

MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER (619) 238-8808

June 2008

In this Issue:

COUNSELING NON-PROFESSIONAL TRUSTEES ABOUT PRINCIPAL AND INCOME ALLOCATIONS AND INVESTMENT POLICIES

TIMOTHY C. POLACEK, ESQ.

PRIVATE LETTER RULING: POSSIBILITIES FOR NON-SPOUSAL REQUIRED MINIMUM DISTRIBUTIONS

BRADFORD N. DEWAN, ESQ.

COUNSELING NON-PROFESSIONAL TRUSTEES ABOUT PRINCIPAL AND INCOME ALLOCATIONS AND INVESTMENT POLICIES

TIMOTHY C. POLACEK, ESQ.



This article reviews certain accounting and investment issues, the importance of which is often underestimated by a non-professional trustee. A typical situation is when a well educated family member serves as trustee and fails to communicate sufficiently with other family members about the trust administration.

Principal and Income Act: The California Uniform Principal and Income Act ("Act") imposes rules upon trustees in allocating receipts and disbursements (*California Probate Code Section 16335-16375*). Some trusts include provisions that allow the trustee to deviate from the Act, but generally, most trusts follow the Act. Therefore, proper administration requires the trustee to be knowledgeable about the Act as well as any specific provisions of the trust that deviate from the Act.

Proper administration is particularly important when a trust is irrevocable and the trustee is not the sole beneficiary. A common situation involves the administration of a living trust after the death of the first spouse, with survivor/marital (Trust A) and bypass (Trust B) trusts. These subtrusts have separate tax identification numbers and each monetary transaction must be properly distinguished between the subtrusts, with receipts and disbursements allocated either to income or principal accounts. For example, the repayment of a promissory note includes interest that is allocated to income, and principal which is allocable to the principal account.

Although corporate trustees are familiar with the Act, most family members who act as trustees are not fully aware of its provisions. This exposes them to liability when trust accountings are not kept current. A common misconception among many non-professional trustees is that a trust's taxable net income governs the amount that must be distributed to a beneficiary, rather than its accounting net income. Quite often, these errors go unnoticed because the family desires to keep administration expenses at a minimum.

But does such neglect of the Act really

matter? Absolutely. This is especially true with blended families and children from prior marriages. When the first trustor dies, a share of his assets are usually available for the surviving spouse's needs. Thereafter, those assets will pass, upon the survivor's death, to the children of the first deceased spouse (from a prior marriage).

Consider the situation where a husband creates a marital trust for his second wife and names his oldest child as trustee. Does this sound familiar? Let's further assume the trustee does not follow the Act, underestimates the trust's annual income and distributes less to the spouse than is required. If the error is discovered, the spouse may feel that the trustee is intentionally withholding trust income from her.

Earnings vs. Redemptions: Receipts are receivables paid to the trust. Receipts can include both earnings and redemptions. However, earnings, including interest and dividends, are allocated to income, and redemptions are allocated to principal. Conversely, proceeds received from the sale (redemption) of a trust asset, such as common stock, clearly are principal, regardless of whether there is a taxable gain or loss.

Distributions From Entities: A particularly difficult situation involves the receipt of cash from a business entity. Let's assume that a marital trust owns a 50% interest in an apartment LLC that is managed by a family member. After years of appreciation, the manager refinances the property and distributes the excess cash to the marital trust. Is this cash distribution to the trust allocable to income or principal? It turns out that the answer to this question depends on the facts.

This is because the Act requires cash receipts from a business entity to be allocated to income, unless the distribution is made in partial or full liquidation (*California Probate Code Section 16350*). As to the latter, a liquidating distribution occurs either when the governing board of the business entity "identifies" the distribution as being made in partial liquidation, or when the distribution exceeds 20% of the entity's gross assets stated on its year-end

financial statement. Unfortunately, most privately owned businesses do not document the nature of their cash distributions. This means the trustee should ask the governing board if the distribution was made in partial liquidation. For those readers who have encountered this issue, *Hasso v. Hasso* (148 Cal. App. 4th 329) provides guidance as to the treatment of a large cash dividend by a corporation to a marital deduction trust.

Paying Trust Debt: Another common situation involves the trustee's use of income from real property to pay down mortgages. The Act requires principal to be used to pay down principal on debt. For trusts that allow income to be accumulated, this should not pose a problem. However, if the trust requires all income to be paid and the trustee has insufficient cash balances, the result is that the trustee usually will use the available cash to pay down principal. Although this satisfies the loan payment, it may result in the beneficiaries receiving less than the accounting net income.

