

## **WHO IS THE SUCCESSOR TRUSTEE OF YOUR LIVING TRUST?**

### **THE PROBLEMS, DIFFICULTIES, AND FAMILY FIGHTS THAT MAY ARISE WHEN A NEW TRUSTEE TAKES OVER AND DOES NOT DO HIS OR HER JOB CORRECTLY AND PROMPTLY**

When husband and wife set up a living trust or when a widow or widower establishes a trust, the question is who becomes the trustee to administer the trust upon the death or incapacity of all of the trust creators. Frequently, the party or parties will name one or more children or other relatives. They may name their daughter, who is an attorney, or nephew, who is a CPA, feeling that the person's background will make him or her competent to act as a trustee.

A trustee of a trust needs to spend the time and energy to determine what he or she legally has to do, and then, usually subject to guidance from an attorney, carry out these duties. Too often, the person named as trustee has a job which requires 40 hours or more per week of work, sometimes with extensive travel, plus a family, and while the trustee's job does finally get done, it may take three years to complete what should have been done in six months.

In one trust, husband and wife both die within a few months of each other and name the wife's nephew, who is the senior litigation attorney for a major law firm, to handle the trust, which continues for the couple's only child. The trustee is 3,000 miles away and is constantly traveling and handling court cases. The attorney for the trust and the nephew's paralegal together handle all of the trust matters. However, it takes two years, instead of what should have been a nine month period.

In another case, a son is named as trustee, and when his mother dies, the trust ends with assets going to the decedent's three children. The son constantly travels so his mother's home sits vacant and neglected for two years before it is put on the market for sale. The other two children constantly complain and finally hire an attorney and threaten to sue their brother if he does not sell the home and distribute the assets. After the trust is finally closed, the siblings never speak to their brother again.

Selecting the right trustee or trustees is very important. The most important factor is appointing someone who has the time to determine what has to be done to carry out the work. The learning experience can be a steep curve, but if someone is willing to spend 10-20 hours a week for several weeks, he or she can quickly accomplish most of the required tasks.

Second, the trustee needs an attorney to advise that him or her. Many people believe a trust is simple to handle so they avoid an attorney. Others do not wish to pay the costs involved. If the trustee makes any mistakes and is challenged by a trust beneficiary, the trustee may have to pay costs and expenses out of his or her pocket. Even where family members are involved, the emotions can run very high after a parent's death, and siblings can be challenged to justify what they are doing.

The trustee's job, when it arises, is to take charge of all of the trust assets, handle the investments for these assets including possible sale of securities and real estate, keep detailed accounting records, make any required or discretionary payments from the trust, see that annual tax returns are filed for the trust, and prepare and mail annual accountings to the trust beneficiaries. Sometimes the trusts end when both the parents die, and sometimes the trusts continue for the benefit of a family member.

### **Trustee's Duties**

A trustee of an irrevocable trust in California acts as a "fiduciary" and has the responsibility to carry out the duties of a trustee as set forth in the law. If the trustee fails to carry out these duties properly, the trustee is liable for any loss involved, may be liable for punitive damages, and may have to pay all legal fees and costs for the person bringing the legal action as well as the legal fees for the trustee's defense. A trustee, if challenged, must prove what he or she did, that it was proper, and that it was done for the good of the trust and the trust beneficiary or beneficiaries.

A trustee is not exempt under the law because he or she is the spouse or child of the trust creator. Although a husband may establish an irrevocable trust at death for his wife and the wife may be the trustee and beneficiary, the children, who receive the trust assets at their mother's death, still have legal rights. They may demand an accounting, inquire as to investments, question payments of principal for their mother's health and support, and even bring a legal action against their mother for the claimed mismanagement of the trust. It is not unusual for a child or children to sue a parent, or for a brother or sister to sue a sibling.

### **Irrevocable Trusts**

In California, a trust is revocable unless the trust document provides otherwise. Trusts are created by a written agreement frequently referred to as a "living trust" or are created in a will of someone who dies, which is called a "testamentary trust." The duties of a trustee of either type of trust are the same.

Irrevocable trusts include the following:

1. A "B" trust or "B" and "C" trusts created by husband and wife after the death of the first spouse.
2. An "A" and "B" trust or "A," "B," and "C" trust upon the death of the surviving spouse.
3. A trust created by a single person after that person dies.
4. An irrevocable trust which was created initially as an irrevocable trust, such as one for the benefit of children and grandchildren.

5. A charitable remainder trust which provides payments to someone during his or her lifetime and then terminates with the assets going to a charity or charities upon the person's death.

Frequently, a husband and wife will establish a living trust to save estate taxes and avoid probate. On the first spouse's death, the trust is divided into sub-trusts, frequently referred to as trusts "A" and "B" or trusts "A," "B," and "C." Usually trust "A" continues as a revocable trust for the benefit of the surviving spouse with trust "B" or trusts "B" and "C" being irrevocable trusts. Many trust documents use different terms for these trusts, referring to them as "survivor's trust," "marital trust," "family trust," "exemption trust," or "qualified terminable interest trust" (QTIP). Although the terms used are different, the types of trust are the same.

