

## **ESTATE AND TRUST LAW, PROFESSIONAL LAW CORPORATION**

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### **GUIDELINES FOR THE INDIVIDUAL TRUSTEE OF AN IRREVOCABLE TRUST**

The following information contains important guidelines for the Trustee of an irrevocable trust, whether trust administration is during or after the life of the Settlor.

#### **I. MANAGEMENT DURING LIFETIME OF SETTLOR**

##### **A. Record Keeping**

The accounting records for the trust must, of necessity, be kept in great detail and with great accuracy. The irrevocable trust is a separate tax-paying entity, and several different trusts may be created on the death of the Settlor, each a separate tax-paying entity. The Trustee has responsibilities to both the income beneficiaries and the remainder beneficiaries (those who will receive the property on termination of the trusts). Careful records must be kept of all trust transactions.

The records must distinguish between income and principal receipts and income and principal disbursements. For example, if a trust holds a note received on the sale of an asset and the note is being paid on an installment basis, each payment most likely will include both a repayment of the principal portion of the note and an interest portion. These items must be broken down as each payment is received: the interest is allocable to the income account while the note repayment portion is allocable to the principal account. (This treatment may or may not be the same for income tax purposes, as fiduciary accounting and fiduciary income taxation are not always parallel.)

Similar careful treatment must be accorded expenses allocable to principal and expenses allocable to income. In some instances the Trustee has the discretion to determine the manner of allocation as between principal and income. In other instances the allocation procedure is not clear. When any question of allocation arises, the accountants or attorneys should be consulted.

To assist you as Trustee in understanding the basic allocation between principal and income accounts, a copy of the California Principal and Income Law is attached to this memorandum.

Please note, again, that fiduciary record keeping differs substantially from normal bookkeeping or even from corporate or personal income tax record keeping. A fiduciary is responsible for every **penny** which passes through her or his fingers and must therefore account to the penny. Thus, the Trustee is required to keep a precise record of every receipt and disbursement, every gain and loss, every distribution to a beneficiary, and every change in the nature of an asset of the trust. This is not difficult if good records are kept from the inception of the sub-trusts. However, failure to keep good records will require time-consuming and costly reconstruction of trust records for both tax and accounting purposes, and will raise adverse inferences against the Trustee

should a dispute arise at a later date. If you have any questions on this subject, you may wish to consult with your accountant.

## **B. Income Tax Returns**

The irrevocable trust and, upon the death of a Settlor, the separate sub-trusts, will be separate taxable entities. As such, each is required to obtain its own taxpayer identification number, and each is required to file its own fiduciary income tax return each calendar year. Either our office or your accountant can obtain this number for you. If you are our client, we prefer to obtain the tax identification numbers in order to insure the application is exactly correct.

Income as well as capital gains and losses generated by sales or exchanges of assets held by the sub-trusts are almost always taxable to them.

Fiduciary income taxation is a highly specialized field and most accountants are not familiar with its intricacies. Therefore, it is extremely important that an accountant familiar with fiduciary income taxation be employed to prepare the sub-trust fiduciary income tax returns. Our office does not generally prepare these returns, but we will work with your accountant if you desire. Additionally, we can give you several referrals, if your accountant indicates fiduciary accounting is not a service he or she is comfortable providing.

If at any time trust income has been accumulated (i.e., not distributed but rather added to principal), the Federal and California income tax laws may require special computations resulting in additional taxes or refunds when the accumulated income is distributed. These "throwback" rules are quite complex and accountants or attorneys should be consulted should there be questions regarding them.

## **C. Powers of the Trustee**

The powers of the Trustee are generally set forth in detail in the trust instrument. Depending upon the terms of the trust, the powers given the Trustee may be very restricted or very broad. However, even where the Trustee is specifically granted absolute or sole discretion, the Trustee must always act in good faith, considering the interests of the income beneficiaries and the remainder beneficiaries.

Unless specifically authorized otherwise by the trust, joint Trustees (Co-Trustees) must act unanimously. If unanimity cannot be reached, the Superior Court may be petitioned for guidance.

Sometimes a Trustee may delegate powers to another Trustee or to an agent. However, a Trustee should be very cautious about the types of functions which are delegated to a person who is not a Trustee. For example, "ministerial" functions may be delegated, such as the trust accounting work or management of a farm or business. Nevertheless, the Trustee remains responsible to oversee the delegated work and is responsible for the actions of the ministerial agent. Discretionary powers (for example, determining whether or not to distribute income or principal) may not be delegated. All decisions concerning trust distributions should be made by the Trustee. Decisions concerning trust investments should usually be made by the Trustee unless the trust expressly provides for the retention of separate investment counsel or vests the investment decisions in one particular Trustee. However, even then the delegating Trustee probably has the responsibility to see that the delegated power is used

prudently.

