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STALE TRUSTS: HOW CAN WE FRESHEN THEM UP?

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I. Introduction to Stale Trusts

A. First Thoughts

In preparing this paper the author realized that many problems associated with "stale trusts" are problems of trust administration generally. Therefore, readers should be sensitive to the overarching requirements the Probate Code generally imposes upon trustees. Appreciation of those duties, combined with the ability to communicate those duties effectively to the trustee (with the hope that the trustee has not turned off his or her hearing aid), should go a long way to avoiding entirely the problems addressed in this outline.

B. Nature of the problem

"Stale trusts" are those trusts as to which problems arise due to a failure to follow the proper rules of trust administration. We refer to these failures of trust administration as resulting in the existence of a "stale trust" because in each case it is the passage of time that has converted the situation from one in which the ordinary process of trust administration is still ongoing but incomplete to one in which delays in administration (or, in some cases, wholesale failure to observe important steps in the trust administration process) have created problems that would not have existed but for those delays. The administration trail has gone cold – the trust is "stale". Like sampling a piece of month-old cake, the entire experience of dealing with the trust has simply become unpalatable. Indeed, it is not at all uncommon to find that once discovered, stale trusts are quickly and quietly re-buried because the trustee (or perhaps the trustee's counsel) has decided that the problems attendant to the long-dormant trust administration are just too unpleasant to contemplate.

The issues derived from a stale trust can involve estate taxes, income taxes, accounting issues, failures in distribution, relationships between beneficiaries, and relationships between the trustee and beneficiaries. These trusts may also affect relationships between attorneys and their clients.

Discovery of a stale trust can occur in any one of a number of ways. The discovery may occur when a client consults a lawyer on a tangential matter, such as a revision to the client's testamentary document, and the lawyer discovers that there is in existence a trust that has never been properly administered. Frequently this discovery will occur long after the death of the client's spouse, which was nominally the triggering event. It is also common, however, for a child to engage counsel after the death of a surviving parent only to discover that required administrative steps were not taken following the first parent's death.

Sometimes the client will have recognized that he or she did nothing following the death of a spouse or a parent, even though there is a trust instrument that appears to have required that "something" be done. Sometimes the client will have been working with a lawyer who moved, retired or died, and the client will have simply let things drift along with no attention to business. Sometimes the client will want to discuss making gifts to children of "his" or "her" assets, only to have the lawyer discover that the assets in question are not properly subject to the client's unilateral control because they may have to be allocated to an irrevocable trust "established" by the client's deceased spouse. A variation on this theme is a child calling on the lawyer following the death of a surviving parent in hopes of learning how quickly all assets can be transferred to the children, only to have the lawyer observe that lurking problems from years of administrative neglect will have to be addressed prior to making any distributions of trust assets.

Commonly experienced trouble spots that are part and parcel of a stale trust situation include the following:

1. Failure to file estate tax returns

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Failure to file a required estate tax return is often an element of stale trusts. Frequently, the trustee will not have undertaken to file the return under the mistaken impression that it was not required because no tax was due. Sometimes the failure to file will not create any direct problems, simply because no tax will have been due upon the filing of that return.

The stale trust can also create substantial estate tax exposure for the surviving spouse's estate. The IRS may argue that the failure to fund, or the failure to administer properly, caused the decedent's bypass trust never to come into existence, or caused it to cease to exist. Consequently, the IRS may claim that all of the assets should be included in the survivor's gross estate. Even if the successor trustee is able to argue successfully that the existence of the bypass trust must be respected by the IRS, the trustee may still face difficulties. The IRS may have a fall back argument that the survivor retained too much control over the bypass trust. The result of this analysis would be that at least part of the bypass trust would be included in the survivor's estate pursuant to the authority of I.R.C. § 2036 as a transfer with a retained life estate. Additionally, if the marital trust is not funded, the income from the marital trust assets may not have been paid to the surviving spouse. This failure could cause disallowance of the marital deduction resulting in a large estate tax deficiency.

Penalties for failure to timely file a federal estate tax return are assessed based upon the amount of tax shown due, so zero-tax returns generate zero penalties. I.R.C. § 6651(a). Nevertheless, even with zero-tax returns, indirect problems are likely to

follow the failure to file an estate tax return. The process of preparing estate tax returns typically encompasses creating a detailed list of all assets in which the decedent had an interest at the time of death and obtaining accurate date of death values for those assets. When an estate tax return is not prepared, the process of listing and valuing assets can be easily overlooked. Without accurate information regarding the assets, subsequent steps of trust administration – including allocation of assets to subtrusts, funding those trusts and accounting for them – become almost impossible to accomplish.