Paying Professional Fees: A similar cash flow shortage can arise when cash is not sufficient to pay annual professional fees. Because the Act requires the trustee, attorney and accounting fees to be allocated equally between income and principal, there is a risk that the trustee will simply use the available income to make these payments. Again, this should not pose a problem for trusts that allow income to be accumulated, but this can result in underpayments to the beneficiaries of a mandatory income trust if cash balances are low and the trustee does not sell assets to provide cash to cover the share of fees allocated to principal.

Proactive Communication: A failure by the trustee to communicate is perhaps the most often cited objection by beneficiaries. When beneficiaries *feel* they are not adequately informed, conflict and even litigation may arise. Family members who serve as trustees should understand this risk and the possible exposure to surcharge. Therefore, we recommend the trustee be proactive when providing information to beneficiaries.

Although the trustee is only required to account to those beneficiaries to whom income or principal is required or authorized in the trustee's discretion to be currently distributed (*California Probate Code Section 16061*), the trustee also has

a duty to keep the beneficiaries of the trust reasonably informed of the trust and its administration (*California Probate Code Section 16060*). This means that the trustee must furnish the remainder beneficiaries with appropriate financial information after receiving a request to do so. Also, under some circumstances it may be useful for a trustee to provide accountings to remainder beneficiaries because it starts the contest period for objection. Similarly, a trustee might provide accountings to remainder beneficiaries as a matter of courtesy.

Another form of trustee communication is a Notice of Proposed Action (*California Probate Code Section 16500 et. seq.*). For example, a trustee may want to send information to the beneficiaries about the terms of the sale of the decedent's residence. This offers the beneficiaries 45 days to object before the transaction has been completed. This Notice of Proposed Action also protects the trustee against a beneficiary later objecting to a transaction if the beneficiary consented or the 45 day period lapsed.

Family Meetings: The benefit of periodic family meetings should not be underestimated. Having family members attend regularly scheduled meetings presents an opportunity to receive information and ask questions about the trust administration. The trustee can use this meeting as a means of carrying out his/her duty to inform the beneficiaries about the trust administration.

The importance of having an open forum for communication may become evident when the trustee realizes that undivided interests in trust assets may have to be distributed to family members at a future date. Disgruntled beneficiaries may see the undivided interest as an opportunity to obtain a dominant management position. For example, take the situation where a family living trust owns an interest in a family limited partnership or LLC and the trustors have directed that each beneficiary receive an equal share of the trust upon the survivor's death. In such case, the chances are good that partnership or LLC interests will be jointly owned by the family members at some time.

Family members who have been given greater control over assets should understand that an annual meeting is a good way to determine whether other family members approve or disapprove of the manner in which trust assets are being administered. If disapproval is demonstrated, consideration should be given to arrangements that will satisfy reasonable requests by the remainder beneficiaries as to the trust assets.

Having family meetings is a preventative approach to estate planning. In situations where a trustor can amend the trust or appoint specific assets and achieve family harmony, a balance can be achieved among the desires and needs of the various beneficiaries. Such a balance may minimize the feelings of remainder beneficiaries that they are powerless as to the ultimate resolution of their inheritances. While it is not always possible to satisfy the desires of all beneficiaries, the demonstration of fairness and sound trust administration may lead some beneficiaries to accept an otherwise undesired circumstance.

Investment Policy Statement (IPS): In addition to making proper accountings, sound trust administration should involve documenting financial decisions through an IPS. An IPS is a document written by the trustee to explain why s/he has made certain investment decisions. The IPS should comply with the criteria set forth under the California Uniform Prudent Investor Act ("UPIA") (*California Probate Code Sections 16045-16054*). An IPS will assist a trustee in showing s/he has exercised reasonable care, skill and caution when making investments decisions, which is required by the UPIA.

Although the UPIA does not require a trustee to guarantee a specific level of return for a trust investment, it does require the trustee to use a procedural approach when investing. Unfortunately, most non-professional trustees do not adequately document their investing approach.

In some situations, a trust will "opt out" of the UPIA investment criteria to reduce this burden. For example, a trust may opt out of the requirement to diversify trust assets. In such case, prudence suggests that trustee should document his/her investment approach and consider investing broadly among varying asset classes.

An IPS should be broad enough to endure changing market conditions, but specific enough to guide the trustee with benchmarks to assess portfolio performance. The UPIA identified client factors and market conditions that are the basis for designing a trust investment portfolio. (See the May 2008 edition of this newsletter for more information regarding trust investments)

The trustee walks a tightrope when balancing the interests of current and remainder beneficiaries. Having an IPS will offer the trustee some protection against claims for fiduciary breach if investing has been systematic and prudent.

**PRIVATE LETTER RULING:
POSSIBILITIES FOR NON-
SPOUSAL REQUIRED MINIMUM
DISTRIBUTIONS**

BRADFORD N. DEWAN, ESQ.



Executive Summary: The IRS ruled that a non-spouse beneficiary who failed to take the initial required distribution by December 31st of the year after the IRA owner's death could still use the life expectancy method for distributions rather than be subject to the 5-year rule.

