

# ASSISTING THE NONPROFESSIONAL TRUSTEE IN IMPLEMENTING THE ADMINISTRATIVE TRUST

John A. Hartog\*  
George R. Dirkes\*\*

## Table of Contents

I.	INTRODUCTION.....	1
II.	IMMEDIATE CREATION THEORY VS. THE ADMINISTRATIVE TRUST.....	1
	A. Immediate Creation Theory.....	1
	B. The Administrative Trust.....	1
III.	ESTABLISHING THE ADMINISTRATIVE TRUST.....	1
	A. Theoretical Considerations.....	1
	B. Practical Considerations.....	2
	1. Duration.....	2
	2. Fiduciary.....	2
	3. Mechanics of Establishing Trust.....	2
	4. Tax Identification Number.....	2
	C. Advantages of the Administrative Trust.....	3
	1. Avoiding Phantom Income.....	3
	2. Disclaimers.....	3
	D. Disadvantages of the Administrative Trust.....	3
	1. Special Assets.....	3
	2. Additional Costs.....	3
IV.	ENTITLEMENT TO INCOME DURING THE TERM OF THE ADMINISTRATIVE TRUST.....	3
	A. Allocation of Income and Gain During Administration	3
	B. Allocation of Income among Residuary Beneficiaries	3
	C. Allocation of Income According to Distributable Net Income or Trustee's Discretion.....	4
V.	INCOME TAXATION OF ADMINISTRATIVE TRUST.....	4
	A. Tax Year.....	4
	B. Taxed as Irrevocable Trust.....	4
	C. Accumulation Distributions.....	4
	D. Taxation of Ordinary Income.....	4

---

\* John A. Hartog, Inc., Orinda, California

\*\* Principal, Bancroft & McAlister, San Francisco, California

E.	Taxation of Distributions.....	5
F.	Taxation of Capital Gains.....	5
G.	Taxation of Unrealized Appreciation.....	5
H.	Quarterly Estimated Tax Payments.....	5
1.	General Rule.....	5
2.	Election to Credit Payments to Beneficiary.....	6
VI.	FILING REQUIREMENTS.....	6
A.	Estate Tax.....	6
1.	Duty to File.....	6
2.	When to File.....	6
B.	Income Tax.....	7
1.	Filing the Final Income Tax Return.....	7
2.	Who May File.....	7
3.	Separate or Joint Return.....	7
C.	Income Included on Final Return.....	8
1.	Constructive Receipt of Interest and Dividends.....	8
2.	U.S. Series EE and Series E Bonds.....	8
3.	Partnership Income.....	9
4.	S Corporation Income.....	9
5.	Individual Retirement Accounts.....	10
D.	Deductions.....	10
1.	Deductions Allowed.....	10
2.	Medical Expenses.....	10
3.	Losses.....	10
VII.	ISSUES ARISING FROM SIMULTANEOUS PROBATE AND TRUST ADMINISTRATION.....	10
VIII.	IDENTIFYING TRUST ASSETS AND DEDUCTIONS.....	11
IX.	DISTRIBUTING FROM THE ADMINISTRATIVE TRUST: FUND FAST OR FUND SLOW.....	11
A.	Impracticability of Funding Fast.....	11
B.	Reason to Fund Fast.....	11
C.	Other Effects.....	11
D.	Funding Issues Involving Pecuniary Gifts.....	11
E.	Partial Distributions.....	11
X.	INCOME TAX ISSUES OF DISTRIBUTIONS AND FUNDING MARITAL DEVICES.....	12
A.	Gain or Loss on Funding.....	12
1.	Funding Risks of Pecuniary Formula Bequests.....	12
2.	Determining Distribution Date.....	12
3.	Assets to Fund Pecuniary Bequests.....	12
4.	Tax Effect of Distributions.....	12
5.	Distribution in Satisfaction of Fractional Share Bequest.....	12
B.	Distribution Pursuant to a Formula Clause or to Satisfy a Pecuniary Amount.....	13

	1.	Distribution Rules Generally.....	13
	2.	Distributions to Satisfy a Specific Devise.....	13
	3.	Distribution to Satisfy Pecuniary Marital Deduction Gift.....	13
	4.	Pecuniary Carve-Out Formula Gift.....	13
	C.	Timing of Distributions: Basic Rules.....	13
	D.	Risks in Funding.....	13
	E.	Trapping Distributions.....	14
XI.		DISTRIBUTION OF GROWTH AND WASTING ASSETS.....	14
	A.	Growth Assets.....	14
	B.	Wasting Assets.....	14
XII.		METHODS OF ALLOCATION OF ASSETS FROM THE ADMINISTRATIVE TRUST TO THE SUBTRUSTS.....	14
	A.	Internal Allocation.....	14
	B.	Formal Asset Transfer.....	15
XIII.		PREPARING A SCHEDULE OF ASSETS AND TRANSFERRING ASSETS FROM THE ADMINISTRATIVE TRUST TO THE SUBTRUSTS.....	15
	A.	Schedule and Proposed Allocation of Assets.....	15
	B.	Physical Distribution of Assets Required.....	15
XIV.		MECHANICS AND DOCUMENTATION OF DIVIDING THE ADMINISTRATIVE TRUST.....	16
	A.	Dividing and Naming the Subtrusts.....	16
	B.	Taxpayer Identification Number.....	16
	C.	Funding Date.....	16
	D.	Termination of Administrative Trust.....	16
XV.		PROBLEMS WITH DISTRIBUTING SPECIAL ASSETS TO AND FROM THE ADMINISTRATIVE TRUST.....	17
	A.	S Corporation Stock Owned by the Administrative Trust.....	17
	B.	Partnership Interests.....	17
		1. Effect of Death.....	17
		2. Section 754 Election.....	17
XVI.		GENERAL PRINCIPLES OF FIDUCIARY DUTY.....	17
	A.	Review of Trust Law.....	19
	B.	Powers of Delegation.....	19
	C.	Clarifying Division of Responsibilities.....	20
XVII.		FAILURE TO FUND: THE "STALE TRUST".....	20
	A.	Defining the Problem.....	20
	B.	Tracing Trust Transactions.....	20
		1. In General.....	20
		2. Never Funded.....	20
		3. Poor Administration.....	20
	C.	Tracing Trust Income.....	21
	D.	Tax Issues.....	21
		1. Income Tax.....	21