After both husband and wife die, all of their trusts become irrevocable, even though the trusts may terminate and go to the couple's children. It takes from six months to several years to conclude the administration of these trusts.

Husband and wife may also direct that after they both die, one or more trusts will continue for the benefit of a child, children, or grandchildren, either for the lifetime of someone or for a period of years. These trusts are also irrevocable.

A single person may set up a revocable trust to avoid probate. After the person's death, the trust becomes irrevocable until the assets are finally distributed. Or, a portion or all of the trust may continue for a period of time, and the trust or trusts will be irrevocable.

An individual or a couple may set up an irrevocable trust to make gifts to their children or grandchildren, an irrevocable charitable remainder trust to benefit a charity and save taxes, or an irrevocable trust to hold life insurance to pay taxes at death and to escape estate taxes on the life insurance. To accomplish this, any such trust must be irrevocable from its inception.

### **Initial Duties of the Trustee**

No trustee is required to serve as trustee. A trustee may legally decline to act, and the next named trustee will then serve. If no successor trustee is named, the local Superior Court can be petitioned to have a bank or individual appointed as the trustee.

Once someone agrees to act as trustee, that person may later resign, but the person cannot be relieved of his or her duty as the trustee until the next named or court appointed trustee takes over.

If several people are named as co-trustees they must act unanimously, not by majority vote, and all are jointly liable for their actions.

The new trustee must carefully read the trust document, such as the will or trust agreement, as to what has to be done by the trustee. The new trustee should immediately inquire what assets are in the trust or what assets will later be coming into the trust such

as through a probate, or by beneficiary designation of a life insurance policy or retirement plan.

In addition, the trustee or trustees must give notification to certain people.

1. If the trust becomes irrevocable due to the death of someone, the trustee must give a specific notice to anyone who has or may have a future interest in the trust and to all of the decedent's heirs at law. This specially worded notice must advise the parties that they have 120 days to contest the trust by a court action and that they may request a copy of the trust and any amendments made to it. If the notification is not made, the trustee may have personal liability for future legal action and costs.
2. If the trust was already irrevocable but there is only a change of trustee, then a notice as to the change of trustee and trustee's address must be mailed to all trust beneficiaries and anyone who may have a future interest in the trust.

If any California real estate is owned, a special notice must be sent to the county assessor for each parcel of real estate owned by the trust. This notice must advise the assessor of the change of trust ownership and whether the property is subject to reassessment or not for California real estate taxes.

The trustee must also quickly take charge of all trust assets and reregister the assets in his or her name as trustee. Assets might be registered in the name of "John Doe, Trustee of the Mary L. Doe living Trust, dated 9-7-98." If a tax identification number has not been previously obtained by the trust, the trustee must complete an Internal Revenue Service form, form SS-4, and forward it to the local Internal Revenue Service Center to obtain this number or obtain the number from the IRS website. This tax identification number will then be used in lieu of a social security number for all trust assets and for all future trust income tax returns.

### **Legal Duties of a Trustee**

California Probate code section 16000-16042 sets forth the general legal duties of a trustee. These include

1. Administering a trust in accordance with the trust provisions.
2. Administering the trust solely for the benefit of the interest of the trust beneficiary or beneficiaries.
3. Where there are two or more trust beneficiaries, dealing impartially with each beneficiary.
4. Not using trust property for the trustee's own profit.
5. Not having any adverse interests to the current trust.
6. Taking reasonable steps to control and preserve trust property.

7. Keeping trust assets registered in the trust name and keeping them separate from the trustee's personal assets.
8. Not delegating to others the duties of the trustee.
9. Where there is a co-trustee or trustees, participating jointly and not turning over trust administration to the other trustee or trustees.
10. Using the trustee's skill in running the trust.

### **Valuing and Handling Trust Assets**

Where the trust has become irrevocable due to the death of the trust creator and the assets are subject to federal estate tax, the trustee must value all of the trust assets as of the date of death, and also determine if a federal estate tax return is due. If one is due, it must be filed within nine months of the date of death, although this may be extended for up to an additional six month period.

If the trust was previously irrevocable and there is merely a change in trustee, then the new trustee must obtain income tax information on the cost basis of the assets and their current value.

If a trust terminates and goes to several people, the trustee is allowed under California law (unless the trust document prohibits it) to distribute different assets to different people, based on the current fair market value of these assets. If assets go to three children, it is not necessary to divide each asset and to give each child one-third of each asset. Instead the trustee may give all of one stock to one child, all of another stock to second child, etc. As long as the current value for assets received by each child is equal, there is no problem.

If the trust is divided into sub-trusts, such as a separate trust for each of the trustor's three children, then the trustee must divide the assets and register them separately. Assets would be registered in the name of "John Doe, Trustee of the Mary L. Doe living Trust, dated 9-7-98 f/b/o Helen Doe." Here, "f/b/o" stands "for the benefit of" followed by the beneficiary's name. Separate individual records need to be kept for each separate, individual trust and a separate tax identification number must be obtained for each sub-trust.

