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# MISADVENTURES IN SUBTRUST ALLOCATION: WHEN A GOOD ESTATE PLAN GOES BAD

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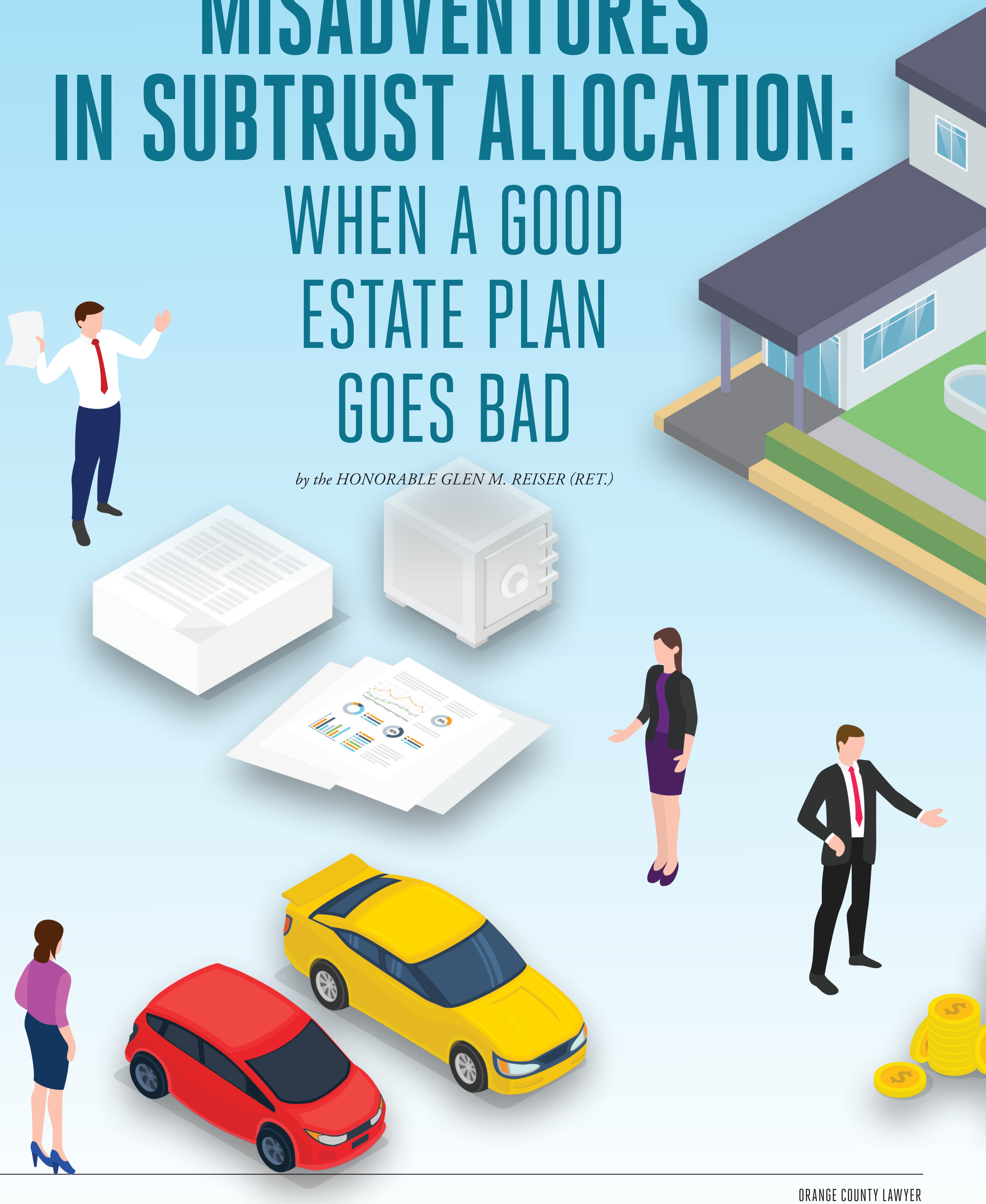