2.	Estate Tax.....	21
E.	Curing the Stale Trust.....	21
F.	Avoiding the Stale Trust.....	22







## PREFACE

Allocations among the subtrusts created as the result of a spouse's death usually cannot be made for many months. Reasons for delays may include difficulty in identifying assets, difficulty in determining what is community and what is separate property, and problems in valuing assets. When these delays are unavoidable, the assets in what had been the revocable living trust must continue in an "administrative" trust until distributions are made. The term of the "administrative trust," commences on the date of death and ends on the date of the final funding of the subtrusts.

This outline discusses establishing the administrative trust. It then addresses the issue of who is entitled to trust income during the term of the administrative trust. Next is discussed the income taxation of the administrative trust, and filing requirements imposed upon the administrative trustee. Issues arising from the distribution of assets to the subtrusts, and the income tax consequences of those distributions, are then reviewed. The outline then discusses allocating assets between the subtrusts, and the mechanics of making these allocations. Next is summarized special issues arising from allocation of particular assets. The outline then discusses the general principles of fiduciary duty imposed upon a trustee, and the consequences of a "stale trust" resulting from the failure to respect those obligations.



# ASSISTING THE NONPROFESSIONAL TRUSTEE IN IMPLEMENTING THE ADMINISTRATIVE TRUST

John A. Hartog  
George R. Dirkes

1. INTRODUCTION
2. IMMEDIATE CREATION THEORY VS. THE ADMINISTRATIVE TRUST
  1. Immediate Creation Theory. An administrative trust may be avoided if the administration of the decedent's trust can be accomplished in the same calendar year as the year in which death occurred. The trustee can treat the subtrusts as having been immediately created at the moment of the settlor's death. The trustee can treat the subtrusts as having been created on the date of death, and file fiduciary income tax returns accordingly on April 15th of the year following the year of death.
  2. The Administrative Trust. Generally, if one can expect to administer a decedent's trust for more than twelve months, or over the course of more than one tax reporting year, an administrative trust will be necessary. Most trust instruments provide no express authority to the trustee to establish an administrative trust. A persuasive factor encouraging use of an administrative trust is the numerous responsibilities imposed on the fiduciary by the Internal Revenue Code. The Regulations also contain language which can be construed to require the use of an administrative trust.<sup>1</sup>
3. ESTABLISHING THE ADMINISTRATIVE TRUST

---

<sup>1</sup> Treasury Regulation § 20.2053-8(a).

1. Theoretical Considerations. For income tax purposes, a *testamentary* trust does not come into existence when the testator or testatrix dies.<sup>1</sup> The Tax Court has held that such trusts generally come into existence after the will has been probated and distribution has been made to the trustee in accordance with local law.<sup>2</sup> A trust will terminate after the trustee has had a reasonable period of time to "perform the duties necessary to complete the administration of the trust."<sup>3</sup> Following this reasoning, and using the probate estate as an analogy, it appears that the subtrusts may be deemed not to be created until they have been funded with the assets allocated to them from the decedent.
  
2. Practical Considerations
  1. Duration. The administrative trust may continue during the period reasonably required to complete administration and distribute the trust assets to the successor beneficiaries.<sup>4</sup>
  
  2. Fiduciary. The fiduciary responsible for administering a decedent's affairs is defined as "any person acting in any fiduciary capacity for any person."<sup>5</sup>
  
  3. Mechanics of Establishing Trust. Upon assuming the trusteeship, the fiduciary should file with the District Director of the IRS notice of the commencement of the fiduciary relationship.<sup>6</sup> Form 56 should be filed with the California Franchise Tax Board as well as with the Internal Revenue Service.<sup>7</sup> Form 56 must be accompanied by evidence of fiduciary authority such as letters testamentary or letters of administration. A successor trustee

---

<sup>1</sup> U.S. v. Britten, 161 F.2d 921 (3d Cir. 1947).

<sup>2</sup> See e.g. Bryan Est. v. Comr., T.C. Memo 1963-182.

<sup>3</sup> Treas. Regs. § 1.641(b)-3(b).

<sup>4</sup> Treas. Reg. § 1.641(b)-3(d); See Rev. Rul. 55-287, 1955-1 C.B. 130; See Marx v. Commissioner (1942) 47 BTA 204 and Coachman v. Commissioner (1951) 16 T. C. 1432.

<sup>5</sup> I.R.C. § 7701(a)(6); Treas. Reg. § 301.7701-6.

<sup>6</sup> I.R.C. § 6903; Treas. Reg. § 301.6903-1.

<sup>7</sup> Form 56 is usually included with most commercially available IRS Forms libraries, in hard copy, or on disk or CD-ROM.

should attach an Affidavit of Successor Trustee, declaring that the successor is the duly constituted successor trustee.

4. Tax Identification Number. The administrative trust must have its own taxpayer identification number. The trustee of the administrative trust should apply for the number by filing IRS Form SS-4.

