LEE R. PHILLIPS

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APRIL
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DEATH OF A CLIENT—CASE STUDY

By Lee R. Phillips, JD

Failure of the Trust

One of my clients passed away last year. He had set up all four pillars of a good estate plan: a living revocable trust, will, living will (health directive), and durable power of attorney. He was supposed to put all of his assets into the trust, so that they wouldn't have to go through probate when he died, but he didn't get the trust "fully funded." The trust assets were ultimately to be distributed in equal shares to each of his four children. He and his present (third) wife had made a prenuptial agreement indicating that all finances would be kept separately and any assets passed on to their respective natural children.

When I wrote the trust, I made sure that his new house (the one piece of property the client told me about) was put into the trust's ownership. He was carefully instructed to put his other assets into the trust. Because he had some mental issues, the other assets never got put into the trust. That meant probate for his family after he died. His daughter had to collect the other assets and use the "pour-over will" to probate the assets and then "pour" them over into the trust.

Luckily, her siblings were more than happy to let her do the legwork. Nobody had really expected to inherit anything, so everyone was mildly surprised to get a little something. The siblings were happy to each sign a waiver of notice in the probate proceedings, so that the letters testamentary could be granted by the county court more quickly. However, the stepmother didn't go along with the successor trustee's requests. She wouldn't sign anything. She wanted the formal notice on each move in the probate process.

Without waivers from every potential interested party, there had to be a waiting period in case anyone challenged the will, appointment of the personal representative, or any other issue related to the probate. If anyone did file a challenge, that would have then required a court proceeding. The family obviously wanted to avoid a formal court appearance. Nobody came forth with a challenge, so the judge simply reviewed the documents at his desk. The daughter (personal representative)

checked back each week after the filing deadline until the court clerks were able to confirm that permission had been granted and they could issue as many dated copies of the letters testamentary as might be needed. It still took the rural county court an additional month to issue the letters testamentary

The Durable Power of Attorney

In the meantime, the daughter tried to do whatever she could to settle the estate. She could immediately work with anything that did not require a signature to access or transfer. Because the client's house had been put in his trust and his daughter was named as the successor trustee, she had immediate legal access to everything he had in the house. She checked with her siblings to see if there was anything in particular they wanted to remember their father by. She watched for those items as she started cleaning out his house so it could be sold. Again, she was lucky that the siblings had low expectations and didn't ask for any of the same items.

The client had never filled out the Schedule B part of his trust, which distributes what I call the "dollies and doilies." Schedule B is a way that the client could have distributed his heirloom items. It's the heirloom items that cause fights in a family. I've seen siblings not talk to each other for decades, because they each wanted a particular keepsake and didn't get it.

The daughter started contacting all of her father's creditors and tracking down his multiple storage units. I was stunned at the number of folks that asked her for a durable power of attorney. They would look at the durable power of attorney and

DEATH OF A CLIENT—CASE STUDY, CONT.

could see that she had been appointed the "agent" for her father in the durable power of attorney. They would then let her take over the storage units, the credit card accounts, and do lots of things as her father's agent under the durable power of attorney. They never asked for the letters testamentary. Lots of people just wanted the durable power of attorney.

Those people were clueless. Everybody should know that upon the death of the principal (in this case the father), the durable power of attorney becomes totally void. A durable power of attorney is not a probate avoidance tool. When someone would ask for a copy of the durable power of attorney, she would ask me what she should do. I told her that if people were stupid enough to deal with her as agent under the durable power of attorney, she should grab the assets. Of course, she poured the assets over into the living revocable trust under the spirit of what was supposed to happen to her father's assets. If she had taken off with the assets, the storage unit folks would have been liable to the other heirs. They didn't understand the law. Don't even think that you can weasel your way around probate using a durable power of attorney. Your chances of running into as many stupid people as she did aren't good.

Joint Ownership

Around the time he set up the will and trust, the client had opened a joint account with his daughter and had put some cash into the account in order to cover funeral and other expenses of the estate. Technically, this was a mistake. As a joint owner upon his death, she became the sole owner of the account, and that money was legally all hers. It would not pass into the estate to be divided up between his children. She could have used the money any way she wanted. In this case, she used the money for the intended purposes, but she didn't have to.

It would have been smarter for him to have put the bank account into his trust and skipped the joint account altogether. If the account was held by the trust, the successor trustee would have had immediate access to the money and would have been bound to use it according to the terms of the trust.

The father and stepmother had jointly purchased a timeshare, despite their prenuptial agreement to keep all finances separate. Their intention was to keep their assets separate, so that their individual assets would go to their respective natural children. The joint ownership meant that the timeshare passed immediately to the stepmother as sole owner. Timeshares can be very difficult to get rid of, so the daughter was glad there was no reason to have to deal with the extra paperwork. But, it is important to note and realize that any items held in joint ownership go to the surviving owner. It doesn't matter how the will or trust say assets are to be divided.

