

# **Settling the Revocable Trust in California**

**A Primer for the Non-Professional Trustee**

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### I INTRODUCTION

#### 1. Background

Since the early 1980's, revocable living trusts have become increasingly popular as estate planning tools in California. Today, in fact, most professionally prepared estate plans for people with significant assets use these trusts.

Since most people who have established living trusts are still alive, there has been relatively little experience on how these trusts actually work when they die, and little has been written on the subject, at least for non-professional audiences.<sup>1</sup> Also, much of what has been written consists of advertising from trust promoters and is often either wrong or seriously misleading. One popular website, for example, states that the successor trustee of a living trust “has nothing to do from a legal standpoint” and that the survivors can “settle the estate in minutes (or possibly an hour).”<sup>2</sup>

The purpose of this guide is to provide basic information about how a living trust works when the settlor dies and about the rights and duties of the trustee and the beneficiaries at that critical time.<sup>3</sup>

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 trustee named to administer the trust when the settlor dies (usually called the “successor trustee”) is responsible for settling the trust in the manner required by law. Where there is no court-appointed executor of the decedent's will, most duties that would otherwise belong to the executor must be performed instead by the successor trustee.<sup>4</sup>

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<sup>1</sup> Continuing Education of the Bar—California publishes a two-volume treatise on the subject, *California Trust Administration*, which is updated periodically. CEB offers educational programs and materials for practicing attorneys under an agreement between the University of California and the State Bar, and its materials are generally considered authoritative. They are designed for use by attorneys, however, and are not light reading.

<sup>2</sup> See, for example, [heritagelivingtrust.com](http://heritagelivingtrust.com)

<sup>3</sup> The “settlor” or “trustor” is the person who set up the trust and transferred assets to it. To avoid confusion the term “settlor” will be used throughout this guide to refer to the person who established the trust.

<sup>4</sup> For example, the tax regulations provide that the final income tax return of a decedent is to be filed by the executor, administrator “*or other person charged with the property of a decedent.*” [Reg. § 1.6012-3(b)(1)] (Emphasis added). As another example, trustees have accounting obligations similar to those of executors under state law. See Prob. Code §§ 16062-63. 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

For example, the trustee is responsible for seeing to it that all required notices of administration are given, 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 and for getting a reasonable investment return on trust assets while the trust is being administered.

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 administer a trust in the manner required by law. 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.<sup>5</sup> Likewise, the trustee may be personally liable for losses arising from improper investments of trust assets.<sup>6</sup>

### **3. Relationships with Beneficiaries**

The beneficiaries of a trust share neither the trustee's authority over the administration of the trust 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.<sup>7</sup>

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

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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.

<sup>5</sup> I.R.C. § 6901; 31 U.S.C. 3713(b)

<sup>6</sup> Prob. Code § 16047

<sup>7</sup> See section VI for a discussion of the use of professional advisors.

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-administered 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 that bars creditors’ claims after a four-month waiting period. 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 probate proceedings 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.<sup>8</sup> 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 have received inaccurate information about how quickly the trust will be settled.<sup>9</sup> 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.

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<sup>8</sup> These procedures are discussed in detail in part II, below.

<sup>9</sup> See note 2 above.

## **II THE TRUST SETTLEMENT PROCESS**

### **1. Giving Notices of Administration**

Until fairly recently, no notices of administration were required when the settlor of a living trust died. However, that meant that beneficiaries might not learn that the trust was being administered, and also that the trustee had no means of determining promptly whether the trust might be contested.<sup>10</sup>

For these reasons, 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. A specific statutory form of notice is required.<sup>11</sup>

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. 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 as in probate proceedings that the trustee give notice to *creditors* of the decedent,<sup>12</sup> even though the trust assets are liable for the settlor's debts.<sup>13</sup> 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 who may have incurred liability for 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 four months after letters of administration are issued to the decedent's personal representative by the court.<sup>14</sup>

### **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.

Some assets may be easy to find (such as 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.

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<sup>10</sup> 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.

<sup>11</sup> Prob. Code § 16061.7

<sup>12</sup> 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.

<sup>13</sup> Prob. Code § 19001(a).

<sup>14</sup> 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.

