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INS AND OUTS OF THE ADMINISTRATIVE TRUST

John A. Hartog*

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INS AND OUTS OF THE ADMINISTRATIVE TRUST

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I. INTRODUCTION

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.

II. ESTABLISHING THE ADMINISTRATIVE TRUST

A. Theoretical Considerations. For income tax purposes, a *testamentary* trust does not come into existence when the testator or testatrix dies.[1] 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.[2] 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."[3] 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.

B. Power To Establish Administrative Trust

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1 *U.S. v. Britten*, 161 F.2d 921 (3d Cir. 1947).

2 See e.g. *Bryan Est. v. Comr.*, T.C. Memo 1963-182.

3 Treas. Regs. § 1.641(b)-3(b).

1. Disagreement exists whether the establishment of the administrative trust requires enabling language within the trust instrument.

2. One approach assumes that the typical language allowing the trustee to delay distribution until fulfillment of the fiduciary responsibilities enables the trustee to utilize the convenience of the administrative trust. Since the administrative trust is used primarily for income tax purposes, without implicating state law considerations, specific enabling language ought to be unnecessary.

3. Another approach contends that a trustee's authority is defined by the instrument. Without proper enabling language, therefore, a trustee cannot "create" an entity neither contemplated nor permitted by the instrument. This theory postulates that a trustee's ability to delay distribution to complete administrative tasks is for caretaking purposes only. Such language is not for the purpose of creating other trusts, even if the only purpose of such other trust is for income tax purposes. This analysis therefore requires specific permissive language within the original trust instrument.

4. This uncertainty should not serve as a material obstacle. The existence or absence of enabling language should be immaterial to the authority and ability of a trustee to marshal and distribute assets to the benefit of the beneficiaries.

5. Potential tax problems may arise regarding the marital deduction if enabling language is used. These potential problems can be addressed, however, if the language of the instrument makes clear that the use of the administrative trust is solely for administrative purposes.

6. Nevertheless, a plausible argument also exists that using a legal fiction (the administrative trust) simply for income tax reporting purposes is within the inherent power of the trustee. Therefore, enabling language within the instrument would be unnecessary.

C. Practical Considerations

1. Allocation of Responsibilities

a. An important early step in the administrative trust process is establishing clear lines of responsibility among the fiduciary's professional advisors.

b. This allocation of responsibilities usually occurs by agreement, but on rare occasions may require a "command decision" by the client.

c. Responsibilities that typically must be assigned include:

- preparation and filing of the estate tax return;
- filing of the Form 56;
- preparing and disseminating notice of the decedent's death;
- assisting the trustee in completing transfer of the assets comprising the trust estate by allocation or documented transfer;
- recording or filing transfer documents;
- reviewing trust assets and establishing an investment policy for those assets;
- preparation of income tax returns;
- establishing and maintaining trust books and records;

d. A part of the challenge when undergoing this process is creating a "team" approach among the trustee's advisors. The concept of cooperation is always honored in meetings, but the commitment occasionally is mere lip service.

e. The ability to create an integrated team approach is of course dependent upon the

willingness of the professionals not to act as "lone rangers."

f. The two participants with the greatest impact on being able to establish the "team" are the client and the lawyer. The client has an important impact simply because he or she is the client. The lawyer can have a substantial impact because the lawyer typically is the "quarterback" of the process.

g. The lawyer should therefore educate the client of the value to the team approach at an early date, because the client's insistence on this approach will inevitably prove persuasive to the other professional members of the team.

h. An obvious example of these strains can arise in the context of the preparation of the Estate Tax Return, Form 706. Trust and estate lawyers naturally presume that they are the best equipped to prepare the estate tax returns. In recent years accountants have discovered that assuming the responsibility for this work is a natural expansion of their practice areas. Clients often equate tax return preparation with accountants. This tension can lead to unseemly "turf wars" between the professionals who should otherwise be cooperating.

i. The professionals should not lose sight of the client's goals. Those goals are usually most effectively accomplished when the professional advisors accept the team approach.

2. Duration. The administrative trust may continue during the period reasonably required to complete administration, and distribute the trust assets to the successor beneficiaries.[4]

3. Fiduciary. The fiduciary responsible for administering a decedent's affairs is defined as

[4] 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.

