What To Do When Your Spouse Dies

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Introduction. You are probably relieved that your loved one is no longer in pain. You may feel a little guilty that you don't miss the care giving. You probably don't fully appreciate that you have lost your partner and you don't feel lonely, yet.

I hope that family and friends are providing support and that time will heal your loss.

You are probably apprehensive about the financial implications of your spouse's death and wonder what you must do to comply with the law and to obtain the benefits to which you are entitled. This discussion was prepared to address these issues for California residents. *This discussion is necessarily generic. Please seek competent advice specific to your circumstances.*

The process of settling your spouse's affairs is going to take longer and will cost more than you may have expected. There has to be an inventory and valuation of your assets and liabilities, tax returns have to be filed and debts and taxes have to be paid before the assets can be distributed to you and to the other beneficiaries. The good news is that costs and delay have been substantially reduced because you and your spouse created a living trust and transferred most of your assets into this trust.

It is good practice to set up a system as soon as possible after your spouse's death to track income and expenses. The system could be as simple as creating a separate checking account for your personal expenses. All is not lost if you don't set up a tracking system but there will be extra bookkeeping costs to sort out the accounts.

You will also want to examine opportunities to save taxes in the period immediately after death. Unfortunately, it is easy to accidentally foreclose opportunities by seemingly innocuous actions. For example, your bank may encourage you to rename your spouse's IRA as your own but this could accelerate taxes. Or, you might claim life insurance benefits without realizing that doing so precludes the possibility of passing these monies to your children free of estate tax.

Before you make any decisions, spend any money or give anything to the heirs, consult with advisers who are familiar with the administration of estates, trusts and pensions.

Overview. Your attorney and tax adviser will help you become comfortable with your new role as a fiduciary. This is discussed in the section "Your Role as Fiduciary."

Your attorney and tax adviser will arrange to share the work so that it is done as expeditiously and inexpensively as possible. Your attorney will likely

- File your spouse's original will with the Court[1]. Filing provides a "certified copy" of the will which you have to attach to the estate tax return.
- Speed the resolution of the estate by notices to potential creditors and heirs, including a Medi-Cal release from California's Health and Human Services Agency.

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[1] California Probate Code §8200

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Notifying creditors can speed resolution of the estate if there are business or other claims. Creditors lose their right to payment if they don't lodge claims promptly[2].

Notifying heirs of the terms of the trusts is useful if there is concern that an heir might contest the trusts. A disgruntled heir has only a few months in which to act if they are notified within the time frame and in the format specified by §16061.7 of the California Probate Code. You may decide, for reasons of privacy, to forgo this notification.

- Retitle assets, especially real estate. Your attorney may have to go to Court to retitle assets that you neglected to move into your living trust.
- Prepare a Certification of Trust[3]. This document lets you keep private, in your dealings with financial institutions, the dispositive provisions and names of the beneficiaries.
- Prepare a summary of the estate planning documents to guide you and your tax adviser. (Alternatively, this summary can be prepared by your tax adviser and reviewed by your attorney.) For example,

  Are there any specific bequests? Who are the beneficiaries of the residuary trust?

  Do you receive the income from the residuary trust? Can there be distributions to other family members during your lifetime?

  What is the formula for funding the residuary trust?

  Who is responsible[4] for funeral and medical expenses?

  How is estate or GST tax to be allocated[5] among the beneficiaries?

  Do your documents limit the trustee's statutory authorities[6] or the provisions of the Uniform Principal and Income Act[7]?
- Petition the Court to resolve ambiguities or correct errors in the estate planning documents. (Your attorney may also recommend updating those documents which can still be changed after your spouse's death.)
- Work with your tax adviser to value your spouse's property, to effect tax elections and disclaimers and to fund the trusts created upon your spouse's death.

  For example, your attorney will decide whether specific assets are community property or the separate property of the deceased.

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[2] California Probate Code §19050 - 19104.

[3] See California Probate Code §18100.5 for required content.

[4] Absent contrary language in your documents, California Probate Code §19326 says that funeral expenses and your spouse's medical expenses are NOT community debts but are to be charged to the decedent's estate.

[5] California Probate Code §20110 calls for an equitable proration of taxes among all beneficiaries absent contrary instructions in your documents.

[6] California Probate Code §16220 et seq.

[7] California Probate Code §16300 et seq. until December 31, 1999; §16320 et seq. thereafter.

- File an accounting of trust assets, income and disbursements in the approved format. A formal accounting is not always necessary but it has the advantage of limiting the period during which a beneficiary can challenge your stewardship.