3. Advantages of the Administrative Trust

1. Avoiding Phantom Income. The establishment of an administrative trust can maximize use of deductions and prevent the premature mismatching of income and losses in the hands of successor beneficiaries, thereby preserving the decedent's income tax planning.
2. Disclaimers. The administrative trust can serve as a buffer between the decedent and the beneficiaries, similar in function to a probate estate.

4. Disadvantages of the Administrative Trust

1. Special Assets. The primary drawback to the use of the administrative trust is that if the decedent owned special assets, such as S Corporation stock, or IRD items, careful planning is required to be certain the administrative trust is a qualified holder of the asset, or income is not inadvertently accelerated.
2. Additional Costs. Using an administrative trust usually involves administrative costs which can be avoided if the subtrusts are treated as having been created immediately on death.

4. ENTITLEMENT TO INCOME DURING THE TERM OF THE ADMINISTRATIVE TRUST

1. Allocation of Income and Gain During Administration. Income earned during administration is allocated to the residue except for income earned more than one year after death on specific cash gifts and property specifically devised.<sup>1</sup> Income from specifically devised property

---

<sup>1</sup> Prob. Code § 12006.

during administration belongs to the devisee, net of expenses attributable to the devised property.<sup>2</sup>

2. Allocation of Income among Residuary Beneficiaries. Two theories of income and gain allocation among residual beneficiaries have developed. One is known as the "fixed fraction approach" and the other as the "changing fraction approach."
3. Allocation of Income According to Distributable Net Income or Trustee's Discretion. In the absence of a provision in the governing instrument specifically allocating different classes of income to different beneficiaries, for trust income tax purposes the various classes of income are allocated among the beneficiaries in accordance with their shares of DNI.

5. INCOME TAXATION OF ADMINISTRATIVE TRUST

---

<sup>2</sup>

Prob. Code § 12002(b).

1. Tax Year. Each trust is required to adopt the calendar year as its taxable year.<sup>1</sup> The administrative trust will therefore report its income and deductions on the calendar year. This rule makes it likely that the income tax returns for the first and last year of the trust will be for short periods.
2. Taxed as Irrevocable Trust. On the death of the settlor the trust becomes irrevocable, functioning as a separate taxpayer for income tax purposes.<sup>2</sup> At this time the trustee will have several opportunities to apply sophisticated tax expertise, provided the trustee is not constrained by an unnecessarily restrictive trust document. The trust remains a taxpayer for a reasonable period of time necessary to wind up the affairs of the trust.<sup>3</sup>
3. Accumulation Distributions. Unlike an estate, an administrative trust is subject to the throwback rules for distributions of accumulated income.<sup>4</sup> Ultimate distributions from the administrative trust, however, should not be subject to the throwback rules.<sup>5</sup>

---

<sup>1</sup> I.R.C. § 645.

<sup>2</sup> See Rev. Rul. 57-51 1957-1 C.B. 171.

<sup>3</sup> Treas. Reg. § 1.641(b)-3(b).

<sup>4</sup> I.R.C. § 666(a).

<sup>5</sup> Treas. Reg. § 1.665(d)-1A.

4. Taxation of Ordinary Income. The basic rules of I.R.C. §§ 661 and 662 for taxing the income of trusts and beneficiaries apply to administrative trusts.<sup>6</sup> Distributions of income are deductible by the trust under § 661 and reportable as income by the distributee under § 662, subject to the limitation of distributable net income as defined in I.R.C. § 643(a).
5. Taxation of Distributions. I.R.C. § 643(e) provides that for assets distributed in kind, the distributee takes an income tax basis equal to the trust's basis, adjusted for any gain or loss the trust realizes on the distribution. The amount of the trust's distributions deduction under I.R.C. § 661 and the amount to be reported by the distributee under I.R.C. § 662 is the lesser of the trust's basis in the property or fair market value.<sup>7</sup>
6. Taxation of Capital Gains. Capital gains will not be included in DNI unless they are allocated to income, or allocated to principal and "paid, credited, or required to be distributed" to a beneficiary during the taxable year.<sup>8</sup> In addition, the allocation must be made "by the fiduciary on its books or by notice to the beneficiary."<sup>9</sup> As a general rule, and under California law, such gains will be allocated to principal.<sup>10</sup>
7. Taxation of Unrealized Appreciation. In Rev. Rul. 85-116,<sup>11</sup> the IRS has ruled that a portion of the gain realized by a trust was includible in DNI. That ruling also stated that the portion of the gain includible in

---

<sup>6</sup> Subchapter J, however, does not specify what constitutes a trust. I.R.C. § 641(a)(2), (4), and (1) refer to "income which is to be distributed currently by the fiduciary to the beneficiaries," "income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated," and "income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the . . . trust."

<sup>7</sup> I.R.C. § 643(e)(1).

<sup>8</sup> Treas. Reg. § 1.643(a)-3(a).

<sup>9</sup> Treas. Reg. § 1.643(a)-(3)(a).

<sup>10</sup> Prob. Code § 16303(b)(1).

<sup>11</sup> 1985-2 C.B. 174.

DNI was taxable to the income beneficiary in the year in which it was realized even though it was not distributed to the beneficiary until a subsequent year.