"any person acting in any fiduciary capacity for any person."[5]

4. Mechanics of Establishing Trust.

   a. Upon assuming the trusteeship, the fiduciary should file with the District Director of the IRS notice of the commencement of the fiduciary relationship.[6]

   b. Form 56 should be filed with the California Franchise Tax Board as well as with the Internal Revenue Service.[7]

   c. Form 56 must be accompanied by evidence of fiduciary authority such as letters testamentary or letters of administration. A successor trustee should attach an Affidavit of Successor Trustee, declaring that the successor is the duly constituted successor trustee.

5. Re-titling Assets.

   a. Assuming that the revocable trust was properly funded, re-titling the various trust assets should not need to occur until the time is ripe for allocation to the subtrusts.

   b. Nevertheless, the issue of re-titling trust assets into the name of the administrative trustee, who is also usually the successor trustee, occasionally arises.

   c. Theoretical considerations, as well as practical obstacles exist, however, to discourage re-titling assets in the name of the administrative trustee.

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[5] I.R.C. § 7701(a)(6); Treas. Reg. § 301.7701-6.

[6] I.R.C. § 6903; Treas. Reg. § 301.6903-1.

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

(1) The theoretical problem with re-titling is that such a transfer may disqualify a gift otherwise intended to be eligible for the marital deduction. IRC section 2056 requires that property qualifying for the marital deduction "pass from" the decedent. An argument may exist for the IRS to assert that re-titling assets in the administrative trustee causes the subsequent distribution to the subtrusts as not qualifying as passing from the decedent.[8]

(2) The practical drawback arises from the extra work required to transfer assets for what should merely be an interim period. Additionally, third parties may unduly delay these transfers because the administrative trustee usually will not have evidence of authority satisfactory to these third parties. The administrative trustee usually does not possess a document equivalent to the probate letters issued by the court to a duly appointed personal representative.

6. 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.

D. 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

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8 See e.g. TAM 9610004

beneficiaries, similar in function to a probate estate.

E. 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.

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

A. 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.[1] Income from specifically devised property during administration belongs to the devisee, net of expenses attributable to the devised property.[2]

B. 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."

C. 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.

[1] Prob. Code § 12006

[2] Prob. Code ϶ 12002(b)

IV. UNIFORM PRINCIPAL AND INCOME ACT (UPAIA)

A. Effective January 1, 2000, the UPAIA, will be found in Probate Code sections 16320 et seq., and will apply to all existing trusts and estates administered in California.[1]

B. The UPAIA is intended to bring fiduciary accounting principals into conformity with the financial discipline and objectives expressed in the Uniform Prudent Investor Act ("UPIA").[2]

C. The UPAIA has as its nominal purpose the goal of affording the trustee with maximum flexibility. This stated goal is consistent with the stated goal of the UPIA. Nevertheless, the intended purpose of flexibility may create unintended exposure for a fiduciary who fails to comply with these revised accounting standards.

D. The new act allows the trustee to make adjustments between principal and income "to the extent the trustee considers necessary"[3] if all of the following conditions are satisfied:

(1) The trustee invests and manages trust assets under the Prudent Investor Rule.

(2) The trust describes the amount that shall or may be distributed to a beneficiary by referring to the trust's income.

(3) The trustee determines . . . that the trustee is unable to administer the trust impartially.

(4) Notwithstanding the power granted by Probate Code section 16336(a), subdivision (b) prohibits the exercise of this power if the adjustment to be made by the trustee would result in the diminution of a beneficiary's interest, either by

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[1] Probate Code section 16339

[2] The UPIA is found at Probate Code section 16045 et seq.

[3] Probate Code section 16336

an actuarial calculation, or by jeopardizing the marital deduction.

E. Probate Code section 16336(f) specifically allows a trustee to overrule a limitation on the trustee's power to make adjustments between principal and income "unless it is clear from the trust that it is intended to deny the trustee the power of adjustment . . .."

