CHAPTER 57

Trust Administration to Reduce Estate Taxes

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Before revocable living trusts became popular, when someone died, the will was probated to take care of assets titled in the decedent's name. Probate is simply a court-supervised process under which the decedent's last will is admitted to probate, and the personal representative (executor) is appointed by the court to marshal the decedent's assets, pay off the decedent's creditors, file the decedent's tax returns, and ultimately distribute the assets to the beneficiaries named in the will.

Some attorneys proclaim that one of the beneficial attributes of a revocable living trust is the fact that assets transferred into the trust avoid the probate process. So does this mean that the trustee of the trust can simply make immediate distribution to the trust beneficiaries following the grantor's death without regard to creditors, taxes, or legal claims against the estate? The answer to this question is a resounding "no."

State laws have evolved over the years to impose on the trustee of a decedent's trust many of the same responsibilities assumed by the personal representative of an estate. These responsibilities include ensuring: the proper trust is being administered, including all amendments properly executed by the grantor; the decedent's creditors get paid; interested parties have the opportunity to object to the validity and/or terms of the trust; taxing authorities are cleared; and ultimately proper distribution is made to beneficiaries.

This chapter will review the various duties most states impose on the trustee of the trust when the grantor dies. While many states have implemented some version of the Uniform Restatement of Trusts Third, it is incumbent upon anyone serving as a trustee of a trust to obtain competent legal counsel to ensure all legal requirements are satisfied. Failure to comply with most state statutes results in the trustee having personal liability to a harmed party.

ADMINISTERING THE MOST RECENT VERSION OF THE TRUST

In many revocable living trust scenarios, the grantor of the trust initially serves as his or her own trustee. Usually the person named as successor trustee only begins serving upon the incapacity or death of the grantor. Therefore it is important for the successor trustee to ensure he or she is administering the most recent version of the grantor's trust. Since most revocable trusts are, by definition, amendable and revocable, it is not uncommon for a trust to have one, two, or even multiple amendments altering its terms.

Hopefully, the successor trustee is familiar with the grantor's advisors, including the trust attorney who drafted the instrument. Most of the time, the grantor's attorney can verify the proper trust to be administered and has knowledge about its amendments.

Because the trust administration process is not governed by any court, there is no judge to determine whether the version of the trust being administered is the proper version. Most state trust administration laws therefore impose the primary duty on the trustee to provide a copy of the trust and any relevant amendments to any interested party who so requests.

It is usually good form, even if not expressly required by state statute, to provide the surviving spouse, beneficiaries, and other interested parties a copy of the current trust instrument following the grantor's death. This, along with the statutory notice provisions discussed below, starts the clock ticking for anyone who may have knowledge of another version of the trust, who believes that the trust being administered is legally invalid, or who wishes to make a statutory claim — such as a spousal elective share. If a party fails to file a challenge to the trust instrument within the legally prescribed time period, he or she generally loses the ability to do so.

It is important to explore these issues before distribution is made under the terms of the trust. If the trustee were to make distribution before giving all parties due process to present a claim or a challenge, the trustee could be held personally liable to a party. The trustee should avoid the unfortunate position of having potential liability to a party who did not get due process without having the assets at the trustee's command to satisfy the liability.

LEGAL NOTICES AT THE INCEPTION OF THE ADMINISTRATION

Most state statutes require the trustee to issue certain notices to interested parties when administering the trust following the death of its grantor. In Florida, the first notice is a "Notice of Trust." This Notice of Trust may be filed with the probate court and identifies the fact that a person died, that he or she had a revocable living trust at the time of his or her death, the name and contact information for the acting trustee of the trust, and the attorney acting for the trustee. This Notice serves as a "bridge" for potential creditors who may wish to file claims against the estate. Creditor claims aspects of a trust administration are discussed below.

The second notice is usually an "Acceptance of Trusteeship." This Acceptance indicates that the person named as successor trustee following the death of the grantor has accepted the office and responsibilities as trustee. The Acceptance is usually forwarded to all institutions (banks and brokerage firms) holding trust assets in order to transfer the ownership on the trust's existing accounts from the decedent's name as trustee to the name of the successor trustee in his or her capacity as trustee of the trust. The Acceptance is also mailed to the beneficiaries of the trust, so they know who is responsible for the trust administration and how to contact that person.

TAXPAYER IDENTIFICATION NUMBER

While the grantor of the revocable living trust is acting as a trustee, the grantor's Social Security number usually serves as the trust's taxpayer identification number. Once another party takes the office of trustee for the trust, a new taxpayer identification number is required.

CREDITOR'S RIGHTS

If there are no assets in the decedent's name individually, which would require opening a probate administration, the trust will be required to stand behind any claims made against the estate during the applicable time period prescribed by statute. In Florida, for example, without the due process afforded to creditors under the probate statutes, a creditor has a two-year statute of limitations in which to file a valid claim against the estate.

Depending upon applicable state law, the trustee may wish to open an empty probate to clear creditors. Looking at Florida again, the statutory claims period is shortened to three months by opening a probate administration and publishing a notice to creditors as directed under Florida law.