8. Quarterly Estimated Tax Payments

1. General Rule. A trust must pay its income tax liability in quarterly installments.<sup>12</sup> If estimated tax payments are at least 90% of the trust's tax liability for the current year, or 100% of the trust's tax liability for the prior year, no penalty may be imposed for underpayment of estimated taxes. If the trust's adjusted gross income<sup>13</sup> exceeds \$150,000, the prior year safe harbor is 110% rather than 100%.<sup>14</sup>
  
2. Election to Credit Payments to Beneficiary. The trustee can make an election under I.R.C. § 643(g) to have the quarterly tax payments treated as having been made on behalf of the distributees. If the election is made, the tax payments are treated as having been distributed to the distributee on the last day of the tax year, and as having been credited to the fourth quarterly estimated tax payment of the distributee. The election must be made by the 65th day after the close of the administrative trust's tax year (by March 6 of the next tax year) and is made on IRS Form 1041-T.<sup>15</sup>

---

<sup>12</sup> I.R.C. § 6654(1).

<sup>13</sup> As defined in I.R.C. § 67(e).

<sup>14</sup> I.R.C. § 6654(d)(1)(C).

<sup>15</sup> I.R.C. § 643(g); Form 1041-T is usually included with most commercially available IRS Forms libraries, in hard copy, or on disk or CD-ROM.

6. FILING REQUIREMENTS

1. Estate Tax

1. Duty to File. The trustee of the administrative trust has a nondischargable duty to file a federal estate tax return<sup>1</sup> when the decedent's gross estate exceeds the amount sheltered by the unified credit.<sup>2</sup>

---

<sup>1</sup> I.R.C. § 2203.

<sup>2</sup> I.R.C. § 6018.



2. When to File. Form 706 must be filed within nine months after the date of death unless an extension has been received.<sup>3</sup> The Internal Revenue Service may grant a reasonable extension of time to file Form 706 on a showing of good and sufficient cause why it is impossible or impractical to file a timely return. The extension of time to file is not given automatically and cannot be granted for more than six months unless the fiduciary is "abroad."<sup>4</sup>

## 2. Income Tax

1. Filing the Final Income Tax Return. The successor trustee will have the task of filing a decedent's final federal income tax return for the tax year ended on the date of decedent's death.<sup>5</sup> When an individual dies after the end of the year, but before the April 15 filing deadline, the fiduciary also has the responsibility of filing the return for the year preceding death.<sup>6</sup>
2. Who May File. If the decedent was married at the time of death, the successor trustee may file a joint final return with the surviving spouse for the decedent and the surviving spouse.<sup>7</sup> The spouse's income for the full year would be included in the return.

---

<sup>3</sup> I.R.C. § 6075(a); Treas. Reg. § 20.6075-1.

<sup>4</sup> I.R.C. § 6081(a); Treas. Reg. § 20.6081-1(a).

<sup>5</sup> I.R.C. § 6013; Treas. Reg. § 1.443-1.

<sup>6</sup> I.R.C. § 6013(c); Treas. Reg. § 1.6072-1(b).

<sup>7</sup> I.R.C. § 6013(a)(3).

3. Separate or Joint Return. Unpaid income taxes are deductible by the trustee if the taxes are for income properly includible in an income tax return of the decedent for the period before his or her death.<sup>8</sup> If income received by a decedent during life is included in a joint income tax return filed by the decedent's estate and the surviving spouse (or filed by the decedent and the surviving spouse), a deduction will be allowed for only a portion of the joint liability for the period covered by the return.<sup>9</sup> This portion is limited to the amount for which the estate would be liable under local law, as between the decedent and the spouse, after enforcement of any effective right of reimbursement or contribution. The regulation<sup>10</sup> further provides that, in the absence of evidence to the contrary, the deductible amount is determined using a formula.<sup>11</sup>

3. Income Included on Final Return. The income included in a decedent's final return is generally determined in the same manner as though the individual were still alive, except that the taxable period ends on the date of death.<sup>12</sup>

1. Constructive Receipt of Interest and Dividends. Generally, under the cash method of accounting, only interest and dividend payments actually received by a decedent are included on the decedent's final return. Interest from a bond coupon is considered constructively received upon the coupon's maturity even if the decedent had not yet cashed the coupon before death.<sup>13</sup> If the coupon date is prior to the date of death, the interest should be included in the final return.

A stock dividend is considered constructively received when it was available for the decedent's use without restriction. If the dividend-paying

---

<sup>8</sup> Treas. Reg. § 20.2053-6(f).

<sup>9</sup> I.R.C. § 6013; Treas. Reg. § 20.2053-6(f).

<sup>10</sup> Treas. Reg. § 20.2053-6(f).

<sup>11</sup> (Joint tax) x (decedent's separate tax) both separate taxes).

<sup>12</sup> I.R.C. § 6013.

<sup>13</sup> I.R.C. § 454(c); Treas. Reg. § 1.454-1(a)(3).

corporation customarily mails its dividend checks and a check was in the mail at the time of a decedent's death, the dividend should not be included in the decedent's final return.<sup>14</sup>

2. U.S. Series EE and Series E Bonds. A cash basis individual need not report interest earned on Series EE or Series E bonds until the interest is received.<sup>15</sup>

---

<sup>14</sup> Treas. Reg. § 1.451-2(b).

<sup>15</sup> I.R.C. § 454.

The trustee may elect to include all interest earned on Series EE or Series E bonds up to the date of death in the decedent's final return if the decedent had not made the election to report the interest annually.<sup>16</sup> The trust then reports only the interest earned after death and no part of this interest is considered income in respect of a decedent.<sup>17</sup> The trustee may also elect to include in the decedent's final return interest earned on bonds owned by the decedent's revocable or other grantor trust created before the decedent's death.<sup>18</sup>

If the interest earned before death is considered income in respect of a decedent, it is not included in the decedent's final return.<sup>19</sup>

3. Partnership Income. The taxable year of a partnership generally does not close as a consequence of a partner's death.<sup>20</sup> A partner must individually report the partner's distributive share of partnership income, gain, loss, deduction, and credit for the partnership's tax year ending within or with the taxable year of the partner.<sup>21</sup> When the partnership's tax year ends after the date of death, the decedent's distributive share of partnership income earned up to and including the date of death is income in respect of a decedent.<sup>22</sup>

If shifting the deceased partner's share of partnership income from the final return to the administrative trust is not desirable, a sale of the decedent's partnership interest to the remaining partners, or to a third party, on the date of death may serve to close the partnership's tax year with respect to the decedent on the date of sale.<sup>23</sup> To be effective, the remaining buyers

---

<sup>16</sup> Rev. Rul. 68-145 1968-1 CB 203.