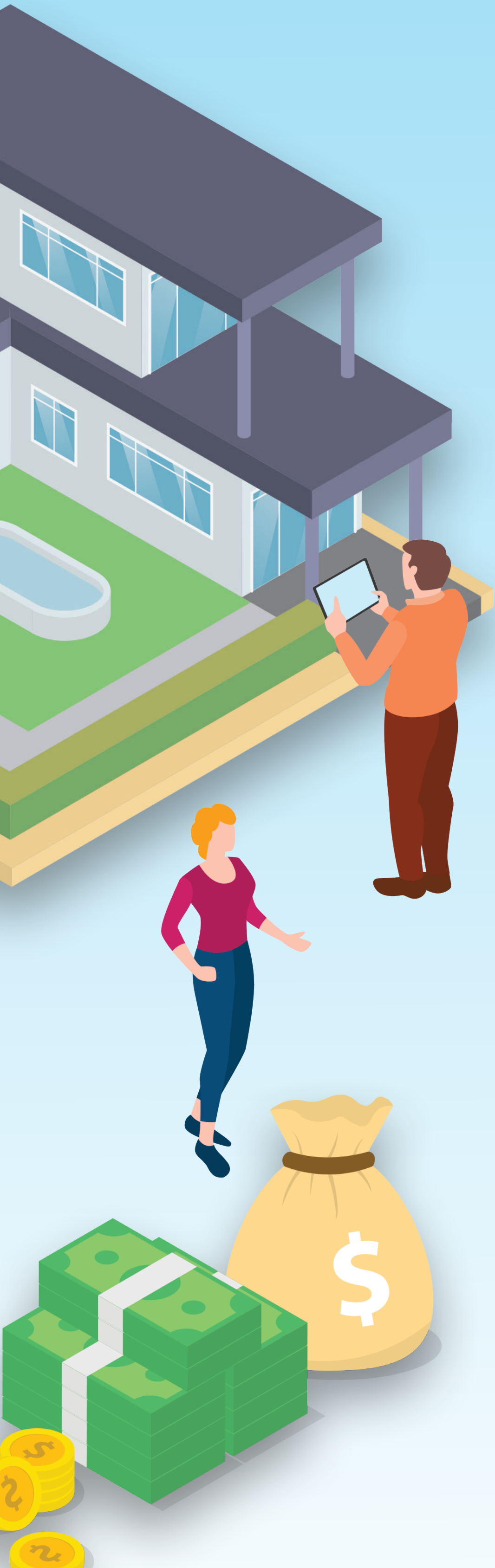

Since the 1960s, revocable living trusts have become the most common estate planning tool in America, allowing families to manage their assets and giving rise to wealth transfers across multiple generations outside of probate. Though no two trusts are exactly alike, the vast preponderance of husband/wife trusts in California take the form of what estate planners commonly refer to as "AB" and "ABC" trusts.

For nearly all AB and ABC trusts signed prior to the Portability Act of 2011, and for a large number of *inter vivos* family trusts drafted since that time, estate assets must be characterized, valued, and divided between subtrusts on the death of the first spouse to pass.

After the first spouse passes under this scenario, one of several things may happen. First, the surviving spouse might never allocate as directed by the trust instrument. Second, every trust asset will be properly characterized, valued, and allocated by the survivor between subtrusts, at least in a manner as to which the ultimate beneficiaries never take issue. Third, the surviving spouse's community property and separate property characterizations, assigned asset values, or subtrust allocations can give rise to unfairness claims among the respective beneficiaries.

Utilizing litigation cases either currently pending or recently tried, the following factual prototypes demonstrate how even a very good estate plan can go wrong.

## Swiss Family Robinson: Who Inherits the Treehouse?

Martin and Emma Schmid grew up in Switzerland and emigrated to America as hard-working young adults. The couple acquired a parcel of land decades ago along the bluff at Ocean Beach (San Diego), upon which they constructed five small residences. The couple moved to Fresno but continued to rent and manage the small homes in San Diego. Emma became a successful lender, investing in a number of mortgages secured by single-family residences in Fresno. Missing their childhood mountain homes in Switzerland, Martin and Emma purchased a recreational mountain cabin at Shaver Lake.

