4th 364, 12 CR3d 411, for example, the court held that the effect of a Colorado adoption by a California settlor on the disposition of a trust that included a choice-of-law clause specifying that the trust was to be governed by California law was determined under Colorado law, because California case law generally provides that the status of adoptees is determined by the law of the state of adoption. The optional phrase "excluding the law of conflicts" in form 18.10-1 attempts to remove such ambiguity, although the effect of the phrase is somewhat uncertain.

Enactment of a new statute after establishment of the trust could change its effect. The drafter may be able to minimize this problem by specifying that the trust will be governed by the law in force on the effective date of the document. For ease of administration, however, settlors usually want the trust to be governed by the law as it changes over time. Under such a clause, the trustee may apply current law without researching the law that existed when the trust document was executed. Choosing to govern the trust by the law as it changes over time also eliminates the need for ascertaining whether a case decided after the trust was executed made new law or merely stated existing law for the first time.

To avoid ambiguity, the drafter may specify that changes in the law apply to the trust, as provided by the optional phrase "as amended from time to time" in form 18.10-1. For additional clauses specifying that changes in statutes, codes, and regulations apply to the trust, see §§18.11, 18.16.

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18.10-1 California law used in construction of trust

Applicable Law. **This document shall be construed in accordance with the laws _ _**[*excluding the law of conflicts*]**_ _ of the State of California _ _**[*in effect on the date of execution of this document/as amended from time to time*]**_ _.**

Comment: For discussion of drafting considerations in determining what laws and which version of laws should apply, see §18.9.

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§18.11 C. Form: Statutory References

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18.11-1 Statutory references

Statutory References. **Except as otherwise specified, all references in this document to specific statutes, codes, and regulations shall be to those provisions as amended from time to time and to the corresponding provisions of any subsequent legislation or regulation.**

Comment: This clause may be inappropriate if the drafter also uses the optional language "in effect on the date of execution of this document" in form 18.10-1. For discussion of drafting considerations in determining which version of laws should apply, see §18.9.

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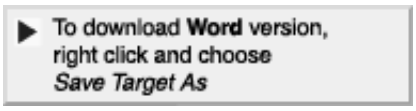
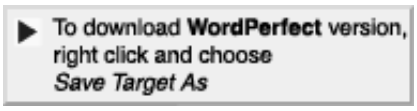
V. OTHER DEFINITIONS AND CONSTRUCTION CLAUSES

§18.12 A. Form: Use of Headings in Construction





18.12-1 Headings, titles, and subtitles

[*Alternative 1: Due regard to headings*]

Context. **The divisions, paragraphs, and subparagraphs of this document shall be construed in context, giving due regard to the headings and the topic of discussion.**

[*Alternative 2: Headings ignored*]

Headings Ignored. **The headings, titles, and subtitles used in this document are inserted solely for convenient reference and shall be ignored in any construction of the document.**

Comment: Alternative 2 is traditional but not recommended. It is highly unlikely that the trust document will be better construed by ignoring the headings, titles, and subtitles. Such a provision may be appropriate for insurance contracts or adhesion contracts in business transactions that may be construed against the drafter, but not in a trust document that is generally interpreted according to the presumed intentions of the settlor. See §18.1.

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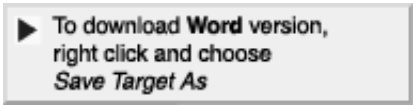
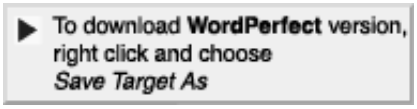
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.13 B. Form: Relevance of Common Estate Planning Practice

§18.13 B. Form: Relevance of Common Estate Planning Practice





18.13-1 Relevance of common estate planning practice

Relevance of Common Estate Planning Practice. **This document is intended to accomplish normal and ordinary objectives of similar trusts commonly drafted by attorneys practicing in the area of trusts and estates at the time this document is executed, and shall be construed accordingly.**

Comment: This form is designed to allow the introduction of expert testimony in the event of litigation over the trust document.

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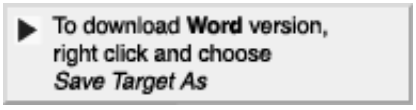
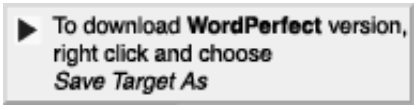
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.14 C. Form: Definition of 'Education'

§18.14 C. Form: Definition of "Education"





18.14-1 Definition of "education"

Education. **"Education" includes primary, secondary, vocational, college, university, postgraduate study, and other specialized studies** _ _[*if in the trustee's discretion the study is being pursued to advantage by the beneficiary*]_ _**.**

[*If appropriate, add the following option*]

[*Option: Related living and traveling expenses*]

In determining payments to be made to the beneficiary for education, the trustee shall consider the beneficiary's reasonable related living and traveling expenses.

Comment: In defining "education," the drafter should take care not to undesirably limit the discretion of the trustee. The settlor may wish to specify other study, *e.g.,* music or art under a particular artist or instructor.

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Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.15 D. Form: Definition of 'Charity'

§18.15 D. Form: Definition of "Charity"

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18.15-1 Definition of "charity"

Charity. **A "charity" is any organization described in Internal Revenue Code §2055 or §2522.**

Comment: This definition should be included if the trust document provides for the creation of trusts any interests of which are intended to qualify for the IRC §2055 estate tax charitable deduction. See chap 4.

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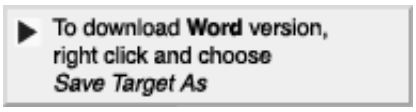
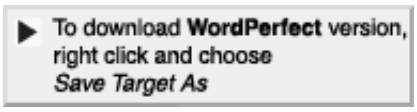
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.16 E. Form: References to Internal Revenue Code

§18.16 E. Form: References to Internal Revenue Code





18.16-1 References to Internal Revenue Code

Internal Revenue Code. **All references in this document to the term "Internal Revenue Code" refer to the Internal Revenue Code of 1986, as amended from time to time, and to the corresponding provisions of any subsequent federal tax law.**

Comment: Although commonly included in trust documents, this definition is generally unnecessary. For a similar form of provision applicable to all statutes, see §18.11.

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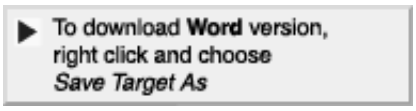
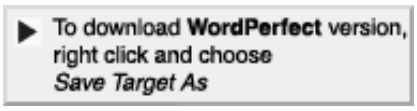
VI. TRADITIONAL CLAUSES

§18.17 A. Form: Gender and Number





18.17-1 Gender and number

Gender and Number. **In all matters of interpretation necessary to give effect to any clause of this document, 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: Most drafters prefer to provide proper gender and number designations throughout the trust. The cautious drafter may include this clause to cover any errors or oversights.

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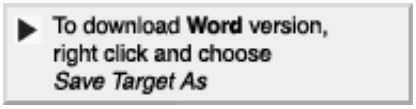
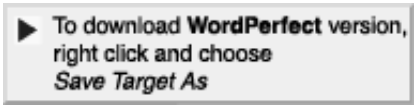
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.18 B. Form: Divisions and Paragraphs

§18.18 B. Form: Divisions and Paragraphs





18.18-1 Divisions and paragraphs

***Organization of Document*. Whenever this document refers to a clause in a specific division or paragraph, the reference shall be to that division or paragraph of this document. For convenience, this document is divided into _ _**[*describe ordering of divisions, paragraphs, subparagraphs, sections*]**_ _.**

Comment: The ordering of divisions, paragraphs, and subparagraphs or sections should be obvious from the trust document.

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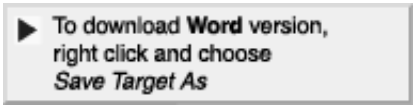
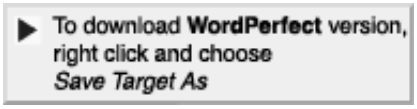
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.19 C. Form: Trustees and Fiduciaries

§18.19 C. Form: Trustees and Fiduciaries





18.19-1 Trustees and fiduciaries

***References to Trustees*. All references in this document to trustees, special trustees, and any other fiduciary shall refer to the individuals or institutions serving from time to time in that capacity under this document.**

Comment: The provisions relating to appointment, powers, and duties of trustees should make this clear.

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Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.20 D. Form: 'Shall' and 'May'

§18.20 D. Form: "Shall" and "May"

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18.20-1 "Shall" and "may"

Shall and May. **All references in this document to the word "shall" indicate a mandatory direction. All references to the word "may" indicate a permissive, but not mandatory, grant of authority.**

Comment: The provisions in which these terms are used should make this clear.

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E. Severability Clause

§18.21 1. Purpose of Severability Clause

A severability clause is included to prevent invalidation of the entire trust document merely because an individual clause, which may not be significant to the overall plan, is invalid. See *Davenport v The Davenport Found.* (1950) 36 C2d 67, 77, 222 P2d 11, in which the court allowed an invalid clause in an instrument to be severed and validated the remaining portion of the instrument because the deleted portion was not so essential to the remainder that its elimination destroyed the settlor's intention or was unfair to other beneficiaries. For a form of severability clause, see §18.22.

The clause may be undesirable, however, because the drafter has no way of knowing what circumstances may cause a portion of the trust to become invalid. Without a severability clause, the general rule in California is that an invalid clause will be severed and the remainder of the trust given effect unless the invalid clause "is so inseparably blended with the others that it cannot be eliminated without destroying the main intent of the trustor, or working a manifest injustice." *Estate of Micheletti* (1944) 24 C2d 904, 909, 151 P2d 833. Usually, a court reviewing the document after the fact will be in a better position to decide whether severance of the invalid clause and enforcement of the trust is consistent with the settlor's intent.

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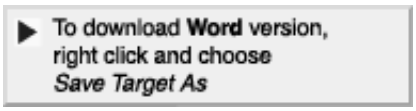
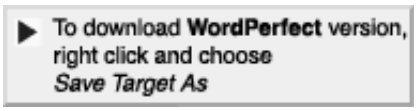
Source: Estate Planning/Drafting California Revocable Trusts/18 Construction of Trusts/§18.22 2. Form: Severability Clause

§18.22 2. Form: Severability Clause





18.22-1 Severability clause

If any provision of this trust document is unenforceable, the remaining provisions shall remain in full effect.

Comment: This clause is usually included at the end of the trust document, just before the execution sections. For discussion of reasons for and against including a severability clause, see §18.21.

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19

No-Contest Clause and Miscellaneous Trust Provisions

K. Bruce Friedman
Donald J. McCubbin

I. NO-CONTEST CLAUSE
- A. Purpose and Effect of No-Contest Clause §19.1
  - 1. Enforceability of No-Contest Clause §19.2
  - 2. Effect of Lifetime Transfer Agreement §19.3
- B. Optional Language in No-Contest Clause §19.4
- C. Form: No-Contest Clause §19.5
- D. Form: Alternative No-Contest Clause §19.5A

II. LIMITING COURT JURISDICTION
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- B. Form: Limiting Court Jurisdiction §19.7

III. DISINHERITANCE CLAUSE
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VII. PROFESSIONAL CORPORATION CLAUSE
- A. Shares of Professional Corporation Held in Trust §19.17
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VIII. CONCLUDING CLAUSES
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- B. Form: Signatures §19.20

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I. NO-CONTEST CLAUSE

§19.1 A. Purpose and Effect of No-Contest Clause

No-contest clauses are used to discourage contests of trusts by providing that any beneficiary who contests the trust forfeits what he or she would have received under the trust. A no-contest clause also usually provides that the contesting beneficiary's issue must forfeit any right to take in place of the contestant. This limitation prevents the issue from taking under the antilapse statute when the contestant is kindred of the settlor or the settlor's spouse or registered domestic partner and the contestant, by virtue of the no-contest clause, is treated as having predeceased the settlor. Prob C §21110; Fam C §297.5(c). Of course, a no-contest clause is an ineffective deterrent if the contestant has no beneficial interest in the trust.

New rules limiting the enforceability of no-contest clauses in Prob C §§21310-21313 became effective January 1, 2010. With limited exceptions, a no-contest clause in an instrument that became irrevocable on or after January 1, 2001, may be enforced only against "direct contests" brought without probable cause.

PRACTICE TIP: The new rules do not alter the essential drafting advice to limit such clauses to particular gifts and beneficiaries where conflict is expected. Blanket clauses imposing a forfeiture on anyone who contests the estate plan are now less likely to be effective but such clauses were never recommended. Although the new rules specifically allow enforcement of a no-contest clause against the filing of a creditor's claim, for example, drafters should not use a blanket forfeiture clause against anyone who files a creditor's claim but rather should expressly provide that certain gifts of property are intended to satisfy any obligation that may be owed to particular beneficiaries and so are conditioned on not filing a claim against the trust or estate. See Prob C §21311(a)(3).

Probate Code §21312 states that the clauses must be strictly construed. See *Burch v George* (1994) 7 C4th 246, 254, 27 CR2d 165. The enforceability of no-contest clauses is limited by the rules in Prob C §§21311, which apply despite any contrary provision in the trust document. Prob C §21314. See §§19.2-19.3.

WARNING: Because no-contest clauses are strictly construed, a no-contest trust clause should be operative if a settlor's will is attacked. Similarly, a no-contest will clause should be operative if the trust is attacked. This advice assumes that the documents containing the cross-references are contemporaneous, because a no-contest clause in a trust that became irrevocable or a will of a decedent dying on or after January 1, 2001, will not be applied to a later-executed document such as a trust amendment or codicil. In *Cory v Toscano* (2009) 174 CA4th 1039, 94 CR3d 841, the court held that interlineated handwritten changes made after an instrument was executed were an amendment and therefore were not part of the instrument containing the no-contest clause. However, a no-contest clause in a will may not apply in any case unless the will is probated and the clause is included or incorporated by reference in the decree of distribution. See *Meyer v Meyer* (2008) 162 CA4th 983, 76 CR3d 546, in which the court held that a no-contest clause in a will did not apply to a testamentary trust in part because the no-contest clause did not unequivocally express an intent to impose forfeiture against a beneficiary challenging the trust.

For discussion of optional language in a no-contest clause authorizing the trustee to defend a contest, see §19.4. For a no-contest clause including the optional language, see §19.5. For an alternative clause incorporating the statute, see §19.5A. For further discussion of no-contest clauses, see 2 California Decedent Estate Practice §19.2 (2d ed Cal CEB 2009); California Trust and Probate Litigation, chap 5 (Cal CEB 1999). See also Hartog, *Taking the Fright Out of In Terrorem: Drafting No Contest Clauses Under the New Regime*, Estate Planning 2009, chap 6 (Cal CEB 2009).

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§19.2 1. Enforceability of No-Contest Clause

Probate Code §21311(a) provides that a no-contest clause shall be enforced only against (1) a direct contest that is brought without probable cause; (2) a pleading to challenge a transfer of property on the grounds that it was not the transferor's property at the time of the transfer; or (3) the filing of a creditor's claim or prosecution of an action based on it. 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. "No-contest clause" is defined in Prob C §21310(c) as a provision that would penalize a beneficiary for filing a pleading in any court.

A "direct contest" is defined in Prob C §21310(b) as a contest brought on one or more of six specified grounds that alleges the invalidity of a "protected instrument" as defined in Prob C §21310(e) (does not include future amendments or codicils). The six grounds are: (1) forgery; (2) lack of due execution; (3) lack of capacity; (4) menace, duress, fraud, or undue influence; (5) revocation; and (6) disqualification of a beneficiary under Prob C §6112 (devise to an interested witness) or Prob C §21350. Probable cause exists if the facts known to the contestant would cause a reasonable person to believe that there is a reasonable likelihood that the requested relief will be granted after an opportunity for further investigation or discovery under Prob C §21311(b).

NOTE: In a partial exception to the more limited enforceability of no-contest clauses under the new rules, the "probable cause" requirement in Prob C §21311(a)(1) appears stricter than the prior standard of "reasonable cause" in former Prob C §21306 as applied to a direct contest brought on grounds of forgery, revocation, or invalid transfer to a disqualified beneficiary under Prob C §21350. See §2.36.

The statute also makes clear that a no-contest clause may be enforced against a pleading to challenge a transfer of property on the grounds that it was not the transferor's property (§21311(a)(2)) or against the filing of a creditor's claim (§21311(a)(3)) if the clause expressly provides for that application. However, it is uncertain whether common law public policy limitations codified in former Prob C §21305(b) continue to apply to marital property forced elections authorized by Prob C §21311(a)(2). 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 former Prob C §21305(b)(6). However, the status of these public policy limitations may be in doubt under the exception in new Prob C §21311(a)(2) with respect to gifts expressly conditioned on the waiver of a right to contend that a surviving spouse trustee underfunded the bypass trust. In some cases, the drafter can obtain the benefits of a no-contest clause by making a conditional gift in which the trustee is directed to distribute trust property to a beneficiary on condition that the beneficiary relinquish or transfer the beneficiary's interest in other trust property to another beneficiary.

The statute does not provide a mechanism to obtain a ruling on whether a proposed action would be a contest in violation of the no-contest clause, as was previously provided in former Prob C §21320. However, provisions regarding the tolling effect (CCP §§366.2-366.3) and appealability (Prob C §§1303-1304) of petitions filed and determinations made in declaratory relief proceedings have been amended to make clear that the relief remains available for instruments that became irrevocable before January 1, 2001.

Probate Code §21312 continues to provide that the clauses must be strictly construed. Common law will continue to govern enforcement of a no-contest clause to the extent that the statutes do not apply. Prob C §21313. The restrictions in Prob C §§21310-21313 apply despite any contrary provision in the trust document. Prob C §21314.

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§19.3 2. Effect of Lifetime Transfer Agreement

Some practitioners believe that the restrictions on enforceability of no contest clauses described in §19.2 can be avoided by entering into an agreement in which the transferee receives property during the transferor's lifetime in exchange for a waiver of the transferee's right to receive property on the transferor's death. The agreement is supposed to represent a binding contract that may be enforced by the personal representative after the transferor's death against any claim by the transferee, and the transfer supposedly does not represent a taxable gift because the value of the putative right given up by the transferee is equal to the value of the transferred property.

While the efficacy of this technique has not been tested in any court proceeding to the editor's knowledge, there appears to be a question whether the receipt of property represents a taxable gain to the transferee even assuming that the value of the transferred property is equal to the value of the right given up in exchange, because the transferee would appear to have a zero income tax basis in the right to receive property on the transferor's death. The only apparent reason that the transferred property might not be included in taxable income would be that the transfer might be treated as a donative gift, but in that case the transfer would represent a taxable gift by the transferor. The transferor in this transaction also might be subject to income tax if the transferred property has a value in excess of the transferor's basis and the transfer is treated as a taxable exchange. Conversely, an effective forfeiture provision in the agreement might be treated as a retained interest that could cause inclusion of the property in the transferor's estate if the transfer is treated as a gift, although the provision might instead be treated as creating a separate obligation to make repayment on the part of the transferee.

Readers are cautioned that such an agreement would not be self-executing and might not prevent claims against the transferor's estate in any event unless the forfeiture provision is incorporated in the dispositive instrument, in which case the enforceability restrictions still might apply. Thus, the desired property disposition still might not occur and the transferor's personal representative would be left with the unenviable task of obtaining a judgment against the transferee in a civil action and then collecting on the judgment.

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§19.4 B. Optional Language in No-Contest Clause

Drafters may want to authorize the trustee to defend a contest or an attack on the trust. See the optional addition in §19.5. Without such a clause, the trustee might be hesitant to defend the trust because a court may rule that an attorney who represents the trustee in an unsuccessful defense of a trust contest is not entitled to have fees paid from the trust. For example, in *Whittlesey v Aiello* (2002) 104 CA4th 1221, 128 CR2d 742, the court found that an undue-influence contest was essentially a dispute between beneficiaries and concluded that 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 trust in unforeseen circumstances when a defense of the trust would be undesirable.

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§19.5 C. Form: No-Contest Clause

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***No-Contest Clause*. If any beneficiary under a trust created by this document shall, singly or in conjunction with any other person or persons, contest in any court the validity of any trust created by this document, or any will or other document making a transfer to this trust, or shall seek to obtain an adjudication in any proceeding in any court that this trust or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside the trust or any of its provisions, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.**

[*If appropriate, add the following option*]

[*Option: Trustee authorized to defend contest*]

The trustee is authorized to defend, at the expense of the trust estate, any contest or other attack of any nature on this trust or any of its provisions.

Comment: Some drafters may want to encourage the trustee to defend the trust. In that event, the drafter may use the optional language. See §19.4.

The phrase "without surviving issue" prevents the issue of a disinherited contesting beneficiary from receiving the beneficiary's interest. See §19.1. This form is generally enforceable in California only with respect to direct contests brought without probable cause. See discussion in §19.2.

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§19.5A D. Form: Alternative No-Contest Clause

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***No-Contest Clause*. If, without probable cause (as defined in California Probate Code §21311(b) or any successor statute), any beneficiary of any trust created by this document, singly or in conjunction with any other person or persons, files a direct contest (as defined in California Probate Code §21310 or any successor statute), that alleges the invalidity of this document or any one or more of its terms or that alleges the invalidity of any will of the settlor[s] or any one or more of its terms, which is in existence on the date this document is executed, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.**

[*If appropriate, add the following option*]

[*Option: Trustee authorized to defend contest*]

The trustee is authorized to defend, at the expense of the trust estate, any contest or other attack of any nature on this trust or any of its provisions.

Comment: This form incorporates the statutory restrictions on enforceability of no-contest clauses discussed in §19.2. The form is adapted from sample clauses in Hartog, *Taking the Fright Out of In Terrorem: Drafting No Contest Clauses Under the New Regime*, Estate Planning 2009 §6.24 (Cal CEB 2009).

The phrase "without surviving issue" prevents the issue of a disinherited contesting beneficiary from receiving the beneficiary's interest. See discussion in §19.1.

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II. LIMITING COURT JURISDICTION

§19.6 A. Purpose of Clause Limiting Court Jurisdiction

Under California case law, a settlor can limit the court's supervision of a trust, although trust clauses that attempt to bar any court jurisdiction and all civil actions regarding the trust are contrary to public policy and unenforceable. *Estate of Parrette* (1985) 165 CA3d 157, 211 CR 313. Trust clauses limiting court jurisdiction appear to be supported by the legislature's declaration of intent that the administration of trusts proceed expeditiously and free of judicial intervention. See Prob C §17209. However, public policy limitations on the enforceability of no-contest clauses also may apply to clauses limiting court supervision. See *Estate of Ferber* (1998) 66 CA4th 244, 77 CR2d 774. In any event, many practitioners consider it poor practice to include provisions in trust documents limiting beneficiary access to the courts. The client's assumption that only undeserving meddlers will attempt to invoke court jurisdiction is debatable at best. Moreover, a clause that effectively prevents beneficiaries from questioning actions of the trustee might conceivably be construed to give the trustee a general power of appointment over the trust, undermining the objectives of the trust. See chap 7.

No provision is needed if the settlor does not wish to limit court jurisdiction. In the absence of such a clause, judicial proceedings concerning trusts are governed by Prob C §§17000-17457. The superior court of the county where the principal place of the trust's administration is located has exclusive jurisdiction over proceedings on the internal affairs of trusts. Prob C §§17000(a), 17002-17005. A trustee or a beneficiary may invoke the court's jurisdiction for the purposes enumerated in Prob C §17200 unless Prob C §15800 applies. Under §15800, while a trust is revocable and the person holding the power to revoke the trust is competent, the person holding the power to revoke (not the beneficiary) has the rights afforded beneficiaries under Prob C §17200, unless the trust instrument provides otherwise or joint action of the settlor and all beneficiaries is required.

PRACTICE TIP: The terms of the instrument may be used to limit the extent of the court's jurisdiction in situations in which the court would otherwise have jurisdiction. For example, the court may not (1) appoint a successor trustee when the trust names one who is qualified and willing to act or (2) use a method of appointing a successor trustee that is different from the method set out in the instrument. Prob C §15660. See chap 16.

If the trust instrument limits the court's jurisdiction, the instrument should include clauses that will deal with the administration issues that are likely to arise. For example, the drafter may wish to include clauses concerning the trustee's accounts and the notice to be given to parties in interest. The settlor may also wish to limit the persons to whom remedies are available. Alternatively, the drafter may wish to provide that court jurisdiction is available as provided in the statute. For a form of clause with alternative provisions limiting persons who may invoke court jurisdiction or providing that court jurisdiction is available, see §19.7.

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Source: Estate Planning/Drafting California Revocable Trusts/19 No-Contest Clause and Miscellaneous Trust Provisions/§19.7 B. Form: Limiting Court Jurisdiction

§19.7 B. Form: Limiting Court Jurisdiction

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19.7-1 Limiting persons who may invoke court jurisdiction

[*If appropriate, use one of the following alternatives*]

[*Alternative 1: Limiting persons who may invoke court jurisdiction*]

***Court Jurisdiction*. After the death of both settlors, only the trustee and _ _**[*designate parties in interest, e.g., any adult person entitled to current income distribution or to current distribution of income or principal at the trustee's discretion*]**_ _ may invoke court jurisdiction.**

[*Alternative 2: Court jurisdiction available*]

***Court Jurisdiction*. Probate Code §§17200-17211 or any successor or substitute provisions of those sections authorizing court jurisdiction over revocable trusts shall apply to all trusts created by this document.**

Comment: Alternative 2 merely confirms that the statute applies to the trust, but it is evidence of the settlor's understanding that the trust is subject to court jurisdiction even though it avoids probate.

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III. DISINHERITANCE CLAUSE

§19.8 A. Purpose of Disinheritance Clause

In most circumstances, a surviving spouse or registered domestic partner who entered into a marriage or domestic partnership with the decedent after execution of a testamentary instrument, or a child of the decedent who was born or adopted after execution of the instrument, has a right to receive a share in the decedent's estate unless the instrument expressly provides that the decedent's failure to provide for the spouse or child was intentional. See Prob C §§21610-21612; Fam C §297.5(c) (omitted spouses and domestic partners); Prob C §§21620-21623 (omitted children). Testamentary instruments include wills and revocable trusts. Prob C §21601(a). A surviving spouse or registered domestic partner may include a putative spouse (*Estate of Leslie* (1984) 37 C3d 186, 207 CR 561) or putative registered domestic partner (*In re Domestic Partnership of Ellis & Arriaga* (2008) 162 CA4th 1000, 76 CR3d 401) who believed in good faith that a void or voidable marriage was valid or that a domestic partnership was registered. Fam C §2251.

Although the statute limits the class of persons who are entitled to claim inheritance as omitted heirs in California, the client intending to disinherit a spouse or children may be able to avoid litigation by including an explicit declaration that the settlor intends not to provide for any heir not named in the trust. See, *e.g., Estate of Mowry* (2003) 107 CA4th 338, 131 CR2d 855, in which the will left the entire estate to the decedent's brother, and an omitted child adopted before execution of the instrument unsuccessfully sued for a share of the estate. See also *Estate of Bay* (Wash 2005) 105 P3d 434, in which the court concluded that the decedent had evidenced an intention to disinherit his second wife with respect to her intestate share when he changed the beneficiary designation of his retirement plan to name her as an 80-percent beneficiary with his children as 20-percent beneficiaries but failed to revoke a will that named his children as successor beneficiaries to his first wife, with the result that they were effectively the sole beneficiaries under the will. The drafter should also consider including such a clause because California law may not apply to the claims of an omitted heir if the client resides in another jurisdiction on the date of death.

For further discussion of disinheritance clauses, see California Will Drafting §§35.5-35.8 (3d ed Cal CEB 1992).

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§19.9 B. Form: Disinheritance Clause

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19.9-1 Disinheritance clause

***Omitted Heirs*. Except as otherwise provided in this document, the _ _[*settlor has/settlors have*]_ _ intentionally and with full knowledge chosen not to provide for _ _[*his/her/their*]_ _ heirs, including, without limitation, _ _[*specify name(s) of omitted person(s)*]_ _.**

Comment: The term "heirs" includes a surviving spouse or registered domestic partner of the settlor. Prob C §44; Fam C §297.5(c).

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IV. PERPETUITIES SAVINGS CLAUSE

§19.10 A. Purpose of Perpetuities Savings Clause

Under Prob C §21205, any interest in real or personal property must vest:

- Within 21 years (plus the period of gestation) after a life in being at the date of the creation of the interest (the common-law perpetuities period); or
- Within 90 years after creation of the interest.

The Uniform Statutory Rule Against Perpetuities (Prob C §§21200-21225) and the related provisions in Prob C §§21230-21231 apply to all nonvested property interests and unexercised powers of appointment, regardless of when they were created, except interests of powers the validity of which have been determined in a judicial proceeding or by settlement. Prob C §21202(b). Because of the savings provisions of Prob C §21209, it is not absolutely necessary to include a specific savings clause in the trust document, but a clause limiting trusts to the common law perpetuities period should be included because the trust may hold property in a jurisdiction that has not enacted the Uniform Rule. Form 19.11-1 may be used for this purpose.

For detailed discussion of the rule against perpetuities, see California Will Drafting, chap 34 (3d ed Cal CEB 1992).

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§19.11 B. Form: Perpetuities Savings Clause

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19.11-1 Perpetuities savings clause

***Rule Against Perpetuities*. Unless terminated earlier in accordance with other provisions of this document, each trust created by this document or by exercise of any power of appointment conferred by this document (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*names of individuals or description of class best suited to be measuring lives*]_ _ living on the date of the death of the Deceased Settlor. In the event of termination under this paragraph, the principal and undistributed income of a terminated trust shall be distributed to the then income beneficiaries of that trust in the same proportion that the beneficiaries are entitled to receive income when the trust terminates. If at the time of such termination the rights to income are not fixed by the terms of the trust, distribution under this clause shall be made to the persons who are then entitled or authorized, in the trustee's discretion, to receive trust payments.**

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V. SPENDTHRIFT CLAUSE

§19.12 A. Purpose and Effect of Spendthrift Clause

If the trust document so provides, the general rule is that a beneficiary's interest in income, principal, or both is not subject to voluntary or involuntary transfer and is not subject to enforcement of a money judgment until it is paid to the beneficiary, but a court, on petition, may issue an order directing the trustee to satisfy a money judgment out of principal that is due and payable to the beneficiary. CCP §709.010; Prob C §§15300-15301.

In some cases, a restraint against transfer is invalid, or a court may order payment from income or principal. In particular, when the settlor is a beneficiary, any clause restraining transfer of the settlor's interest is invalid against transferees or creditors of the settlor. Prob C §15304. Thus, a spendthrift clause is ineffective for the settlor's interests in the corpus and income of a revocable trust. In fact, the revocable trust's assets are available to satisfy the settlor's debts both during lifetime and at death. Prob C §§18200, 19001. Creditors' claims during the settlor's lifetime, however, are subject to all exemptions from the enforcement of money judgments under CCP §§703.010-704.995. Prob C §18201.

A spendthrift clause protects trust funds against the beneficiary's creditors only before distribution to the beneficiary. The clause protects funds after distribution only up to the amount needed for the beneficiary's support and education; all excess amounts required to be distributed or that are distributed are subject to the claims of the beneficiary's creditors. See Prob C §15307. See also *Estate of Lawrence* (1968) 267 CA2d 77, 72 CR 851 (when trust directs accumulation of surplus income, creditor may reach only mandatory payments exceeding beneficiary's needs for education and support based on beneficiary's station in life). Judgment creditors may petition for an order directing the trustee to pay 25 percent of a payment that would otherwise be made to or for the beneficiary to satisfy the judgment. Prob C §15306.5. By permitting accumulation of income and limiting mandatory distributions, form 19.13-2 prevents attachments by creditors and deters their actions against the beneficiary or the trust. In instruments under which no beneficiary other than the surviving settlor has a right to mandatory payments, form 19.13-1 is equally effective.

WARNING: Form 19.13-2, the long-form spendthrift clause, expressly does not apply to a marital deduction trust (other than an estate-type marital deduction trust) or a qualified subchapter S trust (QSST), because it provides for the accumulation of income. See *Virginia Nat'l Bank v U.S.* (4th Cir 1971) 443 F2d 1030. The short-form spendthrift clause (see form 19.13-1) may apply to a marital deduction trust, however, without endangering the marital deduction. Treas Reg §20.2056(b)-5(f)(7). Similarly, use of the short form should not cause a QSST to lose this status. See chap 9 on marital deduction trusts.

The mere presence of a spendthrift clause may not protect trust funds in bankruptcy 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 (retirement plan excluded). 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.

PRACTICE TIP: The drafter should not use a spendthrift clause indiscriminately, because it prevents the beneficiary from assigning his or her interest for estate planning or other desirable purposes and restricts judicial modification under Prob C §15409. The drafter may wish to consider including limitations, *e.g.,* a provision making the clause inapplicable to the surviving spouse or domestic partner or to any beneficiary who has attained a certain age.

For full discussion of spendthrift protection, see California Will Drafting, chap 27 (3d ed Cal CEB 1992).

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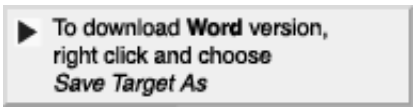
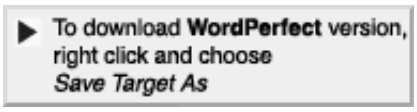
§19.13 B. Form: Spendthrift Clause





19.13-1 Short-form spendthrift clause

***Spendthrift Clause*. The interests of the beneficiaries in the income and principal of the trusts created by this document are not subject to voluntary or involuntary transfer.**

19.13-2 Long-form spendthrift clause

***Spendthrift Clause*.**

1. The interests of the beneficiaries in the income and principal of the trusts created by this document are not subject to voluntary or involuntary transfer.

2. If the creditor of any beneficiary who is entitled to any distributions from a trust established under this instrument attempts by any means to subject to the satisfaction of his or her claim that beneficiary's interest in any distribution, then, despite any other provision in this instrument, until the release of the writ of attachment or garnishment or other process, the distribution directed to be made to that beneficiary shall instead be disposed of as follows:

(a) The trustee shall pay to or apply for the benefit of the beneficiary all sums the trustee determines to be necessary for the reasonable health, education, and support of the beneficiary according to his or her accustomed mode of life; and

(b) The portion of the distribution that the trustee determines to exceed the amount necessary for the reasonable health, education, and support of the beneficiary 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 this instrument, in proportion to their respective interests in the trust estate. If there are no other beneficiaries, the excess income may be paid to or applied for the benefit of the person(s) presumptively entitled to the next eventual interest, in proportion to _ _[*his/her/their*]_ _ respective interests in the trust.

This subparagraph shall not apply to the marital trust or any trust that is a qualified subchapter S trust as defined in Internal Revenue Code §1361.

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VI. GUARDIANSHIP CLAUSES

§19.14 A. Nomination of Guardian

The nomination of a guardian of minor children is usually made in a will, even if there is a revocable trust. However, because applicable law requires only a writing to nominate a guardian, the nomination may also be included in the trust. See Prob C §§1500-1502.

The financial impact on the guardian of taking responsibility for the minor may exceed the direct expense of caring for the minor. For example, the addition of children to a family may require remodeling the family residence or hiring household help. Even though the guardian may be nominated in the will, the trustee may pay the guardian's expenses if the trustee is empowered in the trust instrument to make payments for the minor's benefit. See chap 8.

If the nominated guardian does not reside in California, the settlors may request 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)). As a rule, 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 may petition for appointment in California.

Alternate and successor guardians should be nominated in the event the first-named nominee or first appointee dies or becomes unable or unwilling to serve. Usually, both settlors nominate the same persons as alternate and successor guardians of minor children who may be orphaned. The term "successor guardian" is often used to refer to both alternates and successors. For a form of nomination clause for a guardian of the person of minor children, see §19.15.

On nomination of a guardian and other procedures for protecting the minor children's interests after the parents' death, see California Will Drafting, chap 24 (3d ed Cal CEB 1992). For a complete discussion of appointment of guardians for minors, see California Guardianship Practice, chap 5 (Cal CEB Annual).

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§19.15 B. Form: Nomination of Guardian of Person

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19.15-1 Nomination of guardian of person

***Nomination of Guardian*. We nominate _ _[*name of guardian*]_ _ to be the guardian of the person(s) of our child(ren). If that nominee fails to qualify or ceases to act, we nominate _ _[*name of alternate and successor guardian*]_ _ to be the guardian of _ _[*his/her/their*]_ _ person(s).**

Comment: The settlors may condition the guardian's appointment on factors that the settlor considers important, *e.g.,* that the nominee is living with the same spouse or partner with whom the nominee was living when the trust instrument was executed.

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§19.16 C. Nomination of Guardian of Estate

In most trust-based estate plans, the trustee will provide for the financial needs of the minor children, and a guardianship of the estate will usually be unnecessary and is not recommended as a potential distributee of trust property. See chap 8. Nevertheless, to cover the possibility that a guardian of the estate will be needed for nontrust property, the drafter may wish to provide for both a guardian of the person and of the estate to manage and control the minor's nontrust property until the minor reaches age 18. For forms and discussion, see California Will Drafting, chap 25 (3d ed Cal CEB 1992).

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VII. PROFESSIONAL CORPORATION CLAUSE

§19.17 A. Shares of Professional Corporation Held in Trust

Shares in a professional corporation (*e.g.,* law, medical, or dental corporation) may generally be transferred only to a licensed member of the profession. Corp C §13407. However, shares in a professional corporation may be transferable to a revocable trust under the following conditions (see California Department of Consumer Affairs Legal Opinion 79-5):

- The trustee and current beneficiaries of the trust are licensed; and
- A nonlicensed spouse of a licensed spouse/trustee does not have an interest in the trust greater than his or her community property interest in the shares, and the trust instrument specifies that:
- The licensed spouse/trustee has exclusive control and powers relating to the shares of the professional corporation; and
- On the nonlicensed spouse's death, the spouses' children (or other beneficiaries) have a beneficial interest, if at all, only in the proceeds that may be received from the shares and not equitable title to those shares.

The following is the text of the opinion:

> February 16, 1979
> Legal Op. No. 79-5
>
> RE: Shares of a Professional Corporation Held in Trust
> Dear Mr. Mortensen:
>
> We are in receipt of your letters of December 1, 1978, and January 11, 1979, in which you ask for an opinion on the legal parameters of placing the shares of a professional corporation into a revocable living trust. We regret that the press of business in our office has prevented a speedier response to your inquiries.
>
> The issue to be determined is the extent to which the shares of a professional corporation may be transferred into a revocable living trust. Section 13407 of the Corporations Code states in pertinent part:
>
> "13407. Shares in a professional corporation may be transferred only to a licensed person or to such professional corporation, and any transfer in violation of this restriction shall be void."
>
> Title 16 California Administrative Code Section 1348, subsection (a), states: [now see 16 Cal Code Regs §1348(a)]
>
> "1348. Trusts. (a) The restrictions on the ownership of the shares of professional corporations shall apply to both the legal and equitable title to such shares."
>
> We have held that the shares of a professional corporation may be transferred to an inter vivos trust where the trustee is a licensed person, e.g., a physician, and the beneficiaries of such a trust are also licensed persons. We believe that the restriction on the transfer of shares set forth in Section 13407, above, applies to both the legal and equitable title to such shares. Therefore, only a licensed person may be the beneficiary in such a trust arrangement; however, where spouses enter into a trust agreement and only one spouse is a licensed person, the nonlicensed spouse may have an equitable title to the proceeds of such shares which is not greater than the community property interest he or she already maintains to such shares. If the licensee spouse pre-deceases the nonlicensed spouse, then the shares are sold and the proceeds are distributed according to the terms of the trust.
>
> In those situations where the nonlicensed spouse pre-deceases the licensed spouse, then two separate trusts are created, i.e., a trust for the property of the surviving spouse and a second irrevocable trust for the property of the deceased spouse. At this point the surviving spouse who is a licensed person has legal title to the shares of the professional corporation and the children have a beneficial interest in the trust res. In drafting for this contingency we suggest that it be made clear in the trust instrument that the children have a beneficial interest to only the proceeds which may be received from the shares of the professional corporation and not equitable title to those shares. Additionally, it should be stated in the trust agreement that the trustee/licensed person shall have exclusive control and powers relating to the shares of the professional corporation.
>
> Therefore, we believe that if the trust instrument specifically states that should the children of the grantors become beneficiaries in the trust their interest in the shares of any professional corporation is limited to the proceeds from the sale of those shares after the death of the grantor/licensed person, such a trust

agreement would not be in conflict with the pertinent provisions of Section 13407.

We trust this will be of assistance to you.

Sincerely,
GUS E. SKARAKIS
Chief Counsel

By GREGORY GORGES
Staff Counsel

This opinion also should be read to apply to a nonlicensed registered domestic partner of a licensed trustee. See Fam C §297.5. If a settlor of a jointly settled trust with an unlicensed spouse or domestic partner owns shares in a professional corporation, or is a licensed professional who may come to own shares in a professional corporation, the trust should include the necessary language to allow shares of a professional corporation to be held by the trust. See §19.18.

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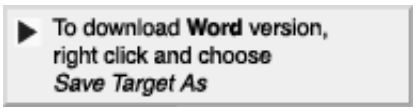
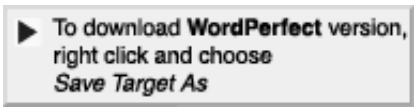
§19.18 B. Form: Shares of Professional Corporation Held in Trust





19.18-1 Shares of professional corporation held in trust

***Professional Corporations*. If at any time the trust property includes shares of a professional corporation as defined in Corporations Code §13401, the settlor who is licensed to practice the profession for which the corporation is organized shall have exclusive control and powers relating to the shares.**

During the joint lifetimes of the Settlors, a nonlicensed spouse or domestic partner shall have only a beneficial interest in the proceeds of such shares, which interest shall not be greater than the community property interest to which he or she is otherwise entitled.

On the Deceased Settlor's death, the trustee shall allocate the shares to the Survivor's Trust to the extent possible if the Surviving Settlor is licensed to practice the profession for which the corporation is organized. If the Surviving Settlor is not licensed to practice the profession for which the corporation is organized, the trustee shall sell the shares and distribute the proceeds according to the terms of this document.

Any beneficiary of a trust created by this document who is not licensed to practice the profession for which the corporation is organized shall not have equitable title to the shares. The interest of the beneficiary in the trust property with respect to the shares, if any, shall extend only to the proceeds that may be received from the shares.

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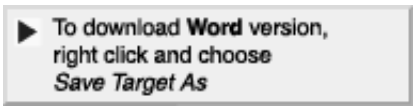
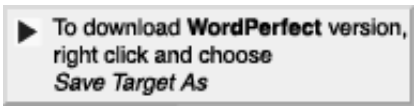
VIII. CONCLUDING CLAUSES

§19.19 A. Form: Name of Trust





19.19-1 Name of trust

***Name of Trust*. The trusts created by this document may be referred to collectively as the _ _[*full names of settlors and year in which trust was established, e.g., John J. Smith and Mary L. Smith _ _[year*]_ _ *Revocable Trust, dated _ _[date*]_ _]_ _, and each separate trust created by this document may be referred to by adding an appropriate designation, such as Bypass Trust, _ _[*QTIP Trust*]_ _, Survivor's Trust, _ _[*Children's Trust, Grandchildren's Trust*]_ _, or the words "Trust for" followed by the name of the beneficiary.**

Comment: Although this clause is not essential, it may be useful in identifying the trust, especially when several trusts have been established by the settlors or will be created by the trust document. Some financial institutions prefer that the full date and not just the year of the trust be included in the trust title. Some drafters omit the word "revocable" in the name of the trust when variations on the trust's name will be used to identify separate trusts, because not all trusts created by the document will be revocable.

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§19.20 B. Form: Signatures

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19.20-1 Execution of trust; signatures

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

[*If the settlors are not the trustees, add one of the following options*]

[*Option 1: Acceptance by individual trustee*]

This trust is accepted on _ _[*date*]_ _.

__[*Signature of individual trustee*]__
_ _[*Typed name*]_ _
Trustee

[*Option 2: Acceptance by corporate trustee*]

This trust is accepted on _ _[*date*]_ _.

_ _[*Typed corporate name*]_ _
Trustee

By __[*Signature*]__
_ _[*Typed name and capacity, e.g., Vice-President and Trust Officer*]_ _

19.20-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal.

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

Comment: If the settlors are not the trustees, the words "and Trustee" should be deleted from the signature lines for the settlors in form 19.20-1 and an individual trustee or authorized individual representing a corporate trustee should execute an acceptance of the trust. The language of the acknowledgment is prescribed by CC §1189 and should not be modified.

Although not required, the signatures of the settlors and the signature of the trustee, if different from the settlors, are usually acknowledged. The acknowledgment in form 19.20-2 is prima facie evidence of the genuineness of the signatures. Evid C §1451. Acknowledgment may also be desirable in order to allow for the possibility of later recording the trust document.

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Revocation and Amendment

Charles A. Larson

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Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/§20.1 I. EXPRESS REVOCATION PROVISIONS RECOMMENDED

§20.1 I. EXPRESS REVOCATION PROVISIONS RECOMMENDED

Under common law, a trust was presumed to be irrevocable in the absence of an express reservation of a right to revoke in the trust document. See Restatement (Second) of Trusts §§330, 332 (1959); 5 Scott & Ascher on Trusts §§35.1, 35.3 (5th ed 2008). Many states still follow that rule. In California, however, a settlor may revoke a trust unless the trust document provides that the trust is irrevocable. Prob C §15400. See also Restatement (Third) of Trusts §63, comment j (2003). Because of these conflicting rules, all trust documents should contain express provisions concerning rights of revocation and amendment. The trust document should further provide for the disposition of the trust property in the event of revocation.

WARNING: A trust amendment or revocation requires a corresponding amendment of an existing pourover will because either (1) the pour-over will mirrors the trust provisions, or (2) the pour-over will incorporates the trust terms as of the date the will was made. If the trust is revoked or terminated before the testator's death, the pourover gift will fail unless the will provides otherwise. Prob C §6300. See §22.6.

Generally, a trust may be revoked by any method provided in the trust document (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)). Merely providing a detailed method for revocation in the trust document is not sufficient to preclude the use of the statutory method. See *Huscher v Wells Fargo Bank* (2004) 121 CA4th 956, 18 CR3d 27. 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. In *Masry v Masry* (2008) 166 CA4th 738, 82 CR3d 915, the court held that a husband's unilateral revocation of a joint revocable trust was valid even though notice was not given to the wife until after his death. The court noted that the trust document did not state that the revocation method described in that document was exclusive and concluded that the husband complied with the statute by executing a document delivered to himself as trustee. If the trust document explicitly establishes an exclusive method for revocation, however, that procedure must be followed. Prob C §15401(a)(2); *Conservatorship of Irvine* (1995) 40 CA4th 1334, 47 CR2d 587 (trust amendment invalid because not properly served on trustee as required by trust terms); *Heaps v Heaps* (2004) 124 CA4th 286, 21 CR3d 239 (sale of trust property held in names of husband and wife trustees in exchange for joint tenancy promissory note did not revoke trust with respect to the note). The forms for joint trusts in this book preserve the ability of each settlor to make unilateral changes concerning dispositions at death without revoking the trust by giving each settlor powers of appointment that can be exercised in ways that include exercise by will—as may be quite desirable if the other settlor no longer has capacity. See §§7.87, 10.5.

In *Rands v Rands* (2009) 178 CA4th 907, 100 CR3d 632, under an unusual provision in the trust document, a determination by two physicians that the settlor lacked capacity resulted in the settlor not being able to revoke his revocable trust until a court determined that the settlor had capacity or two physicians with knowledge of the original certification certified that the settlor had regained capacity. Such a provision is not recommended. In most cases, issues of capacity to revoke or amend a trust should be left to the Due Process in Competence Determinations Act (Prob C §§810-813), as augmented by more particular statutes, such as Prob C §6100.5 provisions concerning competency to make a will, and the extensive body of case law concerning testamentary capacity.

If a trust is created by more than one settlor, each settlor may revoke the trust with respect to the portion of the trust contributed by that settlor unless the trust document provides otherwise. Prob C §15401(b). An exception to this general rule permits either spouse to revoke a trust with respect to community property in the absence of a contrary provision. Fam C §761(b). See §20.4. On revocation of the trust with respect to separate property of a married settlor, see §20.5.

The power to revoke a trust generally includes the power to modify it. Prob C §15402. There is an exception to this rule for community property. Unless otherwise provided in the trust document, both spouses must consent to a modification even though either of them acting alone can revoke. Fam C §761(a). On the effect of revocation of the trust

on a pourover will, see §22.1.

Despite these default rules, the desired rules for revocation and amendment should be expressly stated in the trust document. Doing so avoids arguments about settlor intentions and avoids potential conflict-of-law issues that can arise when it is necessary to resort to state statutes to resolve document construction issues. For a form provision for revocation and amendment by sole settlor, see §20.2. For a form provision for revocation and amendment by married settlors, see §20.3.

NOTE: If the drafter wants a no-contest clause to apply to a trust amendment, a no-contest clause must be included in the amendment unless the no-contest clause in the trust expressly applies to amendments. Prob C §21305(a)(3). See §§19.1-19.5.

On the revocability of the survivor's trust, marital trust, and bypass trust after the death of the first spouse, see §20.6. For a form of amendment to trust, see §20.9. On restatement of the entire trust as an alternative to amendment, see §§20.10-20.11.

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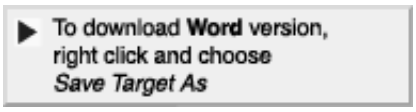
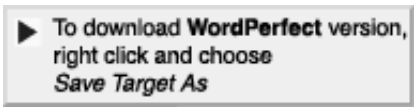
Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/§20.2 II. FORM: REVOCATION AND AMENDMENT BY SOLE SETTLOR

§20.2 II. FORM: REVOCATION AND AMENDMENT BY SOLE SETTLOR





20.2-1 Sole settlor's power to revoke or amend

REVOCATION AND AMENDMENT

A. *Settlor's Power to Revoke and Amend.* During the settlor's lifetime, the settlor may revoke or amend _ _[*this trust/all trusts created by this document*]_ _ at any time. On revocation, the trust property shall be delivered to the settlor or as the settlor directs. _ _[*This trust/All trusts created by this document*]_ _ become irrevocable on the settlor's death.

[*If appropriate, add the following option*]

[*Option: Procedural requirements for amending or revoking trusts*]

B. *Procedural Requirements for Amending or Revoking Trusts*. No amendment or revocation of any trust shall be effective for such purposes unless all of the following requirements are satisfied:

1. *Signed Written Document*. The amendment or revocation must be accomplished by a written document signed by the settlor.

[*Add one of the following alternatives*]

[*Alternative 1: Agent authorized to amend or revoke*]

Despite the previous sentence, the settlor's power to revoke or amend may be exercised by an attorney-in-fact to the extent that the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

[*Alternative 2: Power to revoke personal to settlor*]

The power to revoke or amend this instrument is personal to the settlor and shall not be exercisable on the settlor's behalf by a conservator, an agent under a power of attorney, or any other person.

[*Continue*]

2. *Acknowledgment or Attorney Certificate*. Except in the case of a document executed in accordance with a court order: (a) The document must be personally acknowledged before a notary public by the person signing the document (not a witness); or (b) the document must contain a statement, signed by an attorney at law before or at the time the document is signed by the person taking the action, which declares that the attorney represents the settlor taking the action and approves the form of the document.

3. *Delivery to Trustee*. The document must be delivered during the lifetime of the settlor to each then-acting trustee of the trust other than the settlor.