Your tax adviser will likely

- Establish a system to track for expenses and income during the administration of the decedent's estate. This is discussed further in the section "Paying Bills."
- Assist you to catalog everything that you and your spouse owned. This includes an inventory of your safety deposit box, cash on hand and personal possessions.
- Work with your attorney to value your property, to effect various tax elections and disclaimers and to fund trusts created upon your spouse' death.
- Prepare estate and income tax returns and appropriate extensions of time to file.
- Assist you in choosing new beneficiaries and distribution formulas for IRAs and retirement accounts.
- Alert you and your attorney to possible legal issues that might need resolution.

Your Role As Fiduciary. You and your spouse owned most of your assets as community property. Formal title was held by your living trust and you and your spouse served as co-trustees.

One half of these assets belong to you. The only practical changes as a result of your spouse's death are that the trust holding your assets will be known as the "survivor's trust" and you will be the sole trustee. You will manage the survivor's trust exactly as before with exclusive and absolute control. You can amend the survivor's trust, change beneficiaries, appoint new trustees and spend the money for any legal purpose.

The assets that belonged to your spouse will be used to pay funeral and administrative expenses and to pay any estate taxes. (There probably won't be any estate taxes.) Up to $650,000[8] will be used to fund the "residuary" (by-pass, credit shelter) trust and to pay for specific bequests. The reminder generally goes to the surviving spouse.

If you receive these remaining assets without restrictions, you can combine them with your survivor's trust. If you are not a US citizen, you will generally receive assets exceeding $100,000 in the form of a QDOT trust. If you receive the remaining assets in the form of a marital or QTIP trust, there will be some strings attached.

You, the surviving spouse, are likely to be the trustee of the residuary, marital and QTIP trusts. You have broad discretion in managing these trusts but you do not have absolute control. For example, you won't be able to amend the terms of the trusts and you may not be able to change trust beneficiaries.

You will probably receive all of the interest and dividends from the investments of the residuary trust. You are probably entitled to spend any additional money that you

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[8] This is the current applicable exclusion amount. It is scheduled to gradually increase to $1 million by 2006.

The size of the residuary trust is limited to what your spouse owned less funeral and other expenses, less gifts during your spouse's lifetime and less bequests to other heirs. Absent special planning, it may not be possible to fund the residuary trust to the full exclusion amount if a major portion of your spouse's wealth is in the form of an IRA.

need but you can't spend money from the residuary trust simply because you *want* to since whatever you do not need belongs to the other beneficiaries, probably your children. (The rules are different for marital, QTIP and QDOT trusts.)

While your spouse intended that you should not skimp for the benefit of the other beneficiaries of the residuary trust, it is also true that you have an obligation to manage this trust with their interests in mind. Your primary responsibilities to the beneficiaries of the residuary trust are to invest in a prudent manner and to manage withdrawals in a way that allows them to pay the least taxes at your death.

Because you do not have complete control over the residuary trust, this money will not be included in your estate, even if the trust grows to tens of millions of dollars. A dollar in the residuary trust is therefore more valuable to your heirs than is a dollar in any of the other trusts because these other assets are subject to estate taxes at your death.

As a practical measure, assuming that the ultimate beneficiaries of all of the trusts are the same, you should spend your personal funds and the money in the survivor's, marital, QTIP and QDOT trusts before you take money from the residuary trust so long as your personal estate is large enough to attract estate tax ($650,000 this year.)

If the terms of the residuary trust require that all income be distributed to you, and if you don't need this income, you should rejigger the trust investments so that there is less interest and dividends. Otherwise, you won't be able to spend down your personal assets[9].

This discussion assumes that you and your spouse have common heirs. *If yours is a combined family, the generalizations described here probably don't apply.*

Estate Taxes. As the fiduciary responsible for your spouse's assets, you are responsible for filing your spouse's federal and California estate tax returns. Estate tax returns are required if the value of the decedent's gross estate, plus the value of taxable gifts during their life time, exceeds $650,000[10]. It is possible that you might decide to file an estate tax return even if the gross estate is less than $650,000.

The gross estate is calculated without considering debts and mortgages and may include assets even when the decedent's name does not appear on the title. For example, your spouse's gross estate includes gifts of life insurance within three years of death and a home that you gave away but continued to live in. It probably includes one half of your IRAs, the full value of UTMA accounts with your spouse as custodian and the full value of bank accounts owned in joint tenancy with a third person.

There usually won't be any estate tax liability and it may be possible to eliminate estate tax at your death by spending your assets before spending the residuary trust.

