Successor Fiduciary Liability: When the Follower must be the Leader

BY PATRICIA L. DAVIDSON

A fiduciary is someone who owes a duty of the utmost good faith and fair dealing to another. In probate law, we generally think of fiduciaries as trustees of a trust or executors of an estate, who owe the beneficiaries of the trust or the estate the fiduciary duty.

A "successor fiduciary" is someone who assumes the role after a predecessor ceases to serve. A successor may be a trustee of the trust that takes control of assets that pour over into the trust from an estate; a special administrator appointed by a court after an executor named in a will resigns, is removed by the court or is otherwise unable to serve; or a successor trustee named in the trust who takes over when the predecessor voluntarily resigns. The role of a fiduciary comes with enormous responsibility under any circumstances. However, in addition to the duty to manage an estate or a trust in the best interests of the beneficiaries, a successor may have to make the difficult decision to hold a predecessor liable for any misdeeds.

In addition to the duty to manage an estate or a trust in the best interests of the beneficiaries, a successor may have to make the difficult decision to hold a predecessor liable for any misdeeds.

A successor does not owe a fiduciary duty to his or her predecessor, but rather has a duty to bring claims against the predecessor for any wrongdoing. Generally, these claims will be for breach of fiduciary duty, such as self-dealing, misuse of trust or estate assets, poor investment decisions, or failure to initiate legitimate claims on behalf of an estate or trust. Because successor fiduciaries can be liable for breach of fiduciary duty if they fail to bring a claim against a predecessor or any wrongdoer, a successor must scrutinize the actions of the predecessor. The successor must engage in due diligence such as inspecting real estate, tax returns, and financial statements, to perform an in-depth review and ascertain whether the predecessor managed assets prudently.

The successor should also consider reviewing the predecessor's accounts. An account is essentially a summary of estate or trust income and expenses, which is typically prepared annually. Even if a fiduciary's account has been allowed by the court, a successor can be liable for matters in the account if the successor later discovers fraud, mistake or "manifest error" in the predecessor's account and does not move to reopen these accounts. In addition, a successor's failure to object to a problematic account can create legal exposure for the successor.

Scrutiny of a predecessor's actions requires analysis of the predecessor's process as much as his or her performance. In other words, did the predecessor make reasoned decisions based on information that was available to him or her at the time? Did the predecessor engage and rely on advice from legal, financial or real estate experts? Did the will or trust impose any limitations on the fiduciary that constrained his or her decision-making? Were the fiduciary's actions in accordance with sound financial and business principles, even if in hindsight the actions were imprudent? When scrutinizing any fiduciary's actions, the key question is whether the fiduciary abused his or her discretion and acted reasonably.

If a successor discovers misconduct by a predecessor fiduciary, the successor may need to make a claim on the predecessor's bond. In general, a bond is a type of insurance policy that ensures a fiduciary fulfills his or her duties to the beneficiaries. A beneficiary or a successor fiduciary can seek damages from the bonding company if there are losses or other damages caused by fiduciary misconduct.

Successor fiduciaries must be mindful of relevant statute of limitations issues, which dictate time limits for filing legal claims. The statute of limitations for breach of fiduciary duty claims is typically three years. The three-year limitations period begins to run when a successor fiduciary knows or should have known of a potential breach by a predecessor.

Given the duties of a successor, sometimes finding a successor fiduciary can be difficult. If there are assets declining in value, pending litigation or a contentious group of beneficiaries, institutional or individual fiduciaries may decline to serve as a successor. It can be particularly difficult for a family member or even a beneficiary of a trust or an estate to serve as a successor since family loyalty or complex family dynamics easily can interfere with the obligations to the beneficiaries.

In virtually all circumstances, a fiduciary can benefit from the assistance of an experienced lawyer. Successors in particular can benefit from such help where there are obligations to look back, as well as forward. If a trust or an estate has been administered properly, then the successor can adopt those practices. But if there are problems, a lawyer can help identify the problems, take any action necessary to correct the problems, and assist the successor with staying out of trouble and fulfilling his or her fiduciary duties. ■

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ABOUT US

Attorneys in the Mirick O'Connell Trusts and Estates Group counsel individuals and families in all matters concerning estate, gift, charitable and fiduciary income tax planning, elder law and special needs planning, and asset protection and Medicaid planning.