F. This section appears to be one that will be an invitation to litigation in the appropriate factual circumstances regarding the clarity of the trust language intending to deny the trustee this power. If this hypothesis appears remote, practitioners only need consider the several recent cases interpreting the effect of the equitable apportionment statutes on tax allocation clauses.[4]

G. Probate Code section 16336 also sets out the standard by which the trustee may exercise the power to make adjustments. This standard consists of the following guidelines:

(1) The nature, purpose and expected duration of the trust;

(2) The intent of the settlor;

(3) The identity and circumstances of the beneficiary;

(4) The need for liquidity, regularity of income, and preservation and appreciation of capital;

(5) The assets held in the trust, and the various allocation to different asset categories, and whether an asset was purchased by the trustee or received from the settlor;

(6) The net amount allocated to income;

(7) The extent to which the trust gives the trustee the power to invade principal or accumulate income;

(8) The actual and anticipated effect of economic

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[4] See, e.g. *Estate of Wathen* (1997) 56 Cal.App.4th 48

conditions on principal and income, as well as the effects of inflation and deflation;

(9) The anticipated tax consequences of the adjustment;

H. As a practitioner can readily infer, this standard is so broad as to constitute no meaningful guideline at all. The interest in preserving fiduciary flexibility will have the undoubted effect of preventing a trustee from gaining any security in having a safe harbor. In short, it appears that this standard will allow a trustee intent on making the adjustments to be able to find any kind of rationalization in which to do so. Similarly, this standard will allow a trustee to refrain from making any adjustments, even when it would be beneficial to do so, or from being able to make a decision to act affirmatively.

I. One of the significant procedural developments contained in the UPAIA concerns the ability of the trustee to change fiduciary accounting principles by means of a notice of proposed action.[5] The new section defines matters covered by this notice as including a course of action, as well as covering courses of inaction.

J. Persons entitled to receive this notice include income and principal beneficiaries. The notice of proposed action is not required to be served upon a beneficiary who consents in writing to the trustee’s proposed action or inaction.

K. New Probate Code §16337(d) sets out the procedural requirements for a trustee to comply in order to avoid liability for adopting the course of action or inaction.

L. The notice must specify that the receiving beneficiary must have not less than 30 days in which to object to the trustee’s proposed action or inaction.

M. The beneficiary must serve a written objection to the notice of proposed action within the time period specified in the notice. If the beneficiary fails to serve this written objection in a timely fashion, the

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[5] Probate Code §16337

trustee will not be liable subsequently to the beneficiary for adopting the action or inaction subject to the notice.

N. If an objection is timely received by the trustee from a beneficiary, the trustee has the recourse to then file a petition with the court seeking confirmation of the trustee's action.

V. CREDITORS' RIGHTS AGAINST THE TRUST AND TRUST BENEFICIARIES

A. Creditors of a Trustee

1. The trust estate is not, as a general rule, liable for a trustee's individual debts as distinguished from those debts incurred on behalf of the trust.

2. Thus, property in the name of a debtor which the debtor holds in trust for another (i.e., a client trust account) cannot be used or subjected to the payment of the debtor/trustee's individual debts.[1]

B. Creditors of the Trust

1. Initially, the trustee has the powers given by the trust instrument and the Probate Code.[2] Unless restricted by the Probate Code, the powers are extensive and additional powers may be inferred from Probate Code § 16200(c) giving the trustee the power "to perform any act that a trustee would perform for the purposes of the trust under the standard of care provided in Section 16040."

2. Creditors must enforce their claims against the trust in the civil courts; however, the probate court has concurrent jurisdiction over such actions,[3] and if combined with a petition concerning the internal affairs of the trust [i.e., a petition for instructions under Probate

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[1] (*Nishi v. Downing* (1937) 21 C.A.2d 1, 67 P.2d 1057; *Miller v. Miller* (1942) 55 C.A.2d 199, 130 P.2d 438)

[2] Probate Code §§ 16200-16249

[3] Probate Code § 17000(b)

Code § 17200(6)], the probate court could hear and determine both actions.

a. However, if no consideration was given settlor for the creation of the trust (which is usually the case), then it may be possible to apply the Uniform Fraudulent Conveyance Act[4] to the transaction and invalidate the trust.

b. Query: effect of settlor retaining a general power of appointment?[5]

3. <u>Revocable Trusts: Before Settlor's Death</u>

4. Probate Code § 18200 provides that the trust estate is subject to the claims of a creditor of settlor to the extent of the power to revoke. In short, the trust can be ignored to the extent that it is revocable.