Generally, the Trustee has broad powers to sell, lease, borrow, pledge, and otherwise manage the assets of the trust in a business-like fashion. If a question arises as to the existence or exercise of a power that is not clear from the terms of the trust, the attorneys should be contacted. In those cases where no ready answer is available (whether it concerns Trustee powers or other terms of the trust), a petition may be filed with the Probate Department of the Superior Court to resolve the matter.

#### **D. Duties of the Trustee**

1. Loyalty: The Trustee has an absolute duty of loyalty to the beneficiaries of the trust. This means that although the Trustee is the legal owner of the trust assets, all actions taken in connection with the administration of the trust must be with the sole interest of the beneficiaries in mind. Any self-dealing by the Trustee is a breach of trust. The Trustee cannot deal in any way with any trust assets of the irrevocable trusts which would personally benefit the Trustee (as, for example, buying assets from the Trustee individually, or selling individual assets to the trust) even if such action would also be advantageous to the beneficiaries.

2. Investments: The Trustee has the responsibility for administering the trust in a manner most beneficial to the beneficiaries in accordance with the terms of the trust agreement. Normally, the Trustee will be given power to invest as would a "prudent person," namely, to manage the trust funds with regard to their permanent disposition and considering both the probable income to be earned as well as the probable safety of the principal.

Such a standard recognizes the Trustee's duty not only to the income beneficiaries but also to the remainder persons. Thus, for example, if the Trustee invests in a wasting asset, such as an oil royalty subject to depletion, a portion of the income received must usually be set aside as a reserve to replace the depleting principal; otherwise, the interests of the remainder persons would be prejudiced. On the other hand, the Trustee may be required by the terms of the trust to establish no reserves or even to retain certain assets although they produce no income. Thus, paying close attention to the terms of the trust is of great importance. If there are questions, the Trustee's attorneys should be contacted.

3. Record Keeping and Accounting: The Trustee is generally required to furnish the beneficiaries of each trust an annual accounting and report of trust affairs unless the trust instrument waives an accounting, a beneficiary has waived an accounting, or the beneficiary and Trustee are the same person. The account is to include a statement of receipts and disbursements of principal and income during the accounting period, a statement of assets and liabilities at the end of the period, the amount of Trustee's compensation, the disclosure of the agents hired by the Trustee and their compensation, and other disclosures as set forth on the sample account and report attached.

This accounting shows the starting balance of the trust assets, adds the receipts and gains, and deducts the distributions, losses and disbursements, and then shows the remaining balance on hand at the end of the accounting period. The starting and closing balances will generally be at the "carrying value" for the trust which is most often their income tax basis. A good account will also show market values for the assets so that the investment decisions of the Trustee can be more accurately measured.

4. Summary: A Trustee must act with the highest good faith towards the beneficiaries and use ordinary care and diligence whether the Trustee is compensated or not. The Trustee may not deal with the trust property for personal profit, or for any purpose not connected with the trust. The Trustee may not obtain any advantage over a beneficiary or take part in any transaction with a beneficiary unless the beneficiary, with full knowledge of the transaction and having the legal capacity to enter into the transaction, specifically consents to this and permits the Trustee to do so. Similarly, the Trustee may not commingle personal property with trust property; thus, separate accounts and accurate record keeping are an absolute necessity.

### **E. Trustee Liabilities**

In many ways, a Trustee is an insurer. If the Trustee is negligent, the Trustee may be surcharged (i.e., fined) for such negligence. Thus, penalties and interest for failure to file tax returns will normally be borne personally by the Trustee. Moreover, the tax laws make a Trustee personally liable for unpaid death taxes to the extent of the assets held. Thus, most trusts allow the Trustee to withhold distribution of trust property until all death taxes are determined and paid so that the Trustee will not be later required to pay the taxes from personal funds.

Failure to invest the trust property will subject the Trustee to liability for simple interest on the uninvested funds. If a court were to find that the Trustee willfully failed to invest the trust property, the Trustee would be liable for compound interest and perhaps an additional surcharge.

### **F. Compensation**

Trustees are entitled to reasonable compensation for the services performed to the trust. Often the trust document will specify an amount or a limitation. If it does not, a Trustee is entitled to compensation in the same manner as would anyone else performing similar management or investment services. This usually depends upon the time involved, the responsibilities undertaken, the results achieved, and the magnitude of the problems encountered. A good rule of thumb generally used by corporate trustees in California to estimate trustees' fees is 1-2% of the principal balance of the trust assets recalculated annually.