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 the 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 does not owe the beneficiaries a guarantee that all of the assets have been collected, but is obligated to exercise reasonable care and diligence in identifying trust assets and may incur legal liability for failure to do so.

### **3. Protecting Trust Assets against Loss**

Once the trust assets have been identified, 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 coverage, 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 legal duty to invest the assets of the trust so as to make a reasonable return while the trust is being administered. This means, for example, that cash balances over whatever is needed for day-to-day expenses should be placed in interest-bearing accounts, and that vacant real property should either be rented or sold within a reasonable period of time.

There is no longer a list of specific investments which are "legal" for trust accounts. Instead, the law provides only that a trustee must exercise prudence in investing assets, both to preserve the principal of the trust estate and to provide a reasonable income.



Ordinarily the trustee has a duty to diversify investments, so that the trust is not overly exposed to loss due to the depreciation of a particular type of security or other property.<sup>15</sup>

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 the excess cash 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. Obtaining Title to Trust Assets**

Ideally, the settlors and their attorney will have placed all of their assets in the name of the trust – e.g., “John and Mary Jones, Trustees of the Jones Family Trust dated July 14, 1987.” However, it is rare in practice to see a living trust where *all* of the assets have been put in trust name. Also, when the settlor dies even assets that *are* in trust name need to be re-titled in the name of the successor trustee so that he or she can sell or distribute them.

The type of action required with respect to titles will depend, generally, on what kind of asset is involved and how title to it was held prior to the settlor’s death. While a complete discussion of title problems is beyond the scope of this guide, some common situations are discussed below.

- (a) Assets Held in Trust Name. If real estate is held in trust name (e.g., “Nancy Smith, Trustee of the Smith Family Trust UAD January 10, 1982”), the successor trustee should ordinarily prepare and record an affidavit of death of trustee with the county recorder in the county where the property is located. This document places of record the fact that Nancy is deceased and that the successor trustee, Jane Smith, is now the trustee and can sign a deed to transfer title. Jane of course will eventually need to transfer the property, either to sell it or to distribute it to the beneficiaries of the trust.

Financial accounts with banks and brokerage houses held in trust name are transferred to the successor trustee by means of a trust certificate meeting specific statutory requirements.<sup>16</sup> Basically, the successor trustee presents the account holder with a trust certificate, a death certificate and suitable identification and is then allowed to collect the cash or securities held in the account.

If personal property is not of a type where title is registered (e.g., furniture, dishes, tools, etc.), the trustee merely takes possession of it provided this can be done without a breach of the peace. If however such

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<sup>15</sup> The trust agreement often contains a clause allowing the trustee to retain assets held by the settlor (e.g., a closely held business) even if those assets would not otherwise be appropriate investments for the trust, and without regard to diversification. While such clauses are of some help to the trustee, it is still advisable to distribute or sell them as rapidly as possible if they expose the trust to significant risk of loss. Otherwise, the trustee may be accused later of neglect or mismanagement of the business which could be a separate ground of personal liability for the trustee.

<sup>16</sup> Prob. Code § 18100.5

property is in the hands of others who refuse to deliver it, court proceedings to obtain possession may be required.

- (b) Assets Not Held in Trust Name. Where real estate is not held in trust name, the action required to place title in the name of the successor trustee depends on how title was held by the decedent. If the title lists a predeceased spouse as a joint tenant (e.g., “Tom and Nancy Smith, Husband and Wife as Joint Tenants” where Tom died five years ago and Nancy is the current decedent) – an affidavit of death of joint tenant needs to be filed to remove Tom’s name from the title. Thereafter, a probate court order or other court order will usually be needed to transfer title from Nancy to the name of the successor trustee.<sup>17</sup> A probate or other court order will also be needed to transfer title to real property held in the name of the decedent alone, or as tenants in common with others.

If a financial account, automobile, insurance policy or other non-real property asset is not held in trust name (e.g., the account title is “Nancy Smith”), it may be possible to transfer title by means of a declaration meeting certain statutory requirements.<sup>18</sup> The declaration must state that (1) more than 40 days have passed since the death of the decedent, (2) no probate proceedings are pending or will be filed, and (3) that the successor trustee is the person entitled to collect the account. Provided that the declaration is in proper form and signed under penalty of perjury, the successor trustee can collect the account without court proceedings.