The normal due date for filing of the estate tax returns is nine months after death. However, it is good practice to request a six month extension of time to file in case extra time is needed to clear up various issues. Extra time also allows your executor

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[9] Some residuary trusts appear to have been drafted without considering the implications of requiring that income be paid to the surviving spouse. My preference is to not require any distributions so as to not influence the Trustee's investment decisions. Cf. www.lingane.com/tax/tx_eff.htm.

[10] See footnote 8.

to equalize the taxable estates if you should die soon after your spouse. Equalizing the estates may save taxes.

Even though there may be no estate taxes, the decisions that you make when preparing your spouse's estate tax return will affect future income taxes and the estate tax liability at your death. Therefore, it is necessary to value each and every asset and to document these valuations in the estate tax return. You will be amazed at how thick the return will become once you have attached all required documentation!

Your brokers, banks and IRA custodians will provide date of death values for many of your financial assets. It will be necessary to engage professional appraisers for real estate. The IRS requires a special Form 712 for life insurance and annuity policies.

If your home or rental property is worth a million dollars, it does not follow that a buyer would pay a half million dollars for your spouse's half interest. For example, the Ninth Circuit Court of Appeals held in Propstra that the decedent's share of a community property personal residence was worth less than one half of the fair market value. A controlling interest in a business or partnership might be worth extra. Therefore, you must apply valuation discounts and premiums, and document the basis for these adjustments, when you file the estate tax return.

Liabilities and debts must be determined and documented on the estate tax return. One is entitled to a deduction for real estate tax unpaid for the current fiscal year and, if death is between January and June, for real estate tax for the next fiscal year.

In addition to the valuation information, the IRS wants to see a copy of your living trust and of any other trusts where your spouse was the trustee or a beneficiary.

All estate tax returns are reviewed by an IRS attorney. Your goal should be to provide, with the original return, all the documentation that the attorney needs to decide whether to accept the return as filed. If the IRS has to request information to complete their initial review, there will be delay and the risk of audit will be increased.

Since you cannot make a final distribution of the assets until you get an all clear signal or "closing letter" from the IRS, you will want to file a letter[11] which requires the IRS to expedite their review.

Income Taxes. As the fiduciary responsible for the decedent's assets, you are responsible for filing the various income tax returns.

You will prepare your personal income tax return much as in prior years. You are entitled to the tax rates, standard deduction and personal exemptions of a married couple. Next year, you will file as "single" unless you remarry or have a child at home.

There usually won't be a separate tax return for the survivor's trust but a return must be filed for each of the other trusts and for the estate[12] in any year in which gross

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[11] Write a letter citing IRC §2204(a). As a result of this letter, the regulations require the IRS to notify you of the estate tax liability within nine months. Form 5495, "Request for Discharge from Personal Liability Under IRC §6905," is used to expedite IRS review of income and gift tax returns.

[12] You are allowed to report income and expenses of the living trust during the administrative period on the same tax return as the income and expenses of the probate estate. This is a convenience in that it eliminates one tax return. It also means that the first tax return for the administrative period need not be filed until nearly a year after death. To

income exceeds $600 or if there is tax due. Generally speaking, the income tax return for the estate/administrative trust is filed about a year after death. The returns for the other trusts are due on April 15th, just like your personal tax return.

You will have to distinguish income received before and after your spouse's death in order to allocate income to the proper tax return and to comply with the distributive provisions of the trusts. All income that you or your spouse or your living trust received before death, and any income that you receive after your spouse's death, are reported on your personal return. All income of your spouse and of the living trust which is received after your spouse's death is reported by the administrative trust.

The purpose of the administrative trust is to allocate the income to you, to the residuary and other trusts and to other heirs. You will receive a Form K-1 telling you what your share is. You will report this income on your personal return and the trusts and other heirs will report their shares on their tax returns.

The administrative trust usually does not to pay any income taxes. The tax liability is distributed to you and to the various trusts and other heirs.

Once all assets are distributed, the estate/administrative trust ceases to exist and you won't have to file any more income tax returns for the estate. However, you will continue to file income tax returns for the residuary and other trusts.

Paying Bills. It makes the bookkeeping easier if you set-up a system to distinguish your personal income and expenses from the income and expenses of the administrative trust. Don't be worried if you make mistakes and pay some bills out of the wrong account since a few bookkeeping entries will put things right. However, tracing expenses and income over an extended period becomes burdensome - and expensive – and this is why it is good practice to maintain separate accounts.