<sup>17</sup> Rev. Rul. 68-145 1968-1 CB 203.

<sup>18</sup> Rev. Rul. 79-409, 1979-2 CB 208.

<sup>19</sup> Rev. Rul. 79-409, 1979-2 CB 208.

<sup>20</sup> I.R.C. § 706(c)(1).

<sup>21</sup> I.R.C. § 706(a).

<sup>22</sup> Treas. Reg. § 1.691(a)-1(b).

<sup>23</sup> I.R.C. § 706(c)(2)(I).

should avoid treatment as a liquidation of the deceased partner's interest.<sup>24</sup>

4. S Corporation Income. A decedent's final return must include the decedent's share of S corporation income for the corporation's tax year that ends within or with the decedent's tax year. This rule is similar to rules applicable to partnerships.

---

<sup>24</sup>

I.R.C. § 736.

5. Individual Retirement Accounts. An Individual Retirement Account (IRA) contribution may not be made for an individual after death.<sup>25</sup> The estate is not permitted to make such a contribution on behalf of the decedent because the contribution would not be for retirement purposes.<sup>26</sup>

4. Deductions

1. Deductions Allowed. Deductions that apply during life also apply to a decedent's final return.<sup>27</sup> A personal exemption is allowed, regardless of the date of death.<sup>28</sup>

2. Medical Expenses. Unpaid medical expenses incurred by the decedent before death are deductible against the decedent's gross estate as debts.<sup>29</sup> If the decedent's personal representative so elects, the medical expenses may instead be claimed as an itemized deduction on the decedent's income tax return for the year in which the expenses were incurred.<sup>30</sup>

3. Losses. Net operating loss (NOL) carryovers from business operations in a prior year and capital

---

<sup>25</sup> I.R.C. § 408, § 219.

<sup>26</sup> Letter Ruling 8439066.

<sup>27</sup> Poorbaugh v. U.S., 69-1 USTC Para.9134 (D. Pa. 1968).

<sup>28</sup> Rev. Rul. 71-159, 1971-1 C.B. 50.

<sup>29</sup> I.R.C. § 2053.

<sup>30</sup> I.R.C. § 213(c).

loss carryovers are deductible only on a decedent's final income tax return.<sup>31</sup>

7. ISSUES ARISING FROM SIMULTANEOUS PROBATE AND TRUST ADMINISTRATION

---

<sup>31</sup> I.R.C. § 172.

The entry of an order for probate will in some ways place the administrative trustee in a supporting role, regardless of the discrepancy in the number and value of the assets in the trust versus the estate. A duly appointed executor assumes the statutory responsibility for the filing of the estate tax return. Additionally, under the statute the executor is the person responsible for filing any gift tax returns that may be due<sup>1</sup>, and the decedent's final income tax return.<sup>2</sup>

8. IDENTIFYING TRUST ASSETS AND DEDUCTIONS

One of the first tasks facing a trustee after the death of the settlor is identifying the assets belonging to the settlor which are subject to trust administration. Frequently the trust estate includes more than assets titled in the name of the trust at the time of death. For example, the trust instrument may list certain property as a trust asset although title to the asset may never have been changed to the name of the trust. Identifying all assets, whether or not titled in the trust name, will be of critical importance to the post-death trustee.

9. DISTRIBUTING FROM THE ADMINISTRATIVE TRUST: FUND FAST OR FUND SLOW

1. Impracticability of Funding Fast. A substantial number of problems that arise from the distribution and funding of the subtrusts can be minimized, and even avoided, by funding them as soon as practicable after the date of death. Nevertheless, "as soon as practicable" does not mean immediately. Several required decisions will inevitably cause some delay in funding.
2. Reason to Fund Fast. Dilatory funding can expose the fiduciary to difficulty if there are substantial changes in the values of the allocated assets. If the asset values have decreased, the size of the bypass trust may suffer a resulting reduction.
3. Other Effects. Delays in funding can cause recognition of capital gain if an appreciated asset is used to fund a pecuniary formula gift.

---

<sup>1</sup> Treas. Reg. § 25.2502-2.

<sup>2</sup> I.R.C. § 6012(b)(1).



4. Funding Issues Involving Pecuniary Gifts. If a pecuniary gift is not funded promptly, decreases in value of the estate assets may result in a substantial reduction of the residuary gift. The trustee therefore may find it advisable to fund the pecuniary bequest at an early date.
5. Partial Distributions. If circumstances prevent a complete distribution to the subtrusts in a prompt manner, the trustee should consider the advisability of undertaking a partial distribution, similar to a preliminary distribution in a probate administration.