[C]. *Effect of Defective Documents*. The procedural requirements of this division for revoking or amending trusts are intended to prevent fraud, reduce the risk of undue influence, and provide certainty with respect to the settlor's intentions. A court, in order to give effect to the actual intentions of a settlor, may give effect to a document not satisfying all procedural requirements for revoking or amending a trust if the court finds that (1) the settlor was competent; (2) the attempted revocation or amendment was not the result of fraud, undue influence, or duress; (3) the document was clearly intended to amend or revoke the trust; and (4) there is no reason to deny equitable relief. The proponent of the document shall have the burden of proof. The standard of proof with respect to these matters shall be (1) preponderance of the evidence concerning amendments having no impact or only incidental impact on distribution of the trust after the settlor's death and (2) clear and convincing evidence in the case of changes that substantially affect distribution of a trust.

[D]. *Revocation by Gift.* The procedural requirements of this division for revoking or amending trusts do not apply to gifts of trust property made by the settlor that would be valid if the gifted property was not subject to this trust. Any such gift revokes the trust with respect to the gifted property.

[*If applicable, add one or more of the following options*]

[*Option 1: Amendment not acceptable to trustee*]

[E]. *Amendment Not Acceptable to Trustee*. The trustee's consent is not required for a valid amendment. If a trust amendment substantially increases the trustee's duties or liabilities or changes the trustee's compensation without the trustee's consent, the trustee shall have the right to resign.

[*Option 2: Limitation on amendment or revocation by conservator or guardian of estate; do not add if alternative 2 in paragraph B is used*]

[F]. *Limitation on Exercise of Powers by Conservator or Guardian of Estate*. No conservator or guardian of the settlor's estate shall have any power to amend or revoke this trust _ _[*or exercise any power of appointment*]_ _. The previous sentence does not apply if the conservator or guardian is acting under a court order made in compliance with a "substituted judgment" statute. Until such an order is made, no conservator or guardian shall be deemed to hold such a power for any purpose.

Comment: In general, see §20.1. For a form provision for revocation and amendment by married settlors, see §20.3. For a form of amendment to trust, see §20.9. For a form restating the entire trust, see §20.11.

The client may wish to change the method of revocation provided in paragraph B to a more formal procedure. However, rigorous formalities can defeat client wishes by invalidating intended and desirable gifts and other actions. See §16.29 on limitations on trustee's liability if the trustee is not notified of an event. Alternative 1 in paragraph B or a similar provision should be used if the settlor desires to give an attorney-in-fact a power to revoke or amend the trust. See Prob C §15401(c). *Alternative 2 should not be used in the absence of exceptional circumstances*. Including it creates a malpractice risk for drafters, if the settlor's power of attorney expressly authorizes the agent to exercise broad estate planning powers, including the power to amend or revoke the trust. See §§20.7-20.8.

Paragraph C attempts to reduce the risk that amendments will be attacked as invalid due to the failure to comply with procedural requirements. The paragraph is loosely based on Prob C §631.

Trust settlors are unlikely to execute formal documents when using trust assets to make gifts. Paragraph D attempts to reduce the risk that such a gift will fail. See, *e.g., Austin v City of Alexandria* (Va 2003) 574 SE2d 289, in which the court nullified an obvious intent to transfer property from a revocable trust to a charitable trust. See also *Conservatorship of Irvine* (1995) 40 CA4th 1334, 47 CR2d 587 (trust amendment invalid because not properly served on trustee as required by trust terms).

Many drafters provide that an amendment must be acceptable to the trustee. However, the resulting potential uncertainty concerning the validity of an amendment may be undesirable, particularly in death-bed situations. Optional paragraph E makes it clear that trustee consent is not required. This provision is less traditional but is consistent with Uniform Trust Code §602(c). See Comment to Uniform Trust Code §602(c). For further discussion of third party consent to amendments, see Restatement (Third) of Trusts §63, comment j (2003).

Optional paragraph F should be used unless the provisions of the trust are so highly confidential that the settlor would prefer that the trustee report and account to a court-appointed conservator rather than to the trust beneficiaries. See *Johnson v Kotyck* (1999) 76 CA4th 83, 90 CR2d 99 (when incompetent settlor had conservator, beneficiaries not entitled to accounts because conservator still had the power to revoke the trust). For discussion of trustee accounts, see chap 15.

NOTE: Optional paragraph F may not be used in any event if alternative 2 is used in paragraph B.

The phrase "or exercise any power of appointment" may be used if requirements for the exercise of powers of appointment will be included in the same division of the trust document. See App A. Otherwise, the phrase should be deleted.

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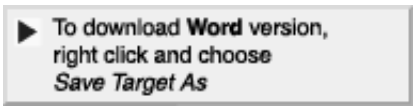
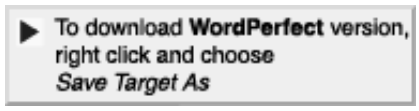
Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/ III. REVOCATION AND AMENDMENT BY MARRIED SETTLORS/§20.3 A. Form: Revocation and Amendment by Married Settlors

III. REVOCATION AND AMENDMENT BY MARRIED SETTLORS

§20.3 A. Form: Revocation and Amendment by Married Settlors





20.3-1 Revocation and amendment by married settlors

REVOCATION AND AMENDMENT

A. *Trust Irrevocable Except as Provided*. Except as provided in this division, all trusts created by this document are irrevocable and cannot be amended.

1. *Exception: Revocable While Both Settlors Are Living*. During the joint lifetimes of the settlors, either settlor may revoke all trusts created by this document, with respect to both halves of the community property and the revoking settlor's own separate property. The revocation must satisfy the procedural requirements of this division for amending or revoking trusts. On revocation, community property subject to the revocation shall be delivered to both settlors or as the settlor(s) direct, except that the property shall be delivered to the competent settlor if only one is competent _ _[*, and if both settlors are competent, the trustee shall deliver any business operated by one of the settlors to the operating settlor*]_ _. Separate property trust assets of each settlor joining in the revocation shall be delivered to the settlor owning the property. A unilateral revocation of the trust by one settlor does not prevent reestablishment of the trust with respect to any property that may later pass to the trust under the will of a settlor or otherwise.

2. *Exception: Amendment While Both Settlors Are Living*. During the joint lifetimes of the settlors, all trusts created by this document may be amended by mutual agreement of the settlors. Any amendments must satisfy the procedural requirements of this division for amending or revoking trusts.

[*If appropriate, add the following option*]

[*Option: Exception: revocation or amendment of the survivor's trust*]

3. *Exception: Revocation or Amendment of Survivor's Trust*. The Survivor's Trust may be revoked or amended, in whole or in part, at any time by the Surviving Settlor. Any such revocation or amendment must satisfy the procedural requirements of this division for amending or revoking trusts. On revocation, the trustee shall deliver the trust property to the Surviving Settlor.

[*If appropriate, add the following option*]

[*Option: Procedural requirements for amending or revoking trusts*]

B. *Procedural Requirements for Amending or Revoking Trusts*. No amendment or revocation of any trust shall be effective unless all of the following requirements are satisfied:

1. *Signed Written Document*. The amendment or revocation must be accomplished by a written document signed by the settlor(s) taking the action.

[*Add one of the following alternatives*]

[*Alternative 1: Agent authorized to amend or revoke*]

Despite the previous sentence, a settlor's power to revoke or amend may be exercised by an attorney-in-fact if and to the extent the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

[*Alternative 2: Power to revoke personal to settlor*]

The power to revoke or amend this instrument is personal to the settlors and shall not be exercisable on either settlor's behalf by a conservator, an agent under a power of attorney, or any other person.

[*Continue*]

2. *Acknowledgment or Attorney Certificate*. Except in the case of a document executed in accordance with a court order: (a) The document must be personally acknowledged before a notary public by the person(s) signing the document (not a witness); or (b) the document must contain a statement, signed by an attorney-at-law before or at the time the document is signed by the person(s) taking the action, which declares that the attorney-at-law represents the settlor(s) taking the action and approves the form of the document.

3. *Delivery to the Trustee*. In the case of an action not requiring the consent of both settlors, the document must be delivered during the lifetime of the settlor taking the action to: (a) Each then acting trustee of the trust who is not a settlor taking the action; and (b) each settlor then living and competent but not joining in the action. In the case of an action requiring the joint action of both settlors, the document must be delivered during the settlors' joint lifetimes to each acting trustee who is not a settlor taking the action.

[C]. *Effect of Defective Documents*. The procedural requirements of this division for revoking or amending trusts are intended to prevent fraud, reduce the risk of undue influence, and provide certainty with respect to the intentions of the settlors. A court, in order to give effect to the actual intentions of a settlor, may give effect to a document not satisfying all procedural requirements for revoking or amending a trust if the court finds that: (1) The settlor taking the action was competent; (2) the attempted revocation or amendment was not the result of fraud, undue influence, or duress; (3) the document was clearly intended to amend or revoke the trust; and (4) there is no reason to deny equitable relief. The proponent of the document shall have the burden of proof. The standard of proof with respect to these matters shall be: (1) Preponderance of the evidence with respect to amendments having no impact or only incidental impact on distribution of the trust after the settlor's death; and (2) clear and convincing evidence in the case of changes that substantially affect distribution of a trust.

[D]. *Revocation by Gift.* The procedural requirements of this division for revoking or amending trusts do not apply to gifts of trust property made by one or both settlors that would be valid if the gifted property was not subject to this trust. Any such gift revokes the trust with respect to the gifted property.

[*If applicable, add one or more of the following options*]

[*Option 1: Amendment not acceptable to the trustee*]

[E]. *Effect of Amendment Not Acceptable to Trustee*. The consent of the trustee is not required for a valid amendment. In the event a trust amendment substantially increases the duties or liabilities of the trustee or changes the trustee's compensation without the trustee's consent, the trustee shall have the right to resign.

[*Option 2: Limitation on exercise of powers by conservator or guardian of the estate*]

[F]. *Limitation on Exercise of Powers by Conservator or Guardian of the Estate*. No conservator or guardian of a settlor's estate shall have any power to amend or revoke this trust _ _[*or exercise any power of appointment*]_ _. The previous sentence does not apply if the conservator or guardian is acting under a court order made in compliance with a "substituted judgment" statute. Until such an order is made, no conservator or guardian shall be deemed to hold such a power for any purpose.

Comment: In general, see §20.1. Note that either settlor alone may revoke, but both settlors need to join in executing an amendment. See §20.4. For discussion of a surviving settlor's power of revocation or amendment, see §20.6.

This form may be adjusted to accommodate the clients' wishes (if any) about the method of revocation or the timing of delivery of revoked assets. The optional portion of subparagraph 1 of paragraph A referring to a business should be included if the clients have a community property business interest operated by one spouse. Paragraphs B, C, and D are substantially identical to paragraphs B, C, and D in form 20.2-1. See comments in §20.2. *Alternative 2 in paragraph B should not be used in the absence of exceptional circumstances*. Including it creates a malpractice risk for drafters, if the settlor's power of attorney expressly authorizes the agent to exercise broad estate planning powers, including the power to amend or revoke the trust. See §§20.7-20.8.

Optional paragraphs E and F are substantially identical to paragraphs E and F in form 20.2-1.

NOTE: Optional paragraph F may not be used in any event if alternative 2 is used in paragraph B.

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Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/§20.4 B. Revocation Power Exercised by Either Settlor With Respect to Community Property

§20.4 B. Revocation Power Exercised by Either Settlor With Respect to Community Property

Unless the trust document expressly provides otherwise, community property that is transferred in trust remains community property during the marriage if (Fam C §761(a)):

- The trust is revocable with respect to that property during the marriage; and
- The power to modify the trust with respect to the rights and interests in that property during the marriage may be exercised only with the joinder or consent of both spouses.

With respect to community property, the power to revoke may be exercised by either spouse acting alone, unless the trust provides otherwise. Fam C §761(b). Requiring the consent of both spouses to revoke the trust is not recommended, because it can create substantial difficulties (including gift tax problems)—especially in cases of marital dissolution, separation, or the incompetency of one spouse.

NOTE: In *Estate of Powell* (2000) 83 CA4th 1434, 100 CR2d 501, the court held that a surviving spouse's attempted revocation of a joint community property trust was effective only with respect to the survivor's half of the trust because the community property trust assets were transmuted to separate property on the decedent's death. The trust document did not adequately address the consequence of a revocation by the survivor.

Clients with spouses or registered domestic partners usually should be advised to revoke their revocable trusts immediately in the event that the client or the client's spouse or partner initiates a dissolution proceeding. See Prob C §15410(a). If title remains in the trust until the end of the proceeding, the judgment that awards property to the spouses or partners may not directly affect record title to the trust property. This can cause title problems, confusion, delay, and unnecessary expense in dividing the assets. Further, a judgment of legal separation is not sufficient to trigger the Prob C §5600 provision causing failure of nonprobate transfers to former spouses, including trust provisions that take effect at death. Therefore, if the client dies during the dissolution proceeding, the trust often will leave virtually all of the assets, both separate and community property, to the surviving spouse or partner, a result that will almost certainly be viewed with hostility by the client's children, who may direct their anger at the attorney who allowed it to happen. If the trust is not yet funded, the client should be advised to draft a temporary will to prevent the pour-over of assets to the trust. See Moore, *Your Client Is Getting a Divorce: Selected Family Law Issues for Estate Planning Lawyers,* Estate Planning 2004, chap 3 (Cal CEB 2004).

Community property (including any income or appreciation) that is withdrawn from a trust by revocation remains community property unless there is a valid transmutation of the property at the time of withdrawal. Fam C §761(b). On transmutation of community property, see Practice Under the California Family Code: Dissolution, Legal Separation, Nullity §5.28 (Cal CEB Annual). When the trust is revoked, the community property corpus may be delivered to both spouses or, if the revoked asset is a business, to either spouse as manager. Fam C §§1100, 1102. See paragraph A, subparagraph 1 of form 20.3-1. The trust document may provide that revocation does not change the character of the revoked assets. See chap 5.

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§20.5 C. Revocation Power With Respect to Revoking Settlor's Separate Property

Typically, a revocable trust for a married couple provides that either settlor may revoke the trust with respect to all of the community property (as discussed in §20.4) and with respect to the revoking settlor's separate property. See paragraph A, subparagraph 1, of form 20.3-1.

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§20.6 D. Revocation and Amendment by Surviving Settlor

The trust containing the survivor's separate property and half share of community property, usually designated as the "survivor's trust," should provide that the surviving settlor may revoke or amend it in whole or in part at any time. See §12.7. If the survivor's trust contains this clause, it will continue to be a grantor or revocable trust without any substantive income, gift, or estate tax consequences for the surviving settlor.

The trust usually sets forth the revocability of the survivor's trust and the irrevocability of the marital and bypass trusts in the same or consecutive clauses. See form 20.3-1.

To avoid federal estate tax inclusion in the surviving spouse's estate, the bypass trust must be irrevocable and unamendable on and after the first spouse's death. Otherwise, the survivor will have a general power of appointment over that trust. IRC §2041. However, the surviving spouse can hold a nongeneral power of appointment. See chap 14.

A qualified terminable interest property (QTIP) marital trust should not be revocable by the surviving spouse. Although revocability does not disqualify the corpus for the marital deduction, it eliminates the primary function of the QTIP trust, which is to guarantee that the trust remainder will ultimately be distributed to the persons whom the deceased spouse has designated as beneficiaries.

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§20.6A IV. REVOCATION AND AMENDMENT BY DOMESTIC PARTNERS

The considerations discussed and forms provided in §§20.3-20.6 also apply to revocation and amendment of a jointly settled trust in which the settlors are registered domestic partners treated as spouses under California law. See Fam C §297.5. Of course, considerations relating to the estate tax marital deduction do not apply to same-sex spouses or domestic partners. See §4.41. Nevertheless, domestic partners with community property may need a joint trust. See §14.5A. For a detailed discussion of estate planning for domestic partners, see California Estate Planning §§4.41-4.63 (Cal CEB 2002).

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V. RIGHTS OF THIRD PARTIES TO EXERCISE POWER TO REVOKE OR AMEND

§20.7 A. Revocation by Conservator

California's "substituted judgment" statute, Prob C §§2580-2586, permits a court to authorize a conservator to take a wide variety of actions on behalf of a conservatee. These actions include making gifts, establishing trusts, and executing wills.

Probate Code §2580(b)(11) permits a court to authorize a conservator to exercise the conservatee's right to revoke or modify a revocable trust, unless the trust document:

- Reveals an intent to reserve that right exclusively to the conservatee;
- Expressly provides that a conservator may not revoke the trust; or
- Demonstrates in some other way an intent inconsistent with authorizing the conservator to revoke the trust.

Generally, it is preferable to permit revocation by a conservator when the conservator is authorized by court order, either by express provision or by silence. This can facilitate emergency tax planning, including annual exclusion gift planning. It also makes it possible to amend the estate plan to take into account changed tax laws. Partial or complete revocation may also be desirable to qualify a settlor for Medi-Cal or to protect assets from creditors. The doctrine of collateral estoppel bars post-death attacks on a revocable trust estate plan executed for a conservatee in accordance with a substituted judgment court order. In *Murphy v Murphy* (2008) 164 CA4th 376, 78 CR3d 784, the court held that a disinherited child was precluded not only from advancing "undue influence" and similar claims, but also from asserting that the estate plan violated a will contract made by the conservatee and the conservatee's predeceased spouse.

In short, the benefits of the substituted judgment statute can be significant, and the statute's substantial safeguards make it unlikely that the power will be used in a manner contrary to the wishes of the settlor. These benefits should not be placed beyond reach without unusual and substantial cause.

Further, a provision that effectively results in a trust becoming irrevocable if the settlor becomes incompetent may have adverse tax consequences. Transfers from a deceased spouse to the irrevocable trust of an incompetent spouse might fail to qualify for the marital deduction, and undistributed income might be taxed in higher tax brackets because income might be taxed to the trust rather than the settlor.

See paragraph F in form 20.2-1 (for sole settlor) and in form 20.3-1 (for married settlors), which provides that the conservator may not exercise the power to revoke without a substituted judgment court order.

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§20.8 B. Revocation by Durable Power Agent

An agent under a durable power of attorney generally may not revoke or amend the principal's revocable trust unless it is both (1) expressly permitted by the trust instrument (Prob C §15401(c)), and (2) expressly authorized by the power of attorney (Prob C §4264(a)). In *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285, the court further 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).

PRACTICE TIP: Some practitioners routinely include a provision in revocable trusts that permits an agent under a durable power of attorney to revoke or amend the trust, on the theory that the settlor is not compelled to grant the amendment power in a power of attorney but failure to include this provision in the trust could result in an inadvertent (and all too conspicuous) failure to comply with Prob C §15401(c) if the power of attorney document explicitly confers revocation and amendment powers. Such a failure to comply might provide the basis for a malpractice claim.

In some cases, the principal under a durable power will grant the agent the power to make specified gifts on the principal's behalf. These may include gift tax annual exclusion gifts, payments for the support of a family member supported by the principal while competent, or continuation of gifts to favored charitable or religious organizations. The agent may be unable to make the desired gifts if the agent cannot "revoke" the principal's revocable trust with respect to sufficient assets to fund the desired gifts. In the case of an unmarried person, the gift powers can be granted to the trustee rather than the agent, but this should not be done with respect to a "survivor's trust" because provisions for distributions to persons other than the surviving spouse during the life of the surviving spouse may result in loss of the marital deduction for transfers to the survivor's trust on the death of the deceased spouse.

Some drafters fear that granting an agent a power to amend a revocable trust will open a Pandora's box of problems. This usually will not be the case if the power is narrowly drafted with respect to the types and purposes of permitted amendments (*e.g.,* "necessary to reduce estate and inheritance taxes"), the trustee is honest, and the trustee is given the option to delay implementation of a purported amendment until the validity of the amendment is determined by a court. The power of attorney also can require that no amendment will be effective unless advance notice of the proposed amendment is given to specified persons. See Dennis-Strathmeyer, *A Power of Attorney for Estate Planning*, 23 CEB Est Plan R 63 (Dec. 2001).

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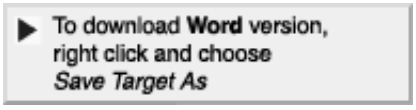
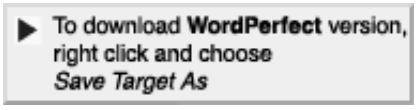
Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/§20.9 VI. FORM: AMENDMENT TO TRUST

§20.9 VI. FORM: AMENDMENT TO TRUST





20.9-1 Amendment to trust

On _ _[*date*]_ _, we, _ _[*name of settlor*]_ _ and _ _[*name of settlor*]_ _, executed the _ _[*name of trust*]_ _.

Under division _ _[*roman numeral*]_ _, paragraph _ _[*letter*]_ _, of this trust, we reserved the power to amend the trust.

We hereby amend the trust as follows:

[*Use one or more of the following options*]

[*Option 1: Paragraph amended in its entirety*]

FIRST: Division _ _[*roman numeral*]_ _ paragraph _ _[*letter*]_ _ is amended to read in its entirety as follows: _ _[*Set forth amended paragraph in its entirety*]_ _.

[*Option 2: Paragraph deleted*]

FIRST: Division _ _[*roman numeral*]_ _ paragraph _ _[*letter*]_ _ is deleted.

[*Option 3: Paragraph added*]

FIRST: Division _ _[*roman numeral*]_ _ paragraph _ _[*letter*]_ _ is added to read as follows: _ _[*Set forth new paragraph _ _*]_ _.

[*Continue*]

SECOND: In all other respects, the trust remains unchanged.

[*Add execution and acknowledgment; see §19.20*]

Comment: The form of amendment should comply with the requirements set out in the clause authorizing amendment of the trust by the settlor or settlors. See §§20.2-20.3.

If the changes are substantial, a restatement of the entire trust may be more appropriate. See §§20.10-20.11.

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VII. RESTATEMENT OF ENTIRE TRUST

§20.10 A. Practical Reasons for Restatement

A restatement of the entire trust is recommended if the proposed changes are too numerous and complex to be accomplished by separate amendments of the existing trust. For a form of restatement of entire trust, see §20.11. For a form of amendment to trust, see §20.9.

NOTE: A restatement of the entire trust requires a corresponding amendment of an existing pour-over will because either (1) the pour-over will mirrors the trust provisions, or (2) the pour-over will incorporates the trust terms as of the date the will was made. If the trust is restated before the testator's death, the pour-over gift will fail unless the will provides otherwise. Prob C §6300. See §§22.3-22.6.

Even though an amendment and restatement of the trust in its entirety supersedes the original trust it does not create a new trust but continues the trust that was established under the original trust document. As a result, there is no need to retitle trust property.

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Source: Estate Planning/Drafting California Revocable Trusts/20 Revocation and Amendment/§20.11 B. Form: Restatement of Entire Trust

§20.11 B. Form: Restatement of Entire Trust

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20.11-1 Restatement of trust in its entirety

_ _[*Name of Trust*]_ _ (as restated in full on _ _[*date*]_ _)

We, _ _[*name of settlor*]_ _ and _ _[*name of settlor*]_ _, sometimes referred to as "Settlors," residing in _ _[*name of county*]_ _, California hereby amend and restate in its entirety the trust originally created by us on _ _[*date*]_ _, and known as the _ _[*Name of Trust*]_ _, declaring:

DIVISION I.
RESTATEMENT OF TRUST; TRUST ASSETS

A. *Restatement of Trust in Its Entirety.* This restatement of the trust is made pursuant to the Settlor's reserved powers in _ _[e.g.*, division XV, paragraph A*]_ _ of the _ _[*Name of Trust*]_ _ to amend the _ _[*Name of Trust*]_ _. This restatement supersedes all previous trust declarations, agreements, amendments, and restatements.

B. *Trust Assets.* We declare that the current assets of the trust include those listed in the attachment to this trust restatement entitled "Current Trust Property."

[*Continue with restated provisions*]

[*Add execution and acknowledgment; see §19.20*]

Comment: There is no legal requirement that a restatement include an updated list of the trust property rather than a list of the original property but it is good practice. For a form of schedule of assets, see §5.38.

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21

Funding the Trust

Linda C. Roodhouse

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II. NONTRANSFERABLE PROPERTY §21.2

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§21.1 I. PURPOSE OF FUNDING THE TRUST

Settlors can create a trust by declaring that they hold particular property as trustees or by conveying that property to a third party as a trustee. See §5.3. As long as the trust document contains a list of trust property and language satisfying the requirement for a declaration or conveyance, the property listed becomes trust property as soon as the document is executed. No further action is necessary. *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433.

Nevertheless, the great majority of California revocable trusts are funded. In this context, "funding" the trust means the process of changing title to property so that the title reflects the existence of the trust and the identity of the trustees. The primary purpose of funding is to facilitate property management by trustees other than the settlor. In a typical revocable trust that names the settlor as the initial trustee, funding the trust will make it easier for the successor trustee to gain control of the trust assets in the event of the settlor's incompetence or death. If the trust is not funded, the trustee may be unable to manage the trust estate without obtaining a court decree declaring that the trust property belongs to the trust. For discussion of filing a *Heggstad* petition under Prob C §850(a)(3), see California Trust Administration §§15.39A, 15.40A-15.40B (2d ed Cal CEB 2001).

An additional purpose of trust funding is to avoid a later claim by the IRS that bypass trust property should be included in the estate of the surviving settlor. See *Estate of Sylvia Gore*, TC Memo 2007-169 (survivor's purported withdrawal and assignment of trust assets to family limited partnership did not result in completed transfers because trust had never been funded). While *Gore* involved a trust that was not created until the first death, the same problem could arise for a trust that remains unfunded until the second death.

Funding also eliminates potential disputes over ownership of particular assets. This issue is particularly important for assets such as "Pay on Death" bank accounts that purport to provide for a disposition on death that is inconsistent with the terms of the trust.

Funding is also the primary means of adding newly acquired assets to the trust. Settlors should be advised to take title to newly acquired assets in the trust's name and to periodically update their schedule of assets. Some practitioners have settlors periodically execute assignments that purport to convey all or substantially all of their assets to the trust in order to avoid contentions that newly acquired assets do not belong to the trust. These general assignments can also cure problems such as the inadvertent unfunding that may occur when, for example, a settlor is required to deed trust real property back to the settlor individually in order to refinance the property.

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§21.2 II. NONTRANSFERABLE PROPERTY

Some assets cannot be transferred during a settlor's lifetime. For example, many qualified pension plans cannot be transferred. Shares of individual professional corporations are usually not transferred to trusts because of statutory restrictions. Other assets cannot be transferred without triggering a tax liability or suffering some other undesirable result. For example, the assets of a traditional individual retirement account regulated by IRC §408 can be transferred during life only by withdrawing the assets and paying income tax on the withdrawal. A power of attorney may be used to manage an IRA during incapacity, and the beneficiary designation (to the trust or to another designated beneficiary) will avoid probate on the owner's death. For married settlors who own pension or IRA assets, it is common to name the spouse as the primary beneficiary and name the trust as the alternate if the spouse fails to survive. This approach is used to preserve the availability of two important pension benefits—the ability to take into account the life expectancy of a named natural person beneficiary for purposes of computing minimum distributions from the plan under IRC §401(a)(9), and the ability of a spouse beneficiary to roll over certain benefits to an IRA or treat a decedent's IRA as belonging to the survivor. IRC §408.

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§21.3 III. LESS THAN FULL FUNDING

It is generally good practice to fully fund the trust at the time of execution, except perhaps for vehicles and the household checking account. However, the objectives of funding can be accomplished without transferring title to each and every one of the settlor's assets to the name of the trust. If the settlor has appointed an attorney in fact who can transfer or otherwise manage property should the settlor become incompetent, the probate avoidance objective of the trust will be preserved as long as the assets outside the trust do not exceed statutory thresholds that trigger the need for a formal probate of the property. For discussion of the coordinated use of durable power of attorney and revocable trust, see §22.7; for a sample durable power of attorney form, see §22.11.

In general, California does not require probate if the value of a decedent's probate estate assets do not exceed $100,000. Prob C §13100. The following assets are not counted in determining whether the $100,000 limit is exceeded:

- Property that would not be subject to probate administration in any event, including revocable trust property, joint tenancy property, and property passing by beneficiary designation;
- Property passing to a surviving spouse or registered domestic partner (Prob C §13050(a); Fam C §297.5(c)); and
- Motor vehicles, wages, and other property expressly excluded in Prob C §13050(b)-(c).

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§21.4 IV. THE FUNDING PLAN

Funding may be accomplished by the attorney, the settlor, or a combination of both. Most attorneys attend to transfers of real property even if they do not customarily provide other funding assistance. Greater attorney involvement is required if the client owns unusual assets or lacks the education or health to successfully complete funding alone. To the extent that the client is expected to handle funding matters, the attorney should provide sufficient written instructions and ask the client to notify the attorney when funding is completed. For a sample client letter, see §21.5. For discussion of the use of certification of the trust and a sample trust certification form, see §§22.1-22.2.

PRACTICE TIP: If the attorney will be responsible for trust funding, it is important to develop efficient internal systems for handling the process to keep the funding costs reasonable. Funding is an excellent job to delegate to paralegals or other office staff.

The remainder of this chapter offers advice for trust funding by either client or attorney. Generally the forms can be provided to clients for their own use or signed by clients for use by the attorney's office.

Funding issues continue to arise throughout the life of the trust, as the settlors acquire new property through purchase, inheritance, or other method. Thus, the initial funding of a trust is partially a process in which the attorney educates the settlor on the importance of establishing the trust as a separate entity and taking title to later-acquired property in the name of the trust.

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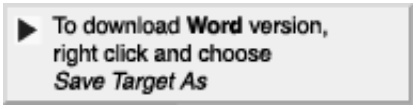
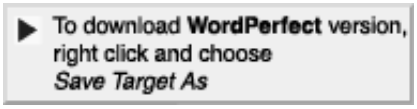
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.5 V. FORM: SAMPLE CLIENT MEMORANDUM ON TRUST FUNDING

§21.5 V. FORM: SAMPLE CLIENT MEMORANDUM ON TRUST FUNDING





_ _[*Attorney's letterhead*]_ _

_ _[*Date*]_ _
_ _[*Name of settlor trustees*]_ _
_ _[*Address*]_ _

Re: _ _[*Name of trust*]_ _
Memorandum: Transferring Assets to Your Trust

Dear _ _[*Name of settlor trustees*]_ _:

I enjoyed meeting with you this morning to execute the documents for your estate plan. I am enclosing the following items for your records:

1. The _ _[*name of trust*]_ _, with the original document and a conformed copy of it;

2. A copy of the grant deed for transferring your residence to your trust and the preliminary change-of-ownership report, which prevents reassessment;

3. A copy of the certification of trust;

4. The "pour-over" wills of each of you, with the original documents and conformed copies of them; and

5. A copy of each change of beneficiary designation form you executed.

Please consider the following items regarding your estate plan:

1. *Amendment.* These documents are executed with certain formalities and may be changed or revoked only through similar procedures. A note in the margin of your document or a striking out of words (even next to your signature) may not be effective. I cannot overemphasize the need to follow the proper steps for amendment. For example, acknowledgment of your signature on an amendment by a notary public is required by law.

2. *Keeping the trust funded.* Although executing the trust documents provides you with an orderly disposition of your estate, you will not avoid probate unless and until the trust obtains legal title to your property. This procedure is called "funding" the trust and requires transferring title to you as trustees:

Documents of title must be executed to fund the trust. For example, you will need new signature cards for the trust bank accounts. Other assets must also be retitled. Title to assets you acquire in the future should be put in the trust's name. If you take title to property in your own name at any time without reference to the trust, that asset will not be a trust asset.

To subject an asset to the terms of the trust, you must transfer title to yourselves as trustees. In general, title on all trust assets should be held in the following way: "John Doe and Jane Doe, trustees of the John and Jane Doe Trust, under document dated _ _[*date*]_ _." In some situations, you may have to abbreviate the trust designation, *e.g.,* "John & Jane Doe, trustees, Doe Trust, 1/1/2008."

For your separate property to retain its character, it must be segregated and designated as such. You have advised me that you regard all your assets as community property, and I have reported them as such on all documents. If either of you receives an inheritance in _ _[*his/her/his or her*]_ _ name only, this property will be

considered separate, rather than community, property. The property should be transferred to both trustees as described above, but the designation should specify that it is "separate property of _ _[*name of spouse or partner*]_ _" unless the inheriting _ _[*spouse/partner*]_ _ wishes to change the character of the property from separate to community. Making this change may have important income and estate tax consequences and will affect the division of property in the event you should dissolve the _ _[*marriage/partnership*]_ _. Legal advice is advisable before any such changes are made.

When you transfer insured property (houses, cars, mobilehomes, etc.) to the trust, you should notify the insurance company (or agent) of the transfer and ask whether any change in the policy is required. This applies to both casualty and liability insurance. It may be desirable for the policy to indicate that the trust is an additional insured.

This memorandum explains ways of accomplishing many common transfers. It is not intended to provide a comprehensive explanation of everything one needs to know about transferring property and it is not intended to encourage you to perform complex legal transactions without further consultation, particularly if you have limited business experience.

This memorandum is based on California law. If you own real estate outside of California or have automobiles, boats, or other property registered with government agencies of other states, you need to consult me.

3. *Change of beneficiary forms.* I am enclosing copies of the executed change of beneficiary and consent forms. I will be sending the original executed forms to the insurance companies to make the necessary changes of beneficiary. These changes will not be effective until the companies have received and acknowledged them. The proceeds from insurance policies and retirement plans may go into the trust so that they will be directed by a trustee according to the estate plan. An outright payment of proceeds will circumvent the plan described in the trust document.

4. *Real property.* To transfer your residence and other real property to the trust, you as settlors must execute the enclosed grant deeds showing the property transferred to the trustees of the trust. After the deeds are executed, they must be recorded at the county recorder's office. When you record the deed, you must also file the enclosed Preliminary Change of Ownership Report to prevent reassessment by mistake. We checked the two boxes on the form which indicate that the transfer is for the benefit of the grantor and that the transfer is to a trust revocable by the transferors. No documentary transfer tax will be due, because the property has not been sold.

***Exception:* If you purchase a home under the Cal-Vet program you should consult with the Department of Veterans Affairs for the proper method of transferring your contract.**

***Note:* If you refinance (or otherwise borrow against) real property, the lender or the title company may require that the property be deeded from the trust back to you immediately before you execute the deed of trust which gives the lender a security interest in your property. (This saves the lender and the title company the task of reading the trust in order to determine whether it says anything that might interfere with the validity of the lender's security interest.) Be sure that you ask the title company to prepare a deed for you to sign transferring the property back into your name as trustee as soon as refinancing is complete. If this does not occur, probate may be necessary. If the title company will not cooperate, be sure to contact me, so that I can prepare the deed necessary to return your property to the trust to avoid probate.**

***Note:* If you transfer property *other than your residence and/or a vacation home which you personally occupy*, there is at least a theoretical possibility that the transfer will trigger the "due-on-sale" clause in any mortgage or other loan on the property. Estate planning attorneys have been concerned about this problem for many years, but so far no one has publicly reported an instance of a lender trying to enforce a due-on-sale clause in this situation. This possibility raises the question of whether you should obtain the lender's permission before making the transfer or whether such an action would be an unnecessary expense. If you own commercial real estate you should consult with me further on this point—particularly if you have is a very large loan with an exceptionally low interest rate that is substantially lower than current market rates.**

5. *Financial institution accounts.* These accounts are normally transferred by changing the name of the account owner on the signature card or other "contract" between you and the bank, broker, etc., to the trustee of the trust (*e.g.,* John Doe and Jane Doe, trustees of the John and Jane Doe Trust, under document dated _ _[*date*]_ _). These institutions are accustomed to making these transfers and you can normally accomplish

them by visiting the institution and presenting a copy of the enclosed certification of trust. Often, the institution will insist that you also complete its own version of the trust certification. If the institution is not local, write the institution a brief letter in the manner described in the next paragraph for individual stocks and bonds. When transferring a checking account, there is no need to get new checks printed that show the trust is the owner. Changing the name on the checks may make it more difficult to cash the checks at some retail establishments.

6. *Stocks and bonds.* The transfer of your securities to the trust must be accomplished by changing title on the certificates themselves:

If you hold your shares through a brokerage firm, you need change the title only on the brokerage accounts, rather than on each share certificate.

If either of you holds title to your securities in your name, however, the stock should actually be transferred to the two of you as trustees. Most issuers of securities (corporations, local government agencies, etc.) pay a bank or some other company to perform the task of keeping track of who its shareholders are. The bank is typically known as the "Transfer Agent." (A few companies, such as PG&E and banks with stock transfer departments, do their own stock transfer work.) The easiest way to transfer securities is to review the literature you receive from the issuer to find the transfer agent's name and address and then send a letter to the transfer agent similar to the following:

_ _[*Name of bank*]**_ _**

Stock Transfer Department

_ _[*Address*]**_ _**

Re: _ _[*Name of company*]**_ _; _ _**[*number of shares of stock*]**_ _**

Certificate number: _ _[*number*]**_ _**

Sirs:

I have created a revocable trust and wish to transfer the referenced stock to the trust immediately. Please tell me what documents you will need to make the transfer.

Thank you.

Normally, the transfer agent will immediately send you instructions.

If you have many securities, you might consider establishing a brokerage account in the name of the trust and letting the broker make the transfers. Most brokers charge modest fees for this service, but they often waive the fees in order to get your business. A single broker is much easier to work with when a settlor becomes incompetent or dies.

Your stockbroker may request a copy of the signed trust instrument for examination by his or her firm's legal department. I generally do not provide a copy of the entire agreement. A copy of the first page and signature page and a copy of the pages setting forth the trustee powers will demonstrate that the trust is properly executed and that the trustees have the necessary powers to borrow money; buy and sell stocks, bonds, and options; trade on margin; and conduct other trust business. Often, brokerage firms have their own Certification of Trust form for you to complete as a requirement of transferring title to your trust. You may also use the Certification of Trust authorized under Probate Code §18100.5, a copy of which is enclosed.

A letter to mutual funds referencing your account number is usually sufficient to transfer that type of investment.

7. *Notes and deeds of trust.* Notes are assigned by adding an endorsement that reads:

I hereby assign all of my interest in this note to John Doe and Jane Doe as trustees of the John and Jane Doe Trust under document dated _ _[*date*]**_ _.**

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

Send the person owing the money two copies of the assignment and ask them to make future payments to the

trustee. Have the person sign and return an acknowledgment of the assignment typed on a copy of the assignment.

If the note is secured by a deed of trust, you must execute and record an "Assignment of Deed of Trust." The form can be obtained from my office, from the title company that is the trustee of the Deed of Trust, or from one of the many office supply stores that sell preprinted legal forms. If a bank or a savings and loan association is collecting a note for you, contact them for any additional documentation that they may require.

8. *Automobiles.* I have not transferred your automobiles to the trust. As a rule, it is not necessary to transfer automobiles to the trust *provided that* you have given someone a durable power of attorney, which will enable them to sell the vehicle and transfer the proceeds to the trust if you become incompetent or if you hold title with your _ _[*spouse/partner*]_ _ or other intended beneficiaries as joint tenants. Not transferring your automobiles eliminates paperwork with the Department of Motor Vehicles (DMV). Alternatively, the next time you purchase a car, you may want to place the title in the name of the trust. If a death occurs before a transfer is made, the surviving _ _[*spouse/partner*]_ _, as the surviving joint tenant, will acquire title to the automobile without the need for probate. Under California law (Vehicle Code §5910), the DMV provides a procedure for an heir or other successor to the decedent's property to transfer registration of title if the decedent left no other property requiring probate and no probate proceeding is being conducted for the decedent's estate. The DMV has a form available for certifying entitlement to transfers under this section, titled "Affidavit for Transfer Without Probate; Titled Vehicle or Vessels Only."

9. *Other personal property.* You have transferred your tangible property to the trust by the execution of an assignment attached to the trust instrument. Please give some thought whether you have other property I may not have considered, such as copyrights, patents, or royalty contracts.

10. *Interests in businesses, including partnerships and small corporations.* Transfers of interests in businesses always require an attorney's assistance. All businesses require a variety of permits and licenses, and it is necessary that they be reviewed in detail before making the transfer.

11. *Tax returns.* The Internal Revenue Code provides that grantor trusts of which the grantor (settlor) is a beneficiary need not file a tax return. Because you are the owners of all property in the trust, you will continue to report _ _[*all trust income on your joint return/one-half of all trust income on each of your individual returns*]_ _ as though it were your own. You may give your own social security numbers when opening accounts in the name of the trust. When a death occurs, a portion of the trust becomes irrevocable. At that time, one or more new trusts come into existence. This necessitates obtaining a taxpayer identification number (TIN) and filing a separate return for each new irrevocable trust.

12. *Joint tenancy.* Except for your automobile and perhaps a small household checking account, you should not hold any assets as joint tenants. A joint tenancy will not be subject to the terms of the trust, may frustrate your intentions, and could have adverse income and estate tax consequences.

This letter concludes my representation. Please let me know if you have any questions about these documents or if you wish to retain me to provide any further services.

__[*Signature*]__

Comment: This form is for use when the client has assumed full responsibility for funding the trust. It can be modified as needed to reflect the actual allocation of responsibility between client and attorney. It can also be modified to advise the client to return periodically to execute a general assignment of all or substantially all of their assets to the trust so that a *Heggstad* petition (Prob C §850(a)(3)) can be used to capture any later acquired items not titled in the name of the trust. See chap 5 for discussion of the form of title in which the trust property will be held. For a grant deed form, see §21.12; for a general assignment form, see §21.16. On transferring securities to the trust, see §§21.21-21.30; on transferring business interests, see §§21.31-21.38. For a discussion of changes to beneficiary designations, see §§21.39-21.41. See chap 4 for discussion of tax returns. For rules for obtaining a TIN, see Treas Reg §301.6109-1(a)(2). See also Treas Reg §1.671-4(b). For discussion of retirement accounts and trusts, see §1.23.

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VI. PARTICULAR TYPES OF ASSETS

A. Real Property

§21.6 1. Personal Residence

Like other real property, the personal residence is generally transferred by executing and recording a standard grant deed. See §19.11. Clients frequently have strong preferences about the disposition of their personal residence under the estate plan. Often, the house represents a substantial portion of the decedent's property. In a typical estate plan for a married couple, the house is usually allocated to the surviving spouse or survivor's trust. Apart from the common desire of the spouse to remain in the family residence, an interest in a personal residence allocated to a QTIP trust or bypass trust will not qualify for the exclusion of any future gain from sale of a principal residence under IRC §121. To qualify for the exclusion, the property must be owned and used by an individual as the individual's personal residence for 2 of the 5 years preceding the sale (or 1 year plus a period of "out-of-residence" care), and the exclusion may be reduced by "periods of nonqualified use" during the ownership period. In addition, it may be impossible to deduct the interest on an acquisition or home improvement loan secured by the residence as qualified residence interest under IRC §163(h)(3).

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.7 2. Transfers to Revocable Trust Do Not Trigger Reassessment

§21.7 2. Transfers to Revocable Trust Do Not Trigger Reassessment

Transfers to a revocable trust or from a revocable trust back to the settlor are excluded from the definition of "change of ownership" and thus exempt from reassessment. Rev & T C §62(d). The following also do not constitute changes of ownership (Rev & T C §§62(p), 63(a)):

- Transfers to a trustee for the beneficial use of a spouse or registered domestic partner;
- Transfers to a trustee for the beneficial use of a deceased transferor's surviving spouse or domestic partner; and
- Transfers by a trustee to a surviving spouse or domestic partner.

For further discussion of tax considerations, see chap 4.

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§21.8 3. Homeowner's Exemption

Homeowners are granted a $7000 exemption from assessed value of principal residences for purposes of determining property tax. See Cal Const art XIII, §3(k); Rev & T C §218. The homeowner's exemption is available when the settlor's personal residence is transferred to a revocable trust. The trustees must reapply for the exemption after the property has been transferred to a revocable trust.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.9 4. Notification of Lender, Insurance Carrier, and Tenants

§21.9 4. Notification of Lender, Insurance Carrier, and Tenants

The Garn-St. Germain Depository Institutions Act of 1982 (Garn Act) (Pub L 97-320, 96 Stat 1469) provides that a due-on-sale clause cannot be enforced on "a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property." 12 USC §1701j-3(d)(8).

NOTE: It is unclear to what extent CC §2924.6 (due-on-sale clause not enforceable if property transferred into living trust in which borrower is a beneficiary), which does not include the Garn Act requirement of borrower occupancy, is preempted by federal law. See §1.29.

If the protection of the Garn Act does not apply, the owner should request a consent to transfer from the obligee. Most lending institutions are willing to give written consent to a transfer of encumbered property into a revocable living trust, although they sometimes (and perhaps improperly) charge a fee to do so.

NOTE: Many practitioners do not apply for waivers, noting that historically lenders have not attempted to accelerate loans merely because of a transfer to a revocable trust.

It is important to notify the client's title insurance company of the transfer of the property to the trustee and to obtain any necessary endorsement to insure that the policy continues to apply. The title company may charge a fee to obtain the endorsement. In *Kwok v Transnation Title Ins. Co.* (2009) 170 CA4th 1562, 1571, 89 CR3d 141, the court held that trust settlors did not succeed as insureds on the transfer of property from a family limited liability company (LLC) to themselves as trustees on dissolution of the LLC. The court stated in dictum that the trustees of a revocable trust do not succeed by operation of law to property transferred by the settlors because the transfer of property is a voluntary act. 170 CA4th at 1571.

If the property is rented, tenants should be advised to make rent payments to the trustees.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.10 5. Grant Deed

§21.10 5. Grant Deed

California real property can be transferred by either grant deed or quitclaim deed. A grant deed is usually the preferred method of transfer because of its implied covenants. See CC §§1092, 1113. In *Luna v Brownell* (2010) 185 CA4th 668, ___ CR3d ___, the court held that a quitclaim deed transferring property from the grantor to himself as trustee of a trust was not void as between the grantor and grantee merely because the trust had not been created at the time the deed was executed. The grantor designation will be taken from the previous deed; the name of the trustee(s) should be used as grantee(s), *e.g.,* John Doe and Jane Doe, trustees of the John and Jane Doe Trust, under document dated _ _[*date*]_ _.

PRACTICE TIP: Counsel should consult a local title company to ascertain local practice about how title should be taken to real property transferred to settlors as trustees of a revocable trust.

For further discussion of the differences between a grant deed and a quitclaim deed, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007). On transfers of out-of-state property, see §19.14.

PRACTICE TIP: Some title companies use a special form called "Trust Transfer Deed" for transfers to revocable trusts to indicate that this is not a transfer for consideration. The attorney should check with the title company.

The grant deed should be acknowledged and recorded in each county in which any part of the real property is situated.

PRACTICE TIP: If the attorney is preparing the grant deed, he or she should ask the clients to bring the deed by which title was transferred to them during purchase or, if the property was inherited, the judgment of final distribution, executor's deed, or trustee's deed. The attorney should also ask the clients about any subsequent gift deeds executed by them, as well as changes in marital status or other events that might affect title. A title report may be needed to verify the status of title.

PRACTICE TIP: The attorney should inform the clients that, if they refinance, the lender may require that the property be transferred out of the trust and into their names as individuals. In this event, the property should be promptly transferred back to the trust after the loan closes. At least one California court has refused to allow a *Heggstad* petition in this situation, finding that the failure to deed the property back to the trust showed a lack of intent that the property was to be subject to the trust.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.11 6. Form: Grant Deed

§21.11 6. Form: Grant Deed

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL THIS DEED AND, UNLESS OTHERWISE SHOWN BELOW, MAIL TAX STATEMENT TO:

NAME

STREET ADDRESS

CITY, STATE & ZIP CODE

TITLE ORDER NO. _____ ESCROW NO. _____

SPACE ABOVE THIS LINE FOR RECORDER'S USE

GRANT DEED

DOCUMENTARY TRANSFER TAX $ _____
☐ computed on full value of property conveyed, or
☐ computed on full value less liens and encumbrances remaining at time of sale.

_____
Signature of Declarant or Agent Determining Tax Firm Name

FOR VALUABLE CONSIDERATION, receipt of which is acknowledged, I (We), _____
(NAME OF GRANTOR(S))

grant to _____
(NAME OF GRANTEE(S))

all that real property situated in the City of _____ (or in an unincorporated area of)

_____ County, _____ described as follows (insert legal description):
(NAME OF COUNTY) (STATE)

Assessor's parcel No. _____

Executed on _____, _____, at _____
(CITY AND STATE)

STATE OF _____

COUNTY OF _____

On _____ before me, _____
(NAME/TITLE, i.e. "JANE DOE, NOTARY PUBLIC")

personally appeared _____ personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

_____
(SIGNATURE OF NOTARY) (SEAL)

RIGHT THUMBPRINT (Optional)

TOP OF THUMB HERE

CAPACITY CLAIMED BY SIGNER(S)
☐ INDIVIDUAL(S)
☐ CORPORATE _____
OFFICER(S) _____
(TITLES)
☐ PARTNER(S) ☐ LIMITED ☐ GENERAL
☐ ATTORNEY IN FACT
☐ TRUSTEE(S)
☐ GUARDIAN/CONSERVATOR
☐ OTHER: _____

SIGNER IS REPRESENTING:
(Name of Person(s) or Entity(ies)

MAIL TAX STATEMENTS TO: _____

Before you use this form, fill in all blanks, and make whatever changes are appropriate and necessary to your particular transaction. Consult a lawyer if you doubt the form's fitness for your purpose and use. Wolcotts makes no representation or warranty, express or implied, with respect to the merchantability or fitness of this form for an intended use or purpose.

WOLCOTTS FORM 778 - Rev. 3-94b (price class 3A)
GRANT DEED ©1994 WOLCOTTS FORMS, INC.

7 67775 39778 9

Comment: Most title companies and stationery stores have preprinted forms that can be used for simple transfers of real property.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.12 7. Preliminary Change of Ownership

§21.12 7. Preliminary Change of Ownership

A Preliminary Change of Ownership Report (PCOR) must be completed by the trustee for each deed transferring real property to the trust to document for the assessor that the property should not be reassessed under Proposition 13. Rev & T C §§60-69.5. See §21.7. Each county has its own PCOR form, based on the generic Board of Equalization (BOE) form reproduced in §21.13 (no longer available on the BOE website). The PCOR may be obtained from the local tax assessor or County Recorder's office where the property is located. Generally, the recorder's office will accept forms from other counties (with the county changed) rather than require the county's own form. The PCOR must be filed at the time the deed is recorded.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.13 8. Form: Preliminary Change of Ownership Report

§21.13 8. Form: Preliminary Change of Ownership Report

BOE-502-A (P1) REV. 11 (07-10)

PRELIMINARY CHANGE OF OWNERSHIP REPORT

To be completed by the transferee (buyer) prior to a transfer of subject property, in accordance with section 480.3 of the Revenue and Taxation Code. A *Preliminary Change of Ownership Report* must be filed with each conveyance in the County Recorder's office for the county where the property is located. Please answer all questions in each section, and sign and complete the certification before filing. This form may be used in all 58 California counties. If a document evidencing a change in ownership is presented to the Recorder for recordation without the concurrent filing of a *Preliminary Change of Ownership Report*, the Recorder may charge an additional recording fee of twenty dollars ($20).

