

Settling the Revocable Trust in California

A Primer for the Non-Professional Trustee

©Toews & Murphy, Inc. 2016

TABLE OF CONTENTS

I	INTRODUCTION	1
1.	Background	1
2.	Responsibilities of the Trustee	1
3.	Relationships with Beneficiaries	2
4.	Settling the Trust – in General	3
II	THE TRUST SETTLEMENT PROCESS	4
1.	Giving Notices of Administration	4
2.	Identifying Trust Assets	4
3.	Obtaining Title to Assets	5
4.	Protecting Trust Assets against Loss	6
4.	Making Prudent Investments	6
5.	Dealing with Assets Not Owned by the Trust	6
6.	Obtaining Appraisals	7
7.	Paying Debts and Taxes	8
8.	Filing Tax Returns	9
9.	Accounting for the Trust	10
10.	Preparing a Plan of Distribution	11
11.	Distributing the Trust	12
III	COMPENSATION OF THE TRUSTEE	12
1.	Entitlement to Compensation	12
2.	Tax and Other Incidents of Trustee’s Fees	13
IV	COURT PROCEEDINGS	13
1.	Probate Proceedings	13
2.	Heggstad Petitions	14
3.	Section 17200 Petitions	14
V	USE OF PROFESSIONAL ADVISORS	15
1.	In General	15
2.	The Trust Attorney	15
3.	The Accountant	16

4.	Appraisers	17
5.	Other Professionals	17
VI	SETTLEMENT COSTS	18
VII	CONCLUSION.....	20

Settling the Revocable Trust in California

A Primer for the Non-Professional Trustee

©Toews & Murphy, Inc. 2016

I INTRODUCTION

1. Background

Since the early 1980s, revocable trusts have become popular as estate planning tools in California because (a) they usually avoid the need for court proceedings to settle the estate of the person who set up the trust (“settlor”) and (b) they usually avoid the need for the court appointment of a conservator in the event that the settlor is incapacitated. For these reasons, most professionally prepared estate plans for people with significant assets use these trusts.

Although revocable trusts usually avoid probate and conservatorship proceedings, they do not administer themselves when the settlor dies. In fact, estates held in revocable trusts have to be administered in much the same way as traditional probate estates except that, in most cases, no court proceedings are required.

The purpose of this guide is to provide basic information about how a revocable trust works when the settlor dies and about the rights and duties of the trustee and the beneficiaries at that critical time.

This guide is not a substitute for legal advice and should not be relied on as an action guide in any specific situation. However, it should be of assistance to the non-professional trustee in understanding how the settlement process works, what issues and problems are likely to be encountered and how and when to seek professional help.

2. Responsibilities of the Trustee

The person whom the trust agreement names to administer the trust when the settlor dies is usually called the “successor trustee”. Where there is no court-appointed executor of the decedent’s will, most duties that would otherwise belong to the executor devolve instead on the successor trustee.¹

For example, the trustee is responsible for seeing to it that all required notices of administration are given, that all of the settlor’s assets are in the name of the trust, that the settlor’s debts are paid or provided for, that all taxes are paid and that all distributions are made in a timely manner to the persons entitled to them. The trustee is also responsible for insuring or otherwise protecting trust assets against loss. If the trust is to

¹ Due to the overlap between the duties of the executor and the duties of the successor trustee, it is common practice to name the same person as executor and as successor trustee. Otherwise, awkward situations could arise where one party (the executor) is responsible for paying taxes but another party (the successor trustee) has control of the assets needed to pay them.

be administered for a significant period of time, the trustee is also responsible for getting a reasonable investment return on trust assets.²

The trustee ordinarily consults with beneficiaries on the conduct of trust business – for example, on whether to retain or sell real estate or whether to cash in stocks, bonds or other investments. However, the trustee has sole authority to actually make decisions on these matters, subject only to the trustee’s duty to be fair, to follow any restrictions in the trust document and to act in the best interest of the beneficiaries.

The trustee may incur personal liability for failure to properly administer the trust. For example, the Internal Revenue Code provides that any trustee who distributes assets to a beneficiary before the applicable taxes have been paid may be personally liable for those taxes to the extent that the assets left in the trust are insufficient to pay them.³ Likewise, the trustee may be personally liable for losses arising from improper investments of trust assets.⁴

3. Relationships with Beneficiaries

The beneficiaries of a trust share neither the trustee’s authority over trust administration nor the trustee’s personal liability for losses or improper payments. Therefore, their interests are very different from those of the trustee, and their attitudes towards the trust settlement process may be different as well.

Most often, beneficiaries will prefer to receive their inheritances immediately and have the trustee sort out any problems with taxes, creditors and the like later on. The trustee on the other hand will want to retain a trust attorney for advice on how to administer the trust, and may want to defer distributions, initiate court proceedings and/or take other steps to protect the trustee against personal liability.

Generally speaking, trust administration expenses are chargeable to the trust before the beneficiaries’ shares are paid and will reduce the amounts paid to the beneficiaries. These expenses will be money well spent so far as the trustee is concerned but may not always be viewed by the beneficiaries in a positive light.

Where family relationships between the trustee and the beneficiaries are close, beneficiaries will typically be supportive of the trustee’s efforts to comply with the law and will not object to reasonable steps taken to protect the trustee. Where relationships are hostile or less than close, the trustee will have to rely on his or her own good judgment on how to settle the trust – and be prepared to accept some level of criticism from beneficiaries who believe that the trust is being improperly handled or that their inheritances are being unreasonably delayed. At the end of the day, the trustee is solely

² Most trusts should be wound up in a few months after the last settlor dies, and in these cases the primary responsibility of the trustee is to avoid losses – i.e., keep trust money in insured accounts or very conservative, money-market type investments. However, if the trust is substantial and is to be administered for several years then investments to protect future beneficiaries against inflation need to be considered.

³ I.R.C. § 6901; 31 U.S.C. 3713(b)

⁴ Prob. Code § 16047

responsible for administering the trust, and must take appropriate steps to protect his or her interest as trustee whether or not these are approved by the beneficiaries.

4. Settling the Trust – in General

In general, the process of settling a revocable trust at the death of the settlor is very similar to the traditional estate settlement process in probate court except that it normally occurs without court proceedings. The more important elements of the process are discussed in part II below.