Our attorneys have extensive experience in drafting sophisticated estate planning documents and implementing wealth planning strategies. The integration of our experienced trusts and estates lawyers with our skillful litigation and trial lawyers enables us to provide sound legal advice and creative dispute resolution strategies.

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This overview is intended to inform our clients of developments in the law and to provide information of general interest. It is not intended to constitute legal advice regarding a client's specific legal problems and should not be relied upon as such. This newsletter may be considered advertising under the rules of the Massachusetts Supreme Judicial Court.

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Trusts & Estates

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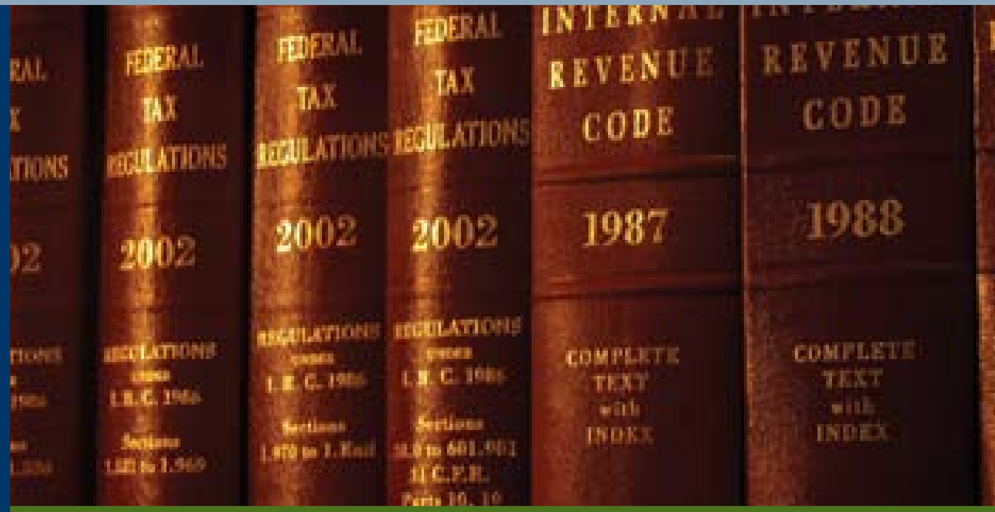

Federal Estate Tax is Repealed for One Year (Possibly)

BY JANET W. MOORE AND TRACY A. CRAIG

Many of us have grown up believing that nothing is certain except for death and taxes. Now, because of the actions, or more particularly the inactions, of Congress, we cannot even be certain about that.

In 2001, Congress passed a ten-year tax law change that phased in increased estate tax exemptions and reduced estate tax rates, culminating in 2010 with a one-year repeal of the federal estate tax, to be reinstated in 2011 at the old 2001 rates. Most estate planning professionals expected Congress to act within the ten-year period to make the changes permanent, in one form or another. However, Congress did not act prior to December 31, 2009, and we now find ourselves in the midst of a period of great uncertainty, which has created much angst among individuals and professionals alike.

For 2010, the federal estate tax is now repealed. At first blush, this sounds like a good thing. However, the result is turmoil, with possibly higher taxes next year. In addition, there is the possibility that Congress will impose a federal estate tax retroactively to January 1, 2010, which creates additional turmoil and uncertainty.

What Are the Changes?

- Repeal of the federal estate tax for 2010 only.
- Repeal of the generation skipping transfer tax for 2010 only.
- Retention of the federal gift tax with the same $1,000,000 lifetime exclusion, but with a lower flat gift tax rate of 35%, for 2010 only.
- Change from "step up in basis" to "carry-over basis" for capital gains tax on inherited assets, with a limited basis increase.
- Sunset of the repeal in 2011, with a reversion back to the old federal estate tax rules that were in effect in 2001 (a $1,000,000 exemption amount and tax rates of up to 55% or 60%).

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What Is the Good News?

- As of right now, for one year only, there will be no federal estate tax for individuals who die in 2010.
- A lower gift tax rate of 35% (for gifts in excess of \$1,000,000).
- No generation skipping transfer tax (which previously was at a flat rate of 45%).