NOTICE: The property which you acquired may be subject to a supplemental assessment in an amount to be determined by the County Assessor. Supplemental assessments are not paid by the title or escrow company at close of escrow, and are not included in lender impound accounts. **You may be responsible for the current or upcoming property taxes even if you do not receive the tax bill.**

SELLER/TRANSFEROR	ASSESSOR'S PARCEL NUMBER
BUYER/TRANSFEREE	BUYER'S DAYTIME TELEPHONE NUMBER ( )

STREET ADDRESS OR PHYSICAL LOCATION OF REAL PROPERTY

MAIL PROPERTY TAX INFORMATION TO (NAME)

ADDRESS	CITY	STATE	ZIP CODE

☐ YES ☐ NO This property is intended as my principal residence. If YES, please indicate the date of occupancy or intended occupancy. MO DAY YEAR

PART 1. TRANSFER INFORMATION *Please complete all statements.*

YES	NO	
☐	☐	A. This transfer is solely between spouses *(addition or removal of a spouse, death of a spouse, divorce settlement, etc.)*.
☐	☐	B. This transfer is solely between domestic partners currently registered with the California Secretary of State *(addition or removal of a partner, death of a partner, termination settlement, etc.)*.
☐	☐	* C. This is a transfer between: ☐ parent(s) and child(ren) ☐ grandparent(s) and grandchild(ren).
☐	☐	* D. This transaction is to replace a principal residence by a person 55 years of age or older. Within the same county? ☐ YES ☐ NO
☐	☐	* E. This transaction is to replace a principal residence by a person who is severely disabled as defined by Revenue and Taxation Code section 69.5. Within the same county? ☐ YES ☐ NO
☐	☐	F. This transaction is only a correction of the name(s) of the person(s) holding title to the property *(e.g., a name change upon marriage)*. If YES, please explain: _____
☐	☐	G. The recorded document creates, terminates, or reconveys a lender's interest in the property.
☐	☐	H. This transaction is recorded only as a requirement for financing purposes or to create, terminate, or reconvey a security interest *(e.g., cosigner)*. If YES, please explain: _____
☐	☐	I. The recorded document substitutes a trustee of a trust, mortgage, or other similar document.
		J. This is a transfer of property:
☐	☐	1. to/from a revocable trust that may be revoked by the transferor and is for the benefit of ☐ the transferor, and/or ☐ the transferor's spouse ☐ registered domestic partner.
☐	☐	2. to/from a trust that may be revoked by the creator/grantor/trustor who is also a joint tenant, and which names the other joint tenant(s) as beneficiaries when the creator/grantor/trustor dies.
☐	☐	3. to/from an irrevocable trust for the benefit of the ☐ creator/grantor/trustor and/or ☐ grantor's/trustor's spouse ☐ grantor's/trustor's registered domestic partner.
☐	☐	4. to/from an irrevocable trust from which the property reverts to the creator/grantor/trustor within 12 years.
☐	☐	K. This property is subject to a lease with a remaining lease term of 35 years or more including written options.
☐	☐	L. This is a transfer between parties in which proportional interests of the transferor(s) and transferee(s) in each and every parcel being transferred remain exactly the same after the transfer.
☐	☐	M. This is a transfer subject to subsidized low-income housing requirements with governmentally imposed restrictions.
☐	☐	* N. This transfer is to the first purchaser of a new building containing an active solar energy system.

* If you checked YES to statements C, D, or E, you may qualify for a property tax reassessment exclusion, which may allow you to maintain your previous tax base. If you checked YES to statement N, you may qualify for a property tax new construction exclusion. A claim form must be filed and all requirements met in order to obtain any of these exclusions. Contact the Assessor for claim forms.

Please provide any other information that will help the Assessor understand the nature of the transfer.

THIS DOCUMENT IS NOT SUBJECT TO PUBLIC INSPECTION

Print

BOE-502-A (P2) REV. 11 (07-10)

PART 2. OTHER TRANSFER INFORMATION

Check and complete as applicable.

A. Date of transfer, if other than recording date: _____

B. Type of transfer:

☐ Purchase ☐ Foreclosure ☐ Gift ☐ Trade or exchange ☐ Merger, stock, or partnership acquisition (Form BOE-100-B)

☐ Contract of sale. Date of contract: _____ ☐ Inheritance. Date of death: _____

☐ Sale/leaseback ☐ Creation of a lease ☐ Assignment of a lease ☐ Termination of a lease. Date lease began: _____

Original term in years *(including written options)*: _____ Remaining term in years *(including written options)*: _____

☐ Other. Please explain: _____

C. Only a partial interest in the property was transferred. ☐ YES ☐ NO If YES, indicate the percentage transferred: _____ %

PART 3. PURCHASE PRICE AND TERMS OF SALE

Check and complete as applicable.

A. Total purchase or acquisition price. Do not include closing costs or mortgage insurance. $_____

Down payment: $_____ Interest rate: _____ % Seller-paid points or closing costs: $_____

Balloon payment: $_____

☐ Loan carried by seller ☐ Assumption of Contractual Assessment* with a remaining balance of: $_____

* An assessment used to finance property-specific improvements that constitutes a lien against the real property.

B. The property was purchased: ☐ Through real estate broker. Broker name: _____ Phone number: ( )

☐ Direct from seller ☐ From a family member

☐ Other. Please explain: _____

C. Please explain any special terms, seller concessions, financing, and any other information (e.g., buyer assumed the existing loan balance) that would assist the Assessor in the valuation of your property.

_____

_____

PART 4. PROPERTY INFORMATION

Check and complete as applicable.

A. Type of property transferred

☐ Single-family residence ☐ Co-op/Own-your-own ☐ Manufactured home

☐ Multiple-family residence. Number of units: _____ ☐ Condominium ☐ Unimproved lot

☐ Other. Description: (i.e., timber, mineral, water rights, etc.) ☐ Timeshare ☐ Commercial/Industrial

_____

B. ☐ YES ☐ NO Personal/business property, or incentives, are included in the purchase price. Examples are furniture, farm equipment, machinery, club memberships, etc. Attach list if available.

If YES, enter the value of the personal/business property: $_____

C. ☐ YES ☐ NO A manufactured home is included in the purchase price.

If YES, enter the value attributed to the manufactured home: $_____

☐ YES ☐ NO The manufactured home is subject to local property tax. If NO, enter decal number: _____

D. ☐ YES ☐ NO The property produces rental or other income.

If YES, the income is from: ☐ Lease/rent ☐ Contract ☐ Mineral rights ☐ Other: _____

E. The condition of the property at the time of sale was: ☐ Good ☐ Average ☐ Fair ☐ Poor

CERTIFICATION

I certify (or declare) under penalty of perjury under the laws of the State of California that the foregoing and all information hereon, including any accompanying statements or documents, is true and correct to the best of my knowledge and belief. ***This declaration is binding on each and every buyer/transferee.***

SIGNATURE OF BUYER/TRANSFEREE OR CORPORATE OFFICER ▶	DATE
NAME OF BUYER/TRANSFEREE/LEGAL REPRESENTATIVE/CORPORATE OFFICER (PLEASE PRINT)	TITLE

E-MAIL ADDRESS

The Assessor's office may contact you for additional information regarding this transaction.

Comment: Under the current version of the preliminary change of ownership report, boxes H1 and H2 in Part I are

usually checked to avoid reassessment of the property. The form must be signed and dated by at least one of the trustees on the second page of the form.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.14 9. Non-California Real Property

§21.14 9. Non-California Real Property

Clients often own real property in other states or even other countries. It is always advisable to consult a local title company or attorney about the requirements for transferring these assets to the trust.

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B. Tangible Personal Property

§21.15 1. Assignment

Usually there is no record of ownership of tangible personal property. Items of personal property that lack any other record of ownership are transferred to the trust through an assignment. The assignment shows the settlor's intent to transfer the assets and vest title in the trustee. Items of particular value, especially items specifically devised in the trust instrument, may be specifically identified in the assignment to avoid any later issue about the authority of the trustee over such items.

NOTE: Some practitioners have clients periodically assign all (or substantially all; see §21.3) assets to the trust so that a *Heggstad* petition (Prob C §850(a)(3)) can be used to capture any overlooked items. See *Estate of Heggstad* (1993) 16 CA4th 943, 948, 20 CR2d 433, and §21.1. For a general assignment, see §21.17. See also the sample schedule of assets in §5.38.

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§21.16 2. Form: Assignment of Tangible Personal Property

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

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

ASSIGNMENT OF TANGIBLE PERSONAL PROPERTY

Name of trust: _____

Settlor(s) of trust: _____

Trustee(s) at date of transfer: _____

_____

Date trust was created: _____

FOR VALUE RECEIVED, but without monetary consideration, we, as Settlors, assign to the Trustee or Co-Trustees all our right, title, and interest in all our tangible personal property. The term "tangible personal property" refers, without limitation, to such items as:

1. All articles of personal and household use and ornament, now owned or acquired later, including but not limited to personal effects, jewelry, art work, club memberships, furniture, furnishings, pictures, books, and other tangible articles of a personal nature, specifically including _ _ _ _ _ _ _ _ _.

2. All insurance covering those articles and any proceeds of these policies.

3. The term "tangible personal property" excludes cash and other items of intangible personal property, if represented by tangible documentation of ownership and excludes tangible personal property used by either settlor in a trade, business, or profession; gold bars; bars of other metals; and any other tangible property of an investment nature (such as art objects and collections of tangible personal property).

This property shall be held, managed, and distributed according to the Trust's terms as they exist as of this date of assignment or as they are amended in the future.

Date signed: _ _ _ _ _ _, at _ _ _ _ _ _, California

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

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

The Trustee accepts this assignment and agrees as above.

Date signed: _ _ _ _ _ _, at _ _ _ _ _ _, California

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

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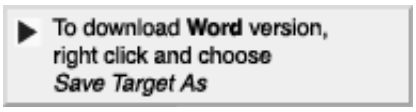
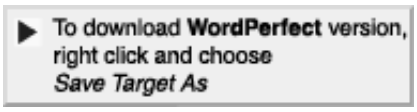
§21.17 3. Form: General Assignment of Property to Trust





ASSIGNMENT OF PROPERTY TO TRUST

_ _[*Name of settlor*]_ _, (hereafter "Settlor"), assigns and transfers to _ _[*name of trustee*]_ _ (hereafter "Trustee") of the _ _[*name of trust*]_ _ dated _ _[*date*]_ _, all of Settlor's right, title, and interest in and to all of the property owned by Settlor that would otherwise be subject to probate on the death of Settlor, to be held, administered, and distributed according to the terms of the trust. This property includes, without limitation, Settlor's home; other real property; all stocks, bonds, mutual funds, and other financial investments; cash; business interests; and tangible personal property. The term "tangible personal property" includes such items as furniture, furnishings, silverware, objects of art, china, clothing, jewelry, sporting equipment, automobiles, books, collections of tangible personal property, and other tangible personal property normally kept at the trustor's residence. The term "tangible personal property" also includes any insurance policies on this tangible personal property and any proceeds of these policies.

[*If appropriate, add*]

Despite the foregoing paragraph, the trust property does not include any of the following property: _ _[*Specify*]_ _.

[*Continue*]

Date signed: _ _ _ _ _ _, at _ _ _ _ _ _, California

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

State of _ _[*name*]_ _)
County of _ _[*name*]_ _)
_____)
)

On _ _[*date*]_ _, before me, _ _[*name of notary*]_ _, a Notary Public in and for said state, personally appeared _ _[*name(s) of settlor(s)*]_ _, who proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) _ _[*is/are*]_ _ subscribed to the within instrument, and acknowledged to me that he/she/they executed the instrument in his/her/their authorized capacit(y/ies), and that by his/her/their signature(s) on the instrument, the person(s), or the entity on behalf of which the person(s) acted, executed the instrument.

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

WITNESS my hand and official seal:

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

Comment: Because the assignment does not apply to nonprobate property, counsel should ascertain whether the client has taken title to any property in a manner that would cause it to be excluded from the assignment so that all property the client intends to transfer to the trust is included.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.18 4. Automobiles, Boats, Mobilehomes

§21.18 4. Automobiles, Boats, Mobilehomes

Automobiles, motor homes, certain mobilehomes and trailers, campers, vessels, trucks, etc., are registered with the Department of Motor Vehicles (DMV). See Veh C §§4000, 9840, 38012. Mobile homes, commercial coaches, and other vehicles are registered with the Department of Housing and Community Development (HCD). See Health & S C §§18010, 18075.

Transferring automobiles to the trust may be impractical because the settlor may buy and sell automobiles frequently. Moreover, if all other nontrust assets are valued at less than $100,000, registered vehicles are not included in the value of the estate for probate purposes and can usually remain outside the trust without jeopardizing the probate avoidance plan. Prob C §13050. See §21.3. Thus, many clients prefer to avoid the inconvenience of reregistering these assets and retain them in their own name.

If the settlors prefer to reregister these assets, they may be directed to the assistance of the California State Automobile Association or the Southern California Automobile Association, if they are members. Otherwise, reregistration usually requires a personal visit to the DMV.

PRACTICE TIP: Any third-party trustee should be added as an insured on insurance policies.

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C. Cash Bank Accounts

§21.19 1. Procedure

Clients usually change title to bank accounts themselves. If the attorney is handling the transfer of accounts, the client must supply copies of all recent statements. Typically, these have the necessary information such as account number(s), institutional addresses, current title. The Letter of Instruction (see §21.20), signed by the client, and accompanied by a Certification of Trust (see §22.2), is generally sufficient to begin the title change process, but the institution usually requires additional forms (*e.g.*, new signature cards and its own trust certification form).

Most institutions do not require that the name of the trust be reflected on the face of checks for trust checking accounts. This policy is important, because merchants can be leery of accepting trust checks.

The client may consider keeping at least one checking account in his or her own name for personal use that will not come under the control of a third-party trustee. The client should be cautioned, however, to make sure that the balance in any nontrust accounts, combined with other nontrust assets, does not exceed $100,000. See Prob C §13100.

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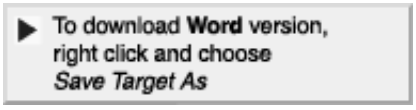
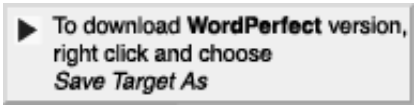
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.20 2. Form: Sample Letter to Financial Institution

§21.20 2. Form: Sample Letter to Financial Institution





_ _[*Date*]_ _

_ _[*Name of financial institution*]_ _
_ _[*Address*]_ _

Re: Account No. _ _ _ _ _ _:
John Doe and Jane Doe

Dear Sir or Madam:

The undersigned are holders of the above-referenced _ _[*e.g., money market*]_ _ account. We have recently created a Revocable Inter Vivos Trust for our benefit. Among the assets to be transferred into the trust is the above-referenced _ _[*e.g., money market*]_ _ account.

Please change title on the account to read as follows:

JOHN DOE and JANE DOE, Trustees of the
DOE REVOCABLE INTER VIVOS TRUST
dated _ _[*date of trust*]_ _

The social security number and mailing address on the account will remain unchanged.

Enclosed is a copy of the Certification of Trust under California Probate Code §18100.5 as evidence of the existence of the trust.

Please notify the undersigned in writing when the transfer has been completed.

Very truly yours,

__[*Signature*]__
John Doe

__[*Signature*]__
Jane Doe

Encl: Certification of Trust

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D. Securities

§21.21 1. Transfer of Brokerage and Mutual Fund Title

Transferring securities, including mutual funds, is much simpler when the securities are held in a "street name" brokerage account. The simplest way to transfer title is to write to the broker or transfer agent and ask for their specific transfer forms. If this is not possible, the client should obtain a copy of a recent statement for the account and notify the institution, using a formal letter and certification of trust, in a form similar to that used for bank account transfers. See §21.22 for a sample letter. The certification should include a statement of the trustee's investment powers. See §22.2 for a certification of trust form. The same procedure is used for mutual fund investments.

NOTE: Some institutions require signatures for letters of instructions to be "medallion guaranteed" (see §21.23).

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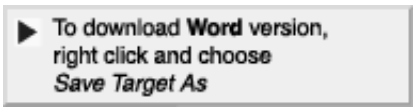
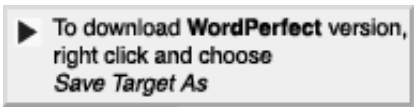
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.22 2. Form: Sample Letter of Instruction to Broker

§21.22 2. Form: Sample Letter of Instruction to Broker





_ _[*Date*]_ _

_ _[*Name of financial institution*]_ _
_ _[*Address*]_ _

Re: Account No.: _ _ _ _ _ _
John Doe and Jane Doe

Dear Sir or Madam:

The undersigned are holders of the above-referenced _ _[*brokerage/mutual fund*]_ _ account. We have recently created a Revocable Inter Vivos Trust for our benefit. Among the assets to be transferred into the trust is the above-referenced _ _[*brokerage/mutual fund*]_ _ account.

Please change title on the account to read as follows:

JOHN DOE and JANE DOE, Trustees of the
DOE REVOCABLE INTER VIVOS TRUST
dated _ _[*date of trust*]_ _

The social security number and mailing address on the account will remain unchanged.

Enclosed is a copy of the Certification of Trust under California Probate Code §18100.5 as evidence of the existence of the trust and the investment powers of the trustee.

Please notify the undersigned in writing when the transfer has been completed.

Very truly yours,

__[*Signature*]__
John Doe

__[*Signature*]__
Jane Doe

Encl: Certification of Trust

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§21.23 3. Transfer of Share Certificates

If a broker or an investment house holds the certificates, they will handle the transfer; if the client holds the certificates, either the attorney or a broker, for a fee, will handle the transfer through a transfer agent. The simplest way to transfer title is to write to the broker or transfer agent and ask for their specific transfer forms.

The transfer and registration of securities held in certificate form are governed by Com C §§8401-8407. The settlor should sign a stock power reciting that he or she assigns the securities to the trustee; and identifies the interest to be transferred, the certificate numbers to be transferred, and the name of the trustee. See form in §21.24.

Because transfer agents have no means of identifying the signatures on the stock power, they usually insist that the signatures on the power forwarded to them be guaranteed by an institution that is a member of a "medallion program," *i.e.,* a program that sets standards for persons authorized to guarantee a signature (*e.g.,* Securities Transfer Agents Medallion Program (STAMP), New York Stock Exchange Medallion Program, or Stock Exchange Medallion Program). Com C §8402(a)(1). The guarantor either must be a bank or trust company with a correspondent in the city in which the transfer agent is located or must be a member firm of a nationally recognized security exchange. Signatures are normally guaranteed by the bank of the person executing the stock power or by the broker who handles the sale or transfer.

The stock power/assignment should be sent to the transfer agent by registered or certified mail in an envelope separate from the stock certificates to avoid someone intercepting the certificate and stock power together (the certificate is negotiable if found with the stock power). See §21.25 for information on how to locate the current transfer agent. The stock certificates should be sent by registered or certified mail with the request that they be transferred to the trustee, giving the trustee's address. See California Decedent Estate Practice §§10.14-10.15, 32.28-32.50 (2d ed Cal CEB 2009). The trustees should include evidence of their appointment. Com C §8402(a)(3)-(4). A certification of the trust should be sufficient for this purpose. See Com C §8402(c)(2)(B). See also Prob C §18100.5. For a form of certification of trust, see §22.2. The transfer agent need not inquire into the details of the transfer by or to the fiduciary or into its compliance with the trust instrument. See UCC Comment 3 to Com C §8402.

If the securities are held in a brokerage account, a letter of instructions to the broker, signed by the settlors, should suffice. See §§21.21-21.22.

The settlors should transmit trust dividends declared after execution of the trust to the trust.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.24 4. Form: Assignment Separate From Certificate or Bond

§21.24 4. Form: Assignment Separate From Certificate or Bond

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ASSIGNMENT SEPARATE FROM CERTIFICATE OR BOND

For no consideration, we, _ _[*names of settlors*]_ _, assign to _ _[*name of trustee*]_ _, Trustee under the _ _[*name of trust*]_ _, assignee, _ _[*number*]_ _ shares of the _ _[*type of stock, e.g., common/preferred*]_ _ stock of _ _[*name of corporation*]_ _, standing in the settlors' names on the books of the corporation, represented by Certificate No. _ _[*number*]_ _, and irrevocably appoint _ _[*leave blank or fill in name of attorney in fact*]_ _ attorney to transfer the stock on the books of the corporation with full power of substitution.

Date: _ _ _ _ _ _ __[*Signature of settlor*]__
_ _[*Typed name*]_ _

Date: _ _ _ _ _ _ __[*Signature of settlor*]__
_ _[*Typed name*]_ _

Signatures of
_ _[*Settlor's name*]_ _ **and** _ _[*Settlor's name*]_ _
Guaranteed by:
__[*Signature of guarantor*]__

In the presence of:
_[*Signature of witness*]__
Witness

Comment: The attorney in fact is normally the person who actually transfers the stock on the books of the corporation. For this reason, it is customary either to leave the space for the attorney in fact blank or to fill in the name of a person (*e.g.,* a broker, a bank) with power of substitution, thus preventing the insertion by an unauthorized person of his or her name as the attorney for transfer. The second alternative is often used if the transferee's name is left blank when the stock power is signed. When forwarding the stock power to the transfer agent, the person with power of substitution sends with it the written appointment of another person.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.25 5. Obtaining Information About Transfer Agent

§21.25 5. Obtaining Information About Transfer Agent

Especially for older certificates, the name of the transfer agent on the certificate may no longer be accurate, because transfer agents change often. However, a registered transfer agent must provide written notice to a registered security depository when terminating or assuming transfer agent services or when changing its name or address. 17 CFR §240.17Ad-16.

The following sources can be helpful in locating a transfer agent:

- Correspondence the client receives from the transfer agent or stock issuer;
- Commerce Clearing House, Inc., Securities Transfer Guide, 1969-;
- Financial Information Inc., 1 Cragwood Rd., 2d Floor, South Plainfield, NJ 07080; http://www.fiinet.com;
- Brentmark Asset Transfers System computer program; see Brentmark Software, Inc., 3505 Lake Lynda Dr., Suite 119, Orlando, FL 32817-8333; http://www.brentmark.com;
- Business library information;
- Secretary of State for the state in which the company was incorporated; or
- The internet at http://www.stocktransfer.com.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.26 6. Lost or Missing Share Certificates

§21.26 6. Lost or Missing Share Certificates

To replace lost or missing certificates, the client (or the attorney) should write to the transfer agent (see §21.25 on how to identify the transfer agent) and request an Affidavit of Lost Certificate and Indemnity Agreement. The client should complete and sign the affidavit in the presence of a notary, swearing that the certificate is lost, and then follow the instructions on the affidavit to furnish bond for issuance of new certificates.

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§21.27 7. Securities of Nominal or No Value

The settlors may wish to transfer securities of nominal value to the trust. Many companies transfer their own stock for a fee that may exceed the market value of the holding. The trust should not incur the expense of transfer unless the settlors insist or the holding will be sold immediately. The securities should be held with a stock assignment from the settlors, along with any other forms required for transfer. Unless the corporation will transfer title on its books without issuing new certificates, title will remain in the settlors' names as far as the company is concerned, and the settlors will receive proxies. If a third party is the trustee, the settlors can either give the proxy to the trustee or relieve the trustee of the voting responsibilities by an amendment to the trust.

If there is any doubt about the value of the holding, the settlors should investigate the matter. The commissioner of corporations for the state of incorporation (shown on the stock certificate) will advise as to whether the company's charter is defunct or will provide the last known address of corporate offices where the trustee can write for further information. There is usually a nominal fee for this service.

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§21.28 8. Restricted Securities

The settlors may own securities that are restricted on sale or transfer. Any restrictions are normally printed across the face of the certificate as a legend. Despite restrictions, these securities can be transferred to the trust, subject to the same restrictions that existed in the settlors' hands. 17 CFR §230.144.

The attorney or settlor should review all documents relevant to the transfer restrictions, including buy-sell agreements, shareholder agreements, voting trust agreements, etc. When the certificates are reregistered, the trustee should verify that the legend on the new certificates has the same terms as on the original and that the restriction was not inadvertently extended. If there is an expiration date on sale restrictions, the trustee should have new certificates issued after that date with the legend removed. This step will facilitate later sales.

See also §§21.31-21.38 on the transfer of closely held business interests.

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§21.29 9. Employee Incentive Stock Option Plans

Incentive stock options usually cannot be transferred to a revocable trust. Incentive stock options cannot be transferred by an employee except by "will or the laws of descent and distribution." IRC §422(b)(5). A violation of this restriction will result in loss of favorable tax treatment. Also, most stock option plans prohibit transfers.

An employee can avoid inclusion of the options in the probate estate by designating a legal representative who is entitled to exercise the options after the employee's death. The employee may designate the successor trustee of the revocable trust as the legal representative to exercise the options. See §21.39 on beneficiary designation.

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§21.30 10. Bonds

The trust may hold corporate or municipal bonds. For corporate bonds, reregistration follows the same procedures as other securities. See §§21.21-21.29.

Municipal bonds might not be registered; instead, they might be in bearer form, with the proceeds payable to the holder. If unregistered bonds or similar assets are among trust corpus, the trustees should place them in a safe-deposit box rented for that purpose in the trustees' name as trustees of the trust in question. A simple assignment form like the one in §21.16 can be used.

United States Savings Bonds can be transferred to the trust by filing form Request to Reissue United States Savings Bonds to a Personal Trust (PD F1851 E).

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.31 E. Closely Held Business Interests

§21.31 E. Closely Held Business Interests

To determine the feasibility and desirability of transferring interests in closely held businesses to the trust, the attorney must obtain and review all relevant information about the business, which would include formation documents, buy-sell agreements, and valuation information. See §§21.32-21.38. For further discussion, see Business Buy-Sell Agreements (Cal CEB 1991).

The attorney also must pay attention to whether any professional licensing laws restrict the transfer of a sole proprietorship, professional corporation (Corp C §13407), or partnership to a trust, *e.g.,* law practice. See §19.17.

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1. Partnerships

§21.32 a. In General

The transfer of a partnership interest can be one of the most complex transactions generated by the creation of a revocable trust. It requires a transfer of the partnership interest, a consent to substitute the trust for the individual partners, and sometimes an amendment to the partnership agreement and to a certificate of limited partnership.

An interest in a commercial partnership may be transferred to a revocable trust if the partnership agreement permits this or if all partners consent. The settlors may transfer either a general or a limited partnership interest to the trust. Although, a trustee usually needs specific authorization to continue as a general partner, this issue is not a problem when a settlor is the trustee of a revocable living trust.

A trust may qualify as a real owner of a family limited partnership interest. Whether the trustee will be recognized as a partner for tax purposes, however, depends on various characteristics of the trustee. A trustee who is independent and unrelated to the donor, participates in partnership activities, and receives income distributions from the partnership will be recognized as a partner for tax purposes. A trustee is not considered to be independent if the trustee is "amenable to the will of the grantor." When the grantor is the trustee, the trust may be recognized as a partner only if the grantor actively represents and protects the beneficiaries' interests in accordance with the obligations of a fiduciary and does not subordinate those interests to the interests of the grantor. Reg §1.704-1(e)(2)(vii).

For discussion of basis in partnership assets on settlor's death, see chap 4.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.33 b. Obtaining Information

§21.33 b. Obtaining Information

The client should provide copies of partnership agreements, buy-sell agreements with all amendments, recent partnership tax returns, balance sheets and annual statements, and any available appraisals or valuations of the partnership.

To make the transfer, the attorney must ascertain:

- The name of the partnership;
- Whether it is a general or limited partnership, and whether the client has a general or limited partnership interest;
- Who the other partners are;
- What percentage interest is owned by the client;
- Whether there are any restrictions on the transfer of a partner's interest;
- Who has to consent to the transfer (*e.g.,* the general partner, all partners);
- How title is held (*e.g.,* if clients are a married couple);
- An estimate of the value of the client's interest; and
- Whether any professional licensing laws restrict the transfer of a sole proprietorship, professional corporation, or partnership to a trust, *e.g.,* law practice (see Corp C §13405).

For more details about transferring partnership interests, see Funding a Revocable Trust, step 38 (Cal CEB Action Guide October 2009).

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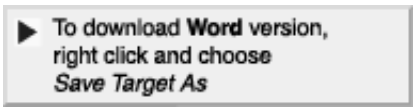
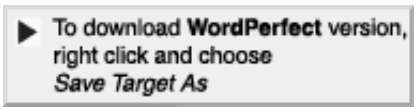
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.34 c. Form: Assignment of Partnership Interest

§21.34 c. Form: Assignment of Partnership Interest





ASSIGNMENT OF PARTNERSHIP INTEREST

For no consideration, _ _[*name*]_ _ and _ _[*name*]_ _ (assignors) assign to _ _[*name of trust*]_ _ all their right, title, and interest in and to their _ _[*limited*]_ _ partnership interest in _ _[*name of partnership*]_ _, a California _ _[*limited*]_ _ partnership (partnership). This assignment shall be effective as of the date of this instrument. Hereafter, _ _[*name*]_ _ shall have the right to receive from the partnership the share of partnership profits, losses, and distributions to which the assignors would otherwise be entitled and the right to the return from the partnership on its dissolution of the assignors' interest in the partnership.

Executed at _ _[*name of city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.35 d. Form: Consent to Assignment of Partnership Interest

§21.35 d. Form: Consent to Assignment of Partnership Interest

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CONSENT TO ASSIGNMENT OF PARTNERSHIP INTEREST

The undersigned general partner of the partnership waives the provision of sections _ _[*number*]_ _ **through** _ _[*number*]_ _ **of the partnership agreement,** _ _[*declines on behalf of the partnership and* _ _[*himself/herself*]_ _ *to acquire the assignors' interest in the partnership,*]_ _ **consents to the foregoing, and approves the admission of the** _ _[*name of trust*]_ _ **to the partnership as a substituted** _ _[*limited*]_ _ **partner, subject to all terms and conditions of the partnership agreement.**

Executed at _ _[*name of city*]_ _**, California, on** _ _[*date*]_ _**.**

__[*Signature of partner*]__
_ _[*Typed name*]_ _
General Partner

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§21.36 2. Closely Held Corporations

The attorney should review all documents pertaining to the settlors' interest in a closely held corporation, including articles of incorporation, shareholders' agreements, and valuation information such as tax returns and balance sheets.

Some practitioners believe that stock in an IRC §1244 small business corporation usually should not be transferred to a trust, because a trust cannot deduct losses under that section. Such concerns are probably unwarranted because the IRS consistently disregards revocable trusts for income tax purposes. IRC §§671, 676.

If the client handles the books for his or her own corporation, the estate planning attorney may be required to handle the stock transfer. See Counseling California Corporations, chap 1 (3d ed Cal CEB 2008). If the transfer is handled by another corporate officer or the corporate attorney, the form of assignment in §21.24 can be modified accordingly.

Transfer procedures for stock in a closely held corporation are the same as for other share certificates. See §§21.23-21.28.

See §4.12 for discussion of transferring stock in S corporations to a trust. On interests in professional corporations, see §21.2.

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§21.37 3. Limited Liability Companies (LLCs)

A trust can be a member of a limited liability company (LLC). The attorney should review the articles of organization and operating agreement regarding any restrictions or limitations on transfer of a membership interest, including all amendments, the most recent company income tax returns, balance sheet, and annual statement, any appraisals available, and any buy-sell agreements. See Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

The attorney must verify the name of the company as well as the number and identity of its members. It is important to ensure that the trustee or trustees are accepted as full members of the LLC. See discussion of partnership interests in §21.33. The forms in §§21.37A-21.37B designed for use by an LLC taxed as a partnership are based on the partnership forms in §§21.34-21.35.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.37A a. Form: Assignment of LLC Membership Interest

§21.37A a. Form: Assignment of LLC Membership Interest

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ASSIGNMENT OF LLC MEMBERSHIP INTEREST

For no consideration, _ _[*name*]_ _ and _ _[*name*]_ _ (assignors) assign to _ _[*name of trust*]_ _ all their right, title, and interest in and to their membership interest in _ _[*name of limited liability company*]_ _, a California limited liability company. This assignment shall be effective as of the date of this instrument. Hereafter, _ _[*name*]_ _ shall have the right to receive from the company the share of company profits, losses, and distributions to which the assignors would otherwise be entitled and the right to the return from the company on its dissolution of the assignors' membership interest in the company.

Executed at _ _[*name of city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

__[*Signature of settlor*]__
_ _[*Typed name*]_ _

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.37B b. Form: Consent to Assignment of LLC Membership Interest

§21.37B b. Form: Consent to Assignment of LLC Membership Interest

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CONSENT TO ASSIGNMENT OF LLC MEMBERSHIP INTEREST

The undersigned manager of the company waives the provision of sections _ _[*number*]_ _ through _ _[*number*]_ _ of the operating agreement, _ _[*declines on behalf of the company and _ _[himself/herself*]_ _ *to acquire the assignors' membership interest in the company,*]_ _ consents to the foregoing, and approves the admission of the _ _[*name of trust*]_ _ to the company as a substituted member, subject to all terms and conditions of the operating agreement.

Executed at _ _[*name of city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of manager*]__
_ _[*Typed name*]_ _
Manager

Comment: Depending on the operating agreement, the consent to assignment may be signed by an officer of the LLC. In a member-managed LLC, the consent to assignment must be signed by all the other members.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.38 4. Sole Proprietorships

§21.38 4. Sole Proprietorships

The client should provide relevant information about the business, including the most recent balance sheet and statement of assets, a list of assets in name of the sole proprietorship, recent Schedules C to IRS Form 1040 (income tax return), fictitious business name statements, and a list of the licenses or permits held by the sole proprietorship.

A sole proprietorship owned by one of the settlors is usually transferred by a simple assignment. The form of assignment in §21.34 can be adapted for that use.

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.39 F. Coordinating Beneficiary Designations

§21.39 F. Coordinating Beneficiary Designations

Whether or not a revocable trust should be named as the beneficiary of property that will pass by beneficiary designation depends on the nature of the asset. Special tax considerations apply in the case of pensions, IRAs, and similar entities and accounts that will trigger taxable income on distribution. See §21.41. When these considerations are not present, particularly in the case of life insurance, naming the trust as the beneficiary permits distributions to be made in accordance with the dispositive provisions of the trust—including provisions for dividing the trust into subtrusts, provisions providing for a wide variety of contingencies, and provisions providing continued trustee management in the event distributions would otherwise be made to minors or other younger beneficiaries. Naming the trust as the beneficiary also makes it much easier for the client to amend the estate plan. If estate taxes will be owed, naming the trust as the beneficiary avoids the potential need for the trustee to attempt to force transferees to pay their legal shares of those taxes—the trustee can withhold the necessary funds up front.

There are also potential disadvantages in naming a trust as beneficiary—particularly when there is a risk that the settlor might become insolvent. Revocable trust assets are liable for the debts of a deceased settlor. Prob C §19001. There may also be times when it would be desirable to have a particular asset pass directly to a named individual rather than the trust in order to achieve greater confidentiality or avoid possible distribution delay.

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§21.40 1. Life Insurance

Traditional life insurance planning strategy has involved getting life insurance out of the insured's taxable estate before the insured's death triggered a great increase in the value of the policy. This was traditionally accomplished by causing an irrevocable inter vivos life insurance trust to be the owner of the policy. See Drafting California Irrevocable Trusts, chap 11 (3d ed Cal CEB 1997); California Estate Planning, chap 19 (Cal CEB 2002). Because of the significant increases in the IRC §2010 unified credit in recent years, there are now more situations in which it is appropriate to consider naming a revocable trust as the beneficiary of life insurance—or even as the owner of the policy—in order to achieve the benefits described in §21.39. Naming the trust as beneficiary may be particularly desirable if the policy is not easily transferred to a life insurance trust (often the case with insurance provided by employers) or if the insurance proceeds will be primarily used to provide for the settlor's minor dependents or other relatively young beneficiaries.

To handle a life insurance policy for a client, the attorney should review a copy of the policy and current declaration page. To change the beneficiary, a special form from the carrier is usually required. Ownership of life insurance policies can be, but is generally not, transferred to the trust. Transferring ownership may be useful in order to permit management of the policy in the event of loss of capacity, although such management can also be provided using a durable power of attorney. The attorney should make sure that the beneficiary change is acknowledged in writing by the carrier.

NOTE: Although a trust may also be named the beneficiary of a commercial annuity, the distribution provisions and tax consequences of commercial annuities may be affected by the identity of the trust beneficiary. Designation of the revocable trust may limit distribution options. The contract should be reviewed carefully and the company that issued the annuity should be contacted.

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§21.41 2. IRA or Qualified Retirement Plan

Deferred compensation plans that meet the requirements of IRC §401 are generally referred to as "qualified plans," *e.g.,* pension or profit-sharing plan or Keogh Plan. By law, title to qualified plans must be held in the name of the individual taxpayer; transfers to another name result in the loss of tax-deferred status. Qualified plans held by a settlor, however, can be integrated into the settlor's estate plan by use of the plan's beneficiary designation.

A surviving spouse may roll over the contents of the deceased spouse's qualified plan into his or her own name without adverse tax consequences. Treas Reg §1.408-8, A-5, A-7. Therefore, the surviving spouse is usually the primary beneficiary for the plan. This provision of federal law does not apply to domestic partners treated as spouses under California law. See §4.41.

Naming the revocable trust as the alternate beneficiary allows the following:

- A spousal disclaimer, so that proceeds can pass to a trust that uses the unified credit (IRC §§2010(a), (c), 2505(a)) to shelter the applicable exclusion amount (*e.g.,* "exemption equivalent," "credit shelter," or "bypass" trust). This strategy is useful if trust assets are unlikely to be sufficient to maximize the unified credit.
- Complex contingent dispositions to be implemented through the trust document; complex dispositions can seldom be incorporated directly in a typical beneficiary designation; and
- Trustee management of the plan proceeds for minor or incompetent beneficiaries.

Designating the revocable trust as the primary beneficiary may be appropriate in certain circumstances, *i.e.,* when designation of spouse as beneficiary is undesirable or inappropriate (*e.g.,* because of management issues or desire to preserve benefits for children of prior marriages) or when the trustee has the power to disclaim benefits (and designation of revocable living trust as beneficiary may preserve flexibility). Although a revocable trust does not have a life expectancy, its beneficiaries can be treated as designated beneficiaries as long as the trust meets the requirements for a conduit trust. See §§7.54A-7.54E.

PRACTICE TIP: Although a revocable trust can be a designated beneficiary, it is better to name an irrevocable subtrust (QTIP trust, bypass trust) of the revocable trust as the trust beneficiary to minimize the possibility of inadvertent disqualification. For instance, a revocable trust with joint settlors may be disqualified if the participant settlor dies first, because part of the trust will still be revocable after the participant's death. Designating a trust requires special advance preparation and planning.

To change the beneficiary of a qualified plan, the forms provided for that purpose by the plan administrator should be used.

For further discussion of estate planning for qualified plans, see Funding a Revocable Trust, step 23 (Cal CEB Action Guide October 2009); California Estate Planning, chap 21 (Cal CEB 2002). For further discussion of problems involved in naming a trust as a beneficiary of qualified plan or IRA benefits, see Cluster & Tippett, *Designating Retirement Plan Beneficiaries,* Estate Planning 2007, chap 6 (Cal CEB 2007).

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G. Other Assets

§21.42 1. Promissory Notes

Promissory notes should be endorsed to the trustees as trustees of the trust. Alternatively, an assignment may be executed. The form in §21.16 can be adapted for this purpose. The makers of the notes should be advised of the assignment and requested to make future payments to the trustees. If any notes are secured by a deed of trust or other security, the deed of trust or other security should also be assigned to the trustees, and the assignment of the trust deed should be acknowledged and recorded in the county or counties in which any part of the land is situated.

The attorney should encourage clients to document previously undocumented loans unless the loan is to be forgiven. Assignments can be prepared for both documented and undocumented loans.

After assignment to the trust, the debtor should make payments to the trustees. See form in §21.43.

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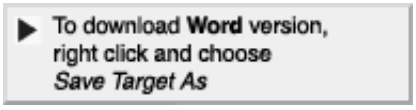
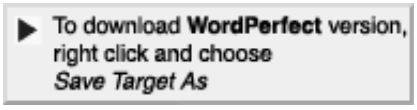
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.43 2. Form: Sample Letter to Payor Regarding Payment on Promissory Note

§21.43 2. Form: Sample Letter to Payor Regarding Payment on Promissory Note





_ _[*Date*]_ _

_ _[*Name(s) of payor(s)*]_ _
_ _[*Address*]_ _

Re: Note Payments

Dear _ _[*name(s) of payor(s)*]_ _:

Enclosed is a copy of the assignment of your note dated _ _[*date*]_ _, to our revocable trust, the John Doe and Jane Doe Trust dated October 12, 2003. Please make all future payments on the note as follows:

"John Doe and Jane Doe, Trustees"

Our address remains the same. Thank you.

Very truly yours,

__[*Signature(s)*]__
_ _[*Typed name(s)*]_ _

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.44 3. Intellectual Property

§21.44 3. Intellectual Property

The attorney should have the client identify any intellectual property assets such as copyrights, patents and trademarks, or royalties. Items with significant value should be assigned to the trust.

NOTE: Clients often forget about these items, so the attorney should specifically inquire about them.

The attorney should ask for a copy of a contract describing the rights attached to the property, *e.g.,* work of art (visual or literary), discovery, or invention. If the intellectual property assets form a major part of the client's estate, a professional appraisal may be needed to assist the client in estimating the value based on, *e.g.*, annual income from the asset, or the value of other similar assets. The attorney should also consider associating an attorney who specializes in patents or copyrights.

Transferring a copyright, patent, or trademark to a trust is accomplished by assigning the copyright, patent, or trademark to the trust. The assignment must be executed by the settlors before a notary. For a copyright, the assignment, a letter of instructions to the copyright office regarding registration of title of the copyright in the name of the trust, and the appropriate fee should be mailed to the Copyright Office. For a patent or trademark, the assignment, a Recordation Form Cover Sheet: Patents Only (Department of Commerce Form PTO-1595) or Recordation Form Cover Sheet: Trademarks Only (Department of Commerce Form PTO-1594), a self-addressed postcard for the Patent and Trademarks Office to confirm receipt of the assignment, and the appropriate fee should be mailed to the Director of the U.S. Patent and Trademark Office.

For forms to assign intellectual property rights, see §§21.45-21.48.

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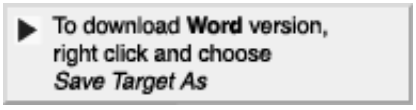
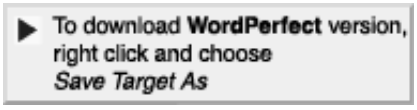
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.45 a. Form: Assignment of Copyright to Trust

§21.45 a. Form: Assignment of Copyright to Trust





ASSIGNMENT OF COPYRIGHT TO TRUST

The undersigned represents that _ _[*he/she*]_ _ is the _ _[*author/composer*]_ _ of _ _[*describe artistic or literary work*]_ _. The undersigned hereby assigns to _ _[*name of trust*]_ _ any and all copyrights in the above-described work, together with any rights of action that may have accrued under these copyrights.

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

State of _ _[*name*]_ _)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal:

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

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§21.46 b. Form: Sample Letter to Copyright Office

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Copyright Office
Library of Congress
Washington, DC 20559
Attn: Document Unit
Re: _ _[*Name of trust*]_ _
_ _[*Copyright number*]_ _

Dear _ _[*Sir/Madam*]_ _**:**

This firm represents _ _[*name*]_ _**, who has created the** _ _[*name of trust*]_ _ **for** _ _[*his/her*]_ _ **benefit.**

Among the assets to be transferred to the trust is the above-numbered copyright for _ _[*describe artistic or literary work*]_ _**. Enclosed is an assignment of the copyright, which has been executed by** _ _[*name*]_ _**.**

Please microfilm the assignment and return the original to this office in the self-addressed, stamped envelope.

Please acknowledge receipt of the enclosed assignment by stamping and dating the enclosed copy of this letter. Thank you.

Very truly yours,

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

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.47 c. Form: Assignment of Patent to Trust

§21.47 c. Form: Assignment of Patent to Trust

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

ASSIGNMENT OF PATENT TO TRUST

_ _[*Names of settlors*]_ _**, whose address is** _ _[*address*]_ _**, have invented** _ _[*describe patent*]_ _**, for which an** _ _[*Application or United States Letters Patent*]_ _ **was granted on** _ _[*date*]_ _**,** _ _[*Serial No.* _ _ _ _ _ _*/Patent No.* _ _ _ _ _ _]_ _**. For the sole purpose of changing formal title,** _ _[*names of settlors*]_ _ **do, without consideration, transfer and assign to** _ _[*name of trust*]_ _ **all their right, title, and interest in and to** _ _[*any and all Letters Patent that may be granted in the United States/the above-referenced Letters Patent*]_ _**. This Assignment is effective immediately.**

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name of settlor*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name of settlor*]_ _

State of _ _[*name*]_ _ **)**
County of _ _[*name*]_ _ **)**
_____)
)

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

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

WITNESS my hand and official seal:

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

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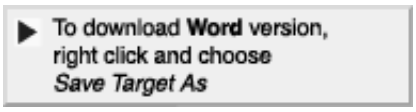
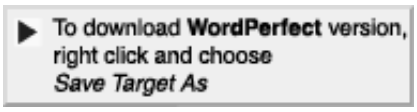
Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.48 d. Form: Assignment of Trademark to Trust

§21.48 d. Form: Assignment of Trademark to Trust





ASSIGNMENT OF TRADEMARK

_ _[*Name of settlors*]_ _, whose address is _ _[*address*]_ _, have adopted, used, or are using a trademark titled _ _[*name of trademark*]_ _, which is registered No. _ _ _, dated _ _[*date*]_ _. For the sole purpose of changing formal title, the _ _[*names of settlors*]_ _, without consideration, transfer and assign to _ _[*name of trust*]_ _ all their right, title, and interest in and to the trademark titled _ _[*name of trademark*]_ _ and the goodwill of the business symbolized by it. This Assignment is effective immediately.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name of settlor*]_ _

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name of settlor*]_ _

State of _ _[*name*]_ _)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal:

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

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Source: Estate Planning/Drafting California Revocable Trusts/21 Funding the Trust/§21.49 4. Foreign Assets

§21.49 4. Foreign Assets

If a client has foreign holdings, the attorney should first attempt to obtain as much information as possible from the client, including valuation of the holdings, if possible. Usually, the client will have some contacts in the foreign country and will be willing to associate legal counsel there to ascertain:

- Whether revocable lifetime trusts are a recognized way of holding title;
- Whether revocable trusts are a recognized way of transferring title on the settlor's death;
- Whether it is to the client's advantage under the laws of that nation to place title to a foreign asset into a trust; and
- If the answer is yes in all cases, how to make the asset a trust asset under the laws of that jurisdiction.

The client may need to have a separate trust or estate plan for foreign assets.

WARNING: Many countries have laws that compel leaving assets to specified relatives. Some countries do not recognize trusts.

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22

Related Documents

CEB Staff

I. CERTIFICATION OF TRUST
- A. Use of Certification of Trust §22.1
- B. Form: Certification of Trust §22.2

II. POUROVER WILL
- A. Purpose of Pourover Will §22.3
- B. Savings Clause If Direct Devise to Trust Is Ineffective §22.4
- C. Form: Disposition of Residue to Trust §22.5
- D. Form: Sample Pourover Will §22.6

III. DURABLE POWER OF ATTORNEY
- A. Coordinated Use of Revocable Trust and Durable Power of Attorney §22.7
  - 1. Selecting Agent §22.8
  - 2. Springing Powers Versus Immediate Powers §22.9
  - 3. Scope of Powers §22.10
- B. Form: Durable Power of Attorney §22.11

IV. CERTIFICATE OF INDEPENDENT REVIEW
- A. Purpose of Certificate of Independent Review §22.12
- B. Form: Certificate of Independent Review §22.13

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I. CERTIFICATION OF TRUST

§22.1 A. Use of Certification of Trust

Probate Code §18100.5 authorizes a trustee to present a certification of trust to any person in lieu of providing a copy of the trust in order to establish its existence or terms. Because the certificate provides protection for a third party doing business with a trustee, the trustee may be asked to supply the certificate. Some financial institutions require a specific form of trust certification for their transactions; other institutions may require a customized certification. Certifications may be needed in funding a revocable trust or a subtrust of a revocable trust for married settlors on the death of the deceased settlor, especially if a change of trustee is involved—as will occur if both settlors act as trustees. See chap 21.

The certification of trust may confirm specified facts or contain specified information, such as the date of execution of the trust, the identities of the settlors and the acting trustees, the revocability or irrevocability of the trust, and the identity of anyone with the power to revoke the trust. Prob C §18100.5(b). The certification should state that the trust has not been revoked, modified, or amended in any manner that would make the representations in the certification incorrect. It should be acknowledged before a notary. Prob C §18100.5(c). Third parties may require that copies of excerpts of the trust regarding the trustee's identity and powers be attached to the certification. Prob C §18100.5(e). The trust's dispositive provisions need not be included. Prob C §18100.5(d). A form of certification with acknowledgment is in §22.2.

A person who acts in reliance on information in the certification of trust, without actual knowledge that the representations set forth are incorrect, may not be held liable for doing so and may assume, without inquiry, the accuracy of facts in the certification. Prob C §18100.5(f). No inference on whether a person has acted in good faith in dealing with the trustee under Prob C §18100 may be drawn from that person's failure to demand a certification of trust. Prob C §18100.5(g). However, a person who in bad faith demands trust documents to prove facts set forth in the certification (other than facts pertaining to the trustee's power to act in the pending transaction) is liable for damages, including attorney fees, incurred as a result of refusing to accept certification in lieu of the requested documents. Prob C §18100.5(h). Any person may record a certification of trust that relates to an interest in real property in the office of the county recorder in any county in which all or a portion of the real property is located, but it is not necessary to record a certification of trust in conjunction with the recordation of a transfer of title of real property involving a trust. Prob C §18100.5(i).

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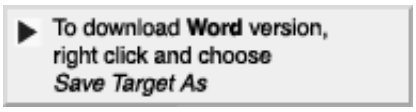
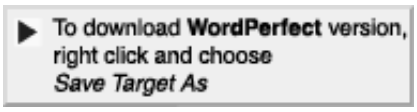
Source: Estate Planning/Drafting California Revocable Trusts/22 Related Documents/§22.2 B. Form: Certification of Trust

§22.2 B. Form: Certification of Trust





22.2-1 Certification of trust

Certification of Trust

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

(1) That _ _[*I am/we are*]_ _ the current trustee(s) of the trust established by _ _[*name(s) of settlor(s)*]_ _ of _ _[*address*]_ _ on _ _[*date*]_ _.

(2) Attached is a true and correct copy of the portion of the trust instrument which provides that the declarant(s) _ _[*is/are*]_ _ the trustee(s).

(3) This trust may be revoked by _ _[*the/either*]_ _ settlor at any time.

(4) The trust's taxpayer identification number is _ _[*number*]_ _.

(5) Title to assets of this trust should be stated as: "_ _[*name of trust*]_ _ dated _ _[*date*]_ _."

(6) _ _[*The trustee may take any action on behalf of the trust/Either trustee acting alone may take any action on behalf of the trust, except that the sale or encumbrance of real property requires the signatures of both trustees*]_ _.

(7) Attached is a true and correct copy of the portion of the trust instrument which lists the powers of the trustee(s).

(8) The trust has not been revoked, modified, or amended in any manner that would cause the representations in this certification to be incorrect.

(9) This certification is being signed by all currently acting trustees of the trust.

__[*Signature*]__ __[*Signature*]__
_ _[*Name of settlor*]_ _ _ _[*Name of settlor*]_ _

22.2-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal:

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

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II. POUROVER WILL

§22.3 A. Purpose of Pourover Will

A pourover will generally transfers all, or at least most, of a decedent's nontrust assets to a revocable trust. The pourover will serves several important functions: First, it minimizes the risk of disputes over the status and sufficiency of inter vivos transfers to the trust because the supposedly transferred property will be distributed under the terms of the trust in any event. Second, it simplifies the postdeath collection of property that was not transferred to the trust—often including tangible personal property and property that was inadvertently never transferred to the trust. Often, the trustee can collect such assets without probate, using such procedures as the Prob C §§13100-13101 affidavit far more easily than would be possible if multiple beneficiaries had to participate in order to meet the collection requirements. Third, the pourover will assures proper distribution of the estate even if there was a virtually complete failure to fund the trust during life.

A transfer by will to a trust is valid under the Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303) even if the trust is revocable and amendable and even if the trust is in fact amended after the will is executed. The trust must be executed before or concurrently with the will. Prob C §6300.