The fact that trust settlements occur out of court usually means that they are faster and cheaper than court probate proceedings for estates of the same size and complexity, all else being equal. However, the time and cost savings from “avoiding probate” may not always be as great as generally supposed, and being out of court may not be a good thing in all cases.

In probate, a notice to creditors is published in the newspaper, and individual notices are sent to all known or reasonably ascertainable creditors. The positive side of this is that creditors have only four months to file their claims, and any claims filed after that are generally barred.

This does not apply to trusts administered out of court, and consequently the beneficiaries take their distributions subject to any creditors’ claims that may arise later. Where there are unknown and potentially large creditors’ claims against the decedent’s estate, this may make it advisable to file a probate proceeding and publish the statutory notice to creditors even where all of the decedent’s assets are in a trust.

Also, the fact that trust administration is out of court means that the actions of the trustee are not approved by a judge or protected by court orders. Where relationships between the trustee and the beneficiaries are hostile, the trustee may want to obtain court orders approving his or her key decisions even if court proceedings are not required to transfer title to the decedent’s assets.

The amount of time and effort required to settle a trust varies widely depending on the circumstances of each case. Settlement of a simple trust for a married couple when the first spouse dies may require nothing more than obtaining asset appraisals, filing the decedent’s will with the county clerk and updating asset titles to reflect the fact that the surviving spouse is now the sole trustee. No accounting is usually required, because in most cases the surviving spouse is the only beneficiary and is also the trustee.

On the other hand, settlement of a large trust subject to estate taxes normally takes at least a year and a half because of estate tax reporting and payment rules applicable to such trusts and because a detailed accounting of the trust to all beneficiaries is generally required. The actual timeline may be longer if there are complications, such as tax audits, title problems and/or disputes with creditors or beneficiaries.

Beneficiaries of a trust understandably want to receive their distributions as soon as possible, and may believe, wrongly, that trusts settle themselves or can be distributed in a very short time after the death of the settlor.

In light of this and in the interest of maintaining good relationships with the beneficiaries, one of the trustee’s first priorities should be to set a schedule for administering the trust

and a budget for administration costs, and to communicate these to the beneficiaries at the earliest possible time. Normally, this will require consultation with an attorney who specializes in trust and estate matters and who can provide an informed estimate of timeframes and settlement costs.

II THE TRUST SETTLEMENT PROCESS

1. Giving Notices of Administration

The California Probate Code was amended in 1997 to require the trustee to give notice of administration to beneficiaries and legal heirs of the settlor upon the settlor's death. The notice must be in a specific statutory format and must advise recipients that they are entitled to a copy of the terms of the trust if requested.⁵ Usually, these notices are prepared by the attorney representing the trustee and sent out to each heir and beneficiary together with a copy of the trust.

One positive effect of giving the notice is that anyone who desires to contest the trust must do so within 120 days after receiving it.⁶ This is obviously useful for the trustee because it means that the trustee can safely proceed with distribution of the trust when the 120 day period expires.

There is no general requirement that the trustee give notice to *creditors* of the decedent, even though the trust assets are liable for the settlor's debts.⁷ However, giving notice to creditors may be advisable in cases where there are unknown and/or contested claims against the settlor's estate. This could apply, for example, where the decedent was a professional such as a doctor, lawyer or accountant against whom there may be unknown malpractice claims.

The procedure often followed in such cases is to file a probate proceeding for the estate and publish the required notice of that proceeding in the local newspaper. This has the effect of barring creditors' claims against the trust assets unless they are filed within the four month creditors' claim period that applies in probate proceedings.⁸

2. Identifying Trust Assets

One of the first duties of the trustee is to find out what the decedent owned at the time of death. It is critical that all trust assets be identified and collected as soon as possible, since the trustee may be held liable later if trust assets are lost, destroyed or stolen.

⁵ Prob. Code § 16061.7

⁶ Contrary to popular belief, trusts are contestable on the same legal grounds as wills. The usual grounds are undue influence, lack of capacity and/or fraud.

⁷ Prob. Code § 19001(a). However, the trustee is required to give notice to the Director of Health Services where the decedent received or may have received Medi-Cal benefits. See Prob. Code § 215.

⁸ Prob. Code § 19006(b). There is also an optional procedure for serving notice to creditors of a deceased settlor without filing probate proceedings. See Prob. Code §§ 19000 and following, which established this procedure in 1992. However, since the more familiar probate process has substantially the same effect, this procedure has been infrequently used.

Some assets may be easy to find (e.g., the house) but others, such as investment accounts, may not be. Ideally, the decedent will have left a financial statement from which the major assets can be identified. If not, other sources will need to be consulted. For example, the trustee should review the decedent's mail since it may contain account statements, dividend checks and other documents from which assets may be identified. The trustee should also look over the decedent's income tax returns for the last three years. Interest and dividends on investments will be reported on Schedule B to Form 1040, and other assets, such as real estate, trust and partnership interests, will be listed on Schedule E.

If the trustee has any reason to believe that important assets are missing, he or she may want to consider hiring a private asset search firm to identify these assets. The trustee need not guarantee that all of the assets have been collected, but is obligated to exercise reasonable care and diligence in identifying trust assets.

3. Obtaining Title to Assets

Since the successor trustee can only deal with *trust* assets, one of the first things that he or she has to do is review the titles to all of the decedent's assets and find out whether they are in fact titled in trust name, e.g., "John Jones, Trustee of the Jones Family Trust dated July 14, 1987." This review will usually be done by the trust attorney, since if any assets are not in trust name the attorney will have to take whatever legal steps are needed to transfer them to the trust.

The specific steps required to transfer any given asset to the trust vary depending on the type and value of the asset. For example, there are non-probate claim procedures that may be used to transfer assets such as motor vehicles and small bank accounts.⁹ For real estate, probate or other court proceedings may be required.¹⁰

Once title to an asset is vested in the trust, the title must be updated to reflect the fact that the original trustee or trustees (usually the settlors) are now deceased and that another person, the successor trustee, is now acting as trustee.