Facts: An IRA owner died in 2002 at age 66, well before his required beginning date. At the time of the Decedent's death, he maintained two IRAs, "IRA X" and "IRA Y." The Decedent had executed individual beneficiary designation forms for IRA X and IRA Y naming his sole surviving Child as the sole beneficiary of each IRA. Decedent was unmarried at the time each beneficiary designation form was executed and remained unmarried until his death.

After Decedent's death, each IRA was appropriately re-titled to reflect that each was an Inherited IRA. Despite the appropriate re-titling of the IRAs, no distributions were taken by December 31st of the year after death. However, the Child finally realized that she should have been taking distributions. In 2005, the Child received distributions for 2003, 2004 and 2005. The amount of each distribution was based on the Child's life expectancy in 2003, the year after the Decedent's death. Since it was not

mentioned, it probably can be assumed that the Child received timely distributions in 2005, 2006 and 2007.

The Child apparently came to realize that the distributions for 2003 and 2004 were not timely and, as a result, in 2007 the Child paid the 50% penalty tax required under IRC section 4974(a) for these two years. Very importantly, the Child represented to the IRS, and submitted evidence to support the representation, that the Child "had not elected the 5-year distribution rule of Code section 401(a)(9)(B)(ii) with respect to either IRA X or IRA Y (as retitled)."

The Child requested a ruling that the failure to timely take the required minimum distributions from the IRAs for 2003 and 2004 did not affect the calculation of the minimum required distributions in those two years, and in all subsequent years, based on the Child's single life expectancy as computed in 2003 and reduced each year thereafter by one. In essence, the Child wanted confirmation that she was not subject to the 5-year rule that would require complete withdrawal of all funds from the IRAs by the fifth anniversary of the IRA owner's death.

COMMENT: GENERAL RULE: Code section 401(a)(9)(B)(i) provides as the general rule that if an IRA owner dies *before* his or her required beginning date, then the entire funds in the IRA must be distributed within 5 years of the IRA owner's death.

Exception: But there is an important exception to the above 5-year rule. If any portion of the deceased IRA owner's interest in the IRA is payable to (or for the benefit of) a "designated beneficiary," then such portion "will be distributed" over the life expectancy of such designated beneficiary with such distributions beginning no later than 1 year after the death of the IRA owner.

- The "required beginning date" refers to April 1 of the calendar year following the calendar in which the IRA owner attains age 70 ½ .
- A "designated beneficiary" is that individual designated as such by the IRA owner who is alive on the date of the IRA owner's death and, generally, remains a beneficiary until September 30th of the year following the year of death.

Any failure to distribute the required minimum

distribution for a taxable year is subject to a tax equal to 50% of the amount of such required distribution not withdrawn.

The IRS, after reviewing the above rules, quotes from the "Explanation of Provisions" of the final regulations under the section entitled "Default Rule For Post-Death Distributions:"

". . . if an employee dies before the employee's required beginning date and the employee has a designated beneficiary, then the life expectancy rule in section 401(a)(9)(B)(iii) is the default distribution rule. Thus, absent a plan provision or election of the 5-year rule, the life expectancy rule applies in all cases in which the employee has a designated beneficiary and the 5-year rule applies if the employee does not have a designated beneficiary . . ." (emphasis added)

The IRS continues by referencing the Treasury Regulation which provides that, with respect to the life expectancy exception to the 5-year rule, distributions to a non-spouse beneficiary are required to begin on or before the end of the calendar year following the year of the IRA owner's death.

The Treasury Regulations are cited which provide, in general, that in the case where the IRA owner dies prior to the required beginning date, that with respect to a non-spouse beneficiary, the applicable distribution period is measured by the *beneficiary's* remaining life expectancy as determined in the calendar year following the IRA owner's death.

The IRS then confirmed that it had received sufficient documentation confirming that the Child was named by the Decedent as the designated beneficiary. As a result of this documentation, the IRS concluded that, as of the date of the death of the IRA owner, the Child "was eligible to receive required minimum distributions from IRA X and IRA Y calculated using her non-recalculated life expectancy." The ruling then affirmed the facts that the Child, as the designated beneficiary, was required under the life-expectancy rule, to receive the first distribution by December 31, 2003. In addition, the required distribution for 2004 was also not taken, but the IRS then notes that not only were

the distributions for these two years and for 2005 taken in 2005, but the 50% excise tax was paid for the failure to timely take the 2003 and 2004 required distributions.