In most situations there are few creditors, and if there are, their claims probably arise from expenses related to the last illness or funeral expenses, which are usually paid in due course. A trustee should, however, assemble a list of any claims or potential claims that may be known or otherwise "reasonably ascertainable." Recent case law has held that a recurring payee in the decedent's checkbook is deemed a reasonably ascertainable creditor.

Copies of the decedent's credit card statements, bank statements, check registers, and computer logs should be reviewed to determine which creditors may have claims against the estate assets. The trustee should work carefully with the trust attorney to ensure any and all creditors who may have claims against the trust estate are provided proper notice and are duly satisfied, where necessary, prior to the final distribution of trust assets.

ACCOUNTINGS

Each "qualified beneficiary" (a legal term defined under the Uniform Restatement of Trusts Third) is entitled to an accounting of the trust assets at least annually, and again upon the termination of the trust. This provision may be, and frequently is, waived by the beneficiaries, but in this instance it will be important for the trust attorney to prepare a proper waiver from the qualified beneficiaries to protect the trustee.

Frequently, family members will waive the accounting requirement, but the more beneficiaries there are, the less likely it will be that everyone will be willing to waive. It is therefore very important that the trustee keep accurate records of all receipts and disbursements for the trust, and that these records are kept consistently throughout the course of the trust administration.

When there are ongoing "testamentary" trusts benefiting one or a group of individuals with income, while other beneficiaries are entitled to the "remainder" interest after the primary beneficiaries' interests terminate, it will be important for the trustee to account separately for the receipt and disbursement of income items, and the receipt, gain or loss, and disbursement of principal items.

Here you will need a qualified attorney or CPA to properly account for trust income and principal. Income generally refers to items such as dividends and interest, while principal typically refers to items such as capital gains and corpus.

While this might seem like a simple concept, in practice, accounting for income and principal can be quite difficult without the assistance of a qualified professional. Consider the complications arising from depreciable real estate or annuities, for example. Most state laws devote whole chapters to the rules surrounding what is considered income and what is considered principal when performing trust accountings and when making trust distributions. It is therefore important for the trustee to engage the services of a qualified professional to properly account for these items.

TAX RETURNS AND VALUING THE TRUST ASSETS

It is generally the trustee's duty to ensure that all necessary trust tax returns have been filed and that any taxes due have been paid. These returns typically include the decedent's last 1040, the trust income tax return 1041, the federal estate tax return Form 706, state income tax returns, as applicable, and if taxable gifts were made prior to the decedent's death, a federal gift tax return Form 709.

In most cases, the trustee will be responsible for determining the date of death values of the assets held by the trust. The trustee must usually hire a real estate appraiser to determine property values. A good faith estimate by a realtor or real estate broker is typically not acceptable to the IRS, so the trustee should ensure he or she is using a licensed appraiser familiar with the neighborhood or county in which the property is located.

Date of death values for stocks, bonds, and mutual funds is easier to obtain, commonly with the assistance of the trust's stock broker or financial professional. When the date of death falls on a weekend, the financial advisor should average the Friday and Monday high and lows for the stocks, bonds, and mutual funds to determine the date of death values.

When the trust owns closely held business interests, partnerships, or interests in land trusts, often the trustee must hire a qualified valuation specialist to value these types of assets.

In some taxable estates, the trustee may also be required to obtain "alternate valuation date" values for the trust assets. If the trust assets fall in value, the "alternate valuation date" (six months past the decedent's date of death) may be used for valuation purposes on the federal estate tax return.

The date of death values are important to obtain even if the estate will not be required to file a federal estate tax return Form 706. The beneficiaries to the trust assets will generally receive a step up in basis equal to the date of death values. Consequently, for the beneficiaries to verify the gain or loss on the sale of an inherited asset on their own personal tax returns, they must know its date-of-death value.

PRUDENT INVESTOR RULE

Generally, the duty of the trustee is to administer the trust diligently for the benefit of the beneficiaries. In carrying out these duties, the trustee is required by law to invest and manage the trust assets during the course of the administration as a "prudent investor." The trustee is advised to retain the services of a qualified investment advisor to assist with this duty if the trustee does not personally have sufficient credentials or skills as a money manager.

If the trust owns a concentration of assets in one or a few securities, it is usually prudent to diversify the holdings. Similarly, because most trust administrations are short-term in duration, a prudent investor would be expected to liquidate more volatile assets in favor of more conservative holdings, unless the beneficiaries sign a direction, such as a "letter of retention" directing the trustee not to sell certain holdings.

The trustee is charged with the responsibility of ensuring the assets do not fall in value following the valuation date used for the federal estate tax return. The trustee, in other words, does not want to be in the situation where the trust estate is paying tax on asset values that have since declined. Consequently, the prudent investor rule leans toward a conservative, asset preservation mode as opposed to a more aggressive growth mode during the course of the trust administration.

Because many assets receive a step up in basis equal to the date-of-death value, the trustee usually does not have to risk incurring capital gains on the sale of volatile assets. These issues should be discussed with the trust attorney, CPA, and financial professional prior to the trustee taking action.