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§22.4 B. Savings Clause If Direct Devise to Trust Is Ineffective

If the trust is revoked or otherwise terminated before the testator's death, the pourover gift will fail unless the will (or a codicil to the will) provides otherwise. Prob C §6300. Most drafters provide in the will that if the devise to the trust fails, the testator's assets will nevertheless be distributed in the same manner as stated in the trust document. This precaution is advisable for two reasons: First, with married settlors, it is necessary to consider the possibility that one settlor will revoke the trust unilaterally—possibly after the other settlor is no longer competent. Unless the competent settlor has a power of appointment, such a revocation might be necessary if the competent settlor wishes to change the disposition of that settlor's own share of trust property in response to the other settlor's incapacity. See chap 7. Second, there is always a risk, albeit usually remote, that a settlor will initially fund a trust but later take actions that result in no assets being put in the trust, thereby providing circumstantial evidence of a revocation. In either situation, a backup arrangement that preserves the intended disposition in all events will deter arguments over disposition of the settlor's property. The will provision may take either of two approaches:

- The will may provide that if the direct devise to the trust fails for any reason, distribution will be made in accordance with the alternative distribution provisions in the will. Those provisions then provide for the same distributions as in the trust.
- The will may incorporate by reference the trust *documents* as they exist on the date of the will (or last codicil containing the incorporation provision) and may provide that, if the direct devise to the trust fails for any reason, the estate will be distributed to the trustee named in the documents for administration as provided in the documents.

Both approaches require updating the will whenever a significant change in the trust is made. Although many states, including California, will probably recognize the validity of later amendments to a trust document incorporated by reference, the direct devise to the trust will probably not fail in those states in the first place if the will provides that the devise is to be valid despite revocation. See the Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303); Uniform Probate Code §2-511. Some states have nonuniform statutes that accomplish the same result.

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 form of pourover clause containing both alternatives is provided in §22.5. A complete sample pourover will taking the first approach with a slightly different disposition clause is provided in §22.6.

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Source: Estate Planning/Drafting California Revocable Trusts/22 Related Documents/§22.5 C. Form: Disposition of Residue to Trust

§22.5 C. Form: Disposition of Residue to Trust

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22.5-1 Disposition of residue to trust

I give the residue of my estate to the trustee of the revocable trust established by me and known as _ _[*name of trust*]_ _ **then in office of the trust identified below, to be held and administered by the trustee according to the trust's terms and conditions, including, without limitation, any amendment made to it before my death. This gift shall be made regardless of whether that trust is revoked during my lifetime.**

[*Add one of the following alternatives*]

[*Alternative 1: Mirror-image trust provision*]

If for any reason the gift to my trust is not valid, I give the residue of my estate to _ _[*name*]_ _**, as trustee, to be held, administered, and distributed as follows:** _ _[*Specify provisions of "backstop" trust.*]_ _

[*Alternative 2: Incorporation of trust terms by reference*]

If for any reason the gift to my trust is not valid, I hereby incorporate by reference the documents containing the terms of the trust that exist on this date and give the residue of my estate to the trustee named in those documents, to be held, administered, and distributed according to the provisions of those documents.

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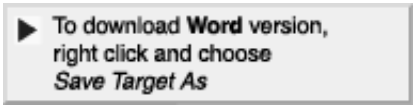
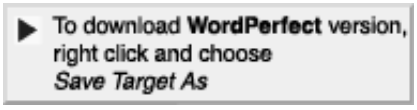
Source: Estate Planning/Drafting California Revocable Trusts/22 Related Documents/§22.6 D. Form: Sample Pourover Will

§22.6 D. Form: Sample Pourover Will





22.6-1 Sample pourover will

WILL of
_ _[*Name of testator*]_ _

DIVISION I

DECLARATIONS

I, _ _[*name of testator*]_ _, a resident of _ _[*name of county*]_ _, California, declare this to be my will. I have also been known as _ _[*other name*]_ _.

I revoke all wills and codicils that I have previously made.

I am married to _ _[*name of spouse*]_ _, to whom the term "my spouse" refers in my will.

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. The above birthdates are conclusive for all purposes under my will. I have no deceased children.

DIVISION II

DISPOSITION OF ESTATE

Paragraph A. Gift of Personal Property

***1. Gift to Spouse*. 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 spouse if my spouse survives me by 30 days.**

***2. Successor Gift to Children*. If my spouse does not survive me, 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.**

***3. Division by Executor*. If my children are unable to 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.**

***Paragraph B. Disposition of Residue to Trust*. 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*]_ _.

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*]_ _.

DIVISION III

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.

DIVISION IV

POWERS OF EXECUTOR

***Power to Sell Estate Assets*. My executor may sell, 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.**

***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.**

***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.**

***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.**

DIVISION V

PAYMENT OF ESTATE TAXES

The trustee of the _ _[*name and date of trust*]_ _ is directed by its terms to pay all estate and inheritance taxes, generation-skipping transfer taxes, Internal Revenue Code §2032A recapture taxes, and interest and penalties on such taxes attributable to assets passing under or outside my will. If at my death that trust does not exist or is unable to pay all the death taxes, the trustee of the testamentary trust created by the provision of this will relating to disposition of the residue shall pay the taxes.

DIVISION VI

NO-CONTEST CLAUSE

If any beneficiary under my will in any manner, directly or indirectly, contests my will or any of its provisions in any legal proceeding that is designed to thwart my wishes as expressed in my will, any share or interest in my estate given to that contesting beneficiary under my will is revoked and shall be disposed of under the terms of my will as if that contesting beneficiary had predeceased me without issue.

DIVISION VII

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.

We believe that the testator is 18 or more years of age, is of sound mind, and is under no constraint or undue influence.

_____	_____	_____
Signature of witness	*Signature of witness*	*Signature of witness*

We declare under penalty of perjury 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: This sample document is intended only as a drafting guide. It is based on California Will Drafting, App D (3d ed Cal CEB 1992). Before preparing a pourover will, the drafter should refer to the text of that book.

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III. DURABLE POWER OF ATTORNEY

§22.7 A. Coordinated Use of Revocable Trust and Durable Power of Attorney

A revocable trust does not provide a complete solution for managing the settlor's property in the event of incompetence. The trustee, as such, has the power only to manage trust assets. Some assets, such as pension benefits and individual retirement accounts, cannot be transferred to a trust before the benefits are actually payable to a named beneficiary. There is also a risk that the settlor will acquire property at a future time after becoming incompetent. In addition, the trustee as such usually cannot accomplish various personal tasks, such as signing tax returns, settling tax disputes, or filing personal injury lawsuits.

Thus, it is very desirable for the settlor to execute a durable power of attorney that, *at a minimum,* will permit the agent to transfer the settlor's property to the trust and to perform a limited variety of personal tasks. For a comprehensive discussion of powers of attorney, see California Powers of Attorney and Health Care Directives (Cal CEB 2008).

When a revocable trust estate plan includes a power of attorney, several coordination issues arise as a consequence of the fact that the settlor will have executed two documents, both of which purport to confer powers to manage property.

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§22.8 1. Selecting Agent

In most cases involving the combined use of a revocable trust and a power of attorney, the persons named as agents and successor agents under the power of attorney should be the same persons named as the trustees of the trust. This precaution minimizes the risk of disputes between the agent and the trustee. In a few instances, it will be desirable that the agent be someone other than the trustee, particularly if the trust has a corporate trustee. Further, it may be desirable to name a different person as agent when drafting a durable power that confers powers to make gifts rather than merely property management powers.

If the agent is someone other than the trustee, and a trust is to be fully funded, it is usually desirable to provide in the power that the trust is the primary property management device. A power of attorney document can also be used to nominate a conservator of the person, the estate, or both. Prob C §4126. Although a conservator is seldom needed when a properly designed revocable trust estate plan includes a power of attorney, unhappy family members sometimes seek appointment as a conservator of the estate in order to exert influence over the trustee. Nominating the trustee as the conservator can hinder such attempts because the nominee of a proposed conservatee has priority over other persons seeking to be appointed as conservator unless the court finds that the appointment of the nominee is not in the proposed conservatee's best interests. Prob C §1810.

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§22.9 2. Springing Powers Versus Immediate Powers

A durable power may take effect immediately on execution or on the occurrence of a future event—such as incompetence. A power that takes effect at a later time is a "springing" power. Prob C §4030. Clients vary greatly in their willingness to appoint agents who can act on their behalf. The drafter of a revocable trust will usually have addressed client concerns of this type in the provisions of the trust that provide for the determination of the settlor's incapacity. Most power of attorney provisions concerning competence mirror those of the trust. Probate Code §4129 expressly provides for designating the persons who can establish that the event has occurred that will activate a springing power.

Some practitioners prefer an immediately effective power of attorney for the specific power to transfer the settlor's assets to the trust. Because there is little risk of abuse of such a power, even the most wary settlor is usually willing to permit an agent to hold the power without a determination that the settlor is incompetent.

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§22.10 3. Scope of Powers

At a minimum, a power of attorney executed in connection with a revocable trust estate plan should permit the agent to transfer property to the trust, file tax returns, settle tax controversies, receive tax refunds, apply for and receive social security and other government benefits, and apply for and receive insurance benefits. Government agencies may not honor the power of attorney per se, but are likely to do so indirectly. The Social Security Administration, for example, will probably appoint the agent/trustee as the settlor's "representative payee." See §1.35.

Settlors are generally willing to grant a general power of attorney, at least on a springing basis. A general power of attorney reduces the risk that appointment of a conservator might be necessary in order to accomplish some necessary action.

It is sometimes appropriate to authorize the agent to take action regarding trust property. For example, the agent may have the power to make gifts and may need to remove funds from the trust in order to do so. It may also be appropriate to permit the agent to exercise much broader powers over the trust, which may include the power to amend the trust. If so, the drafter should be cognizant of Prob C §15401(c), which provides that an attorney-in-fact cannot modify or revoke a trust unless the action is authorized in the *trust* itself. For further discussion and a suggested form, see §20.2.

Moreover, Prob C §4264 provides that:

> A power of attorney may not be construed to grant authority to an attorney-in-fact to perform any of the following acts unless expressly authorized in the power of attorney:
> (a) Create, modify, or revoke a trust.
> (b) Fund with the principal's property a trust not created by the principal or a person authorized to create a trust on behalf of the principal.
> (c) Make or revoke a gift of the principal's property in trust or otherwise.
> (d) Exercise the right to make a disclaimer on behalf of the principal. This subdivision does not limit the attorney-in-fact's authority to disclaim a detrimental transfer to the principal with the approval of the court.
> (e) Create or change survivorship interests in the principal's property or in property in which the principal may have an interest.
> (f) Designate or change the designation of beneficiaries to receive any property, benefit, or contract right on the principal's death.
> (g) Make a loan to the attorney-in-fact.

In addition, powers to do such things as create a revocable trust do not necessarily authorize the agent to change the persons entitled to the principal's property on the principal's death. *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285.

For a complete discussion of DPOAs, including drafting tips and sample forms, see California Powers of Attorney and Health Care Directives, chaps 4-6 (Cal CEB 2008).

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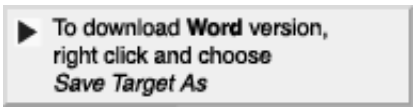
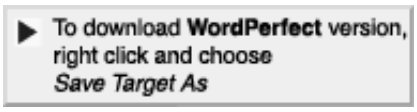
Source: Estate Planning/Drafting California Revocable Trusts/22 Related Documents/§22.11 B. Form: Durable Power of Attorney

§22.11 B. Form: Durable Power of Attorney





22.11-1 Power of attorney

GENERAL DURABLE POWER OF ATTORNEY

I, _ _[*name of principal*]_ _, residing at _ _[*address of principal*]_ _, hereby appoint my _ _[*describe relationship*]_ _, _ _[*name of agent*]_ _, who resides at _ _[*address of agent*]_ _, as my attorney-in-fact, with the power to perform on my behalf any act whatsoever that I may lawfully perform through an attorney-in-fact. In the event that the agent fails to qualify, resigns, or ceases to act, then my _ _[*describe relationship*]_ _, _ _[*name of alternate agent*]_ _, who resides at _ _[*address of alternate agent*]_ _, shall become the attorney-in-fact under this instrument with the same powers.

[*Use one of the following alternatives*]

[*Alternative 1: Effective immediately*]

This power of attorney is effective immediately and shall not be affected by the principal's subsequent incapacity.

[*Alternative 2: Effective on incapacity (springing power)*]

This power of attorney shall become effective on the principal's incapacity.

[*If appropriate, add the following option to Alternative 2*]

[*Option: Designated person has power to determine incapacity*]

In accordance with California Probate Code §4129, I designate _ _[*name of designee*]_ _ of _ _[*address of designee*]_ _, as the person who, by a written declaration under penalty of perjury, shall have the power to determine conclusively that my incapacity has occurred.

[*Continue*]

IN WITNESS WHEREOF, the principal has signed this durable power of attorney on _ _[*date*]_ _, at _ _[*city*]_ _, California.

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

[*Acknowledgment; see form 22.2-2*]

[*Continue*]

The undersigned acknowledges and accepts appointment as agent and agrees to serve as agent under this _ _[*springing*]_ _ durable power of attorney.

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

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IV. CERTIFICATE OF INDEPENDENT REVIEW

§22.12 A. Purpose of Certificate of Independent Review

California law imposes special requirements in connection with documents that make donative transfers to persons who are identified as "disqualified persons." Prob C §§21350-21356. Under Prob C §21350, the following persons may be "disqualified persons" unless an exception applies:

- The "drafter" of the transfer document;
- Persons and entities closely related to the "drafter," including close relatives, cohabitants, and business associates;
- Conservators and other persons having a fiduciary relationship with the transferor who transcribes the document or causes it to be transcribed; and
- Care custodians of a transferor who is a dependent adult.

If a trust benefits a person who may be a disqualified person, the transfer may fail unless the settlor is counseled by an independent attorney who executes a "Certificate of Independent Review." The form for this certificate is set forth in Prob C §21351(b) and §22.13. For a more detailed discussion of the disqualified person statute, see §5.18A. For a discussion of problems that arise when a disqualified person is named a trustee and an appropriate form of certificate of independent review to be used in that situation, see §§5.14-5.15.

NOTE: 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 the list of 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 care giver is uncertain. As of this writing, the Trusts and Estates Section of the State Bar of California was considering recommending legislation that would amend the statute to expressly permit the drafter to execute the certificate in such a case. Unless and until such legislation is enacted, it is recommended that the certificate be executed by an attorney other than the drafter and independent of the drafter.

Under Prob C §21351(b), an attorney and client can agree in writing that the scope of the engagement is limited solely to the preparation of the certificate. Presumably such an agreement would avoid attorney liability for unrelated mistakes in the document being reviewed.

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Source: Estate Planning/Drafting California Revocable Trusts/22 Related Documents/§22.13 B. Form: Certificate of Independent Review

§22.13 B. Form: Certificate of Independent Review

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

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

22.13-1 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.

Date: _ _ _ _ _ _

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

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23

Multistate Trusts

Joseph L. Wyatt, Jr.
Patrick R. McCabe

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I. PLANNING AND DRAFTING MULTISTATE TRUSTS

§23.1 A. Role of Conflicts in Multistate Trusts

This chapter discusses the principles of conflict of laws as they relate to revocable trusts in §§23.2-23.5 and applies those principles to a hypothetical case described in §23.6. The law relating to testamentary trusts differs in many respects, because the settlors' domicile at death is of much greater importance. On the need to use out-of-state counsel, see §23.7. General rules applicable to trusts are discussed in §§23.8-23.41. Special problems of multistate trusts are discussed in §§23.42-23.71.

This chapter discusses conflict-of-laws problems of United States domestic revocable trusts. Conflict-of-laws problems involving trusts with assets outside the United States are not covered. For a treatment of problems relating to the recognition of trusts in civil law jurisdictions that traditionally have not recognized the Anglo-American trust as a juridical institution, see Hendrickson & Silverman, Changing the Situs of a Trust, chap 11 (1982).

Besides conflict-of-laws problems, numerous tax problems may be created by a multistate trust. See §§23.72-23.103, discussing potential multiple state imposition of death, gift, income, and property taxes and planning possibilities. An awareness of the differences in applicable tax laws can help to minimize tax problems and to reduce taxes payable by these trusts. For a comprehensive checklist, see §23.104.

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§23.2 B. Conflict-of-Laws Problem

An individual's estate plan presents potential conflict-of-laws problems whenever the laws of two or more jurisdictions may affect the plan. Common examples include:

- A husband and wife (separately or together) own property located in more than one state.
- The client resides in one state, and the trustee of the client's trust resides in another state.
- The donee of a power of appointment resides in one state, and the donor of the power (or the trustee) resides in another state.
- The donee or the donor of a power of appointment resides in one state and the appointees reside in another state or states.
- A client has residences in two or more states.

In planning a multistate trust, the attorney must determine which conflict-of-laws problems might arise concerning validity, construction, administration, and taxation of the trust and which jurisdiction will decide these matters.

The choice of law applicable to these problems depends on such factors as the character of the property, the relationship of the parties involved, or a state's interest in the subject matter. Furthermore, different states may have different jurisdictional rules regarding which forum should decide disputes on any of the foregoing matters.

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§23.3 1. Continuing Change in Conflict-of-Laws Theories

Although this chapter sets out the general rules for solving choice-of-law problems, the practitioner should remember that the law on this subject is unsettled. In the conflict-of-laws arena, the cases are sometimes "rather unsatisfactory," the statutes are "ambiguous," and many problems are untouched by either case or statute. 7 Scott & Ascher on Trusts §46.9 (5th ed 2010). In addition, there has been a shift in choice-of-law theories from the "territorial location of vested rights" approach (Restatement of Conflict of Laws (1934)) and the "most significant relationship" approach (Restatement (Second) of Conflict of Laws (1971)) to the "governmental interests" test (Currie, Selected Essays on the Conflict of Laws (1990), criticized in Juenger, Selected Essays on the Conflict of Laws (2001)) and the "considerations" approach (McDougal, Felix, Whitten & Leflar, American Conflicts Law (5th ed 2001)).

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§23.4 2. Application of Interest-Analysis Theory

In resolving a conflict-of-laws problem by using the interest-analysis approach, the discrete interests of the litigants and each state involved are considered, and the law of the state with the greater interest in the issue, rather than the law of the situs, may be applied. Interest analysis assumes that states have special interests in litigation affecting persons domiciled or residing in that state.

California has generally adopted the interest-analysis principle in resolving conflict-of-laws questions. See *Offshore Rental Co. v Continental Oil Co.* (1978) 22 C3d 157, 163, 148 CR 867. But see Prob C §21103 (directing construction of instrument according to state law selected by transferor unless contrary to surviving spouse's community or quasi-community property rights or other public policy); *Wong v Tenneco, Inc.* (1985) 39 C3d 126, 216 CR 412 (applying principle of comity to choice-of-law question, in a decision criticized in Sprague, *Choice of Law: A Fond Farewell to Comity and Public Policy*, 74 Cal L Rev 1447, 1469, 1475 (1986) for not using interest analysis to reach same result).

Applying the interest-analysis theory to trusts, however, may mean that the policy that favors giving effect to the settlors' intentions also favors resolving choice-of-law problems by looking to the law of any state substantially related to the transaction that will validate the intended disposition. See, *e.g., Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228; 1 Nossaman & Wyatt, Trust Administration and Taxation §10.03 (rev 2d ed 1966). California trust law gives extensive deference to the same policy of giving effect to the settlors' intentions. See, *e.g.,* Prob C §§16000 (duty to administer according to trust instrument), 21102(a) (intention of transferor controls disposition under any instrument). See form in §23.5.

Therefore, the drafter must meticulously draft a multistate living trust to anticipate and prevent any conflict-of-laws problems. If possible, potential problems should be reduced or eliminated by concentrating substantially all of the trust elements in one state.

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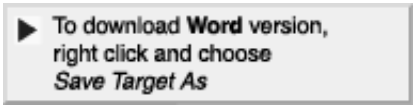
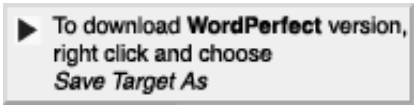
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.5 3. Form: Trustee May Apply Principle of Validation

§23.5 3. Form: Trustee May Apply Principle of Validation





23.5-1 Trustee may apply principle of validation

***Principle of Validation*. In administering this trust and construing its provisions, the trustee (and any court considering the matter) shall look to the law of any state related to the trust, any transaction involved, or persons involved that will validate the intended disposition or other transaction should any conflict between the laws of any jurisdictions arise. It is my overall intent to create a valid trust with valid disposition of its assets.**

Comment: If it is not possible to concentrate all of the trust elements in one state, this clause may be used. It specifically tracks the principle of validation set forth in *Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228. See §23.4.

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§23.6 C. Hypothetical Case: The Jones Trust

Robert Jones, a 65-year-old married man, is an executive of a New York corporation. He lived and worked in New York until 5 years ago, when he was transferred to the corporation's Los Angeles office. He often travels to New York City on business for prolonged periods, and while in New York City occupies an apartment in a building that he owns. He has family, friends, a club, and church affiliations in New York City and Los Angeles. He has two adult married children (one son, one daughter), both residents of New Jersey, and one adopted minor grandchild, adopted by his daughter and son-in-law.

Robert's assets, all of which are in his name alone, and the source of the funds used to acquire them are as follows:

Assets	*Source*
New York apartment building (unencumbered)	Funds inherited from father
Los Angeles home (unencumbered)	New York earnings after marriage
Oklahoma oil interests	California earnings after marriage
Securities in New York brokerage account	New York earnings after marriage

Robert wishes to give his wife only that share of his estate to which she is entitled by law (see §§23.47-23.50), to leave his securities in trust for a nonprofit New York hospital for 10 years, and to leave the remainder of his estate in a discretionary trust for the benefit of his two children, giving them a testamentary power of appointment over the trust corpus exercisable in favor of their issue. Robert would like to name a New York bank as trustee and to give his children the right to select a cotrustee to act with the bank after his death.

If Robert leaves his property by a will that includes a testamentary trust, several conflict-of-laws problems are presented. It is necessary to have probates of Robert's will in New York and California, and possibly in Oklahoma if the oil interests are considered to be real rather than personal property under Oklahoma law. For the inconsistent language of state and federal decisions on whether Oklahoma oil interests are treated as real or personal property, see 1 Williams & Meyers, Oil & Gas Law §214.2 (1959). In addition, several testamentary trusts may be necessary because of the multistate properties. The proper state to administer Robert's estate is also in question, because his legal residence may be in California or New York—or both. For discussion of multiple domiciles, see §23.78.

A common method of avoiding multiple probate administrations and multiple testamentary trusts is to establish a revocable trust that provides for disposition of assets on the client's death. The assets can be either distributed outright or held in trust in accordance with the client's desires. Robert decided to transfer his assets to a revocable trust for his benefit during his lifetime. On his death, his wife will receive the interest accorded to her by law (see §§23.50, 23.53, 23.57), and the remainder will be retained in trust for the benefit of the New York hospital and Robert's children.

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§23.7 D. Use of Out-of-State Counsel

When multiple states are involved, it is essential to have local counsel in each state review the trust and its plan of operation to ensure (1) conformity with local law or practice and (2) that both counsel may discover and resolve issues arising in their respective jurisdictions and any conflicts between them. See Schoenblum, Multistate and Multinational Estate Planning (2d ed 1999), discussing problems of professional responsibility, unauthorized practice of law in a foreign jurisdiction, malpractice in advising on foreign law, retention of foreign counsel, and methods of dealing with these problems. See also California Estate Planning, chap 16 (Cal CEB 2002); Wyckoff, *Multijurisdictional Estate Plans Including Foreign Trusts*, 51 NYU Inst Fed Tax, chap 28 (1993).

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II. GENERAL RULES ON VALIDITY, CONSTRUCTION, INTERPRETATION, AND ADMINISTRATION OF TRUSTS

§23.8 A. Analyzing Conflicts of Laws in Terms of "Characterization"

The process by which conflict-of-laws problems have been analyzed has been defined by some scholars as "characterization." See Hess, Bogert & Bogert, The Law of Trusts and Trustees §293 (3d ed 2000). This terminology has been adopted to some degree by the courts. See, *e.g., Grant v McAuliffe* (1953) 41 C2d 859, 865, 264 P2d 944; *Estate of Victor W. Richman,* TC Memo 1994-421.

The characterization most frequently recognized in the choice-of-law process in trust matters is classification between matters of validity, construction, or administration and whether the trust assets involved are to be treated as real or personal property. Thus, the analysis of a trust problem potentially raises three major issues:

- *Validity.* Is a valid trust created, or is a particular clause valid?
- *Construction and interpretation.* What is the meaning of a particular clause of the trust in particular circumstances?
- *Administration.* What are the rights and duties of the trustee and the rights of the beneficiaries and other interested parties, such as the creditors of the settlors or the spouses of beneficiaries?

Other characterization issues may relate to the basic determination of whether the matter involved is a trust (as distinguished from a tort, contract, or other element of the law) and whether the applicable rules are substantive or procedural. Answers to any of these questions may affect the resolution of conflict-of-laws issues.

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§23.9 1. Questions of Validity

Questions of validity include technical problems (such as compliance with formal requirements and the parties' legal capacity, *e.g.,* who may act as trustee) and substantive problems (such as the rights of a spouse, children, or certain creditors of the settlors or of certain beneficiaries); the purpose of the trust; and compliance with local rules of law (such as rules against perpetuities, accumulations, testamentary disposition requirements, and limitations on charitable gifts). See §§23.12-23.17.

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§23.10 2. Questions of Construction and Interpretation

Questions of construction and interpretation relate to the actual meaning of the words used in the trust instrument, the settlors' intent, gaps in the instrument, the legal effect of technical terms (*e.g.,* "heirs at law" and "lawful issue" (see §23.37)), and whether an interest is vested or contingent. Sometimes ambiguities arise because legal language means different things in different states—the state where the trust was drafted versus the state where it is now being administered or enforced. See §§23.18-23.21.

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§23.11 3. Questions of Administration

Questions of administration include all matters dealing with operation of the trust. For the trustee, these may include:

- Powers of sale, mortgage, and investment of trust assets;
- Allocation and payment of principal and income;
- The obligation to account to the beneficiary, to invest and manage the trust estate with prudence, and to make prompt and correct distribution under the terms of the trust;
- Liability for breach of any of the duties described above and the effect of various exculpatory clauses;
- Compensation; and
- Resignation and appointment of successor trustees.

Failure to define in detail the trustee's administrative powers leaves the scope of these powers to be determined by state law. This is not desirable. If the estate plan affects more than one state, the governing law state must be determined. See §§23.22-23.28.

Additional questions of administration involve the beneficiary's right to assign his or her interest or terminate the trust, a creditor's right to reach a beneficiary's interest, and the settlors' rights to revoke the trust. The latter is a special problem for trusts with a California contact, in view of Prob C §15400, which provides that all trusts are revocable by the settlors unless expressly stated to be irrevocable in the trust instrument. For discussion of revocability, see §23.36.

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§23.12 B. Validity of Trust

When establishing a trust, it is essential to know which state's law governs the validity of the trust. This is usually determined by the nature of the trust property, *i.e.,* whether it is an interest in real property, personal property, or both. (Although the terms "movables" and "immovables" are generally used in the field of conflict of laws, the terms "personal property" and "real property" will be used in this chapter.)

In the hypothetical Jones trust described in §23.6, the execution of the trust, the naming of a trustee, the rights created for the benefit of Robert's wife and children, the charitable gift, and any accumulation and perpetuities clauses are all governed by the law of the state that determines the validity of the trust.

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§23.13 1. Validity of Real Property Trust

If a trust includes only real property and tangible personal property with a permanent situs, the traditional rule is that the law of the situs governs the validity of the trust. Other factors, such as the settlors' intentions regarding the law to be applied, the place of administration of the trust, and the domicile of the settlors, beneficiaries, and trustee are usually considered to be immaterial. Thus, in California, "[r]eal property within the State is governed by the law of this State, except where the title is in the United States." CC §755. See *Estate of Patterson* (1980) 108 CA3d 197, 208, 166 CR 435 (probate sale of California property in ancillary administration of Maryland decedent's estate governed by California law). Compare *Estate of Patmore* (1956) 141 CA2d 416, 419, 296 P2d 863 (surviving spouse's right to take Kansas real property by election against will determined by Kansas law) with *Campbell-Kawannanakoa v Campbell* (1907) 152 C 201, 92 P 184 (trust under Hawaii decedent's will funded with California land violated California law and was held void).

In the hypothetical Jones trust described in §23.6, application of the traditional situs rule means testing the validity of the trust under the laws of New York, California, Oklahoma, and New Jersey.

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§23.14 2. Equitable Conversion of Real Property

If the trust instrument includes a direction for sale of real property and reinvestment in personal property or real property situated in another state, the law of that state may determine the validity of the trust if it does not violate public policy of the situs state. See *Estate of Dunphy* (1905) 147 C 95, 81 P 315 (trust holding Nevada real property, with direction to sell property and reinvest proceeds in California real property, was considered to be trust of California real property under doctrine of equitable conversion).

Under the traditional conflict-of-laws approach, the trustee's sale of real property and reinvestment in personal property does not prevent the law of the situs of the real property from determining the validity of the trust. This rule may not be applied in the future, however, because of the changing conflict rules and the courts' tendency to apply the law of a state related to the trust that will uphold the validity of the trust. See §§23.3-23.4.

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§23.15 3. Validity of Personal Property Trust

The validity of a trust of intangible or tangible personal property is determined by the law of the state designated by the settlors as long as it has a substantial connection with the trust and does not violate any strong public policy of the state having the most significant relationship to the trust on the matter at issue. See Prob C §21103.

Important factors in determining the most significant relationship are:

- The place where the trust property is kept;
- The place of administration;
- The place where the trust was created;
- The settlor's domicile when the trust was created; and
- The trustee's and beneficiaries' domiciles.

The general tendency is to apply the law of whatever state will uphold the validity of the trust, presuming that the law best upholds the settlors' intent. Restatement (Second) of Conflict of Laws §270, Comment d (1971). See *In re Griswold's Trust* (Sup Ct 1950) 99 NYS2d 420 (court applied New Jersey law to uphold validity of trust with contacts in New York, New Jersey, and Rhode Island).

When the trust may be invalid under the law of one jurisdiction, however, and the trust expressly states that validity is to be determined under the law of a new place of administration, this clause may be given effect in view of the tendency of the courts to uphold the validity of a trust whenever possible. See §23.4. A form retaining the original law generally, while applying the law of the new situs to administrative matters, is included in §23.39 as Alternative 3.

PRACTICE TIP: New York has enacted a statute relating to the validity of multistate trusts. See NY Est Powers & Tr L §7-1.10 (New York law governs the validity, effect, and interpretation of a trust created by a nonresident who holds personal property located within or outside New York when the instrument designates New York law as the governing law and appoints a New York trustee; New York law governs a trust of any property situated in New York when the trust is created, if the instrument so provides, even if the trustee is not a resident of New York). This statute governs the hypothetical Jones trust described in §23.6, except for foreign real property, if New York law is specified as the governing law.

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§23.16 4. Validity of Real and Personal Property Trust

If a trust includes both real and personal property, the applicable law is uncertain because of the changing conflict-of-laws principles and the traditional rule that the law of the situs of real property governs the validity of a trust of real property. See §§23.13-23.14.

Until the law is more certain, it seems advisable, in a multistate trust of real and personal property, to include a clause designating the law of each situs state to determine the validity of the trust of real property within the state and the law of a state with a substantial connection with the trust, which does not violate strong public policy of a related state, to determine the validity of the trust of personal property. For appropriate trust clauses, see §§23.39-23.40.

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§23.17 5. Determining Character of Trust Property

Sometimes the character of trust property may create a question about which law governs the validity of the trust. Leasehold interests, oil interests, or notes secured by encumbrances on real property may be considered real property in some states and personal property in others. The law of the situs of the property generally determines whether trust property is real or personal property. Hendrickson, Interstate and International Estate Planning §6.5 (1968).

In the hypothetical Jones trust described in §23.6, it is necessary to examine carefully the nature of the oil interests and determine whether they are considered real or personal property under Oklahoma law. Although the oil interests may be considered real property by Oklahoma in determining the validity of the trust, they may be considered personal property by other states for other purposes (*e.g.,* income or inheritance taxation). See §§23.77, 23.95.

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§23.18 C. Interpretation and Construction of Trust

The settlor can generally designate the law of any state to apply to interpretation and construction of a trust, regardless of the amount of contact between the trust and the designated state, if the law selected is not contrary to the public policy of a state having a close connection with the trust. 7 Scott & Ascher on Trusts §46.3 (5th ed 2010); Restatement (Second) of Conflict of Laws §277 (1971).

In the hypothetical Jones trust described in §23.6, problems of interpretation and construction can be solved by expressly stating in the trust instrument that the law of New York, the trustee's place of business, applies to the interpretation and construction of the instrument. See Alternative 1 in §23.39.

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§23.19 1. Construction of Real Property Trust

For trusts consisting only of real property, when the settlors have not designated a particular law, the law of the situs of the real property generally determines interpretation and construction problems. See *Hutchinson v Hutchinson* (1941) 48 CA2d 12, 119 P2d 214 (California court applied Illinois law to determine validity and interpretation of trust holding Illinois real property). The courts of the situs state, however, may apply the law of the settlors' domicile to determine certain questions, such as the extent of a beneficiary's interest. Restatement (Second) of Conflict of Laws §227, Comment c (1971); 1 Nossaman & Wyatt, Trust Administration and Taxation §11.02 (rev 2d ed 1966).

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§23.20 2. Construction of Personal Property Trust

Questions of interpretation and construction of trusts of personal property are usually determined by the law of the state having the most substantial contact with the trust. This may be the domicile of the settlors when the trust was created, the trustee's or beneficiaries' domicile, the situs of the trust property, the place of administration, or the place where the trust was created. See CC §946 (personal property governed by law of "owner's" domicile). When the question of construction relates to administration of the trust, the construction issue often is governed by the same law that governs administration of the trust. See Land, Trusts in the Conflict of Laws 183 (1940). On administration of the trust, see §§23.22-23.26.

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§23.21 3. Construction of Real and Personal Property Trust

In mixed trusts, when a choice-of-law clause has been omitted, the court may apply the law of the situs of the real property, the place of administration, or the state having substantial contact with the trust. In the leading case of *Cary v Carman* (Sup Ct 1921) 190 NYS 193, the court applied the law of Massachusetts—the settlor's, trustee's, and beneficiaries' residence when the trust was created—to determine the meaning of the term "heirs at law," even though the real and personal property of the trust was in New York, the last beneficiary to die was a resident of New York, and it was her "heirs at law" who were the subject of the suit. For appropriate trust clauses, see §§23.39-23.40.

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§23.22 D. Administration of Trust

The law that applies to questions of trust administration depends on the nature of the trust property, because the rules applicable to trusts of real property (see §23.23) differ from those applicable to trusts of personal property (see §§23.24-23.25). Sometimes, when the trustee has mismanaged or repudiated the trust, administrative matters may be determined by the court of a state that has jurisdiction over the person of the trustee. See *Starr v Berry* (NJ 1958) 138 A2d 44 (court found New Jersey to be proper forum for trial of mismanagement allegations but did not decide whether it would apply its own law or law of situs state). On change in governing law when there is a change in the place of administration, see §§23.26-23.28. On jurisdiction generally, see §§23.29-23.34.

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§23.23 1. Administration of Real Property Trust

The law of the situs generally determines administrative matters of real property trusts. In *Hardy v Hardy* (1958) 164 CA2d 77, 330 P2d 278, the California court applied Illinois law to determine whether the Illinois real property interest of a California resident in a spendthrift trust could be reached for payment of costs and attorney fees in a California divorce action. The settlors' intent regarding the applicable law may, however, govern on administrative matters that are not contrary to public policy of the situs state. See Land, Trusts in the Conflict of Laws 242 (1940); Restatement (Second) of Conflict of Laws §279, Comment b (1971).

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§23.24 2. Administration of Personal Property Trust

In trusts holding personal property, the settlors may designate the law of any state to apply to administrative matters having no element of public policy (*e.g.,* the trustee's commissions or permissible investments), even if that state has no connection with the trust. On matters that may affect public policy (*e.g.,* alienability of beneficiaries' interests or exculpatory clauses), only the law of a state that has substantial contact with the trust may be designated. 7 Scott & Ascher on Trusts §45.2.1 (5th ed 2010).

The trustee's domicile is usually the place of administration, but other factors also may be considered, *e.g.,* the settlors' domicile when the trust was created, the place of execution of the trust, the situs of the trust property, the purpose of the trust, or the beneficiary's domicile. See Land, Trusts in the Conflict of Laws 231 (1940).

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§23.25 3. Administration of Real and Personal Property Trust

When the trust includes both real and personal property, the law of the situs of the real property may control administration of the entire trust if the state has other close contacts with the trust. Without these contacts, the law of the situs may apply only to administrative matters relating to real property, and the law of another state having a substantial contact with the trust may apply to govern administrative matters relating to personal property. Land, Trusts in the Conflict of Laws 241 (1940). However, there is an increasing tendency to apply the law designated by the settlors to govern administrative matters of real property trusts unless it violates public policy. See §23.23.

In applying the foregoing rules to the hypothetical Jones trust described in §23.6, it appears that the settlor may designate the law of one state to govern administration of the entire trust unless the designated law violates public policy of the situs state. For example, if New York law differs from the spendthrift laws of the situs states (California and possibly Oklahoma if the oil interests are considered real property), it is questionable whether New York law applies to a California or Oklahoma creditor's rights. See §23.63, suggesting that the result may depend on which state is considered to have the most substantial contacts with the transaction.

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§23.26 4. Change in Place of Administration

Although some court decisions provide that a change in the place of administration does not change the governing law, the better rule for trusts not involving "tax-sensitive" powers seems to be to permit a change in the law governing administration when there is a change in the place of administration. See *Wilmington Trust Co. v Wilmington Trust Co.* (Del 1942) 24 A2d 309. This result is generally desirable because it enables the trustee to apply the law with which he or she is familiar and under which the trustee can act most efficiently. It also avoids the added expense and delay of employing out-of-state counsel before action is taken. For a clause providing for a change in the governing law, see §23.27.

In a marital deduction trust, however, or any tax-sensitive trust in which a nonindependent trustee (*e.g.,* a settlor or beneficiary) is acting, a change in the law of administration may result in undesirable tax consequences. The trustee's powers may be so changed that the marital deduction is lost, trust income is taxed to the trustee, or trust corpus is included in the trustee's gross estate for estate tax purposes. See IRC §§671-678, 2041, 2056-2056A; 2 Nossaman & Wyatt, Trust Administration and Taxation §§38.18[6], 38.19[8], 39A.18[3], 42A.06 (rev 2d ed 1966). For a savings clause intended to prevent such unforeseen tax consequences, see §23.28.

In the hypothetical Jones trust described in §23.6, the settlor's children (who are residents of New Jersey) may select a New Jersey corporate trustee to act on the settlor's death. The trust instrument should expressly provide whether, in this event, New York or New Jersey law governs administration of the trust. For discussion of this issue and suggested alternative clauses, see §§23.39-23.40.

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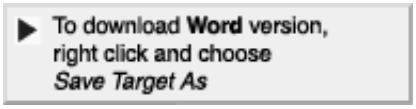
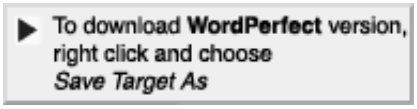
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.27 5. Form: Trust Governed by Law of Place of Administration

§23.27 5. Form: Trust Governed by Law of Place of Administration





23.27-1 Trust governed by law of place of administration

***Governing Law*. Matters concerning the administration of this trust shall be governed by the law applicable in the place of administration. The Settlor's intent is to encourage ease of administration by the trustee and to adapt administration to the local law with which the trustee is most familiar.**

Comment: This form provides for a change in the law governing administration of the trust. It should be used when it is likely that the place of administration may change. See §23.26 on possible tax consequences of this clause.

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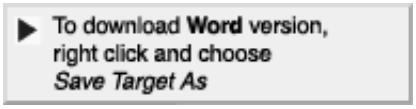
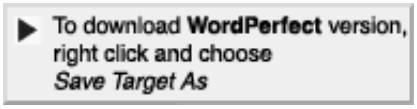
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.28 6. Form: Savings Clause for Unforeseen Tax Consequences

§23.28 6. Form: Savings Clause for Unforeseen Tax Consequences





23.28-1 Savings clause for unforeseen tax consequences

***Estate Tax Savings Clause*. Despite any of the foregoing, any _ _**[*trustee/successor trustee to the trustor-trustee*]**_ _ is specifically forbidden from holding or exercising any power as trustee (whether or not in combination with any other right or power, held as trustee or in any other capacity, and whether asserted by choice of applicable law or otherwise) that causes any part of any trust created by this instrument to be taxed to the _ _**[*trustee/successor trustee*]**_ _ on his or her death. It is not my intent to confer, and I do not in this trust confer, any such power on any _ _**[*trustee/successor trustee*]**_ _.**

Comment: This form may be used as a savings clause designed to ensure that no unforeseen estate tax consequence will occur by the operation of conflict-of-laws principles. See §23.26.

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§23.29 III. JURISDICTION TO RESOLVE VARIOUS ISSUES

Beside questions of validity, construction, and administration, questions of court jurisdiction over issues and parties must also be considered when multiple jurisdictions are involved. See 1A Nossaman & Wyatt, Trust Administration and Taxation §§34.06, 34.08-34.09 (rev 2d ed 1966) (discussing trust jurisdiction generally in federal versus state courts, and venue).

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§23.30 A. Jurisdiction to Determine Conflicting Rights and Claims to Trust Property

The court having jurisdiction of the trust res, whether real or personal property, has jurisdiction to determine conflicting rights and claims to the trust property. *McNeil v Dow* (1948) 89 CA2d 370, 200 P2d 859 (court resolved conflicting claims to real property involving constructive trust, estoppel, and failure to join indispensable parties). Equitable actions by trustees for instructions fall within this category, permitting service of summons by publication on nonresident beneficiaries. *Franz v Buder* (8th Cir 1926) 11 F2d 854; *First Trust Co. v Matheson* (Minn 1932) 246 NW 1.

When several states have equally substantial contacts with a trust of personal property, multiple assertions of jurisdiction may occur and the beneficiaries' interests may be affected by courts of one state even though the settlors have provided that a different state's law is to control. In *Cocke v Duke Univ.* (NC 1963) 131 SE2d 909 and *Davison v Duke Univ.* (NC 1973) 194 SE2d 761, the trust instrument provided that New Jersey law governed administration of the trust created by a New Jersey domiciliary. Suit was brought in North Carolina by trustees seeking to change the investments mandated by the trust. Over objections of some beneficiaries, the North Carolina court concluded that it had jurisdiction.

The jurisdiction where real property is located likewise may acquire jurisdiction over nonresident trustees in a declaratory relief action to determine interests in corpus. *Avery v Bender* (Vt 1964) 204 A2d 314. When there are multiple trustees, it may be sufficient that the court has jurisdiction over one of them. See *Schwartz v Capital City First Nat'l Bank* (Fla App 1978) 365 So2d 181 (permissible unless trustee shows that he or she cannot alone represent trust).

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§23.31 B. When Courts of Other States May Act

Although courts of the situs state have jurisdiction over a trust of real property, courts of another state will sometimes act. In *Smith v Davis* (1891) 90 C 25, 27 P 26, for example, a California court with jurisdiction over the necessary parties appointed a trustee to fill a vacancy for a trust of real property situated in Washington.

In *McElroy v McElroy* (1948) 32 C2d 828, 198 P2d 683, the trustee appeared in a California suit even though he was a resident of Oregon and the trust property was located in Oregon. The court concluded that the trustee's appearance conferred jurisdiction over the trustee to award judgment in favor of a beneficiary. See also *Estate of Knox* (1942) 52 CA2d 338, 126 P2d 108 (California court assumed jurisdiction over Illinois trustee who voluntarily appeared in action for accounting, settling account for both California and non-California trust assets).

If neither the trust property nor the trustee is within a state, however, state courts cannot exercise jurisdiction over the trust. See *Harvey v Fiduciary Trust Co.* (Mass 1938) 13 NE2d 299. See also *Hardy v Hardy* (1958) 164 CA2d 77, 330 P2d 278 (California court could not impose lien on California resident's interest in spendthrift trust of Illinois real property because lien was invalid attempt by California court to affect title to real property in another state).

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§23.32 C. When Federal Courts May Refuse Jurisdiction

When diversity jurisdiction otherwise exists, a federal court may exercise its discretion not to take jurisdiction under the doctrine of abstention, but only in certain special circumstances. Compare *Wohl v Keene* (4th Cir 1973) 476 F2d 171 (abstention reversed in diversity action seeking declaratory judgment to void settlement agreements about testamentary trusts) with *Reichman v Pittsburgh Nat'l Bank* (3d Cir 1972) 465 F2d 16 (although district court might have jurisdiction over testamentary trust litigation, dismissal of complaint affirmed under abstention doctrine because of state court's special ability to decide issues and greater administrative efficiency permitted by adjudication in court having jurisdiction over all beneficiaries).

Apart from abstention, the federal courts have applied the rule that "the court first assuming jurisdiction over property may maintain and exercise that jurisdiction to the exclusion of the other" to exclude federal courts from proceeding on state living trust matters. See *Norton v Bridges* (7th Cir 1983) 712 F2d 1156, 1165 (Wisconsin state court's jurisdiction to deal with various requests for relief held to exclude federal jurisdiction).

Note that the probate exception to diversity jurisdiction has not been applied to trusts. See *Beach v Rome Trust Co.* (2d Cir 1959) 269 F2d 367, 372 (retaining federal jurisdiction over breach of trust claims); *Barnes v Brandup* (SD NY 1981) 506 F Supp 396, 399 (following *Beach* in retaining jurisdiction over both testamentary and living trusts when Connecticut probate court did not have continuing jurisdiction over trusts); *Weingarten v Warren* (SD NY 1990) 753 F Supp 491, 494 (following *Barnes* in remainder beneficiary's action against attorney for trustee). In *Marshall v Marshall* (2006) 547 US 293, 164 L Ed 2d 480, 126 S Ct 1735, the Court held that the probate exception reserves to state probate courts the probate or annulment of a will and the administration of the decedent's estate, but does not bar federal courts from adjudicating matters outside those confines.

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§23.33 D. Validity of Choice-of-Forum Clauses

In *Hall v Superior Court* (1983) 150 CA3d 411, 197 CR 757, the court held that a choice-of-*forum* clause in a private California securities agreement was not enforceable, because the choice-of-*law* clause in the same agreement violated the Corporations Code and the public policy of California. However, a clause like the one struck down in *Hall* would presumably be upheld in a private trust if public policy is not thereby violated. See *Smith, Valentino & Smith, Inc. v Superior Court* (1976) 17 C3d 491, 494, 131 CR 374 (contract case); *America Online, Inc. v Superior Court* (2001) 90 CA4th 1, 108 CR2d 699 (contract case); *Furda v Superior Court* (1984) 161 CA3d 418, 428, 207 CR 646 (contract case distinguishing *Hall*). For a clause that may be used in a private trust, see §23.34.

Even with such a clause, a party may resist suit by raising the doctrine of forum non conveniens. See *Appalachian Ins. Co. v Superior Court* (1984) 162 CA3d 427, 440, 208 CR 627 (clause agreeing to submit disputes to "any court of competent jurisdiction" in insurance contract case did not preclude dismissal of action).

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§23.34 E. Form: Choice-of-Forum Clause

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

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

23.34-1 Choice-of-forum clause

[*Use one of the following alternatives*]

[*Alternative 1: Disputes subject to resolution in courts of specified state*]

***Choice of Forum*. It shall be a condition to acceptance of any trusteeship or any beneficial rights under this instrument that all disputes between or among beneficiaries or trustees shall be resolved, if not otherwise settled, in the courts of _ _[*name of state*]_ _.**

[*Alternative 2: Disputes subject to arbitration*]

***Choice of Forum*. It shall be a condition to acceptance of any trusteeship or any beneficial rights under this instrument that all disputes between or among beneficiaries or trustees shall be resolved, if not otherwise settled, in an arbitration conducted in _ _[*name of state*]_ _ and in accordance with its laws.**

Comment: Alternative 2 should be used if arbitration is an alternative to litigation.

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§23.35 IV. PLANNING FOR VALIDITY, CONSTRUCTION, INTERPRETATION, AND ADMINISTRATION OF TRUSTS

Apart from choice-of-law questions, the trust instrument should clearly express the settlors' intentions on the identity of the trust beneficiaries, their interests in the trust, the administration of the trust, and the ultimate distribution of the trust estate. Clarifying these issues will minimize later questions regarding the validity, construction, or administration of the trust. See the checklist in §23.104 for general planning of the trust and §§23.36-23.44 for salient points that should not be overlooked.

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§23.36 A. Revocability of Trust

The trust instrument should expressly state whether the trust is revocable, because the rules of revocability differ among the states. In California, a trust is revocable unless the trust instrument expressly states that it is irrevocable. Prob C §15400. In other states, however, a trust is presumed to be irrevocable unless the trust instrument contains a clause to the contrary. Restatement (Third) of Trusts §63 (2003); Restatement (Second) of Trusts §330 (1959); 5 Scott & Ascher on Trusts §35.1 (5th ed 2008).

The absence of a clause regarding revocability can have severe tax consequences. In *Hughes v Commissioner* (9th Cir 1939) 104 F2d 144, a California settlor was subject to gift taxes on transfer of securities to a Massachusetts trustee on the grounds that the trust was irrevocable because it was governed by Massachusetts law (the place of administration) and did not include a statement of revocability. The fact that the trust was executed in California and would have been revocable under California law was not considered controlling.

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§23.37 B. Defining Technical Terms ("Issue" and "Children")

Technical terms (*e.g.,* "issue," "children") should be carefully defined because meanings may vary from state to state. For example, in some states "issue" and "children" may include adopted children; in others, the terms may exclude them. See, *e.g.,* Prob C §6450 (defining an adopted child to be the same as a natural child for purposes of succession).

The hypothetical Jones trust described in §23.6 should state that the term "issue" includes adopted children, because a child's exercise of a power of appointment in favor of an adopted child should not be open to question under the variations in state laws.

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§23.38 C. Enforceability and Desirability of Choice-of-Law Clause

Under California law, a choice-of-law provision stating that the law of another state shall govern will be honored unless the application of that law is contrary to the rights of the surviving spouse to community and quasi-community property or to any other California public policy applicable to the disposition of such property. Prob C §21103.

WARNING: A choice-of-law clause may not be honored with regard to the administration of real property located outside California, because the law of the situs generally governs real property held in a trust. See CC §755. If the trust specifies that the law of another state applies to the validity of the trust for that real property, however, the court of the state in which the real property is located may recognize the choice-of-law clause. See *Rudow v Fogel* (Mass App 1981) 426 NE2d 155, 159.

Although no California case has specifically dealt with choice-of-law clauses in trusts, California does not have a public policy against a choice-of-law clause when otherwise appropriate. In *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 466 n4, 11 CR2d 330, the court held that the choice-of-law clause, which required that the contract be "governed by" the law of Hong Kong, was fully enforceable and applicable to claims for breach of fiduciary duties as well as to breach-of-contract claims. In *Washington Mut. Bank v Superior Court* (2001) 24 C4th 906, 103 CR2d 320, the court held that a trial court considering certification of a nationwide class action against a mortgage lender must apply the analysis in *Nedlloyd* to evaluate disputed claims that class causes of action were subject to a choice-of-law clause in a deed of trust. An agreement designating a foreign law is ineffective, however, if it violates a strong California public policy on a related issue. See *Application Group, Inc. v Hunter Group, Inc.* (1998) 61 CA4th 881, 72 CR2d 73.

