Memorandum 92-8

Subject: Study F-3050/L-3050 - Nonprobate Transfers of Community Property (Comments on Recommendation)

The Commission's recommendation relating to nonprobate transfers of community property addresses problems raised by Estate of MacDonald, 51 Cal. 3d 262 (1990). It clarifies when spousal consent is required for a nonprobate transfer of community property, what the effect of the consent is, whether the consent is revocable, and other issues. The Commission has approved the recommendation for submission to the 1992 Legislature.

We have received several letters relating to the recommendation. The issues raised in the letters are addressed below.

Form of Consent to Nonprobate Transfer of Community Property

Professor Grace Ganz Blumberg of UCLA Law School (Exhibit 1) criticizes the Commission's recommendation because it may effectuate the uninformed written consent of a spouse to a nonprobate transfer of community property. In her opinion, the written consent of a spouse may not be a knowing consent, which should not be given effect. "The problem in MacDonald lies not in current state law but rather in bank use of IRA forms that are responsive neither to California marital property norms nor to the interest of bank depositors in knowingly and knowledgeably ordering the disposition of their property at death."

It is not clear exactly what Professor Blumberg is suggesting, but it appears she would require a spousal consent to be a full transmutation of property in order to be effective: "But legislation proposed by the Commission would seem to overrule MacDonald by recasting the MacDonald transaction as a spousal consent to a nonprobate testamentary gift of community property and, as such, exempting it from the rigorous 'express declaration' transmutation requirement of Civil Code Section 5110.730."

To require a spousal consent to a nonprobate transfer to take the form of a transmutation of property would be disastrous. Simply to make an estate plan a spouse would be required to give up all rights in community property. In the event of dissolution of marriage, the consenting spouse would be unable to recover the spouse's rightful share of the community asset. A transmutation requirement would destroy the genius of the nonprobate transfer, which is to specify rights at death without probate and without affecting lifetime rights in the property.

An alternative approach to Professor Blumberg's concern about uninformed consent would be to prescribe statutory form language for a spousal consent. The Commission has considered this possibility in the course of this study on several occasions, but has declined to impose another layer of state regulation on the finance and insurance industries, and has deemed it inappropriate to tell them how to run their businesses. The Commission's recommendation merely specifies "written consent"; we assume the term "consent" requires there to be a knowing agreement before a signed writing amounts to a consent, and we do not develop the matter further.

Rights in Nonprobate Assets After Death of Consenting Spouse

The most troublesome problem dealt with in the Commission's recommendation are the relative rights of the parties after the death of the consenting spouse but before the death of the donor spouse. In the MacDonald case, for example, the wife consented to the husband's IRA beneficiary designation for community property and then died. The Commission's recommendation makes clear that the wife's death fixes her consent. The wife's heirs may not revoke the consent, and any later change of beneficiaries by the husband affects only the husband's one-half interest in the community property and not the deceased wife's one-half interest, which passes to the beneficiary consented to.

This makes logical sense, but as the Commission has recognized at past meetings, it puts the wife's community interest in limbo during the interim until the husband's death. Does the husband have a fiduciary duty in managing the property? Can the husband consume the principal? Do the wife's beneficiaries have any rights in the

property--either to interest or to consumption of principal? The Commission has decided these issues are too complex to deal with by statute, and has left their development to case law.

But Richard Kinyon of San Francisco (Exhibit 2) writes to criticize this decision. He thinks that the proposed legislation puts the surviving spouse in the position of a constructive trustee for the ultimate benefit of the consented to beneficiary following the death of the surviving spouse. It is not clear what the interim rights of the surviving spouse in the property are, which may cause the consenting spouse's share to be taxable rather than qualifying for the marital deduction. He suggests a better resolution would be to adopt the MacDonald reasoning and provide that the consenting spouse's share passes to the consenting spouse's estate beneficiaries, who may thereupon exchange the one-half interest in the nonprobate asset for other property of the surviving spouse or may revoke the consent and otherwise deal with the property as they choose. This will avoid the difficult and unresolved problems of the rights of the various parties during the interim before the donor spouse's death.