What Is the Bad News?

- The administrative burden of carry-over basis is extremely difficult and likely unworkable.
- Many more people will be affected by the capital gains tax associated with carry-over basis than would have been by estate tax, resulting in overall higher taxes for most people.
- Because Massachusetts still has an estate tax, there will still be a step up in basis for Massachusetts income tax purposes. Two sets of records will need to be kept.
- It is possible Congress will attempt to reinstate the federal estate tax in 2010 on a retroactive basis to January 1, which may or may not be constitutional, likely resulting in litigation.
- There is uncertainty regarding allocation of the generation skipping transfer tax exemption to generation skipping trusts during and after 2010, due to the one-year repeal of the generation skipping transfer tax.

What You Should or Should Not Do:

- Review your current estate plan and estate planning documents to be sure there are no unintended results or ambiguities due to this change in the tax laws.
- Do not believe that the federal estate tax or the generation skipping transfer tax is gone for good.
- Do not abandon your current gifting plans for family and charities.
- Do not give up on estate planning, which is still needed to plan for family needs, asset protection, beneficiaries of retirement plans and disposition of the family business, among other things.

2010: By the Numbers

BY TRACY A. CRAIG

Below is a summary of some of the important tax benefits in 2010:

- Annual exclusion from gift taxes (the amount an individual may give to an unlimited number of donees each year) remains at \$13,000; the annual exclusion for gifts to a non-citizen spouse remains at \$134,000.
- Repeal of federal estate tax and the federal generation skipping transfer tax (note this could change by retroactive legislation).
- Federal gift tax exemption remains at \$1,000,000; tax rate for federal gift taxes decreases to a flat 35%.
- Massachusetts estate tax exemption remains at \$1,000,000 per person.
- Maximum 401(k) and 403(b) contribution amounts remain at \$16,500 per year. Workers 50 years of age or older in 2010 can continue to contribute an additional \$5,500 to their 401(k) and 403(b) plans, bringing the total contribution amount to \$22,000.
- Basic IRA contribution remains at \$5,000, and individuals 50 years of age and older can continue to make an additional \$1,000 "catch up" contribution.
- Single taxpayers with adjusted gross income of less than \$105,000 (up to \$120,000) and joint taxpayers with adjusted gross income of less than \$167,000 (up to \$177,000) can make nondeductible contributions to a Roth IRA. Beginning in 2010 there is no income limitation for rolling over a regular IRA to a Roth IRA.
- The annual amount of earnings subject to social security taxes remains at \$106,800.
- The kiddie tax threshold remains at \$1,900.

Estate Planning for Your Vacation Home

BY JANET W. MOORE

Planning to protect a vacation home and to ensure that it passes to your loved ones is an important part of the estate planning process. The following is an overview of some of the estate planning techniques available:

1. **Sale to a Family Member.** This is a simple way to remove the home from your estate and get it to a family member who wants it. However, capital gains tax will apply to the sale if the value of the home has appreciated. Since the vacation home is not a primary residence, the \$250,000/\$500,000 exclusion from capital gains tax will not apply. In addition, if the sale is for less than the fair market value, there could be a taxable gift involved.
2. **Outright Gift to a Family Member.** Again, a gift is very simple, but there could be gift tax ramifications, and possibly the need to file a gift tax return. Gifts can be made over time or all at once. The donee of the gift receives your basis in the home (known as "carry-over basis) so that if later sold, capital gains tax may be applicable.
3. **Bequest under Will.** Your will can direct who will receive the vacation home after you are deceased. The vacation home will be included in your taxable estate and, therefore, may bear the burden of estate tax. Assuming the estate tax is reinstated, the beneficiary who receives the vacation home will also receive a step up in basis to the value on date of death. Consequently, if the home is later sold, capital gains tax will be minimized.