In the case of real estate, the title update is usually done by recording an affidavit with the county in which the property is located indicating that the trustee of record is deceased and stating that another person (the successor) is now the trustee. For financial accounts, the successor trustee submits a certificate meeting certain code requirements¹¹ to the bank or other account custodian stating that the successor is now the trustee and therefore entitled to access the account. These certificates are usually prepared by the trustee's attorney, although many financial institutions now have their own, in-house approved forms.

⁹ Prob. Code §§ 13100 et seq.

¹⁰ See discussion of court proceedings at IV, below.

¹¹ Prob. Code § 18100.5

4. Protecting Trust Assets against Loss

Once the trust assets have been identified and titled in the trust, the trustee should take immediate steps to protect them against loss. For example:

- If the assets include checking accounts, the trustee should be sure that there are no checkbooks floating around that could give unauthorized access to those accounts. If there is any doubt about who has access, the trustee should close the accounts as soon as possible and transfer the funds to a new account that is accessible only by the trustee.
- The trustee should call the decedent's insurance agent to be sure that homeowner's and other insurance policies are current and to purchase additional riders, if needed. Note that homeowner's insurance may not be appropriate for the decedent's house (since it is no longer used as a personal residence) and may need to be replaced with insurance coverage designed for investment property.
- If there are collectibles such as jewelry, coins, etc., these should be separately insured and put in a secure place for storage.
- If trust property, such as a rental house, is being used by anyone without paying for it, the trustee should either terminate that use or require the user to pay the trustee reasonable rent for the use of the property.

The specific steps required to secure assets will obviously depend on the type of assets owned by a particular trust. The general point is that the trustee must do whatever is necessary to make sure that the assets are not lost, destroyed or stolen and must exercise reasonable care and diligence in carrying out that responsibility.

4. Making Prudent Investments

The trustee has a duty to invest the assets of the trust so as to make a reasonable return while the trust is being administered.

The level of care and attention that should be devoted to investment matters will depend on the size of the trust and the length of time for which it must be administered. If the trust is small and the trustee expects to distribute within three or four months, putting any cash not needed to pay current expenses in interest bearing accounts is probably all that is required. On the other hand, the trustee of a multi-million dollar trust that is likely to be administered for several years should retain the services of a professional investment advisor.

5. Dealing with Assets Not Owned by the Trust

Certain types of assets that may have been beneficially owned by the settlor of a revocable trust may not have been titled in the trust, either for tax or other legal reasons. The most common examples of such assets are Individual Retirement Accounts, (which for tax reasons cannot be transferred to a trust),¹² insurance policies and so-called "pay on death" (POD) accounts. The beneficial interest in these assets is transferred by means of a

¹² I.R.C. § 401(a)(13)

beneficiary designation which is filed with the IRA account custodian, the insurance company or, in the case of a POD account, the financial institution.

Where the trust is designated as beneficiary of the asset, the successor trustee is responsible for preparing the necessary claim forms, filing them with the relevant institution and collecting the asset. Where the insurance policy or IRA is payable to someone other than the trustee, the trustee is still responsible for reporting the asset for estate tax purposes and should obtain verification of the asset value as of the date of the settlor's death. In the rare cases where transfer taxes are payable with respect to such assets, the successor trustee/executor has the right to recover those taxes from the named beneficiaries if they are not paid voluntarily.¹³

In cases where no beneficiary of an insurance policy, IRA or POD account has been designated, the policy or account will generally be payable to the estate of the owner and will pass to the trustee under the settlor's pour-over will.¹⁴ In these cases the successor trustee must claim the asset either by filing a probate proceeding or by using a non-probate claim procedure.¹⁵

6. Obtaining Appraisals

The trustee should ordinarily obtain appraisals for trust assets (particularly real estate) as soon as possible after taking office. Appraisals are significant for future income tax reporting because, with some exceptions, the cost basis of an asset included in a decedent's estate is adjusted to its fair market value on the date of death.¹⁶ This is usually beneficial to the estate because unrealized capital gains that may have existed at the time of decedent's death are eliminated.

In the case of property subject to depreciation (e.g., investment real property or business assets), the date-of-death appraisal will affect the amount of depreciation allowed in future years as well as the amount of capital gain or loss on any subsequent sale. In such cases it is important to have the appraiser separately identify the depreciable and non-depreciable parts of the property being appraised.

If the estate is large enough to be subject to Federal estate taxes, appraisals are also required in order to file Form 706, the Federal estate tax return. Real property appraisals must generally be attached to the return. The estate tax regulations contain special rules for valuing some listed securities, generally requiring the reported value to be the mean between the high and low selling prices on the date of death. The procedure is involved enough that professional estate administrators often use a securities valuation service to obtain estate tax reporting values.

¹³ Prob. Code § 20116

¹⁴ Most trust-based estate plans include a so-called "pour-over will," which provides in substance that any asset owned by the signer individually at death passes to the trustee then in office of the signer's trust.

¹⁵ Assets which collectively do not exceed the probate threshold (currently \$150,000) may usually be claimed by non-probate claim procedures authorized by sections 13100 and following of the Probate Code. If the assets are worth more than that amount then probate proceedings may be required.

¹⁶ I.R.C. § 1014

Finally, appraisals are important in accounting for and distributing the assets of the trust. Particularly where assets are to be distributed in kind, it is vital to have agreed values so as to limit the potential for disputes between the beneficiaries as to the values of the assets they receive.

