#F-3050/L-3050

ns115
05/24/91

Second Supplement to Memorandum 91-32

Subject: Study F-3050/L-3050 - Donative Transfers of Community Property (Policy Issues--State Bar Comments)

Enclosed are comments of Team 2 and of the Executive Committee of the State Bar's Estate Planning, Trust and Probate Law Section on the policy issues raised in Memorandum 91-32 relating to donative transfers of community property. The Bar apologizes for the delay in getting the comments to the Commission; however, things should improve in the future, now that the State Bar's General Counsel has determined they need not undergo the Keller review process in order to comment to the Commission directly.

We will raise the State Bar points orally at the meeting in connection with the particular issues to which they relate.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

ESTATE PLANNING, TRUST AND PROBATE LAW SECTION

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June 5, 1991

REPLY TO: 56570-000

<u>**BY FEDERAL EXPRESS**</u>

Nathaniel Sterling, Esq.
California Law Revision Commission
4000 Middlefield Road, D-2
Palo Alto, CA 94303-4739

Re: Memorandum 91-32
<u>Donative Transfers of Community Property</u>

Dear Nat:

At the Meeting of the Executive Committee of the Estate Planning, Trust and Probate Law Section on April 26 and 27, we began the process of addressing the policy issues raised in California Law Revision Commission Memorandum 91-32 regarding Donative Transfers of Community Property. Time did not permit us to address all of the issues. I wrote you a letter reflecting those decisions, but apparently it was mislaid by the Office of General Counsel of the State Bar when it was sent there for review under the regulations we must follow under <u>Keller</u>.

In the meantime, we reorganized our committee structure so that an enlarged Team 2 will address itself solely to issues of community property law. Team 2 met for four hours on May 31 to discuss the policy issues raised in Memorandum 91-32 and the First Supplement to it, utilizing as background material the study contained in Memorandum 91-19, the report of Professor Kasner, the consultant on this project. Although the Executive Committee met on June 1, there was not adequate time for it to review the conclusions of Team 2.

At the Executive Committee meeting on June 1, we did receive the good news that the General Counsel of the State Bar has determined that we do not need to undergo the Keller review process in order to comment to the California Law Revision Commission. As a result, you will have the benefit of our comments in a much more timely manner.

Since this letter contains decisions of the entire Executive Committee and those of only Team 2, I will try to be very explicit as to which are which as I review the issues.

We determined that it greatly helps consideration of these issues to divide them into two major subdivisions: (1) Donative transfers intended to take immediate effect; and (2) Donative transfers intended to take effect in the future (most commonly at death of one or both of the spouses). These two subdivisions will be utilized in this letter. We were concerned that the terminology used in Memorandum 91-32 sometimes merged two separate concepts, and we tried to be as clear as we could in our discussion.

The Executive Committee agrees that where the intent of the parties is clearly expressed in writing, that intent should control. Assuming that the term "nonprobate instrument" refers to a beneficiary designation form, consent of spouse form, or other similar writing, the Executive Committee agrees that the terms of such an instrument limiting or precluding changes should control. We are troubled, however, that the term "nonprobate instrument" could include the terms of the employee benefit plan, I.R.A., or insurance policy. If that term were to be so broadly defined, we could not favor having the terms preclude change in beneficiary designations or revocation of consent.

DONATIVE TRANSFERS OF BOTH TYPES

1. Should the case law regarding donative transfers of community property to third parties be codified?

The Executive Committee said "yes".

2. Should the requirement of a writing and its effect be clarified in the process?

The Executive Committee said "yes".

3. Should the requirement of written spousal consent currently found in Civil Code § 5125(b) be retained?

The Executive Committee said "yes".

Note: As Professor Kasner points out, § 5125 (b) is for personal property and § 5127 is worded differently for real property. Some adjustments to them might be in order if the same standards are to apply to both types of gifts.

4. Since the cases have interpreted Civil §5125 to mean that the gift is "voidable, but not void," the Executive Committee believes that the retention of the requirement should be with this judicial gloss. Similarly, the Executive Committee believes the limitation found in the case law that only the nonconsenting spouse may exercise the option to void the gift should be retained.

5. Should the law favor the application of the "gift statutes" or the "transmutation statutes" in ambiguous situations?

The Executive Committee said "gift statutes" and that a gift does not imply a transmutation or effect one.

6. Should the clear written intent of the donors control?

The Executive Committee said "yes".

7. In the First Supplement, the Beverly Hills Bar raises issues of informed consent. Should the law presume written consent is informed?