The Commission's consultant, Professor Jerry Kasner, responds (Exhibit 3) that although the Commission's recommendation is not perfect, it is better than Mr. Kinyon's alternative solution. If the property passes to the consenting spouse's estate beneficiaries, their exchange of it for other property would cause the new property to be taxable income to the estate. And allowing them to revoke consent to the nonprobate transfer would codify the very problem we are trying to solve--the inability of married persons to make an effective and assured estate plan involving community property under the MacDonald rule.

Professor Kasner also notes that to allow the consenting spouse's estate beneficiaries to take the consenting spouse's one-half interest in the nonprobate asset will create massive procedural problems. The beneficiaries would have to file a claim in connection with any insurance policy, IRA account, etc., and would have to cash in the asset or somehow impose a lien on distributions. He doubts this would

be acceptable to the banking and insurance industries or to estate planners, and notes that for many assets it would be either practically or legally impossible to accomplish.

Professor Kasner suggests that the interim problems in dealing with these community property nonprobate assets are inherent in the nature of many of the assets.

> These problems already exist, they have simply been ignored up to now. If the deceased spouse in fact has a community interest in nonprobate assets, then there is no doubt that interest should participate in future growth in value or income earned from those assets. It is also true the surviving spouse has fiduciary duties in management of such assets. This problem is not that different than those encountered in a divorce where an asset such as a pension plan cannot readily be divided at the time of divorce. The courts have always found solutions to protect the community interest of the former spouse in such assets. They can do the same to protect the interest of a deceased spouse.
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> . . .
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> In summary, I still believe the solution the Commission has adopted, while not perfect or problem free, is the best one.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

UNIVERSITY OF CALIFORNIA, LOS ANGELES

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December 13, 1991

Nathaniel Sterling
Executive Secretary
4000 Middlefield Road
Suite D-2
Palo Alto, CA 94303-4739

Dear Mr. Sterling:

As per our conversation yesterday, I enclose a copy of the commentary I sent today to California Family Law Monthly. I hope it is useful.

Sincerely yours,

Grace Ganz Blumberg
Professor of Law

GGB:jjr

Enclosure

Comment for California Family Law Monthly on
Nonprobate Transfers of Community Property,
21 Cal. L. Revision Comm'n Reports 163 (1991)
Grace Ganz Blumberg
December 13, 1991

In its lengthy introduction to *Nonprobate Transfers of Community Property*, the Law Revision Commission explains that its proposed legislation is responsive to *Estate of MacDonald* [51 Cal. 3d 262 (1990)] and *Ablamis v. Roper* [937 F.2d 1450 (9th Cir. 1991)]. As such, the legislation is misdirected and misguided. *Ablamis*, an ERISA preemption case, is unreachable by state law, as the Commission's introduction finally acknowledges at the very end. The problem in *MacDonald* lies not in current state law but rather in bank use of IRA forms that are responsive neither to California marital property norms nor to the interest of bank depositors in knowingly and knowledgeably ordering the disposition of their property at death.

If *MacDonald* were merely the springboard for essentially unrelated legislation, the Commission's evident misreading* of that case would be only minor cause for concern. But legislation

*See particularly the case analysis at 21 Cal. L. Revision Comm'n Reports 168-169, where the Commission states that: "The California Supreme Court held that the wife's consent to a beneficiary designation was not a [present] transmutation of the wife's interest in the community property into the husband's separate property, with the result that the consent remained revocable and the revocation could be exercised after the wife's death by her personal representative." *MacDonald* does not explicitly or even implicitly turn on a personal representative's power to revoke an otherwise effective consent after the consenting spouse's death; it is instead a case about *ineffective* consent. Whether one characterizes Mrs. MacDonald's signature as a present transmutation or a present consent to a future nonprobate transfer, the problem of *knowing* consent remains.