Apart from these considerations of public policy, it is generally advisable for the trust instrument to include clauses specifying the law applicable to the validity, construction, interpretation, and administration of the trust. See forms in §§23.39-23.40.

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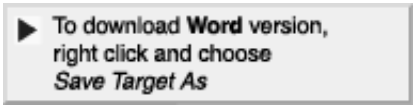
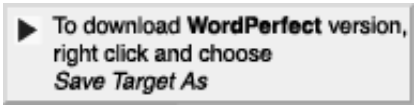
§23.39 1. Form: Choice of Law (All Real and Personal Property in One State)





23.39-1 Choice of law (all real and personal property in one state)

[*Use one of the following alternatives*]

[*Alternative 1: Specified state law governs administration of trust*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust** _ _[*including, e.g., investment, management, and distribution of the trust estate, and trustee's compensation*]_ _ **shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of the creation of this trust/from time to time*]_ _**.**

[*Alternative 2: Change of situs does not change law governing administration*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust** _ _[*including trustee's compensation*]_ _ **shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of the creation of this trust/from time to time*]_ _, **regardless of whether the situs or place of administration of the trust has changed.**

[*Alternative 3: Change of situs changes law governing administration*]

***Governing Law*. All questions concerning the validity, construction, interpretation, and administration of this trust** _ _[*including trustee's compensation*]_ _ **shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of the creation of this trust/from time to time*]_ _. **If, however, the situs or place of administration of the trust is changed to another state, the law of that state shall govern the administration of the trust.**

Comment: Alternative 1 makes the law of a single state govern the validity, construction, interpretation, and administration of a trust of personal and real property situated within that state.

Alternative 2 is similar to Alternative 1, but it also specifies that a change in the situs of the trust does not affect the law governing administration of the trust.

Alternative 3 permits a change in the law governing administration. This type of clause may sometimes be desirable. In the hypothetical Jones trust described in §23.6, it may be more practical to permit New Jersey law to apply to administration of the trust if the settlor's children select a New Jersey trustee to act after his death.

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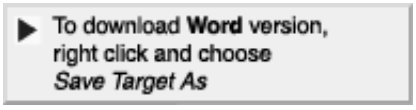
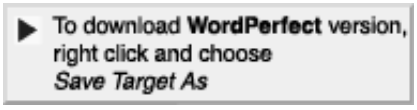
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.40 2. Form: Choice of Law (Real Property in Several States and Personal Property)

§23.40 2. Form: Choice of Law (Real Property in Several States and Personal Property)





23.40-1 Choice of law (real property in several states and personal property)

[*Use one of the following alternatives*]

[*Alternative 1: Law of situs governs real property; specified state law governs personal property*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust** _ _[*including trustee's compensation*]_ _ **for all property, shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of creation of this trust as amended/from time to time*]_ _**.**

[*Alternative 2: Change of situs does not change law governing administration*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust** _ _[*including trustee's compensation*]_ _ **for all property, shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of creation of this trust as amended/from time to time*]_ _, **regardless of whether the situs or place of administration of the trust changes.**

[*Alternative 3: Change of situs changes law governing administration*]

***Governing Law*. The validity of this trust for real property shall be governed by the law of the state of its situs. The validity of this trust for personal property, and all matters concerning the construction, interpretation, and administration of this trust** _ _[*including trustee's compensation*]_ _ **for all property, shall be governed by the law of the state of** _ _[*specify state*]_ _ **in force** _ _[*on the date of creation of this trust as amended/from time to time*]_ _**. If, however, the situs or place of administration of the trust is changed to another state, the law of that state shall govern administration of the trust.**

Comment: For trusts that include real property in several states or both real and personal property (*e.g.,* the hypothetical Jones trust described in §23.6), traditional choice-of-law clauses designate the law of the situs state to govern validity for real property, the law of a state having a substantial connection with the trust to govern the validity of the trust for personal property, and the construction and administration of the trust for all property. It is advisable to designate the law of the place of administration as the governing law because of the trustee's familiarity with such law. The attorney should make sure, however, that the designated law does not violate the public policy of another state having a close connection with the trust.

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§23.41 3. Application of Choice-of-Law Clause to Hypothetical Jones Trust

Because the trust corpus in the hypothetical Jones trust described in §23.6 will include real and personal property situated in three states, the trust should probably designate the law of New York to apply to construction, interpretation, and administration of the trust. The drafter should, however, first carefully review New York law to ensure that the trust will carry out the settlor's intent, that it will not violate a strong public policy of California (and Oklahoma, if the oil interests are considered to be real property), and that it will not adversely affect taxation of the trust. It is advisable to have counsel in the designated state and each situs state review the trust instrument to ensure compatibility with local law and policy.

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§23.42 D. Law Governing Investments

The law governing investments can be fully determined by the settlors' choice of applicable law, unlimited by constraints of policy. The settlors may provide that trust investments shall be governed by the law of the settlors' domicile (see *Application of City Bank Farmers Trust Co.* (Sup Ct 1957) 166 NYS2d 772), the state of the trust's administration, or some other state. In the absence of such a clause, the law where the designated trustee administers the trust ordinarily applies, unless the settlors disclose an intent to determine the propriety of trust investments by the law of the settlors' domicile.

For cases applying New York law when a New York trustee administers the trust, see *Irving Trust Co. v Natica, Lady Lister-Kaye* (Sup Ct 1935) 284 NYS 343 (English settlor; New York law applied to determine propriety of investments); *In re Carter's Trust* (Sup Ct 1958) 178 NYS2d 569 (Hawaii settlor; similar result on whether retention of investments was proper); *In re Lowman's Trust* (Sup Ct 1949) 92 NYS2d 238 (Ohio settlor; result similar to *Irving*).

For a case applying the law of the settlors' domicile, see *Stetson v Morgan Guar. Trust Co.* (Conn 1960) 164 A2d 239 (Connecticut law applied to investments of revocable trust created by Connecticut couple for their children of which one settlor was original trustee and New York trust company was successor trustee).

In summary, it appears that a choice-of-law clause is valuable for disposition of the investments of a multistate trust. See the forms suggested in §§23.39-23.40.

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§23.43 E. Trustee's Liabilities; Exculpatory Clauses

State law does not uniformly impose surcharge liability for a trustee's breach of trust. The law applicable to investments determines liability for losses resulting from improper investments. The law of the place of administration determines whether the trustee is liable for self-dealing. *Campbell v Albers* (Ill App 1942) 39 NE2d 672.

The terms of the trust may provide that the trustee is relieved from liability for breach of trust or may permit self-dealing, which would otherwise be improper. See 1A Nossaman & Wyatt, Trust Administration and Taxation §§27.16, 28.21 (rev 2d ed 1966). But suppose that giving the trustee permission to self-deal is against public policy. In that situation, the settlors may not be able to avoid a restriction imposed by the law of their domicile by designating as controlling the law of some other, more lenient state or by locating the administration of the trust in another state. See 7 Scott & Ascher on Trusts §45.6.6 (5th ed 2010).

In the hypothetical Jones trust described in §23.6, a more cautious approach is to avoid any general exculpatory clause and instead to relieve the trustee from some particular obligation otherwise generally imposed on trustees, such as the duty to dispose of unproductive property by a specific limited clause to that effect.

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§23.44 F. Trustee's Compensation

The amount of the trustee's compensation varies among the different states. Some statutes provide for whatever is "reasonable" under the circumstances; others provide for commissions based on percentages of income or principal. Rules on additional compensation for extraordinary services and on the sharing of compensation among several trustees or successive trustees also vary. See Hess, Bogert & Bogert, The Law of Trusts and Trustees §§977-978 (3d ed 2000); 4 Scott & Ascher on Trusts §§21.1-21.1.10 (5th ed 2007).

If the settlors have fixed the administration of the trust in a particular state (*e.g.,* by appointing a resident of that state as trustee), the law of the place of administration should determine the trustee's compensation. If no place of administration is fixed by the settlors, compensation should be decided by the law of the state having the most significant relationship to the trust. In cases involving requests for extraordinary compensation, the law of the state having the most significant relationship to the transactions justifying the request for compensation should prevail.

A clause on this issue should be included in the hypothetical Jones trust described in §23.6, covering both the amount of compensation and the choice of law. See form 23.39-1. See also Restatement (Second) of Conflict of Laws §187 (1971) (illustrations of choice-of-law clauses); *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 466 n4, 11 CR2d 330 (example from trust hypothetical that appears to allow parties in some circumstances to specify law of state with no relation to parties or transaction). In *Nedlloyd* the court noted that Restatement §187(1) did not apply because there was no evidence that the parties had incorporated by reference extrinsic material to fill a gap in their contract. In *CMR Mortgage Fund, LLC v Canpartners Realty Holding Co. IV LLC* (*In re CMR Mortg. Fund, LLC)* (Bankr ND Cal 2009) 416 BR 720, the court held that, because the making of a contract was not in dispute, the law chosen by the parties did not need to have any reasonable relationship to the place of creation or performance of the contract. The court noted that such a relationship was necessary under Restatement §187 only when parties sought to specify choice of law governing issues concerning the formation or validity of a contract. 416 BR at 729.

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V. SPECIAL PROBLEMS OF MULTISTATE TRUSTS

§23.45 A. Who Can Act as Nonresident Trustee

Any corporate or individual trustee, regardless of place of business or residence, can generally act as trustee of a living trust of personal property, because the settlor can transfer these assets in trust to a resident of any state. If, however, a trust includes real property in a state other than the trustee's residence or place of business, a question may arise about the trustee's right to act.

An individual—whether a resident or nonresident of the state where the real property is situated—can serve as trustee in most states. Many states, however, including California, have statutes limiting a foreign corporation's right to act as trustee. These statutes either absolutely prohibit a foreign corporation from acting as trustee or allow it to serve only if the corporation qualifies to do business in the state. California generally prohibits a foreign corporation from acting as a living or testamentary trustee, except a national banking association authorized to conduct a trust business in California or a bank from another state. See Fin C §§1503, 1750-1751.

If a trust includes real property situated in a state that prevents a nonresident corporate trustee from acting, one solution is to appoint an individual cotrustee and give the cotrustee all rights and powers for the real property. The law of the situs state must be reviewed, however, to ensure that the individual trustee can serve as a cotrustee with limited powers. New Jersey, for example, does not permit this. Another solution is to permit the corporate trustee to appoint another trustee to act as trustee of the real property. See form in §23.47.

Whenever a cotrustee is appointed for the purpose of holding title to real property, the cotrustee's domicile should be carefully considered; appointing a cotrustee with a different domicile could significantly affect taxation of the trust. See §23.95. Therefore, it may sometimes be more advantageous to appoint an individual rather than a corporate cotrustee because the individual and corporate trustees can be domiciliaries of the same state.

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§23.46 1. Application of Nonresident Trustee Laws to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, either an individual trustee or a California corporate trustee must act as trustee for California real property if (as is probable) the New York corporate trustee is not a national bank authorized to conduct a trust business in California and therefore cannot act as trustee in California. Whether another trustee is necessary for the Oklahoma oil interests depends on whether they are categorized as real or personal property. If the interests are considered to be real property, an individual trustee would probably be required. The individual trustee must be carefully selected because taxation of the trust may be based in part on the trustee's residence. See §§23.92, 23.94.

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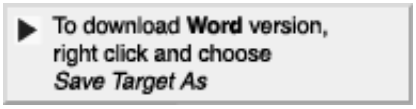
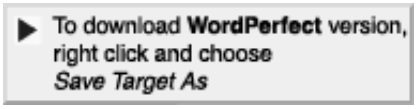
§23.47 2. Form: Appointing Trustee for Real Property





23.47-1 Appointment of trustee for real property

***Appointment of Trustee for Real Property*. If the trust estate includes any real property situated in a state other than the corporate trustee's place of business, and the corporate trustee is unable or unwilling to hold title to such property as trustee, the individual cotrustee shall take title to the property in his or her own name, shall hold or dispose of the property according to the terms of this Declaration of Trust, and shall act as sole trustee for that property. When the property is sold or otherwise disposed of, the corporate trustee shall act as cotrustee (or sole trustee if no other trustee is then acting) of the proceeds or other property received in exchange, if the corporate trustee can legally do so. If no individual trustee is then acting and the trust estate includes property described above, the corporate trustee shall appoint an individual or corporate trustee to take title of this Declaration of Trust. When the property is converted into property that the corporate trustee can legally hold, the appointed trustee shall transfer title to the corporate trustee and forthwith resign. An individual trustee who holds title to property is authorized to appoint the corporate trustee as his or her agent to handle all receipts and disbursements for the property.**

Comment: This form may be adapted for use in any multistate trust. It is not tailored to the hypothetical Jones trust described in §23.6.

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B. Validity of Pourover Transfer to Revocable Trust

§23.48 1. When Pourover Transfer Permitted

Most states, including California, have enacted the Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303) or other statutes expressly permitting bequests or devises to revocable trusts. California permits such a transfer if the trust is identified in the testator's will and the trust is executed before or concurrently with the will. In states without legislation, the validity of a pourover transfer depends on the doctrines of incorporation by reference or independent legal significance. See Hess, Bogert & Bogert, The Law of Trusts and Trustees §§107, 264.5 (3d ed 2000); 1 Scott & Ascher on Trusts §§7.1-7.1.4 (5th ed 2006); 1 Nossaman & Wyatt, Trust Administration and Taxation §5.06 (rev 2d ed 1966).

In any matter involving a pourover of assets to a trust situated in another state, it is essential to review the law of the testator's domicile to determine whether a transfer of assets to a foreign trust is permissible and to ascertain requirements of the trust. The trust must generally be executed before or concurrently with the will, and in some states it must be acknowledged by the parties. See, *e.g.,* NY Est Powers & Tr L §3-3.7(a). The trust should not be amended without reviewing the applicable law to determine the validity of an amendment, because in some states an amendment after execution of the will makes the transfer invalid. The invalidity can generally be avoided, however, by republishing the will by a codicil immediately after execution of the trust amendment. See chap 22.

In situations involving a pourover of assets to a revocable trust in another jurisdiction, the following questions should be considered:

- Will the testator's domicile permit a pourover to a trust in another jurisdiction?
- What are the surviving spouse's rights to trust assets? See §§23.53, 23.60.
- If there are charitable gifts, do any mortmain statutes of the testator's domicile or of the trust situs apply? See §23.70.
- What are the pretermitted heirs' rights? See §23.61.
- How are estate and inheritance taxes to be paid? See §§23.87-23.89.

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§23.49 2. Application of Pourover Transfer Laws to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, the settlor's will should include a pourover transfer to the settlor's revocable trust so that all nontrust assets held on the date of death will be transferred to the trust and administered as part of it. Because both California and New York have adopted statutes permitting a pourover transfer (see Prob C §§6300-6303; NY Est Powers & Tr L §3-3.7), a testamentary transfer to the trust is valid as long as, for New York property, the settlor and trustee have acknowledged the trust instrument. Although Robert Jones's real property should be transferred to the trust before his death, if transfer were delayed until after death and accomplished by means of a pourover transfer, a problem would arise regarding inability of the New York corporate trustee to hold title to California real property (and possibly the Oklahoma oil interests). See §23.46.

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C. Transfer of Marital Property to Trust in Another Jurisdiction

§23.50 1. Nature of Marital Property Problems

The transfer of community or separate property to a trust situated in a state that has a different property system may create both tax and substantive law problems. See, *e.g., Paley v Bank of America* (1958) 159 CA2d 500, 324 P2d 35 (move from separate to community property state). These problems are described and solutions suggested in §§23.51-23.59.

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§23.51 a. Separate or Community Character of Property Transferred

Separate property and community property generally retain their status as separate and community property, even though the property may be transferred to a trust in a state with a different property system or used to acquire real property in that state. See *Addison v Addison* (1965) 62 C2d 558, 43 CR 97 (separate personal property brought to California); *Tomaier v Tomaier* (1944) 23 C2d 754, 146 P2d 905 (community funds invested in Missouri real property); *People ex rel Dunbar v Bejarano* (Colo 1961) 358 P2d 866 (employee death benefits accumulated in community property states and paid in separate property state); Restatement (Second) of Conflict of Laws §259 (1971). See also Cline, *Selected Planning Issues for the Migrant Client*, Estate Planning 2006, chap 6 (Cal CEB 2006).

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Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.52 b. Character of Property for State Death Tax Purposes

§23.52 b. Character of Property for State Death Tax Purposes

The courts of the situs state sometimes have incorrectly disregarded the original nature of the property for tax reasons. For example, community property used to purchase real property in a common-law state has been subjected to inheritance taxes in the situs state on the husband's death as if it were his separate property. See, *e.g., Estate of Kessler* (Ohio 1964) 203 NE2d 221 (securities acquired in California as community property taxed on husband's death by Ohio, his domicile at date of death); *Estate of Hunter* (Mont 1951) 236 P2d 94 (on death of husband, a California resident, Montana taxed both spouses' share of community real property situated in Montana).

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§23.53 c. Marital Rights of Nonresident Spouse

The laws of the community property states vary on a nonresident spouse's rights for property situated within the jurisdiction. For example, in Texas and Washington, the surviving spouse has no right to a nondomiciliary decedent's separate real property situated within the state. See Gilchrist, *Washington Disinherits the Non-Native Wife*, 46 Wash L Rev 283 (1971). In California and Idaho, however, for real property situated within the state, the surviving spouse has the same right to elect to take against the nondomiciliary decedent's will as if the real property had been situated in the decedent's domicile. In effect, California and Idaho apply the law of the domiciliary state when determining the survivor's right to real property within the state. See Prob C §120.

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§23.54 d. Income Tax Effects of Transfer of Community Property

There may be income tax problems on the transfer of community property to a revocable trust in a common-law state. If property is determined to be community property under state law, then it is community property for purposes of IRC §1014(b)(6) regardless of the form in which title was taken. If the situs state does not recognize the community nature of the property, the surviving spouse may not be entitled, on the first spouse's death, to a stepped-up basis for income tax purposes on his or her share of the community trust assets under IRC §1014(b)(6). Under Rev Rul 66-283, 1966-2 Cum Bull 297, a stepped-up basis is permitted for the survivor's half of community property in a California revocable trust.

In Rev Rul 68-80, 1968-1 Cum Bull 348, the IRS disallowed a stepped-up basis for New Mexico community property traded for Virginia real property held by the spouses as tenants-in-common. The Virginia property was held not to be community property under state law even though it was acquired in exchange for community assets. Therefore, the property was not treated as community property for purposes of IRC §1014(b)(6).

To avoid the problem entirely, the parties should not transfer community property that has appreciated in value to a trust in another jurisdiction. Instead, the parties should retain the property in a trust in the community property state, with an express clause designating the law of that state to apply to its validity, construction, interpretation, and administration.

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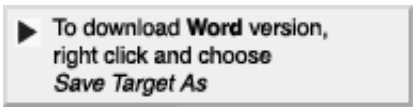
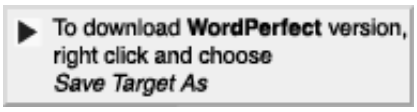
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.55 e. Form: Choice of Law for Community Property

§23.55 e. Form: Choice of Law for Community Property





23.55-1 Choice of law for community property

***Governing Law*. It is intended by this clause that any community property of my spouse and myself shall be governed by the law of _ _[*specify community property state in question*]_ _.**

Comment: This clause may be used to modify the forms in §§23.39-23.40 to accommodate an expression of intent that the law of a community property state applies to the validity, construction, interpretation, and administration of a trust.

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§23.56 f. Effect of Agreement Between Spouses

The character of separate or community property transferred to a trust may be changed by an agreement to hold the property under the law of the situs state. See, *e.g., Wyatt v Fulrath* (1965) 264 NYS2d 233, 211 NE2d 637 (New York court permitted New York joint-tenancy bank accounts belonging to Spanish national and resident to be distributed to surviving spouse under New York law, although distribution was invalid under Spanish community property laws).

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Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.57 2. Steps to Take on Transfer of Marital Property

§23.57 2. Steps to Take on Transfer of Marital Property

If separate or community property must be transferred to a trust in a state with a different property system, the following steps should be taken to minimize tax and substantive problems:

- Property that is clearly separate or community property should be identified as such.
- If the property is community property, both spouses should be the settlors. This step may help the parties avoid the situation of *Estate of Hunter* (Mont 1951) 236 P2d 94, in which the community property in the husband's name was presumptively owned by him under Montana inheritance tax laws.
- The trust instrument should specify that the trust property and the income will remain separate or community property.
- The surviving spouse's rights should be set out.
- No rights should be given to a settlor, spouse, or any beneficiary that would alter the character of the property.
- The requirements of any applicable statutes should be followed.

If California community property is to be transferred to a trust in another state, the provisions of Fam C §761 should be followed to preserve the community character of the property. See §20.4.

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§23.58 3. Effect of Change of Settlors' Residence

Additional problems arise if the settlors subsequently become residents of the state in which trust property is situated. For example, in California all personal property wherever situated, and all real property situated in California, acquired by a spouse while domiciled outside California is defined as "quasi-community property" for succession purposes on death if that property would have been community property if acquired while the spouse was domiciled in California. Prob C §66. California treats half the quasi-community property of a married person whose death occurs while domiciled in California as belonging to the surviving spouse. Prob C §101.

A change in the settlors' domicile may also affect the character of income of the trust property. In Texas, Idaho, and Louisiana, income derived by residents from separate property becomes the husband and wife's community property. In California, income from true separate property remains the separate property of the owner (Fam C §770(a)(3)), but income from quasi-community property is subject to the surviving spouse's succession rights under Prob C §101. Therefore, when the settlors become residents of the state of the trust situs, the situs state's tax, succession, and other applicable laws should be reviewed to determine their effect on the trust property and income and on the settlors' dispositive plans.

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§23.59 4. Application of Marital Property Laws to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, if Robert Jones is considered to be a resident of New York at the time of his death, his spouse's marital rights in his California real property are not affected by a transfer of his property into a trust. On Robert's death, California will apply New York law to determine his wife's interest in the property, and she will be entitled to receive the same interest in the property as though it had been situated in New York.

If Robert is considered to be a California resident at the time of his death, the California law of succession will apply. His widow will be entitled to elect against his will and to receive outright half of his quasi-community property (*i.e.,* his California real property and his New York securities account) because the property was acquired with Robert's earnings after marriage and would have been community property had the parties lived in California when it was acquired. Prob C §§66, 101. Robert cannot extinguish his wife's interest in his property by transferring it to a revocable trust. He can do so only by transferring the property before his death and retaining no rights of ownership or control at the time of his death, *e.g.,* by an irrevocable transfer in trust for the benefit of third parties or by an outright gift. See Prob C §102 (listing transfers subject to restoration of surviving spouse's quasi-community property interest).

Although his wife may receive an increased share of the California real property and the New York securities account if Robert dies while he is a resident of California, he can defeat his wife's statutory rights in the New York real property if he wishes to do so. California law does not give a spouse of a deceased resident any rights over separate real property situated outside the state, and New York does not provide a forced share of New York property for spouses of nonresidents unless the decedent has elected to have the disposition of his or her New York property governed by the law of New York. NY Est Powers & Tr L §5-1.1-A(c)(6). Accordingly, by establishing the trust in California and by providing for California law to govern the trust and his will, Robert can preclude his wife from receiving any part of his New York real property.

For the Oklahoma oil interests, her rights would depend on whether Robert is a resident of New York or California, whether the oil interests are real or personal property under Oklahoma law, and whether the applicable laws of succession are those of New York, California, or Oklahoma.

- If the oil interests are personal property and Robert is a resident of California, the interests would be considered community property, and his wife would be entitled to a one-half vested interest under California law.
- If the interests are transferred to a trust to be governed by New York law, however, it is not clear whether New York would apply its law or California law in determining the wife's rights.
- If Robert is a resident of New York, the interests would be considered to be separate property because they were derived from his earnings, and his wife would be entitled to her statutory share under New York law.
- If the interests are considered to be real property, her rights would be determined by Oklahoma, which may apply its own law or the law of Robert's domicile in determining his wife's rights.

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D. Trusts in Violation of Family Rights

§23.60 1. Surviving Spouse's Rights

Most common-law states permit a surviving spouse to share in the decedent's estate. If a settlor residing in such a state creates a living trust in another state with different laws or with laws that protect only a resident surviving spouse, a question arises about the settlor's right to defeat his surviving spouse's domiciliary marital rights.

Under the current trend in conflict of laws, the surviving spouse's rights should be a matter to be determined by the law of the settlor's domicile because, for this purpose, domicile has the most significant relationship to the trust. See *Estate of Crichton* (1967) 281 NYS2d 811, 228 NE2d 799 (court applied law of settlor's domicile); *Rose v St. Louis Union Trust Co.* (Ill 1969) 253 NE2d 417 (court applied law of settlor's domicile when trust was created); 7 Scott & Ascher on Trusts §45.4.2.4 (5th ed 2010).

This position has been adopted in a New York case involving a disposition by will. In *Estate of Clark* (1968) 288 NYS2d 993, 236 NE2d 152, the New York Court of Appeals applied Virginia law to give a widow her full statutory share of the estate of a Virginia resident, although most of the decedent's assets were in New York and his will provided for testamentary dispositions to be determined under New York law.

Clark may have been effectively overruled, however, by *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341, in which the court upheld a French domiciliary's choice-of-law direction that New York law apply to New York assets, rejecting her son's claim to a forced share in these assets (as required under the laws of France). The court noted that the legislative history of the controlling statute (NY Est Powers & Tr L §3-5.1(h)) supported the conclusion that the statute was intended to permit a nonresident testator to invoke New York law for his assets physically located in New York and thereby avoid the forced heirship of his domicile.

Before establishing a trust in a state other than the settlor's domicile, the parties should review the laws of the situs and domiciliary states to determine the marital rights of a surviving spouse. Otherwise, the spouse may be given unintended rights that can disrupt the settlor's dispositive plan or the spouse may be deprived of rights that were intended. See *Estate of Rhoades* (Sup Ct 1994) 607 NYS2d 893 (New York domiciliary can defeat spouse's rights under New York's right of election by changing domicile at any time before death and executing will in another state).

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§23.61 2. Children's Rights

Although, in the United States, children's forced heirship rights (commonly referred to as "the legitime") exist only in Louisiana, controversies can still result from domestic efforts to enforce foreign-conferred rights (see *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341 (French law)) or from different local laws on questions of legitimacy, pretermitted heirship, or adoption. Therefore, it is necessary to consider the statutory interests of surviving children in planning wills and probate estates. With the exception of adoption, these issues have not involved living trusts.

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§23.62 3. Application of Family Rights to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, if Robert Jones is considered to be a resident of New York, his wife's rights will not be affected by establishment of the trust, because Robert's domicile and the situs of the trust will be the same. If Robert is considered to be a resident of California, however, his wife's succession rights will be changed on his death. Under California law, she will be entitled to a one-half share of the community property and the quasi-community property but to none of the separate real property situated in New York acquired with inherited funds. See Fam C §§65, 125, 760, 770; Prob C §§28, 66, 100-101.

In this event, the question arises whether New York, the trust situs, will apply its law or California law (or possibly Oklahoma law if the oil interests are real property) in determining the wife's rights, in view of *Estate of Renard* (Sur Ct 1981) 437 NYS2d 860, aff'd (App Div 1981) 447 NYS2d 573, aff'd (1982) 453 NYS2d 625, 439 NE2d 341, discussed in §23.60, and New York statutory provisions denying the right of election to the spouse of a nonresident. See NY Est Powers & Tr L §5-1.1-A(c)(6).

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§23.63 E. Assignment, Attachment, and Disclaimer of Beneficiary's Interest; Creditors' Rights

The law of the situs of a trust of real property and the law of the designated place of administration of a trust of personal property generally determine whether a beneficiary's interest can be assigned by him or her or reached by a creditor. For personal property, if there is no fixed place of administration, the law of the state having the most substantial contact with the trust governs. See 1 Nossaman & Wyatt, Trust Administration and Taxation §24.03[7] (rev 2d ed 1966); 7 Scott & Ascher on Trusts §45.7.1.2 (5th ed 2010). However, the settlor's intent cannot vitiate statutes regulating spendthrift clauses, because these laws are considered a matter of public policy. If the settlor desires a strong spendthrift clause, it may be advisable to have a trust of personal property administered in a state that permits a strong clause, unless that would be contrary to public policy in the settlor's domicile.

In the hypothetical Jones trust described in §23.6, if Robert Jones were concerned about the spendthrift tendencies of his children, he might transfer his personal property to a trust in a jurisdiction such as Alaska or South Dakota, which give creditors fewer rights than New York, California, or many other states. It is doubtful, however, whether he could avoid the spendthrift laws of situs states for real property, because these laws are generally a matter of public policy that the situs state has an interest in enforcing.

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F. Powers of Appointment

§23.64 1. Applicable Law on Powers of Appointment

Complex conflict-of-laws problems can arise from the inclusion of a power of appointment in a multistate trust. The law applicable to questions relating to the interpretation and scope of a power may differ from the law applicable to questions about validity of the exercise of the power. In addition, the law applicable to a power given to a beneficiary may differ from the law applicable to a power reserved by the settlors. See §§7.19-7.37; California Estate Planning, chap 9 (Cal CEB 2002).

In real property trusts, questions regarding the validity of exercising a power of appointment have traditionally been determined by the law of the situs of the real property. The scope of the power is a question of construction determined by the same law that applies to construction of the trust.

In personal property trusts, the law varies so much from state to state that no general rules can be set out. In *Estate of Erdman* (1968) 264 CA2d 335, 70 CR 774, the court held that the testamentary exercise by a California donee of a limited power of appointment over trusts established in Illinois was not effective. The California court applied Illinois law to the trusts, which provided that intangible personal property was to be controlled by Illinois trustees.

When the donee wishes to exercise a power over personal property by a further appointment in trust, the following questions arise:

- Does the power permit a further appointment in trust?
- Will the exercise of the power violate any perpetuity rules?
- Can the donee select a trustee in another jurisdiction?

In *In re Morgan Guar. Trust Co.* (1971) 320 NYS2d 905, 269 NE2d 571, for example, the court held that the rule against perpetuities of the donee's domicile (California) should be applied in determining whether the exercise of a general power of appointment under a New York living trust was valid. In *Sloan v Segal* (Del Ch, Jan. 8, 2008, C.A. No. 2319-VCS) 2008 Del Ch Lexis 3, the court held that the validity of the exercise of a special power of appointment over a marital trust with a Delaware situs by codicil executed in Florida by the settlor's surviving spouse (who was a Florida resident) was determined by Delaware law, because the trust instrument provided that all questions of validity and administration of the trust should be determined under Delaware law.

The law is uncertain regarding the selection of a new trustee to administer a trust created by a power of appointment. In California, Prob C §§17400-17457 provide for the transfer of trust administration to another jurisdiction in the court's discretion if specified statutory conditions are satisfied. For California or other states with similar statutes, if the settlors' intent indicates that the place of administration may be changed, the trust assets should be transferred to the new trustee. See also Restatement (Second) of Conflict of Laws §272, Comment b (1971).

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Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.65 2. Drafting Considerations for Powers of Appointment

§23.65 2. Drafting Considerations for Powers of Appointment

Because of the many issues that can result from a power of appointment and the uncertainty of the applicable law, the power must be carefully drafted, with conflict-of-laws questions in mind. The trust instrument should state:

- How the power is to be exercised (by will or other instrument) and whether express mention of the power is necessary;
- Whether there can be further appointments in trust, and whether trust assets can be transferred to a trustee in another state; and
- Whether the power can be released.

The trust should include a clause specifying the law to apply to the scope and validity of the power of appointment. The drafter should remember that the designated law may not govern the validity of the exercise of a power over real property located in another state if the traditional rule applies. See form 23.66-1.

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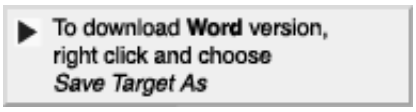
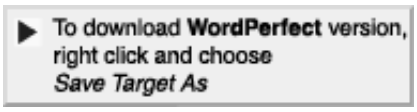
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.66 a. Form: Exercise of Power of Appointment

§23.66 a. Form: Exercise of Power of Appointment





23.66-1 Exercise of power of appointment

***Exercise of Power of Appointment*. The power of appointment granted in this instrument must be exercised by a will or any codicil to it (1) that is executed according to the formalities required at the time of the donee's death by the laws of the state of his or her domicile and (2) that specifically refers to this power. The property subject to this power may be appointed outright or in trust. If a trust is created, the donee may designate any person or persons, otherwise qualified to act, as trustee, and the trust property shall be transferred to the designated trustee, regardless of the place of his or her domicile. Subject to the limitations contained in this instrument, the donee may confer further powers of appointment. The donee may disclaim, limit, or release this power in whole or in part by written instrument delivered to the trustee.**

No attempted exercise of this power shall be void if it can be construed or reformed to be limited as follows: If the donee attempts through the exercise of the power to create a trust that would continue for a period beyond 21 years after the death of the last survivor of the settlor's descendants and their spouses who were living when this trust was created, that trust shall terminate on the 21st anniversary of the last survivor's death and the entire principal of the trust shall be distributed to the person or persons then entitled to receive the income of that trust.

Comment: This form includes a clause to avoid the unintended violation of the rule against perpetuities. See Prob C §§21200-21225. However, the drafter should be careful to avoid violating the rule because it is not certain whether the provision would be effective in states without legislation similar to Prob C §21205. For a general exercise clause that may be adapted to a multistate trust by making appropriate reference to the donee's domicile, see §7.87.

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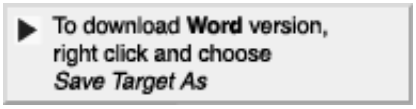
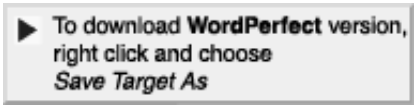
Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.67 b. Form: Choice of Law Governing Exercise of Power of Appointment

§23.67 b. Form: Choice of Law Governing Exercise of Power of Appointment





23.67-1 Choice of law governing exercise of power

***Governing Law*. Questions regarding interpretation, scope, and validity of the exercise of this power shall be determined under the law of the state of _ _[*specify state*]_ _ as long as any question regarding the validity of the exercise of this power for real property shall be governed by the law of the state of its situs.**

Comment: See discussion in §23.65.

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§23.68 3. Application of Law Governing Powers of Appointment to Hypothetical Jones Trust

A power of appointment should not be drafted, exercised, or released without a careful review of the laws of all states having contact with the trust and the situs of any real property subject to the power. In the hypothetical Jones trust described in §23.6, the laws of New York, California, Oklahoma, and New Jersey (the donees' domicile) should be reviewed before drafting the power to ensure that the power can be exercised or released as provided by the trust. These laws should also be reviewed before any donee exercises or releases the power to ensure that the exercise or release is valid.

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G. Charitable Trusts

§23.69 1. Nature of Charitable Trust Problems

The creation of a multistate charitable trust raises several questions, discussed in §§23.70-23.73:

- Is the charitable purpose valid under the law of the state that governs the validity of the trust?
- Does the trust qualify for a tax exemption in the state that has the power to tax the trust?
- If the trust is revocable, does it violate any mortmain statutes of the settlors' domicile or of the state that governs the validity of the trust?
- Does the trust violate the rule against perpetuities of the state that governs the validity of the trust?
- Does the trust violate a spouse's marital rights?
- Is the trust subject to supervision by a state official?

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§23.70 a. Effect of State Law on Validity and Taxation of Charitable Trusts

The law of the state that governs the validity of the trust and of the state that has the power to tax the trust should be reviewed to ensure that the trust purposes are considered to be charitable and that a tax exemption under state law is available. Some tax exemption statutes do not apply to charities situated in a foreign state unless the foreign state has a reciprocal exemption statute.

Although the settlors' domicile or the state that governs the validity of the trust may impose limitations on the amount of a testamentary transfer to charity, these limitations generally do not apply to lifetime charitable gifts (*Rutherford v Ott* (1918) 37 CA 47, 51, 173 P 490; *Drew v Richards* (Ohio App 1960) 177 NE2d 631) even if the motive in creating the trust was to avoid the impact of such a statute (*Will of Frank* (App Div 1976) 383 NYS2d 777).

In a state that still has mortmain laws, a settlor may create a living trust in a nondomiciliary state to avoid domiciliary statutes, reserving a testamentary power of appointment exercisable in favor of charities. See *In re Pratt's Trust* (App Div 1958) 172 NYS2d 965, aff'd (1960) 203 NYS2d 906, 168 NE2d 709 (Florida resident's testamentary exercise of reserved power of appointment in favor of charities under New York living trust held to be valid under New York law, although invalid under Florida's mortmain laws).

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§23.71 b. Application of Rule Against Perpetuities to Charitable Trusts

When the trust is to continue for an indefinite period of time, the rule against perpetuities in the state that governs the validity of the trust should be reviewed. The statutes of some states seem to exempt gifts to charities from operation of the rule. See, *e.g.,* Prob C §21225(e) (expressly exempting charitable gifts). For discussion of the perpetuities problem, see 1 Nossaman & Wyatt, Trust Administration and Taxation §3.10 (rev 2d ed 1966).

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§23.72 c. Effect of Marital Rights on Charitable Trusts

A spouse's marital rights should be considered when establishing a living charitable trust. In some cases, a spouse's rights may be defeated by creating a trust in a jurisdiction that does not recognize a surviving spouse's right to take assets of a living trust. In other cases, the spouse's rights may be enlarged under the law governing the trust. For discussion of this problem, see §§23.53, 23.59-23.60, 23.62.

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§23.73 d. Administrative Problems of Charitable Trusts

Administrative problems must also be considered with respect to a charitable trust. In some states, including California, special statutes relate to the supervision and enforcement of charitable trusts by the state attorney general or another state official. See Govt C §§12580-12599.5. These supervisory statutes generally require submission of trust documents and periodic reports and accountings. Although these requirements are absent from the California statutes, the laws of some states permit the court to prohibit, limit, or authorize accumulations by charitable trusts. See, *e.g.,* NY Est Powers & Tr L §8-1.1(e). If the settlors wish to avoid supervision of a charitable trust, the trust should be established and administered in a state without these statutes.

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§23.74 2. Application of Charitable Trust Laws to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, because Robert Jones may be a resident of either New York or California, the laws of both states must be reviewed to determine the validity, tax effects, and supervisory problems of the gift in trust for the New York hospital.

The gift to the hospital, a nonprofit hospital for the poor that charges no fees, is considered to be a charitable transfer under both California and New York law. See *Dingwell v Seymour* (1928) 91 CA 483, 267 P 327; *Estate of Cohen* (Sur Ct 1945) 58 NYS2d 924.

The marital rights of Robert's wife under both California and New York law will not be affected by the trust, because she will be receiving her statutory share outright. The trust will not violate a rule against perpetuities or mortmain statutes; mortmain statutes of California and New York have both been repealed.

The main problem for the charitable trust is the supervisory statute of New York as the place of administration. If Robert wishes to avoid the New York statute and supervision over the trust, he should consider providing for the transfer of the charitable gift to a trust in another state (not California) without supervisory legislation.

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§23.75 VI. TAXATION OF MULTISTATE TRUSTS

A multistate trust presents death, gift, income, and property tax problems. The following discussion focuses on one of the most significant problems: double taxation. For further discussion, see Schmoker, *Minimizing State Death Taxes; Domicile; Tax Situs of Various Assets,* NYU 41st Inst Fed Tax, vol 2, chap 45 (1983); Gutierrez, *Oops! The State Income Taxation of Multi-Jurisdictional Trusts,* 25 U Miami Inst Est Plan, chap 12 (1991).

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§23.76 A. State Death Taxes

The U.S. Supreme Court has outlined the constitutional limitations on the imposition of state death taxes in a series of decisions in the first half of the 20th century. The guiding principle is that a state may not impose a death tax on property that is not subject to that state's jurisdiction. To do so is an unconstitutional taking of property without due process of law prohibited by the Fourteenth Amendment to the United States Constitution. See *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603.

In applying this guiding principle, the courts have treated real property and tangible personal property (see §23.77) differently from intangible personal property (see §23.78). On the effect of state tax exemption and arbitration statutes, see §§23.79-23.81. On special problems arising from the interplay of state death taxes and the federal estate tax, see §§23.82-23.83. On substantive law problems involving taxation of community and separate property, see §23.84.

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§23.77 1. Taxation of Real Property and Tangible Personal Property

Real property and tangible personal property generally can be taxed at death *only* by the state where the property is located. See, *e.g., Treichler v Wisconsin* (1949) 338 US 251, 94 L Ed 37, 70 S Ct 1 (real and tangible personal property located in Illinois and Florida not subject to Wisconsin inheritance tax); *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603 (tangible personal property of Pennsylvania decedent with situs in New York and in Massachusetts not subject to Pennsylvania estate tax).

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§23.78 2. Taxation of Intangible Personal Property

Intangible personal property may be taxed at death by several states. See, *e.g., Graves v Elliott* (1939) 307 US 383, 83 L Ed 1356, 59 S Ct 913 (bonds in Colorado trust benefiting New York domiciliary subject to death taxes in both Colorado and New York); *Curry v McCanless* (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900 (stocks and bonds in Alabama trust benefiting Tennessee domiciliary subject to death taxes in both Tennessee and Alabama). See also *Estate of Lincoln v Briggs* (Iowa 1972) 199 NW2d 337 (Iowa decedent's land-sale contract interest in Illinois real property held to be intangible personal property subject to Iowa inheritance tax).

On examination of the cases in which multiple taxation of intangible personal property was allowed by the court in a trust situation, it appears that certain types of contact by a trust with a state reflect sufficient exercise by the state of its jurisdiction of the trust property to allow the state to impose a death tax:

- The domicile of the decedent;
- The domicile of the trustee;
- The place in which the trust assets are kept; and
- The place where the business of the trust is carried on.

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§23.79 3. Tax Exemption and Arbitration Statutes

Multiple death taxation problems have been reduced in some situations by statutes providing for exemption from death taxes of intangibles belonging to nonresidents. Almost all states have these statutes. The language of the applicable statutes should be carefully reviewed, however, because exemptions granted by one state may differ from those granted by another state. In some states, the exemption applies only if there is a reciprocal exemption for residents of the state where the intangible personal property is located.

The exemption statutes for intangible personal property owned by nonresidents have not solved two significant double taxation problems involving intangible personal property:

- Conflict-of-laws problems relating to the characterization of property (see §23.80); and
- Conflict-of-laws problems when two states claim the decedent as a domiciliary (see §23.81).

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§23.80 a. Conflicting Characterization of Property

When the domicile of a decedent characterizes a property interest as intangible property, and the situs state of the property characterizes it as tangible or real property, both states can then assess a death tax on the property interest. Partnership interests, land subject to a contract for sale, and interests of beneficiaries in a trust holding real property can be subject to such conflicting characterizations. See *Blodgett v Silberman* (1928) 277 US 1, 72 L Ed 749, 48 S Ct 410 (partnership interest was tangible property for New York death tax purposes but intangible property for Connecticut death tax purposes); *Department of Revenue v Gruenwald* (Or App 1970) 467 P2d 660 (Oregon decedent's interest in trust property in Arizona was real property under Arizona law and personal property under Oregon law).

California considers secured and unsecured notes, bonds, partnership interests, and interests in Illinois land trusts to be intangible personal property. See 18 Cal Code Regs §13303.3. See also *Estate of Tutules* (1962) 204 CA2d 481, 22 CR 427 (beneficial interest in Illinois land trust held by California resident subject to California inheritance tax).

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§23.81 b. Tax Problem of Multiple Domiciles

Although an individual can theoretically have only one domicile at a time, this is not necessarily true when determining domicile for death tax purposes. See *Texas v Florida* (1939) 306 US 398, 83 L Ed 817, 59 S Ct 563 (four states claimed to be domicile of decedent).

The imposition of death taxes by more than one state, when each state has made its own judicial finding that the decedent was a domiciliary, has been held to be constitutional. See *Worcester County Trust Co. v Riley* (1937) 302 US 292, 82 L Ed 268, 58 S Ct 185. See also *California v Texas* (1982) 457 US 164, 72 L Ed 2d 755, 102 S Ct 2335 (reaffirming *Worcester* while simultaneously granting California leave to file federal interpleader action because of conflict between California and Texas in each claiming Howard Hughes was its domiciliary for inheritance tax purposes).

To avoid double taxation because of domicile, some states have statutes authorizing (1) compromise of claims for death taxes when domicile is at issue or (2) the arbitration of domiciliary disputes. These statutes are generally permissive, however, and may not lead to equitable results. In addition, they may be inapplicable unless each of the states involved has a similar statute.

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§23.82 4. Computation of State Death Tax Credit or Deduction for Federal Estate Tax

The IRS has recognized the problem of double taxation and has permitted the total amount of death taxes paid to two states that taxed the same property to be included in computing the state death tax credit allowable under former IRC §2011. See Rev Rul 70-272, 1970-1 Cum Bull 187 (relating to death taxes imposed by decedent's domicile and situs of corporate stock); Rev Rul 60-88, 1960-1 Cum Bull 365 (relating to death taxes imposed by two states claiming to be decedent's domicile). For decedents dying after 2004, similar principles should apply to the IRC §2058 deduction for state death taxes paid. However, under the "pick-up" tax, no California estate tax will be paid by California domiciliaries with respect to property situated in California. See §23.83.

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§23.83 5. Pick-Up Tax Problem

California repealed its inheritance tax and gift tax laws, effective June 8, 1982, and replaced them with a "pick-up" estate tax (see Rev & T C §§13302-13304) intended to take maximum benefit of the credit allowed on the federal estate tax return for state death taxes paid. Under Rev & T C §13302, the California pick-up tax may not result in total (federal and California) tax liability in excess of the federal estate tax that would otherwise be due.

However, some states have an estate tax in the form of a pick-up tax with an exemption amount less than the IRC §2010(c) applicable exclusion amount, with the consequence that a state estate tax may apply to property situated in another state to the extent that the amount not eligible for the federal estate tax marital deduction allocated to the credit shelter trust in a typical estate plan exceeds the state estate tax exemption amount.

One solution to this problem is to place additional assets in a trust (excess exemption QTIP trust) qualifying for the state estate tax marital deduction, but this may have the consequence of exposing those assets to federal estate tax in the estate of the surviving spouse. This may require making both a federal and state QTIP election for the additional assets and then seeking relief from the unnecessary federal election in the estate of the surviving spouse under Rev Proc 2001-38, 2001-1 Cum Bull 1335. For further discussion, see Graham, Gans & Blattmachr, *Quadpartite Will: Decoupling and the Next Generation of Instruments*, 32 Est Plan 3 (Apr. 2005); Graham, Gans & Blattmachr, *Quadpartite Will Redux: Coping With the Effects of Decoupling*, 32 Est Plan 15 (Oct. 2005).

Another solution is to make an inter vivos gift of the assets if the other state has an estate tax but no gift tax. Often a better solution is to create an entity such as a limited partnership or limited liability company to hold the assets. Interests in the entity are intangible property and will be taxed in the state of the decedent's domicile, not in the state where the assets owned by the entity are located. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§23.84 6. Character of Decedent's Interest as Community or Separate Property

In addition to the problems of multiple death taxation discussed in §23.83, there may be substantive law problems concerning taxation of the decedent's interest in the trust property if a trust situated in a common law state includes community property, or a trust situated in a community property state includes separate property.

Although in some states community or separate property will retain its original character for tax purposes (*People ex rel Dunbar v Bejarano* (Colo 1961) 358 P2d 866), in other states it may be treated differently (see *Estate of Kessler* (Ohio 1964) 203 NE2d 221; *Estate of Hunter* (Mont 1951) 236 P2d 94 (all community property taxed on husband's death)).

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B. Application of State Death Tax Planning to Hypothetical Jones Trust

§23.85 1. Avoiding Multiple Domiciles

The hypothetical Jones trust described in §23.6 presents several state death tax problems. The question of Robert Jones's domicile should be clearly resolved to prevent both New York and California from claiming him as a resident and subjecting his intangibles to double taxation, although any double taxation costs would be slight because California claims as estate tax only that share of the former IRC §2011 state death tax credit allocable to the share of the gross estate "having a situs in California." See Rev & T C §13304. Under current law, it is desirable to establish a California domicile if possible because the California estate tax is zero for all estates of decedents dying after December 31, 2004. See §23.83.

Once the decision on domicile has been made, Robert should be advised to take the following steps to prevent any ambiguities:

- Use the selected domicile as his address on all documents;
- Vote, file tax returns, and obtain a driver's license and automobile registration in the selected domicile;
- Concentrate his social and church activities in that domicile;
- Transfer to that domicile any bank accounts or other intangibles that he may acquire that are not a part of the trust; and
- Limit the amount of time he spends in the nondomiciliary state.

Although a compromise procedure or negotiation with the taxing authorities might be necessary to avoid double taxation of intangibles in the Jones trust, unless the domicile is clearly established, the trust real property will be taxed only by the situs state.

NOTE: For state income tax purposes, Robert is presumed to be a resident of California if he spends more than 9 months a year in California, and he is considered to be a resident of New York if he spends more than 183 days a year there. Rev & T C §17016 (rebuttable presumption of residence); NY Tax L §605(b) (defining "resident" and "nonresident").

The Oklahoma oil interests could present a problem, because they might be categorized by Oklahoma as real property and by the domiciliary state as personal property, resulting in double taxation of the interests. However, Oklahoma currently has a "pick-up" tax that results in zero tax for decedents dying after December 31, 2004.

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§23.86 2. Planning to Minimize State Death Taxation

Trust real property is taxed by the situs state. The only way to avoid this taxation is (1) by making a completed gift of the property before death, (2) by forming an entity and transferring the property to the entity (with the consequence that the decedent's interest in the entity is intangible property taxed in the state of domicile), or (3) by selling the property and reinvesting the proceeds in another state. Any death taxes avoided by a disposition of the property may, however, be offset by the income tax on the sale of appreciated property (unless there is a tax-free exchange under IRC §1031) or, on a gift, by the loss of a stepped-up basis for the property in the hands of the donee for income tax purposes under IRC §1014. See §4.41.

Problems of double taxation of intangibles can generally be minimized if the trust situs is located in the settlor's domicile or else in a state that exempts from taxation intangibles of a nonresident settlor or has only a "pick-up" estate tax, such as California.

In the hypothetical Jones trust described in §23.6, the settlor might consider disposing of the oil interests or forming an entity to hold the interests because they may be taxed as personal property by his domicile and as real property by Oklahoma. He might also consider the tax effects of a gift of the trust real property to his children or to charity, or a sale or exchange of the property if he wishes to avoid taxation of the real property by the situs states. With respect to the apartment building, New York has a "pick-up" tax that now results in payment of additional tax. See NY Tax L §952(a).

If Robert becomes a resident of California, New York will exempt the intangibles from death taxation. See NY Tax L §960(a). If he becomes a resident of New York, the intangibles will be subject to tax by New York only. Compare NY Tax L §954(a) with Rev & T C §13304 (California "pick-up" estate tax based on property "having a situs in California"). The settlor may wish to create an entity to hold the apartment building, because the settlor's interest in the entity is an intangible. No tax will be owed to California in any event. However, estate tax may still be owed to New York on estates of domiciliaries in excess of $1 million. NY Tax L §951(a).

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C. Payment of State Death Taxes and Apportionment

§23.87 1. Nature of Apportionment Problem

Under federal law, the decedent's probate estate bears the burden of all federal estate taxes attributable to taxable property, absent a state tax apportionment statute or an express clause by the decedent on payment of taxes. IRC §§2205-2207B. See chap 15.

Many states, including California, have apportionment statutes that provide for allocation of federal and state death taxes among the persons receiving interests in the decedent's taxable estate, unless the decedent has directed otherwise. See Prob C §§20100-20225; *Hoover v Hartman* (1982) 136 CA3d 1019, 186 CR 669. A few states (*e.g.,* Alabama) specifically provide against apportionment, and some states have no statutory provisions. In those states, absent a direction by the decedent, all taxes are generally paid from the residuary estate.