Martin and Emma raised three children: Max, Karl, and Mila. Max studied law and business. Because Max had learned Swiss German at a young age, he accepted a position in Germany as a professor and research scientist. Karl, following his mother's lead, became a real estate lender and remained in Fresno. Mila, the youngest, married and took a job as a real estate agent in Newport Beach.

Martin and Emma, relying upon a competent estate planner, signed a standard AB trust, dividing their estate *equally* upon their passing between Martin, Karl, and Mila, each as to an undivided one-third. Upon the death of the first spouse, an irrevocable decedent's trust (B trust) was to be established to the extent of the federal estate tax exemption, with the balance passing to a survivor's trust (A trust). In standard fashion, the couple's assets were to be valued and allocated between subtrusts at the time of the death of the first spouse.

Martin passed first. Emma, however, did not return to the estate planner. Having successfully managed the couple's assets during their marriage, Emma felt no compulsion or urgency to divide the marital estate into subtrusts as directed in the trust agreement.

Each of the couple's children enjoyed a different lifestyle and had varying degrees of need. Emma decided that the family estate plan needed a new distributive scheme. In a three-page trust amendment, Emma sought to amend the entirety of the family trust by gifting the five Ocean Beach units to Mila and her five children in a spendthrift trust. The family home in Fresno would pass directly to Karl. The mountain cabin at Shaver Lake was gifted to Max. The trust deeds were to be divided equally between Max and Karl.

Upon Emma's passing, Max and Karl challenged their mother's trust amendment as void, contending that Emma had no right to gift specific family assets intended to be divided equally by Martin in the family trust. Mila contended that the specific gifting was fine and that the survivor's trust could be construed as giving Emma's survivor's estate to Mila in light of the meaningful value differentials between the Ocean Beach property and the remaining assets.

The case proceeded to trial. It was determined after several days of testimony that Emma's failure to allocate assets between subtrusts on Martin's death effectively titled one-sixth of each family trust asset in each of the three children. Emma, free to amend her survivor's trust as she saw fit upon Martin's passing, could gift the remaining one-half of the San Diego property to Mila, the remaining one-half of the Fresno home to Karl, and the remaining one-half of the Shaver Lake cabin to Max.

The trial court decision, legally correct, brought about a result that neither Martin nor Emma had intended and none of the children wanted. Martin had expected that each of his children would own an equal share of all family trust assets. Emma had intended that each of her children receive the asset(s) most appropriate to their situation. Instead, they each wound up as tenants-in-common at different percentages. The failure by Emma to value and allocate assets upon Martin's passing capsized the family estate plan and, at the same time, undermined Emma's very specific intentions.

### Sharknado: Be Careful When You Bite Back

Following the 1906 San Francisco earthquake and fire, a number of Italian fishermen moved their families and fishing boats to San Diego. The city subsequently became the "tuna capital" of the American West Coast. Over the course of decades, descendent family commercial fishing interests expanded into commercial and residential real estate ownership.

Sal and Angelina had been married for many years but were never blessed with children. Sal and Angelina agreed that their extensive marital estate, consisting of numerous real estate holdings in and around San Diego, would pass one-half each to their respective extended families. Sal and Angelina visited a respected estate planning attorney and established an AB trust.

Angelina became incapacitated. Sal brought in one of Angelina's nephews, Vincent, to assist as a co-trustee in managing the marital commercial estate. At some point, Sal determined that Vincent was covertly helping himself to family capital under Angelina's power of attorney. Sal removed Vincent as co-fiduciary. Vincent responded by requesting a conservatorship over Sal. The issues were settled by Sal to avoid litigation, with Vincent retaining hundreds of thousands of dollars of family assets. Sal neither forgave nor forgot.