proposed by the Commission would seem to overrule *MacDonald* by recasting the *MacDonald* transaction as a spousal consent to a nonprobate testamentary gift of community property and, as such, exempting it from the rigorous "express declaration" transmutation requirement of Civil Code Section 5110.730. [See sections 5010, 5011, and 5022 of the proposed legislation at 21 Cal. L. Revision Comm'n Reports 179, 183.] The wisdom of *MacDonald's* application of the rigorous transmutation standard is best appreciated by close examination of the universal IRA form, a document drafted by a private banking association for nationwide use. It is difficult to understand, confusing even for a specialized attorney, buried at the end of a document otherwise intended to effectuate a present nonprobate transfer, and explained in small print.

This is not a case where the depositor wishes to open an account and actively chooses among various forms of title, some of which offer him the opportunity of achieving future nonprobate death transfer. Here the depositor has come, often with a large pension rollover, to open an IRA for tax deferral purposes, and he is asked, parenthetically, to make a beneficiary designation. His spouse is asked, even more parenthetically, to sign-off on this designation. That this procedure is largely for the bank's convenience is emphasized by the consequence of an IRA depositor's failure to make a beneficiary designation. The IRA document establishes its own order of succession: The funds (without regard to their state law separate or community charac-

ter) will pass entirely to the depositor's surviving spouse and, if none, to his issue, and, if none, to his estate.

MacDonald, as that opinion wisely suggests, should stimulate sensitive reform of the IRA adoption agreement rather than efforts to circumvent the *MacDonald* holding. [See footnote 9 of the opinion.] The California Supreme Court directed its cautionary advice to the drafters of IRA adoption agreements, but it is equally apt for the Law Revision Commission.

My dismay with the Law Revision Commission response to *MacDonald* may stem, at least in part, from my perspective as a community property lawyer. I am concerned that community property ownership rights be respected and effectuated unless a spouse has knowingly and clearly renounced those rights. The Commission, in contrast, would seem to reflect the probate lawyer's concern that property be simply and readily transmissible at death. A sensitive treatment must reconcile both sets of concerns. But it is important, as a start, to sharply define the problem presented by *MacDonald*. *MacDonald* does not involve active donation, the usual issue in framing rules for nonprobate death transfer, but concerns instead the passive acquiescence of the co-owner spouse, who may have little or no knowledge of her property interests or of state property ownership rules. When passivity is enhanced by context (an institutional setting, a lengthy small-print standard form that makes no mention of any possible spousal co-ownership interest, a signing request inci-

dental to the primary transaction, a "sign-here at the 'X'" instruction from a bank official), consent should not be lightly or readily found. That is the wisdom of *MacDonald*. This wisdom should be codified rather than avoided by statute.

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November 25, 1991

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File:

California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, CA 94303-4739

Attention: Nathaniel Sterling
Assistant Executive Secretary

Re: Number F-3050/L-3050 (Nonprobate Transfers of Community Property)

Dear Nat:

This letter is in response to the Tentative Recommendation relating to Nonprobate Transfers of Community Property, dated September 1991. As I mentioned to you over the telephone earlier this month, I got behind in my reading of California Law Revision Commission (CLRC) materials, and I just had a chance to catch up over the November 1 weekend. Therefore, I was unable to meet your October 18 deadline for comments on this tentative recommendation.

As I mentioned to you over the telephone, although I am in general agreement with most of the provisions of this recommendation, I believe that proposed section 5023(b)(2) of the Probate Code, relating to the effect of the consent of the holder's spouse following such spouse's death and prior to the holder's death, is undesirable and would create both a tax and nontax problem. It provides a result that neither party to the litigation in Estate of McDonald, 51 Cal. 3d 262 (1990), advocated, and apparently the holder would be required to hold the deceased spouse's one-half community interest in the property during this period as a constructive trustee for the ultimate benefit of the named beneficiary of the property following the holder's death.