7. Paying Debts and Taxes

As noted earlier, there is no general requirement under present law that creditors be notified of the administration of the trust. This is convenient because there are no formalities that need to be observed. However, the trustee needs to be very sure that all of the debts are paid before disbursing assets to the beneficiaries. Otherwise, the beneficiaries may be personally liable for the claims of unpaid creditors to the extent that the remaining trust assets are not sufficient to pay them.¹⁷ Also, it is at least possible that failure to pay creditors may result in personal liability for the trustee.¹⁸

In most cases, creditors can be identified by a careful review of the decedent's mail. However, some kinds of claims against the decedent may not be discoverable by such simple means. For example:

- The decedent may have received Medi-Cal benefits for which the State has a claim for reimbursement, or medical services which are as yet unbilled and which were wholly or partially uninsured.
- The decedent may have accrued but unpaid income taxes that will be due with the final return. It is the trustee's responsibility to file that return and pay any taxes that may be due.
- The decedent may have incurred liability for back income taxes, particularly if he or she was self-employed, or had investments in tax shelters or other transactions with significant tax risks. In such cases a careful review of at least the last three years' income tax returns by a tax professional is recommended.
- The estate may be liable for Federal estate taxes, even if the assets are below the exemption amount (currently \$5.4 million). This is because taxable gifts made during the decedent's lifetime are added back to the assets at the time of death to determine the taxable estate.¹⁹ If there is any doubt, an attorney or accountant knowledgeable in estate tax matters should review the decedent's books and records to determine whether there is a significant risk of estate tax liability.
- The decedent may have incurred legal liability of some kind which has not yet been asserted but could be at some future date. Examples of this include liability

¹⁷ See Cal. Prob. Code §§ 19400, 19402.

¹⁸ The courts have held that the trustee of a revocable trust is not personally liable to creditors for failure to pay their claims before making distributions to the beneficiaries. See *Valentine v. Read* (1996) 50 Cal. App. 4th 787; 57 Cal. Rptr. 2d 836. However, this holding even if correct does not apply to tax creditors where the applicable tax statutes provide otherwise, and may or may not protect the trustee against *beneficiary* claims arising from improper payments.

¹⁹ See I.R.C. § 2001(b)(1)(B).

arising from an auto accident involving the decedent, or from a contract that was only partially performed at the time of death.

In most cases the trustee will be able to verify significant liabilities and establish appropriate reserves for any that are contested or not currently due. Occasionally, however, there may be a large number of unknown potential claims that cannot readily be checked – the case of the deceased professional with potential malpractice claims among hundreds of clients is a common example.

In those exceptional cases, the trustee may be well advised to file a probate proceeding because the published notice will cut off any unknown creditors' claims which are not filed within the four-month creditors' claim period. If a probate is not filed, creditors of a decedent may file claims against the estate (for which the trust may be responsible) up to one year following the date of death of the settlor.²⁰

8. Filing Tax Returns

The trustee is responsible for filing all tax returns due for the decedent, the trust and the probate estate (if any), at least unless someone else has been appointed as the decedent's executor.²¹ The returns usually required are as follows:

- Final personal income tax returns on Forms 1040/540 for the decedent are due for the short tax year beginning January 1 and ending with the date of death. These returns are due April 15 of the year following the year of death.
- Fiduciary income tax returns on Forms 1041/541 must be filed for all tax years after the date of death until the trust is finally distributed. Although these returns have traditionally been filed on a calendar year basis, recent changes in the tax law permit the trustee to elect a fiscal year. This may be advantageous where, for example, the date of death is in November and the trust will be closed in 6 months, because in such a case the trustee can elect to report on an October 31 fiscal year basis and only one fiduciary return will need to be filed.
- A Federal estate tax return must be filed if the decedent's *gross assets* (without deducting liabilities) were more than the estate tax exemption in effect at the time of death.²² Estate tax returns when required are due nine months after the date of death.

Determining whether an estate tax return is due may be more difficult than it sounds for several reasons, such as:

²⁰ Code Civ. Proc. § 366.2

²¹ The tax law generally assigns reporting responsibility to the decedent's personal representative. This usually means the court-appointed executor if one is appointed, but means the trustee if there is no executor or if, as is usually the case, the same person is acting as executor and trustee.

²² The current estate tax exemption is \$5.4 million, meaning that estate taxes are not a problem for most estates.

Recently, a bill was approved by the House of Representatives that would have completely repealed the estate tax. While the future of such measures is not free from doubt, it is widely expected that further changes to the exemption schedule will be made in the next several years.

- The decedent may be treated as owning various assets for estate tax purposes which were actually owned by others, e.g., an insurance policy on which the decedent had the right to borrow or change the beneficiary;
- Lifetime gifts are required to be reported as part of the taxable estate, and may mean that filing is required even if the decedent's assets at the date of death are below the filing threshold.²³
- Recent changes in the law which permit the unused estate tax exemption of a decedent to be carried over to the estate of a surviving spouse may make it *advisable* to file an estate tax return for a person who is married on the date of death even though the value of the estate is below the filing threshold. For instance, filing may be indicated for a married decedent where the decedent's share of the estate is \$4 million (one half of a community property estate of \$8 million), since filing is required to carry over the unused portion of the decedent's exemption (\$1.4 million) to the estate of the surviving spouse.

The estate tax rate is significant (currently 40% of the taxable amount) and penalties for failure to file a required return and pay the tax can be severe.²⁴ Since any penalties are likely to be the personal liability of the trustee, the trustee should consult an attorney or accountant with substantial experience in estate matters if there is any doubt about whether a return needs to be filed.

9. Accounting for the Trust

The trustee is required to keep the beneficiaries of the trust reasonably informed of the progress of administration of the trust and also to account for it in a special format prescribed by statute.²⁵ In general, the required report starts with assets existing on the date of death, reports receipts, disbursements, gains and losses subsequent to that date and ends with assets on hand as of the date of the report. Various other items of information, such as the trustee's compensation and amounts paid to agents hired by the trustee, must also be reported.²⁶

The trust accounting is not a financial statement and does not follow generally accepted accounting principles. For that reason, it is usually best to have the accounting prepared by a law firm or an accounting firm that specializes in estate and trust work and maintains software specifically designed for trust accountings.

The trustee does not need to prepare an accounting if it is waived by all of the beneficiaries. However, preparing the accounting is may be a good idea because it limits the potential for future claims against the trustee. State law provides that no claim can be made against the trustee for any matter disclosed in an accounting unless it is made

²³ I.R.C. § 2001(b)(1)(B)

²⁴ Penalties for failure to pay the tax and file the return on time may be as much as 50% of the tax, not including interest, and can be even more if negligence or fraud is involved.

²⁵ Prob. Code §§ 16060, 16062-63

²⁶ Prob. Code § 16063

within three years after the account is delivered.²⁷ Also, the trust instrument often provides that no beneficiary can object to the accounting more than a stated time (such as 60 or 90 days) after it is delivered.

