SERVING AS A TRUSTEE
PART I - Initial Duties of a Trustee

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Stepping in to serve as Trustee (the person in charge of administering and managing a trust) can be one of the most important things you do for a loved one or friend (the Trustor or creator of the trust). Complying with the many rules and obligations can also be time consuming and confusing. As you read this article, remember that a host of professionals, including your attorney and accountant as well as tax return preparers, financial planners, real estate brokers, and property managers, can help you with this grand and rewarding responsibility. The following article primarily discusses serving as Trustee after the death of a Trustor, but also applies to Trustees who step in while the Trustor is still living.

This article will be published in five parts, as follows: Part I discusses the initial duties of a Trustee, Part II will address dealing with trust assets and expenses, Part III will discuss paying estate and trust taxes, Part IV will address Trustee liability, and Part V will address funding subtrusts and making distributions to beneficiaries.

THE FIRST YEAR

The first year after the death of a Trustor is the busiest for the Trustee. During the first year, the Trustee must collect information regarding the Trustor, his or her assets, debts, and beneficiaries, file tax returns with federal, state, and county taxing authorities, and make payments to creditors and distributions to beneficiaries.

First Steps

The very first thing the Trustee should do is get copies of the Trustor's estate planning documents and READ them carefully. More specifically, you should become familiar with the provisions in the Trust(s) and any amendments thereto, the Will and any codicils (amendments) thereto, and, if the Trustor is still living, any Powers of Attorney. These documents will help you identify the following: (1) the scope of your duties and powers as Trustee; (2) the identity of the beneficiaries; (3) the nature and value of assets of the Trustor's estate; and (4) the identity of any other co-trustees, executors, or fiduciaries. You should also obtain certified copies of the death certificate; typically five to ten copies are sufficient.

Second, you should notify certain agencies of the death of the Trustor. Typically, this would include social security and the agencies administering the decedent's pension(s). If the decedent (or his predeceased spouse) ever received Medi-Cal benefits, that agency must be notified. If any beneficiaries are in prison, you must notify the state Victims Fund. You should also notify certain entities that you are now acting as Trustee for the decedent. You should send IRS Form 56 to both the IRS and the California Franchise Tax Board (FTB) to let them know you are responsible for the various returns and taxes that will be due. By alerting these agencies, you also ensure that you will receive the correspondence and information necessary to do your job as Trustee, possibly including information about outstanding taxes and/or liens. Finally, you should record an affidavit regarding the change of Trustee with the County Recorder in each county in which the Trustor owned real property.

Third, California law requires a Trustee to notify the trust beneficiaries and the decedent's heirs at law (generally, the spouse, children and grandchildren) following the death of the Trustor. This notification must be made in a specific format within 60 days of the Trustor's death, so you should locate contact information for all of the beneficiaries and heirs as soon as possible. A failure to comply with the notification requirement could make you liable for any resulting damages.

Fourth, you will need to gather information. Other useful information to obtain includes the Trustor's social security number; the taxpayer identification numbers for related partnerships, trusts, etc.; information about the Trustor's marriages (there may be outstanding obligations from a marital settlement agreement); the citizenship of the Trustor and his surviving spouse; and the rights of his surviving spouse in employee benefits.

Finally, for purposes of determining the value of the gross estate, and whether an estate tax return (IRS Form 706) will be required, you will also need to determine if the Trustor made gifts during life, when he made them, and to whom they were made. This will help determine how much estate tax and/or generation skipping tax, if any, is due and payable.

Summary

A Trustee's initial steps require him or her to gather information, give notice, and take possession of the assets.

Part II - Trust Assets and Expenses

Trustees are responsible for managing trust assets, and paying trust (and possibly Trustor) liabilities. This article discusses these responsibilities.

Assets

Compiling a complete list of all of the decedent's assets and their values is important for a number of reasons including determining whether an estate tax return will be required, determining the new income tax basis of assets and, ultimately, for distribution among the beneficiaries. It is also important to collect information regarding any taxable lifetime gifts made by the Trustor, as well as debts and creditors.