5. <u>Revocable Trusts: After Settlor's Death</u>[6] The assets of the trust subject to the settlor's power to revoke are subject to the claims of the creditor's of the deceased settlor "to the extent that the deceased settlor's estate is inadequate to satisfy those claims and expenses."[7]

a. Definition of claims.[8] Family allowance is not a claim for which the trust estate is liable.[9]

(1) Queries:

(a) If there is a probate estate, creditor must file a creditor's

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4 Civ. Code §§ 3439-3440.9

5 See Probate Code §§ 680-684

6 Probate Code §§ 19000-19400

7 Probate Code § 19001

8 Probate Code § 19000

9 Probate Code § 19001; *Parson v. Parson* (1996) 49 C.A.4th 537, 56 C.R.2d 686

claim. What then?

(b) Must the decedent's estate be exhausted before resort to the trust?

(c) What does the term "inadequate" mean?

(d) Must all specific gifts under a will abate before determining that an estate is "inadequate"?

(e) What constitutes "the decedent's estate"? Probably not assets passing outside decedent's estate (i.e., life insurance proceeds or joint tenancy assets. However, what about community property passing to a surviving spouse? Or property transferred under Probate Code § 13100 et seq.?

b. In the event of doubt as to whether the trust is liable for payment, the trustee may petition the court for instructions under Probate Code § 17200(b)(20).

c. If no petition for administration of a deceased settlor's estate has been filed, the trustee may voluntarily file a proposed notice to creditors in the probate court which initiates a trustee's notice and claim procedure for creditors[10]

(1) The entire statutory procedure for trust creditors' claims parallels decedent's estates set forth in Probate Code §§ 9000, et seq.

(2) There is no duty on a trustee to initiate or liability of a trustee for failure to initiate the claims notice procedure[11]

[10] Probate Code § 19003, et seq.

[11] Probate Code § 19010

d. Caveat: Code of Civil Procedure § 366.2 should not be overlooked in strategic planning as the filing of the creditor's claim (not the notice to creditors) tolls the statutes of limitation until the trustee acts on the claim.[12]

e. Options of Creditors:

(1) Force a probate.

(2) Sue the trust as a "successor-in-interest" of deceased settlor[13] under Probate Code § 19001(a).

(3) Do both.

f. *In re Marriage of Perry* (1997) 58 Cal.App.4th 1104, 68 Cal.Rptr. 2d 445. A case in which an arguably proper result was reached by use of a peculiar analysis. The case demonstrates the court's attitude with respect to use of trust to avoid just debts.

6. Judgments Against Settlor or Trust[14]

a. Money judgments are payable in the course of administration of the trust and are not enforceable against the trust property.[15]

b. A judgment for the possession of specific trust property or sale of specific trust property (not money judgment) may be enforced by execution under Code of Civil Procedure § 680.10 et seq.[16]

c. If the trust property was subject to a judgment lien or attachment lien which is

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[12] Probate Code § 19253(b)

[13] Code Civ. Proc. §§ 377.11 and 377.41

[14] Probate Code §§ 19300-19304

[15] Probate Code § 19300(a)

[16] Probate Code § 19302

subsequently converted into a judgment lien, then a creditor may execute on the trust property pursuant to the provisions of the Code of Civil Procedure[17]

(1) Probate Code § 15306.5 – general judgment creditor:

(a) General judgment creditors may reach part or all of mandatory or discretionary payments to the beneficiary upon petition under Code of Civil Procedure § 709.010 subject to the following:

(i) Amounts necessary for the support of the beneficiary or the beneficiary's dependents are excluded.

What is the standard to be determined as necessary for beneficiary support?

(ii) The order may not require that more than 25% to be paid to the creditor. If there is more than one such order, the aggregate may not exceed 25%, except orders for payment of support judgments may exceed the 25% limitation.

(iii) Payments of a support judgment will reduce the amount available for payment to general judgment creditors so that if support payments exceed 25%, the creditor receives nothing.

(iv) A support judgment has priority over any other judgment.

(b) There is no provision dealing with

[17] Probate Code §§ 19303, 19304

the priorities of general judgment creditors or of payments to multiple general judgment creditors. Since the court has the discretion to satisfy "all or part" of the judgment, it seems logical to assume the court could exercise such discretion by deciding how much to pay each general judgment creditor.

(c) This section does not compel a trustee to exercise discretion in order to provide funds to satisfy the beneficiary's creditors. Thus, the trustee with discretion could alter the amount or terminate payment to the beneficiary entirely and defeat the creditor's judgment.