Team 2 was of the strong belief that it should be presumed that the written consent was informed consent. Team 2 thought that the burden of overcoming the presumption should be on the person seeking to revoke the consent (presumably by successors in interest to consenting spouse at death or by consenting spouse at dissolution), and that the standard should be that of clear and convincing evidence. Team 2 believes that it should not be too easy to overturn written consents because of the need for third party reliance, the desirability of discouraging litigation, and the problems of poor memories or second thoughts being elevated to a preponderance of the evidence.

PRESENT GIFTS OF COMMUNITY PROPERTY

1. Is the gift irrevocable as to both spouses if both consent in writing?

Team 2 said "Yes."

2. Should the nonconsenting spouse be able to revoke the entire gift or only his or her half of the community property?

Existing law allows the entire gift to be revoked. The remedy of the nonconsenting spouse is either to set aside the gift and recover the property, or to seek reimbursement. Team 2 was in favor of retaining the current law as the alternatives appeared to introduce a great deal of undesirable complexity. Team 2 raised issues of the effect of an intervening bona fide purchaser (e.g., gift of one spouse to charity auction and purchase from the auction by bona fide purchaser), but believes these issues should be addressed later as the Commission drafts detailed provisions.

3. Should any gifts be exempted from the requirement of written consent?

Team 2 believes that there should be no exceptions to the requirement of written consent. Team 2 recognizes that the case law has allowed a de minimus exception, but believes that is poor policy. A disproportionate amount of litigation is generated by trying to determine if the unconsented-to gift falls within the standard for a de minimus gift. If the gift is small and not consented-to, then it should not be a tremendous burden to allow revocation or reimbursement.

4. Should there be a period of limitations for the nonconsenting spouse to exercise his or her right to void the gift?

If so, how long?

Team 2 believes there should be a one-year period commencing with the date the nonconsenting spouse obtained actual knowledge of the gift of community property. Team 2 believes that a period of voidability for so long as the marriage lasted was too long if there was knowledge. If there was no knowledge, it was appropriate.

If the period lasts as long as the marriage, it is extended only one year from the date an action for dissolution is filed. Discovery proceedings should reveal the gifts within that period. If the marriage ends by death, the limitations period should be the same one year currently found in C.C.P. §353.

<u>FUTURE GIFTS OF COMMUNITY PROPERTY</u>

There is consensus that future gifts of community property by beneficiary designation raise the issue of consent, because a spouse can be deprived of his or her half of the community property if he or she is deprived of the ability to either receive the property or to designate who should receive it. Examples include life insurance, employee benefit plans, I.R.A. and P.O.D. accounts.

1. Should any gifts be exempted from the requirement of written consent?

Team 2 strongly opposed a de minimus exception.

2. What should the lack of written consent do to the status of the beneficiary designation (gift)?

"Voidable but not void", but the case law only allows the nonconsenting spouse to void his or her half of the gift at this time. Team 2 concurs with the case law, recognizing that the issues differ from those of present gifts.

3. Should there be a period of limitations for the nonconsenting spouse to exercise his or her right to void the gift?

If so, how long?

Since the possibility exists that the designation will be changed during the marriage or the fund will be exhausted (e.g., the spending down of an I.R.A. or pension plan), it makes more sense to extend the time for potential voidability in this case than in the case of the present gift.

Team 2 concluded the action to void one-half of the gift should be commenced within one year from the date of the termination of the marriage by dissolution or by death of the participant-donor spouse (whether he or she is the first or the second to die).

4. At the time of the beneficiary designation, is it irrevocable by the participant-donor spouse as to his or her half of the community property regardless of whether the other spouse consents?

Team 2 says "No." If the beneficiary designation itself is made irrevocable by its express written terms, then the donor-participant's half is irrevocable, but the other half does not become irrevocable absent written consent.

5. Is the gift irrevocable as to both spouses if both consent in writing?

Team 2 believes the correct answer is "No". Even if there is written consent, it is the nature of this type of property interest to be revocable, and a consent should not convert its status.

6. If the donor-participant spouse changes a designation that has been previously consented to by the other spouse, what is the effect of the change?

Team 2 believes that generally it will be effective as to at least the community half of the donor-participant spouse. However, some employee benefit plans require the consent of a spouse to make a beneficiary designation to third parties, and a purported change without spousal consent may have no effect as to either half of the community property in such a circumstance.

Team 2 believes such a change should be treated as if the consent of the other spouse was automatically revoked when the donor-participant spouse changed the beneficiary designation. If so, the new designation could be effective as to both halves, but it would be voidable as to half by the nondonor nonconsenting spouse.

Team 2 raised the issue of what would happen in the case of simultaneous death, but did not discuss it in detail.