The problem with proposed section 5023(b)(2) is that during this period the rights of the holder of the property, the beneficiaries of the deceased spouse's estate,

and the named beneficiary with respect to the deceased spouse's one-half interest in the property, are unclear. Does the holder have the right to any of the income or principal with respect to that one-half interest, and if so, to what extent? Unless the holder has the right to all of the income from that one-half interest, the right to cause it to produce a reasonable amount of income, and no one else has any right to principal during the holder's remaining lifetime, the deceased spouse's one-half interest will not qualify for the marital deduction. In addition, if the named beneficiary does not survive the holder, what happens to the deceased spouse's one-half interest in the property? Presumably the beneficiaries of the deceased spouse's estate would be entitled to it as of the date of the named beneficiary's death, since the deceased spouse's consent would then be ineffective.

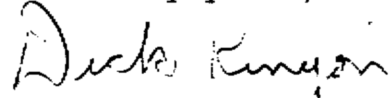
Furthermore, it is not clear what the holder's powers and duties are with regard to that one-half interest during his or her remaining lifetime. If the holder is a constructive trustee with respect to the deceased spouse's one-half interest in the property, the Trust Law (Division 9 of the Probate Code) is inapplicable. See Probate Code § 15003(a).

In cases where the intent of the consenting spouse is unclear, the best solution to this problem may be to adopt the McDonald case reasoning and simply let the deceased spouse's interest in the asset pass, subject to the beneficiary designation, to the beneficiaries of the deceased spouse's estate, the same as all other property owned by the deceased spouse. They (or the deceased spouse's personal representative) would then have the right to (1) exchange the deceased spouse's one-half interest in the property for the holder's interest in other community property of equal value as part of a non-pro rata division of the community property generally, or (2) retain that interest and revoke the deceased spouse's consent to the beneficiary designation at any time prior to the holder's death. Any other solution requires a presumption as to the deceased spouse's intent when in all likelihood he or she never focused on the problem.

I have discussed this problem with most of the individuals shown below as receiving a copy of this letter, who for the most part agree with my suggested solution. Although I believe Ed Halbach would treat the consent as evidencing an intent to give the deceased spouse's interest

in the property to the holder as of the deceased spouse's death, he and I are in agreement that proposed section 5023(b)(2) is undesireable.

Sincerely yours,



Richard S. Kinyon

RSK:bjs

cc: L. Martin Blaha, Esq.
Francis J. Collin, Jr., Esq.
Raymond G. Ellis, Esq.
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Edward C. Halbach, Jr.
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THE UNIVERSITY OF SANTA CLARA

SCHOOL OF LAW

December 7, 1991

Nathaniel Sterling
Executive Secretary
California Law Revision Commission
4000 Middlefield Road
Palo Alto, California 94303-4739

Re: MacDonald

Dear Nat:

I am in receipt of your letter of November 26, and the enclosed copy of the letter of Dick Kinyon. I acknowledge all of the problems Dick sees in proposed Section 5023(b)(2), and suggest that the suggested solutions in Dick's letter are worse.

As to the first solution, there is no right to a non-pro rata distribution of community property. So far as I know, all authorities in the field, including Professor Reppy, classify California as an item theory state. Such a division can only be the result of an agreement between the estate and the surviving spouse.

Such agreements can have severe federal income tax consequences, far worse than those suggested in Dick's letter. The transfer of undivided interests in property between the estate and surviving spouse is probably fully taxable, LTR 8016050 notwithstanding. I understand the IRS is presently raising just that point in several tax cases, particularly in Marin county.

The tax consequences of swapping interests in nonprobate assets can be particularly disastrous, since they are frequently classified as "income in respect of a decedent" for federal income tax purposes under IRC Sec 691. If the estate receives other assets in exchange for its interest in such an asset, and an IRA is a good example, it will have immediate recognition of income. For example, if the estate has a one-half community interest in an IRA of $200,000, and trades that for some other community asset worth $100,000, the estate will have immediate recognition of $100,000 in taxable income.