For federal estate tax purposes, you will need to compile information regarding all assets of the decedent, even including assets not held in the trust. Assets held outside the trust may include assets titled in joint tenancy, pay on death accounts, life insurance, pensions and annuities. Other types of assets to consider include: real estate, insurance policies, retirement plans, mutual funds, stocks, bonds, bank accounts, cash, interests in closely-held businesses and partnerships, patents, copyrights, leases, automobiles, boats, jewelry, art, etc. All of these assets are typically part of the overall taxable estate that is included on the estate tax return.

Determine How Assets Are Held

After identifying the assets owned by the Trustor, you should determine how these assets are held. Assets can be held as community property, separate property, in joint tenancy or some other form. Assets may be held in the name of the trust or in another manner. If the Trustor owned assets outside of the trust with a total value in excess of $100,000, then a probate administration is usually required to transfer those assets. If the value of the assets owned by Trustor outside of the trust is less than $100,000, California allows these assets to be transferred by affidavit, without probate. Additionally, if real property is owned outside the trust and located in a state other than California, you should investigate the laws of that state to determine whether an ancillary probate will be needed in that other state with respect to that property. An estate or inheritance tax return may also be required if the decedent owned assets outside of California.

Secure the Assets

Once you have determined which assets are included in Trustor's estate, you should take steps to secure this property. Cash should be placed in an appropriate bank account. Securities, jewelry and other valuables should be secured in safe deposit boxes. Automobiles, art and other personal property should likewise be secured. Credit card companies should be notified of Trustor's death, and all credit cards should be destroyed or returned to the issuer promptly. Real property and other valuables should be property insured, or if already insured, the adequacy of insurance should be confirmed. Real property should be occupied if possible, otherwise vandalism coverage may not be available.

Valuation of Assets

Your next step is to determine the value of the assets as of the date of death, and the "alternate valuation" six months after death (if values have declined), in which case the lower value can be used for estate tax purposes. For some assets (i.e., bank accounts, insurance policies, retirement plans, automobiles, etc.), valuation will be accomplished fairly easily. However, you will need a professional appraisal for many types of assets, including: real property, partnership interests, stock of closely held businesses, and rare art and jewelry. The date of death value of real property, partnership interests, and the stock of closely held businesses may also be subject to discounts or premiums, which must be documented properly. Hard-to-value assets should be appraised by professional appraisers.

Expenses

In some cases the trust may have very little cash or other liquid assets with which to pay the expenses incurred in administering the trust/estate and/or taxes. You must be careful in deciding which assets to sell and/or whether to borrow money in order to pay expenses. In addition, you must be careful in making distributions to the beneficiaries. For example, the son who was supposed to inherit Dad's '65 Mustang may not appreciate your selling it to make the mortgage payments on the house going to his sister. Seeking the assistance of an attorney or accountant can help you avoid making decisions that will have adverse liability and tax consequences.

Duty to Keep Detailed Accounting

Under California law, Trustees have a duty to account for every penny that comes into, or goes out of, the trust. Getting into careful and detailed accounting habits early will help satisfy this duty as well as stave off disgruntled beneficiaries.

Trustor's Debts

As with assets, you should make a list of all debts owed by the Trustor and the names of the creditors to whom these debts are owed. Many of the payments in satisfaction of these debts will be deductible on either the estate tax return and/or another tax return. Additionally, deductions are available for funeral bills, last illness expenses, attorney and accountant fees, appraisal fees, insurance premiums, mortgage payments, broker fees, real property maintenance and any normal household bills incurred prior to but paid after death. The availability of these tax deductions reinforces the need to keep accurate and complete records of payments made from the trust/estate.

Summary:

Determining and gathering the assets, and paying the Trust (and possibly the Trustor's) just debts is a very important part of a Trustee's duties.

Part III - Filing and Paying Estate Taxes, Trust Taxes, and Subtrust Funding

TAXES

Estate Tax Return (Form 706)

One of the Trustee's most important responsibilities during the first year is filing the Federal Estate Tax Return (IRS Form 706), and any applicable state estate and/or inheritance tax returns. Such returns must be filed and the tax paid within nine months of the Trustor's date of death. The IRS will grant a six-month extension for filing the return (upon request), but an extension is not typically available for paying the estate tax. Therefore, you should attempt to get a good estimate of the value of the estate tax liability and pay all of the estate tax within the nine-month time frame, even if you do not file the estate tax return until later. If it is not possible to pay the entire tax, paying as much of the estimated estate tax as possible will help reduce the interest and penalties that may accrue.

