

## First Supplement to Memorandum 87-31

Subject: Study L-640 - AB 362 (Trusts--Exercise of power to distribute)

We have received a letter from Charles A. Collier, Jr., discussing a trust problem. (See Exhibit 1, attached hereto.) Mr. Collier urges that Civil Code Section 2269(e) be restored to the Trust Law to deal with a tax problem. This provision reads as follows:

(e) Unless specifically so authorized, a person who holds a power to appoint or distribute income or principal to or for the benefit of others, either individually or in a fiduciary capacity, may not use the power to discharge his or her legal obligations.

It appears that this provision, enacted in 1981, was intended to deal with a problem arising with regard to grantor trusts. See Collier, *Unscrambling Pre-ERTA Estate Plans*, in *Estate Planning 1982* § 7.12, at 195 (U.C.L.A.-Cal. Cont. Ed. Bar 1983).

The staff would add the substance of this provision to the Trust Law as Probate Code Section 16082 and would include this provision in AB 362 so that it will be in place when the Trust Law becomes operative on July 1, 1987. The staff recommends the following provision:

**Probate Code § 16082 (added). Use of discretionary power to discharge personal obligations**

16082. Except as otherwise specifically provided in the trust instrument, a settlor who holds a power to appoint or distribute income or principal to or for the benefit of others, either as an individual or as trustee, may not use the power to discharge the settlor's legal obligations.

**Comment.** Section 16082 restates former Civil Code Section 2269(e) without substantive change, as applied to trusts. This provision is intended to deal with grantor trust problems under federal tax law. See I.R.C. §§ 674(a), 678(c), 2036.

Draft Section 16082 is phrased in terms that deal specifically with powers retained by settlors, since this is where the problem arises. The section does not need to apply to powers held by persons

other than the settlor since property subject to the power is not taxable to the holder of the power unless it is exercised. See I.R.C. § 677(b).

If this provision is approved, it will be drafted in proper form and included with the amendments attached to Memorandum 87-31. The comment will be included in the draft committee report attached to Memorandum 87-31.

Respectfully submitted,

Stan G. Ulrich  
Staff Counsel

## LAW OFFICES

IRELL &amp; MANELLA

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

1800 AVENUE OF THE STARS

SUITE 900

LOS ANGELES, CALIFORNIA 90067

(213) 277-1010 AND 879-2600

April 1, 1987

CABLE ADDRESS: IRELLA  
TELEX 181258  
TELECOPIER  
(213) 277-5604 AND 553-9276

WRITER'S DIRECT DIAL NUMBER

ORANGE COUNTY OFFICE  
840 NEWPORT CENTER DRIVE, SUITE 500  
NEWPORT CENTER  
NEWPORT BEACH, CALIFORNIA 92660  
TELEPHONE (714) 760-0991

Mr. John H. DeMouilly  
California Law Revision Commission  
4000 Middlefield Road, Room D-2  
Palo Alto, California 94303-4739

Re: AB-362

Dear John:

My partner, John Cohan, was reviewing the changes in the trust law which become effective July 1, 1987 and noted that Civil Code Section 2269(e) has been deleted from the new law (see Selected 1986 Trust and Probate Legislation with Official Comments, page 1489). The Comment suggests that subdivision (e) was omitted because it is unnecessary in light of Civil Code Sections 1381.2, 1385.1 and 1387.2. Subdivision (e) was added by Chapter 1046 of the 1981 Statutes, and I believe was the result of a proposal by the Probate Section of the State Bar of California. The purpose of subsection (e) was to minimize certain income and estate tax problems where a person might have a power to discharge his or her legal obligations. Pertinent are IRC Section 677(b) and IRS Section 678(c), both of which relate to taxing income used to discharge support obligations of the grantor or of another person who has substantially the same power as the grantor.

For estate tax purposes, a reserved power to discharge a legal obligation of the decedent, including the obligation for support of a dependent during decedent's lifetime, is a reservation of the "use, possession, right to income or other enjoyment of the transferred property" within the meaning of IRC Section 2036. IRC Regulation 20.2036-1(b)(2). Subparagraph (e) was intended to minimize tax problems in this area by requiring that a party had a power to discharge his or her legal obligations only if specifically authorized by the governing instrument.

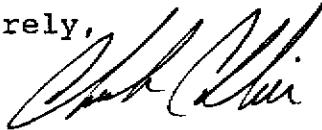
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Mr. John H. DeMouilly  
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Because this section was included specifically for income and estate tax purposes, we believe it should be retained in the law. An appropriate place for it would appear to be an additional subdivision in Section 16081. We hope that this can be added back into the law under AB-362, which because of its urgency clause will be effective on July 1, 1987.

Sincerely,



Charles A. Collier, Jr.

CAC:vjd

cc: John Cohan, Esq.  
Kenneth Klug, Esq.