10. Preparing a Plan of Distribution

Most trust documents as well as state law give the trustee wide discretion to determine the exact manner in which the trust is to be distributed. The trustee is usually authorized to retain or sell any or all of the trust assets, distribute in cash or in kind or partly in cash or in kind, and to make non pro rata distributions.²⁸

Although the law gives the trustee wide latitude in determining how to distribute the trust, the *best practice* is to prepare and obtain agreement with the beneficiaries on a plan of distribution that meets their needs while minimizing taxes and expenses payable by the trust.

To illustrate what is involved, assume that the trust document requires assets to be distributed to the settlor's three children in equal shares and that the assets remaining after payment of all taxes, liabilities and expenses are as follows:

Asset	Value
a. Cash	\$150,000
b. Personal residence	450,000
c. Securities	350,000
d. Individual Retirement Account	250,000
Total Assets:	1,200,000

Since the total assets are \$1.2 million, each share will be one-third of that amount or \$400,000. However, there are many different ways in which these shares could be funded and paid.

One plan of distribution might provide that the trustee is to sell all non-cash assets, collect the IRA and distribute the cash remaining after taxes and expenses to the beneficiaries in equal shares. This plan has the advantage of being simple but would involve significant costs. Sale of the residence would generate real estate commissions and other expenses of about 6% of the sales price (\$27,000 in this example) and the IRA would be subject to immediate income taxes of about \$75,000. There would also be commissions on the sale of the securities, the amounts of which would vary depending on the type of securities held.

Alternative plans might involve distributing some or all of the assets in kind. For example, the plan could provide that one child takes the house, paying the trustee the

²⁷ Ibid.

²⁸ In fact, California law grants the trustee these powers unless they are limited by the trust document. See Prob. Code § 16246.

\$50,000 by which its value exceeds his or her share of the trust.²⁹ The IRA could be allocated to another beneficiary together with enough cash to make up that share. The remaining share would be funded with cash and securities.

Under this alternative plan some adjustments to the share amounts might be required to make the distribution fair, since the IRA would be subject to future income taxes whereas the other assets would not be. Also, adjustments could be required to account for the fact that distributed real estate and securities, unlike cash, would be subject to commissions and/or capital gains taxes on any subsequent sale. Hopefully, the beneficiaries and the trustee will agree on any required adjustments and make these adjustments part of the plan.

The plan of distribution should also provide for various matters other than the funding of beneficiary shares. For example, the trustee will normally want to retain a reserve for closing expenses and contingencies, to cover such things as the cost of filing final income tax returns and final payments to the trustee's attorney. The plan will usually state that this reserve is to be maintained for an agreed period of time, and that the trustee is to account for it and distribute any remaining balance when that time expires.

The trustee may also want the beneficiaries to waive a formal accounting for the trust, since the cost of preparing that document will be charged to the trust. Beneficiaries will normally agree to this provided that the trustee has sent them bank statements and otherwise kept them informed of the administration of the trust.

The trustee may also want to obtain an indemnity from the beneficiaries against any unknown liabilities if, as is usually the case, the distribution is made without filing probate proceedings and complying with probate procedures governing notice to creditors. The usual provision is that each beneficiary agrees to be responsible for any such liabilities, but in an amount not to exceed his or her distributions from the trust.

11. Distributing the Trust

After the trustee's accounting and plan of distribution are approved, the trustee's final responsibility is to actually distribute the trust assets or the proceeds of their sale to the beneficiaries. This usually requires the preparation of deeds, assignments and other transfer documents which actually transfer title to trust assets to the beneficiaries.

III COMPENSATION OF THE TRUSTEE

1. Entitlement to Compensation

The trustee of a revocable trust who administers the trust upon the death of the settlor is ordinarily entitled to a fee for his or her services. The most common provision seen in trust documents, which mirrors state law on this subject, states that the trustee is entitled to pay himself "reasonable compensation" without prior court order.

²⁹ If the beneficiary cannot pay this amount, the plan may provide that the residence is to be distributed subject to a note and deed of trust which comes due in, say, one year. This gives the beneficiary time to refinance the residence and pay off the note after the distribution.

The term “reasonable compensation” is generally understood to mean that fee which a professional trustee would charge for performing those services. This is usually understood to refer to the fee schedules published by bank trust departments in the area where the trust is being administered.

As of this writing, the fee charged by professional trustees for small to medium-sized estates will be the same as, or close to the statutory probate fee for an estate of similar size. Since probate fees are based on the gross assets of the estate, fees for large estates may be negotiated at levels below that of the published schedule.

2. Tax and Other Incidents of Trustee’s Fees

Where the successor trustee is a family member and is also a beneficiary of the trust, payment of trustee’s fees may or may not be a good idea. First, the trustee must take into account the fact that fees are subject to income tax whereas inheritances are not.³⁰

Second, at least a portion of the fee will be deducted from the share of the trust that the trustee will receive as beneficiary. For example, if the trustee is a 50% residual beneficiary of the trust, half of the fee will in effect be paid by the trustee to himself. After taking this and the tax effect into account, it turns out that the trustee may only receive an extra 30 cents for each dollar of trustee fees charged. At this level, the trustee may question whether raising the whole issue of fees with other family members is worthwhile.

The tax effects of fees are different for larger estates subject to estate taxes, since fees are deductible for estate tax purposes as administration expenses. Since estate tax rates are may be higher than income tax rates, it may be advisable from a tax standpoint to charge the maximum fee allowable under state law. This may not be popular with the beneficiaries, however, unless some arrangements are made to share the tax benefit of the fee with them.

Regardless of whether the trustee charges a fee, he or she is always entitled to reimbursement for out-of-pocket expenses. The most significant of these are likely to be for attorneys, accountants, real estate brokers and other professional advisors retained by the trustee.

IV COURT PROCEEDINGS

Since revocable trusts are normally administered without resort to court proceedings and in fact are often advertised as “avoiding probate,” it may come as a surprise to learn that court proceedings may be necessary or advisable in many cases to complete the administration of a revocable trust. Some of the more common types of proceedings and the reasons for them are discussed below.