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The results are equally bad if life insurance is involved. If the estate has a community interest in a life insurance policy, and trades that interest with the surviving spouse for some other community asset, an interest in the policy has been transferred "for value" to the surviving spouse, and under IRC Sec 101, part of the proceeds, which are normally received tax free on the death of the insured, may be subject to federal income tax. In addition, the surviving spouse will then be the owner of the policy, and its proceeds will be entirely subject to federal income tax when he or she dies.

Dick's second proposed solution simply adopts the position of the Supreme Court in MacDonald. I thought the furor over that decision is what brought this issue to the Commission in the first place. If we allow the estate of the predeceased spouse to set aside the beneficiary designation, and require an immediate transfer of the nonprobate asset to the estate or heirs of the predeceased spouse, that will solve the problems Dick discusses in his letter. It also takes us right back to square one.

If at this late date the Commission decides MacDonald was right to begin with, the estate of the predeceased spouse will be compelled to always file a claim in connection with any insurance policy, IRA account, or other nonprobate asset to assert a community interest. This would appear to require cashing in the insurance, or making a distribution from the IRA account, or somehow imposing a lien or claim against the asset to secure the community interest. This in effect means that all consents to beneficiary designations are automatically revoked if the consenting spouse is the first to die.

This solution is likely to be opposed by insurance companies and financial institutions, as well as a good many estate planners. I believe a return to the MacDonald solution may be actively opposed by the state bar, since it has already taken the position MacDonald should be overturned.

Dick's letter seems to assume that if the nonparticipant spouse is the first to die, his or her estate can automatically collect his or her community interest in nonprobate assets. While I am not an expert on employee benefits, I have some doubts that Mrs. MacDonald's heirs are in a position to force Mr. MacDonald to distribute his wife's interest in the IRA to them. IRC Sec 408(g) indicates the provisions of IRC Sec 408, which govern the administration of an IRA, are to be applied without regard to any community property laws. Section 408 has express provisions for transfers pursuant to a divorce, but nothing relating to transfers at death. I suggest

the attorneys for the MacDonald estate be asked what was the actual disposition of the IRA account in that case.

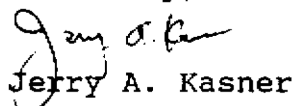
It is also impossible to divide some nonprobate assets, such as term life insurance or unfunded death benefit plans. To cash out a community interest in other life insurance would require a probate court to compel the surviving spouse to cash it in.

The interim problems Dick mentions in his letter are inherent in the nature of many nonprobate assets. These problems already exist, they have simply been ignored up to now. If the deceased spouse in fact has a community interest in nonprobate assets, then there is no doubt that interest should participate in future growth in value or income earned from those assets. It is also true the surviving spouse has fiduciary duties in management of such assets. This problem is not that different than those encountered in a divorce where an asset such as a pension plan cannot readily be divided at the time of divorce. The courts have always found solutions to protect the community interest of the former spouse in such assets. They can do the same to protect the interest of a deceased spouse. Possibly the state equivalent of a qualified domestic relations order used in divorce cases could be applied. Also, I refer you to my discussion in the study of attempts in Wisconsin to deal with these problems where the community owns life insurance. There is an interesting discussion of the concept of a probate qualified domestic relations order in the California Tax Lawyer, Volume 1, No. 3, suggesting such an approach could be taken to protect the community interest of a nonparticipant predeceased spouse in a qualified pension plan.

Insofar as what happens if the designated beneficiary predeceases the consenting spouses, I assume the answer is the same as it would be anytime a designated beneficiary predeceases the person who designates the beneficiary. I fail to see how this raises any new problems.

In summary, I still believe the solution the Commission has adopted, while not perfect or problem free, is the best one.

Sincerely,



Jerry A. Kasner