On the other hand, when a tax is actually due, the penalty for filing a late federal estate tax return is five percent of the amount properly shown due on the return for each month or portion of a month that the return is late, up to a maximum penalty equal to twenty-five percent of the tax properly shown due on the late return. I.R.C. § 6651(a)(1). In addition to the penalty for late filing, a penalty for late payment of the tax due is assessed at the rate of one-half of one percent per month, up to a maximum penalty equal to twenty-five percent of the tax properly shown due on the return. I.R.C. § 6651(a)(2). Additionally, interest is charged on late payments, at a rate based on applicable interest rates from time to time and compounded daily. I.R.C. §§ 6601, 6621 and 6622. When the problem of late filing and/or late payment arises because of the dereliction of the trustee, he or she can be personally liable for the applicable penalties and interest. And, of course, all of the indirect results that can arise when a return is not prepared are just as likely to cause problems for the trustee in a taxable estate situation.

2. Failure to allocate assets to subtrusts

Of all of the problems giving rise to problems in the context of stale trusts, probably none is more common – or more difficult to resolve – than the failure to allocate assets to subtrusts. As time passes, values of assets change – and the composition of assets held in the trust estate also can change. Depending upon the terms of the trust and how allocation of assets is to be determined, these changes can present a challenge to even the most impartial and fair-minded trustee when decisions are make regarding the selection of assets to be allocated to the various subtrusts. Even more problematic is the typical case when the trustee is also a beneficiary (e.g., the surviving spouse), and when the decisions regarding asset allocation can have tremendous impacts on the right enjoyed by each of the beneficiaries.

If the trust instrument specified that asset distribution was to be done according to date of distribution values, i.e., a "true worth" clause, substantial capital gain might result upon funding. If the stale trust resulted from nonfunding of the subtrusts, and if there was little turnover in trust assets, the amount of gain can be measured. If the assets have appreciated, the gain could be significant. Allocation to the subtrusts will cause recognition of a gain, without raising the cash necessary to

pay the tax. Explaining this consequence to the trustee will be an unpleasant task for the practitioner. This potential gain, and the associated income tax on funding, may become another reason to deter the trustee from "freshening" the stale trust. It will be additionally unpleasant if the trustee is advised that the trustee should use the trustee's personal resources, if the trust has inadequate cash, to pay that tax. The trustee may be required to use these personal resources because the capital gain liability is being incurred in direct consequence of the trustee's failure to fund the subtrusts in a timely manner.

If substantial turnover in the trust assets rather than retention of assets has occurred, calculating the amount of gain might be onerous. For example, the trustee may have been reporting the transactions in prior years on the trustee's individual return. Reallocating those gains may impose an unrealistic financial burden on the trust to reimburse those sums. Alternately, the trustee may leave those prior transactions untouched, and simply convey the current assets to the trust. The current assets would assume a carryover basis.

If the instrument instead specified date of death values, i.e. a fairly representative clause, the successor trustee may face substantial obstacles if many of the assets existing at the decedent's death were sold or exchanged between then and the survivor's death. In such a case the successor trustee will need to review all of the transactions of the trust during the period between the two deaths. This review may not be easily accomplished because the trustee of the stale trust probably did not keep thorough records.

The successor trustee facing the first problem can resolve it in a straightforward manner. The financial burden resulting from payment of the capital gain tax may, however, be substantial. The successor trustee facing the second problem will have a substantial task to review trust records. If the records are inadequate, the successor trustee may be compelled to resort to an arbitrary assignment of assets in order to determine the identity of the present trust assets. Whatever approach the successor trustee uses, the trustee should nevertheless follow the funding formula set out in the trust instrument.

Whenever allocation does occur, the trustee has two alternate approaches available:

a) Internal Allocation. California law generally requires the trustee to keep trust property separate and designated as property of the trust. Probate Code § 16009. Nevertheless, a trustee may make an "internal" allocation of trust assets rather than a physical separation. To justify an internal allocation, the Probate Code is interpreted to mean that the internal allocation of assets is the equivalent of keeping trust property separate

from other property. Probate Code § 16009. The Tax Court, however, has ruled that mere bookkeeping entries are not enough to constitute a distribution for income tax purposes. *See Estate of Johnson*, 88 T.C. 225 (1988) Failure to account properly for income and principal can cause confusion when the time comes to prepare income tax returns or to make distributions.

b) Formal Asset Transfer. Allocation by formal transfer establishes the allocation date for valuation and tax purposes. Using a formal allocation will assist the trustee in determining whether any income taxable gain must be recognized. The formal allocation method also "clears title" and helps the nonprofessional trustee account for trust assets in the future. Tracing of assets upon subsequent termination of the trusts also will be simplified with the formal asset transfer method, something that is especially valuable if the several subtrusts have different income or remainder beneficiaries. Formal asset transfers also can be helpful upon an estate tax audit of the income beneficiary's estate to demonstrate which trust, if any, should be included or excluded from the subsequent decedent's gross estate. The trustee will still have the continuing obligation to maintain the separate identity of the several trusts throughout the existence of each.