Based on the above, the IRS states that "the issue to be addressed is whether the failure to timely take certain required distributions requires that distributions from either IRA X or IRA Y (or both) be made in accordance with the 5-year rule" of the Code section cited above. Then the IRS specifically affirmed that "*the 'Default' required distribution rule with respect to IRAs in the case where an IRA holder dies prior to attaining his required beginning date and has designated a beneficiary is the life-expectancy rule and not the 5-year rule.*" (Emphasis added) However, this emphasis on the "Default" rule, while likely quite beneficial generally, is a bit quixotic since there might not have been a need to rely on a "default" rule. The ruling specifically notes that each IRA, presumably in each IRA's custodial agreement, provided for post-death distributions to a beneficiary where the IRA owner died before the required beginning date to be made in accordance with the life expectancy rule unless the designated beneficiary chose otherwise. The ruling then notes that the Child had not elected the 5-year rule with respect to either IRA.

Let's elaborate a bit here. The Treasury Regulations ask the question of how to determine whether the 5-year rule or the life expectancy rule applies to a distribution.

No plan provision. This Treasury Regulation section essentially states the "default rule." If the plan has not adopted one of the provisions described below, then the method of distribution must be made as follows:

- If the IRA owner has a designated beneficiary, then "distributions are to be made in accordance with the life expectancy rule."
- If the IRA owner has *no* designated beneficiary, then "distributions are to be made in accordance with the 5-year rule."

Optional plan provisions. A plan may adopt a provision whereby the 5-year rule will apply either in only *certain* situations or in *all* situations, even if

there is a designated beneficiary. (NOTE: This is the provision that is seen in most qualified pension plans)

Elections. Under the final option, a plan may permit an employee or the beneficiary to elect on an individual basis whether, in the case where there is a designated beneficiary, the 5-year rule or the life expectancy rule will apply to distributions after the death of the employee.

The ruling makes it clear that the terms of both IRAs stated that where the IRA owner died before the RBD, then "the balance of the IRA must be distributed to the non-spouse designated beneficiary over his or her life expectancy" starting in the year after death. The IRA terms also stated that a non-spouse beneficiary may elect to receive distributions in accordance with the 5-year rule. This suggests that any such election must be affirmatively and clearly made. The ruling then points out that the Child had not made such an affirmative election to have the 5-year rule apply.

The result? The Child, by paying the 50% excise tax with respect to the late distributions for 2003 and 2004, was able to preserve the right to use the life expectancy rule for all future distributions. It must have been clear to the Child that the payment of the 50% penalty would be offset by the benefits of continued tax deferred growth. The results of this calculation in other similar situations where the non-spouse beneficiary fails to take the required distributions in the first few years after the death of the IRA owner would likely be the same.

CAUTION! This very beneficial ruling may not be seen in all cases with similar facts. The most important and determinative factor that the IRS relied on was that each IRA (again, presumably in the custodial agreement) clearly *mandated* the use of the life expectancy rule in this fact pattern (i.e. IRA owner dies before RBD and there is a designated beneficiary). However, not all custodians may have stated this application of the life expectancy rule so clearly (unless the designated beneficiary affirmatively elects otherwise) in their respective custodial agreements. Consequently, when confronted with this situation, advisors will have to check

whether the applicable custodial agreement has this type of provision and has not otherwise mandated the use of the 5-year rule, but at least there is the prospect of a favorable result for such a non-spouse beneficiary.

PLR 200811028; IRC section 401(a)(9)(B)(ii), (iii); Treas. Reg. section 1.401(a)(9)-3, Q/A-1, Q/A-4.

If you would like to receive further information regarding the topics in this newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

Disclaimer: This newsletter is provided to share knowledge and expertise with our colleagues with the goal that all may benefit. The content of this newsletter is for general informational purposes only. The information contained within this newsletter is not intended to serve as legal advice or as a guarantee, warranty or prediction regarding the outcome of any particular legal or tax matter. Nothing contained within this newsletter should be used as a substitute for legal advice and does not create an attorney-client relationship between the reader and Miller, Monson, Peshel, Polacek & Hoshaw. Legal advice depends on the specific facts and circumstances of each individual's situation. You should not rely on this newsletter without first consulting with a qualified, licensed attorney.

IRS Circular 230 Notice: Any federal tax advice contained in this communication, including any attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

**MILLER, MONSON,
PESHEL,
POLACEK & HOSHAW**

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS
Providing quality legal services since 1959

RALPH GANO MILLER, RETIRED

THOMAS M. MONSON

MARY J. PESHEL

TIMOTHY C. POLACEK

WILLIAM D. HOSHAW[†]

ROBERTA D. REPASY[†]

SUSAN L. HORNER

RAY W. RIDLON

BRADFORD N. DEWAN

PHILIP R. FREDRICKSEN[†]

JUDY S. BAE

MICHELE R. SHIPP

[†]OF COUNSEL

501 WEST BROADWAY, SUITE 700

SAN DIEGO, CALIFORNIA

(619) 239-7777

FAX (619) 238-8808

<http://www.mmpgh.com>