#L-1038

rm16
6/8/87

Third Supplement to Memorandum 87-37

Subject: Study L-1038 - Abatement; Interest and Income Accruing During Administration

Attached to this Supplement are letters from Valerie Merritt for the Probate and Trust Law Section of the Los Angeles County Bar Association (Exhibit 1) and from attorney Richard Kinyon of San Francisco (Exhibit 2).

Commencement of Income on General Pecuniary Devise in Trust

The question generating the most controversy concerns when interest should commence on an unpaid pecuniary devise to trust. See proposed Section 12003. Although existing statutory language appears in conflict (*compare* Prob. Code § 663(a) *with* Prob. Code §§ 661 *and* 16304(a)), the cases hold that interest on an unpaid pecuniary devise in trust commences at death. See cases cited in Comment to repealed Section 661 (page 15 of draft attached to Memo 87-37). Most lawyers who reviewed previous drafts favor the commencement-at-death rule of existing law.

In the First Supplement to Memo 87-37, two alternatives are proposed. Both provide for interest on an unpaid pecuniary devise in trust to commence at death. The LA Bar (Exhibit 1) supports the commencement-at-death rule for trusts, with no preference between Alternatives #1 and #2.

Mr. Kinyon (Exhibit 2) would delay commencement of interest on an unpaid general pecuniary devise in trust. He is concerned that interest at ten percent may exceed actual income, and that if it commences at death it will diminish the residuary estate. He proposes a compromise under which interest on all general pecuniary devises, including those in trust, would commence six (or possibly nine) months after death:

Alternative #3:

> 12003. If a general pecuniary devise, including a general pecuniary devise in trust, is not distributed within six [nine] months after the testator's death, the devise bears interest thereafter.

Because the LA Bar favors commencing interest at death, it would likely be unenthusiastic about Alternative #3.

Expenses of Specifically Devised Property

The LA Bar (Exhibit 1) reiterates its opposition to proposed Section 12002(b) (expenses of specifically devised property). The LA Bar prefers the existing rule that all expenses of specifically devised property are borne by the specific devisee, whether or not there is any income from the property. This is discussed in the basic Memo (87-37).

Transitional Provision

The LA Bar favors the transitional provision on page 13 of the draft attached to the basic Memo (87-37).

Respectfully submitted,

Robert J. Murphy III
Staff Counsel

3rd Supp. to Memo 87-37 Study L-1038

EXHIBIT 1

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June 3, 1987

California Law Revision Commission
4000 Middlefield Road, No. D-2
Palo Alto, California 94303-4739

Re: Memorandum 87-37; Abatement; Interest and Income Accruing During Administration

Commissioners:

On behalf of the Probate and Trust Law Section of the Los Angeles County Bar Association, I would like to contribute some additional commentary to that already made in Memorandum 87-37 and the existing two supplements to it.

First, we agree that it is a good idea to split the draft to three portions to go in separate parts of the code.

We approve of the staff's revisions to Section 21400. In that regard, the minor technical changes to that Section recommended by Team 4 is desirable.

With regard to the commencement of interest and income from testimentary trusts, Professor Halbach correctly points out that there is some inconsistency between existing Section 16304(a) and proposed Section 12003. There is a further tension in that under current rules, the provision for interest on a pecuniary devise in trust only appears to apply to estates subject to probate administration, whereas a pecuniary devise contained within an intervivos trust appears not to be subject to this rule. For all of these reasons, it appears to be sound public policy to treat the income (including interest on a pecuniary devise) of all bequests in trust the same. We favor having trust income commence at death with regard to all trusts.

However, it does not necessarily follow (as Team 4 appears to believe) that such a proposed change would increase the amount distributed to the credit shelter trust. In the first place, some practitioners define the credit shelter trust in terms of a pecuniary devise in trust and other practitioners define the marital deduction bequest as the pecuniary devise. In the second place, in today's market place, the interest accruing on a pecuniary devise is in excess of the income earned by the underlying assets for most estates. If there is a pecuniary devise of the marital deduction in trust, commencing interest from date of death may reduce the amount distributed to the credit shelter trust. In other words, regardless of what rule is adopted by the Commission, as always, the practitioners will have to use care in how they draft their trust instruments.

Our section has no stand as to whether alternative 1 or 2 as set forth in the First Supplement would be inherently better. We recognize that any such rule has the potential to enlarge the amounts going to the pecuniary devisee at the expense of the residuary devisee. On the other hand, we believe that it is inappropriate to have one rule for pecuniary devises in trust under probate administration and a different rule for an intervivos trust. We would note that the proposed changes to Section 12003 do not include any provision for the commencement of the period of interest to be altered by the trust instrument or Will. We believe that language similar to that in Section 16304(a) should be used to recognize that interest may accrue from the date specified in the Will or trust instrument, which may be different from date of death.