Tax apportionment questions may arise when the trust situs differs from the settlor's domicile and the apportionment law of the two states differ, one state requires apportionment and the other does not, or a decedent dies leaving a taxable probate estate in one jurisdiction and nonprobate taxable assets in trust elsewhere. Problems also may arise when the place of the decedent's domicile is in dispute.

It is not clear whether the law of the settlor's domicile or the trust situs governs payment of taxes. See *Doetsch v Doetsch* (7th Cir 1963) 312 F2d 323, 328 (in determining apportionment of tax, law of Arizona, as settlor's domicile, applied, rather than law of Illinois, as trust situs). But see *Isaacson v Boston Safe Deposit & Trust Co.* (Mass 1950) 91 NE2d 334 (law of trust situs rather than law of settlor's domicile governed apportionment). By refusing to apply the law of the decedent's domicile, the state of the trust's situs may have the last word on which jurisdiction's law of apportionment applies.

In more recent cases, however, the courts have favored the law of the domicile. This trend comports with the modern interest-analysis approach, *i.e.,* choosing which law to apply in a multijurisdictional problem on the basis of weighing each state's interest in applying its own law. See *Mazza v Mazza* (DC Cir 1973) 475 F2d 385, 388 (analyzing superior interest of decedent's domiciliary jurisdiction in protecting principal beneficiaries of his bounty).

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§23.88 2. Planning for Payment of Death Taxes

The trust instrument and the will should specify whether taxes on the trust property must be paid by the executor of the settlor's estate or by the trustee. In the latter case, the trust instrument should state whether the taxes should be charged against income or remainder interests or collected directly from the trust beneficiaries and how any penalties or interest should be charged. If a settlor's will provides for payment of all estate and inheritance taxes by the executor, it should state whether or not there is a right of contribution against the trust; if there is, the trust should authorize the trustee to reimburse the executor for taxes paid by him or her on trust property.

Charging of taxes against trust interests is particularly important if there are marital or charitable bequests, because charging taxes against these bequests may endanger the amount of the marital or charitable deduction and thereby increase the amount of death and estate taxes payable. See *Estate of Herbert R. Penney* (1972) 59 TC 102, rev'd (6th Cir 1974) 504 F2d 37 (Ohio law differently construed by Tax Court and court of appeals). See also 3 Nossaman & Wyatt, Trust Administration and Taxation §§49.05-49.06 (rev 2d ed 1966) (discussion of divergent law of various states).

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§23.89 3. Application of Apportionment Clause to Hypothetical Jones Trust

In the hypothetical Jones trust described in §23.6, the trust should include a clause directing the trustee to pay all federal estate taxes and state death taxes because substantially all the settlor's assets will be transferred to the trust. If Robert Jones intends to make the maximum gift to his children, the taxes should be charged against both shares; otherwise, they should be charged only against the nonmarital share going to the children. To avoid reducing the value of the charitable deduction, taxes should not be charged against the charitable gift.

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§23.90 D. State Death Taxation of Beneficiary's Interest

On a beneficiary's death, his or her domicile may be able to tax the beneficiary's interest in a trust of intangibles situated in another state if the interest is vested or the beneficiary has a power of appointment over the trust property. See *Graves v Schmidlapp* (1942) 315 US 657, 86 L Ed 1097, 62 S Ct 870 (upholding validity of New York estate tax on New York decedent who exercised general power of appointment over intangibles in Massachusetts trust); *Estate of Johnson* (1965) 233 CA2d 785, 43 CR 913 (Missouri law determined whether California beneficiary's remainder interest in Missouri trust was vested and, if vested, was subject to California inheritance tax).

When the power has not been exercised, non-California cases differ about whether the donee's domicile may tax intangibles in a trust situated in another state. In some cases, the donee's domicile has taxed such property, even though the power had been reduced from a general to a limited power. See *Estate of Mueller* (Wis 1970) 177 NW2d 60; *Colorado v Cooke* (Colo 1962) 370 P2d 896. In *Schneider v Laffoon* (Ohio 1965) 212 NE2d 801, 804, however, the court held that such property was not taxed by the donee's domicile.

In the hypothetical Jones trust described in §23.6, the laws of New York, California, Oklahoma, and New Jersey must be reviewed to determine the tax effects of giving the settlor's children limited powers of appointment and the tax effects of the exercise or nonexercise of these powers.

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E. State Gift Taxation

§23.91 1. Taxation of Real Property and Tangibles

When a completed gift has been made, the transfer in trust of real property and tangible personal property permanently situated in another state is usually subject to gift taxation only by the situs state. The transfer in trust of tangible personal property temporarily located in another state is generally taxed only by the settlors' domicile.

In at least one case, the settlor's domicile taxed the transfer of tangibles in another state, which were purchased with intangibles as part of an overall plan to avoid gift taxation, on the ground that the transaction was essentially a transfer of intangibles. See *Van Dyke v Commissioner* (Wis 1940) 292 NW 313, aff'd (1940) 311 US 605, 85 L Ed 383, 61 S Ct 36 (Wisconsin taxed resident on "transfer" in trust of several tons of silver dollars purchased in Illinois even though trust agreement was executed in Illinois and trustee, a Wisconsin corporation, actually received trust corpus in Illinois).

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§23.92 2. Taxation of Intangibles

In general, only the settlors' domicile can impose a gift tax on intangibles situated in their domicile that are transferred to a trustee in another jurisdiction. In some cases, however, when the intangibles have acquired a situs in another state at the time of the transfer, or at the time of relinquishment by the settlors of retained trust rights that result in a completed gift, the transfer also may be subject to gift taxation by the situs state.

These general rules are subject to statutory variations. For example, some states exempt from gift tax a transfer of intangibles situated in another state; other states exempt transfer of intangibles by nonresidents; and some states exempt intangibles transferred by the residents of other states with reciprocal exemption statutes. See Hess, Bogert & Bogert, The Law of Trusts and Trustees §300 (3d ed 2000).

In the hypothetical Jones trust described in §23.6, because the settlor is establishing a revocable trust for his benefit during his lifetime and is not making a completed gift, gift taxes will not be due on the transfer of either real or personal property to the trust.

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§23.93 3. Planning for Gift Taxes

Gift taxation by the situs state of a completed gift of real property in trust cannot be avoided. The settlors might, however, consider selling the real property and transferring the proceeds to a trust in another state, thereby eliminating a gift in the situs state. The disadvantages of this approach are that a capital gains tax on appreciated property would have to be paid and, if the sales proceeds are evidenced by a note secured by the real property, the situs state might consider the note to be real property.

If it is more advantageous to have tangible personal property taxed by the situs state than by the settlors' domiciliary state, as many independent facts as possible should be marshaled to demonstrate that the situs is permanent. If it is more advantageous to have the property taxed by the settlors' domicile, facts indicating that the situs is only temporary should be gathered.

It is usually difficult to avoid paying gift taxes to the settlors' domicile on a completed gift of intangibles, except when the domicile exempts from taxation the transfer of intangibles with a situs in another state. However, it may be possible to transfer assets completely free from gift taxation when the settlors' domicile exempts transfer of intangibles in another state and the situs state exempts the transfer of intangibles by nonresidents.

In the absence of exemption statutes, the parties may be able to avoid double payment of taxes to both the domiciliary state and the state in which the intangibles are located. If the intangibles have acquired a situs in another state (*e.g.,* securities held in an agency account in a state that imposes a gift tax), the intangibles should be moved to the settlors' domicile before the transfer in trust is made.

Imposition of gift tax by the situs state may be difficult to prevent when the settlors relinquish rights in the trust after its establishment, resulting in a taxable gift at that time. Accordingly, relinquishment of all rights at the inception of the trust should be considered to avoid taxation by the situs state and the domiciliary state at a later date.

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§23.94 4. Application of State Gift Taxation to Hypothetical Jones Trust

California and New York gift taxes were repealed effective in 1982 and 2000, respectively, but assume that the taxes remain in effect with respect to the hypothetical Jones trust described in §23.6. If Robert Jones were to release his power of revocation over the trust, gift taxes would be payable to each state, with respect to trust real property situated in that state, and possibly to Oklahoma if the oil interests are real property. Gift taxes would be payable to the domiciliary state on the completed gift of the securities.

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F. State Income Taxation

§23.95 1. Taxation of Trusts and Beneficiaries

State taxation of trust income differs widely from state to state. Some states have no income tax laws, and the tax laws of the other states are far from uniform. In general, most states with income tax laws, including California, tax all trust income derived from sources within the state regardless of whether the trustee, beneficiary, or settlor is a resident of the state. On federal and California taxation of trusts and beneficiaries, see chap 4.

What constitutes "income derived from sources within the state" is a complex question. For example, the source of dividends on stock may be the situs of the corporate payor or the place of the owner's domicile. See *Miller v McColgan* (1941) 17 C2d 432, 438 110 P2d 419. Compare *Robinson v McColgan* (1941) 17 C2d 423, 424, 110 P2d 426 (situs of stock held in California revocable trust was in China, home of settlor-beneficiary, when sole duty of trustee was to collect and pay trust income to settlor), with *Henley v Franchise Tax Bd.* (1953) 122 CA2d 1, 4, 264 P2d 179 (dividends from Canadian corporation doing business only in Canada held not to be "sources within" California). See also *Valentino v Franchise Tax Bd.* (2001) 87 CA4th 1284, 105 CR2d 304 (source of income of S corporation, not situs of stock, determines whether nonresident shareholder's pro rata share of income is taxable by California).

In California, all trust income, whether derived from sources within or outside the state, is taxable to the trust if either the trustee or a beneficiary, other than a contingent beneficiary, is a resident, subject to the apportionment rules described below. Rev & T C §17742(a). When the trustee and the beneficiary are nonresidents, only that income derived from sources within California is taxed to the trust. Rev & T C §17953. If the trust income is currently distributable (whether to a resident or a nonresident beneficiary), the trust is entitled to a deduction for amounts distributable—just as it is under federal law. Rev & T C §17731; IRC §651. Although a California beneficiary is taxed on all current distributions, a nonresident beneficiary is taxed by California only on income from sources within California. Rev & T C §17953.

NOTE: This discussion relates to taxation of an irrevocable trust over which the settlors have retained no powers. If the settlors have retained the power to revoke the trust or other taxable powers, the trust income is generally taxed to them as under federal law.

When there are California and non-California trustees, accumulated income from sources outside California is taxable to the trust based on the proportionate number of California trustees. Rev & T C §17743. Similarly, when there are California and non-California beneficiaries, accumulated income from sources outside the state is taxable to the trust based on the proportionate number of California beneficiaries. Rev & T C §17744.

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§23.96 2. Tax Credit Statutes

Although most states have tax credit statutes allowing a resident a credit for income taxed by another state, many of these statutes were not designed specifically for trust problems and do not afford any relief for double taxation of trust income. These statutes generally apply to income taxed to the same person by two jurisdictions. In a multistate trust, however, trust income can be taxed to different persons by different states, *e.g.,* the trustee and the beneficiary may both be taxed on the same income by their respective domiciles.

In California and a few other states, there are express statutory provisions allowing tax credits to prevent double taxation of trust income. Subject to certain qualifications, California residents and trusts are permitted a credit for taxes paid to another state on trust income from sources within that state. Rev & T C §§18001-18005. Nonresident individuals and trusts are permitted a credit against California income taxes for income taxes paid to their state of residence if that state has a reciprocal statute for California residents. Rev & T C §18002. When a trust is considered to be a resident of both California and another state, it is entitled to a credit for taxes paid to the other state even without a reciprocity statute. Rev & T C §18004. The California credit cannot exceed that proportion of the California tax attributable to income taxed by other states even though the total taxes paid may be greater. Rev & T C §18001.

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§23.97 3. Application of State Income Taxation to Hypothetical Jones Trust

If, in the hypothetical Jones trust described in §23.6, Robert Jones is considered to be a resident of New York, all income of the trust will be taxed to him during his lifetime by New York, as it is for federal tax purposes, because he has retained the right to income and the right to revoke the trust. See NY Tax L §§601, 611-616. California will impose a tax on Robert on the trust income from real or personal property situated within the state because Robert is technically the owner of this property for tax purposes. See Rev & T C §17734.

Assuming that Robert has not changed his New York residence and that a resident of New York will act as trustee of real property outside New York (see §§23.46-23.47), the trust will be taxed on his death as follows: New York will tax all income from all sources as fully as it is taxed for federal income tax purposes. Oklahoma and California will continue to impose a tax on trust income derived from sources within the state, but double taxation by New York will be alleviated by the New York tax credit statute. NY Tax L §620.

Robert's children, residents of New Jersey and the beneficiaries of a portion of the trust on Robert's death, will be taxed by New York only on income distributions to them from sources within New York, to the same extent as they are subject to federal taxes, subject to some modification. See generally NY Tax L §§631-639.

If Robert is considered a resident of California, the income tax aspects of the trust will be significantly changed during his lifetime. California will tax all the trust income to him as the owner of the trust property, subject to a credit for income taxes paid to another state. New York will tax only income to him from sources within the state. Although New York and Oklahoma will tax income from sources within the state, the California tax credit statute substantially eliminates double taxation.

Assuming that Robert was a California resident at the time the trust was established and that a New York individual cotrustee will act with respect to the California real property, on his death the trust will not be considered a California or a New York resident trust. When neither the trustee nor the beneficiaries are residents, California will tax only income from sources within the state. See Rev & T C §§17734, 17742-17744, 17953. The trust will not be a New York resident because New York determines the residence of a trust by the domicile of the settlor at the time of his or her death if the trust was created at the time of his or her death, or at the time of creation of the trust if the trustor was then domiciled in New York, regardless of the residence of the trustee and place of administration. NY Tax L §605(b). Therefore, it appears that New York, California, and Oklahoma will tax only trust income derived from sources within the state and that income and capital gains of the intangibles will not be taxed by any state.

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§23.98 4. Planning for State Income Taxes

Before establishing a multistate trust, the parties should examine the income tax laws of the domiciles of the settlors, beneficiaries, and proposed trustee and of the trust situs to ascertain how the trust income will be taxed. When a state has no income tax laws, the property tax laws should be reviewed because in some states property taxes may be based on trust income. See §§23.95-23.97.

If convenient, the trust situs and trustee's domicile should be in a state that does not levy an income tax or a property tax based on income. If this cannot be accomplished, as a general rule, most of the elements of the trust should be concentrated in one state to avoid multiple taxation by several states. For example, in the hypothetical Jones trust described in §23.6, it would be better to have a resident of New York act as cotrustee with the New York corporate trustee to avoid having half the trust income taxed by California. If, however, the trust is situated in a state with a high rate of income tax and the tax is based on the residence of the trustee (*e.g.,* California), it may be advantageous to appoint additional trustees in other states that have no income tax laws or that have lower income tax rates, thus reducing the total taxes paid by the trust.

PRACTICE TIP: The trust should include a specific clause authorizing the trustees to appoint additional trustees, because it is unclear whether trustees can be added, absent such a clause. See 1A Nossaman & Wyatt, Trust Administration and Taxation §26.09 (rev 2d ed 1966).

As noted in §23.97 with respect to the Jones trust, in some situations taxation of trust income after the settlors' deaths can be minimized by establishing a trust outside the settlors' domicile. Taxation of income of intangibles may be avoided if the trust situs bases residence on the settlors' domicile (*e.g.,* New York) and the settlors' domicile bases residence on the trustees and beneficiaries situated within the state (*e.g.,* California).

After the trust has been established, the trustee should be certain that all taxes on trust income owed to his or her domicile have been paid before making any distributions of trust income or principal. Otherwise, the trustee may be held personally liable for such taxes in certain instances. See Rev & T C §19516.

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G. Property Taxes

§23.99 1. Basic Property Tax Principles

Real property and tangible personal property with a permanent situs are subject to property taxation only by the situs states. See *Union Refrigerator Transit Co. v Kentucky* (1905) 199 US 194, 50 L Ed 150, 26 S Ct 36. Intangibles, however, may be taxed by more than one state. See *Curry v McCanless* (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900. Accordingly, a trust of intangibles may be subject to property taxation by the domiciles of the trustees as well as the domiciles of the settlors and the beneficiaries if they have certain rights of ownership. See *Greenough v Tax Assessors* (1947) 331 US 486, 91 L Ed 1621, 67 S Ct 1400 (upholding Rhode Island property tax on Rhode Island cotrustee based on his proportionate share of trust corpus, even though other cotrustee was New York resident and entire trust corpus, consisting of stock certificates, was situated in New York).

However, many states do not impose a property tax on intangibles, including California and New York. The problems of multiple taxation of trust intangibles are minimal for a trust having contacts only with such states.

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§23.100 2. Taxation of Intangibles by Settlors' Domicile

If the settlors retain no rights with respect to the trust, their domicile cannot tax trust intangibles unless other factors on which taxation can be based are present, *e.g.,* if the trust situs or the domicile of the trustee is within the state. See *Safe Deposit & Trust Co. v Virginia* (1929) 280 US 83, 74 L Ed 180, 50 S Ct 59; 3 Nossaman, Wyatt & McDaniel, Trust Administration and Taxation §50.24[2] (rev 2d ed 1966). If the settlors retain a power of revocation, however, the property may be considered to be owned by the settlors for property tax purposes and may be taxable by their domicile. In this event, if the trust situs and settlors' domicile differ, the trust property may be subject to property taxation by both states.

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§23.101 3. Taxation of Intangibles by Beneficiary's Domicile

The domicile of the beneficiary cannot tax trust intangibles unless certain elements of the trust are situated within the beneficiary's domicile or he or she has the right to possession or control of the trust assets. See *Brooke v Norfolk* (1928) 277 US 27, 72 L Ed 767, 48 S Ct 422. In the latter event, the beneficiary may be considered to be the owner of the property, and his or her domicile as well as the situs state may tax the trust property.

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§23.102 4. Application of Property Taxes to Hypothetical Jones Trust

Real property in the hypothetical Jones trust described in §23.6 will be taxed by the situs states. Accordingly, the New York apartment building will be taxed by New York, and the California real property will be taxed by California. The oil interests may be taxed by Oklahoma if they are considered to be real property by Oklahoma.

Intangibles of the trust will not be taxed regardless of Robert Jones's residence because neither New York nor California imposes a property tax on intangibles.

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§23.103 5. Planning for Property Taxes

Multiple taxation of trusts of intangibles can be prevented by establishing the trust in a state that does not tax intangibles. If, however, the trust will be established in a state that taxes intangibles, multiple taxation can be eliminated if neither the settlors nor the beneficiaries have any rights with respect to the trust, which are considered to be equivalent to present ownership of the trust property. If the elimination of these rights is not feasible, it is advantageous to have all the trustees or a majority of the trustees reside in the domicile of the settlors or the beneficiaries to reduce the number of states that may impose a tax.

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Source: Estate Planning/Drafting California Revocable Trusts/23 Multistate Trusts/§23.104 VII. CHECKLIST: MULTISTATE TRUSTS

§23.104 VII. CHECKLIST: MULTISTATE TRUSTS

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The following is a checklist of items that should be considered by an attorney in the initial planning, drafting, and administration of a multistate trust. The checklist is designed to guide an attorney faced with the problem of planning and drafting a trust with multistate contracts or a problem after the trust has been created. This checklist is only a starting place, however; careful practitioners will devise their own checklist for specific problems.

The checklist need be no different from those commonly used by drafters, but it should deal with *every* state involved. The best way to tailor a checklist to individual needs is to test the trust against what may happen in the future.

A. Planning the Trust

- Which state would be most favorable as the trust situs for validity, construction, administration, and taxation?
- Which state will be selected for concentration of the trust elements?
- Review the laws of each state having contact with the trust for the matters set out below.

B. Validity of Trust

- Does the trust violate rules against perpetuities, accumulations, testamentary dispositions, and charitable gifts?
- Are the trust purposes valid?
- Is the trust adequately funded?
- Is a pourover to the trust permitted under the laws of the settlors' domicile and the trust situs?
- Who can act as trustee?
- What is the effect of total or partial invalidity of the trust?

C. Execution of Trust and Amendment to Trust

- What are the formalities of execution?
- Is notarization or recordation necessary?
- Is execution with testamentary formalities necessary?
- Is acceptance by the trustee necessary?
- Is notification of the beneficiaries necessary?
- For a trust of community property, are the signatures of both spouses necessary?
- What documents are necessary to transfer title to trust assets to the trustee?
- Are there any particular requirements regarding the form of title to trust assets?
- Must the trustee be identified as a trustee?
- Can the trustee take title in the name of a nominee?
- What procedures must be followed to amend the trust?
- If the settlor's will provides for a pourover to the trust, does an amendment to the trust require codicils to the wills thereafter?

D. Rights of Settlors, Beneficiaries, and Their Creditors

- Is a declaration regarding revocability or irrevocability necessary?

- Does the settlor have the right to amend the trust?
- Is a spendthrift clause valid?
- What are the rights of the creditors of the settlors?
- What are the rights of the creditors of the beneficiaries?
- When do income payments begin?
- What are the respective rights of life and remainder beneficiaries?

E. Trustee's Problems

- What is the procedure for resignation and removal of the trustee and appointment of a successor trustee?
- Can trust assets be transferred to a new place of administration with a change of trustee?
- What law governs administration and construction of the trust with a change of trustee?
- How does the trustee account?
- Who has the right to demand an accounting?
- How conclusive is such an accounting?
- Is joint action necessary by multiple trustees?
- What investments can be made by the trustee?
- What are the requirements regarding bonding of the trustee?
- How is the trustee's compensation determined?
- How are trust assets distributable, *e.g.,* in cash, in kind, or on a nonprorata basis?
- What are the trustee's liabilities?
- What are the effects of an unauthorized act?
- What is the effect of an exculpation clause?
- Are there any prohibitions against authorizing self-dealing?
- Are there particular rules of trustee liability?
- What court has jurisdiction over the trustee in the event of a breach of trust?
- Will the jurisdiction permit alternative forms of dispute resolution?
- May the duties of the trustee be divided among different persons or entities?

F. Powers of Appointment

- Is the power valid under the law governing the trust?
- Can the power be exercised by a further appointment in trust?
- Can appointed property be transferred to another jurisdiction?
- Can the power be released and, if so, what procedure must be followed?

G. Marital Rights

- What are the surviving spouse's dower, statutory share, community property, or quasi-community property rights?
- What are the tax and substantive effects of a transfer of community property to a separate property jurisdiction?
- What are the consequences if the settlors subsequently become residents of the trust situs?

H. Charitable Trusts

- Are the purposes valid?
- Are any mortmain statutes or perpetuity statutes violated?

- Are a spouse's rights violated?
- Will the trust be exempt from income and death taxation?
- To what extent will the trust be subject to state supervision?

I. Tax Problems

- Is the settlors' domicile or residence clearly established under the tax laws?
- What are the inheritance, gift, income, and property tax consequences of creating the trust—to the settlors as well as the beneficiaries?
- Will exemption statutes avoid double taxation?
- Can any trust property be categorized as both real or personal property? If so, should it be converted into other forms?
- For death tax purposes, will the marital deduction be allowed, and will separate and community property be treated as such by the taxing state?
- How will death taxes on trust property be paid?
- Are there adequate provisions for payment in the settlors' wills and the trust?

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Appendix A

Married Settlors' Formula Marital Deduction Trust—Optional QTIP Trust

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Description

This form is suitable as a framework for married couples having sufficient wealth to be concerned with the imposition of federal estate taxes. The settlors are named as trustees. On the death of the first spouse to die, the trust property is distributed to three or more trusts. The first trust is the survivor's trust, which is funded with the surviving settlor's half of the community property and the survivor's own separate property. The deceased settlor's property is primarily distributed to a QTIP marital deduction trust and a bypass trust. The QTIP marital trust contains enough property to reduce the federal estate tax to zero on the first death. With the modifications described in the practice tip below, the QTIP trust can be omitted, with the Survivor's Trust being used as the marital deduction trust.

WARNING: If one of the settlors is not a United States citizen, the qualified domestic trust (QDOT) provisions in §13.33 should be incorporated in the trust to ensure that the trust qualifies for the marital deduction.

The surviving settlor has complete access to the assets of the survivor's trust. The survivor is also entitled to all income from the QTIP trust and the bypass trust. This form permits liberal invasions for the surviving settlor. These distribution terms can be modified, subject to the limitation that the survivor must receive all income from the QTIP trust and no one else can receive property from the QTIP trust during the survivor's lifetime. These forms also give the survivor powers to appoint the remainder interests in the QTIP trust and bypass trust. These powers are optional and would not be appropriate absent additional restrictions when the settlors wish to protect the interests of issue of previous marriages.

PRACTICE TIP: This form can be modified to provide that the marital deduction gift is to be made to the survivor's trust rather than the QTIP trust. Paragraph IV.C. should be modified to change references to the QTIP Trust to the Survivor's Trust, Division VII should be deleted, and the references in VIII.A. to the QTIP Trust should be amended to refer to the Survivor's Trust.

The distribution provisions in this form are incomplete. The drafter must edit and complete, as appropriate, the first death distribution provisions in paragraph IV.C., the Survivor's Trust second death distribution provisions in paragraph V.D., the Bypass Trust second death distribution provisions in VI.E., and the QTIP Trust second death distribution provisions in VII.H. Sometimes a settlor will want certain distributions made on his or her death regardless of the order of death. If so, it will often be necessary to have a double set of distribution provisions—one that applies if that settlor dies first and another that applies if that settlor dies last.

WARNING: If the trust benefits a "disqualified person," 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 to determine whether any transferee or trustee might meet the definition. See *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248. See also *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390. An attorney who fails to advise the settlor that a certificate of independent review is needed may later be sued by the disappointed intended transferee. See *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246. For a form of certificate of independent review intended for use when a disqualified person will be a trustee, see §5.15. For a form that can be used when a disqualified person will be a beneficiary of a trust, see §22.13.

A simpler alternative can be used for Division III (distributions while both settlors are living) if there is little separate property or if the owner of the separate property is willing to allow the other settlor greater access to that property.

WARNING: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

THE _ _[*NAME OF TRUST*]_ _ TRUST

OPENING DECLARATION

DIVISION I. CREATION OF TRUST

A. Initial Trust Property

B. Character of Trust Property

DIVISION II. PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. Purposes of Trust

B. Initial Trustees

C. Successor Trustees

D. Family Information

DIVISION III. DISTRIBUTIONS WHILE BOTH SETTLORS ARE LIVING

A. Distributions of Community Property

B. Distributions of Separate Property

DIVISION IV. DISTRIBUTION ON FIRST DEATH

A. Surviving Settlor's Property

B. Decedent's Property; Power of Appointment

C. Decedent's Property That Is Not Effectively Appointed

D. Simultaneous Death

DIVISION V. SURVIVOR'S TRUST

A. Purpose of Survivor's Trust

B. Distributions During Survivor's Lifetime

C. Distribution on Death—General Power of Appointment

D. Distribution if Power of Appointment Not Exercised

E. Marital Deduction Survivor's Trust

DIVISION VI. BYPASS TRUST

A. Purpose of Bypass Trust

B. Income Distributions During Survivor's Lifetime

C. Principal Invasions During Survivor's Lifetime

D. Distribution on Death—Special Power of Appointment

E. Distribution if Power of Appointment Not Exercised

DIVISION VII. QTIP TRUST

A. Purpose of QTIP Trust

B. Authorization to Make QTIP Election

C. Income to Surviving Settlor for Life

D. Principal Invasions During Survivor's Lifetime

E. Consideration of Other Resources

F. Division of QTIP Trust

G. Taxes Resulting From Inclusion of Generation-Skipping Tax-Exempt QTIP Property

H. Distribution on Death—Limited Power of Appointment

I. Distribution if Power of Appointment Not Exercised

DIVISION VIII. ADDITIONAL DISTRIBUTION PROVISIONS

A. Distribution to QTIP Trust and Bypass Trust

B. Interest on Pecuniary Amounts

C. Undistributed Income

D. Distributions to Young Persons

E. Distribution Terminology

F. Distribution Powers

G. Limitations on Discretionary Distributions to Trustee

H. Prohibition Against Discharge of Support Obligation

I. Apportionment of Taxes

J. Transfer Taxes Caused by Disclaimer

DIVISION IX. DEBTS

A. Debts of Deceased Settlor and Estate

B. Allocation Between Deceased Settlor and Surviving Settlor

C. Debts of Surviving Settlor and Estate

D. Limitations on Sources of Payments

DIVISION X. OFFICE OF TRUSTEE

A. Definition of Trustee

B. Scope of Trustee Provisions

C. Resignation of Trustee

D. Removal of Any Trustee

E. Power to Name Successor Trustee

F. Temporary Trustee

G. Trustee's Power to Delegate

H. Applicable Rules for Cotrustees

I. Compensation of Trustees

DIVISION XI. TRUSTEE POWERS

A. General Powers of Trustee

B. Specific Powers of Trustee

DIVISION XII. TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

A. Duties of Trustee

B. Limitations on Trustee's Duty of Loyalty

C. Acceptance of Additions

D. Exculpation of Trustee

E. Cotrustee's Duty to Act

F. Limitation on Duty to Investigate Predecessor or Cotrustee

DIVISION XIII. RULES OF CONSTRUCTION

A. Applicable Law

B. Context

C. Relevance of Common Estate Planning Practice

DIVISION XIV. MISCELLANEOUS

A. Property Retains Character

B. Exception: Joint Tenancy Property

C. Spendthrift Clause

D. Rule Against Perpetuities

E. No-Contest Clause

DIVISION XV. REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

A. Trust Irrevocable Except as Provided

B. Procedural Requirements for Amending or Revoking Trusts

C. Effect of Defective Documents

D. Revocation by Gift

E. Effect of Amendment not Acceptable to Trustee

F. Limitation on Exercise of Powers by Conservator or Guardian of Estate

G. Exercise of Powers of Appointment

Signatures; Acknowledgment

EXHIBIT A

Initial Trust Property

5.37-1 Opening declaration

OPENING DECLARATION

The _ _[*Name of Trust*]**_ _ Trust**

We, _ _[*name of settlor*]**_ _ and _ _**[*name of settlor*]**_ _, sometimes hereafter called "settlors," residing in _ _**[*name of county*]**_ _, California, hereby create The _ _**[*Name of Trust*]**_ _ Trust, declaring:**

5.37-2 Creation of trust

DIVISION I
CREATION OF TRUST

A. *Initial Trust Property.* The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is now held by us in trust. This property and any other property later transferred to the trust is hereafter referred to as the trust property and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.

5.30-1 Characterizing trust property

B. *Character of Trust Property.* The attached listing of trust property does not constitute a binding agreement between the settlors with respect to the character of that property as community property, separate property, or quasi-community property, but the trustee may rely on any characterizations of the trust property in that listing until such time as an interested party notifies the trustee that a characterization in the listing is disputed or incorrect.

5.37-3 Purposes, trustees, and family declarations

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. *Care of Settlors.* To provide for our care and maintenance as long as either of us is living;

2. *Avoid Conservatorship.* To facilitate management of the trust property in the event of the incapacity of one or both of us;

3. *Transfer Property at Death.* To facilitate transfer of the trust property on our deaths; and

4. *Tax Planning.* To provide opportunities for reducing or postponing taxes that might be imposed as a result of our deaths.

B. *Initial Trustees.* We are the initial trustees of this trust.

C. *Successor Trustees.* If either of us ceases to be a trustee of this trust, the other shall become the sole trustee. If the sole trustee resigns or ceases to be trustee, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify, resigns, or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.

D. *Family Information.* In connection with the administration of this trust, the trustee may rely on the following family information:

1. *Marriage*. We are husband and wife and were married in _ _[*city and state of marriage*]_ _ on _ _[*date of marriage*]_ _.

2. *Citizenship*. _ _[*We are both/We are not/_ _[Name of settlor*]_ _ *is a citizen of the United States. _ _[Name of settlor*]_ _ *is not a*]_ _ citizen(s) of the United States.

3. *Children*. The names and birthdates of our children are: _ _[*List names and birthdates*]_ _.

4. *Deceased Children*. Neither of us have deceased children who are survived by issue now living.

DIVISION III
DISTRIBUTIONS WHILE BOTH SETTLORS ARE LIVING

6.5-1 Distributions of community property

A. *Distributions of Community Property.* While we are both living, the trustee shall pay to us, or apply for our benefit, as much of the community property income and principal of this trust as either of us requests plus such additional sums as the trustee in its discretion determines are appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. All distributions of community property income or principal shall be paid to us or applied for our benefit as community property.

6.8-1 Distributions of separate property to married settlors

B. *Distributions of Separate Property.* While we are both living, trust property that is the separate property of one of us (the "owning settlor") shall be distributed or provided for use in kind as the owning settlor requests. If at any time an owning settlor is not competent to make requests, the trustee shall pay to us or apply for out benefit as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. In exercising its discretion, the trustee shall take into account that we desire that property shall be applied for these purposes in a manner similar to the applications we made while competent. If the trustee is uncertain about our past practices, or if a particular expense is new or significantly changed in amount, the trustee shall apply property in the following order:

1. *Income*. _ _[*Approximately proportionate shares of the income from community and the income from separate property./First from the community property income and thereafter from the separate property income.*]_ _ For purposes of this subparagraph, "income" includes periodic receipts commonly used to pay current living expenses, including receipts from pensions, social security, and disability or long-term care insurance.

**2. *Liquid Investment Assets*. _ _[*Approximately proportionate shares of community property and separate property*

cash, marketable securities, and other liquid assets./First from the community property cash, marketable securities, and other liquid assets, thereafter from the separate property cash, marketable securities, and other liquid assets.]_ _

3. *Other Property*. _ _[*Approximately proportionate shares of any remaining community property and separate property./First from any remaining community property and thereafter from separate property.*]_ _

DIVISION IV
DISTRIBUTION ON FIRST DEATH

10.8-1 Division of trusts

On the death of whichever of us is the first to die (the "Deceased Settlor"), the property of the survivor of us (the "Surviving Settlor") shall be distributed to the trustee of the Survivor's Trust described in the next Division and the property of the Deceased Settlor shall be allocated and distributed in accordance with the wishes of the Deceased Settlor, as follows:

A. *Surviving Settlor's Property.* The trustee shall distribute to the trustee of the Survivor's Trust the Surviving Settlor's separate property, one-half interest in community property, and any share of the separate property of the Deceased Settlor that the Surviving Settlor would be entitled to receive under the laws of the Deceased Settlor's domicile at death, including, if applicable, any share of quasi-community property or other forced share.

B. *Decedent's Property; Power of Appointment*. The trustee shall distribute the remaining property (the "Deceased Settlor's property") as the Deceased Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee including the Deceased Settlor's estate.

C. *Decedent's Property That Is Not Effectively Appointed*. The trustee shall distribute any of the Deceased Settlor's property that was not effectively appointed by the Deceased Settlor under the preceding paragraph as follows:

1. *To the Trustee of the Survivor's Trust*: _ _[*Specify, e.g., all furniture, furnishings, clothing, personal effects, private papers, jewelry, motor vehicles, tools, and recreation equipment.*]_ _

2. *To the Trustee of the QTIP Trust*: A fractional share of the residue of the Deceased Settlor's property that is the smallest fractional share of the Deceased Settlor's property 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 the Deceased Settlor's death, as further explained in the Division of this document titled "Additional Distribution Provisions."

3. *To the Trustee of the Bypass Trust*: The other fractional share of the residue of the Deceased Settlor's property.

9.7-1 Simultaneous death

D. *Simultaneous Death*. If the order of the settlors' deaths cannot be ascertained, _ _[*name of deemed survivor*]**_ _ shall be deemed to be the Surviving Settlor for purposes of this Division.**

DIVISION V
SURVIVOR'S TRUST

12.6-1 Purpose of survivor's trust

A. *Purpose of Survivor's Trust*. This trust is established to hold property that would belong to the Surviving Settlor following the death of the Deceased Settlor but for the provisions of this trust. It is established to provide for the care and maintenance of the Surviving Settlor, to facilitate management of the trust property in the event of the Surviving Settlor's incompetence, and to facilitate transfer of the trust property to beneficiaries chosen by the Surviving Settlor on the Surviving Settlor's death. The Surviving Settlor may revoke the Survivor's Trust with respect to any and all assets at any time as more particularly set forth in the Division of this document concerning Revocation, Amendment, and Exercise of Powers. In the event of such a revocation,

the trustee shall deliver the trust property to the Surviving Settlor.

12.11-1 Distribution of income and principal

B. *Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the income and principal of the Survivor's Trust as the Surviving Settlor requests, plus such additional sums as the trustee, in the trustee's discretion, determines are appropriate for the Surviving Settlor's health, maintenance, support, or education.

12.13-1 General power of appointment

C. *Distribution on Death-General Power of Appointment*. On the death of the Surviving Settlor, the trustee shall distribute the remaining trust property as the Surviving Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Surviving Settlor's estate.

12.17-1 Specified distribution of survivor's trust

D. *Distribution on Death—Property Not Appointed*. On the death of the Surviving Settlor, any property not effectively appointed by the Surviving Settlor shall be distributed as follows: _ _[*Specify.*]**_ _**

12.9-1 Marital deduction survivor's trust

E. *Marital Deduction Survivor's Trust*. If property included in the taxable estate of the Deceased Settlor passes to the Survivor's Trust by reason of the death of the Deceased Settlor, that property shall be held as a separate trust, called the Marital Deduction Survivor's Trust, to be administered and distributed in the same manner as the regular Survivor's Trust, except that during the lifetime of the Surviving Settlor, distributions may be made only to or for the benefit of the Surviving Settlor. It is contemplated but not required that the Surviving Settlor will eliminate the need for this separate trust after the death of the Deceased Settlor by directing that all assets of the Marital Deduction Survivor's Trust be distributed to the regular Survivor's Trust.

DIVISION VI
BYPASS TRUST

14.27-1 QTIPable bypass trust

A. *Purpose of Bypass Trust*. In addition to other purposes, a primary purpose of this Bypass Trust is to avoid estate taxation of the assets of this trust on the death of the Surviving Settlor. Nevertheless, the trust qualifies for a qualified terminable interest property (QTIP) federal estate tax election, so that the tax treatment can be changed if it becomes appropriate to do so.

B. *Income Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor all net income of the Bypass Trust in quarter-annual or more frequent installments. Income earned between the last distribution date and the date of the Surviving Settlor's death shall be distributed to the persons entitled to distribution of income earned immediately following the Surviving Settlor's death. The Surviving Settlor, including any attorney-in-fact or Conservator authorized to act on behalf of the Surviving Settlor, may compel the trustee to invest the trust property in income-producing assets, in which event any otherwise existing trustee power to hold or retain unproductive property shall not apply.

C. *Principal Invasions During Survivor's Lifetime.* If the income is insufficient, the trustee shall pay to or apply for the benefit of the Surviving Settlor, at quarter-annual or more frequent intervals, as much of the principal of this Bypass Trust as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, support, maintenance, and education. In exercising its discretion, the trustee is permitted, but not required, to take into account the Surviving Settlor's income and other resources readily available for these purposes.

D. *Distribution on Death-Special Power of Appointment*. On the death of the Surviving Settlor, the remaining assets of the Bypass Trust shall be distributed as the Surviving Settlor appoints, in accordance with the provisions of this document for exercising a power of appointment. The permitted appointees of this power are

limited to descendants of a parent of either settlor, spouses (including former spouses) of such descendants, and organizations satisfying the definition of "charity" in the Division of this trust on Additional Distribution Provisions, and trusts exclusively benefiting such persons or organizations.

E. *Distribution If Power of Appointment Not Exercised*. If the Surviving Settlor's power of appointment is not effectively exercised with respect to any property of the Bypass Trust, the property not effectively appointed shall be distributed as follows: _ _[*Specify*]**_ _**

DIVISION VII
QTIP TRUST

13.2-1 QTIP trust purpose

A. *Purpose of QTIP Trust.* The property of the QTIP trust shall be held and administered as provided in this Division. This trust is intended to qualify for the federal estate tax marital deduction to the extent that an Internal Revenue Code §2056(b)(7)(B) election is made for that purpose.

13.24-1 Authorization to make QTIP election

B. *Authorization to Make QTIP Election.* The person permitted by Treasury Regulation §20.2056(b)-7(b)(3) to make the Internal Revenue Code §2056(b)(7)(B) election is authorized and encouraged to make that election and thereby qualify the trust for the federal estate tax marital deduction. Nevertheless, the election need not be made, and the authorized person should consider the possible advantages of a partial election or no election, taking into account all relevant factors, including the health and life expectancy of the Surviving Settlor and the impact of the Internal Revenue Code §2013 previously taxed property credit.

13.14-1 Income for life; conversion of nonproductive property

C. *Income to Surviving Settlor for Life.* During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor the entire net income of the QTIP trust in quarter-annual or more frequent installments and no person shall have the power to appoint any part of the trust property to any person other than the Surviving Settlor. Despite the foregoing, trust income earned between the last distribution date and the date of the Surviving Settlor's death shall not be distributed to the Surviving Settlor or the Surviving Settlor'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 the Surviving Settlor. Regardless of any other provision of the trust, the Surviving Settlor shall have the power to require that the trustee make unproductive property productive or convert it to productive property within a reasonable time.

7.62-1 Basic ascertainable standard HEMS power

D. *Principal Invasions During Survivor's Lifetime.* Quarter-annually or more often, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the trust property as the trustee determines is appropriate for the Surviving Settlor's health, education, maintenance, and support.

7.68-1 Consideration of other resources

E. *Consideration of Other Resources*. In exercising its discretion to determine the amount appropriate for the beneficiary's health, education, maintenance, and support, the trustee is permitted but not required to take into account other resources readily available for these purposes.

4.218-1 Division of QTIP trust

F. *Division of QTIP Trust.* If an election is to be made to qualify all or part of the QTIP Trust for the federal estate tax marital deduction, and if a Internal Revenue Code §2652(a)(3) reverse QTIP election is to be made, the QTIP Trust so qualified shall, if necessary, be divided and established as two separate trusts rather than one in order to permit the reverse QTIP election to be made with respect to one trust (the Reverse QTIP Trust), but not the other (the Nonexempt QTIP Trust). The division shall be accomplished in a manner that complies with Internal Revenue Code §2642(a)(3).

4.221-1 Estate tax apportionment

G. *Taxes Resulting From Inclusion of Generation-Skipping Tax Exempt QTIP Property.* If the taxable estate of the Surviving Settlor includes a QTIP trust that is exempt from federal generation-skipping transfer taxes and another QTIP trust that is not exempt, the amount of estate taxes subject to a right of recovery under Internal Revenue Code §2207A as a result of inclusion of the trusts in the Surviving Settlor's taxable estate shall be paid from the nonexempt trust to the extent possible.

13.19-1 Limited power of appointment

H. *Distribution on Death—Limited Power of Appointment.* On the death of the Surviving Settlor, the trustee shall distribute any remaining balance of the QTIP trust property to _ _[*specify class of beneficiaries, e.g., one or more of the settlors' issue and their spouses, including widows and widowers*]_ _ on any terms and conditions, either outright or in trust, and in any proportion that the Surviving Settlor shall appoint in accordance with the provisions of this document for exercising a power of appointment.

12.15-1 Pour over into bypass trust

I. *Distribution If Power of Appointment Not Exercised*. Any trust property not effectively appointed by the Surviving Settlor under the preceding paragraph shall be distributed in accordance with the provisions for distribution of the Bypass Trust that would have applied on the death of the survivor of the settlors had the Surviving Settlor died first.

DIVISION VIII
ADDITIONAL DISTRIBUTION PROVISIONS

11.45-1 Fractional share marital formula

A. *Distribution to QTIP Trust and Bypass Trust*. When the residue of the Deceased Settlor's property is distributed to the QTIP Trust and the Bypass Trust, as provided above, the shares of the trusts and the allocations between them shall be determined and accomplished as follows:

1. *Distribution to QTIP Trust*. The share of the QTIP Trust shall equal the smallest fractional share of the Deceased Settlor's property 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 the Deceased Settlor's death, after taking into account all factors relevant to this estate tax objective, including but not limited to:

(a) All deductions claimed and allowed in determining the estate tax payable by reason of the Deceased Settlor's death.

(b) The net value of all other property (whether or not it is given under this instrument and whether or not it passes at the time of the Deceased Settlor's death or has passed before the Deceased Settlor's death to or in trust for the Surviving Settlor) that is included in the Deceased Settlor's gross estate and qualifies for the federal estate tax marital deduction. If the Surviving Settlor disclaims any property that would otherwise qualify for the federal estate tax marital deduction, the disclaimer shall be disregarded.

(c) All credits allowed for federal estate tax purposes; provided, however, that for this purpose account shall not be taken of any credit for (1) taxes paid in the estate of one whose death occurs after the death of the Deceased Settlor or (2) any state inheritance or estate tax unless, and to the extent that, the tax would be payable to the state or states regardless of the federal credit.

(d) The value of assets as finally determined for estate tax purposes.

2. *Distribution to Bypass Trust*. The Bypass Trust share shall equal the remaining share of the trust property. It is understood that the share of the Bypass Trust as determined under this formula may be 100 percent. Also, if the federal estate tax is repealed or is otherwise not in effect at the time of the Deceased Settlor's death, the share of the residue of the Deceased Settlor's property that will be allocated to the Bypass Trust will be 100 percent.

3. *Qualification for Marital Deduction*. When distributing the Deceased Settlor's property due to the Deceased Settlor's death, the trustee, to the extent possible, shall use property qualifying for the federal estate tax marital

deduction in making distributions to the Surviving Settlor or to the Survivor's Trust, any QTIP Trust, or other trust that otherwise qualifies for the federal estate tax marital deduction.

8.72-1 Interest on pecuniary amounts

B. *Interest on Pecuniary Amounts.* When a beneficiary is entitled to receive payment of a pecuniary amount or an annuity, the beneficiary shall be entitled to receive interest on delayed distributions to the extent provided by California law. If California law has no provision expressly applicable to trusts, interest shall be paid in accordance with California law applicable to a decedent's estate.

7.94-1 Accumulation of undistributed income

C. *Undistributed Income*. In any instance in which this document fails to expressly provide for the distribution or accumulation of any trust income, that income shall be accumulated and added to principal.

8.30-1 Retention in further trust until specified age

D. *Distributions to Young Persons.* If any person otherwise entitled to outright distribution of any property from any trust created by this document is under the age of _ _[*age*]_ _ at the time the right to distribution vests, the trustee shall not make the distribution, but shall, instead, retain the property that would otherwise be distributed in a separate trust for the benefit of the underaged person ("Beneficiary"). 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 then-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 under the provisions of this trust for exercising a power of appointment. If this appointment power is not effectively exercised with respect to any trust property, that property shall be distributed to the then-living issue of Beneficiary, per capita at each generation, and, if none, then to the then-living siblings of 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 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.

E. *Distribution Terminology*. The following directions and definitions apply to the distribution provisions of this trust.

18.15-1 Definition of "charity"

1. *Charity.* A "charity" is any organization described in Internal Revenue Code §2055 or §2522.

8.62-1 Manner of making distribution per capita at each generation

2. *Distribution Per Capita at Each Generation*. In making a per capita distribution at each generation, the trustee shall divide the property to be distributed 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.

18.14-1 Definition of "education"

3. *Education.* "Education" includes primary, secondary, vocational, college, university, postgraduate study, and other specialized studies _ _[*if in the trustee's discretion the study is being pursued to advantage by the beneficiary*]_ _.

18.5-1 Terms of relationship

4. *Terms of Relationship*. Except as expressly provided in this paragraph, half bloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons when appropriate to the class, are included or excluded in terms of class gift or relationship in accordance with California law for determining relationship and inheritance rights for purposes of intestate succession that are in effect on the date of execution of this document. However, a person born out of wedlock to a natural parent shall not be considered a child of that person unless the person lived, while a minor, as a regular member of the household of the natural parent or of that parent's parent, sibling, or spouse; or otherwise during minority was both openly acknowledged by such a person to be the child of the parent and was involved with such a person in an active social relationship. Further, an adopted child shall not be considered the child of an adopting parent unless the adopted person lived while a minor (either before or after adoption) as a regular member of the household of the adopting parent.

F. *Distribution Powers.* For purposes of making distributions, the trustee's powers include the following.

11.50-1 Power to make nonprorata distribution

1. *Nonprorata Distributions*. 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 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 appropriate to accommodate such distributions.

8.68-1 Nonprorata division of community property

2. *Nonprorata Division of Community Property.* Community property and quasi-community property may be divided on the basis of a nonprorata division of the aggregate value of the property, or on the basis of a division of each individual item or asset, or partly on each basis.

8.70-1 Power to delay distributions

3. *Power to Delay Distributions.* When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent

or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it, and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after the trustee receives the income. This provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. Nor does this provision authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.

7.79-1 Limitations on discretionary distributions to trustee

G. *Limitations on Discretionary Distributions to a Trustee*. A person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of him- or herself may exercise that power in his or her favor only for health, education, maintenance, or support within the meaning of Internal Revenue Code §§2041, 2514. Despite the foregoing and California Probate Code §15620, if a power to make discretionary distributions of income or principal is conferred on two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power; and, as long as there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary of that power, and the power may be exercised by the trustee appointed by the court. The restrictions of this paragraph do not apply to a person making distributions of property that the person could withdraw by exercising that person's own power of revocation.

7.25-1 Prohibition against discharge of support obligation

H. *Prohibition Against Discharge of Support Obligation*. No one may exercise, alone or with others, a discretionary power conferred by this document in a manner that results in the discharge of that person's obligation to support another person. This prohibition applies to both personal powers and fiduciary powers. These restrictions do not apply to a person making distributions of property that the person could withdraw by exercising his or her power of revocation.

15.14-1 Equitable proration under California law

I. *Apportionment of Taxes*. Except as otherwise provided in this document, all estate, generation-skipping, and inheritance taxes, including interest and penalties, imposed on or by reason of the inclusion of any trust property in the gross taxable estate of either settlor may be paid by the trustee and charged to, prorated among, or recovered from the trust property or the persons entitled to the benefits under the trust as provided in the California Probate Code and the Internal Revenue Code.

15.16-1 Payment of additional taxes from disclaimed property

J. *Transfer Taxes Caused by Disclaimer.* Any increase in estate, generation-skipping, or inheritance taxes, including interest and penalties, resulting from a qualified disclaimer shall be paid from the disclaimed property.

DIVISION IX
DEBTS

15.28-1 Payment of debts: married settlors' joint trust

A. *Debts of Deceased Settlor and Estate*. On the death of the Deceased Settlor, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. The Deceased Settlor's funeral and last illness expenses;

2. *Other Debts*. Debts of the Deceased Settlor, the Surviving Settlor, or both, that would be properly payable by the Deceased Settlor's probate estate if the trust property were included in the probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Deceased Settlor's probate estate.

B. *Allocation Between Deceased Settlor and Surviving Settlor*. Payments made for the purposes described in Paragraph A shall be allocated and charged to the separate and community property of each settlor as provided by California law, including Probate Code §§19320-19326, and the trustee shall take any action necessary to recover from the Surviving Settlor or the Survivor's Trust amounts paid that are chargeable to the Surviving Settlor's property. Funeral and last illness expenses shall be allocated and charged to property included in the gross estate of the Deceased Settlor for federal estate tax purposes to the extent possible.

C. *Debts of Surviving Settlor and Estate*. On the death of the Surviving Settlor, the trustee may pay from the property of the Survivor's Trust:

1. *Funeral and Last Illness Expenses*. The Surviving Settlor's funeral and last illness expenses.

2. *Other Debts*. Debts of the Surviving Settlor that would be properly payable by the Surviving Settlor's probate estate if the trust property were included in the Surviving Settlor's probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Surviving Settlor's probate estate.