## **II. PROCEDURES UPON DEATH OF SETTLOR**

### **A. Initial Duties**

#### Notice

Probate Code section 16061.7 requires that when a trust or portion thereof becomes irrevocable, the trustee must serve a specified notification. This notification must be served upon each beneficiary of the irrevocable trust or irrevocable portion thereof, upon the deceased Settlor's heirs if the event requiring notification is the death of the Settlor, and upon the Attorney General if the trust is a charitable trust subject to Attorney General supervision. The notification must be served within 60 days following the event requiring service of the notification. A trustee who fails to give notification may be responsible for damages including attorneys fees and costs. The notification must include the following:

- (i) the identity of the Settlor(s) and the date of the trust;
- (ii) identifying information regarding the trustee;
- (iii) address of principal place of administration of the trust;
- (iv) any additional information which may be required by the terms of the trust;
- (v) notification that the recipient is entitled to a copy of the trust;
- (vi) a warning set out in a separate paragraph in not less than 10 point boldface type reading as follows:

**"You may not bring an action to contest the trust more than 120 days from the date this notification by the trustee is served upon you or 60 days from the date on which a copy of the terms of the trust is mailed to you in response to your request during that 120 day period, whichever is later."**

Under Probate Code section 16061.7, when the trust, or portion thereof, becomes irrevocable, the trustee shall upon request provide a complete copy of the terms of the irrevocable portion of the trust to any beneficiary and to any heir of a deceased settler. The phrase "terms of the trust" is broadly defined at Probate Code section 16060.5 to include the entire trust instrument, or those portions of the trust instrument which describe or affect an irrevocable portion of the trust, including signatures, amendments, disclaimers and directions or instructions to the trustee.

#### Valuation/Taxes

At the death of a Settlor, trust assets must be valued, generally estate tax returns will be required to be filed, assets allocated to the proper sub-trusts, if applicable, appropriate books (records) established so that income and principal receipts of each irrevocable trust can be recorded accurately, and investments carefully made. The Trustee is responsible to all of the trust's beneficiaries, even if they are not yet born or identified.

Normally, the Trustee's attorneys or accountants will prepare the Federal and California Estate Tax returns necessitated by the death of a Settlor. They will also assist the Trustee in collecting assets, valuing them and allocating them between trusts or to the beneficiaries. The attorneys will, upon request, assist with any questions of trust administration or interpretation. Most of these items relating to the continuing management of the trust are discussed in greater detail below.

#### **B. Allocation of Assets**

Upon the death of a Settlor, the irrevocable trust is usually divided into separate sub-trusts for the benefit of children or other beneficiaries, otherwise it is paid out, free of trust, to the beneficiaries as specified in the trust instrument.

Federal law allows the Trustee to minimize taxes by valuing the decedent's trust assets either at date of death or six months thereafter (unless they have been distributed or sold), so allocation of assets among sub-trusts is not normally made until at least six months after the Settlor's death. Prior to allocation, the income, expenses, and capital gains and losses are divided and allocated once the Trustee has determined the extent and value of the assets in the manner required by the trust document.

Sometimes a pro rata portion of each asset is required to be allocated to each of the sub-trusts. For example, one-half of each asset will be allocated to each of two trusts. However, almost all

trusts drafted by Attorney Jacqueline Skay specifically allow the Trustee to allocate various whole assets (rather than undivided interests) to each sub-trust to achieve better management, to encourage future estate planning, and to meet the varying needs of the different beneficiaries. For example, if the home and its contents are owned by the trust, it is quite common to allocate them to one beneficiary (rather than a one-half interest to each person).

The mathematical computations governing allocation of trust assets, while not difficult, are complex because of many factors which may be present. For example, death taxes, funeral expenses and expenses of last illness may be chargeable against the residual estate while debts (i.e., unpaid bills outstanding at the time of the deceased Settlor's death) may be chargeable proportionally among the beneficiaries. The actual procedure depends upon the language of the trust and the nature of the debt. Thus, it is most important when allocating trust assets for the Trustee to consult with attorneys or accountants skilled in fiduciary accounting (as opposed to business accounting), so that the all-important "starting figures" for each trust may be determined. The importance of proper asset allocation and generally getting off to a good start cannot be overemphasized.

### **III. SUMMARY AND CONCLUSION**

The irrevocable trust is a useful device for managing property and, in many instances, saving estate and income taxes. However, like a partnership or corporation, it must have adequate management and record keeping procedures. Once these procedures are properly established, their continued maintenance is relatively easy. Most trusts can be managed by individual Trustees (after they are successfully under way) with minimal assistance from accountants and attorneys. They can achieve numerous benefits for the Settlor, the Settlor's children, and other beneficiaries at minimal cost.

Nevertheless, being a Trustee is a substantial responsibility, and a Trustee should not hesitate to seek professional investment, accounting, or legal assistance whenever questions arise.