The declaration procedure can only be used if the total value of the account and all other assets subject to probate is less than \$100,000. If the total assets subject to probate are worth more than that sum, probate proceedings must be filed to transfer these assets. However, autos, mobile homes, vessels and certain employment-related death benefits are ignored for purposes of this test.<sup>19</sup>

- (c) Assets that Pass to Designated Beneficiaries. Some types of assets pass not according to who holds title but according to who was designated as a beneficiary of the asset by the decedent. The most common examples are individual retirement accounts, insurance policies and bank accounts that are payable to a designated beneficiary upon the death of the account holder (“pay-on-death” or “P.O.D” accounts).

(i) Individual Retirement Accounts

Title to individual retirement accounts (“IRAs”) is never in trust name, since by law retirement accounts cannot be assigned.<sup>20</sup> Whether the trustee is entitled to collect the

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<sup>17</sup> It may sometimes be possible to transfer title to real property by a court proceeding known as a “Heggstad” petition after *Estate of Heggstad*, (1993) 16 Cal.App.4<sup>th</sup> 943, 20 Cal. Rptr.2d 433. See discussion at part V below.

<sup>18</sup> Prob. Code §§ 13100 and following

<sup>19</sup> Prob. Code § 19050

<sup>20</sup> I.R.C. § 401(a)(13)

account depends on how beneficiaries were designated by the decedent.

Most IRA holders designate the surviving spouse as the first beneficiary of the account because the survivor is entitled to “roll over” the account, i.e., combine it with the survivor’s own account, without paying immediate income taxes on the account proceeds. Thus if the decedent had a surviving spouse, IRAs are generally not a problem since the survivor collects the account, albeit in his or her individual capacity and not as trustee.

Where there is no surviving spouse, the account will be payable to the named beneficiaries, if any (e.g., children) or, if none, to the estate of the account owner. In the first case the trustee cannot collect the account since the named beneficiaries, not the trustee, are named as account beneficiaries.<sup>21</sup> In the second case, the trustee will normally have to file probate proceedings to collect the account unless the estate meets the under-\$100,000 test, in which case the trustee can collect it by the declaration procedure outlined in section (b) above.

(ii) Insurance Policies

Insurance policies are generally payable to the beneficiaries named in the policy or, if there are no named beneficiaries, to the estate of the policy owner. If there are no named beneficiaries, the trustee can collect the policy via the declaration procedure outlined in section (b) above provided that the under-\$100,000 test is met. If it is not, a probate order will generally be required.

## **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.<sup>22</sup> 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

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<sup>21</sup> This may create problems for the trustee where the estate is subject to estate taxes, since the trustee is liable for estate taxes on all of the decedent’s assets, including taxes attributable to the IRA. The Probate Code provides that the personal representative of the decedent (who is usually the trustee) may sue the payees of the IRA if necessary to collect such taxes. See Prob. Code § 20116.

<sup>22</sup> I.R.C. § 1014

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.

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.<sup>23</sup> Also, it is at least possible that failure to pay creditors may result in personal liability for the trustee.<sup>24</sup>

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 \$1.5 million). This is because taxable gifts made

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<sup>23</sup> See Cal. Prob. Code §§ 19400, 19402.

<sup>24</sup> At least one court has 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.

during the decedent's lifetime are added back to the assets at the time of death to determine the taxable estate.<sup>25</sup> 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 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.

## **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.<sup>26</sup> 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 trustee expects to fully distribute the trust in 6 months. 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 – at least if distribution is completed before October 31 of the following year.
- 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.<sup>27</sup> In such case the trustee must also file a California estate tax return (Form

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<sup>25</sup> See I.R.C. § 2001(b)(1)(B).

<sup>26</sup> 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.

<sup>27</sup> As of 2004, the estate tax exemption was \$1.5 million. Under current law the exemption is scheduled to increase to \$2 million on January 1, 2006 and \$3.5 million on January 1, 2009. Also, the tax is scheduled to expire in 2010 but will be reinstated with a \$1 million exemption on January 1, 2011.