3. Failure to fund subtrusts

A problem related to the failure to allocate assets is that of failing to take the formal steps necessary to fund the subtrusts once allocation decisions have been made. To be considered a distribution, the transfer must cause the property to be either paid or "properly credited"; mere bookkeeping entries are not enough. *Estate of Johnson* 88 T.C. 225 (1988). In a Technical Advice Memorandum, the IRS has taken the position that the distribution deduction is not available to eliminate double taxation if the funds are not actually distributed to the beneficiaries. Tech. Adv. Mem. 9413005

Without proper segregation of assets – at least for bookkeeping purposes – the passage of time almost certainly means that properly accounting for each subtrust becomes difficult or worse. This omission can often lead to a situation in which the allocation decisions are effectively ignored, as the trustee exchanges assets without giving due consideration to which trust is selling one asset and in which, properly, title to the newly-acquired asset will be held.

In fact, in some senses this circumstance can create more difficult paper trail problems than in cases in which no allocation decisions have been made. When no allocation decisions are in place to be carried out, long-delayed allocation and funding decisions can be made all at once and without as great a need for tracing transactions over the years. Conversely, when there is an allocation schedule but no funding, it may become more important to be able to trace everything back to the date as of which the allocations were deemed to have been made.

A typical risk to the trustee in funding a marital deduction trust, regardless of timing, arises when valuation adjustments, e.g. discounts, are used. Adjusting the value of property may cause an under funding of the marital deduction trust. *See Chenoweth v. Comm'r* 88 T.C. 1577 (1987) In *Chenoweth* 51% of a family corporation was bequeathed to the surviving spouse, and 49% was bequeathed to the children. The estate argued, and the court agreed, that the 51% block bequeathed to the spouse should carry a control premium, and that the minority interest bequeathed to the children should be discounted. This approach allowed fewer shares to be placed in the marital deduction trust, resulting in more shares passing to the children. The result in *Chenoweth* should be compared with that in *Provident Nat'l Bank v. U.S.*, 581 F. 2d 1081 (3d Cir. 1978). in which the value of nonvoting common stock was not altered when it was recapitalized after death into preferred stock as required by the decedent's will. Needless to say, these risks are aggravated when the funding is delayed.

4. Failure to administer subtrusts properly

a. Failure to maintain proper accounting records

Failure to maintain adequate accounting records is a common problem for non-professionally-managed trusts, including many such trusts that are not otherwise properly viewed as stale trusts. In the ordinary course, bringing accountings current may be viewed as an annoyance, but something that can be easily handled with sufficient effort. But when the basic records are not properly maintained, the task becomes much more daunting. While it is true that some old records can be obtained from the reporting institutions for a price, it is equally true that it is increasingly common to find that records of a certain vintage are simply not available at all as institutional records retention policies are changed.

Without having the source records available, it is virtually impossible to create accurate accountings for individual subtrusts. When remainder beneficiaries of the various subtrusts are not identical, the inability to accurately account for each subtrust on its own can lead to disastrous consequences. A related problem is the inability to accurately distinguish income from principal for purposes of allocating receipts and

disbursements appropriately, which in addition to leaving unhappy beneficiaries can bring unwanted attention from tax authorities.

b. Failure to file 1041's and 541's

When a trustee has failed to allocate assets to subtrusts and/or to fund subtrusts according to the allocation schedule, it is a safe bet that proper income tax reporting has not occurred. Even in cases where there is but a single stale trust to be dealt with, the inattention that resulted in having a stale trust almost certainly means that appropriate tax returns have not been filed. When the accounting records have not been maintained, recreation of records for tax reporting purposes is a true nightmare.

c. Failure to distribute income and/or principal in accordance with the trust instrument

It is virtually a given that when complete accounting records are not maintained, distinctions between income and principal will be ignored when distributions from the trust are made. Similarly, such an inattentive trustee may pay little heed to the terms of the trust that may require that certain distributions be made (e.g., minimal requirements for a federal estate tax marital deduction-qualified trust) or not be made (e.g., a prohibition on distributing any principal to a particular beneficiary from a particular trust). Indeed, it is fairly typical for a surviving spouse who has otherwise neglected to attend to any other details of proper trust administration to be ignorant of (or oblivious to) the distinction between income and principal, often having a sense of entitlement to unrestrained use of all of the trust assets and the income and other proceeds therefrom.