D. *Limitations on Sources of Payment*. Despite the provisions in Paragraphs A, B, and C, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including an Individual Retirement Account) benefits in which the trust acquires an interest as a result of the settlor's death. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the settlor's death in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

DIVISION X
OFFICE OF TRUSTEE

16.3-1 Definition of trustee

A. *Definition of Trustee.* The term "trustee" as used in this document usually refers to such one or more persons or entities who, alone or in combination, have the power to take action on behalf of the trust, but it may instead refer to any form of limited power or special trustee or one or more individual cotrustees, depending on context.

16.4-1 Scope of trustee provisions

B. *Scope of Trustee Provisions.* Except as otherwise provided, the provisions of this document concerning the identity of trustees apply to all trusts established by this document. Similarly, except as otherwise provided, the provisions of this document concerning trustee duties, powers, privileges, and protections from liability, apply to all trustees, including successor trustees, of all trusts established by this document.

16.34-1 Trustee resignation

C. *Resignation of Trustee.* The trustee may resign at any time by mailing notice to the persons entitled by law to receive a trustee's account. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.

16.41-1 Removal of any trustee

D. *Removal of Any Trustee.* Any trustee, including a settlor, may be removed in accordance with California law.

16.39-1 Removal of incompetent settlor acting as trustee

1. *Removal of Settlor-Trustee*. A settlor may be removed from the position of trustee if the settlor can no

longer effectively manage the affairs of the trust because the settlor is missing, lacks the physical ability to act, or lacks sufficient mental capacity to perform the duties of the trustee. A majority of the following named persons shall have the power to determine that a settlor is unable to act as trustee for any of those reasons: _ _[*Names of persons given the power to make the determination*]_ _. The removal power must be exercised by executing and delivering to the successor trustee an affidavit that states that the settlor cannot perform the duties of the trustee and explains the reason(s). Alternatively, if the inability to act is due to lack of physical ability or sufficient mental capacity, a settlor's inability to manage the affairs of the trust may be established by the affidavits of two physicians authorized to practice medicine in the place where the settlor then resides. In the event of a removal of a settlor from the position of trustee under this paragraph, the successor trustee must immediately give that settlor written notice that the successor has assumed the position of trustee unless the whereabouts of that settlor are unknown. A removal under this paragraph does not constitute a determination that the settlor lacks the capacity to exercise any powers of amendment or revocation, and nothing in this paragraph prevents a settlor from overriding a determination under this paragraph by exercising those powers.

16.40-1 Removal of corporate trustee

2. *Removal of Corporate Trustee.* The current income beneficiary (or a legal representative of that beneficiary) of a trust created under this document may remove a current corporate trustee and substitute a successor corporate trustee if the beneficiary or representative reasonably believes that substitution will result in a significant reduction in trustee fees.

16.55-1 Power to name successor

E. *Power to Name Successor Trustee.* A trustee of this trust shall have the power to name a person or entity who shall become that trustee's successor if a successor is required and this document makes no other provision for a successor, or if the successors named in this document are not willing to act. The power shall be exercised as provided in this document for the exercise of a power of appointment.

16.49-1 Temporary trustee

F. *Temporary Trustee*. If an incumbent trustee or co-trustee is temporarily unable to administer the trust, the person(s) otherwise entitled to be the trustee if the incumbent resigned shall become the trustee until the incumbent can resume the duties of trustee.

17.51-1 Delegation of powers and duties

G. *Trustee's Power to Delegate.* The trustee may delegate duties and powers _ _[*other than discretionary distribution powers*]_ _, as long as the trustee exercises reasonable care, skill, and caution in:

1. Selecting an agent;

2. Establishing the scope and terms of the delegation; and

3. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

16.7-1 Cotrustees

H. *Applicable Rules for Cotrustees.* The following rules apply when a trust has more than one trustee, none of whom have the power to revoke the trust:

1. *Lack of Unanimity.* Cotrustees who are unable to reach a unanimous decision may act by majority decision.

***2. Vacancy.* If a vacancy occurs in a cotrusteeship, the remaining cotrustees may act for the trust.**

3. *Disqualified Trustees.* If one or more trustees cannot participate in a decision concerning a discretionary distribution, the decision shall be made in accordance with the provisions of this document expressly addressing that circumstance.

4. *Temporary Disability.* If a cotrustee is unavailable to perform duties because of absence, illness, disqualification under other law, or other temporary incapacity, and prompt action is necessary to achieve the purposes of the trust or to avoid injury to the trust property, the remaining cotrustee or a majority of the remaining cotrustees may act for the trust.

5. *Delegation of Authority.* A trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly. Unless a delegation was irrevocable, a trustee may revoke a delegation previously made.

16.20-1 Trustee compensation

I. *Compensation of Trustees.* Trustees are entitled to reasonable compensation.

DIVISION XI
TRUSTEE POWERS

17.19-1 Broad trustee powers: statement of trustee powers

A. *General Powers of Trustee*. Subject to any limitations expressly stated in this document, the trustee of each trust established under this document is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

1. *California Law.* The 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 complying with any otherwise applicable requirement for a court order.

2. *Prudent Person*. The power to perform any act that a prudent person would take in order to accomplish the objectives of the trust.

3. *Prudent Investor.* The power to perform any act that a prudent investor would take in investing trust property.

4. *Owner of Property.* The power to exercise any right or privilege that an unmarried competent adult has over individually owned property.

5. *Other Powers. A*ny other powers appropriate to achieve the proper investment, management, and distribution of the trust property.

6. *Uniform Trust Code*. Any other powers conferred by the Uniform Trust Code, as revised and amended in 2001 by the National Conference of Commissioners on Uniform State Laws.

B. *Specific Powers of Trustee*. The powers listed in the previous paragraph include, but are not limited to, those described in this paragraph. The trustee may:

1. Collect trust property and accept or reject additions to the trust property from a settlor or any other person;

2. Acquire or sell property, for cash or on credit, at public or private sale;

3. Exchange, partition, or otherwise change the character of trust property;

4. Deposit trust money in an account in a regulated financial-service institution;

5. Borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the duration of the trust;

6. With respect to an interest in a proprietorship, partnership, limited liability company, business trust, corporation, or other form of business or enterprise, continue the business or other enterprise and take any action that may be taken by shareholders, members, or property owners, including merging, dissolving, or otherwise changing the form of business organization or contributing additional capital;

7. With respect to stocks or other securities, exercise the rights of an absolute owner, including the right to:

a. Vote, or give proxies to vote, with or without power of substitution, or enter into or continue a voting trust agreement;

b. Hold a security in the name of a nominee or in other form without disclosure of the trust so that title may pass by delivery;

c. Pay calls, assessments, and other sums chargeable or accruing against the securities, and sell or exercise stock subscription or conversion rights; and

d. Deposit the securities with a depositary or other regulated financial-service institution;

8. With respect to an interest in real property, construct, or make ordinary or extraordinary repairs to, alterations to, or improvements in, buildings or other structures, demolish improvements, raze existing or erect new party walls or buildings, subdivide or develop land, dedicate land to public use or grant public or private easements, and make or vacate plats and adjust boundaries;

9. Enter into a lease for any purpose as lessor or lessee, including a lease or other arrangement for exploration and removal of natural resources, with or without the option to purchase or renew, for a period within or extending beyond the duration of the trust;

10. Grant an option involving a sale, lease, or other disposition of trust property or acquire an option for the acquisition of property, including an option exercisable beyond the duration of the trust, and exercise an option so acquired;

11. Insure the property of the trust against damage or loss and insure the trustee, the trustee's agents, and beneficiaries against liability arising from the administration of the trust;

12. Abandon or decline to administer property of no value or of insufficient value to justify its collection or continued administration;

13. With respect to possible liability for violation of environmental law:

a. Inspect or investigate property the trustee holds or has been asked to hold, or property owned or operated by an organization in which the trustee holds or has been asked to hold an interest, for the purpose of determining the application of environmental law with respect to the property;

b. Take action to prevent, abate, or otherwise remedy any actual or potential violation of any environmental law affecting property held directly or indirectly by the trustee, whether taken before or after the assertion of a claim or the initiation of governmental enforcement;

c. Decline to accept property into trust or disclaim any power with respect to property that is or may be burdened with liability for violation of environmental law;

d. Compromise claims against the trust that may be asserted for an alleged violation of environmental law; and

e. Pay the expense of any inspection, review, abatement, or remedial action to comply with environmental law;

14. Pay or contest any claim, settle a claim by or against the trust, and release, in whole or in part, a claim belonging to the trust;

15. Pay taxes, assessments, compensation of the trustee and of employees and agents of the trust, and other expenses incurred in the administration of the trust;

16. Exercise elections with respect to federal, state, and local taxes;

17. Select a mode of payment under any employee benefit or retirement plan, annuity, or life insurance payable to the trustee, exercise rights thereunder, including exercise of the right to indemnification for expenses and against liabilities, and take appropriate action to collect the proceeds;

18. Make loans from trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, including imposition of a lien on future distributions for purposes of securing repayment of a loan;

19. Pledge trust property to guarantee loans made by others to the beneficiary;

20. Appoint a trustee to act in another jurisdiction regarding trust property in the other jurisdiction, confer on the appointed trustee all powers and duties of the appointing trustee, require that the appointed trustee furnish security, and remove any trustee so appointed;

21. Pay an amount distributable to a beneficiary who is under a legal disability or who the trustee reasonably believes is incapacitated, by paying it directly to the beneficiary or applying it for the beneficiary's benefit, or by:

a. Paying it to the conservator or guardian of the beneficiary's estate;

b. Paying it to the beneficiary's custodian under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) or similar statute and, for that purpose, creating a custodianship or custodial trust;

c. If the trustee does not know of a conservator, guardian, or custodian, paying it to an adult relative or other person having legal or physical care or custody of the beneficiary, to be expended on the beneficiary's behalf; or

d. Managing it as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution;

22. Resolve a dispute over the interpretation of the trust or its administration by mediation, arbitration, or other procedure for alternative dispute resolution;

23. Prosecute or defend an action, claim, or judicial proceeding in any jurisdiction to protect trust property and the trustee in the performance of the trustee's duties;

24. Sign and deliver contracts and other instruments that are useful to achieve or facilitate the exercise of the trustee's powers;

25. Combine two or more trusts into a single trust or divide a trust into two or more separate trusts;

26. On termination of the trust, exercise the powers appropriate to wind up the administration of the trust and distribute the trust property to the persons entitled to it; and

27. Appoint any person to be an authorized signer (either alone or with others, jointly or severally) for any financial institution account or securities account.

DIVISION XII
TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

17.36-1 Trustee's duties

A. *Duties of Trustee*. Except as expressly provided in this document, the trustee has the duties imposed by

law, including the duty to report and account to trust beneficiaries, statutory duties to give notice and copies of this document to trust beneficiaries and heirs at law on the death of a settlor, and the duty to invest property in accordance with the Uniform Prudent Investor Act.

17.41-1 Limitations on trustee duty of loyalty

B. *Limitations on Trustee's Duty of Loyalty.* As long as the trustee does not act in bad faith or in disregard of the purposes of the trust, it is not a breach of the trust for the trustee to take any of the following actions:

1. Lend the trustee's own funds to the trust for any trust purpose, with interest at current rates;

2. Receive reasonable security for such a loan;

3. Purchase trust property from the trust at fair market value, provided the purchase price is paid in full in advance;

4. Lease or sell the trustee's own property to the trust at a rent or price not in excess of its fair market value;

5. Employ the trustee, a relative of the trustee, or a business in which the trustee has an interest, to perform needed services for the trust or any business in which the trust has an interest and to pay compensation not exceeding fair market value;

6. Acquire or retain an interest in property in which the trust also has an interest;

7. Acquire or retain stock of a corporate trustee or an affiliate of a corporate trustee unless the acquisition or retention would violate the trustee's duties in the case of stock of a similar corporation other than the trustee or its affiliate;

8. Deposit funds in a bank in which the trustee has an interest;

9. Perform as trustee any action described above with a relative of the trustee or a business in which the trustee has an interest;

10. Hold property of multiple trusts without segregating or dividing the property and without separately titling the property of each trust, but instead keeping accounts sufficient to identify the property of each trust.

17.59-1 Acceptance of additions

C. *Acceptance of Additions*. The trustee has a duty to accept additions to this trust unless an addition would significantly expand the trustee's duties, the transferred property is hazardous or otherwise creates a substantial increased risk of trustee liability, or the property is transferred by a competent person other than a settlor who retains the capacity to establish a trust naming a different trustee. If an addition is rejected on the ground of increased duties or liabilities and the transferor is deceased or lacks capacity, the trustee shall give reasonable notice to the persons interested in the trust.

16.23-1 Exculpation of trustee

D. *Exculpation of Trustee.* A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, 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 previous 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 person who regularly engages in the business of acting as a trustee.

16.25-1 Cotrustee's duty to act

E. *Cotrustee's Duty to Act*. A cotrustee must participate in the performance of a trustee's function unless the cotrustee is unavailable to perform the function because of absence, illness, disqualification under other law, or other temporary incapacity or unless the cotrustee has properly delegated the performance of the function

to another trustee.

16.26-1 Limitation on duty to investigate predecessor or cotrustee

F. *Limitation on Duty to Investigate Predecessor or Cotrustee*. A successor trustee or cotrustee has no duty to audit or investigate the administration or accounts of any prior trustee or cotrustee unless an audit or investigation is demanded in writing by a beneficiary. Each trustee shall exercise reasonable care to (1) prevent a cotrustee from committing a serious breach of trust, and (2) compel a cotrustee to redress a serious breach of trust.

DIVISION XIII
RULES OF CONSTRUCTION

18.10-1 California law used in construction of trust

A. *Applicable Law.* This document shall be construed in accordance with the laws of the State of California _ _[*in effect on the date of execution of this document/as amended from time to time*]_ _.

18.12-1 Headings, titles, and subtitles

B. *Context.* The divisions, paragraphs, and subparagraphs of this document shall be construed in context, giving due regard to the headings and the topic of discussion.

18.13-1 Relevance of common estate planning practice

C. *Relevance of Common Estate Planning Practice.* This document is intended to accomplish normal and ordinary objectives of similar trusts commonly drafted by attorneys practicing in the area of trusts and estates at the time this document is executed, and shall be construed accordingly.

DIVISION XIV
MISCELLANEOUS

5.23-1 Character of trust property

A. *Property Retains Character*. Except as expressly provided in this document, all property becoming subject to this trust shall retain its character as community property, quasi-community property, or separate property after becoming trust property.

B. *Exception: Joint Tenancy Property*. No property now or hereafter subject to this trust is joint tenancy property or community property with right of survivorship. Any property that was joint tenancy property or community property with right of survivorship before becoming trust property shall become community property as a result of becoming trust property to the extent that the settlors' interests in the property were previously equal.

19.13-1 Short-form spendthrift clause

C. *Spendthrift Clause*. The interests of the beneficiaries in the income and principal of the trusts created by this document are not subject to voluntary or involuntary transfer.

19.11-1 Perpetuities savings clause

D. *Rule Against Perpetuities*. Unless terminated earlier in accordance with other provisions of this document, each trust created by this document or by exercise of any power of appointment conferred by this document (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*names of individuals or description of class best suited to be measuring lives*]_ _ living on the date of the death of the Deceased Settlor. In the event of termination under this paragraph, the principal and undistributed income of a terminated trust shall be distributed to the then income beneficiaries of that trust in the same proportion that the beneficiaries are entitled to receive income when the trust terminates. If at the time of such termination the rights to income are not fixed by the terms of the trust, distribution under this clause shall be made to the persons who are then entitled or authorized, in the trustee's discretion, to receive

trust payments.

19.5-1 No-contest clause

E. *No-Contest Clause*. If any beneficiary under a trust created by this document shall, singly or in conjunction with any other person or persons, contest in any court the validity of any trust created by this document, or any will or other document making a transfer to this trust, or shall seek to obtain an adjudication in any proceeding in any court that this trust or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside the trust or any of its provisions, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.

DIVISION XV
REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

20.3-1 Revocation and amendment by married settlors

A. *Trust Irrevocable Except as Provided*. Except as provided in this division, all trusts created by this document are irrevocable and cannot be amended.

1. *Exception: Revocable While Both Settlors Are Living*. During the joint lifetimes of the settlors, either settlor may revoke all trusts created by this document, with respect to both halves of the community property and the revoking settlor's own separate property. The revocation must satisfy the procedural requirements of this division for amending or revoking trusts. On revocation, community property subject to the revocation shall be delivered to both settlors or as the settlor(s) direct, except that the property shall be delivered to the competent settlor if only one is competent _ _[*, and if both settlors are competent, the trustee shall deliver any business operated by one of the settlors to the operating settlor*]_ _. Separate property trust assets of each settlor joining in the revocation shall be delivered to the settlor owning the property. A unilateral revocation of the trust by one settlor does not prevent reestablishment of the trust with respect to any property that may later pass to the trust under the will of a settlor or otherwise.

2. *Exception: Amendment While Both Settlors Are Living*. During the joint lifetimes of the settlors, all trusts created by this document may be amended by mutual agreement of the settlors. Any amendments must satisfy the procedural requirement of this division for amending or revoking trusts.

3. *Exception: Revocation or Amendment of Survivor's Trust*. The Survivor's Trust may be revoked or amended, in whole or in part, at any time by the Surviving Settlor. Any such revocation or amendment must satisfy the procedural requirements of this division for amending or revoking trusts. On revocation, the trustee shall deliver the trust property to the Surviving Settlor.

B. *Procedural Requirements for Amending or Revoking Trusts*. No amendment or revocation of any trust shall be effective unless all of the following requirements are satisfied:

1. *Signed Written Document*. The amendment or revocation must be accomplished by a written document signed by the settlor(s) taking the action. Despite the previous sentence, a settlor's power to revoke or amend may be exercised by an attorney-in-fact if and to the extent the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

2. *Acknowledgment or Attorney Certificate*. Except in the case of a document executed in accordance with a court order: (a) The document must be personally acknowledged before a notary public by the person(s) signing the document (not a witness); or (b) the document must contain a statement, signed by an attorney-at-law before or at the time the document is signed by the person(s) taking the action, which declares that the attorney-at-law represents the settlor(s) taking the action and approves the form of the document.

3. *Delivery to the Trustee*. In the case of an action not requiring the consent of both settlors, the document must be delivered during the lifetime of the settlor taking the action to: (a) Each then-acting trustee of the trust who is not a settlor taking the action; and (b) each settlor then living and competent but not joining in the action. In the case of an action requiring the joint action of both settlors, the document must be delivered during the settlors' joint lifetimes to each acting trustee who is not a settlor taking the action.

C. *Effect of Defective Documents*. The procedural requirements of this division for revoking or amending trusts are intended to prevent fraud, reduce the risk of undue influence, and provide certainty with respect to the intentions of the settlors. A court, in order to give effect to the actual intentions of a settlor, may give effect to a document not satisfying all procedural requirements for revoking or amending a trust if the court finds that: (1) The settlor taking the action was competent; (2) the attempted revocation or amendment was not the result of fraud, undue influence, or duress; (3) the document was clearly intended to amend or revoke the trust; and (4) there is no reason to deny equitable relief. The proponent of the document shall have the burden of proof. The standard of proof with respect to these matters shall be: (1) Preponderance of the evidence with respect to amendments having no impact or only incidental impact on distribution of the trust after the settlor's death; and (2) clear and convincing evidence in the case of changes that substantially affect distribution of a trust.

D. *Revocation by Gift.* The procedural requirements of this division for revoking or amending trusts do not apply to gifts of trust property made by one or both settlors that would be valid if the gifted property was not subject to this trust. Any such gift revokes the trust with respect to the gifted property.

E. *Effect of Amendment Not Acceptable to Trustee*. The consent of the trustee is not required for a valid amendment. In the event a trust amendment substantially increases the duties or liabilities of the trustee or changes the trustee's compensation without the trustee's consent, the trustee shall have the right to resign.

F. *Limitation on Exercise of Powers by Conservator or Guardian of Estate*. No conservator or guardian of a settlor's estate shall have any power to amend or revoke this trust or exercise any power of appointment. The previous sentence does not apply if the conservator or guardian is acting under a court order made in compliance with a "substituted judgment" statute. Until such an order is made, no conservator or guardian shall be deemed to hold such a power for any purpose.

7.87-1 Exercise of powers of appointment

G. *Exercise of Powers of Appointment*. A power of appointment conferred by this document, other than a power held in a fiduciary capacity by a trustee, may be exercised only by an instrument that specifically refers to both this trust and the specific power being exercised. Such a power must be exercised by will, codicil, or a "qualified lifetime document." For purposes of this paragraph, a "qualified lifetime document" is a document meeting the requirements described above for revoking a trust with respect to the revoking settlor's separate property, including, if applicable under those requirements, a document executed by a conservator or an attorney-in-fact. A court may give effect to an attempted exercise that fails to satisfy the requirements of this paragraph in accordance with the criteria that would apply to a defective amendment of this document. It being a purpose of this trust to avoid probate, the trustee may distribute trust property in accordance with a will or codicil that has not been probated.

19.20-1 Execution of trust; signatures

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

19.20-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

On _ _[*date*]_ _, before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within

instrument and acknowledged to me that he/she/they executed the instrument in his/her/their authorized capacit(y/ies) and that by his/her/their signature(s) on the instrument the person(s), or the entity on behalf of which the person(s) acted, executed the instrument.

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

WITNESS my hand and official seal.

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

5.38-1 Schedule of assets

THE _ _[*Name of Trust*]_ _ TRUST

Exhibit A

Initial Trust Property

The initial trust estate consists of all right, title, and interest of the settlors or either of them in or to any and all of the following property.

[*Edit as appropriate*]

1. The residence commonly known as _ _[*street address*]_ _.

2. The contents of that residence.

3. All other real property.

4. All bank, stock brokerage, and other financial and securities accounts of any kind.

5. All stocks, bonds, and other securities of any kind.

6. All intangible property, including any indebtedness of any person or entity.

7. Vehicles, boats, _ _[*other known tangible property*]_ _.

8. Small business interest: _ _[*Identify*]_ _.

Despite the foregoing, the initial trust estate does not include the following property: _ _[*Specify*]_ _.

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Appendix B

Married Settlors' Simple Joint Trust (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 form is suitable as a framework for married couples who are unlikely to have estate tax concerns even if the first spouse to die leaves that spouse's property entirely to the survivor. The distribution provision in paragraph IV.C. transfers all trust property to the Survivor's Trust on the first death. This provision can be modified to make other distributions on the first death. The form makes clear that it is unnecessary to retitle property in the name of the Survivor's Trust if that is the only trust created on the first death. In the event the facts known at death unexpectedly suggest that a transfer of all or most of the property of the deceased spouse to the Survivor's Trust will result in exposing the survivor's estate to estate taxes, the surviving spouse will have the option to disclaim some or all of the transfers to the survivor's trust with the consequence that they will pass to a disclaimer trust. For a discussion of this strategy, see §14.28. The drafter must complete paragraph VI.E. concerning the disposition of the disclaimer trust on the death of the surviving settlor. For an explanation of the importance of making sure the recipients of the remainder are the chosen beneficiary's of the *survivor*, see §14.33. If desired, Division VI provisions for a disclaimer trust can be deleted.

PRACTICE TIP: If one of the settlors is not a United States citizen and that settlor is the survivor, the transfer of the deceased settlor's property to the survivor's trust on the first death will not qualify for the federal estate tax marital deduction. Because use of this Appendix B form assumes that it is unlikely that the settlors will have federal estate tax problems, it is not necessary to provide in the trust for the creation of an IRC §2056A qualified domestic trust (QDOT). If, however, it appears at the time of the first death that federal estate taxes may be a concern, the surviving settlor can create the QDOT postdeath. For discussion of QDOTs, see §§13.27-13.33.

In many cases, this form will be unnecessarily complex. Particularly when working with elderly couples who have small estates, easily managed assets, and simple provisions for outright dispositions on the survivor's death, large amounts of the "boilerplate" can be deleted. This form contains a shorter list of trustee powers than the form in Appendix A. The list in Appendix A may be substituted.

WARNING: If the trust 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." Prob C §21351. For further discussion, see the "Warnings" in the introduction to App A.

The distribution provisions in this form are incomplete. In addition to the distribution provisions noted above, the drafter must complete the paragraph V.D. concerning the disposition of the Survivor's Trust on the death of the survivor. These are the most important distribution provisions of the trust. For distribution forms, see chap 6.

WARNING: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, it does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to its counterpart in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix.

THE _ _[*NAME OF TRUST*]**_ _ TRUST**

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Signatures; Acknowledgment

EXHIBIT A

Initial Trust Property

5.37-1 Opening declaration

OPENING DECLARATION

The _ _[*Name of Trust*]_ _ Trust

We, _ _[*name of settlor*]_ _ and _ _[*name of settlor*]_ _, sometimes hereafter called "settlors," residing in _ _[*name of county*]_ _, California, hereby create The _ _[*Name of Trust*]_ _ Trust, declaring:

5.37-2 Creation of trust

DIVISION I
CREATION OF TRUST

A. *Initial Trust Property.* The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is now held by us in trust. This property and any other property later transferred to the trust is hereafter referred to as the trust property and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.

5.30-1 Characterizing trust property

B. *Character of Trust Property.* The attached listing of trust property does not constitute a binding agreement between the settlors with respect to the character of that property as community property, separate property, or quasi-community property, but the trustee may rely on any characterizations of the trust property in that listing until such time as an interested party notifies the trustee that a characterization in the listing is disputed or incorrect.

5.37-3 Purposes, trustees, and family declarations

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. *Care of Settlors.* To provide for our care and maintenance as long as either of us is living;

2. *Avoid Conservatorship.* To facilitate management of the trust property in the event of the incapacity of one or both of us;

3. *Transfer Property at Death.* To facilitate transfer of the trust property on our deaths; and

4*. Tax Planning.* To provide opportunities for reducing or postponing taxes that might be imposed as a result of our deaths.

B. *Initial Trustees.* We are the initial trustees of this trust.

C. *Successor Trustees.* If either of us ceases to be a trustee of this trust, the other shall become the sole trustee. If the sole trustee resigns or ceases to be trustee, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify, resigns, or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.

D. *Family Information.* In connection with the administration of this trust, the trustee may rely on the following family information:

1. *Marriage*. We are husband and wife and were married in _ _[*city and state of marriage*]_ _ on _ _[*date of marriage*]_ _.

2. *Citizenship*. _ _[*We are both/We are not/_ _[Name of settlor*]_ _ *is a citizen of the United States. _ _[Name of settlor*]_ _ *is not a*]_ _ citizen(s) of the United States.

3. *Children*. The names and birthdates of our children are: _ _[*List names and birthdates*]_ _.

4. *Deceased Children*. Neither of us have deceased children who are survived by issue now living.

DIVISION III
DISTRIBUTIONS WHILE BOTH SETTLORS ARE LIVING

6.5-1 Distributions of community property

A. *Distributions of Community Property.* While we are both living, the trustee shall pay to us, or apply for our benefit, as much of the community property income and principal of this trust as either of us requests plus such additional sums as the trustee in its discretion determines are appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. All distributions of community property income or principal shall be paid to us or applied for our benefit as community property.

6.8-1 Distributions of separate property to married settlors

B. *Distributions of Separate Property.* While we are both living, trust property that is the separate property of one of us (the "owning settlor") shall be distributed or provided for use in kind as the owning settlor requests. If at any time an owning settlor is not competent to make requests, the trustee shall pay to or apply for the benefit of us as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. In exercising its discretion, the trustee shall take into account that we desire that property shall be applied for these purposes in a manner similar to the applications we made while competent. If the trustee is uncertain about our past practices, or if a particular expense is new or significantly changed in amount, the trustee shall apply property in the following order:

1. *Income*. _ _[*Approximately proportionate shares of the income from community and the income from separate property./First from the community property income and thereafter from the separate property income.*]**_ _ For purposes of this subparagraph, "income" includes periodic receipts commonly used to pay current living expenses, including receipts from pensions, social security, and disability or long-term care insurance.**

2. *Liquid Investment Assets*. _ _[*Approximately proportionate shares of community property and separate property cash, marketable securities, and other liquid assets./First from the community property cash, marketable securities, and other liquid assets, thereafter from the separate property cash, marketable securities, and other liquid assets.*]**_ _**

3. *Other Property*. _ _[*Approximately proportionate shares of any remaining community property and separate property./First from any remaining community property and thereafter from separate property.*]**_ _**

DIVISION IV
DISTRIBUTION ON FIRST DEATH

10.5-1 Distribution to survivor's trust

On the death of whichever of us is the first to die (the "Deceased Settlor") the property of the survivor of us (the "Surviving Settlor") shall be distributed to the trustee of the Survivor's Trust described in the next Division and the property of the Deceased Settlor shall be allocated and distributed in accordance with the wishes of the Deceased Settlor, as follows:

A. *Survivor's Property*. The trustee shall distribute to the trustee of the Survivor's Trust the Surviving Settlor's separate property, half interest in community property, and any share of the separate property of the Deceased Settlor that the Surviving Settlor would be entitled to receive under the laws of the Deceased Settlor's domicile at death, including, if applicable, any share of quasi-community property or other forced share.

B. *Decedent's Property; Power of Appointment*. The trustee shall distribute the remaining property as the Deceased Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Deceased Settlor's estate.

C. *Decedent's Property That Is Not Effectively Appointed*. The trustee shall distribute any of the Deceased Settlor's property that was not effectively appointed by the Deceased Settlor under the preceding paragraph to the trustee of the Survivor's Trust.

D. *Survivor's Trust as Only Trust.* If the Survivor's Trust is the only trust established on the death of the Deceased Settlor, a transfer to that trust need not be evidenced by a change of title.

9.7-1 Simultaneous death

E. *Simultaneous Death*. If the order of the settlors' deaths cannot be ascertained, _ _[*name of deemed survivor*]_ _ shall be deemed to be the Surviving Settlor for purposes of this Division.

DIVISION V
THE SURVIVOR'S TRUST

12.6-1 Purpose of survivor's trust

A. *Purpose of Survivor's Trust*. This trust is established to hold property that would belong to the Surviving Settlor following the death of the Deceased Settlor but for the provisions of this trust. It is established to provide for the care and maintenance of the Surviving Settlor, to facilitate management of the trust property in the event of the Surviving Settlor's incompetence, and to facilitate transfer of the trust property to beneficiaries chosen by the Surviving Settlor on the Surviving Settlor's death. The Surviving Settlor may revoke the Survivor's Trust with respect to any and all assets at any time as more particularly set forth in the Division of this document concerning Revocation, Amendment, and Exercise of Powers. In the event of such a revocation, the trustee shall deliver the trust property to the Surviving Settlor.

12.11-1 Distribution of income and principal

B. *Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply to the benefit of the Surviving Settlor as much of the income and principal of the Survivor's Trust as the Surviving Settlor requests, plus such additional sums as the trustee, in the trustee's discretion, determines are appropriate for the Surviving Settlor's health, maintenance, support, or education.

12.13-1 General power of appointment

C. *Distribution on Death—General Power of Appointment*. On the death of the Surviving Settlor, the trustee shall distribute the remaining trust property as the Surviving Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Surviving Settlor's estate.

12.17-1 Specified distribution of survivor's trust

D. *Distribution on Death—Property Not Appointed*. On the death of the Surviving Settlor, any property not effectively appointed by the Surviving Settlor shall be distributed as follows: _ _[*Specify.*]_ _

12.9-1 Marital deduction survivor's trust

E. *Marital Deduction Survivor's Trust*. If property included in the taxable estate of the Deceased Settlor passes to the Survivor's Trust by reason of the death of the Deceased Settlor, that property shall be held as a separate trust, called the Marital Deduction Survivor's Trust, to be administered and distributed in the same manner as the regular Survivor's Trust, except that during the lifetime of the Surviving Settlor, distributions may be made only to or for the benefit of the Surviving Settlor. It is contemplated but not required that the Surviving Settlor will eliminate the need for this separate trust after the death of the Deceased Settlor by directing that all assets of the Marital Deduction Survivor's Trust be distributed to the regular Survivor's Trust.

DIVISION VI
DISCLAIMER TRUST

14.35-1 Disclaimers by surviving settlor

A. *Purpose of Disclaimer Trust*. In this Division, a disclaimer is a Surviving Settlor's refusal to accept a transfer of property (or a particular right or interest in property) from the Deceased Settlor. Disclaimers are sometimes used to fine-tune an estate plan after the death of the Deceased Settlor, thereby saving substantial taxes. This is particularly true if family wealth has significantly increased or if it is determined that the Surviving Settlor has an unexpectedly short life expectancy. The provisions in this Division are intended to provide the Surviving Settlor with increased opportunities to use disclaimers in appropriate cases. The Settlors understand that it is important to consult a tax professional promptly after the death of the Deceased Settlor about the possible benefits of a disclaimer. The Surviving Settlor has no obligation whatever to make any

disclaimers.

B. *Disclaimer of Property Passing to Surviving Settlor*. The Surviving Settlor (or the personal representative of a deceased Surviving Settlor) shall have the right to disclaim any property of the Deceased Settlor distributable to the Survivor or the Survivor's Trust. In the event of such a disclaimer, the disclaimed property shall be held and administered by the trustee as a separate trust known as the Disclaimer Trust. The trustee shall pay to the Surviving Settlor all income of the Disclaimer Trust in quarter-annual or more frequent intervals, plus as much of the principal as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, and support. In exercising its discretion, the trustee may take into account other income and resources available to the Surviving Settlor to such extent, if any, as the trustee deems appropriate.

C. *Surviving Settlor's Disclaimer of Mandatory Income Interest*. If the Surviving Settlor 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 the Surviving Settlor as much of the trust property as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, education, and support. In exercising its discretion, the trustee may consider other income and resources available to the Surviving Settlor to such extent, if any, as the trustee deems appropriate.

D. *Surviving Settlor's Disclaimer of All Rights in Disclaimer Trust*. If the Surviving Settlor 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, the Surviving Settlor will be deemed to have died on the date of death of the Deceased Settlor.

E. *Distribution on Surviving Settlor's Death.* On the death of the Surviving Settlor, the remaining trust property shall be distributed as follows: _ _[*Specify*]_ _

DIVISION VII
ADDITIONAL DISTRIBUTION PROVISIONS

8.72-1 Interest on pecuniary amounts

A. *Interest on Pecuniary Amounts.* When a beneficiary is entitled to receive payment of a pecuniary amount or an annuity, the beneficiary shall be entitled to receive interest on delayed distributions to the extent provided by California law. If California law has no provision expressly applicable to trusts, interest shall be paid in accordance with California law applicable to a decedent's estate.

7.94-1 Accumulation of undistributed income

B. *Undistributed Income*. In any instance in which this document fails to expressly provide for the distribution or accumulation of any trust income, that income shall be accumulated and added to principal.

8.30-1 Retention in further trust until specified age

C. *Distributions to Young Persons.* If any person otherwise entitled to outright distribution of any property from any trust created by this document, is under the age of _ _[*age*]_ _ at the time the right to distribution vests, the trustee shall not make the distribution, but shall, instead, retain the property that would otherwise be distributed in a separate trust for the benefit of the underaged person ("Beneficiary"). 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 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 then-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 under the provisions of this trust for exercising a power of appointment. 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.

D. *Distribution Terminology*. The following directions and definitions apply to the distribution provisions of this trust.

18.15-1 Definition of "charity"

1. *Charity.* A "charity" is any organization described in Internal Revenue Code §2055 or §2522.

8.62-1 Manner of making distribution per capita at each generation

2. *Distribution Per Capita at Each Generation*. In making a per capita distribution at each generation, the trustee shall divide the property to be distributed 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.

18.14-1 Definition of "education"

3. *Education.* "Education" includes primary, secondary, vocational, college, university, postgraduate study, and other specialized studies _ _[*if in the trustee's discretion the study is being pursued to advantage by the beneficiary*]_ _.

18.5-1 Terms of relationship

4. *Terms of Relationship*. Except as expressly provided in this paragraph, half bloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons when appropriate to the class, are included or excluded in terms of class gift or relationship in accordance with California law for determining relationship and inheritance rights for purposes of intestate succession that are in effect on the date of execution of this document. However, a person born out of wedlock to a natural parent shall not be

considered a child of that person unless the person lived, while a minor, as a regular member of the household of the natural parent or of that parent's parent, sibling, or spouse; or otherwise during minority was both openly acknowledged by such a person to be the child of the parent and was involved with such a person in an active social relationship. Further, an adopted child shall not be considered the child of an adopting parent unless the adopted person lived while a minor (either before or after adoption) as a regular member of the household of the adopting parent.

E. *Distribution Powers.* For purposes of making distributions, the trustee's powers include the following:

11.50-1 Power to make nonprorata distribution

1. *Nonprorata Distributions*. 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 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 appropriate to accommodate such distributions.

8.68-1 Nonprorata division of community property

2. *Nonprorata Division of Community Property.* Community property and quasi-community property may be divided on the basis of a nonprorata division of the aggregate value of the property, or on the basis of a division of each individual item or asset, or partly on each basis.

8.70-1 Power to delay distributions

3. *Power to Delay Distributions.* When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it, and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after the trustee receives the income. This provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. Nor does this provision authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.

7.79-1 Limitations on discretionary distributions to trustee

F. *Limitations on Discretionary Distributions to a Trustee.* A person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of him- or herself may exercise that power in his or her favor only for health, education, maintenance, or support within the meaning of Internal Revenue Code §§2041, 2514. Despite the foregoing and California Probate Code §15620, if a power to make discretionary distributions of income or principal is conferred on two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power; and, as long as there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary of that power, and the power may be exercised by the trustee appointed by the court. The restrictions of this paragraph do not apply to a person making distributions of property that the person could withdraw by exercising that person's own power of revocation.

7.25-1 Prohibition against discharge of support obligation

G. *Prohibition Against Discharge of Support Obligation*. No one may exercise, alone or with others, a discretionary power conferred by this document in a manner that results in the discharge of that person's obligation to support another person. This prohibition applies to both personal powers and fiduciary powers. These restrictions do not apply to a person making distributions of property that the person could withdraw by exercising his or her power of revocation.

15.14-1 Equitable proration under California law

H. *Apportionment of Taxes*. Except as otherwise provided in this document, all estate, generation-skipping,

and inheritance taxes, including interest and penalties, imposed on or by reason of the inclusion of any trust property in the gross taxable estate of _ _[*the/either*]_ _ settlor may be paid by the trustee and charged to, prorated among, or recovered from the trust property or the persons entitled to the benefits under the trust as provided in the California Probate Code and the Internal Revenue Code.

15.16-1 Payment of additional taxes from disclaimed property

I. *Transfer Taxes Caused by Disclaimer.* Any increase in estate, generation-skipping, or inheritance taxes, including interest and penalties, resulting from a qualified disclaimer shall be paid from the disclaimed property.

DIVISION VIII
DEBTS

15.28-1 Payment of debts: married settlors' joint trust

A. *Debts of Deceased Settlor and Estate*. On the death of the Deceased Settlor, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. The Deceased Settlor's funeral and last illness expenses;

2. *Other Debts*. Debts of the Deceased Settlor, the Surviving Settlor, or both, that would be properly payable by the Deceased Settlor's probate estate if the trust property were included in the probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Deceased Settlor's probate estate.

B. *Allocation Between Deceased Settlor and Surviving Settlor*. Payments made for the purposes described in Paragraph A shall be allocated and charged to the separate and community property of each settlor as provided by California law, including Probate Code §§19320-19326, and the trustee shall take any action necessary to recover from the Surviving Settlor or the Survivor's Trust amounts paid that are chargeable to the Surviving Settlor's property. Funeral and last illness expenses shall be allocated and charged to property included in the gross estate of the Deceased Settlor for federal estate tax purposes to the extent possible.

C. *Debts of Surviving Settlor and Estate*. On the death of the Surviving Settlor, the trustee may pay from the property of the Survivor's Trust:

1. *Funeral and Last Illness Expenses*. The Surviving Settlor's funeral and last illness expenses.

2. *Other Debts*. Debts of the Surviving Settlor that would be properly payable by the Surviving Settlor's probate estate if the trust property were included in the Surviving Settlor's probate estate and a timely creditor's claim was filed.

3. *Probate Expenses*. Necessary and proper expenses of administration of the Surviving Settlor's probate estate.

D. *Limitations on Sources of Payment*. Despite the provisions in Paragraphs A, B, and C, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including an Individual Retirement Account) benefits in which the trust acquires an interest as a result of the settlor's death. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the settlor's death in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

DIVISION IX
OFFICE OF TRUSTEE

16.3-1 Definition of trustee

A. *Definition of Trustee.* The term "trustee" as used in this document usually refers to such one or more persons or entities who, alone or in combination, have the power to take action on behalf of the trust, but it may instead refer to any form of limited power or special trustee or one or more individual cotrustees, depending on context.

16.4-1 Scope of trustee provisions

B. *Scope of Trustee Provisions.* Except as otherwise provided, the provisions of this document concerning the identity of trustees apply to all trusts established by this document. Similarly, except as otherwise provided, the provisions of this document concerning trustee duties, powers, privileges, and protections from liability, apply to all trustees, including successor trustees, of all trusts established by this document.

16.34-1 Trustee resignation

C. *Resignation of Trustee.* The trustee may resign at any time by mailing notice to the persons entitled by law to receive a trustee's account. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.

16.41-1 Removal of any trustee

D. *Removal of Any Trustee.* Any trustee, including a settlor, may be removed in accordance with California law.

16.39-1 Removal of incompetent settlor acting as trustee

1. *Removal of Settlor-Trustee.* A settlor shall cease to be a trustee or cotrustee of this trust if the settlor lacks the ability to perform the duties of the trustee. A majority of the following named persons shall have the power to determine that a settlor lacks such ability: _ _[*Names of persons given the power to make the determination*]**_ _. The determination shall be effective at such time as the persons making the determination deliver to the successor trustee declarations executed under penalty of perjury that state that the declarants have determined that the settlor lacks the ability to perform the duties of the trust. In the event of such a determination, the successor trustee shall immediately give the removed settlor written notice that the successor has assumed the position of trustee. The notice shall be given by personal delivery to the settlor. Nothing in this paragraph precludes the settlor from overriding the determination of these persons by exercising the settlor's powers of revocation or amendment, but a successor trustee who becomes trustee as a result of a determination made in accordance with this paragraph is entitled to exercise all powers of the trustee unless or until the successor's powers are terminated or limited by further action of the settlor or a court order.**

16.40-1 Removal of corporate trustee

2. *Removal of Corporate Trustee.* The current income beneficiary (or a legal representative of that beneficiary) of a trust created under this document may remove a current corporate trustee and substitute a successor corporate trustee if the beneficiary or representative reasonably believes that substitution will result in a significant reduction in trustee fees.

16.55-1 Power to name successor

E. *Power to Name Successor Trustee.* A trustee of this trust shall have the power to name a person or entity who shall become that trustee's successor if a successor is required and this document makes no other provision for a successor, or if the successors named in this document are not willing to act. The power shall be exercised as provided in this document for the exercise of a power of appointment.

16.49-1 Temporary trustee

F. *Temporary Trustee*. If an incumbent trustee or co-trustee is temporarily unable to administer the trust, the person(s) otherwise entitled to be the trustee if the incumbent resigned shall become the trustee until the incumbent can resume the duties of trustee.

17.51-1 Delegation of powers and duties

G. *Trustee's Power to Delegate.* The trustee may delegate duties and powers, other than discretionary distribution powers, as long as the trustee exercises reasonable care, skill, and caution in:

1. Selecting an agent;

2. Establishing the scope and terms of the delegation; and

3. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

16.7-1 Cotrustees

H. *Applicable Rules for Cotrustees.* The following rules apply when a trust has more than one trustee, none of whom have the power to revoke the trust:

1. *Lack of Unanimity.* Cotrustees who are unable to reach a unanimous decision may act by majority decision.

2. *Vacancy.* If a vacancy occurs in a cotrusteeship, the remaining cotrustees may act for the trust.

3. *Disqualified Trustees.* If one or more trustees cannot participate in a decision concerning a discretionary distribution, the decision shall be made in accordance with the provisions of this document expressly addressing that circumstance.

4. *Temporary Disability.* If a cotrustee is unavailable to perform duties because of absence, illness, disqualification under other law, or other temporary incapacity, and prompt action is necessary to achieve the purposes of the trust or to avoid injury to the trust property, the remaining cotrustee or a majority of the remaining cotrustees may act for the trust.

5. *Delegation of Authority.* A trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly. Unless a delegation was irrevocable, a trustee may revoke a delegation previously made.

16.20-1 Trustee compensation

I. *Compensation of Trustees.* Trustees are entitled to reasonable compensation.

DIVISION X
TRUSTEE POWERS

17.19-1 Broad trustee powers: statement of trustee powers

A. *General Powers of Trustee*. Subject to any limitations expressly stated in this document, the trustee of each trust established under this document is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

1. *California Law.* The 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 complying with any otherwise applicable requirement for a court order.

2. *Prudent Person*. The power to perform any act that a prudent person would take in order to accomplish the objectives of the trust.

3. *Prudent Investor.* The power to perform any act that a prudent investor would take in investing trust property.

4. *Owner of Property.* The power to exercise any right or privilege that an unmarried competent adult has over individually owned property.

5. *Other Powers. A*ny other powers appropriate to achieve the proper investment, management, and distribution of the trust property.

6. *Uniform Trust Code*. Any other powers conferred by the Uniform Trust Code, as revised and amended in 2001 by the National Conference of Commissioners on Uniform State Laws.

B. *Specific Powers of Trustee*. The powers listed in the previous paragraph include, but are not limited to, those described in this paragraph. The trustee may:

1. Acquire or sell property, for cash or on credit, at public or private sale;

2. Borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the duration of the trust;

3. Abandon or decline to administer property of no value or of insufficient value to justify its collection or continued administration;

4. Make loans from trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, including imposition of a lien on future distributions for purposes of securing repayment of a loan;

5. Pledge trust property to guarantee loans made by others to the beneficiary;

6. Combine two or more trusts into a single trust or divide a trust into two or more separate trusts;

7. Appoint any person to be an authorized signer (either alone or with others, jointly or severally) for any financial institution account or securities account.

DIVISION XI
TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

17.36-1 Trustee's duties

A. *Duties of Trustee*. Except as expressly provided in this document, the trustee has the duties imposed by law, including the duty to report and account to trust beneficiaries, statutory duties to give notice and copies of this document to trust beneficiaries and heirs at law on the death of a settlor, and the duty to invest property in accordance with the Uniform Prudent Investor Act.

17.41-1 Limitations on trustee duty of loyalty

B. *Limitations on Trustee's Duty of Loyalty.* As long as the trustee does not act in bad faith or in disregard of the purposes of the trust, it is not a breach of the trust for the trustee to take any of the following actions:

1. Lend the trustee's own funds to the trust for any trust purpose, with interest at current rates;

2. Receive reasonable security for such a loan;

3. Purchase trust property from the trust at fair market value, provided the purchase price is paid in full in advance;

4. Lease or sell the trustee's own property to the trust at a rent or price not in excess of its fair market value;

5. Employ the trustee, a relative of the trustee, or a business in which the trustee has an interest, to perform needed services for the trust or any business in which the trust has an interest and to pay compensation not exceeding fair market value;

6. Acquire or retain an interest in property in which the trust also has an interest;

7. Acquire or retain stock of a corporate trustee or an affiliate of a corporate trustee unless the acquisition or retention would violate the trustee's duties in the case of stock of a similar corporation other than the trustee or its affiliate;

8. Deposit funds in a bank in which the trustee has an interest;

9. Perform as trustee any action described above with a relative of the trustee or a business in which the trustee has an interest;

10. Hold property of multiple trusts without segregating or dividing the property and without separately titling the property of each trust, but instead keeping accounts sufficient to identify the property of each trust.

17.59-1 Acceptance of additions

C. *Acceptance of Additions*. The trustee has a duty to accept additions to this trust unless an addition would significantly expand the trustee's duties, the transferred property is hazardous or otherwise creates a substantial increased risk of trustee liability, or the property is transferred by a competent person other than a settlor who retains the capacity to establish a trust naming a different trustee. If an addition is rejected on the ground of increased duties or liabilities and the transferor is deceased or lacks capacity, the trustee shall give reasonable notice to the persons interested in the trust.

16.23-1 Exculpation of trustee

D. *Exculpation of Trustee.* A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, 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 previous 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 person who regularly engages in the business of acting as a trustee.

16.25-1 Cotrustee's duty to act

E. *Cotrustee's Duty to Act*. A cotrustee must participate in the performance of a trustee's function unless the cotrustee is unavailable to perform the function because of absence, illness, disqualification under other law, or other temporary incapacity or unless the cotrustee has properly delegated the performance of the function to another trustee.

16.26-1 Limitation on duty to investigate predecessor or cotrustee

F. *Limitation on Duty to Investigate Predecessor or Cotrustee*. A successor trustee or cotrustee has no duty to audit or investigate the administration or accounts of any prior trustee or cotrustee unless an audit or investigation is demanded in writing by a beneficiary. Each trustee shall exercise reasonable care to (1) prevent a cotrustee from committing a serious breach of trust, and (2) compel a cotrustee to redress a serious breach of trust.

DIVISION XII
RULES OF CONSTRUCTION

18.10-1 California law used in construction of trust

A. *Applicable Law.* This document shall be construed in accordance with the laws of the State of California _ _[*in effect on the date of execution of this document/as amended from time to time*]_ _**.**

18.12-1 Headings, titles, and subtitles

B. *Context.* The divisions, paragraphs, and subparagraphs of this document shall be construed in context, giving due regard to the headings and the topic of discussion.

18.13-1 Relevance of common estate planning practice

C. *Relevance of Common Estate Planning Practice.* This document is intended to accomplish normal and ordinary objectives of similar trusts commonly drafted by attorneys specializing in trusts and estates at the time this document is executed, and shall be construed accordingly.

DIVISION XIII
MISCELLANEOUS

5.23-1 Character of trust property

A. *Property Retains Character*. Except as expressly provided in this document, all property becoming subject to this trust shall retain its character as community property, quasi-community property, or separate property after becoming trust property.

B. *Exception: Joint Tenancy Property*. No property now or hereafter subject to this trust is joint tenancy property or community property with right of survivorship. Any property that was joint tenancy property or community property with right of survivorship before becoming trust property shall become community property as a result of becoming trust property to the extent that the settlors' interests in the property were previously equal.

19.13-1 Short-form spendthrift clause

C. *Spendthrift Clause*. The interests of the beneficiaries in the income and principal of the trusts created by this document are not subject to voluntary or involuntary transfer.

19.11-1 Perpetuities savings clause

D. *Rule Against Perpetuities*. Unless terminated earlier in accordance with other provisions of this document, each trust created by this document or by exercise of any power of appointment conferred by this document (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of the last survivor of _ _[*names of individuals or description of class best suited to be measuring lives*]_ _ living on the date of the death of the Deceased Settlor. In the event of termination under this paragraph, the principal and undistributed income of a terminated trust shall be distributed to the then income beneficiaries of that trust in the same proportion that the beneficiaries are entitled to receive income when the trust terminates. If at the time of such termination the rights to income are not fixed by the terms of the trust, distribution under this clause shall be made to the persons who are then entitled or authorized, in the trustee's discretion, to receive trust payments.

19.5-1 No-contest clause

E. *No-Contest Clause*. If any beneficiary under a trust created by this document shall, singly or in conjunction with any other person or persons, contest in any court the validity of any trust created by this document, or any will or other document making a transfer to this trust, or shall seek to obtain an adjudication in any proceeding in any court that this trust or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside the trust or any of its provisions, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.

DIVISION XIV
REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

20.3-1 Revocation and amendment by married settlors

A. *Trust Irrevocable Except as Provided*. Except as provided in this division, all trusts created by this document are irrevocable and cannot be amended.