10. INCOME TAX ISSUES OF DISTRIBUTIONS AND FUNDING MARITAL DEVICES

1. Gain or Loss on Funding

1. Funding Risks of Pecuniary Formula Bequests. Gains are recognized when appreciated property is distributed in satisfaction of a specific pecuniary bequest. The amount of gain is equal to the difference between the date of distribution value of the property and its basis, which is usually its estate tax value.<sup>1</sup> Conversely, however, the trust will not be allowed to deduct a loss suffered when funding a pecuniary amount in kind with property that has decreased in value.<sup>2</sup>
2. Determining Distribution Date. California appears to follow the common law that requires distribution of property as of the date of its distribution.<sup>3</sup>
3. Assets to Fund Pecuniary Bequests. The funding of a pecuniary formula gift is not considered the devise of a specific sum of money.<sup>4</sup>
4. Tax Effect of Distributions. To the extent there is undistributed DNI, a distribution of principal to satisfy a pecuniary credit shelter or marital deduction bequest will carry with it distributable net income which must be reported by the distributee.<sup>5</sup>

---

<sup>1</sup> Treas. Regs. § 1.1014-4(a)(3).

<sup>2</sup> I.R.C. § 267(b)(6).

<sup>3</sup> Treas. Reg. § 1.663(a)-1(b)(1).

<sup>4</sup> Treas. Reg. § 1.663(a)-1(b)(1).

<sup>5</sup> I.R.C. §§ 661(a)(2) and 662(a)(2)(B).

5. Distribution in Satisfaction of Fractional Share Bequest. A distribution in satisfaction of a fractional share formula bequest is a distribution of a portion of the residuary estate, and does not qualify as a specific devise.
2. Distribution Pursuant to a Formula Clause or to Satisfy a Pecuniary Amount
  1. Distribution Rules Generally. A distribution from a trust to a beneficiary ordinarily carries out distributable net income (DNI) that is deductible by the trust<sup>6</sup> and reportable as taxable income by the beneficiary.<sup>7</sup>
  2. Distributions to Satisfy a Specific Devise. Distributions in satisfaction of a specific devise do not carry out DNI.<sup>8</sup>
  3. Distribution to Satisfy Pecuniary Marital Deduction Gift. Marital deduction formula gifts are not treated as specific devises because the exact amount of the devise is not ascertainable at the time of death.<sup>9</sup>
  4. Pecuniary Carve-Out Formula Gift. If a "pecuniary carve-out" clause is used, the formula amount cannot be determined until after the date of death.

---

<sup>6</sup> I.R.C. § 661.

<sup>7</sup> I.R.C. § 662.

<sup>8</sup> I.R.C. § 663(a)(3).

<sup>9</sup> Treas. Reg. § 1.663(a)-1(b)(1).

3. Timing of Distributions: Basic Rules. Income is deductible by the distributing trust<sup>10</sup> up to the amount of DNI, with a like amount includable in the income of the recipient trust.<sup>11</sup>

---

<sup>10</sup> I.R.C. § 661.

<sup>11</sup> I.R.C. § 662.

4. Risks in Funding. A typical risk to the trustee in funding a marital deduction trust arises when valuation adjustments, e.g. discounts, are used. Adjusting the value of property may cause an under funding of the marital deduction trust.<sup>12</sup> In *Chenoweth v. U.S.*,<sup>13</sup> 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 *Provident Nat'l Bank v. U.S.*,<sup>14</sup> in which the value of nonvoting common stock recapitalized after death into preferred stock as required by the decedent's will was not altered.
5. Trapping Distributions. "Trapping" distributions can occur when (1) the initial distribution carries out DNI to the distributee trust; (2) a portion or all of that distribution constitutes trust corpus of the distributing trust; and (3) the distributee trust does not make a distribution to its beneficiaries. Under current law trust income tax rates are higher than individual rates,<sup>15</sup> and trapping distributions are not useful.

#### 11. DISTRIBUTION OF GROWTH AND WASTING ASSETS

1. Growth Assets. If an asset with high growth potential but little or no current yield is distributed to a QTIP trust, there is a risk of disqualifying the QTIP trust because of the retention of unproductive property.

---

<sup>12</sup> See *Chenoweth v. U.S.* (1987) 88 T.C. 1577.

<sup>13</sup> *Chenoweth v. U.S.* (1987) 88 T.C. 1577.

<sup>14</sup> *Provident Nat'l Bank v. U.S.* (1978) 581 F. 2d 1081 (3d Cir.).

<sup>15</sup> Compare I.R.C. § 1(a)-(d) (individual rates) with I.R.C. § 1(e) (rates for trusts and estates).

2. Wasting Assets. A trustee will ordinarily want to allocate a wasting asset to the trust that is to be taxed on the second death, such as the Survivor's Trust or the Marital Trust.

12. METHODS OF ALLOCATION OF ASSETS FROM THE ADMINISTRATIVE TRUST TO THE SUBTRUSTS

1. Internal Allocation. California law generally requires the trustee to keep trust property separate and designated as property of the trust.<sup>1</sup> 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.<sup>2</sup> The Tax Court has ruled that mere bookkeeping entries are not enough to constitute a distribution for income tax purposes.<sup>3</sup> Failure to account properly for income and principal can cause confusion when the time comes to prepare income tax returns or to make distributions.

2. Formal Asset Transfer. Formal allocation 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, especially 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 continued obligation to maintain the separate identity of the several trusts throughout the existence of each.

13. PREPARING A SCHEDULE OF ASSETS AND TRANSFERRING ASSETS FROM THE ADMINISTRATIVE TRUST TO THE SUBTRUSTS

---

<sup>1</sup> Prob. Code § 16009.

<sup>2</sup> Prob. Code § 16009.

<sup>3</sup> See Estate of Johnson, 88 T.C. 225.