C. Source of the problem

Having reviewed the types of problems that typically arise in the stale trust context, we must consider how we ended up in such a situation. That is, why did things go awry? There are generally a few usual suspects.

1. Failure of attorney to advise client properly

Much as we would like to believe otherwise, it is probably a safe assumption that in a certain number of cases, a well-intentioned client has contacted a lawyer who has failed to properly explain to the client-trustee all of the intricacies of trust administration. Perhaps the lawyer was not familiar with the trust administration process, perhaps the lawyer was shooting from the hip and failed to take into account the provisions of the specific trust in question, or perhaps the lawyer carefully reviewed the documents but simply reached erroneous conclusions about the applicable law or about how to proceed in that particular case. Regardless of how

things got to that point, the lawyer may be the one on the hot seat.

2. Failure of accountant to advise client properly

It is not uncommon to see problems arise from the advice the client received from his or her accountant. Many accountants are unfamiliar with the requirements of trust administration, and they may confuse tax accounting and trust accounting rules. Sometimes they fail to file required tax returns (or they may file the required returns but complete them improperly). We also see cases in which the accountant casually slips into the role of lawyer, often with disastrous consequences. There are, of course, many excellent accountants with a firm grasp on the tax and non-tax aspects of fiduciary accounting, but it is often difficult for clients to identify those individuals.

3. Failure of client to notify professionals of existence of trust and/or death of settlor

While we might like to believe that a client will promptly notify us after the death of his or her spouse or parent, the truth is that not infrequently the individual never calls the lawyer to report the death and inquire about what might need to be done as a result. Sometimes this silence is an intentional approach designed (in the client's mind) to avoid incurring legal fees and related expenses, but sometimes the client has decided that trust administration will be taken care of "later" and the client eventually forgets to do so. Often in such cases, years will go by before an attorney is made aware of a settlor's death, but which time postmortem planning options may have become limited or non-existent and the overall expense of dealing with the now-stale trust will almost certainly have increased greatly.

4. Refusal of client to follow advice of professionals

A related scenario arises when the client notifies the lawyer and/or accountant of the settlor's death, expecting to hear something like "thanks for telling me" and nothing more. Such clients are often startled to learn that many procedures of varying degrees of formality will be required, and potentially significant fees and expenses will be incurred in the process. The shock comes because these clients fall into the rather large group of those who believe in a simple mantra: "It's a living trust, so it means I don't have to do anything, right?" Of course, this notion is fed by trust-mills and lots of other misinformation that is readily available to those with even a passing interest in estate planning. It is worth noting that many of the providers of this information do no work in the area of trust administration – they just "sell documents" and move on.

In any event, clients in this group can react with much more than surprise – they can be rather hostile and suspicious, believing that the steps being outlined by

the professionals are make-work projects designed solely to generate fees. In this context, it is easily understood why the clients might choose to ignore the advice being given. Sometimes the professional is made aware of the client's decision, and the professional is thus given an opportunity to write a disengagement letter or otherwise take steps aimed at limiting his or her exposure to a later claim of professional malpractice. In many cases, however, the client simply fails to carry out the work he or she has told the professional will be completed, and the professional's failure to regularly follow-up with such a client can be a recipe for disaster.

II. Failure to file estate tax returns

A. Taxable estate

1. File late return

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When a lawyer is asked to help freshen a stale trust, and he or she discovers that no estate tax returns have been filed, he or she must determine whether or not the decedent's estate is taxable. For present purposes, we will assume that an estate is "taxable" if payment of some estate tax is necessary, after taking into account all deductions, credits and exemptions. We will address below cases in which the decedent's estate exceeds in value the amount of the applicable unified credit exemption equivalent.

When it is determined that the estate is taxable, steps must be undertaken as soon as possible to prepare and file the appropriate estate tax returns. As with any trust administration project, the decision must be made whether the responsibility for preparing the return will fall to the attorney or to the client's accountant. In preparing the return, it should be noted that certain postmortem planning options are not available when the return is not timely filed (e.g., the I.R.C. § 6166 election, the I.R.C. § 2032A election, and qualified disclaimers under I.R.C. § 2518.)