ET-1) as well as estate tax returns required by any other states in which the decedent held real property or other assets taxable in those states. 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 because the decedent may be treated as owning various assets for estate tax purposes which were actually owned by others. For example, if the decedent had the right to change the beneficiary of an insurance policy, the proceeds are subject to estate tax even though the policy was owned by someone else. Likewise, property which the decedent retained the right to use or control may be treated as an asset for estate tax purposes even though title was vested in someone else at the time of death. Complicating the problem still further are rules that require lifetime gifts to be reported as part of the taxable estate.<sup>28</sup>

Estate tax rates are high and penalties for failure to file a required return and pay the tax can be severe.<sup>29</sup> 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 law.<sup>30</sup> 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.<sup>31</sup>

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 usually 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 within three years after the account is delivered.<sup>32</sup> Also, the trust instrument often

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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.

<sup>28</sup> I.R.C. § 2001(b)(1)(B)

<sup>29</sup> As of this writing, the top estate tax rate is 45%. 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.

<sup>30</sup> Prob. Code §§ 16060, 16062-63

<sup>31</sup> Prob. Code § 16063

<sup>32</sup> Ibid.

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.<sup>33</sup> The trustee's responsibility is to prepare and obtain agreement on a plan of distribution that meets the needs of the beneficiaries 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:

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

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 7% of the sales price (\$28,000 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 \$50,000 by which its value exceeds his or her share of the trust.<sup>34</sup> 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

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<sup>33</sup> In fact, California law grants the trustee these powers unless they are limited by the trust document. See Prob. Code § 16246.

<sup>34</sup> 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 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 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 SETTLEMENT OF A JOINT MARRIED TRUST UPON DEATH OF THE FIRST SPOUSE**

### **1. In General**

The settlement of a joint living trust for a married couple upon the death of the first spouse is usually simpler than indicated in part II above because of special circumstances that apply to such settlements.

For example, it is generally not necessary to determine or pay the debts of the deceased spouse, because the trust continues for the benefit of the surviving spouse and, generally speaking, he or she continues to be liable for these debts.

Likewise, it is usually unnecessary to prepare an accounting or plan of distribution for the trust, because no assets are being distributed to anyone other than the surviving spouse and he or she is usually the first successor trustee. An accounting may be necessary or advisable, however, where assets are being distributed to someone other than the surviving spouse or where the surviving spouse is not the trustee.

Nevertheless, there are always a number of tasks for the successor trustee even where the only immediate beneficiary of the trust is the surviving spouse. A short discussion of the major items is set out in the sections below.



## **2. Appraisals**

As noted in part II above, the income tax basis of most assets included in the estate of a decedent is adjusted to their fair market values on the date of death.<sup>35</sup> This means that the successor trustee should obtain appraisals of assets such as real estate and closely held businesses to establish their values for future income tax reporting. This is particularly important for assets subject to depreciation, because deductions for depreciation after the date of death will be based on the appraised values.

## **3. Asset Titles**

It is generally advisable to review the manner in which title to all assets is held and to take action to update those titles as required. This is true even if all significant assets are held in the name of the trust.

For example, if title is held as “John and Mary Jones, Trustees of the Jones Family Trust UAD June 5, 1985,” the title needs to be updated when John dies to show Mary as the sole successor trustee. Where the asset is real property, this is usually done by filing an affidavit of death of trustee and preliminary change of ownership report with the county where the property is located.

Where title to an asset is not held in trust name, appropriate action needs to be taken to place title in the trust for the benefit of the survivor. Some common procedures for transferring assets are discussed in part II, section 5.

## **4. Split (“A/B” and “A/B/C”) Trusts**

Revocable trusts for married people often provide that the assets are to be divided into separate shares upon the death of the first spouse. The most common provisions provide for the creation of –

- A “survivor’s trust” consisting of the survivor’s share of the community property plus his or her separate property, if any.
- An “exemption trust” (also known as a “bypass trust” or “credit shelter trust”) consisting of the decedent’s share of the estate up to the amount of the applicable estate tax exemption; and
- A “marital trust” consisting of the amount, if any, by which the decedent’s share of the estate exceeds the applicable estate tax exemption. Some trusts provide that such excess is to be added to the survivor’s trust rather than be set up as a separate trust.<sup>36</sup>

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<sup>35</sup>For this purpose, assets that are entitled to a new income tax basis refers to any assets that are includible in the estate of the decedent for Federal estate tax purposes – even if they were not actually owned by the decedent at the time of death. See discussion at II3.8 above.