The first step is to create a separate checking account under your Social Security number. Ideally, you would open this new account in the name of the Survivor's Trust. Use this account to pay your personal bills and have your payroll, Social Security and pension checks deposited to this account. If necessary, the administrative trust can advance you money to deposit into this new account.

The next steps are to obtain tax identification numbers for the estate and for the administrative trust and to change the tax identification (Social Security) number on the living trust accounts into the new number of the administrative trust. This should be done in a way that causes the financial institutions to issue separate year end tax documents, Forms 1099, for the periods before and after your spouse's death.

Income from investments in the name of the living trust should be deposited under the tax ID of the administrative trust. It makes the bookkeeping simpler if you stop reinvesting interest and dividends for the duration of the administrative period. Reinvesting capital gains is OK.

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be able to report everything on one tax return, you must obtain tax identification numbers for both the estate and the living trust and you must file an election citing Revenue Procedure 98-13 with the estate's income tax return.

It is common for beneficiaries to report trust income directly on their personal returns without an administrative trust as intermediary. This is not illegal but it does preclude reporting on a fiscal year basis, probably increases income taxes since an estate/administrative trust is entitled to extra deductions and may prevent you from disclaiming assets.

Expenses and debts and credit card bills incurred before your spouse's death should be paid from a living trust account with this new ID.

What are personal bills and what are expenses of the administrative trust? Funeral expenses and your spouse's unpaid medical expenses are trust expenses. Fees for legal, accounting, tax and investment advice related to the estate are administrative expenses. Rent, utilities, food and recreation after your spouse's death are your personal expenses.

Utility bills and income taxes have to be prorated for the periods before and after death. The portion of these bills for the period before death are the responsibility of the administrative trust while the portion after death are your responsibility.

Rental income and expenses, and mortgages and real estate taxes for property owned by the living trust, are paid from the administrative trust.

Your wages, pensions, IRA distributions, and Social Security benefits are personal income. Interest and dividends on your separate property held outside the living trust are your personal income but income from your separate property held within the living trust is the responsibility of the administrative trust.

Net income during the administrative period from rentals and businesses belongs to the person or trust who ultimately inherits the asset. It probably makes sense to segregate this income in a separate account within the administrative trust.

You will have to manage rental properties, business interests and investments during the administrative period. You may want to close unneeded credit card accounts and to combine brokerage and bank accounts. Most of these actions are probably benign but it would be prudent to confirm specific transactions with your advisers in advance lest you unwittingly sell an asset specifically bequeathed to one of the heirs or do anything that would affect the valuation of the estate, preclude an opportunity to disclaim or decrease the amount of money that can be sheltered in the residuary trust.

Stepped-Up Valuation. The income tax on unrealized gains on homes, rental properties and stock portfolios, which you and your spouse held as community property, was forgiven upon the death of your spouse.

This can be a substantial tax benefit. It also means that you can sell these assets without the chore of trying to reconstruct what you paid for them!

Often times, unrealized gains keep us from making changes to our investment portfolios. The death of your spouse means that you can rearrange your investments without tax consequences. It is probably opportune, therefore, to review your investments at about the time that you fund the residuary trust.

But Is It Community Property? Determining whether an asset is separate or community property can require a careful legal and/or accounting analysis. The presumption is that something is community property unless it can be proven otherwise. The formal title on a brokerage or bank account is seldom determinative and real estate can be community property even if the deed says something else.

Ask yourself the following questions.

- Have you and your spouse ever executed a legal document with the intent of changing some assets into the separate property of one or the other spouse?

  If the answer is "No", then everything that you acquired during marriage as a result of your personal effort is probably community property. Wages are community property. The home that you buy with your wages and the IRA and pension accounts financed from your wages are community property. Assets that you acquired during marriage while living in another state are treated as community property after you move to California.

  It is notoriously difficult to draft separate property agreements in a way that is legally binding. For example, agreements have been ruled invalid when one spouse was not represented by independent legal counsel and the ERISA rules make it impossible to enter into a pre-nuptial agreement concerning pension assets. Ask your attorney to review any existing separate property agreements to be sure that they are consistent with current case law.

- Did you or your spouse bring assets into the marriage? Did either of you receive gifts or inheritances during marriage?

  Such assets are probably separate property so long as they were never commingled with money that you earned during marriage. Commingling does not necessarily convert separate to community property but the effect is the same if it becomes impossible to trace the separate portion.

- When did you purchase your home? A personal residence acquired in California before 1984 is presumed to be community property even if the deed says joint tenancy. A home purchased more recently in joint tenancy is probably not community property, but the situation is seldom clear cut.