(d) The trustee has no obligation to oppose a petition by a general judgment creditor or assert any claim of exemption on behalf of the beneficiary.[18]

d. Any amount in excess of that required for the support and education of beneficiary may be ordered by the court to be paid to satisfy a money judgment against the beneficiary.[19]

(1) How does this section apply in light of the 25% limitation of Probate Code § 15306.5?

(2) What is the standard to determine the appropriate support or education level? Is the standard different than the amount necessary for support of § 15306.5? If the standard is the beneficiary's "station in life", a rich spendthrift beneficiary support level

[18] Probate Code § 15306.5(e)

[19] Probate Code § 15307

may be considerably higher than a poor beneficiary's to the detriment of a creditor.[20]

e. Under the prior law (which presumably still applies), the burden of showing the existence of the surplus payments to the beneficiary is on the creditor.[21]

f. Notwithstanding state law, the Internal Revenue Service can levy on all of a beneficiary's interest in a non-spendthrift or spendthrift trust.[22]

7. Liability of Distributee/Beneficiaries (Probate Code §§ 19400-19403)

a. Subject to Code of Civil Procedure § 366.2 (1-year statute of limitations against decedents), if there is no probate estate and the trustee does not initiate the creditor claim notice pursuant to Probate Code § 19040, et seq., then a beneficiary who receives a distribution from the trust is personally liable for the unsecured claim of the creditors of deceased settlor's estate.[23]

b. Even if the trustee filed and published a creditor's claim notice and if the identity was known to, or reasonably ascertainable by, the trustee within 4 months of the publication of notice, then a beneficiary is personally liable for the creditor's claim, without a claim being filed, if

(1) the claim was not merely conjectural;

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20 See *Magner v. Crooks* (1903) 139 C. 640, 73 P.585, where the court adopted the "station in life" standard under old law.

21 *Estate of Laurence* (1968) 267 C.A.2d 77, 72 C.R. 851; *DiMara v. Bank of California, supra*

22 IRC § 6331: *Leuschner v. First Western Bank* (9th Cir. 1958) 261 F.2d 705

23 Probate Code § 19400; On the horizon - a public policy exception for a beneficiary's intentional or negligent tort creditors? See *Sligh and Sligh v. First National Bank, Trustee*, 1997 Miss. Lexis 505 (Miss. 1997)

(2) notice was not given to the creditor and neither the creditor nor his attorney had actual knowledge of the administration of the trust estate sooner than one year after the first publication; and

(3) the statute of limitations of Code of Civil Procedure § 366.2 has not run.[24]

c. Both §§ 19400 and 19401 are subject to the provisions of Probate Code § 19402 which provides that:

(1) the distributee may assert any defense, cross-complaint or setoff available to the deceased settlor; and

(2) the personal liability is only to the extent that the claim cannot be satisfied from the trust estate and is limited to the prorata portion based on the proportion that the value of the property received by the beneficiary bears to the total trust assets distributed to all beneficiaries; and

(3) the personal liability shall not exceed the fair market value of the property on the date of distribution to the beneficiary from the trust.

d. The prorata liability provisions of 19402 applied to only one defendant beneficiary (others were not named and trustee was not liable for distributing trust even if it was intended to defeat creditor's claim).[25]

8. Statute of Limitations/Code of Civil Procedure § 366.2

a. In the wake of *Tulsa Professional Collection Services, Inc. v. Pope* (1988) 485 U.S. 478, 108 S.Ct. 1340, the California legislature

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[24] Probate Code § 19401

[25] *Valentine v. Read* (1996) 50 C.A.4th 787, 57 C.R.2d 836

not only enacted substantial changes in the creditor claim notice provisions set forth in Probate Code § 9050, et seq., but also enacted Code of Civil Procedure § 366.2 as a self-executing 1-year statute of limitations on claims against a deceased person.

b. Code of Civil Procedure § 366.2 provides that if a person against whom an action may be brought on an "accrued or unaccrued liability" whether arising in contract, tort "or otherwise" dies before expiration of the applicable statute of limitations and the cause of action survives (see C.C.P. § 377.20, et seq.), suit must be commenced within 1 year after the date of the said deceased person and the otherwise applicable statute of limitations does not apply.