1. Probate Proceedings

As discussed above, probate proceedings may be necessary to transfer assets to the trustee that were not in trust prior to decedent’s death. This is particularly true of real

³⁰ I.R.C. § 102(a)

property, because under California law real property may be transferred without probate only where all real and personal property of the decedent's estate in California does not exceed \$150,000.³¹

The other main reason for filing probate proceedings is to limit creditors' claims against the estate. The personal representative in a probate proceeding is required to publish notice to creditors and to give mailed notice to known creditors. Compliance with the notice requirements for probate has the effect of barring any creditors' claims that are not filed within four months following the issuance of letters of administration.

2. Heggstad Petitions

Under some conditions it may be possible to obtain a court judgment determining that property held in the decedent's individual name is actually trust property. The usual basis for such a petition is that the property was listed on a schedule to the trust, or there is some other credible evidence that the decedent intended the property to be subject to the trust.

If the petition is granted, the court issues an order declaring that the property in question is in fact trust property and transfers it to the trustee.

Heggstad petitions may be opposed where the property if considered as belonging to the decedent would pass to persons other than the beneficiaries of the trust. This could happen, for example, where the decedent left no will and where the beneficiaries of the trust are persons other than the decedent's heirs at law.³² Nevertheless, the trustee's duties to protect the interests of the trust beneficiaries probably require the trustee to file the petition if there is any basis for asserting that the property in question is trust property.

3. Section 17200 Petitions

The Probate Code permits, but does not require court proceedings to be filed when necessary to resolve issues pertaining to the internal administration of a trust.³³ Such issues include, by way of example, determining whether the trustee has breached the trust, ruling on the adequacy of the trustee's accounting, fixing the trustee's compensation and ruling on the trust's liability for debts of the deceased settlor.³⁴

The fact that the Probate Code provides ready *access* to the courts under section 17200 tends in practice to facilitate the administration of trusts even though court proceedings are usually unnecessary. The law encourages the trustee to comply strictly with his or her legal duties, since the beneficiaries have a clear and speedy legal remedy for abuses of the trustee's power. Also, the trustee has a ready means of resolving conflicting claims

³¹ Prob. Code § 13151.

³² Heirs at law will normally be the decedent's children or, if there are no children, the decedent's parents. The rules for determining who is an heir at law are set forth in sections 6400 and following of the Probate Code.

³³ Prob. Code § 17200

³⁴ Prob. Code §§ 17200(b)(5), (b)(9), (b)(20)

against the trust assets and of obtaining court rulings on the propriety of the trustee's actions if they are questioned. The overall effect is to encourage reasonable behavior by both the trustee and the beneficiaries of the trust.

V USE OF PROFESSIONAL ADVISORS

1. In General

As indicated in the preceding sections of this guide, the proper administration of a revocable trust upon the death of the settlor may raise complex legal and tax questions on which the non-professional trustee cannot reasonably be expected to be an expert. However, the trustee can and should seek expert advice on legal, tax and other matters that are beyond the trustee's personal competence, and may incur personal liability for failure to do so.³⁵

The trustee should also bear in mind that reasonable fees for attorneys, accountants and other experts are chargeable to the trust as expenses of administration, and that these expenses generally do not reduce the compensation to which the trustee is entitled. For these reasons, the trustee should feel free to consult a trust attorney and whatever other experts are needed to be sure that the trust is administered in a competent manner.

This is not to say that the trustee should be insensitive to costs when retaining professionals, since incurring liability for unreasonable fees and costs could also amount to a breach of the trustee's duty of care. To the contrary, the trustee should determine at an early stage which professionals are likely to be required, what the scope of their services will be and approximately how much they will cost. Although most law firms charge for estate settlement work at their hourly rates, experienced specialists in trust and estate matters can at least give the trustee ballpark estimates of what their total charges will be.³⁶

2. The Trust Attorney

Ideally, the person selected as the trustee's attorney selected will have substantial experience in trust and estate settlements as well as knowledge of the income, estate and

³⁵ The courts hold that the non-professional trustee is required to administer the trust exercising "that degree of prudence and diligence which a man of ordinary judgment would be expected to bestow upon his own affairs of a like nature." *Estate of Beach* (1975) 15 Cal. 3d 623, 630-31; 542 P.2d 994, 998; 125 Cal. Rptr.570, 574, citing [Estate of Moore \(1892\) 96 Cal. 522, 525 31 P. 584](#), and *Estate of Barbikas* (1959) 171 Cal.App.2d 452, 457-458, 341 P.2d 32.

However, this duty apparently includes the duty to seek expert advice on matters beyond the trustee's personal competence. See, e.g., [Talbot Estate \(1956\) 141 CA2d 309, 296 P2d 848, 58 ALR2d 658](#) ("It is matter of common prudence for [the] trustee to seek expert advice on investments and to consult with interested beneficiaries").

Where the trustee is a professional, such as a bank, the trustee is required to exercise the skill and knowledge ordinarily possessed by professional fiduciaries. See [Gagne v. Bertran \(1954\) 43 Cal.2d 481, 489, 275 P.2d 15; Rest. 2d Torts, § 299A](#). Also, if the trustee has special skills, he or she is obligated to apply those skills in administering the trust. Prob. Code § 16014.

³⁶ See discussion of settlement costs, below.

gift tax issues related to the administration of trusts and estates. Most, though not all attorneys meeting these criteria will have been in practice for a minimum of five years and be certified specialists in trust and probate law and/or taxation law.

The services performed by the trust attorney will typically include the following:³⁷

- (1) Advice to the successor trustee on his or her responsibilities as successor trustee;
- (2) Preparation of notices of administration, and advice as to who is entitled to receive such notices;
- (3) Review of asset titles to determine whether all assets are properly titled in the trust;
- (4) Recommending, initiating and completing any remedial actions necessary to transfer non-trust assets to the trustee, including preparation of declarations, affidavits of death, court petitions and other documents as necessary;³⁸
- (5) Determining what court proceedings or other steps, if any, need to be taken to protect the trustee and the beneficiaries against creditors' claims;
- (6) Preparation of the trust inventory, including obtaining date-of-death balances on financial accounts, date-of-death values for real estate and business assets as required;
- (7) Where division of the trust into separate trusts or shares is required, preparation of an allocation plan and advice to the trustee on how to allocate assets between the various trusts;
- (8) Preparation of accountings to beneficiaries;
- (9) Advice to the trustee on tax rules and reporting requirements applicable to the trust;
- (10) Preparation of a plan of distribution and a distribution agreement;
- (11) Preparation of deeds and other transfer documents needed to effectuate distributions or allocations; and
- (12) Preparation of Federal and California estate tax returns.