1. Schedule and Proposed Allocation of Assets. The trustee should make a written schedule of each asset to be allocated to each subtrust. In preparing the proposed allocation, the practitioner should make sure to account for all assets that will be held by the trust. All assets, including probate and nonprobate assets that will pass to the trust as a result of the settlor's death, must be accounted for. Once the practitioner has determined how to allocate the trust assets, the trustee, either directly or through the trustee's professional advisor, should convey title, by deed or otherwise, to the name of the new subtrusts.
2. Physical Distribution of Assets Required. To be considered a distribution, the transfer must cause the property to be either paid or "properly credited"; mere bookkeeping entries are not enough.<sup>1</sup> 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.<sup>2</sup>

14. MECHANICS AND DOCUMENTATION OF DIVIDING THE ADMINISTRATIVE TRUST

1. Dividing and Naming the Subtrusts. The name of each subtrust ordinarily reflects the nature of that subtrust as created by the governing trust instrument. In some cases, the trust instrument itself will specify the names of the various subtrust or provide guidance as to how these trusts are to be named.
2. Taxpayer Identification Number. All irrevocable trusts must obtain a separate taxpayer identification number.<sup>1</sup> Since the bypass trust always becomes irrevocable on the first settlor's death, a separate tax identification number must always be obtained for that subtrust.
3. Funding Date. Except when date-of-death values are required to be used for allocating assets, the asset valuation will be determined as of the funding date, so that appraisals of real property, and market values for publicly traded securities as of that date, should be obtained. If the alternate valuation date is elected, any property distributed, sold, exchanged or otherwise

---

<sup>1</sup> Estate of Johnson (1988) 88 T.C. 14.

<sup>2</sup> TAM 9413005.

<sup>1</sup> Treas. Reg. § 31.6011(b)-1(a)(1).

disposed of within six months after the date of death must be valued as of the date of distribution, sale, exchange or disposition.<sup>2</sup>

4. Termination of Administrative Trust. As the subtrusts are established, the administrative trust, if any, must be terminated. A final fiduciary income tax return for the administrative trust will need to be filed. Responsibility for the preparation and filing of the final return should be assigned among the trustee and the professional practitioners.

15. PROBLEMS WITH DISTRIBUTING SPECIAL ASSETS TO AND FROM THE ADMINISTRATIVE TRUST

---

<sup>2</sup>

I.R.C. § 2032(a)(i); Estate of Aldrich v. Comr. (1983) 46 T.C.M. 1295.

1. S Corporation Stock Owned by the Administrative Trust. If an administrative trust holds S corporation stock, the trustee must either distribute those shares or cause the administrative trust to meet the requirements of trusts holding S corporation shares; in other words, qualify as a qualified subchapter S trust in order to avoid loss of S corporation status. Alternately, the trustee may commence a probate administration to hold the S corporation stock, because an administrative trust may not qualify as an eligible S corporation shareholder.<sup>1</sup> This procedure may be essential when the S Corporation stock is a substantial asset of the decedent.
  
2. Partnership Interests
  1. Effect of Death. A partner or a partner's successor in interest realizes partnership income at the close of the partnership year.<sup>2</sup> If the decedent dies late in the partnership year and sheltering income or deductions were realized by the decedent earlier in the year, the trustee should consider an immediate distribution to the surviving spouse in the year of death.
  
  2. Section 754 Election. The I.R.C. § 754 election would benefit the trustee if the value of the underlying assets as of the date of death exceeded their basis. The effect of such an election is to transfer the decedent's stepped-up basis in the partnership interest to the assets of the partnership.

## 16. GENERAL PRINCIPLES OF FIDUCIARY DUTY

One of the first tasks the practitioner must undertake is educating the trustee on the principles of fiduciary duty. The practitioner should begin by giving the trustee written materials which explain in general terms the role of a trustee in the administration of an irrevocable trust. These subjects should then be discussed in more detail at the initial meeting. In particular, the practitioner should discuss the following subjects with the trustee:

---

<sup>1</sup> I.R.C. § 1361(c)(2)(d).

<sup>2</sup> I.R.C. § 706(a).



1. The trustee has a duty to administer the trust according to the trust instrument. The trustee must therefore read and remain familiar with the terms of the trust instrument.<sup>1</sup>
2. The trustee has a duty to administer the trust solely for the benefit of the beneficiaries.<sup>2</sup> Where there are multiple beneficiaries, the trustee must deal impartially with all beneficiaries.<sup>3</sup>
3. The trustee must avoid conflicts of interest.<sup>4</sup> The trustee cannot act as trustee of another trust that may have interests adverse to the trust.<sup>5</sup>

---

<sup>1</sup> Prob. Code § 16000; See *Saks v. Damon Raike & Co.* (1992) 7 Cal. App.4th 419, 8 Cal. Rptr. 2d 869.

<sup>2</sup> Prob. Code § 16002; See *Pierce v. Lyman* (1991) 1 Cal. App. 4th 1093, 3 Cal. Rptr. 2d 236; *Van de Kamp v. Bank of America* (1988) 204 Cal. App. 3d 819, 251 Cal. Rptr. 530.

<sup>3</sup> Prob. Code § 16003.

<sup>4</sup> Prob. Code § 16004; See, e.g., *Estate of Auen* (1994) 30 Cal. App. 4th 300, 35 Cal. Rptr. 2d 557; *Ramirez v. Sturdevant* (1994) 21 Cal. App. 4th 904, 26 Cal. Rptr. 2d 554.

<sup>5</sup> Prob. Code § 16005.

4. The trustee has a duty to keep control of and preserve the trust property,<sup>6</sup> to make the trust property productive, unless the trust instrument provides otherwise,<sup>7</sup> to keep trust property separate from other property,<sup>8</sup> to enforce claims on behalf of the trust,<sup>9</sup> and to defend actions that may result in a loss to the trust.<sup>10</sup> The trustee should keep bank accounts in insured accounts to minimize risk of loss in the event of the failure of the institution.