<sup>36</sup> A trust providing for a separate marital trust is commonly referred to as an “ABC” trust since it is divided into three shares upon the death of the first spouse. An “AB” trust is one where the marital deduction portion of the deceased spouse’s estate is added to the survivor’s trust rather than being set up as a separate trust.

The trust usually provides that the surviving spouse is the trustee and life beneficiary of all three trusts, and that he or she can revoke or amend the survivor's trust but not the other trusts.

One reason for splitting the trust upon the death of the first spouse is to eliminate Federal estate taxes on the estate of the first spouse to die and to minimize such taxes on the estate of the survivor as much as possible. A second and equally important reason (particularly if the couple is a second marriage with families from first marriages on both sides) is to limit the ability of the survivor to change the disposition of the decedent's share of the estate.

The tax benefits of creating an exemption trust may be very significant for sizable estates where the combined assets of the couple exceed the estate tax exemption.

Assume, for example, that a couple's assets are \$2.5 million, that all of their property is community property, that the applicable estate tax exemption is \$1.5 million, and that husband dies first. Under these facts the estate taxes on the total estate should be zero if an exemption trust is set up, since the husband's entire share of the estate (\$1.25 million) will be allocated to that trust and since that trust will not be includible in the wife's taxable estate.<sup>37</sup> Her estate will also be only \$1.25 million (assuming no change in value) and will be completely sheltered by her estate tax exemption.

On the other hand, the tax on the wife's estate using a "simple" trust (where the entire trust continues for the benefit of the survivor as a single trust) would be at least 41% of the excess of her assets over the exemption amount, or \$410,000 in this example. The reason for exemption trusts thus becomes very clear.

The process of funding the "split" trusts is similar to the process of developing a plan of distribution (see part II 10 above) except that the surviving spouse is the only party immediately affected. In both cases, the allocations are usually not pro rata and are heavily influenced by income and estate tax considerations – some of which may be highly technical. While a complete discussion of split trust funding and administration is beyond the scope of this guide, here are some of the factors to be considered:

- Personal Residences. Favorable tax rules applicable to personal residences (including the \$250,000 exemption from capital gains tax) require that the taxpayer both own and use the property as a personal residence. Since the ownership test would not be met if the residence were allocated to the exemption or marital trusts, the personal residence is normally allocated entirely to the survivor's trust.
- Trust Income Taxes. The exemption trust is an irrevocable trust and is subject to income taxes at compressed rates. Currently, trust income in excess of \$9,350 is taxable at the top Federal rate of 35%. It is possible to avoid such taxes by making distributions to the survivor (since the trust gets a deduction for distributions), but this has the effect of transferring funds from a trust not

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<sup>37</sup> A properly drafted exemption trust provides that the survivor cannot amend or revoke it and contains enough restrictions on the ability of the survivor to administer it that it is not considered as owned by the survivor for purposes of taxing it in his or her estate.

subject to estate taxes (namely, the exemption trust) to the survivor's taxable estate.

The usual solution to this problem is to fund the exemption trust in such a manner that its expenses more or less offset its taxable income. In some cases this may require reinvesting the assets of the exemption trust in assets that do not produce much taxable income, e.g., appreciation-oriented stocks, tax-exempt bonds or leveraged real estate.

- Appreciating vs. Depreciating Assets. Since the exemption trust will not be subject to estate taxes in the survivor's estate, it is preferable, all else being equal, to allocate the assets with the greatest potential for appreciation to this trust. Depreciating assets such as autos and other personal-use assets are normally allocated to the survivor's trust.
- Tax-Deferred Assets. Certain types of tax-deferred assets such as installment notes do not receive increases in their income tax bases even though they pass through a decedent's estate. Allocation of such assets to a "pecuniary amount trust" triggers immediate taxation of all of the built-in gain on such assets and should be avoided wherever possible.<sup>38</sup>

Once the allocations to the various trusts have been determined, the trustee must obtain separate taxpayer identification numbers for each trust and transfer legal title to all assets to the appropriate trust.<sup>39</sup> In addition, the trustee needs to notify the accountant for the trust of what the allocations are, since the accountant must file separate tax returns for each trust and must know what income is reportable by each trust. If this is properly done, the allocations are usually set forth in an allocation agreement or similar document signed by the trustee and then copied to the accountant.