2. Pay tax, interest and penalties

Upon the filing of the return, payment of the tax must be made, along with the interest and penalties that will be imposed. As noted above, the interest charged on late payments is imposed at a rate based on applicable interest rates from time to time and is compounded daily (I.R.C. §§ 6601, 6621 and 6622), and penalties for late filing of the 706 and late payment of the estate tax can total as much as a combined 50% of the tax actually due (I.R.C. §§ 6651(a)(1) and (2)).

3. Determine proper distributions (outright or in trust)

Of course, part of any proper trust administration is the determination and

effectuation of proper distributions. The handling of such matters is discussed below in Part III.

4. Look for professional negligence

When failure to file a required estate tax return is discovered, part of the inquiry should be whether the reason for the failure stemmed, at least in part, from professional negligence. A review of prior counsel's files is necessary. Similarly, a review of the accountant's files should be conducted. Because the statute of limitations for legal malpractice is only four years from the date of the wrongful act or omission, or one year from the time when discovery of the wrongful act or omission occurs or should have occurred if reasonable diligence were exercised, whichever occurs first (Cal. Code of Civ. Proc. § 340.6), the inquiry into a possible action for legal malpractice cannot be deferred until "things simmer down." While the statute of limitations for accounting malpractice can be a bit longer (within two years after the accrual of the action is discovered or, through reasonable diligence, should have been discovered – Cal. Code of Civ. Proc. § 339(1); *see Van Dyke v. Dunker and Aced*, 46 Cal. App. 4th 446, 451 (1996)), delay in making investigation of a possible claim could result in the lawyer attempting to correct past failures finding himself or herself on the receiving end of the claim for professional negligence.

a. Bring in appropriate counsel for possible malpractice claim

As with all areas of practice, the business of bringing claims for professional negligence is highly specialized. In any case when there is a hint of the potential for a claim against a professional, it is highly advised to bring in a lawyer who specializes in pursuing such claims in order to satisfy the standard of practice requiring associating counsel (or at least consulting with counsel) who is competent in the particular practice area. *See* Cal. Rules of Prof. Conduct, Rule 3-110.

B. "Grey zone" estate – value of gross estate near but not over limit of filing requirement

Estates involving stale trusts are as likely as other estates to face a decision over whether to file an estate tax return when it is not clear that the estate is larger than the unified credit exemption equivalent. As with other such cases, the decision of whether to go to the trouble and expense of filing a return will involve consideration of the nature of the assets involved. Assets with clearly defined values present easier cases, whereas assets that are harder to value – such as real property and interests in closely held businesses – make the choice more difficult. Perhaps an additional factor when a stale trust is involved is whether a late-filed return is likely to generate more scrutiny, such that even if the estate eventually pays no estate tax,

expenses are increased because of an audit. While this exposure seems like a minor factor, some practitioners may want to weigh it in the decision-making process.

C. Non-taxable estate

1. Generally occurs at death of the first spouse to die

Continuing to use the idea of a "taxable" estate as one in which taxes will actually be paid *after* taking into account all deductions, credits and exemptions, the most typical example of a case when failure to have filed a timely return can be problematic is when the decedent is the first spouse to die and his or her estate will, at least in part, avoid taxation through the use of the federal estate tax marital deduction.

a. Death of single person (including surviving spouse)

If the decedent was a single person (or a surviving spouse) and his or her estate was not taxable, then failure to have filed an estate tax return would generally not be an issue. No return is required when the estate is less than the applicable unified credit exemption equivalent. However, this excuse is not always the case. For example, if the estate exceeded that exemption equivalent, but estate tax could be avoided by claiming available deductions, a return is still required. It should also be observed that certain procedures that can be used to limit the size of an individual's estate – for example, a qualified disclaimer under I.R.C. §§ 2046 and 2518 – must be completed within specified periods of time or they may become unavailable.

b. Value of filing return for smaller estates

In the first death scenario, it is possible that there will be no tax because the decedent's estate is less than the applicable exemption equivalent under the unified credit (but perhaps the estate is approaching that amount in value). Nevertheless, the decision may be made to prepare and file a return in order to take positions regarding valuation and to set up the appropriate funding of a bypass trust. Certainly, the longer the delay in filing the return, the more difficult it becomes to be determine and justify reliance on values as of the decedent's date of death.

c. Necessity of filing return when marital deduction is used

In the first death scenario, it is possible that there will be no tax because of reliance on the federal estate tax marital deduction. In this case, a return is required, and asset allocation issues become very significant vis a vis the eventual taxation of marital trust assets in the estate of the surviving spouse.