1. *Exception: Revocable While Both Settlors Are Living*. During the joint lifetimes of the settlors, either settlor may revoke all trusts created by this document, with respect to both halves of the community property

and the revoking settlor's own separate property. The revocation must satisfy the procedural requirements of this division for amending or revoking trusts. On revocation, community property subject to the revocation shall be delivered to both settlors or as the settlor(s) direct, except that the property shall be delivered to the competent settlor if only one is competent _ _[, *and if both settlors are competent, the trustee shall deliver any business operated by one of the settlors to the operating settlor*]_ _. Separate property trust assets of each settlor joining in the revocation shall be delivered to the settlor owning the property. A unilateral revocation of the trust by one settlor does not prevent reestablishment of the trust with respect to any property that may later pass to the trust under the will of a settlor or otherwise.

2. *Exception: Amendment While Both Settlors Are Living*. During the joint lifetimes of the settlors, all trusts created by this document may be amended by mutual agreement of the settlors. Any amendments must satisfy the procedural requirements of this division for amending or revoking trusts.

3. *Exception: Revocation or Amendment of Survivor's Trust*. The Survivor's Trust may be revoked or amended, in whole or in part, at any time by the Surviving Settlor. Any such revocation or amendment must satisfy the procedural requirement of this division for amending or revoking trusts. On revocation, the trustee shall deliver the trust property to the Surviving Settlor.

B. *Procedural Requirements for Amending or Revoking Trusts*. No amendment or revocation of any trust shall be effective unless all of the following requirements are satisfied:

1. *Signed Written Document*. The amendment or revocation must be accomplished by a written document signed by the settlor(s) taking the action. Despite the previous sentence, a settlor's power to revoke or amend may be exercised by an attorney-in-fact if and to the extent the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

2. *Acknowledgment or Attorney Certificate*. Except in the case of a document executed in accordance with a court order: (a) The document must be personally acknowledged before a notary public by the person(s) signing the document (not a witness); or (b) the document must contain a statement, signed by an attorney-at-law before or at the time the document is signed by the person(s) taking the action, which declares that the attorney-at-law represents the settlor(s) taking the action and approves the form of the document.

3. *Delivery to the Trustee*. In the case of an action not requiring the consent of both settlors, the document must be delivered during the lifetime of the settlor taking the action to: (a) Each then acting trustee of the trust who is not a settlor taking the action; and (b) each settlor then living and competent but not joining in the action. In the case of an action requiring the joint action of both settlors, the document must be delivered during the settlors' joint lifetimes to each acting trustee who is not a settlor taking the action.

C. *Effect of Defective Documents*. The procedural requirements of this division for revoking or amending trusts are intended to prevent fraud, reduce the risk of undue influence, and provide certainty with respect to the intentions of the settlors. A court, in order to give effect to the actual intentions of a settlor, may give effect to a document not satisfying all procedural requirements for revoking or amending a trust if the court finds that: (1) The settlor taking the action was competent; (2) the attempted revocation or amendment was not the result of fraud, undue influence, or duress; (3) the document was clearly intended to amend or revoke the trust; and (4) there is no reason to deny equitable relief. The proponent of the document shall have the burden of proof. The standard of proof with respect to these matters shall be: (1) Preponderance of the evidence with respect to amendments having no impact or only incidental impact on distribution of the trust after the settlor's death; and (2) clear and convincing evidence in the case of changes that substantially affect distribution of a trust.

D. *Revocation by Gift.* The procedural requirements of this division for revoking or amending trusts do not apply to gifts of trust property made by one or both settlors that would be valid if the gifted property was not subject to this trust. Any such gift revokes the trust with respect to the gifted property.

E. *Effect of Amendment Not Acceptable to Trustee*. The consent of the trustee is not required for a valid amendment. In the event a trust amendment substantially increases the duties or liabilities of the trustee or changes the trustee's compensation without the trustee's consent, the trustee shall have the right to resign.

F. *Limitation on Exercise of Powers by Conservator or Guardian of Estate*. No conservator or guardian of a settlor's estate shall have any power to amend or revoke this trust or exercise any power of appointment. The

previous sentence does not apply if the conservator or guardian is acting under a court order made in compliance with a "substituted judgment" statute. Until such an order is made, no conservator or guardian shall be deemed to hold such a power for any purpose.

7.87-1 Exercise of powers of appointment

G. *Exercise of Powers of Appointment*. A power of appointment conferred by this document, other than a power held in a fiduciary capacity by a trustee, may be exercised only by an instrument that specifically refers to both this trust and the specific power being exercised. Such a power must be exercised by will, codicil, or a "qualified lifetime document." For purposes of this paragraph, a "qualified lifetime document" is a document meeting the requirements described above for revoking a trust with respect to the revoking settlor's separate property, including, if applicable under those requirements, a document executed by a conservator or an attorney-in-fact. A court may give effect to an attempted exercise that fails to satisfy the requirements of this paragraph in accordance with the criteria that would apply to a defective amendment of this document. It being a purpose of this trust to avoid probate, the trustee may distribute trust property in accordance with a will or codicil that has not been probated.

19.20-1 Execution of trust; signatures

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

19.20-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal.

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

5.38-1 Schedule of assets

THE _ _[*Name of Trust*]_ _ TRUST

Exhibit A

Initial Trust Property

The initial trust estate consists of all right, title, and interest of the settlors or either of them in or to any and all of the following property.

[*Edit as appropriate*]

1. The residence commonly known as _ _[*street address*]**_ _.**

2. The contents of that residence.

3. All other real property.

4. All bank, stock brokerage, and other financial and securities accounts of any kind.

5. All stocks, bonds, and other securities of any kind.

6. All intangible property, including any indebtedness of any person or entity.

7. Vehicles, boats, _ _[*other known tangible property*]**_ _.**

8. Small business interest: _ _[*Identify*]**_ _.**

Despite the foregoing, the initial trust estate does not include the following property: _ _[*Specify*]**_ _.**

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Appendix C

Trust for Individual: Long Form

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

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

Description

This form provides a suitable framework for a trust established by only one person. It may be used for an unmarried settlor or for a married settlor who desires to establish a trust funded entirely with separate property. This "long form" trust is likely to be more suitable than the short form in Appendix D when substantial assets in multiple jurisdictions are involved and when a trust will provide for continuing trusts after the settlor's death. The drafter must insert provisions for the disposition on the settlor's death in Division IV. For distribution forms, see chaps 5-6.

WARNING: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix. If the trust 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." Prob C §21351. For further discussion, see the "Warnings" in the introduction to App A.

THE _ _[*NAME OF TRUST*]_ _ TRUST

OPENING DECLARATION

DIVISION I. CREATION OF TRUST

DIVISION II. PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. Purposes of Trust

B. Initial Trustee

C. Successor Trustees

D. Family Information

DIVISION III. DISTRIBUTIONS DURING SETTLOR'S LIFETIME

DIVISION IV. DISTRIBUTION ON DEATH

A. Distribution on Death

B. _ _[*Specify.*]_ _

DIVISION V. ADDITIONAL DISTRIBUTION PROVISIONS

A. Interest on Pecuniary Amounts

B. Undistributed Income

C. Distributions to Young Persons

D. Distribution Terminology

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EXHIBIT A

Initial Trust Property

5.19-1 Opening declaration

The _ _[*Name of Trust*]_ _ Trust

I, _ _[*name of settlor*]_ _, sometimes hereafter called "settlor," residing in _ _[*name of County*]_ _, California, hereby create The _ _[*Name of Trust*]_ _ Trust, declaring:

5.19-2 Creation of trust

DIVISION I
CREATION OF TRUST

The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is now held by me in trust. This property and any other property later transferred to the trust is hereafter referred to as the "trust property" and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.

5.19-3 Purposes, trustees, and family declarations

DIVISION II

PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. Care of Settlor. **To provide for my care and maintenance as long as I am living;**

2. Avoid Conservatorship. **To facilitate management of the trust property in the event of my incapacity; and**

3. *Transfer Property at Death.* **To facilitate transfer of the trust property on my death.**

B. *Initial Trustee.* **I am the initial trustee of this trust.**

C. *Successor Trustees.* **When the initial trustee ceases to act, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.**

D. *Family Information.* **In connection with the administration of this trust, the trustee may rely on the following family information:**

1. *Marital Status*. I am not married and do not have a registered domestic partner.

2. *Children*. _ _[*I have no children/The names and birthdates of my children are* _ _[*list names and birthdates*]_ _]_ _**.**

3. *Deceased Children*. _ _[*I have no deceased children who are survived by issue now living/My child,* _ _[*name*]_ _*, is deceased and is* _ _[*not*]_ _ *survived by issue now living*]_ _**.**

DIVISION III
DISTRIBUTIONS DURING SETTLOR'S LIFETIME

6.14-1 Distributions to single settlor

During my lifetime, the trustee shall pay to or apply for my benefit as much of the income and principal of this trust as I request, plus such additional sums as the trustee in its discretion determines are appropriate for my health, education, maintenance, and support in accordance with my accustomed standard of living.

DIVISION IV
DISTRIBUTION ON DEATH

8.32-1 Introduction to dispositive provisions

A. *Distribution on Death.* **On my death, the trustee shall distribute the remaining trust property in accordance with the provisions in paragraph B. of this Division.**

B. _ _[*Specify.*]_ _

DIVISION V
ADDITIONAL DISTRIBUTION PROVISIONS

8.72-1 Interest on pecuniary amounts

A. *Interest on Pecuniary Amounts.* **When a beneficiary is entitled to receive payment of a pecuniary amount or an annuity, the beneficiary shall be entitled to receive interest on delayed distributions to the extent provided by California law. If California law has no provision expressly applicable to trusts, interest shall be paid in accordance with California law applicable to a decedent's estate.**

7.94-1 Accumulation of undistributed income

B. *Undistributed Income*. In any instance in which this document fails to expressly provide for the

distribution or accumulation of any trust income, that income shall be accumulated and added to principal.

8.30-1 Retention in further trust until specified age

C. *Distributions to Young Persons.* If any person otherwise entitled to outright distribution of any property from any trust created by this document, is under the age of _ _[*age*]_ _ at the time the right to distribution vests, the trustee shall not make the distribution, but shall, instead, retain the property that would otherwise be distributed in a separate trust for the benefit of the underaged person ("Beneficiary"). 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 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 then-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 under the provisions of this trust for exercising a power of appointment. 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.

D. *Distribution Terminology*. The following directions and definitions apply to the distribution provisions of this trust.

18.15-1 Definition of "charity"

1. *Charity.* A "charity" is any organization described in Internal Revenue Code §2055 or §2522.

8.62-1 Manner of making distribution per capita at each generation

2. *Distribution Per Capita at Each Generation*. In making a per capita distribution at each generation, the

trustee shall divide the property to be distributed 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.

18.14-1 Definition of "education"

3. *Education.* "Education" includes primary, secondary, vocational, college, university, postgraduate study, and other specialized studies _ _[*if in the trustee's discretion the study is being pursued to advantage by the beneficiary*]_ _.

18.5-1 Terms of relationship

4. *Terms of Relationship*. Except as expressly provided in this paragraph, half bloods, adopted persons, persons born out of wedlock, stepchildren, foster children, and the issue of these persons when appropriate to the class, are included or excluded in terms of class gift or relationship in accordance with California law for determining relationship and inheritance rights for purposes of intestate succession that are in effect on the date of execution of this document. However, a person born out of wedlock to a natural parent shall not be considered a child of that person unless the person lived, while a minor, as a regular member of the household of the natural parent or of that parent's parent, sibling, or spouse; or otherwise during minority was both openly acknowledged by such a person to be the child of the parent and was involved with such a person in an active social relationship. Further, an adopted child shall not be considered the child of an adopting parent unless the adopted person lived while a minor (either before or after adoption) as a regular member of the household of the adopting parent.

E. *Distribution Powers.* For purposes of making distributions, the trustee's powers include the following.

11.50-1 Power to make nonprorata distribution

1. *Nonprorata Distributions*. 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 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 appropriate to accommodate such distributions.

8.70-1 Power to delay distributions

2. *Power to Delay Distributions.* When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it, and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after the trustee receives the income. This provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. Nor does this provision authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.

7.79-1 Limitations on discretionary distributions to trustee

F. *Limitations on Discretionary Distributions to a Trustee.* A person who is a beneficiary of a trust that permits the person, as trustee or cotrustee, to make discretionary distributions of income or principal to or for the benefit of him- or herself may exercise that power in his or her favor only for health, education, maintenance, or support within the meaning of Internal Revenue Code §§2041, 2514. Despite the foregoing and California Probate Code §15620, if a power to make discretionary distributions of income or principal is conferred on two or more trustees, the power may be exercised by any trustee who is not a current permissible beneficiary of that power; and, as long as there is no trustee who is not a current permissible beneficiary of that power, any party in interest may apply to a court of competent jurisdiction to appoint a trustee who is not a current permissible beneficiary of that power, and the power may be exercised by the trustee appointed by the court. The restrictions of this paragraph do not apply to a person making distributions of property that the

person could withdraw by exercising that person's own power of revocation.

7.25-1 Prohibition against discharge of support obligation

G. *Prohibition Against Discharge of Support Obligation*. No one may exercise, alone or with others, a discretionary power conferred by this document in a manner that results in the discharge of that person's obligation to support another person. This prohibition applies to both personal powers and fiduciary powers. These restrictions do not apply to a person making distributions of property that the person could withdraw by exercising his or her power of revocation.

15.14-1 Equitable proration under California law

H. *Apportionment of Taxes*. Except as otherwise provided in this document, all estate, generation-skipping, and inheritance taxes, including interest and penalties, imposed on or by reason of the inclusion of any trust property in the gross taxable estate of _ _[*the/either*]_ _ settlor may be paid by the trustee and charged to, prorated among, or recovered from the trust property or the persons entitled to the benefits under the trust as provided in the California Probate Code and the Internal Revenue Code.

15.16-1 Payment of additional taxes from disclaimed property

I. *Transfer Taxes Caused by Disclaimer.* Any increase in estate, generation-skipping, or inheritance taxes, including interest and penalties, resulting from a qualified disclaimer shall be paid from the disclaimed property.

DIVISION VI
DEBTS

15.27-1 Payment of debts: single settlor

A. *Debts of Settlor's Estate*. On my death, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. My funeral and last illness expenses.

2. *Other Debts*. My other debts that would be properly payable by my probate estate if the trust property were included in a probate estate rather than this trust and a timely creditor's claim was filed in that estate.

3. *Probate Expenses*. Necessary and proper expenses of administration of my probate estate.

B. *Limitations on Sources of Payment*. Despite the provisions in Paragraph A, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including individual retirement account) benefits in which the trust acquires an interest as a result of the death of the settlor. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the death of the settlor in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

DIVISION VII
OFFICE OF TRUSTEE

16.3-1 Definition of trustee

A. *Definition of Trustee.* The term "trustee" as used in this document usually refers to such one or more persons or entities who, alone or in combination, have the power to take action on behalf of the trust, but it may instead refer to any form of limited power or special trustee or one or more individual cotrustees, depending on context.

16.4-1 Scope of trustee provisions

B. *Scope of Trustee Provisions.* Except as otherwise provided, the provisions of this document concerning the identity of trustees apply to all trusts established by this document. Similarly, except as otherwise provided, the provisions of this document concerning trustee duties, powers, privileges, and protections from liability, apply to all trustees, including successor trustees, of all trusts established by this document.

16.34-1 Trustee resignation

C. *Resignation of Trustee.* The trustee may resign at any time by mailing notice to the persons entitled by law to receive a trustee's account. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.

16.41-1 Removal of any trustee

D. *Removal of Any Trustee.* Any trustee, including a settlor, may be removed in accordance with California law.

16.39-1 Removal of incompetent settlor acting as trustee

1. *Removal of Settlor-Trustee.* A settlor shall cease to be a trustee or cotrustee of this trust if the settlor lacks the ability to perform the duties of the trustee. A majority of the following named persons shall have the power to determine that a settlor lacks such ability: _ _[*Names of persons given the power to make the determination*]_ _. The determination shall be effective at such time as the persons making the determination deliver to the successor trustee declarations executed under penalty of perjury that state that the declarants have determined that the settlor lacks the ability to perform the duties of the trust. In the event of such a determination, the successor trustee shall immediately give the removed settlor written notice that the successor has assumed the position of trustee. The notice shall be given by personal delivery to the settlor. Nothing in this paragraph precludes the settlor from overriding the determination of these persons by exercising the settlor's powers of revocation or amendment, but a successor trustee who becomes trustee as a result of a determination made in accordance with this paragraph is entitled to exercise all powers of the trustee unless or until the successor's powers are terminated or limited by further action of the settlor or a court order.

16.40-1 Removal of corporate trustee

2. *Removal of Corporate Trustee.* The current income beneficiary (or a legal representative of that beneficiary) of a trust created under this document may remove a current corporate trustee and substitute a successor corporate trustee if the beneficiary or representative reasonably believes that substitution will result in a significant reduction in trustee fees.

16.55-1 Power to name successor

E. *Power to Name Successor Trustee.* A trustee of this trust shall have the power to name a person or entity who shall become that trustee's successor if a successor is required and this document makes no other provision for a successor, or if the successors named in this document are not willing to act. The power shall be exercised as provided in this document for the exercise of a power of appointment.

16.49-1 Temporary trustee

F. *Temporary Trustee.* If an incumbent trustee or co-trustee is temporarily unable to administer the trust, the person(s) otherwise entitled to be the trustee if the incumbent resigned shall become the trustee until the incumbent can resume the duties of trustee.

17.51-1 Delegation of powers and duties

G. *Trustee's Power to Delegate.* The trustee may delegate duties and powers, other than discretionary distribution powers, as long as the trustee exercises reasonable care, skill, and caution in:

1. Selecting an agent;

2. Establishing the scope and terms of the delegation; and

3. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

16.7-1 Cotrustees

H. *Applicable Rules for Cotrustees.* The following rules apply when a trust has more than one trustee, none of whom have the power to revoke the trust:

1. *Lack of Unanimity.* Cotrustees who are unable to reach a unanimous decision may act by majority decision.

***2. Vacancy.* If a vacancy occurs in a cotrusteeship, the remaining cotrustees may act for the trust.**

3. *Disqualified Trustees.* If one or more trustees cannot participate in a decision concerning a discretionary distribution, the decision shall be made in accordance with the provisions of this document expressly addressing that circumstance.

4. *Temporary Disability.* If a cotrustee is unavailable to perform duties because of absence, illness, disqualification under other law, or other temporary incapacity, and prompt action is necessary to achieve the purposes of the trust or to avoid injury to the trust property, the remaining cotrustee or a majority of the remaining cotrustees may act for the trust.

5. *Delegation of Authority.* A trustee may not delegate to a cotrustee the performance of a function the settlor reasonably expected the trustees to perform jointly. Unless a delegation was irrevocable, a trustee may revoke a delegation previously made.

16.20-1 Trustee compensation

I. *Compensation of Trustees.* Trustees are entitled to reasonable compensation.

DIVISION VIII
TRUSTEE POWERS

17.19-1 Broad trustee powers: statement of trustee powers

A. *General Powers of Trustee*. Subject to any limitations expressly stated in this document, the trustee of each trust established under this document is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

1. *California Law.* The 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 complying with any otherwise applicable requirement for a court order.

2. *Prudent Person*. The power to perform any act that a prudent person would take in order to accomplish the objectives of the trust.

3. *Prudent Investor.* The power to perform any act that a prudent investor would take in investing trust property.

4. *Owner of Property.* The power to exercise any right or privilege that an unmarried competent adult has over individually owned property.

5. *Other Powers. A*ny other powers appropriate to achieve the proper investment, management, and distribution of the trust property.

6. *Uniform Trust Code*. Any other powers conferred by the Uniform Trust Code, as revised and amended in 2001 by the National Conference of Commissioners on Uniform State Laws.

B. *Specific Powers of Trustee*. The powers listed in the previous paragraph include, but are not limited to, those described in this paragraph. The trustee may:

1. Collect trust property and accept or reject additions to the trust property from a settlor or any other person;

2. Acquire or sell property, for cash or on credit, at public or private sale;

3. Exchange, partition, or otherwise change the character of trust property;

4. Deposit trust money in an account in a regulated financial-service institution;

5. Borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the duration of the trust;

6. With respect to an interest in a proprietorship, partnership, limited liability company, business trust, corporation, or other form of business or enterprise, continue the business or other enterprise and take any action that may be taken by shareholders, members, or property owners, including merging, dissolving, or otherwise changing the form of business organization or contributing additional capital;

7. With respect to stocks or other securities, exercise the rights of an absolute owner, including the right to:

a. Vote, or give proxies to vote, with or without power of substitution, or enter into or continue a voting trust agreement;

b. Hold a security in the name of a nominee or in other form without disclosure of the trust so that title may pass by delivery;

c. Pay calls, assessments, and other sums chargeable or accruing against the securities, and sell or exercise stock subscription or conversion rights; and

d. Deposit the securities with a depositary or other regulated financial-service institution;

8. With respect to an interest in real property, construct, or make ordinary or extraordinary repairs to, alterations to, or improvements in, buildings or other structures, demolish improvements, raze existing or erect new party walls or buildings, subdivide or develop land, dedicate land to public use or grant public or private easements, and make or vacate plats and adjust boundaries;

9. Enter into a lease for any purpose as lessor or lessee, including a lease or other arrangement for exploration and removal of natural resources, with or without the option to purchase or renew, for a period within or extending beyond the duration of the trust;

10. Grant an option involving a sale, lease, or other disposition of trust property or acquire an option for the acquisition of property, including an option exercisable beyond the duration of the trust, and exercise an option so acquired;

11. Insure the property of the trust against damage or loss and insure the trustee, the trustee's agents, and beneficiaries against liability arising from the administration of the trust;

12. Abandon or decline to administer property of no value or of insufficient value to justify its collection or continued administration;

13. With respect to possible liability for violation of environmental law:

a. Inspect or investigate property the trustee holds or has been asked to hold, or property owned or operated by an organization in which the trustee holds or has been asked to hold an interest, for the purpose of

determining the application of environmental law with respect to the property;

b. Take action to prevent, abate, or otherwise remedy any actual or potential violation of any environmental law affecting property held directly or indirectly by the trustee, whether taken before or after the assertion of a claim or the initiation of governmental enforcement;

c. Decline to accept property into trust or disclaim any power with respect to property that is or may be burdened with liability for violation of environmental law;

d. Compromise claims against the trust that may be asserted for an alleged violation of environmental law; and

e. Pay the expense of any inspection, review, abatement, or remedial action to comply with environmental law;

14. Pay or contest any claim, settle a claim by or against the trust, and release, in whole or in part, a claim belonging to the trust;

15. Pay taxes, assessments, compensation of the trustee and of employees and agents of the trust, and other expenses incurred in the administration of the trust;

16. Exercise elections with respect to federal, state, and local taxes;

17. Select a mode of payment under any employee benefit or retirement plan, annuity, or life insurance payable to the trustee, exercise rights thereunder, including exercise of the right to indemnification for expenses and against liabilities, and take appropriate action to collect the proceeds;

18. Make loans from trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, including imposition of a lien on future distributions for purposes of securing repayment of a loan;

19. Pledge trust property to guarantee loans made by others to the beneficiary;

20. Appoint a trustee to act in another jurisdiction regarding trust property in the other jurisdiction, confer on the appointed trustee all powers and duties of the appointing trustee, require that the appointed trustee furnish security, and remove any trustee so appointed;

21. Pay an amount distributable to a beneficiary who is under a legal disability or who the trustee reasonably believes is incapacitated, by paying it directly to the beneficiary or applying it for the beneficiary's benefit, or by:

a. Paying it to the conservator or guardian of the beneficiary's estate;

b. Paying it to the beneficiary's custodian under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) or similar statute and, for that purpose, creating a custodianship or custodial trust;

c. If the trustee does not know of a conservator, guardian, or custodian, paying it to an adult relative or other person having legal or physical care or custody of the beneficiary, to be expended on the beneficiary's behalf; or

d. Managing it as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution;

22. Resolve a dispute over the interpretation of the trust or its administration by mediation, arbitration, or other procedure for alternative dispute resolution;

23. Prosecute or defend an action, claim, or judicial proceeding in any jurisdiction to protect trust property and the trustee in the performance of the trustee's duties;

24. Sign and deliver contracts and other instruments that are useful to achieve or facilitate the exercise of the trustee's powers;

25. Combine two or more trusts into a single trust or divide a trust into two or more separate trusts;

26. On termination of the trust, exercise the powers appropriate to wind up the administration of the trust and distribute the trust property to the persons entitled to it; and

27. Appoint any person to be an authorized signer (either alone or with others, jointly or severally) for any financial institution account or securities account.

DIVISION IX
TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

17.36-1 Trustee's duties

A. *Duties of Trustee*. Except as expressly provided in this document, the trustee has the duties imposed by law, including the duty to report and account to trust beneficiaries, statutory duties to give notice and copies of this document to trust beneficiaries and heirs at law on the death of a settlor, and the duty to invest property in accordance with the Uniform Prudent Investor Act.

17.41-1 Limitations on trustee duty of loyalty

B. *Limitations on Trustee's Duty of Loyalty.* As long as the trustee does not act in bad faith or in disregard of the purposes of the trust, it is not a breach of the trust for the trustee to take any of the following actions:

1. Lend the trustee's own funds to the trust for any trust purpose, with interest at current rates;

2. Receive reasonable security for such a loan;

3. Purchase trust property from the trust at fair market value, provided the purchase price is paid in full in advance;

4. Lease or sell the trustee's own property to the trust at a rent or price not in excess of its fair market value;

5. Employ the trustee, a relative of the trustee, or a business in which the trustee has an interest, to perform needed services for the trust or any business in which the trust has an interest and to pay compensation not exceeding fair market value;

6. Acquire or retain an interest in property in which the trust also has an interest;

7. Acquire or retain stock of a corporate trustee or an affiliate of a corporate trustee unless the acquisition or retention would violate the trustee's duties in the case of stock of a similar corporation other than the trustee or its affiliate;

8. Deposit funds in a bank in which the trustee has an interest;

9. Perform as trustee any action described above with a relative of the trustee or a business in which the trustee has an interest;

10. Hold property of multiple trusts without segregating or dividing the property and without separately titling the property of each trust, but instead keeping accounts sufficient to identify the property of each trust.

17.59-1 Acceptance of additions

C. *Acceptance of Additions*. The trustee has a duty to accept additions to this trust unless an addition would significantly expand the trustee's duties, the transferred property is hazardous or otherwise creates a substantial increased risk of trustee liability, or the property is transferred by a competent person other than a settlor who retains the capacity to establish a trust naming a different trustee. If an addition is rejected on the

ground of increased duties or liabilities and the transferor is deceased or lacks capacity, the trustee shall give reasonable notice to the persons interested in the trust.

16.23-1 Exculpation of trustee

D. *Exculpation of Trustee.* A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, 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 previous 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 person who regularly engages in the business of acting as a trustee.

16.25-1 Cotrustee's duty to act

E. *Cotrustee's Duty to Act*. A cotrustee must participate in the performance of a trustee's function unless the cotrustee is unavailable to perform the function because of absence, illness, disqualification under other law, or other temporary incapacity or unless the cotrustee has properly delegated the performance of the function to another trustee.

16.26-1 Limitation on duty to investigate predecessor or cotrustee

F. *Limitation on Duty to Investigate Predecessor or Cotrustee*. A successor trustee or cotrustee has no duty to audit or investigate the administration or accounts of any prior trustee or cotrustee unless an audit or investigation is demanded in writing by a beneficiary. Each trustee shall exercise reasonable care to (1) prevent a cotrustee from committing a serious breach of trust, and (2) compel a cotrustee to redress a serious breach of trust.

DIVISION X
RULES OF CONSTRUCTION

18.10-1 California law used in construction of trust

A. *Applicable Law.* This document shall be construed in accordance with the laws of the State of California _ _[*in effect on the date of execution of this document/as amended from time to time*]_ _**.**

18.12-1 Headings, titles, and subtitles

B. *Context.* The divisions, paragraphs, and subparagraphs of this document shall be construed in context, giving due regard to the headings and the topic of discussion.

18.13-1 Relevance of common estate planning practice

C. *Relevance of Common Estate Planning Practice.* This document is intended to accomplish normal and ordinary objectives of similar trusts commonly drafted by attorneys specializing in trusts and estates at the time this document is executed, and shall be construed accordingly.

DIVISION XI
MISCELLANEOUS

19.13-1 Short-form spendthrift clause

A. *Spendthrift Clause*. The interests of the beneficiaries in the income and principal of the trusts created by this document are not subject to voluntary or involuntary transfer.

19.11-1 Perpetuities savings clause

B. *Rule Against Perpetuities*. Unless terminated earlier in accordance with other provisions of this document, each trust created by this document or by exercise of any power of appointment conferred by this document (unless an appointed trust is entitled to a new perpetuities period) shall terminate 21 years after the death of

the last survivor of _ _[*names of individuals or description of class best suited to be measuring lives*]_ _ living on the date of the death of the Deceased Settlor. In the event of termination under this paragraph, the principal and undistributed income of a terminated trust shall be distributed to the then income beneficiaries of that trust in the same proportion that the beneficiaries are entitled to receive income when the trust terminates. If at the time of such termination the rights to income are not fixed by the terms of the trust, distribution under this clause shall be made to the persons who are then entitled or authorized, in the trustee's discretion, to receive trust payments.

19.5-1 No-contest clause

C. *No-Contest Clause*. If any beneficiary under a trust created by this document shall, singly or in conjunction with any other person or persons, contest in any court the validity of any trust created by this document, or any will or other document making a transfer to this trust, or shall seek to obtain an adjudication in any proceeding in any court that this trust or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside the trust or any of its provisions, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.

DIVISION XII
REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

20.2-1 Sole settlor's power to revoke or amend

A. *Settlor's Power to Revoke and Amend.* During the settlor's lifetime, the settlor may revoke or amend _ _[*this trust/all trusts created by this document*]_ _ at any time. On revocation, the trust property shall be delivered to the settlor or as the settlor directs. _ _[*This trust/All trusts created by this document*]_ _ become irrevocable on the settlor's death.

B. *Procedural Requirements for Amending or Revoking Trusts*. No amendment or revocation of any trust shall be effective for such purposes unless all of the following requirements are satisfied:

1. *Signed Written Document*. The amendment or revocation must be accomplished by a written document signed by the settlor. Despite the previous sentence, the settlor's power to revoke or amend may be exercised by an attorney-in-fact to the extent that the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

2. *Acknowledgment or Attorney Certificate*. Except in the case of a document executed in accordance with a court order: (a) The document must be personally acknowledged before a notary public by the person signing the document (not a witness); or (b) the document must contain a statement, signed by an attorney at law before or at the time the document is signed by the person taking the action, which declares that the attorney represents the settlor taking the action and approves the form of the document.

3. *Delivery to Trustee*. The document must be delivered during the lifetime of the settlor to each then-acting trustee of the trust other than the settlor.

C. *Effect of Defective Documents*. The procedural requirements of this division for revoking or amending trusts are intended to prevent fraud, reduce the risk of undue influence, and provide certainty with respect to the settlor's intentions. A court, in order to give effect to the actual intentions of a settlor, may give effect to a document not satisfying all procedural requirements for revoking or amending a trust if the court finds that (1) the settlor was competent; (2) the attempted revocation or amendment was not the result of fraud, undue influence, or duress; (3) the document was clearly intended to amend or revoke the trust; and (4) there is no reason to deny equitable relief. The proponent of the document shall have the burden of proof. The standard of proof with respect to these matters shall be (1) preponderance of the evidence concerning amendments having no impact or only incidental impact on distribution of the trust after the settlor's death and (2) clear and convincing evidence in the case of changes that substantially affect distribution of a trust.

D. *Revocation by Gift.* The procedural requirements of this division for revoking or amending trusts do not apply to gifts of trust property made by the settlor that would be valid if the gifted property was not subject to this trust. Any such gift revokes the trust with respect to the gifted property.

E. *Amendment Not Acceptable to Trustee*. The trustee's consent is not required for a valid amendment. If a trust amendment substantially increases the trustee's duties or liabilities or changes the trustee's compensation without the trustee's consent, the trustee shall have the right to resign.

F. *Limitation on Exercise of Powers by Conservator or Guardian of Estate*. No conservator or guardian of the settlor's estate shall have any power to amend or revoke this trust _ _[*or exercise any power of appointment*]_ _. The previous sentence does not apply if the conservator or guardian is acting under a court order made in compliance with a "substituted judgment" statute. Until such an order is made, no conservator or guardian shall be deemed to hold such a power for any purpose.

7.87-1 Exercise of powers of appointment

G. *Exercise of Powers of Appointment*. A power of appointment conferred by this document, other than a power held in a fiduciary capacity by a trustee, may be exercised only by an instrument that specifically refers to both this trust and the specific power being exercised. Such a power must be exercised by will, codicil, or a "qualified lifetime document." For purposes of this paragraph, a "qualified lifetime document" is a document meeting the requirements described above for revoking a trust with respect to the revoking settlor's separate property, including, if applicable under those requirements, a document executed by a conservator or an attorney-in-fact. A court may give effect to an attempted exercise that fails to satisfy the requirements of this paragraph in accordance with the criteria that would apply to a defective amendment of this document. It being a purpose of this trust to avoid probate, the trustee may distribute trust property in accordance with a will or codicil that has not been probated.

19.20-1 Execution of trust; signature

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

19.20-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal.

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

5.38-1 Schedule of assets

THE _ _[*Name of Trust*]_ _ TRUST

Exhibit A

Initial Trust Property

The initial trust estate consists of all right, title, and interest of the settlor in or to any and all of the following property.

[*Edit as appropriate*]

1. The residence commonly known as _ _[*street address*]**_ _.**

2. The contents of that residence.

3. All other real property.

4. All bank, stock brokerage, and other financial and securities accounts of any kind.

5. All stocks, bonds, and other securities of any kind.

6. All intangible property, including any indebtedness of any person or entity.

7. Vehicles, boats, _ _[*other known tangible property*]**_ _.**

8. Small business interest: _ _[*Identify*]**_ _.**

Despite the foregoing, the initial trust estate does not include the following property: _ _[*Specify*]**_ _.**

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Appendix D

Trust for Individual: Short Form

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

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

Description

Drafters occasionally encounter situations, including situations involving clients with terminal illnesses, in which there is a high level of certainty about the facts that will exist at the time of death. It may be certain that no estate taxes will be payable, that all beneficiaries will be adults, that there will be no need for continuing trusts after the settlor's death, that there will be no additions to the trust that the trustee would refuse, that at least one of the nominated trustees and successor trustees will live long enough to complete the administration of the trust, and that the trust will not have cotrustees. In most of these situations the settlor's deteriorated physical condition will make it desirable to produce a document that is short and easily understood. This appendix provides a bare bones form that can be used in such situations. This form assumes that, because of the settlor's deteriorated health, the settlor is not the initial trustee. If the settlor is the trustee, the form for removing an incompetent settlor in §16.39 should be added. The drafter must insert provisions for the disposition on the settlor's death in Division IV. For distribution forms, see chaps 7-8.

WARNING: The trust in this Appendix is a sample only. For the purpose of presenting a complete, streamlined trust, the trust does not include every possible alternative or option that could be used. Alternative or additional optional forms, if any, are set out in the body of the text of the book. Each form is numbered to refer to the counterpart form in the body of the text. Some of the forms, however, are not exact replicas of their counterparts in the text; they have been modified to comport with the specific requirements of the type of trust created in this Appendix. If the trust 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." Prob C §21351. For further discussion, see the "Warnings" in the introduction to App A.

THE _ _[*NAME OF TRUST*]_ _ TRUST

OPENING DECLARATION

DIVISION I. CREATION OF TRUST

DIVISION II. PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. Purposes of Trust

B. Initial Trustee

C. Successor Trustees

D. Family Information

DIVISION III. DISTRIBUTIONS DURING SETTLOR'S LIFETIME

DIVISION IV. DISTRIBUTION ON DEATH

A. Distribution on Death

B. _ _[*Specify.*]_ _

DIVISION V. ADDITIONAL DISTRIBUTION PROVISIONS

A. Trustee Distribution Powers

B. Distributions to Young Persons

DIVISION VI. DEBTS

A. Debts of Settlor's Estate

B. Limitations on Sources of Payments

DIVISION VII. OFFICE OF TRUSTEE

A. Definition of Trustee

B. Scope of Trustee Provisions

C. Resignation of Trustee

D. Removal of Any Trustee

E. Power to Name Successor Trustee

F. Temporary Trustee

G. Trustee's Power to Delegate

H. Compensation of Trustees

DIVISION VIII. TRUSTEE POWERS

A. General Powers of Trustee

B. Specific Powers of Trustee

DIVISION IX. TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

A. Duties of Trustee

B. Limitations on Trustee's Duty of Loyalty

C. Acceptance of Additions

D. Exculpation of Trustee

E. Cotrustee's Duty to Act

F. Limitation on Duty to Investigate Predecessor or Cotrustee

DIVISION X. NO-CONTEST CLAUSE

DIVISION XI. REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

A. Settlor's Power to Revoke and Amend

B. Exercise of Powers of Appointment

Signatures; Acknowledgment

EXHIBIT A

Initial Trust Property

5.19-1 Opening declaration

The _ _[*Name of Trust*]_ _ Trust

I, _ _[*name of settlor*]_ _, sometimes hereafter called "settlor," residing in _ _[*name of County*]_ _, California, hereby create The _ _[*Name of Trust*]_ _ Trust, declaring:

5.19-2 Creation of trust

DIVISION I
CREATION OF TRUST

The property described in the attached listing of "Initial Trust Property," marked "Exhibit A," is now held by me in trust. This property and any other property later transferred to the trust is hereafter referred to as the "trust property" and shall be held, administered, and distributed as provided in this document and any subsequent amendments to this document.

5.19-3 Purposes, trustees, and family declarations

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

A. *Purposes of Trust*. The primary purposes of this trust are:

1. *Care of Settlor.* To provide for my care and maintenance as long as I am living;

2. *Avoid Conservatorship.* To facilitate management of the trust property in the event of my incapacity; and

3. *Transfer Property at Death.* To facilitate transfer of the trust property on my death.

B. *Initial Trustee.* _ _[*I am/_ _[Name*]_ _ *is*]_ _ the initial trustee of this trust.

C. *Successor Trustees.* When the initial trustee ceases to act, _ _[*name of first successor trustee*]_ _ shall become trustee. If this nominated successor fails to qualify or ceases to act, _ _[*name of second successor trustee*]_ _ shall become the trustee.

D. *Family Information.* In connection with the administration of this trust, the trustee may rely on the following family information:

1. *Marital Status*. I am not married and do not have a registered domestic partner.

2. *Children*. _ _[*I have no children/The names and birthdates of my children are _ _[list names and birthdates*]_ _]_ _**.**

3. *Deceased Children*. _ _[*I have no deceased children who are survived by issue now living/My child,* _ _[*name*]_ _*, is deceased and is _ _[not*]_ _ *survived by issue now living*]_ _**.**

DIVISION III
DISTRIBUTIONS DURING SETTLOR'S LIFETIME

6.14-1 Distributions to single settlor

During my lifetime, the trustee shall pay to or apply for my benefit as much of the income and principal of this trust as I request, plus such additional sums as the trustee in its discretion determines are appropriate for

my health, education, maintenance, and support in accordance with my accustomed standard of living.

DIVISION IV
DISTRIBUTION ON DEATH

8.32-1 Introduction to dispositive provisions

A. *Distribution on Death.* On my death, the trustee shall distribute the remaining trust property in accordance with the provisions in paragraph B. of this Division.

B. _ _[*Specify.*]**_ _**

DIVISION V
ADDITIONAL DISTRIBUTION PROVISIONS

A. *Trustee Distribution Powers*. For purposes of making distributions, the trustee's powers include the following:

11.50-1 Power to make nonprorata distribution

1. *Nonprorata Distributions*. 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 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 appropriate to accommodate such distributions.

8.70-1 Power to delay distributions

2. *Power to Delay Distributions.* When an event occurs on which the trustee is required to divide or distribute trust property, the trustee may delay the division 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, contingent or otherwise, against the trust property. During this period, the trustee may pay the net income of the trust to the beneficiaries entitled to it, and any income not distributed shall on resolution of any tax claim or other liability be payable to the person entitled to it immediately after the trustee receives the income. This provision shall not be deemed to postpone or defer the vesting of any interest created by the dispositive clauses of the trust. Nor does this provision authorize a delay in any distribution that might result in a transfer's losing eligibility for a federal estate tax marital deduction or charitable deduction.

8.30-1 Retention in further trust until specified age

B. *Distributions to Young Persons.* If any person otherwise entitled to outright distribution of any property from any trust created by this document is under the age of _ _[*age*]**_ _ at the time the right to distribution vests, the trustee shall not make the distribution, but shall, instead, retain the property that would otherwise be distributed in a separate trust for the benefit of the underaged person ("Beneficiary"). 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 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 then-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 under the provisions of this trust for exercising a power of appointment. 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.

DIVISION VI
DEBTS

15.27-1 Payment of debts: single settlor

A. *Debts of Settlor's Estate*. On my death, the trustee may pay from the trust property:

1. *Funeral and Last Illness Expenses*. My funeral and last illness expenses.

2. *Other Debts*. My other debts that would be properly payable by my probate estate if the trust property were included in a probate estate rather than this trust and a timely creditor's claim was filed in that estate.

3. *Probate Expenses*. Necessary and proper expenses of administration of my probate estate.

B. *Limitations on Sources of Payment*. Despite the provisions in Paragraph A, the trustee shall not pay any estate or inheritance taxes (including interest or penalties), last illness and funeral expenses, attorney fees, administration expenses, debts, or other obligations of the settlor or the settlor's estate, from any retirement plan (including individual retirement account) benefits in which the trust acquires an interest as a result of the death of the settlor. Further, the trustee shall not pay any such obligation from any life insurance or other property passing to the trust on the death of the settlor in accordance with a beneficiary designation unless the property would have been liable for the obligation had the property passed to an individual beneficiary rather than the trust.

DIVISION VII
OFFICE OF TRUSTEE

16.3-1 Definition of trustee

A. *Definition of Trustee.* The term "trustee" as used in this document usually refers to such one or more persons or entities who, alone or in combination, have the power to take action on behalf of the trust, but it may instead refer to any form of limited power or special trustee or one or more individual cotrustees, depending on context.

16.4-1 Scope of trustee provisions

B. *Scope of Trustee Provisions.* Except as otherwise provided, the provisions of this document concerning the identity of trustees apply to all trusts established by this document. Similarly, except as otherwise provided, the provisions of this document concerning trustee duties, powers, privileges, and protections from liability, apply to all trustees, including successor trustees, of all trusts established by this document.

16.34-1 Trustee resignation

C. *Resignation of Trustee.* The trustee may resign at any time by mailing notice to the persons entitled by law to receive a trustee's account. Unless circumstances are such that it is not necessary to replace the resigning trustee, the resignation becomes effective on the acceptance of office by the successor trustee who replaces the resigning trustee.

16.41-1 Removal of any trustee

D. *Removal of Any Trustee.* Any trustee, including a settlor, may be removed in accordance with California law.

16.55-1 Power to name successor

E. *Power to Name Successor Trustee.* A trustee of this trust shall have the power to name a person or entity who shall become that trustee's successor if a successor is required and this document makes no other provision for a successor, or if the successors named in this document are not willing to act. The power shall be exercised as provided in this document for the exercise of a power of appointment.

16.49-1 Temporary trustee

F. *Temporary Trustee*. If an incumbent trustee or cotrustee is temporarily unable to administer the trust, the person(s) otherwise entitled to be the trustee if the incumbent resigned shall become the trustee until the incumbent can resume the duties of trustee.

17.51-1 Delegation of powers and duties

G. *Trustee's Power to Delegate.* The trustee may delegate duties and powers, other than discretionary distribution powers, as long as the trustee exercises reasonable care, skill, and caution in:

1. Selecting an agent;

2. Establishing the scope and terms of the delegation; and

3. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

16.20-1 Trustee compensation

H. *Compensation of Trustees.* Trustees are entitled to reasonable compensation.

DIVISION VIII
TRUSTEE POWERS

17.19-1 Broad trustee powers: statement of trustee powers

A. *General Powers of Trustee*. Subject to any limitations expressly stated in this document, the trustee of each trust established under this document is authorized to exercise the following powers for purposes of discharging the trustee duties imposed by this document and by law:

1. *California Law.* The 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 complying with any otherwise applicable requirement for a

court order.

2. *Prudent Person*. The power to perform any act that a prudent person would take in order to accomplish the objectives of the trust.

3. *Prudent Investor.* The power to perform any act that a prudent investor would take in investing trust property.

4. *Owner of Property.* The power to exercise any right or privilege that an unmarried competent adult has over individually owned property.

5. *Other Powers. A*ny other powers appropriate to achieve the proper investment, management, and distribution of the trust property.

6. *Uniform Trust Code*. Any other powers conferred by the Uniform Trust Code, as revised and amended in 2001 by the National Conference of Commissioners on Uniform State Laws.

B. *Specific Powers of Trustee*. The powers listed in the previous paragraph include, but are not limited to, those described in this paragraph. The trustee may:

1. Acquire or sell property, for cash or on credit, at public or private sale;

2. Borrow money, with or without security, and mortgage or pledge trust property for a period within or extending beyond the duration of the trust;

3. Abandon or decline to administer property of no value or of insufficient value to justify its collection or continued administration;

4. Make loans from trust property, including loans to a beneficiary on terms and conditions the trustee considers to be fair and reasonable under the circumstances, including imposition of a lien on future distributions for purposes of securing repayment of a loan;

5. Pledge trust property to guarantee loans made by others to the beneficiary;

6. Combine two or more trusts into a single trust or divide a trust into two or more separate trusts;

7. Appoint any person to be an authorized signer (either alone or with others, jointly or severally) for any financial institution account or securities account.

DIVISION IX
TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

17.36-1 Trustee's duties

A. *Duties of Trustee*. Except as expressly provided in this document, the trustee has the duties imposed by law, including the duty to report and account to trust beneficiaries, statutory duties to give notice and copies of this document to trust beneficiaries and heirs at law on the death of a settlor, and the duty to invest property in accordance with the Uniform Prudent Investor Act.

17.41-1 Limitations on trustee duty of loyalty

B. *Limitations on Trustee's Duty of Loyalty.* As long as the trustee does not act in bad faith or in disregard of the purposes of the trust, it is not a breach of the trust for the trustee to take any of the following actions:

1. Lend the trustee's own funds to the trust for any trust purpose, with interest at current rates;

2. Receive reasonable security for such a loan;

3. Purchase trust property from the trust at fair market value, provided the purchase price is paid in full in

advance;

4. Lease or sell the trustee's own property to the trust at a rent or price not in excess of its fair market value;

5. Employ the trustee, a relative of the trustee, or a business in which the trustee has an interest, to perform needed services for the trust or any business in which the trust has an interest and to pay compensation not exceeding fair market value;

6. Acquire or retain an interest in property in which the trust also has an interest;

7. Acquire or retain stock of a corporate trustee or an affiliate of a corporate trustee unless the acquisition or retention would violate the trustee's duties in the case of stock of a similar corporation other than the trustee or its affiliate;

8. Deposit funds in a bank in which the trustee has an interest;

9. Perform as trustee any action described above with a relative of the trustee or a business in which the trustee has an interest;

10. Hold property of multiple trusts without segregating or dividing the property and without separately titling the property of each trust, but instead keeping accounts sufficient to identify the property of each trust.

17.59-1 Acceptance of additions

C. *Acceptance of Additions*. The trustee has a duty to accept additions to this trust unless an addition would significantly expand the trustee's duties, the transferred property is hazardous or otherwise creates a substantial increased risk of trustee liability, or the property is transferred by a competent person other than a settlor who retains the capacity to establish a trust naming a different trustee. If an addition is rejected on the ground of increased duties or liabilities and the transferor is deceased or lacks capacity, the trustee shall give reasonable notice to the persons interested in the trust.

16.23-1 Exculpation of trustee

D. *Exculpation of Trustee.* A trustee of any kind nominated by this document, otherwise designated by a settlor, or designated as authorized in this document, 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 previous 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 person who regularly engages in the business of acting as a trustee.

16.25-1 Cotrustee's duty to act

E. *Cotrustee's Duty to Act*. A cotrustee must participate in the performance of a trustee's function unless the cotrustee is unavailable to perform the function because of absence, illness, disqualification under other law, or other temporary incapacity or unless the cotrustee has properly delegated the performance of the function to another trustee.

16.26-1 Limitation on duty to investigate predecessor or cotrustee

F. *Limitation on Duty to Investigate Predecessor or Cotrustee*. A successor trustee or cotrustee has no duty to audit or investigate the administration or accounts of any prior trustee or cotrustee unless an audit or investigation is demanded in writing by a beneficiary. Each trustee shall exercise reasonable care to (1) prevent a cotrustee from committing a serious breach of trust, and (2) compel a cotrustee to redress a serious breach of trust.

DIVISION X
NO-CONTEST CLAUSE

19.5-1 No-contest clause

If any beneficiary under a trust created by this document shall, singly or in conjunction with any other person or persons, contest in any court the validity of any trust created by this document, or any will or other document making a transfer to this trust, or shall seek to obtain an adjudication in any proceeding in any court that this trust or any of its dispositive provisions are void, or otherwise seek to void, nullify, or set aside the trust or any of its provisions, then the right of that person to take any interest given to him or her by this document shall be determined as it would have been determined had the person predeceased the execution of this declaration of trust _ _[*without surviving issue*]_ _.

DIVISION XI
REVOCATION, AMENDMENT, AND EXERCISE OF APPOINTMENT POWERS

20.2-1 Sole settlor's power to revoke or amend

A. *Settlor's Power to Revoke and Amend.* During the settlor's lifetime, the settlor may revoke or amend _ _[*this trust/all trusts created by this document*]_ _ at any time. On revocation, the trust property shall be delivered to the settlor or as the settlor directs. _ _[*This trust/All trusts created by this document*]_ _ become irrevocable on the settlor's death.

7.87-1 Exercise of powers of appointment (modified)

B. *Exercise of Powers of Appointment*. A power of appointment conferred by this document, other than a power held in a fiduciary capacity by a trustee, may be exercised only by an instrument that specifically refers to both this trust and the specific power being exercised. Such a power must be exercised by will, codicil, or a "qualified lifetime instrument." For purposes of this paragraph, a qualified lifetime instrument is a written document signed by the power holder. Except in the case of a document executed in accordance with a court order, the document must be personally acknowledged before a notary public by the person signing the document. The document must be delivered during the lifetime of the settlor to each then-acting trustee of the trust. It being a purpose of this trust to avoid probate, the trustee may distribute trust property in accordance with a will or codicil that has not been probated.

19.20-1 Execution of trust; signature

Executed at _ _[*city*]_ _, California, on _ _[*date*]_ _.

__[*Signature of settlor*]__
_ _[*Typed name*]_ _
Settlor and Trustee

19.20-2 Acknowledgment

State of California)
County of _ _[*name*]_ _)
_____)
)

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

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

WITNESS my hand and official seal.

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

5.38-1 Schedule of assets

THE _ _[*Name of Trust*]_ _ TRUST

Exhibit A

Initial Trust Property

The initial trust estate consists of all right, title, and interest of the settlor in or to any and all of the following property.

[*Edit as appropriate*]

1. The residence commonly known as _ _[*street address*]_ _.

2. The contents of that residence.

3. All other real property.

4. All bank, stock brokerage, and other financial and securities accounts of any kind.

5. All stocks, bonds, and other securities of any kind.

6. All intangible property, including any indebtedness of any person or entity.

7. Vehicles, boats, _ _[*other known tangible property*]_ _.

8. Small business interest: _ _[*Identify*]_ _.

Despite the foregoing, the initial trust estate does not include the following property: _ _[*Specify*]_ _.

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Source: Estate Planning/Drafting California Revocable Trusts/Table of Statutes, Regulations, and Rules

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