For a death occurring in 2011 or 2012, an estate tax return is required when the Trustor's estate exceeds $5,000,000. If taxable lifetime gifts have been made, a return may be due even if the estate is valued at less than $5,000,000 at death. In addition, if there is a surviving spouse, filing an estate tax return may be desirable in order to make an election allowing the surviving spouse to use any of the deceased spouse's unused estate tax exemption amount. It may also be prudent to file an estate tax return for a smaller estate, as doing so limits amount of time the IRS has to assess additional tax (for which the Trustee could be personally liable) to 3 years. If no return has been filed, the IRS can assess additional tax at any time.

In some cases, the Trustee may not be in control of all of the assets. Joint tenancy, pay on death, pension and/or life insurance may pass to others. The Trustee must learn about all of these assets before making a determination as to whether an estate tax return is due.

California does not currently impose an inheritance or estate tax. However, if the decedent was a resident of another state, or had property in another state which has a separate state inheritance or estate tax, you may need to file a tax return in that state. You should seek advice from an attorney in that state to determine your filing obligations.

If a decedent died in 2010, the executor/trustee has the option of (1) filing an estate tax return, in which case an estate of up to $5,000,000 can pass free of estate tax and all assets receive a new income tax basis, or (2) filing an asset allocation return (with the final income tax return) in which case the estate can be of unlimited size and not result in any tax, but the basis increase in the assets is limited.

Trustor's Individual Tax Returns

In addition to possibly filing an estate tax return (depending on the size of the estate), you will have to file the Trustor's final state and federal income tax returns for the period starting January 1 through his date of death. You may also have to file a final gift tax return as well as the income and gift tax returns for any years the Trustor did not file. Understandably, a Trustor who was ill during the last part of his life may not have filed his tax returns. Also, if the Trustor died before April 15, there may be an income and/or gift tax return due for the prior year. These returns may be filed jointly with the surviving spouse as well, subject to certain requirements. All individual tax returns must be filed in the state where the Trustee lives.

Make sure the IRS and State tax agencies get paid.

As Trustee, you are legally responsible for filing the tax returns and paying taxes, both income and estate, before the assets are distributed to the beneficiaries. Both the IRS and the California Franchise Tax Board (FTB) will hold a Trustee personally liable for any tax due, if that Trustee made distributions to beneficiaries and/or creditors before paying the taxes. This liability is limited to the value of the assets in your possession at the date of death. In addition, the IRS provides mechanisms for discharging this personal liability. These include requesting an "early determination" of estate tax liability. Even if you, as Trustee, are relieved of personal liability, both the estate, and the beneficiaries (to the extent of their distributions), continue to be liable for the tax due.

Certain important tax elections must also be made in a timely fashion by the Executor/Trustee. These include: a QTIP election (for the marital deduction), a reverse QTIP election, a spousal election to use any unused estate tax exemption (portability), an election to take deductions on either the estate tax return or the Trustor's final individual income tax return, an election for a calendar versus a fiscal year, an election under IRC 754 regarding partnerships, and an election to execute a Notice to Creditors. If you have any questions about whether or not to make one of these elections, please consult an attorney or other tax specialist.

Trust Income Tax Returns

You will also be responsible for reporting the yearly income of the trust (and/or estate) to both the IRS and the FTB. In addition, you must supply each of the beneficiaries with Form K-1, which sets out all distributions made to that beneficiary during the trust's taxable year. This form is necessary in order for the beneficiary to report his individual income tax properly.

FUNDING THE TRUSTS

Couples often set up a family trust that will split up into several "subtrusts" upon the death of the first spouse. It is your responsibility to make sure that each of these subtrusts is properly funded, which can be quite tricky, so getting the assistance of an attorney is highly recommended.

Funding usually occurs after the estate tax return (if any) is filed and the estate has received a closing letter from the IRS. The trust itself will dictate how assets will be divided among the several subtrusts, but

not necessarily which assets are to be placed in each subtrust. It is therefore essential that you understand the trust provisions that apply at the death of the Trustor.

Smart Funding

There are many estate planning tools and techniques available to reduce estate and income taxes due upon the death of a person. In all likelihood, the Trustor and his attorney discussed most of these techniques before setting up the trust. Unless you were privy to these discussions, you will not know what the Trustor planned with respect to which assets should be used to fund each trust. This is where the assistance of an attorney and/or accountant will be most helpful.