2. When is discovery of the failure to file an estate tax return made?

When the failure to file an estate tax return upon the death of the first spouse to die is discovered during the lifetime of the surviving spouse, there may be more latitude in processing the return and using it as the basis for subtrust allocations than will be true when the situation is discovered only after the death of the surviving spouse. Because there are no hard and fast rules in this area, this "truism" may be more a matter of perception than reality. Certainly, in either case a properly prepared 706 will look the same. Nevertheless, a decision about allocation of assets to subtrusts – which necessarily ties in to the estate tax return itself – made while the surviving spouse is still arrive will appear to be less "rigged" than one made after the surviving spouse has died and allocation decisions are based on 100% hindsight. Even though the former allocation will involve a certain degree of hindsight (and potentially benefit from that hindsight), it doesn't "feel" the same as an allocation made after the survivor has died and information is available about how each asset fared over the years between the two deaths. It may be equally true, however, that the real issue is about how stale the trust really is – a decision about subtrust allocations made years after the first death, but while the survivor is still alive, may still create the appearance of an attempt to benefit too much from hindsight with not enough honest, fiduciary decision-making involved.

3. Should the 706 be filed?

What should be done if no tax will be due – should an estate tax return be filed at all? Clearly, if the estate will pay no taxes because deductions – including the marital and/or charitable deductions – will reduce the taxable estate to an amount below the applicable exemption equivalent under the unified credit, a return is due and should be filed. Conversely, when the estate is well below the applicable exemption equivalent under the unified credit, no return is required and one would rarely if ever be filed, stale trust or not. Thus, it appears once again that only estates in the "grey zone" will face a difficult choice here.

It should be observed, however, that in many cases practitioners make the "practical" choice to let sleeping dogs lie, filing no return when one would be required but no estate tax will have to be paid. This approach appears to be a particularly poor choice. Especially in cases when there is a surviving spouse who had an estate plan in common with his or her predeceased spouse (e.g., the typical revocable family trust in California estate planning), the first return often is viewed as setting up the second return. That is, valuation approaches on each return should be consistent, and establishing *any* set of values from which to allocate assets to subtrusts provides a much firmer basis on which to predicate the estate tax return to be filed when the surviving spouse dies. In short, just because no tax will be due should never, in and of itself, guide the decision about whether or not to file an estate tax return.

4. Should we worry about failures to fund after first spouse died?

When the decedent's estate was not taxable, should steps be taken to address failures to fund subtrusts provided for under the decedent's estate plan (e.g., bypass trust, marital trust) that are discovered long after his or her death regardless of whether or not an estate tax return is eventually filed? In some cases, the best answer may be "it doesn't matter," while in others the only proper answer may be "you have no choice but to work on late funding of subtrusts" – yet in many cases the final answer may be determined as much by practical concerns as by technical niceties.

a. When the federal estate tax marital deduction is used to eliminate estate tax

It is plain that when an estate is pays no estate tax only because the federal estate tax marital deduction is relied upon to eliminate estate tax, a failure to fund subtrusts must be redressed upon discovery. If, for example, some portion of the decedent's estate was to go to a bypass trust (or other gift designed to take advantage of the applicable exemption equivalent under the unified credit) and the rest was to go to a marital trust (or other marital-deduction qualified gift), proper freshening of the stale trust requires that steps be taken to determine appropriate asset allocations and to then effectuate those allocations. Failure to take such steps will lead to a situation where, upon the surviving spouse's death, no good way exists to determine which assets are properly includible in his or her estate for federal estate tax purposes. Experience tells us that the paralysis such circumstances can create will often result in a second stale trust.

b. When the estate is smaller than the exemption equivalent under the unified credit and beneficiaries of all subtrusts are the same

When there is a small estate – less in value than the exemption equivalent under the unified credit – and the beneficiaries are all subtrusts mandated under the controlling instruments are the same, does it really matter if we attend to funding the stale trust's subtrusts? Perhaps the best answer here is "it depends." Certainly, we will often find ourselves facing a choice between the "practical approach" and what we may find to be "legal requirements."

For example, suppose a married couple had a typical living trust that called for creation of three subtrusts at the first death – a survivor's trust, a bypass trust and a marital trust. Upon examination, it is determined that the estate is too small to require the creation of a marital trust. Additionally, the beneficiaries of the survivor's and bypass trusts are the couple's three children, each to take an equal share. Is it

necessary – or proper – to divide the family trust into the two equal portions called for in the instrument?

