LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
MONDAY, OCTOBER 31, 2022

PERSPECTIVE

Subtrust allocation: a primer for litigators

By Glen M. Reiser

The federal estate tax exemption will be $12.92 million for individuals passing in 2023. For a married couple both still living, this translates to a federal tax-free distribution to heirs and beneficiaries of $25.4 million. The current federal estate tax rate is 40% over the exemption sum. Unlike a number of other states, California does not have either a state death tax or an inheritance tax. Beginning in 2011, estate tax exemptions became "portable," allowing unused exemption sums after the death of the first spouse to be added to the exemption available to the surviving spouse.

It has not always been this way. From 1942 to 1976, for example, the federal estate tax exemption amount was $60,000, and the federal estate tax rate was 77%. Since that time, however, other than statutory peculiarities in 2010 and 2011, the federal estate tax exemption sum has consistently increased, and the federal estate tax percentage has consistently decreased.

Prior to 2011, the vast majority of family estate plans were written (and to some meaningful degree are still being written) to timely leverage the death tax exemption available to the first passing spouse. This resulted in the A-B (or often A-B-C) trusts, which trust litigators and judges must regularly review and assess.

Under the classic revocable living A-B trust calculus, upon the death of the first spouse, assets are allocated up to the decedent's statutory exemption sum for the year of passing, typically consisting of the decedent's spouse's separate property and, in California, one-half share of the community property. Assets of the first passing spouse in excess of the exemption sum will often fund a C (most often called a QTIP, marital or marital deduction) subtrust, with rules prescribed by federal law.

Under these estate plans, the surviving spouse generally continues as trustee of both the still-revocable A (survivor's) trust and the now-irrevocable B (bypass) trust, retaining the right to lifetime income from both subtrusts.

Nor does every surviving spouse who signed an AB trust necessarily have an informed view as to the extent and breadth of the decedent spouse's community property rights.

Litigators can become confused because the B subtrust is found in estate plans under a number of different names, but it is most typically denominated as either the bypass or credit shelter trust.

Despite continuing administration by the surviving spouse (or other appointed successor trustee), as well as the right to continuing income from the entirety of the marital estate, the bypass trust becomes immediately irrevocable on the first spouse's passing. At that time, the trustee must, among other things, obtain a separate taxpayer identification number (TIN) for the bypass trust; must inventory and value the entire trust estate, including the survivor's portion; must provide a statutory California Probate Code § 16061.7 notice to not only the bypass trust beneficiaries, but also the deceased spouse's statutory heirs; and must file annual tax returns for the bypass trust and account to its beneficiaries upon demand. The rules applicable to a B trust also apply to a C trust.

Perhaps most importantly, it is the surviving spouse's job to allocate assets between the survivor's trust and the bypass trust, including the unilateral determination as to which assets are separate property and which are community property. The assets allocated to the decedent spouse's bypass trust must be specifically segregated and titled in the bypass trust. For capital gains tax purposes, assets allocated to the bypass trust receive a step-up in basis to the date of death of the first spouse. Assets retained in the survivor's trust will ultimately receive a step-up in basis for capital gains tax purposes to the date of death of the survivor.

Over the course of trust mediation practice, there appears to be a rising number of litigated claims by beneficiaries challenging subtrust allocation determinations (or lack of allocation) by the surviving spouse. While the breadth of such claims is diverse, several common factual scenarios appear to have surfaced.

There remain hundreds of thousands of AB trusts in circulation in California, some of which were prepared by highly competent attorneys, some of which were prepared by "trust mills" and some of which were downloaded from the internet by well-intentioned but often uninformed couples.

Not every surviving spouse who signs an AB trust is aware of or otherwise recalls the obligation to allocate assets between subtrusts after their husband or wife's funeral. If the surviving spouse, without proper subtrust allocation,

*Judge **Glen M. Reiser** (Ret.) is a mediator and arbitrator at JAMS, also often serving as a court-appointed referee in trust, probate and conservatorship matters. He has had vast experience adjudicating trust and intra-family disputes as a neutral, a respected trial judge and as a litigator. He can be reached at GReiser@jamsadr.com.*

subsequently amends the survivor's trust to allocate specific assets among certain children or even a later spouse, or to simply adjust percentages, there would likely be a legitimate objection from any bypass trust beneficiary arguably entitled to an undivided pro rata interest in up to one-half of each of the original trust's joint marital assets.

Nor does every surviving spouse who signed an AB trust necessarily have an informed view as to the extent and breadth of the decedent spouse's community property rights.

Family law attorneys can regale you with the complexities of Moore-Marsden forensic analysis and the differing treatment of family law presumptions versus record title presumptions on death. Separate property rights of the deceased spouse ought not be knowingly or negligently overlooked by the surviving spouse fiduciary as assets are characterized.

Date-of-death valuations are matters of expert opinion and can be under-calculated on the passing of the first spouse or recalculated in the years following, to the possible disadvantage of the bypass trust beneficiaries.

Placing all or most income-producing assets in the bypass trust, which income flows to the survivor, with the appreciating assets allocated to the survivor's trust, may result in massively different subtrust valuations on the death of the survivor, again to the potential disadvantage of the irrevocable bypass trust beneficiaries.

As the survivor's trust most typically remains revocable and amendable until the date of the survivor's passing, changes by the survivor to the originally contemplated family estate plan can result in hurt feelings among family members, and, ultimately, consultation with litigation counsel regarding the propriety of spousal fiduciary action or inaction. Whether the situation involves a survivor's spouse's possible asset misallocation, prejudicial change in allocation, self-serving allocation or failure of allocation, these concerns are appearing more frequently and are being scrutinized by California trust litigation attorneys.

Reasonable advice to trust litigators reviewing these issues is, at a minimum:

1. Always be mindful of statutes of limitations associated with Probate Code § 16061.7(h), Code of Civil Procedure § 366.2(a) and Family Code § 1101(d), as well as the application of laches.

2. Consult an experienced estate planning attorney and trust tax accountant when assessing the fiduciary propriety of a non-per capita or non-pro rata subtrust allocation and, to the extent applicable, consult with an experienced family law attorney.

3. Consider the retention of an appraiser when concerned with the accuracy of business and/or real property valuations.

Trusts are complicated. Estate planners are nuanced and creative, and may have fully incorporated beneficiary impartiality obligations into their subtrust allocation model. Trust litigation lawyers should not be hesitant to contact the estate planner or tax accountant associated with the estate's subtrust allocation plan, if known, prior to recommending litigation to any aggrieved bypass trust beneficiary.

Disclaimer: The content is intended for general informational purposes only and should not be construed as legal advice. If you require legal or professional advice, please contact an attorney.

Reprinted with permission from the *Daily Journal*. ©2022 Daily Journal Corporation. All rights reserved. Reprinted by ReprintPros 949-702-5390.