#L-1029 ns38k
04/01/87

Memorandum 87-27

Subject: Study L-1029 - Amendments to AB 708 (Marital Deduction Gifts)

At the March meeting in San Francisco the Commission approved the recommendation relating to marital deduction gifts for printing and inclusion in the Commission's 1987 probate legislation. Attached to this memorandum as Exhibit 1 are amendments to AB 708 to implement changes made as a result of decisions at the meeting. We have also received a letter from Edna R. S. Alvarez of Los Angeles (Exhibit 2) raising a number of issues in connection with the recommendation. This memorandum analyzes the points made by Ms. Alvarez and other points that have come up in connection with the recommendation.

§ 21523. Maximum marital deduction for instrument dated September 13, 1981, or earlier (AB 708, page 199)

This section provides that a pre-ERTA marital deduction gift is to be construed to pass the maximum marital deduction amount that would have been allowed under the law as it existed before ERTA was enacted. Ms. Alvarez points out what appears to be a technical defect in this provision. It allows the maximum deduction under federal law "as it existed before August 13, 1981, (before the applicability of the Economic Recovery Tax Act of 1981)." However, August 13 was the date of enactment, whereas September 13 was the date the law took effect. Ms. Alvarez suggests that the parenthetical clause should refer to the date of enactment. This change appears proper.

Subdivision (a) of this section requires the pre-ERTA marital deduction gift to be adjusted by the provisions of I.R.C. § 2056(c)(1)(B) and (C) as in effect at the time ERTA was enacted. Ms. Alvarez is uncertain about the purpose of this subdivision, since it seems to be a specific application of the general rule that a pre-ERTA gift passes the maximum amount available under pre-ERTA law. We will consult with Bob Mills on this point.

Subdivision (b) of this section requires that a pre-ERTA marital deduction gift be reduced by other property passing to the surviving spouse either under or outside the instrument. The purpose of this provision presumably is to make sure that only the amount the transferor actually intended passes to the surviving spouse (i.e., the maximum amount of the marital deduction and no more). Ms. Alvarez questions the policy of this provision. She states that the Internal Revenue Service in fact allows a deduction both for the marital formula clause and for other property that passes to the surviving spouse (e.g., joint tenancy, insurance benefits, pension benefits, and specific gifts) for pre-ERTA instruments. She states, "I have had several matters involving so-called pre-ERTA instruments where it was very important, from a tax perspective, to achieve a marital deduction for assets passing outside of the instrument and for assets passing outside the formula. My position on these matters has been accepted by the Service." This is a policy issue that the Commission must resolve. The staff suspects that the position taken by Ms. Alvarez (to allow the maximum amount possible to pass to the surviving spouse) would generally be preferred by the interested parties over existing law. Whether that would also have been the intent of the transferor had the transferor known that the law would change to permit an unlimited marital deduction, is open to question. The policy of the existing law is to limit the amount passing to the surviving spouse on the assumption that the transferor's main purpose was an estate plan that was equitable to all beneficiaries, influenced but not controlled by tax considerations. This is particularly relevant where there is a conflict between the transferor's second spouse and the children of the transferor's first marriage. One possible way to take into account the circumstances of the parties is to retain existing law as the general rule but to allow the fiduciary to pass greater amounts to the surviving spouse under the marital deduction formula if all the beneficiaries consent.

§ 21524. Marital deduction gift in trust (AB 708, pages 199-200)

Section 21524 sets up a number of limitations on a marital deduction gift made in trust to ensure that the gift does not violate the conditions for achieving a marital deduction.

Subdivision (a) requires that the transferor's spouse be the only income or principal beneficiary of the trust. Ms. Alvarez points out that this would disqualify a trust that gave the spouse a power of appointment. The staff would cure this defect by adding, "Nothing in this subdivision precludes exercise by the transferor's spouse of a general power of appointment included in the trust."

Subdivision (b) requires payment of accumulated income not less frequently than annually. Ms. Alvarez points out that this should not apply to the so-called estate trust. In fact, the statute already excepts the estate trust. See Section 21521 (AB 708, page 199).

Subdivision (d) addresses the problem of undistributed income at the death of the transferor's spouse and requires it to go to the spouse's estate "unless the instrument provides otherwise." Ms. Alvarez points out that this is overbroad, since the instrument should only be able to provide otherwise in a manner that will not destroy the marital deduction. The staff would revise this provision to impose the statutory requirement "unless the instrument provides a different disposition that qualifies under Section 2056(b)(7) or Section 2523(f)."

§ 21525. Survival requirement for marital deduction gift (Exhibit 1, Amendment 2)

This section is intended to save a marital deduction gift that violates federal tax requirements by its inclusion of a survival requirement that exceeds six months or of an unlimited common disaster provision. The section does this by limiting the survival requirement to six months or, in the case of a common disaster provision, to the time of the final tax audit.

The Commission decided to clarify the provision by treating the two types of survival requirements separately. Professor Halbach is not satisfied with this treatment because it does not clarify the interrelation of survival requirements. The staff has attempted to

deal with this problem in a simple but understandable manner in the draft, by excluding common disaster provisions from the six month limitation. The Commission should review this carefully to see whether it appears sufficient.