#### **IV 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.

The term "reasonable compensation" is generally understood to mean that fee which a professional trustee would charge for performing those services. Since most professional

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<sup>38</sup> Treas. Reg. § 1.661(a)-2(f)(1). A "pecuniary amount trust" is a trust the funding of which is a specific dollar amount, which may either be a dollar figure (such as "\$200,000"), or a formula amount (such as "the minimum pecuniary amount necessary to eliminate or reduce as much as possible Federal estate taxes on the estate of the settlor").

<sup>39</sup> Many trusts provide that the trustee need not segregate the assets of the different shares so long as the trustee keeps records from which the allocations may be determined. Nevertheless, it is better to title assets separately and file income tax returns with the IRS which clearly show which assets belong to which trust. This at any rate is the safest way to minimize disputes with the IRS about which assets belong to the exemption trust and which ones belong to the survivor's trust (and are therefore taxable at rates exceeding 40%).

trustees are banks, this refers in practice 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.<sup>40</sup>

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 almost always 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.

## **V 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 name prior to decedent's death. This is particularly true of real property, because under California law real property may be transferred without

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<sup>40</sup> I.R.C. § 102(a)

probate only where all real property of the decedent's estate does not exceed \$20,000 in value.<sup>41</sup>

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 and with the use of a Heggstad Petition, 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.<sup>42</sup> 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.<sup>43</sup> 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.<sup>44</sup>

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 – failure to account, self-dealing, inappropriate investments and the like. Also, the trustee has a ready means of resolving conflicting claims against the trust assets and of obtaining court rulings on the propriety of the trustee's actions if they are

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<sup>41</sup> Prob. Code § 13200

<sup>42</sup> 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.

<sup>43</sup> Prob. Code § 17200

<sup>44</sup> Prob. Code §§ 17200(b)(5), (b)(9), (b)(20)

questioned. The overall effect is to encourage reasonable behavior by both the trustee and the beneficiaries of the trust.

## **VI 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.<sup>45</sup>

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 some professionals may want to charge for their services by the hour, there are specialists in trust and estate matters who will quote fees for their services on either a flat fee or budgeted basis.<sup>46</sup>

### **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 gift tax issues related to the administration of trusts and estates. Most, though not all

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<sup>45</sup> 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.

<sup>46</sup> As of this writing, Toews Law Office, Inc. quotes either fixed or budgeted fees for the administration of modest-sized decedent estates. Reliable trade sources indicate that other offices specializing in estate matters are also quoting fixed or budgeted fees.

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:<sup>47</sup>

- (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 pleadings and other documents as necessary;<sup>48</sup>
- (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 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

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<sup>47</sup> This list is taken from the website of Toews Law Office, Inc. ([toewslaw.com](http://toewslaw.com))

<sup>48</sup> See discussion at II 5, above.

arcane rules that do not apply to most tax returns and which may therefore be unknown to the average tax preparer.<sup>49</sup>

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.<sup>50</sup>

#### **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.<sup>51</sup>

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.<sup>52</sup>

#### **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 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

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<sup>49</sup> The definitive work in this field is Professor Jerry Kasner's 1594-page treatise, *Post-Mortem Tax Planning* [Shepard's 1982].

<sup>50</sup> 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.

<sup>51</sup> 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. As of 2004, the maximum discount was \$850,000.

<sup>52</sup> 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).



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.

## **VII 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.<sup>53</sup> 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:

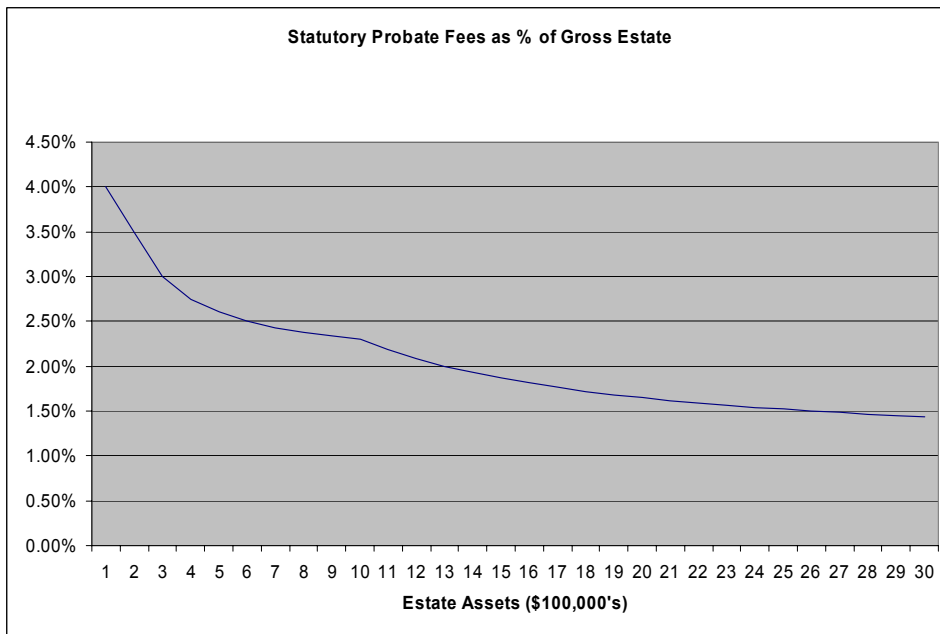
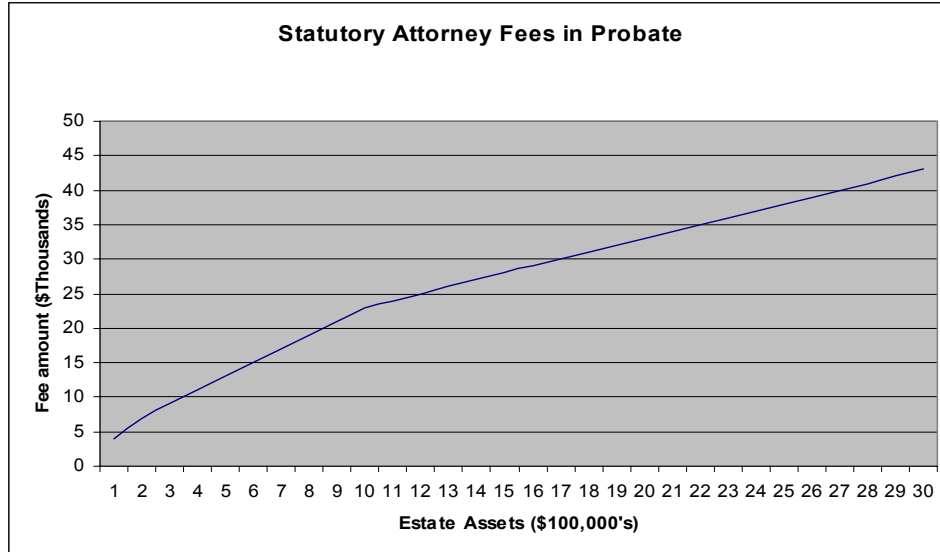
1. Fees for settling a trust should usually be less than the statutory probate fee for an estate of similar size and complexity, all else being equal, because trusts are not subject to the statutory fee schedule applicable to probates and court proceedings are usually not required.
2. The current probate 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.<sup>54</sup> Thus, probate fees for small estates can be as much as 4% of the estate but on larger ones are usually below 2%.<sup>55</sup> The following charts show these fees both in absolute amounts and as a percentage of the gross assets of the estate:

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<sup>53</sup> In probate cases, the Probate Code prescribes the same fees for the executor and the attorney. See Prob. Code §§ 10800, 10810.

<sup>54</sup> Prob. Code 10810. The section prescribes smaller percentages for estates over \$10 million.

<sup>55</sup> 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 simple assets could be 25% of 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.<sup>56</sup> Where an estate tax deduction is claimed, the actual burden of fees on the estate is only a little over half of the stated costs because the tax deduction is worth 45% or more of each dollar of fees charged.

## **VIII 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 the trustee should normally seek expert advice from a trust attorney and other professionals as required regarding responsibilities and legal and tax issues that arise in the administration of the trust.

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San Luis Obispo, CA  
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<sup>56</sup> Current tax laws allow fees and other administration expenses to be deducted for income tax purposes or estate tax purposes, but not both.