7. Can a consenting nondonor spouse revoke his or her consent if the donor spouse's designation is unchanged?

Team 2 believes the correct answer is "yes." Team 2 believes the revocation of consent should be done on the same terms and with the same formalities as would be required for a change of beneficiary designation. Thus, if the donor-participant must deliver written notice to the insurance company or plan administrator to change a beneficiary designation, then the consenting spouse must deliver written notice to the insurance company or plan administrator of revocation of consent. There should, however, be no greater requirements for the revocation of consent.

8. If a beneficiary designation has been made by one spouse and the other spouse has given written consent, should there be a duty to give notice of changes to such beneficiary designations?

Team 2 believes it would be desirable to impose a duty on the holder of the funds to give notice to the consenting spouse if the donor-participant spouse makes a change and to give notice to the donor-participant spouse if the consenting spouse revokes his or her consent. Having said that, we also recognize the likely opposition that will be encountered in the legislature from the insurance and banking industries to the imposition of any additional duties upon them.

As noted earlier, some employee-benefit plans require spousal consent in order to have an effective designation of third-party beneficiaries. If such is the case, a revocation of spousal consent revokes the beneficiary designation. In such cases, the plan administrator should definitely have a duty to notify the plan participant of the revocation of consent.

While Civil § 5125.1 indicates there is probably already a duty of the spouses to notify each other, Team 2 felt the effect of a failure to comply with the spousal duty is not very clear. In other words, what is the real downside risk of failing to comply with the duty? While we don't yet have the answer of what it should be, we do believe this issue requires further study as the Commission deals with these issues.

There was a vocal minority to the Team 2 position. That minority believes all changes should be able to be accomplished in secrecy if that is what the spouse desires, and there should be no duty in anyone to give notice.

9. If the non consenting non-participant spouse dies first and his or her estate acts to void the beneficiary designation, what is the effect? Will it vary depending upon type of asset?

Team 2 believes the effect will vary with the type of asset.

If there is life insurance and it was a community property asset, the estate of the first spouse to die is a co-owner of the policy. There was some concern among our team members that the discussion of life insurance in Memorandum 91-19 at pages 63-78 did not always clearly distinguish between the insured and the owner or clarify who the owner is. If one spouse purchased the policy on behalf of the community (as opposed to a separate-property, e.g., cross-owned situation), then the community owns the policy. As a co-owner, the estate of the first spouse to die has all of the rights and benefits of a co-owner. The only real issues are determining what that package of rights and benefits is, valuing that package, and then determining (at the option of the estate representative) whether the co-ownership should continue or be bought out.

If employee benefit plan, the nonconsenting nonparticipant spouse should have the same rights at death as at dissolution. Thus, the estate representative can not compel payments from the plan if it is not yet in pay status, but there may be rights to an equitable offset. We did not have time to discuss these issues in the depth that we felt to be necessary to adequately address the conflicting policy issues.

10. There are five alternatives on pages 8 and 9 of Memorandum 91-32. Team 2 was not happy with any of the five as the best solution. Team 2 had no problem rejecting alternative (4), but felt it more difficult to reach consensus on the other alternatives as each had strengths and weaknesses. On a straight vote, alternative (2) received the most votes, but it was without enthusiasm. There was also strong support for some method of melding alternatives (1) and (5). Alternative (5) was liked for the flexibility inherent in it, but was distrusted because it was too open-ended.

During the discussion, the concept of a "Super Will" came up, and one of the Team members has since forwarded to me an article on the subject. The Team felt it might be useful to consider this option as part of the overall policy discussion.

A related issue is what happens to beneficiary designations upon the dissolution of the marriage. Just as Probate §6122 revokes certain terms of a Will automatically upon dissolution or annulment of the marriage, Team 2 believes it would be desirable to have a statutory provision automatically revoking all beneficiary designations in favor of the spouse upon dissolution or annulment of the marriage. The statute should also automatically revoke all spousal consents.

WHAT ISSUES SHOULD BE DEFERRED?

Team 2 did not have time to discuss what issues should be deferred. Our discussion agenda listed not only those issues listed in Memorandum 91-32, but also some addressed in Memorandum 91-19 but not listed in Memorandum 91-32. My personal opinion, not discussed with the others, is that the issue of defining the nonemployee spouse's right to make testamentary disposition of retirement plans and death benefits must be discussed at this time as it is inextricably related to other issues under consideration. While federal preemption is a possibility as to some of those plans, it is not an issue for non-qualified plans and I.R.A.s.

My personal view is that the following issues should be deferred for the present time, although they should be addressed later:

1. Gifts in view of impending death.

2. Tracing issues.

3. Quasi-community property rights.

   (a) Allocation of community versus non-community interests.

   (b) Statutory definition of non-insured spouse's interest in life insurance.