Certainly, the proper administration of any trust by a fiduciary who is striving to adhere to standards of fiduciary conduct requires that the provisions of the trust instrument be followed as closely as possible. Thus, the technically correct answer is that the trust assets should be allocated between the two subtrusts.

But what if the overall estate is small – so small that it appears almost certain that no estate tax would be due at the surviving spouse's death *even if* all of the assets (including those properly allocated to the bypass trust) were to be included in his or her taxable estate? Allocation between the two subtrusts will mean two small trusts to deal with, one of which is irrevocable and a separate taxpayer. Clients in such cases will often press to ignore the express terms of the trust. To obtain "cooperation" from the professionals involved, they will often claim that the surviving spouse has no desire to change the outcome for the eventual beneficiaries – he or she simply wants to streamline the administration process.

Complying with such a request seems harmless – but what if that doesn't turn out to be the case? For example, the bypass trust is never established, and subsequently the surviving spouse makes a large gift to one child, or simply amends the survivor's trust – the only trust then in existence? The professional who aided the process of ignoring creation of the bypass trust may be the easy target when these outcomes are finally discovered. What assurance is there that the surviving spouse will not end up favoring one child or another, regardless of his or her intentions at the time the request is made to ignore funding of subtrusts? On the other hand, the lawyer may be well-acquainted with the surviving spouse and the children, and may know the integrity of all involved in honoring the deceased spouse's wishes. In such a case, the practical approach may well be to ignore funding the subtrusts and allow things to proceed in a simplified manner.

Clearly, this issue can arise before a trust becomes stale – indeed, it is often the trigger for a trust becoming stale. What is the role of the professional when approached with a stale trust that has never had its subtrusts funded? In a sense, this situation is almost better than that which arises immediately postmortem, before a track record has been developed about relationships among the family members. Indeed, experience shows that often the stale trust situation is brought to light specifically because one of the remainder beneficiaries learns of the failure to fund the subtrusts and the likelihood that he or she has been or is about to be treated less than equally. Thus, greater care in the circumstance of a stale trust is warranted.

c. When the estate is smaller than the exemption equivalent under the unified credit and beneficiaries of all subtrusts

are the same

When there is a small estate – less in value than the exemption equivalent under the unified credit – and the beneficiaries are all subtrusts mandated under the controlling instruments are the *not* identical, it clearly is very important that we attend to the proper funding of the stale trust's subtrusts. One need look no further for an example of the problems that can arise than the relatively recent case of *Penny v. Wilson*, 123 Cal. App. 4th 596 (2004). In *Penny*, the surviving spouse waited sixteen years after his wife's death to allocate assets to the "survivor's trust" and the "decedent's trust," but he did so based upon date of death values. Roughly a year later, he removed an asset from the survivor's trust to fund a residence trust that benefitted only one of his four children, even though all four children were to have been equal beneficiaries of both trusts under the instrument as originally drafted. The court determined (not surprisingly) that the relative values of the assets allocated to the subtrusts had changed substantially since the wife's date of death, and it remanded for an allocation based on more current values. Importantly, the court did *not* mandate a pro rata allocation of assets to the two subtrusts, and at the same time it allowed extra benefits to flow through the survivor's trust to the one child who was the intended beneficiary of the residence trust (an interesting outcome showing that, apparently, the court treated the failed effort to create the residence trust as tantamount to an amendment of the survivor's trust; the decision includes no indication that an express amendment of the survivor's trust was ever attempted).

In *Penny*, the two subtrusts were treated as having different remainder beneficiaries (four equal beneficiaries under the decedent's trust, but only one beneficiary under the survivor's trust). And in such a circumstance, the court required careful consideration of the allocation of assets, handled in a manner to properly reflect appreciation and depreciation in the values of the various assets that had been available for allocation. While there may be various legitimate approaches to accomplishing this outcome, it is plain that *some* effort to achieve a proper allocation to the subtrusts in a manner consistent with the language of the trust instrument must be pursued.

III. Estate tax return is filed, but subtrust allocations are not made

On some occasions, a practitioner will come across a stale trust situation in which administration was commenced but never completed. Not infrequently, an estate tax return will have been prepared and filed, but no further steps to implement the terms of the trust will have been undertaken. The steps necessary to address such cases may depend upon the point in time when the stale trust comes to light.