Monthly Social Security and Pension Benefits. Call 1-800-772-1213 and tell the Social Security Administration of your spouse's death. They will ask for your spouse's Social Security number and date of birth. Any benefits received after the month of death have to be returned.

Your own Social Security benefits may increase. A surviving spouse is usually entitled to the larger of the benefit based on their own earnings or on their spouse's earnings. Unless you have a child at home, you won't receive this benefit until you are of retirement age requirements and apply for Social Security benefits, even if your spouse was receiving benefits at the time of their death.

You can claim a $255 lump-sum death payment by filing a claim with the Social Security Administration within two years of your spouse's death. This payment is not included in your spouse's gross estate.

See www.ssa.gov/pubs/deathbenefits.htm for additional information.

If your spouse was receiving a monthly pension or annuity payment, you are probably entitled to continued payments. The monthly amount may be reduced. Contact the payer to learn the details and the procedure for claiming benefits. The value of these continued benefits is probably included in your spouse's gross estate.

Disclaimers. Pensions, IRAs and life insurance pass automatically to the named beneficiaries. IRAs and life insurance are usually community property assets and the decedent's share of these assets generally passes to the surviving spouse.

You do not have to accept your spouse's share of these assets. Saying "No, thank you" may be a way to control the size of your spouse's taxable estate and the residuary trust. This control may save your heirs estate taxes.

Disclaimers are only effective if you have received no benefit from the pension or life insurance. Therefore, consider disclaimers before applying for life insurance or pension benefits and before retitling or taking money from your spouse's IRA account.

A misstep could cost big bucks.

Funding the Residuary Trust. Once all of the assets are valued, all the bills paid and the estate tax return accepted by the IRS, it is time to fund the trusts and make final distributions to the other heirs.

You will usually fund the residuary trust with assets which will appreciate. This strategy lets your heirs pay the least estate tax at your death.

You will also want to fund the trust in a way that presents the least hassle. For example, if you put half of your residence inside the residuary trust, you will have to negotiate with yourself as trustee if you want to paint your home and it is conceivable that the color or expenses might not be in the best interests of the remainder beneficiaries. While the concept of negotiating with yourself may strike you as bizarre, you will have to pay the painter (and real estate taxes and homeowners insurance) with two checks, one from your personal account and the other drawn on the residuary trust.

It might save estate taxes at your death if you split[13] a business or partnership interest among more than one trust. This creates fractional interests which may reduce the value of the asset for estate tax purposes at your death.

There are income tax considerations. For example, if an asset which has appreciated after death goes to the wrong trust, there can be an income tax bill. If you fund the residuary trust with your personal residence, you lose the $250,000 personal exemption when your home is sold and there will be no step-up in basis when you die.

If you decide to put your personal residence into the residuary trust, you will increase the trust's basis, and reduce income taxes when the your home is sold, if you initially allocate your home to the survivor's trust and then sell it to the residuary trust at fair market value.

If you and your spouse executed a special community property agreement under §100 of the California Probate Code, it will be possible to fund the residuary trust with IRAs and other assets not owned by the administrative trust. Disclaimers may be another way to fund the residuary trust with assets outside the administrative trust.

There are further considerations if you and your spouse chose to leave your money to different heirs.

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[13] See Estate of Mellinger, 112 TC 4 (1999). The IRS has agreed to apply this decision to other taxpayers; AOD 1999-006 is available at http://ftp.fedworld.gov/pub/irs-aod/mellingr.pdf.

Further Reading. For the views of California attorneys, see

“Administering a California Living Trust After the Death of the First Spouse” by Milton Berry Scott. This is available at http://www.mbscott.com/firstdea.htm.

“A Practical Workshop on Trust Administration of the Living Trust, Exhibits 46 and 51.” by David B. Gaw, 1999. Offered by the California CPA Education Foundation, (800) 922-5272. See also www.calcpaed.org and www.gvmsmm.com

“Federal Estate Tax: Hot Issues and Battlegrounds of Form 706” by Keith Schiller, 1999. Offered by the California CPA Education Foundation, (800) 922-5272 and www.calcpaed.org.

“Make Your Own Living Trust” by Dennis Clifford, Nolo Press, 3rd Edition 1999.

"California Community Property” by Eileen Preville. This course is offered by the California CPA Education Foundation, (800) 922-5272 and www.calcpaed.org.

These comments are meant for educational purposes only. Consult with your advisers before taking any actions.

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