§ 21526. QTIP Election (AB 708, page 200)

Ms. Alvarez points out that this section immunizes the fiduciary for making a QTIP election but fails to deal with a partial election. This could be remedied by providing the fiduciary is not liable for a good faith decision to make the election or not to make the election "in whole or in part."

Former § 1039 (repealed)

Probate Code Section 1039 would be repealed as part of revision of the marital deduction gift provisions. This section provides that, "The failure to comply with the provisions of this article shall not invalidate the interest of a good faith purchaser, lessee, or encumbrancer for value in real property acquired without knowledge of an alleged violation of this article." It appears to Ms. Alvarez that there could be utility in the retention of this provision and confusion as to the reason for its deletion.

This provision for the most part serves no useful purpose, since the only consequence of a "violation" of the provisions is that the full benefit of the marital deduction is lost; rights in property are not affected. The provision was added to the law during the legislative process when the marital deduction gift provisions were first enacted because of concerns expressed by the banks. The author of the bill made the political decision at that time that it would be simpler to add meaningless language to satisfy the opposition than it would be to try to explain why the language was unnecessary.

The provision could have some application where the amount of property that passes to the transferor's spouse under a pre-ERTA instrument is affected. See discussion of Section 21523, above. However, the provision is not needed to protect bona fide purchasers in

this instance, since general rules governing distribution of estate assets protect not only bona fide purchasers but the distributees themselves. See, e.g., Prob. Code § 1021 (order of final distribution conclusive). The special marital deduction gift bona fide purchaser provision can thus be omitted in this revision.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

EXHIBIT 1

Amendment 1

On page 198, strike out lines 26 to 33, inclusive, and insert:

21502. (a) If an instrument includes a formula intended to eliminate the federal estate tax, the formula shall be applied to eliminate or to reduce to the maximum extent possible the federal estate tax.

(b) If an instrument includes a formula that refers to a maximum fraction or amount that will not result in a federal estate tax, the formula shall be construed to refer to the maximum fraction or amount that will not result in or increase the federal estate tax.

Amendment 2

On page 200, strike out lines 23 to 31, inclusive, and insert:

21525. (a) If an instrument that makes a marital deduction gift includes a condition that the transferor's spouse survive the transferor by a period that exceeds six months, other than a condition described in subdivision (b), the condition shall be limited to six months as applied to the marital deduction gift.

(b) If an instrument that makes a marital deduction gift includes a condition that the transferor's spouse survive a common disaster that results in the death of the transferor, the condition shall be limited to the time of the final audit of the federal estate tax return for the transferor's estate, if any, as applied to the marital deduction gift.

Amendment 3

On page 201, lines 12 and 13, strike out "After the death of the transferor, the" and insert:

The

Amendment 4

On page 201, line 27, strike out "After the death of the transferor, the" and insert:

The

EXHIBIT 2

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March 19, 1987

Arthur K. Marshall, Esq.
Chair
California Law Revision Commission
300 S. Grand Avenue, 29th Floor
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RE: CALIFORNIA COMMISSION - MEMORANDUM 87-7
STUDY L-1029 - ESTATE AND TRUST CODE
(MARITAL DEDUCTION GIFTS - DRAFT OF
RECOMMENDATION) - 2/04/87

Dear Arthur:

I am in receipt of the above-captioned document which was sent to me at my request. In regard thereto, I have the following initial comments:

1. **SECTION 21523. MAXIMUM MARITAL DEDUCTION FOR INSTRUMENT DATED SEPTEMBER 13, 1981, OR EARLIER**

a. Proposed Section 21523 provides, in general, that if there is an instrument that was executed before the effective date of the Economic Recovery Tax Act of 1981 (9/13/81) and there is an indication of the testator's intent to provide for the maximum marital deduction, then the instrument passes to or for the benefit of the transferor's spouse an amount equal to what would have been the maximum marital deduction as it existed before the date of enactment of the Economic Recovery Tax Act of 1981, with certain adjustments.

b. As a mere technical matter, after the words "before August 13, 1981" in line 5, appear the words "(before the applicability of the Economic Recovery Tax Act of 1981), ..." I believe that August 13, 1981 is the date of enactment and September 13, 1981 is the date of applicability.

Recommendation: The language should read "... before August 13, 1981 (before the date of enactment of the Economic

Recovery Tax Act of 1981), ..." (Emphasis provided.)

c. Proposed Subsection (a) of Section 21523 adjusts the general rule of Section 21523 by certain specific Code provisions in effect immediately before the Economic Recovery Tax Act of 1981. Since Proposed Section 21523 states that the pre-Economic Recovery Tax Act of 1981 rule applies, it would appear that such application would already include the Code provisions then in effect. Consequently, I am uncertain as to the purpose or function of Subsection (a).

d. Proposed Subparagraph (b) of Section 21523 reduces the maximum marital deduction gift by the value of any property that passes under or outside of the instrument and qualifies for the marital deduction. This provision seems contrary to the position of the Internal Revenue Service which allows a marital deduction for property that passes to the transferor's spouse outside of the testamentary instrument (such as by joint tenancy, insurance benefits, pension benefits) and/or that passes by the terms of the testamentary instrument outside of the formula (such as a specific gift to the transferor's spouse). This is also the position of the Service as to formulae falling under the Tax Reform Act of 1976. Of course, if the testamentary instrument provides by its terms for a reduction of the marital deduction based on assets passing outside of the instrument or outside of the formula gift, then the amount of the marital deduction passing under the formula of the testamentary instrument would be reduced by the value of such assets. I have had several matters involving so-called pre-ERTA instruments where it was very important, from a tax perspective, to achieve a marital deduction for assets passing outside of the instrument and for assets passing outside of the formula. My position on these matters has been accepted by the Service.