   (1) Caveat: This statute can have the effect of extending or reducing the normal statute of limitations period.

   (2) This statute by its terms applies only to the decedent and does not apply to other persons who may be jointly or severally liable on the same cause of action.

c. Furthermore, Code of Civil Procedure § 366.2 is "not tolled or extended for any reason" except by:

   (1) timely filing of a creditor's claim

   (2) a § 9103 petition to file a late claim

   Query: Can the filing of such a petition prior to the order for final distribution extend beyond the 1-year limitations period?

   (3) timely filing of a Probate Code § 19000 revocable trust asset claim

   (4) filing of a Probate Code § 21300 declaratory relief petition on no-contest clauses.

d. Exceptions: At the present time, there are two statutory exceptions and one recently decided case law exception to the applicability or enforceability of Code of Civil Procedure § 366.2:

(1) Insured claims against the decedent may be pursued so long as limited to the insurance coverage and may be filed after the 1-year period;[26]

(2) Lien claims in which the lienholder files a judicial foreclosure where the lienholder expressly waives all recourse against other property in the estate;[27]

(3) Equitable estoppel[28]

e. A creditor's compliance with the Probate Code filing requirements pursuant to Probate Code § 8000 et seq. Is a prerequisite to a creditor's right to maintain an action on the claim.[29] Therefore, if there is no probate estate opened, a creditor must open an estate and file the claim prior to the running of the 1-year period under Code of Civil Procedure § 366.2 to preserve his claim.

Caveat: The *Battuello* case may now provide an equitable estoppel defense to the 1-year limitation.

f. Strategic considerations.

9. Election of Remedies and Secured Debts

a. The doctrine of election of remedies applies where the filing of a claim is inconsistent

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[26] Probate Code §§ 550-555

[27] Probate Code § 9391

[28] See *Battuello v. Battuello*, (1998) 64 Cal.App.4th 842

[29] Probate Code § 9002

with another remedy. For example, if at the date of decedent's death there is a conditional sales contract for personalty (i.e., stock or chattel), the filing of a creditor's claim is a waiver of the right to repossess the personalty.[30] However, this election does not apply to a vendor's lien on the sale of realty to decedent.[31]

b. The Probate Code allows for the filing of a creditor's claim on a secured debt.[32] However, if no claim is filed, the rights to a deficiency judgment and attorney fees or to proceed against other estate property must be waived upon a judicial foreclosure.[33]

c. A creditor may file a nonjudicial foreclosure against the estate property securing the debt without filing a claim (or even after filing a claim) and without a Probate Code § 9391 waiver because recourse to <u>other</u> estate property is barred as a matter of law.[34]

d. Strategic Considerations.

10. <u>Liability for Payment of Creditor's Claims</u>

a. In general, all of a decedent's estate property is chargeable with the payment of decedent's debts, expenses of administration and family allowance (except property exempt from execution such as a probate homestead or small estates set aside) in the order of priority set forth in Probate Code § 11420.

b. Certain preferred debts set forth in Probate Code § 11421 (funeral expenses, last

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30 *Holt Mfg. Co. v. Ewing* (1895) 109 Cal.353, 42 Pac. 435

31 *Selna v. Selna* (1899) 125 Cal. 357, 58 Pac. 16

32 See Probate Code § 9152(b)

33 Probate Code § 9391

34 C.C.P. §§ 580b, 580d; *Cosentino v. Coastal Const. Co.* (1994) 30 Cal.App.4th 1712, 36 Cal.Rptr.2d 444

illness, family allowance and wage claims) are to be paid as soon as the personal representative has sufficient funds to do so. All remaining claims are not required to be paid until payment has been ordered by the court.[35]

c. If the personal representative fails to pay a debt as ordered by the court, the personal representative individually and the surety bond are liable for its payment.[36] However, an unpaid creditor (whether or not ordered to be paid by the court) has no right of contribution from another creditor who is paid.[37]

d. A distributee of estate property may be liable to an unpaid creditor, even if no claim is filed, but only if the conditions set forth in Probate Code § 9392 are satisfied. The conditions to be satisfied are:

(1) the creditor was known to, or reasonably ascertainable, within 4 months by the personal representative;

(2) the claim is not merely conjectural;

(3) notice of administration was not given to the creditor;