SALE OF REAL PROPERTY

The sale or disposition of real property, particularly homestead real property presents unique issues. Some of these issues involve whether the trustee has proper and clear vested title, or whether certain court orders must be obtained before clear title can be transferred.

Therefore the trustee should not list to sell, contract to sell, or transfer real property without consulting trust counsel. The trustee does not want to be in the situation where he or she has a contractual obligation to pay a commission to a broker or to close a transaction when the trust has a legal impediment, such as a tax release, homestead order, or other contingency which must occur before the trustee has authority to close the transaction.

In other words, the trustee needs to avoid the situation where he has contractually obligated the trust to act when in fact there are circumstances beyond the trustee's control (court orders might take longer to obtain than originally anticipated, for example) that prevent him from acting and therefore renders the trust in breach of the obligation. Competent real estate and trust counsel can assist the trustee in avoiding these situations.

DUTY TO ACT IMPARTIALLY

Often the trustee charged with the duties and responsibilities of administering the trust is also a beneficiary of the trust. Here, the trustee must be very careful to administer the trust impartially, without regard to his or her own or any particular beneficiary's interest.

Suppose a child of the grantor is named as the trustee of the trust following the grantor's death. Assume further that the trust continues for the benefit of the child's stepmother for the rest of her life, paying her income, while principal may be invaded for the stepmother's health, maintenance, and support.

The child/trustee understands that if the trust is balanced more for income than for growth,this will adversely affect his own interest and benefit his stepmother's interest. Further, if the child were to distribute principal for the stepmother's benefit during her lifetime, these dollars will not end up with the child/trustee's remainder interest.

Nevertheless, when accepting the office of trustee, the child assumes the role of an independent, impartial, and disinterested fiduciary and must carry out his or her duties without regard to personal gain or loss. Instead, the trustee should always consider what the intent of the grantor would have been had the grantor been alive to provide further instruction.

TRUSTEE AND PROFESSIONAL FEES

Generally speaking, most trusts and state statutes provide that the trustee may take a reasonable trustee's fee and may also employ legal, accounting, tax, appraisers, and other advisors. The trust assets are used to pay these fees, and the fees are normally tax-deductible.

In cases where the trustee is also a family member or beneficiary, trustee fees may be waived. As one can determine by reading this chapter, however, acting in the capacity of trustee takes a substantial amount of time and effort and is fraught with liability. For other beneficiaries to expect the person acting as trustee to take on these obligations without compensation is not a reasonable position.

Costs, such as filing fees, newspaper publication costs, and the like, should also be paid by the trust assets. Where the trustee or another person has forwarded these costs on behalf of the decedent, the trustee can use trust funds to reimburse the party.

Certain expenses, such as those associated with family members attending funeral services, are not deductible by the trust or the estate and are generally considered not to be expenses that should be reimbursed by trust assets. The trustee should consult with the trust attorney prior to making any such reimbursements.

IS A TRUST ADMINISTRATION AS BURDENSOME AS A PROBATE?

After reviewing this chapter, you may inquire whether having a revocable living trust is worth it, given the fact that the trustee has so many obligations to satisfy. If one considers that the trust administration process is private and rarely do issues appear in a public forum such as the probate court, then one can come to the conclusion that a trust administration is preferred to a probate administration.

Couple this with the fact that one does not have to wait for a court to respond to pleadings, something that can often delay a probate administration for weeks or months given most probate court's crowded dockets, and one can easily surmise that having a revocable living trust is preferable to not having one.

Many of the rules surrounding the obligations of trustees have been around for quite some time. It is only in recent history that these common law rules have been codified into state statutes to provide clear guidance to trustees and their advisors, ensuring everyone affected by the grantor's death is treated fairly and responsibly.

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Postmortem Actions to Increase Estate Liquidity and Reduce Estate Taxes

REDUCING CASH NEEDS OF THE ESTATE	INCREASING CASH AVAILABLE TO THE ESTATE
Reduce gross estate: • Lifetime gifts • Special-use valuation • Valuation discounts	• Sale of illiquid assets • Buy-sell agreements for business interests • Section 303 redemption of closely held stock
Reduce taxable estate: • Alternate valuation date • Marital deduction • Charitable deduction • Qualified disclaimers • Election against the will • QTIP election	• Life insurance
Reduce estate tax payment: • Installment tax payments • Section 303 redemption	• IRA and retirement plan benefits available to the estate
Reduce probate and administration costs: • Living trust • Will substitutes • Avoid ancillary probate • Postmortem elections and actions	• Loans • Irrevocable life insurance trust (may make loans to or buy assets from estate)

Postmortem Actions to Reduce Income Taxes

ACTION	OPTIONS
Medical expense deduction	May be taken on: • Estate tax return or • Decedent's final income tax return
Estate administration expense deduction	May be taken on: • Estate tax return or • Decedent's final income tax return
Waiver of executor commissions	Avoids reporting and being taxed on income that will be received as a bequest
Selection of fiscal year for estate	Income can be spread over more years potentially benefiting heirs and legatees
Reporting interest on U.S. savings bonds	May be reported on: • Decedent's final income tax return or • Estate tax return