For example, the marital trust (which will be taxed at the surviving spouse's death) is typically not funded with assets that are likely to appreciate, because doing could increase the amount of estate taxes due at the surviving spouse's death. Such assets are best placed in a Bypass or Credit Shelter trust which is not taxable at the survivor's death. Pitfalls like these can result in increased income and/or estate tax, and get a Trustee into hot water with the beneficiaries. Other considerations in funding include the needs of the surviving spouse for income or asset protection (for example, a family could be placed in an irrevocable trust to limit the survivor's personal liability).

Summary

Preparing and filing timely tax returns for the estate and trust, and paying the taxes, is a significant responsibility of the Trustee and carries with it personal liability. Likewise, careful subtrust funding can enhance the benefits available to the trust beneficiaries.

Part IV - Trustee Liability

TRUSTEE LIABILITY

It is very important for you, as the Trustee, to be familiar with the provisions of the Trustor's estate planning documents. The trust gives you certain powers as Trustee. You also have powers conferred under California and Federal law. An attorney can help familiarize you with your powers and possible limits on your powers. You need to be aware of potential pitfalls that could make you personally liable for any resulting harm.

Duties to Beneficiaries

A primary concern is the duty you owe to the beneficiaries. As noted in Part III of this series, the Trustee must remain impartial as between all beneficiaries, including between the income and the principal beneficiaries. Doing business with one of the beneficiaries is usually prohibited. A Trustee must keep all the beneficiaries reasonably informed about the trust and the administration of the trust. Also, you must provide a beneficiary with information requested, including a copy of the trust.

No Self-Dealing

As between yourself and the trust, you have a duty to avoid conflicts of interest and not to engage in self-dealing. An example of what not to do would be to use trust money to invest in your own personal start-up company. These and other acts of misconduct are called "breaches of trust" and can result in your personal liability for any harm done as well as your removal as Trustee. Other acts of misconduct include allowing an insurance policy to lapse and inadequately securing personal property. You also have a duty to employ any special skills you may have (i.e., as investment advisor, attorney, accountant, real estate broker, etc.).

Prudent Person/Investor

As trustee, you must conduct yourself as a "Prudent Person" and as a "Prudent Investor" would. Among the actions taken by Prudent Persons and Prudent Investors are preserving the trust assets, making them productive, and reviewing your investment strategy on a regular basis. Of course, all such

duties are subject to the terms of the trust instrument itself. Fortunately, you may enlist the help of financial planners and other advisors in satisfying your financial duties. However, keep in mind that, generally, you will remain personally responsible for the actions taken by the trust advisors you hire, and YOU must make all final decisions.

Adequate Time

As Trustee, you must spend adequate time administering the trust and its assets. Annual tax filings, with related documents, accountings, and regular monitoring of investments, are necessary to manage and preserve the assets. A Trustee who fails to manage and monitor a trust adequately is subject to being removed by a Court and may be liable for any damages resulting from such lack of attention to trust matters. Fortunately, most trusts permit the Trustee to hire others to assist with these tasks.

Advisors

When dealing with advisors like accountants, financial advisors and attorneys, make sure that each individual knows the scope of his/her duties. Putting the assigned responsibilities in writing, even in a simple letter, will go a long way toward avoiding confusion and missed deadlines. For example, you do not want your CPA and your attorney each thinking that the other was responsible for filing a tax return with the result that it does not get filed.

Co-Trustees

Oftentimes, the trust provides for two or more Co-Trustees to serve. If this is the case, all decisions must be made unanimously, unless the trust directs otherwise.

Conclusion

Trustee liability can be a serious issue for a trustee. Being sure to understand your duties, devote adequate time, and ask for help from advisors can go a long way toward avoiding costly mistakes.

Part V - Distributions to Beneficiaries

DISTRIBUTIONS TO BENEFICIARIES

Making distributions to beneficiaries is a significant responsibility for a Trustee. Most beneficiaries will have little involvement with a Trustee other than when distributions are made. In most circumstances the Trustee will look just to the trust instrument, including all amendments, for guidance in making distributions. In some cases a Court Order or Distribution Agreement may be relevant and must be reviewed.