An experienced trust attorney will also assist the trustee in locating other professionals, such as accountants, appraisers, business consultants and real estate advisors where the trustee needs those services.

3. The Accountant

If the decedent had an accountant with experience in trust and estate matters, it will be better all else being equal for the trustee to retain that person as the trustee's accountant – he or she will be familiar with the decedent's affairs and have a file on prior-year returns. However, if the decedent used a tax preparation service, it will usually be better to retain

³⁷ This list is taken from the website of Toews & Murphy, Inc. (toewslaw.com)

³⁸ See discussion at II 5, above.

an experienced estate accountant to file the decedent's last return and to prepare income tax returns for the trust. Post-mortem taxation is a sub-specialty with many arcane rules that do not apply to most tax returns and which may therefore be unknown to the average tax preparer.³⁹

At a minimum, the accountant will prepare final personal income tax returns for the decedent and will prepare fiduciary income tax returns for the trust until it is finally distributed. The accountant may also prepare estate tax returns and trust accountings where the trust attorney does not prepare these documents, and may advise the trustee and the trust attorney on trust allocations, income tax consequences of assets sales and other trust matters. If administration of the trust is to be efficient, close coordination between the trust attorney and the accountant is essential.⁴⁰

4. Appraisers

Appraisers will be needed to administer any trust which owns assets of indeterminate value such as real estate, antiques and other collectibles, and closely held businesses. Business interests held by the decedent should be valued by a business appraiser with substantial experience in that type of business, and may qualify for special discounts if the decedent had a minority or non-controlling interest. Certain farm and business properties may qualify for special estate tax valuations based on special tax code rules applicable to assets of that type.⁴¹

Since appraisals can be expensive, the trust attorney should be asked for advice on what appraisals are needed in a particular case. A good attorney can tell the trustee not only what appraisals are needed but will also be able to identify appraisers who will do the work in a timely and cost-effective manner. He or she may also be able to give the appraiser some direction about the objectives of the appraisal.⁴²

5. Other Professionals

The trustee may well require the services of professionals other than the attorney, the accountant and the appraiser(s) depending on the nature of the trust's assets. If the decedent owned a large apartment building or commercial office structure, then a

³⁹ The classic work in this field is Professor Jerry Kasner's 1594-page treatise, *Post-Mortem Tax Planning* [Shepard's 1982]. Definitely not light reading.

⁴⁰ For example, current tax laws provide that administration expenses may be deducted for income tax purposes or estate tax purposes, but not both. Where the attorney prepares the estate tax return, he or she needs to touch base with the accountant on the treatment of these expenses. Also, date-of-death appraisals commissioned by the attorney will often affect depreciation allowances on income tax returns prepared by the accountant and need to be communicated to the accountant in a timely manner.

⁴¹ For example, I.R.C. section 2032A permits land used as a family farm to be valued at its value for farming purposes rather than fair market value (usually a value for development purposes) if various requirements are met. However, the total discount claimed cannot exceed a maximum statutory amount which is adjusted for inflation.

⁴² It is routine for the estate attorney to tell the appraiser whether the estate will (or will not) be subject to estate taxes. Although the appraiser is ethically required to be independent, the appraisal is nevertheless an opinion which may vary somewhat depending on whether a high value will cost the client estate tax dollars (taxable estate) or only increase basis for income tax reporting purposes (non-taxable).

property manager qualified to manage properties of that type should be retained if one is not in place already. Similarly, if the decedent had an operating business or a farm, then a manager with experience in that line of work may need to be retained to preserve the value of the business or farm for the estate.

In each of these cases, the trustee does not need to be an expert who provides all of the services the trust may need. He or she does, however, have a duty to assess what services are needed and then to retain appropriately qualified professionals to render those services.

VI SETTLEMENT COSTS

The main costs involved in settling any trust estate, excluding estate taxes, are normally the fees charged by the executor or trustee, legal fees charged by the trust attorney, appraisers' fees, and fees for accountants and other professionals.

Trustee's fees when they are charged are often the same as, or similar to the fees charged by the trustee's attorney for legal services.⁴³ However, these fees are often waived where the trustee is a family member, particularly if no estate tax deduction is available for such fees. Accordingly, the discussion below will focus on fees charged by the estate attorney.