Recommendation:

i. The terminology in the introductory paragraph of Proposed Section 21523 should be modified to refer to a "formula provision contained in an instrument" rather than just to an "instrument."

ii. The first sentence of Subparagraph (b) should be deleted.

iii. The second sentence of Subparagraph (b) should be retained as a part of the body of Section 21523 with the addition of the words "Notwithstanding the aforesaid sentence to the contrary."

iv. The last seven words of the first sentence of Section 21523 - i.e. "with adjustments for the following, if applicable" would be deleted as there would be no adjustments.

2. SECTION 21524. MARITAL DEDUCTION GIFT AND TRUST

a. Subpargraph (a) of Proposed Section 21524 provides, in general, that if a marital deduction gift is made in trust, "the transferor's spouse is the only beneficiary of income or principal of the marital deduction property as long as the spouse is alive." (Emphasis Provided).

Under a general power of appointment marital deduction trust (as contrasted, for example, with a QTIP trust), the surviving spouse could be given an inter vivos general power of appointment and such a trust would qualify for the marital deduction. Under such a trust, principal could be distributed to one other than the spouse upon the exercise of the general power of appointment by the spouse. I am uncertain whether such a situation - i.e. a trust under which principal could be distributed to a non-spouse upon the exercise of a power of appointment - would meet the requisites of proposed Subparagraph (a).

It is clear that under a so-called "QTIP" trust the transferor's spouse must be the sole beneficiary of principal. Perhaps this is a matter of semantics - i.e. perhaps it is a matter of the definition of the term "beneficiary." See Section 24.

Recommendation: The provision should be clarified so that a general power of appointment trust would continue to qualify for the marital deduction.

b. Subparagraph (b) provides, in general, that the transferor's spouse is entitled to all of the income of the marital deduction property not less frequently than annually. (Emphasis Provided.)

Under a so-called "marital deduction estate trust" income may be accumulated and/or distributed during the lifetime of the transferor's spouse and is payable, at the death of the transferor's spouse, to the extent not previously distributed to the transferor's spouse, to the estate of the transferor's spouse.

Recommendation: An exception should be drafted for a so-called marital deduction estate trust.

c. Subparagraph (d) deals with the problem of undistributed income in a so-called QTIP trust and provides for distribution on the death of the transferor's spouse of undistributed income to the estate of the transferor's spouse, "... unless the instrument provides otherwise." I have some concerns with the wording "... unless the instrument provides otherwise."

Frequently, the problem being addressed by Subparagraph (d) will arise in the context of a trust that was initially intended to be a "non-marital trust" and which the taxpayer is trying to convert into a "QTIP trust". The instrument will provide that on the death of the transferor's spouse all accumulated income and principal is to be distributed to the next layer of beneficiaries. It is this provision in the instrument for distribution of accumulated income that creates the problem addressed by Subsection (d). The use of the language "unless the instrument provides otherwise" as an exception to the "saving provision" seems to destroy the applicability of Subsection (d) to the very problem that exists. I presume that the intent of the language "unless the instrument provides otherwise" was to cover situations in which appropriate alternatives had been provided for in the instrument - such as a provision giving the transferor's spouse a general testamentary power of appointment over the accumulated income.

Recommendation: Narrow the language to provide that Subsection (d) will apply unless the instrument provides for the disposition of the income on the death of the transferor's spouse in a way that meets the requirements of IRC Section 2056(b)7.

3. **SECTION 21526. QTIP ELECTION**

a. Proposed Section 21526 provides, in general, that a

fiduciary, is not liable for a decision "... to make the election or not to make the election referred to in Section 2056(b)(7)." (Emphasis Provided).

b. I would suggest that consideration be given to expanding this "hold harmless" provision to expressly include partial QTIP elections.

Recommendation: Draft language to expressly include parital elections.

4. REPEAL OF SECTION 1039

It appears to me that there could be utility in the retention of Section 1039 and that confusion may be raised as to the reason for its deletion.

I hope that the aforesaid comments are deemed to be constructive. The opinions expressed are based upon my general knowledge. I look forward to the Commission's reaction to the comments and would like to be kept on the mailing list as the recommendations of the Commission evolve in this area. Please let me know if I can be of assistance to the Commission.

Yours truly,

EDNA R. S. ALVAREZ

ERSA/eeb

pc: Professor Edward Halbach,
Ken Klug
Robert Mills
Nathaniel Sterling, Asst. Ex. Secy.