(4) neither the creditor nor his attorney had actual knowledge of the administration of the estate before the final order for distribution;

(5) the statute of limitations under Code of Civil Procedure § 366.2 has not expired.[38]

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[35] Probate Code § 11422

[36] Probate Code § 11424

[37] Probate Code § 11429

[38] Does this mean that only estates closed within one year of the date of death qualify?

e. Assuming all of these conditions are satisfied, liability of the distributee is allowed only to the extent that the claim cannot be satisfied out of the decedent's estate and then is limited to a prorata portion of the total distributed property not to exceed the equity value of the property on the date of distribution.[39]

VI. INCOME TAXATION OF ADMINISTRATIVE TRUST

A. Tax Year. Each trust is required to adopt the calendar year as its taxable year.[1] 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.

B. Taxed as Irrevocable Trust. On the death of the settlor the trust becomes irrevocable, functioning as a separate taxpayer for income tax purposes.[2] 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.[3]

C. Accumulation Distributions. Unlike an estate, an administrative trust is subject to the throwback rules for distributions of accumulated income.[4] Ultimate distributions from the administrative trust, however, should not be subject to the throwback rules.[5]

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39 Probate Code § 9392(b)

1 I.R.C. § 645

2 *See* Rev. Rul. 57-51 1957-1 C.B. 171

3 Treas. Reg. § 1.641(b)-3(b)

4 I.R.C. § 666(a)(d)-1A

5 Treas. Reg. § 1.665(d)-1A

D. 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.[6] 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).

E. 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. э 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.[7]

F. 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.[8] In addition, the allocation must be made "by the fiduciary on its books or by notice to the beneficiary."[9] As a general rule, and under California law, such gains will be allocated to principal.[10]

G. Taxation of Unrealized Appreciation. In Rev. Rul. 85-116,[11] the IRS has ruled that a portion of the gain

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6 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."

7 I.R.C. § 643(e)(1)

8 Treas. Reg. § 1.643(a)-3(a)

9 Treas. Reg. § 1.643(a)-(3)(a)

10 Prob. Code § 16303(b)(1)

11 1985-2 C.B. 174

realized by a trust was includible in DNI. That ruling also stated that the portion of the gain includible in 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.

H. Quarterly Estimated Tax Payments

1. General Rule. A trust must pay its income tax liability in quarterly installments.[12] 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[13] exceeds $150,000, the prior year safe harbor is 110% rather than 100%.[14]

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.[15]

VII. FILING REQUIREMENTS

A. Income Tax

1. Filing the Final Income Tax Return. The successor trustee will have the task of filing a

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[12] I.R.C. § 6654(l)

[13] As defined in I.R.C. § 67(e)

[14] I.R.C. § 6654(d)(1)(C)

[15] 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.

decedent's final federal income tax return for the tax year ended on the date of decedent's death.[5] 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.[6]

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.[7] The spouse's income for the full year would be included in the return.

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.[8] 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.[9] 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[10] further provides that, in the absence of evidence to the contrary, the deductible amount is determined using a formula.[11]

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5 I.R.C. § 6013; Treas. Reg. § 1.443-1

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

7 I.R.C. § 6013(a)(3)

8 Treas. Reg. § 20.2053-6(f)

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

10 Treas. Reg. § 20.2053-6(f)

11 (Joint tax) x (decedent's separate tax) both separate taxes).

B. 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.[12]

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.[13] 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 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.[14]

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.[15]

   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.[16] The trust then reports only the interest earned after death and no part of this interest is considered income in respect

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[12] I.R.C. § 6013

[13] I.R.C. § 454(c); Treas. Reg. § 1.454-1(a)(3)

[14] Treas. Reg. § 1.451-2(b)

[15] I.R.C. § 454

[16] Rev. Rul. 68-145 1968-1 CB 203

of a decedent.[17] 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.[18] If the interest earned before death is considered income in respect of a decedent, it is not included in the decedent's final return.[19]

3. Partnership Income. The taxable year of a partnership generally does not close as a consequence of a partner's death.[20] 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.[21] 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.[22]

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.[23] To be effective, the remaining buyers should avoid treatment as a liquidation of the deceased partner's interest.[24]

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[17] Rev. Rul. 68-145 1968-1 CB 203

[18] Rev. Rul. 79-409, 1979-2 CB 208

[19] Rev. Rul. 79-409, 1979-2 CB 208

[20] I.R.C. § 706(c)(1)

[21] I.R.C. § 706(a)

[22] Treas. Reg. § 1.691(a)-1(b)

[23] I.R.C. § 706(c)(2)(I)

[24] I.R.C. § 736

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.