We continue to believe that it is appropriate to continue existing law with regard of the expenses of property specifically devised. While the most common specific devise may be the personal residence, and while Professor Halbach's suggestion may be a solution with regard to that particular asset, it does not cover all situations. Another commonly occurring situation is the vacant land which incurs real property taxes and which the specific devisee believes should not be sold. In that situation, since the specific devisee has the ability to interfere with the ability of the estate to raise money from the property, the specific devisee should be obligated to bear the real property taxes. It may be appropriate to authorize the personal representative to advance his expenses for a period of up to one year from the date of death of deceased. Otherwise, a personal representative may be placed in the untenable position of being charged with the duty of protecting the property and yet be unable to collect the expenses of so doing. One year should give the personal representative adequate time to determine the best method of dealing with the property, and to obtain an order for distribution subject to the reimbursement of the expenses or other appropriate order from a Court.

The proposal that the expenses of property specfically devised be born by the estate, even for a limited period, appears to be inconsistent with the idea that income and interest are earned from the date of death. We see no reason why negative income shouldnot also start accruing from the date of death.

Like Team 4, we support the suggestion of Grace Banoff and the staff that the chapter on interest and income accruing during administration should only apply to estates of decedents who die on or after the effective date.

Finally, as we have stated before, the existing rules in this area are so lacking in clarity that we are grateful that the Commission will be clarifying and improving them regardless of what final decisions are made in the areas that are still open.

Sincerely,

Valerie J Merritt

Valerie J. Merritt

VJM/cdk
Copy to Richard Stack, Esq.

3rd Supp. to Memo 87-37

Study L-1038

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Re: Study L-1038 - Abatement; Interest and Income Accruing During Administration

Dear Bob:

I agree with the problem referred in the First Supplement to Memorandum 87-37, dated 5/6/87, with respect to the initial proposal, although we have lived comfortably with it for many years and I am not troubled by it. In most cases a trust is unlikely to be funded much sooner than six months after death (because of the necessary delay in getting the will admitted to probate and the four-month period for creditors' claims to run before any distributions can safely be made), so the income beneficiary normally has to wait for six months or more to start receiving income anyway. In addition, in my experience and practice the most common form of general pecuniary devise in trust by far is the marital deduction trust, and the trustee frequently has discretion to distribute principal to the spouse, if necessary, which would ameliorate any hardship that might result from the initial proposal. Furthermore, a needy spouse would be entitled to a family allowance. Finally, the testator could always require interest to accrue earlier than one year after death in an appropriate situation.

The principal difficulty with having to pay interest on a general pecuniary devise (whether outright or in trust) from the date of death is that the interest expense could exceed the available income, resulting in an invasion of residuary principal to pay the interest. This is likely to be the case in relatively large estates involving a pecuniary formula marital deduction provision designed to reduce the estate tax to zero. Where a pecuniary marital deduction formula provision is used, the formula marital deduction amount often is not ascertainable with much accuracy until a draft of the federal estate tax return has been prepared, which in many cases is not feasible until at least six months after death. Commencement of interest at death could curtail the use of the relatively simple pecuniary formula marital deduction clause. Furthermore, it is not clear that interest paid on a general pecuniary devise is deductible by the estate for income tax purposes under IRC Section 163, as amended by the Tax Reform Act of 1986, although the interest clearly is taxable income to the devisee. In any event an interest deduction in excess of trust income would be of no benefit to anyone except for the last taxable year of the estate when it could be carried out to the residuary beneficiaries under IRC Section 642(h)(2).

As I mentioned to you in an earlier letter, a good compromise might be to reduce the one-year interest-free period to six or nine months. This would give the executor some breathing room and avoid the need to pay interest on those general pecuniary devises that are funded within a reasonable period of time after death. It also would enable the executor to avoid the need to invade residuary principal in some estates or to incur possibly a non-deductible interest expense. However, in many cases (particularly those where no estate tax return is due) the estate can be closed within one year after death, and there is no need to go back to court after the will has been admitted except for the order of final distribution. If interest commences before one year after death, the executor may feel compelled to go into court for an order of preliminary distribution to avoid the need to pay interest on general pecuniary devises, resulting in additional time and effort that can be avoided under current law and the initial proposal.

Finally, whatever the commission decides regarding the commencement of interest on general pecuniary devises, a companion provision should be added to the trust law regarding mandatory general pecuniary distributions from trusts.

Please feel free to call me if you would like to discuss this matter further.

Best regards.

Sincerely yours,

Dick Kinyon

Richard S. Kinyon

RSK:pld

cc: Prof. Edward C. Halbach, Jr.