The Trustee has a duty to act impartially among the beneficiaries in all actions, including when making distributions. For example, the distribution of all stock to one beneficiary and all real property to another beneficiary may not be considered fair. The best approach is often to distribute proportionate shares of each asset to each beneficiary.

Mandatory vs. Discretionary Distributions. When trusts continue over time, the instrument may provide for both mandatory distributions and discretionary distributions. The mandatory distributions are fairly easy to administer. For example, trusts often provide for all net income to be distributed to one or more beneficiaries.

Discretionary distributions are more complicated and often allow for distributions for "needs", typically defined as the "health, education, support or maintenance" of the beneficiary. In order to determine the beneficiary's need, the Trustee often obtains financial information from the individual. Decisions about discretionary distributions can be difficult; this is an area where professional advice may be helpful.

Some trusts provide for withdrawal rights when the beneficiary reaches certain ages (i.e., 25 years, 30 years and 35 years). The Trustee should be aware of the ages of the various beneficiaries so these distributions can be made in a timely manner.

Subtrusts. If the trust divides the assets into subtrusts (for example Trusts A, B and Q, or Trusts for children or grandchildren), each of these subtrusts will likely be a separate entity for income tax purposes. Therefore, you should request a taxpayer identification number for each subtrust. This can be done using IRS Form SS-4 (your attorney or accountant can obtain these for you).

You will need to change the ownership records to show that the Trustee of the appropriate trust owns certain assets (i.e., real property, insurance policies, securities, etc.). The listed owner should read something like: "Bill Smith, as Trustee for the Jones Family Trust dated October 6, 1991, as amended, Trust 'Q'". Bank accounts should be established in the name of each subtrust; this will help prevent the commingling of funds among the different trusts. Separate accounts will also be helpful in preparing accurate and complete accountings.

With respect to assets such as securities and insurance, a phone call or email to the company will usually reveal the proper method for changing title. Changing ownership of real property will require more inquiry and paperwork, including deeds and, in California, preliminary change of ownership reports. Changing ownership of real property can trigger a reassessment of property taxes. Certain transfers, such as between spouses, and between parents and children, are exempt from property tax reassessment (though documents must be filed with the appropriate Assessor's Office, in a timely manner, in order to obtain the parent-child exclusion). Also there are special rules which must be complied when a trust owns contaminated property, such as gas stations and mills.

Income vs. Principal? Items coming into and going out of the trust should be categorized either as "income" or "principal". These distinctions are made in the trust accounting records and are important as the beneficiaries may be entitled to distributions of income only.

The trust instrument normally identifies what types of items are allocated to income and what are allocated to principal. To the extent the trust does not so provide, California has adopted the Uniform Principal and Income Act ("UPIA"), which also makes these distinctions. The following is a list of how items are generally characterized. However, you should still review the terms of each trust and the UPIA (Probate Code Sections 16230-16238) for rules applicable to your situation.

Income:	Principal:
* Rent	* Capital gains, unless trust provides otherwise
* Interest	* Portion of note payment towards principal repayment
* Dividends	* Assets set aside for remainder beneficiaries
	* Reserve set aside for wasting assets (*i.e.,* oil wells)

Notifying the Beneficiaries. In some circumstances the Trustee must notify beneficiaries when they have a right to withdraw assets from the trust. This usually arises when the trust is a "Crummey" trust, which grants the beneficiary a certain period of time in which to withdraw gifts made to the trust. The trust may also require the Trustee to notify beneficiaries when making adjustments between principal and income under the UPIA.

Taxation of Distributions. Distributions of principal are generally not taxable when received by the beneficiary. Distributions of income are taxed as income to the recipient. Trusts are taxed at a 35% tax rate when their income reaches $11,250, while an individual is not taxed at that rate until his/her income reaches $379,150. As it is likely that the beneficiaries have lower tax rates than the trust, distributing income from the trust to the beneficiaries may produce greater overall tax savings.

Keep Good Records. One of the best ways to avoid pitfalls is to maintain current and accurate records of all trust business. You should keep these records in a safe place and keep them for at least four or five

years after the trust has terminated (keep tax returns for seven years). Your attorney or accountant can provide you with a sample trust accounting format to get you off on the right track.