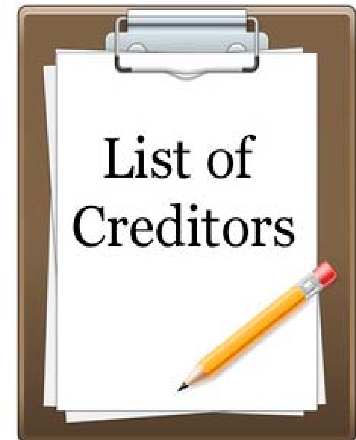
Once the letters testamentary were obtained, the daughter started visiting her father's banks and calling all the creditors and institutions that wouldn't talk to her until she had the written proof from the court that she was the personal representative. Over the next several months, each asset was moved from the estate to the trust and each known creditor was paid off.

Zero Out the Trust

As the tax year drew to an end, the daughter struggled to know how much money needed to be paid out to the beneficiaries. I had told her to zero out the trust by the end of the year, but she didn't understand what it meant to zero out the trust. She assumed she had to distribute all of the assets by the end of the year. She was worried, because she knew there were expenses associated with her father's estate that would be payable in the following year. She could see that if everything was distributed, no funds would be left to administer the trust.

I explained that she only had to zero out the income in the trust each year. She needed to zero out the income the trust earned, because she didn't want the trust to have any income that it had to pay taxes on. The trust became irrevocable when her father died, and she needed to get a tax ID (EIN) for the trust. She would need the tax ID in order to file a tax return for the trust. She got the concept that the trust shouldn't have income on which the trust would have to pay taxes, but she didn't know what was considered income to the trust. She asked if everything that was moved into the trust was considered "income" to the trust? My answer was no.

The original property in the trust and all of the assets that poured over into the trust through probate or even using the durable power of attorney were considered the "principal" of the trust.



Assets in a trust may generate income, just as your personal assets may generate income. In a revocable trust, the terms of the trust usually state that all the income should pass through to the beneficiaries at least annually. In an irrevocable trust, income is either kept in the trust or passed through to the beneficiaries. The trust basically gets a tax deduction for the income it passes through to a beneficiary. The successor will have to issue K-1s to each beneficiary and the beneficiary will have to show the K-1 income on his or her 1040. The beneficiary has to recognize the payment from the trust as income, if it was income to the trust. Distributions of trust principal are not income to the beneficiary.

Income that is kept in the trust (accumulated in the trust) is taxed as the trust's income. Because trust tax rates are so high, passing ALL income through to the beneficiaries is usually better than accumulating it in the trust. At a little over $12,000 in total income, the trust's tax rate kicks in at the highest possible tax rate. That's 39.6% for the federal income tax, plus the state's maximum income tax. NOT GOOD!

DEATH OF A CLIENT—CASE STUDY, CONT.

Basis of Trust/Estate Property

Trust principal has a "basis," for tax purposes, just like your personal assets have a basis. When the assets are sold from a trust, there is an income or loss, just as if you sold them outside of the trust. The basis for each asset in the client's trust (the property the father put in and everything else that was put in after his death) was the fair market value of the asset on the day he died. All of his assets that passed through the probate process or through the trust got a "step up" in basis because of his death.

In this client's case, his total net worth at death was way less than $5.45 million (the exemption equivalent amount this year), and there was no federal estate tax payable. Technically, all of the assets were subject to the estate tax and were actually taxed through the estate tax at the fair market value of the asset on the day the client died. However, the estate got a credit which was sufficient to offset the federal estate tax on all property up to the exemption equivalent value. There is a federal estate tax that applies to everyone, plus about a third of the states have a state estate tax. For most families, the federal estate tax doesn't actually require a payment of taxes, because of the "unified tax credit" which offsets the taxed owed on assets up to the exemption equivalent amount of $5.45 million. Some states that have a state estate tax actually start collecting taxes at lower amounts – on the order of $1 million.

Calculating income for a trust–revocable or irrevocable–was the same as it would have been for the daughter as an individual. If the trust sold trust assets above their basis value, which was their fair market value on the father's date of death, the difference in the basis and sales price was income to the trust. A 1041 tax return must be filed by the trust, but it will hopefully show zero income.

I also told the daughter that the wages paid to her father, after his death, were not considered income to the trust. Those poured over into the trust as assets and are counted as principal. It is the interest earned on assets or return on investments made with trust assets that are considered income to the trust.

As it turned out, the distributions she had already paid out to her siblings were considerably more than would have been required. I instructed her that for the next year she would need to estimate the income accruing to the trust and physically pay that out to the beneficiaries per the terms of the trust. She has a fiduciary duty to reserve enough of the income and principal to be able to administer the trust and meet its financial obligations until all of the assets in the trust have been sold and distributed. If everything was paid out immediately and outstanding debts payable by the estate came up after a complete distribution of the trust's assets, the trustee could be personally liable for the debts.