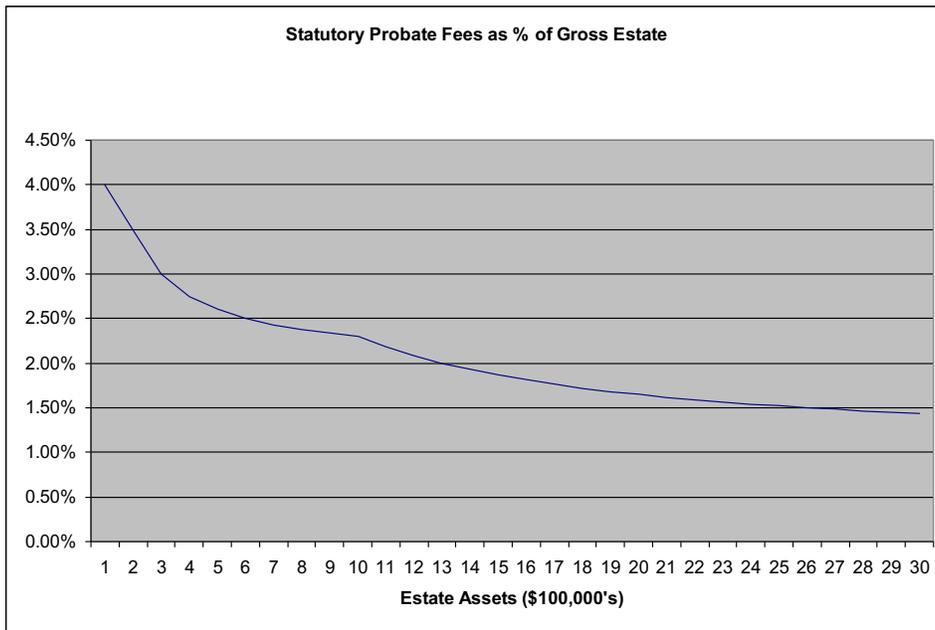
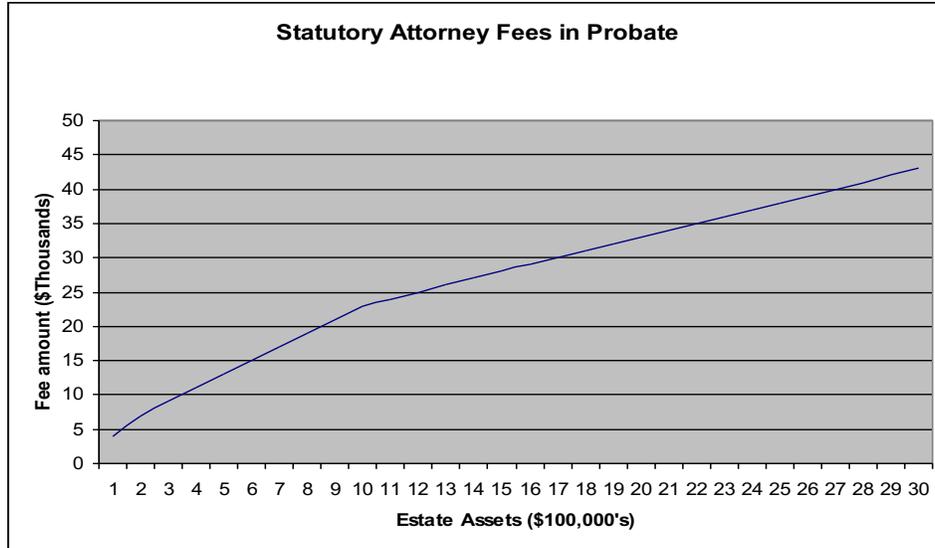
Legal fees charged for trust settlement services vary widely depending on the size of the trust, the complexity of its assets, the existence of significant tax and creditor issues, the number and type of beneficiaries, and whether relationships between the trustee and the beneficiaries are close or hostile. Accordingly, meaningful generalizations about the dollar cost of settling any particular trust are very difficult. However, there are some relationships involving these fees which hold true most of the time. These are roughly as follows:

1. Fees for settling a trust should usually be less than the statutory probate fee for an estate of similar size and complexity, all else being equal, because trusts are not subject to the statutory fee schedule applicable to probates and court proceedings are usually not required.
2. The current probate fee schedule provides that the attorney's fee is 4% of the first \$100,000 of assets, 3% of the next \$100,000, 2% of the next \$800,000 and 1% of the excess over \$1 million.⁴⁴ Thus, probate fees for small estates can be as much as 4% of the estate but on larger ones are usually below 2%.⁴⁵ The following charts show these fees both in absolute amounts and as a percentage of the gross assets of the estate:

⁴³ In probate cases, the Probate Code prescribes the same fees for the executor and the attorney. See Prob. Code §§ 10800, 10810.

⁴⁴ Prob. Code 10810. The section prescribes smaller percentages for estates over \$10 million.

⁴⁵ These figures ignore charges for so-called "extraordinary" services, which refer to extra fees charged for asset sales during probate, litigation and other services not covered by the "ordinary" fee. As of this writing, it is the practice of at least some courts not to approve "extraordinary" fees unless the statutory ordinary fee is inadequate to cover everything the attorney has done.



3. Attorneys' fees for a trust settlement as a very rough rule of thumb should be in the range of $\frac{1}{2}$ to $\frac{1}{3}$ of the statutory probate fee on middling-size estates (\$500-\$1.5 million) with no special problems. So, for example, if the estate is \$800,000 and the statutory probate fee would be \$19,000, the cost of settling a trust of that size should be in the range of \$6-9,000, given average complexity and no court proceedings or other special issues. Since probate fees for estates in this range are 2% or thereabouts, the trust administration fee should usually be in the range of 1% of gross assets.
4. Administration costs as a percentage of the gross estate usually decline as the size of the estate increases, as is the case with statutory probate fees. This is partly because there is a minimum effort level in handling any estate file (giving notices, preparing required filings, etc.), regardless of the size of that file.

5. The differential between the statutory probate fee and the trust administration fee is usually greater on larger estates, and may be zero or negative on small estates. To take an extreme example, legal fees for settling a \$100,000 trust with contentious beneficiaries and complicated assets could easily exceed the \$4,000 statutory probate fee for that estate. On the other hand, the settlement fee for a \$3 million estate with very simple assets could be \$5,000-\$10,000 rather than the \$43,000 fee that would apply to that same estate in probate.
6. The net impact of fees on beneficiaries of larger estates is smaller than the above figures would indicate because the fees are deductible for either estate tax or income tax purposes.⁴⁶ Where an estate tax deduction is claimed, the actual burden of fees on the estate will be substantially less than the amounts charged because of the tax effect of deducting the fees.

VII CONCLUSION

The process of settling a revocable living trust upon the death of the settlor is not “automatic” and in fact is similar to the traditional probate process except that it normally occurs without court proceedings.

Trust estate settlements are normally faster and cheaper than probate settlements, all else being equal, because court proceedings are not required. On the other hand, the trustee’s actions are not protected by court orders, and the beneficiaries do not have the protection from creditors afforded by the traditional probate process. In appropriate cases these factors may make it advisable to file probate or other court proceedings even if they are not otherwise required to complete administration of the trust.

The successor trustee is required to administer the trust in a careful and competent manner, and is accountable to the beneficiaries for his or her actions (and failures to act) as trustee. This means that if the trustee is not a professional, he or she should normally seek expert advice from a trust attorney and other professionals as required regarding the trustee’s responsibilities and on legal and tax issues that arise in the administration of the trust.

TOEWS & MURPHY, INC.

San Luis Obispo, CA

2016

⁴⁶ Current tax laws allow fees and other administration expenses to be deducted for income tax purposes or estate tax purposes, but not both.