### **Payments from Trust**

If a trust continues after the trustor's death, payments are normally made to the trust beneficiary or beneficiaries. These payments to the beneficiary can be discretionary, such as payments for "health, support, and education" and are at the trustee's discretion. Or, the beneficiary may get all of the trust income, and the principal can be used in the trustee's discretion for the beneficiary's "health, support, maintenance, and education."

"Income" from a trust refers to interest, dividends, and net rental income. It does not include capital gains. Principal includes trust assets together with any gain or loss from

the sale of an asset. An irrevocable trust normally keeps any capital gain on the sale of a trust asset and pays tax on this gain. There are special provisions under California's Principal and Income Act as to what is "income" and what is "principal." In addition, the law provides how to treat unusual assets, such as oil royalties, and unproductive assets, such as non-income producing real estate held for several years and then sold.

A change in California law, effective January 1, 2000, allows a trustee, under certain circumstances, to make an adjustment in income by increasing or decreasing the amount paid to the trust beneficiary or beneficiaries. If the trustee wishes to make such an adjustment a notice of proposed action must be mailed to all parties who would be affected at least 30 days before the adjustment is made. If anyone objects, an adjustment cannot be made without court approval.

A trustee can also, under certain circumstances, convert a trust which pays "net income" to a beneficiary to a "unitrust," which pays a percentage of the trust value determined annually to the trust beneficiary.

### **Investments**

California law applies as to how the trustee invests the trust assets. This is referred to as "The California Uniform Prudent Investor Act." This act provides that a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." It then sets forth a number of guidelines.

A trustee needs to diversify the assets and to invest, balancing the income which comes in with the future growth of the assets. Assets cannot be invested totally for income or totally for growth, unless the trust document directs this. There may be a 60-40 split between growth and income assets, or a 40-60 division, depending on circumstances.

A trustee may hire an investment advisor to manage the investments and, provided certain requirements are met, the trustee is not liable to the trust beneficiaries for the investment decisions made or action taken.

### **Record Keeping and Accounting**

One of the trustee's duties is to keep detailed records and to render an accounting to the trust beneficiary, usually annually. An accounting is not usually required if the trust is revocable, if the trust beneficiary has waived the accounting in writing, or where the trustee and sole trust beneficiary are the same.

An annual accounting is not required for a living trust created by a trust agreement or trust declaration executed before July 1, 1987, or a testamentary trust created by a will where the will was signed before July 1, 1987.

Other than the exceptions listed above, the trustee must account at least annually and at the termination of the trust to each trust beneficiary to whom income or principal is required to be paid or may be paid. This annual account must include:

1. A statement of receipts and disbursements.
2. A statement of assets and liabilities.
3. The trustee's compensation for the last year.
4. Any agents hired by the trustee, their relationship to the trustee, and their compensation.
5. A statement that any recipient of the accounting may petition the court for a review of this accounting and the acts of the trustee.
6. A statement that any claims based on this accounting may not be made more than three years after the beneficiary receives the accounting.

In addition to the accounting, the trustee must keep detailed records of trust income (in terms of each dividend, interest payment, and item of income received), of sale and purchase of trust assets, of payments made from the trust, of taxes paid, and of trustee's compensation. Statements for payments should also be retained in case they are ever questioned.

California's Uniform Principal and Income Act requires a two column register of items that are income and that are principal. This is rather complex and involved. For instance, trustee's fees are charged one-half to income and one-half to principal. If the trustee does not do this correctly, then the trust beneficiary, who receives payments from the trust, is either overpaid or underpaid.

### **Trust Taxation**

The trustee needs to employ an accountant, enrolled agent, or tax preparer to prepare annual income tax returns for the trust.

As has been mentioned, there may be an estate tax return due when the trustor dies. This is due within nine months of the date of death, although an extension may be obtained.

An annual federal and a California trust income tax return must be filed. Forms 1041 (federal) and 541 (California) need to be filed by April 15th for the prior calendar year ending December 31st. These returns report all of the taxable income in terms of interest, dividends, rents, capital gains and losses on sale of assets, and any other taxable income. Deductions include any allowable interest paid, real estate taxes, California income taxes (on the federal return), trustee's fees, accountant's fees, and other deductible expenses.

If the income is paid to a trust beneficiary, a deduction is taken on the trust income tax return for the payments made and the beneficiary is then taxed on these payments. A form K-1 is attached to the return for each trust beneficiary, listing the beneficiary's name, address, and social security number, and showing the taxable income. A copy of the form is given to the trust beneficiary so he or she will know what to report on the beneficiary's personal income tax return.

If the trust owes tax, estimated taxes may have to be paid during the year.

If there are several trusts with separate identification numbers, a separate set of returns is required for each trust.

### **Summary**

Being the trustee of an irrevocable trust or trusts involves a great deal of work and skill. The trustee must carefully observe all of the legal, accounting, and tax rules regarding the trust and if the trustee violates these rules, even innocently, the trustee may be personally liable for any monetary loss.

Anyone acting as a trustee should carefully select an experienced attorney and an accountant or tax preparer who is familiar with trust taxation to advise the trustee to avoid potential problems.

When someone is naming a successor trustee to take over when he or she dies, that person should consider the above and name a person or persons who both have the time and will carry out within a reasonable time the various duties of a California trustee.

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