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

C. Deductions

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

2. Medical Expenses. Unpaid medical expenses incurred by the decedent before death are deductible against the decedent's gross estate as debts.[29] 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.[30]

3. Losses. Net operating loss (NOL) carryovers from business operations in a prior year and capital loss carryovers are deductible only on a decedent's final income tax return.[31]

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25 I.R.C. § 408, § 219

26 Letter Ruling 8439066

27 *Poorbaugh v. U.S.*, 69-1 USTC Para.9134 (D. Pa. 1968)

28 Rev. Rul. 71-159, 1971-1 C.B. 50

29 I.R.C. § 2053

30 I.R.C. § 213(c)

31 I.R.C. § 172

VIII. 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.

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

A. 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.

B. 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.

C. Other Effects. Delays in funding can cause recognition of capital gain if an appreciated asset is used to fund a pecuniary formula gift.

D. 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.

E. 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.

X. INCOME TAX ISSUES OF DISTRIBUTIONS AND FUNDING MARITAL DEVISES

A. 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.[1] 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.[2]

2. Determining Distribution Date. California appears to follow the common law that requires distribution of property as of the date of its distribution.[3]

3. Assets to Fund Pecuniary Bequests. The funding of a pecuniary formula gift is not considered the devise of a specific sum of money.[4]

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.[5]

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1 Treas. Regs. § 1.1014-4(a)(3)

2 I.R.C. § 267(b)(6)

3 Treas. Reg. § 1.663(a)-1(b)(1)

4 Treas. Reg. § 1.663(a)-1(b)(1)

5 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.

B. 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[6] and reportable as taxable income by the beneficiary.[7]

2. Distributions to Satisfy a Specific Devise. Distributions in satisfaction of a specific devise do not carry out DNI.[8]

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.[9]

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.

C. Timing of Distributions: Basic Rules. Income is deductible by the distributing trust[10] up to the amount of DNI, with a like amount includable in the income of the recipient trust.[11]

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6 I.R.C. § 661

7 I.R.C. § 662

8 I.R.C. § 663(a)(3)

9 Treas. Reg. § 1.663(a)-1(b)(1)

10 I.R.C. § 661

11 I.R.C. § 662

D. 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.[12] In *Chenoweth v. U.S.*,[13] 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.*,[14] in which the value of nonvoting common stock recapitalized after death into preferred stock as required by the decedent's will was not altered.

E. 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,[15] and trapping distributions are not useful.

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

A. Internal Allocation. California law generally requires the trustee to keep trust property separate and designated as property of the trust.[1] Nevertheless, a trustee may make an "internal"

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12 *See Chenoweth v. U.S.* (1987) 88 T.C. 1577

13 *Chenoweth v. U.S.* (1987) 88 T.C. 1577

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

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

1 Prob. Code § 16009

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.[2] The Tax Court has ruled that mere bookkeeping entries are not enough to constitute a distribution for income tax purposes.[3] 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. 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.

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

A. 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

[2] Prob. Code § 16009

[3] *See Estate of Johnson*, 88 T.C. 225

trustee's professional advisor, should convey title, by deed or otherwise, to the name of the new subtrusts.

B. 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.[1] 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.[2]

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[1] *Estate of Johnson* (1988) 88 T.C. 14

[2] TAM 9413005

XIII. MECHANICS AND DOCUMENTATION OF DIVIDING THE ADMINISTRATIVE TRUST

A. 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.

B. Taxpayer Identification Number. All irrevocable trusts must obtain a separate taxpayer identification number.[1] 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.

C. 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 disposed of within six months after the date of death must be valued as of the date of distribution, sale, exchange or disposition.[2]

D. 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.

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[1] Treas. Reg. § 31.6011(b)-1(a)(1)

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

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

A. 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.[1] This procedure may be essential when the S Corporation stock is a substantial asset of the decedent.

B. 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.[2] 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.

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[1] I.R.C. § 1361(c)(2)(d)

[2] I.R.C. § 706(a)