

Probate Department Newsletter

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Upcoming CLE Presentations of Interest

Sept 14-15, 2018: CLA Annual Meeting including programs such as Highlights of 2018: The Winter Olympics, A Royal Wedding, and Recent Developments in Trusts & Estates; Appellate Issues in Trusts and Estates Matters; and Understanding Special Needs Trust

September 20-21, 2018: Basic Conference: Estate Planning present by CEB

October 17-20, 2018: 37th Annual Tax & Estate Planning Forum formerly known as The Southern California Tax & Estate Planning Forum

November 14, 2018: 39th Annual Inland Empire Estate Planning Seminar

November 16, 2018: 43rd Annual Trust and Estate Conference presented by USC Gould School of Law

Pitfalls of Split-Interest Trusts for Blended Families

By Jeremy J. Ofseyer, Esq.*

Estate planning clients with blended families often want various “split-interest” trusts, to provide benefits for a surviving spouse for life, with any trust remainder going to children from a prior marriage (or marriages). Although this typically reflects a natural wish to take care of one’s spouse while providing for one’s children, it is fraught with risks of conflict for the blended family, especially when there is scant affection between step-parent and step-children. Such families often find a deceased trustor was the “glue” that held the family together, insofar as it was close, and absent that, conflicts between step-parent and step-children surface (or re-surface). These risks are quite high when the late trustor’s children resent that a step-parent is much younger than the late parent or seen as a “gold-digger” – or perhaps even a financial elder abuser – and the children must long await the step-parent’s death before inheriting.

Common split-interest structures include the joint living trust that requires division on the first death, so the late trustor’s share goes into an irrevocable “decedent’s trust” -- and, if the estate exceeds the applicable exemption amount, perhaps also a “marital deduction trust.” The A-B (or A-B-C) structure is often largely a vestige of tax planning that has lost its point for all but the very largest estates, given how few estates under current law exceed the exemption amount, and the “portability” of the deceased spouse’s unused exemption (subject to key caveats).

Beyond the tax rationale, continuing reasons for the A-B structure include: balancing the benefits for spouse and descendants; shielding the decedent's assets with the protection of an irrevocable trust; preserving those assets with stewardship by an independent trustee; and maintaining "dead hand control" to accomplish these and other objectives. A trustor cannot, by contrast, assure achieving these goals, if a joint trust remains fully revocable or amendable by a surviving trustor (or an individual's trust makes a spouse the sole outright beneficiary), so that assets are not in an irrevocable trust, and the survivor has a free hand to disinherit a step-family. (Leaving everything in the absolute control of a surviving spouse may involve a breach of spousal fiduciary duties under the Family Code, subject to a presumption of undue influence, as recognized in *Lintz v. Lintz* (2014) 222 Cal.App.4th 1346.)

Split-interest trusts may cause trouble due to the conflicts of interest created by the resulting zero-sum financial relationship, where the greater the duration and amount of the step-parent's gain, the greater the step-children's corresponding loss. Given this natural conflict, the trustee's various duties (and beneficiary's corresponding rights), which are designed to ensure fair trust administration (e.g., loyalty, impartiality, making property productive, separating property, prudent investing, informing and reporting to beneficiaries, etc.) all become possible flash-points between lifetime and remainder beneficiaries, which often end up in litigation.

In particular, giving a surviving spouse a life interest in a residence is a common recipe for step-family strife. If the client insists on this, thorough discussion is needed to address several devilish drafting details, such as: responsibility for several categories of expenses, making clear specifically what the trust will or won't cover; any consequences for the lifetime beneficiary defaulting on an expense payment obligation; possible changes of residence (including due to incapacity); possible sales or encumbrances; any consequences for re-marriage or cohabitation; and any rights to lease the property. These delicate issues can be side-stepped, if financially feasible, by having the survivor get the residence outright or as part of a survivor's trust.

Planning alternatives that avoid leaving an entire estate to a spouse, without split-interest trusts (and the resulting friction), may include, where affordable, gifts on the first death, which can be from a trust or via beneficiary designations for financial accounts (e.g., IRAs) or life insurance.

Finally, some options to reduce family friction when drafting split-interest trusts include: (1) a neutral trustee, who has no stake in favoring either lifetime or remainder beneficiaries; (2) fixed formulas for distributions to spouse, so as to minimize trustee discretion over spending; (3) unitrusts (instead of "net income" trusts), to avoid conflict over investing for income vs. growth and issues in principal and income accounting; (4) requiring exhaustion of the survivor's trust before the spouse may get principal (and perhaps income) of the decedent's trust; and (5) distributing the principal residence to the survivor or survivor's trust.

Most of these options may be available during trust administration (though often unappealing to a surviving spouse), even if not clearly provided for in the trust instrument. The survivor/ trustee may be authorized to appoint a neutral trustee (or special trustee) of the decedent's trust. A trustee with distribution discretion may exercise it by following a fixed formula for distributions, so they are less subject to recurring debate. Probate Code §§ 16336.4-16336.6 authorize converting a "net income" trust to a unitrust (without court approval if all beneficiaries agree). And non-pro rata sub-trust funding can allocate a principal residence to a survivor's trust.

Estate planning attorneys do their clients a greater service when they help them steer clear of traps for the unwary, such as the common ones associated with split interest trusts, instead of just being a scrivener who drafts a trust as requested, without a clear-eyed plan to minimize the risks.