Name Beneficiaries

In most cases, IRAs do not become part of the estate, for probate purposes. They are included in the estate when estate taxes are calculated. IRAs are actually trusts. The IRA should name beneficiaries, and those beneficiaries will "automatically" receive the IRA as beneficiary of the IRA, not as beneficiary of the living revocable trust. Hopefully, the beneficiaries can "stretch" the IRA and keep the money growing within the IRA structure. The beneficiary will have to pay required minimum distributions (RMDs), based on their own life expectancy. If the RMDs are not taken, the IRS will impose a penalty of 80%. So it is important that the RMDs are actually taken.

In this client's case, one of the IRAs had hi s father listed as the primary beneficiary and his children listed as secondary beneficiaries. The client's father had been dead for over 20 years. That presented big problems, because his estate had been closed decades ago. Please check all your IRAs, life insurance and other documents that require naming of a beneficiary.

It is important to start working with brokerage firms as soon as you get your letters testamentary. Many investment firms will only accept letters testamentary for 90 days after they are issued. Some firms only accept them for 60 days after they are issued. If you are past their "acceptance" date, you will have to go back to court to get a fresh letters testamentary. (Yes, it is plural "letters," even though there is just one document. Letters is just part of the name.) In this case, by the time the successor trustee got her grandfather's death certificate and worked her way through the brokerage firm's hierarchy, the 90 days had run out, and she had to go back to court and get a fresh letters testamentary.

Death of the Trust

When all of the assets were moved into the trust and they had all been distributed, the trust was ready to be terminated. When the trust doesn't own any assets, it basically dies. However, the EIN number has to be killed with the IRS. This is done by simply filing a 1041 tax return and checking the box, (final return) on the front page of the form. The final return can be filed at any time, so you don't have to wait until the end of the tax year.

A lot of issues have been exposed in this article – the concept of a trust, duties of a trustee, joint tenancy, naming beneficiaries, etc. Hopefully, you can see how they come together in considering your estate plan. ■

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2013** OMB No. 1545-0092

▶ Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041.*

A Check all that apply:
☐ Decedent's estate
☐ Simple trust
☐ Complex trust
☐ Qualified disability trust
☐ ESBT (S portion only)
☐ Grantor type trust
☐ Bankruptcy estate-Ch. 7
☐ Bankruptcy estate-Ch. 11
☐ Pooled income fund

For calendar year 2013 or fiscal year beginning , 2013, and ending , 20

Name of estate or trust (If a grantor type trust, see the instructions.)

C Employer identification number

Name and title of fiduciary

D Date entity created

Number, street, and room or suite no. (If a P.O. box, see the instructions.)

E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions.
☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . ▶ ☐
☐ Described in sec. 4947(a)(2)

City or town, state or province, country, and ZIP or foreign postal code

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Net operating loss carryback ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . . . ▶ ☐ Trust EIN ▶

Income

		Line	
1	Interest income	1	
2a	Total ordinary dividends	2a	
b	Qualified dividends allocable to: **(1)** Beneficiaries **(2)** Estate or trust		
3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
7	Ordinary gain or (loss). Attach Form 4797	7	

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LEGALEES CORPORATION

USING THE LAW TO MAKE MONEY

RENTING TO CRIMINALS?

John Anderson is a recent graduate of the BYU Law School. He is a valuable addition to our company. We are fortunate to have him working with us.

By John H. Anderson, JD

The U.S. Department of Housing and Urban Development (HUD) is creating new regulations in connection with the Fair Housing Act. Under these new regulations, HUD is seeking to make housing more available for individuals with criminal records. HUD hopes to provide housing for individuals with criminal records by limiting a landlord's ability to reject a potential tenant based on the tenant's criminal record.

The new HUD regulations make it so that a landlord cannot have a blanket policy of not renting to anyone who has a criminal record. Normally, having a criminal record is not a protected class under the Fair Housing Act, but HUD feels that African Americans and Hispanics are disproportionately harmed by these blanket bans. Housing Secretary Julian Castro told NPR that "When landlords refuse to rent to anyone who has an arrest record, they effectively bar the door to millions of folks of color for no good reason."

Now a landlord is going to have to consider the type of offense on the criminal record and the amount of time that has passed since the crime was committed. If the landlord does deny the application based on the criminal record, the landlord must show a substantial, legitimate, nondiscriminatory interest as to why that criminal record was factored in. The new regulation does allow for a blanket ban on anyone who has been convicted of manufacturing or distributing narcotics.

The Fair Housing Act applies to most landlords in the United States. There are a few exemptions and those exemptions are very limited. One exemption is called the Mrs. Murphy exemption and applies to owner-occupied buildings with four or fewer units. Another exemption is for a landlord who owns three or fewer single family homes and who does not use a broker. The Fair Housing Act also applies to people who are selling houses and who do not fall under the three single family homes exemption.

The criminal background changes in HUD regulations are still being initiated and will probably create a wave of litigation at first. It is not clear if these regulations will be upheld in court. Just know that they are out there as a possible source of litigation, and you probably don't want to be the first test case. ■