   (c) How to determine nonparticipant's interest in retirement plans.

4. Ability of spouses to encumber community property (not really donative if receive consideration).

5. Gifts between spouses.

6. Clarification or modification of transmutation rules.

Bob Temmerman is a member of Team 2 and will be at the next meeting of the Commission on Thursday, June 13, 1991, if additional discussion or clarification of our views is desired.

Sincerely,

Valerie J. Merritt

Valerie J. Merritt
Team Captain

VJM:gjm

cc: Members of Team 2
Members of Executive Committee

of the Super Will, or could withhold payment until a court decision interpreted the Super Will.

If a testator wanted privacy, he could decline to have a Super Will and instead do what he can do today, namely use an inter vivos trust and beneficiary designations. The Super Will would be optional.

A Super Will could not preempt Federal law. A testator could not use it as a method to circumvent the Federal requirement that a spouse be named the beneficiary of retirement plans. But as a practical matter, an overwhelming majority of testators name their spouses as beneficiaries of their entire estates, so that in such cases there would be no violation of Federal law. The Super Will merely would make it easier for a lawyer to accomplish what the testator desires. To the extent a Super Will names someone other than the spouse to receive retirement benefits, and the spouse has not consented, the designation would be ineffective.

Jointly owned property need not be subject to the Super Will concept, because of concerns that jointly owned property presently gives rights to others that should not be taken away from them without their knowledge and perhaps without their consent. A Super Will statute could provide that it would not affect the rights of a surviving spouse who elects against the testator's will.

A uniform law permitting a Super Will would be helpful because life insurance companies are located in many states, and testators typically buy insurance from companies that may not be located in their state of domicile. In the author's opinion, the Commissioners on Uniform State Laws should adopt a uniform law allowing a Super Will. •

Later stock sale did not preclude tax-free merger

FRANCHISEES WHO exchanged stock in their corporation for stock in the franchising corporation were able to treat the transaction as a tax-free merger in *Estate of Christian*, TCM 1989-413, even though they sold the stock they received shortly after the merger. Because of the absence of intent, the Tax Court held the step-transaction doctrine was inapplicable.

As part of a program of acquiring its restaurants from franchisees, McDonald's offered the taxpayers McDonald's common stock in exchange for the stock of the franchised corporation. Less than a year after the merger, the shareholders of the acquired companies donated some of their McDonald's stock to a charity and sold the rest for cash. The taxpayers reported the gain at the time of the sale (and reported no gain on the donation), but treated the merger as tax free under Section 368(a)(1)(A). The Service argued the taxpayers should have recognized gain at the time of the exchange.

In order for a merger to be tax free, it must satisfy the continuity of interest doctrine. Under this doctrine, the parties are not taxed because they have not terminated their investment; rather, they have merely altered its form. If one of the parties to a reorganization intends to terminate his interest immediately upon the completion of the transaction, the continuity of interest is lost under the step-transaction doctrine. Under this doctrine, the reorganization and the subsequent sale are collapsed into one transaction and the taxpayer is taxed on the exchange.

Three tests have been devised to determine if the step-transaction doctrine should be applied to collapse a reorganization and sale into one transaction:

1. Under the "binding commitment" test, the transactions are collapsed if, prior to the merger, there was a binding commitment to make the sale. The Service conceded that there was no such commitment here.
2. The "end result" test invokes the step-transaction doctrine if it appears that a series of formally separate steps are really prearranged parts of a single transaction. The test is based on subjective intent.
3. The "interdependence test" looks to whether the merger would have taken place without a guarantee that the acquired stock would be salable.

In applying the last two tests, the Tax Court focused on the following facts:

1. McDonald's never offered, and the taxpayers never requested, that the consideration include cash. This would have indicated that the taxpayers intended to cash out.
2. There was no history of ill will between McDonald's and the taxpayers that would imply that the taxpayers would not want to remain shareholders in McDonald's.
3. The taxpayers gave no consideration to selling their stock at the time of the merger.
4. McDonald's desires dictated the timing of the merger, not any tax needs of the taxpayers.
5. Although the taxpayers' attorney had bargained for certain rights affecting the marketability of the McDonald's stock, these appeared to be his own demands, rather than those of his clients, and reflected his desire to achieve maximum flexibility for his clients.
6. The contract and negotiations leading to it were "noticeably void" of evidence suggesting an intent to sell the stock subsequent to the exchange.

The court found that a number of these factors, and the lack of intent to sell from the outset, made the end result test inapplicable. The court also found no interdependence between the merger and the sale requiring application of the step-transaction doctrine. The taxpayers' decision to sell the stock was made after the merger was complete, albeit, soon after. •