Angelina meanwhile passed away, resulting in her B trust becoming irrevocable. As Sal was working with counsel to value and allocate assets among the respective families, Sal decided to place the bulk of the valuable real estate holdings and associated income on his A side of the ledger, which he compensated through an "equalizing" unsecured promissory note to the B trust, paying interest at a low rate, which interest in any event was to be paid to Sal as surviving spouse.

Litigation ensued after Sal's passing. A judgment was ultimately rendered against the successor trustee of the A trust because there were other beneficiaries of Angelina's B trust (not Vincent) prejudiced by Sal's interpretation of his duty of impartiality to all beneficiaries of both subtrusts. While such a finding does not suggest that asset allocation by the surviving spouse must be *pro rata* across the spectrum of estate properties and interests in every trust, in that case a comparison between the historic appreciation of downtown San Diego real estate and the face value of Sal's promissory note to the B trust bore little correlation.

### The Parent Trap: Dad Is Doing What?

Don spent his career in the world of information technology and medical billing. Don began working at IBM in 1961 and ultimately ran his own companies. Throughout his successful career, Don was supported full-time by his wife, Judy.

Don and Judy raised two children, David and Lindsay. In 1999, Don and Judy asked Lindsay to learn the family business as a segue to eventually managing the company. Lindsay became president of the company in 2004. Don took a substantial buyout and an advisory role.

Judy died unexpectedly. Prior to her passing, Don and Judy had created an ABC trust. Upon Judy's death, with the assistance of counsel, the couple's assets were characterized, valued, and allocated between the various subtrusts.

After a period of time, Don began dating and married Carolyn, a younger woman and a former family neighbor. Lindsay was reportedly unhappy with her father's remarriage. Lindsay allegedly defaulted on certain financial obligations owing to her father, purportedly eliminated certain company benefits that Don had been receiving, and acted uncooperatively on other matters. Don began reconsidering both the wisdom and accuracy of the initial subtrust allocation.

With new estate planning counsel, Don uncovered what he asserted to be major errors in both trust asset characterization and in the valuation of marital assets on the date of Judy's death, along with alleged material asset omissions. Don determined that he had seriously overfunded Judy's B and C trusts.

Among other things, Don reallocated the entirety of the family home that he had shared with Judy to the survivor's trust, which Don and Carolyn then abruptly sold. Don modified the date of death values of other assets and made substantial changes in the composition of the irrevocable subtrusts irrevocably passing to David and Lindsay or their issue. A lawsuit involving the subtrust reallocation has been filed, and the matter is currently being litigated.

### Lessons Learned

In husband/wife trusts designed to guarantee that at least some meaningful portion of the marital estate will pass according to the wishes of the first spouse to pass, the surviving spouse is under an obligation to value and legally split the trust estate according to the trust terms, fairly and impartially. The B trust and any C trust become irrevocable. Among other things, this requires statutory notice and implicates subtrust tax and accounting obligations.

In family situations where all material trust assets are divided *pro rata* in unchanging percentages among the same beneficiaries across all subtrusts, allocation will likely never become a problem. Where there is not full symmetry of beneficiaries or percentages over the various subtrusts, however, as was the case with Sal and Angelina's estate and is likely to become the case with Don and Judy's estate, each set of beneficiaries will compare their respective inheritances and closely assess the surviving spouse's compliance with her or his fiduciary duty of impartiality. In situations where there was never a subtrust allocation, though required, as is the case with Martin and Emma's estate, there will be a distinct possibility that no one, living or dead, will wind up satisfied.

Allocate subtrust assets fairly and appropriately. Consider the intentions of the first passing spouse and the vested rights of the beneficiaries of the B and any C trust in a fair and impartial valuation and division. Avoid overweighting the irrevocable trust with income-producing assets that benefit only the surviving spouse. Keep professional liability insurance premiums current.

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***Hon. Glen M. Reiser (Ret.)*** *is an arbitrator, mediator, and special master at JAMS. He has vast experience adjudicating and resolving thousands of complex commercial, real property/environmental, trust, and family law disputes as a respected trial judge and litigator. He can be reached at GReiser@jamsadr.com.*

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