4. **Transfer to a Trust.** Several different types of trusts may be used to plan for a vacation home, such as:
   - (a) Revocable (Living or Intervivos) Trust. This type of trust is very common in estate planning and is often used to save or postpone payment of estate tax and to avoid probate. It can be especially useful for a vacation home that is located outside of Massachusetts (or your state of residence). Because title is in the trust, the vacation home does not need to pass through probate upon your death. This not only ensures easy passage of title to the next generation, but avoids the fairly significant expense of probate in the non-resident state (which is known as "ancillary probate"). A home owned in a revocable trust will be includible in your estate for estate tax purposes.
   - (b) Medicaid "Income Only" Trust. This type of trust can help protect the vacation home from having to be sold to pay for your nursing home or long-term care, provided the transfer to the trust is made at least five years prior to the date of application for long-term care benefits under Medicaid. You can reserve the right to use the vacation home for your lifetime and the home can pass to your intended beneficiaries after your death under the terms you dictate in the trust.
   - (c) Qualified Personal Residence Trust. This type of trust is used to reduce estate taxes and to ensure that the vacation home passes to your intended beneficiaries in a smooth manner. The trust must be irrevocable and can be funded only with interests in your primary residence or vacation home. You transfer the home into the trust and retain the right to use the home for a term of years of your choosing. If you survive the term, both the value of the residence and its future appreciation are removed from your estate for estate tax purposes. This will have been achieved at a reduced gift tax cost since the value of the gift equals the value of the home on the initial date of transfer less the value of the term of years you retained in the trust. The longer the term, the greater reduction in the value of the gift. However, if you die before the term ends, the entire appreciated value of the home will be included in your estate – as if you had not made the transfer.
   - (d) Irrevocable Family Trust with Crummey Powers. This type of trust allows you to gift portions of a vacation home over time or the entire vacation home all at once, and for the gifts to qualify for the \$13,000 annual exclusion. In addition, you can dictate the terms and conditions under which the home can be used, who is in control and when, if at all, the home can be sold. If portions of the home are gifted over several years by use of the annual exclusion, this type of trust can provide a very effective way of removing the home from your taxable estate at little or no gift tax cost.
5. **Limited Liability Company (LLC) or a Family Limited Partnership (FLP).** These entities provide a formal structure both for the management of the vacation home for your family and for protection from liability. Liability is confined to the interest in the home owned by the LLC or FLP. The assets owned individually by the members or partners would not be at risk for any liabilities associated with the LLC or FLP assets. Additional costs such as annual state filing fees, management fees and tax returns should be reviewed and considered.

Regardless of which method you may choose to transfer your vacation home to younger generations, the following issues should be considered:

- When can each beneficiary use the home?
- Who pays the expenses, including taxes, insurance, maintenance and repairs? For example, should cash be transferred to a trust to help pay for these expenses?
- How can the beneficiary get out of or sell his interest in the home, trust, partnership, etc.?
- How is the home valued to determine the value of a beneficiary's interest?
- Who will be the trustee or manager of the home, and is this person able to get along with the other beneficiaries?

A final consideration is that if your estate is large enough and the vacation home is owned in a different state than your primary residence, you may be required to file a state estate tax return, and perhaps pay estate tax, in more than one state. Proper planning must be done to ensure that you do not have to pay more than your proportionate share of taxes to each state. ■

New Law Changes Rights of Adopted Beneficiaries

BY MICHAEL R. CHRISTY

Previously in Massachusetts, an adopted descendent was presumed to be a beneficiary under a will, testamentary trust or intervivos trust only if the document was executed after August 26, 1958. See M.G.L. ch. 210, §8. Prior to 1958, only beneficiaries adopted by the testator or settlor were considered beneficiaries under trusts and wills (meaning that adopted descendants of a beneficiary would not inherit under such wills or trusts like a natural born descendant would inherit).

In 2009, the Legislature dramatically altered these long-standing principles by providing that all adopted descendants will inherit the same as natural born descendants regardless of when the will or trust was executed. This change was so significant that the Legislature postponed its effectiveness until July 2010. This will allow fiduciaries time to consider the impact of these changes and develop strategies to comply with the new law. ■

WELCOME

Mirick O'Connell is pleased to announce that **Arthur P. Bergeron** has joined the Trusts and Estates Group as Of Counsel. Art focuses his practice on elder law, estate planning, probate and trust administration, and land use matters. He counsels senior citizens and their loved ones regarding elder law and special needs planning, asset protection and Medicaid planning. He works with individuals in all areas of estate planning, including wills, trusts, durable powers of attorney and health care proxies.

Brenda Costa also recently joined the Trusts and Estates Group as a Paralegal.