---

<sup>6</sup> Prob. Code § 16006; See *Purdy v. Bank of America N. T. & S. Assn.* (1935) 2 Cal.2d 298; *Estate of Duffill* (1922) 188 Cal. 536.

<sup>7</sup> Prob. Code § 16007; *Saks v. Damon Raike & Co.* (1992) 7 Cal. App. 4th 419, 8 Cal. Rptr. 2d 869.

<sup>8</sup> Prob. Code § 16008.

<sup>9</sup> Prob. Code § 16010.

<sup>10</sup> Prob. Code § 16011.

5. The trustee generally may not delegate duties of the trustee to others,<sup>11</sup> but may delegate investment and management functions "as prudent under the circumstances".<sup>12</sup>
6. Except with respect to investment and management functions, which are governed by a different section of the Probate Code,<sup>13</sup> the trustee "shall administer the trust with reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument."<sup>14</sup>

The Uniform Prudent Investor Act<sup>15</sup> modifies the more traditional duties of a trustee as set out above. A duty imposed upon a new trustee by the Uniform Prudent Investor Act is the duty, "within a reasonable time after accepting the trusteeship" to "review the trust assets and make and

---

<sup>11</sup> Prob. Code § 16012.

<sup>12</sup> Prob. Code § 16052.

<sup>13</sup> Prob. Code § 16047.

<sup>14</sup> Prob. Code § 16040(a); See e.g. Pillsbury v. Karmgard (1994) 22 Cal. App. 4th 743, 27 Cal. Rptr. 2d 491; Di Grazia v. Anderlini (1994) 22 Cal. App. 4th 1337, 28 Cal. Rptr. 2d 37; Estate of Gump (1991) 1 Cal. App. 4th 582, 2 Cal. Rptr. 2d 269.

<sup>15</sup> Prob. Code §§ 16045 et seq.

implement decisions;"<sup>16</sup> that is, the trustee has the duty to prepare and complete an investment policy statement.

2. Review of Trust Law. After the practitioner has reviewed with the trustee the trustee's *duties* under state law and under the trust instrument, the practitioner should review with the trustee the *powers* given the trustee under the trust instrument and under state law.<sup>17</sup>

---

<sup>16</sup> Prob. Code § 16049.

<sup>17</sup> Prob. Code §§ 16200-16249.

3. Powers of Delegation. Except with respect to investment and management functions, the trustee has a duty not to delegate to others functions that the trustee can reasonably perform.<sup>18</sup> The duty not to delegate does not, however, preclude the trustee's employment of agents in the proper circumstances.
4. Clarifying Division of Responsibilities. Whether the practitioner or the trustee assumes responsibility for specific tasks incident to the administration of the trust, all persons concerned with the administration should have a clear understanding of these responsibilities, and to whom each task has been assigned. Once an understanding is reached, prudence would suggest that the practitioner confirm the assignments in writing.

17. FAILURE TO FUND: THE "STALE TRUST"

1. Defining the Problem. A "stale trust" is a trust that the trustee has neglected or abandoned. A "stale trust" results from a trustee's disregard of the trustee's fiduciary duties during the term of the trust. A stale trust can be created upon the death of the first spouse by the trustee's failure to fund the Bypass Trust and the Marital Trust. A stale trust also can result during the term of the survivor's lifetime by the trustee's failure to administer the subtrusts properly. Whatever the cause, the stale trust is usually not discovered until its existence has been a fact for several years.
2. Tracing Trust Transactions
  1. In General. Identifying trust assets at the time the stale trust is discovered usually requires tracing the assets back to the date of death of the deceased spouse.
  2. Never Funded. If the stale trust was stale from the beginning because none of the subtrusts was ever funded, curing the stale trust will be a daunting endeavor. If the deceased spouse died many years earlier, the trustee may not have the previous Form 706, estate tax return. The trustee may request a copy from the Service by completing IRS Form 4506.
  3. Poor Administration. A stale trust can also result from inattentive administration of the subtrusts

---

<sup>18</sup>

Prob. Code § 16012(a).

following their funding and termination of the administrative trust.

3. Tracing Trust Income. Allocation of trust income to the proper subtrust is a corollary to the problem of tracing trust assets. The trustee should have filed a Fiduciary Income Tax Return, IRS Form 1041, and California FTB Form 541, for each year that each irrevocable subtrust existed. In the context of the stale trust, it is unlikely that such returns were ever filed.
4. Tax Issues
  1. Income Tax. The practitioner should be sensitive to the income tax consequences of a late allocation of trust assets. 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 will be significant. This potential gain may become another reason to deter the trustee from "freshening" the stale trust.
  2. Estate Tax. The stale trust can 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.
5. Curing the Stale Trust. Curing the problems created by the stale trust will usually require considerable effort on the part of the practitioner. After the assets have been traced, and an allocation between the subtrusts has been completed, documents evidencing the allocation should be prepared and completed.

Similarly, fiduciary income tax returns should be prepared and filed for the years in which they were due but not filed. The 3-year statute of limitations<sup>1</sup> does

---

<sup>1</sup> I.R.C. §6501

not commence until a return has been filed;<sup>2</sup> consequently, every year for which a return is due will still be open.

6. Avoiding the Stale Trust. The most effective way to avoid a stale trust resulting from a failure to fund the subtrusts is to fund them quickly; *i.e.*, early in the administration process. Many of the problems discussed can be minimized, or avoided entirely, by allocating assets to the respective subtrusts in a timely manner at the conclusion of the term of the administrative trust.

---

<sup>2</sup>

I.R.C. §6501(a); *Hotel Equities Corp. v. Commissioner*, 546 F.2d 725 (7th Cir. 1976).