A. Discovery during lifetime of surviving spouse

When discovery is made during the lifetime of the surviving spouse, it will be possible and perhaps useful to pick up where things were left off. That is, making the appropriate asset allocations and funding the subtrusts will still prove to be a useful exercise. Clients may balk at this suggestion, especially if the trust has been stale for years and all of the subtrusts have identical remainder beneficiaries. Nevertheless, failure to allocate and fund means that, at the very least, income tax returns have not been filed as appropriate and separate accountings for the several subtrusts will not have been prepared; it also is possible that the surviving spouse will make an effort to change beneficial interests of the remaindermen. Again, such situations inevitably lead to difficulties in determining which assets properly are includible in the gross estate of the surviving spouse upon his or her death.

In such circumstances, it is important that all of the remaining steps in postmortem trust administration following the first spouse's death be completed. This means preparation of allocation schedules, formal transfer of assets pursuant to those schedules and bringing accountings current for each subtrust. While the last step – accountings – may appear to be a tremendous nuisance, it is crucial in helping to establish that all funds are placed in the appropriate trusts. When there is a QTIP marital deduction trust, this process may also help to establish that all income has been distributed to the surviving spouse at least annually, as required under the Internal Revenue Code.

B. Discovery following death of surviving spouse

When discovery is made following the death of the surviving spouse, it still will be possible to complete the steps that should have been completed following the death of the first spouse to die – but it is far less clear that the process will still prove useful. Particularly when the beneficiaries of each subtrust are identical, completing all of the formal steps may be pointless. Nevertheless, completing the process of allocating assets – at least on paper – will be important to tie in with the preparation of the estate tax return for the surviving spouse, because certain assets will not be includible in his or her gross estate (those assets allocated to the bypass trust) while other assets will form part of his or her gross estate (those assets allocated to the survivor's trust and/or the marital trust). While it is true that the IRS may not recognize such a late allocation of assets – or for that matter, any allocation that is not coupled with formal transfers of assets pursuant to the allocation schedule (*see Estate of Johnson* 88 T.C. 225 (1988)) – it is equally true that being able to demonstrate good faith in the preparation of the survivor's estate tax return is very important.

C. Allocations between principal and income

The allocation schedule typically produced in the course of timely administration of a trust following a settlor's death deals with the assets that were on

hand in the trust at the decedent's death (including assets added to the trust shortly after the decedent's death as a result of his or her death). The process of allocating receipts and expenses is often considered only after the subtrusts have been established, commonly in conjunction with preparation of the various income tax returns. When there is a stale trust, however, and perhaps many intervening years of receipts and expenses must be accounted for, the subtrust allocations themselves must take those later-arising items into account.

This process really involves two distinct steps. First, allocation of principal assets must be determined in accordance with the mandates of the trust instrument and applicable law. Second, allocation of receipts and disbursements in a manner harmonious with the allocation of principal assets must be determined. Clearly, allocation of receipts and disbursements requires a careful review of allactivity since the decedent's death, in order to be able to separate assets initially on hand from those changes in assets on hand that subsequently took place. Indeed, if anything clarifies the benefits of regular preparation of accountings, this may be it.

This outline will not go into the details of allocation of individual items among the subtrusts or between income and principal. A few words, however, are in order regarding how the process is to be approached. The first step is to determine which items relate to the more or less immediate postmortem administration of the trust following the decedent's death; this process clarifies whether items are deemed to affect the amount deemed initially available for allocation (by being treated broadly as affecting the "administrative trust" phase of postmortem administration), or whether items are to "follow" the allocation of assets to which they relate and be dealt with inside each separate subtrust. The allocation of items of income and expense during this phase of trust administration is governed by the provisions of Probate Code §§ 16304 through 16347. These rules help clarify the differences in allocations based upon the nature of the gifts (or subtrust funding instructions) set forth in the trust instruement, i.e., specific gifts, pecuniary gifts and general gifts are each covered individually. Within each category, rules are provided for the treatment of individual items as being allocated to income or principal, or partly to each.

Once individual items of receipts and disbursements have been matched up with the allocation of assets to the several subtrusts, Probate Code §§ 16350 through 16375 come into play to help guide the allocation of each item between income and principal within each subtrust. In the context of a stale trust, this split between income and principal within each subtrusts informs the preparation of as-yet-unfiled income tax returns, including the proper completion of the Schedules K-1 to be attached to those returns. It should be observed that this can prove to be another reason that clients might shun proper advice from professionals. If the income tax has already been paid on the "right" return (e.g., the surviving spouse was the sole income beneficiary of each subtrust and he or she simply reported all of the income on his or