Memorandum 93-24

Subject: F/L-3050.1 — Nonprobate Transfer Legislation Revisited

This memorandum reports developments concerning the legislation enacted on recommendation of the Commission relating to nonprobate transfers of community property. No Commission action is required at this time.

BACKGROUND

The legislation governing nonprobate transfers of community property (AB 1719) was enacted in 1992 on recommendation of the Commission. See Prob. Code §§ 5000-5032. The legislation sets out basic principles governing nonprobate transfers of community property:

(1) Each spouse has the right to control disposition of a half-interest in the community property at the spouse's death; this may be done by a nonprobate transfer as well as by a testamentary transfer.

(2) A purported nonprobate transfer of community property by a spouse acting alone affects only the interest of that spouse and not the interest of the other spouse unless the other spouse joins in or consents to the transfer.

(3) If the other spouse joins in or consents to a nonprobate transfer, the joinder or consent is not a transmutation of the community property, and the joinder or consent remains revocable until the death of either spouse, at which time it becomes irrevocable.

(4) The transferring spouse may change the terms of a nonprobate transfer that has previously been joined in or consented to, with the renewed joinder or consent of the other spouse.

(5) If the transferring spouse changes the terms of a nonprobate transfer without reaffirmation of the other spouse's joinder or consent, the change is effective as to the half interest of the transferring spouse but terminates the transfer as to the half interest of the other spouse. And if the other spouse has died before the change is made, the other spouse's half interest passes as originally joined in or consented to.

PROBLEM AREA

The last of the principles set out above—a change in terms of a nonprobate transfer after the death of the consenting spouse does not affect the disposition of the consenting spouse's share—was the aspect of the recommendation the Commission struggled with most, and recognized there would be most problems with. However, the Commission decided that the policy is sound even though there may be practical problems in application, that legislation cannot cure every issue that will come up, and that the courts will just have to construe the statute as questions of interpretation arise.

The provision is embodied in Probate Code Section 5023, which reads:

> 5023. (a) As used in this section "modification" means revocation of a provision for a nonprobate transfer on death in whole or part, designation of a different beneficiary, or election of a different benefit or payment option.
>
> (b) If a married person executes a provision for a nonprobate transfer of community property on death with the written consent of the person's spouse and thereafter executes a modification of the provision for transfer of the property without written consent of the spouse, the modification is effective as to the person's interest in the community property and has the following effect on the spouse's interest in the community property:
>
> (1) If the person executes the modification during the spouse's lifetime, the modification revokes the spouse's previous written consent to the provision for transfer of the property.
>
> (2) If the person executes the modification after the spouse's death, the modification does not affect the spouse's previous written consent to the provision for transfer of the property, and the spouse's interest in the community property is subject to the nonprobate transfer on death as consented to by the spouse.
>
> (3) If a written expression of intent of a party in the provision for transfer of the property or in the written consent to the provision for transfer of the property authorizes the person to execute a modification after the spouse's death, the spouse's interest in the community property is deemed transferred to the married person on the spouse's death, and the modification is effective as to both the person's and the spouse's interests in the community property.

Since enactment of the provision it has been severely critiqued, particularly by Professor Ed Halbach and by Jeff Strathmeyer of the CEB Estate Planning and California Probate Reporter. (When this matter was first before the Commission

Professor Halbach argued for a rule that after the death of the consenting spouse the transferring spouse should have full power of disposition over the property, including the right to change beneficiaries). The provision also has also been closely analyzed by several commentators in the State Bar's Estate Planning, Trust & Probate News. And we have received correspondence from a number of persons including Valerie Merritt arguing that the legislation yields the correct result in most cases and should not be tampered with, Stanley Arenberg of the Beverly Hills Bar Association Probate and Trust Section raising a number of questions of interpretation and suggesting repeal of the legislation, and the Commission's consultant Professor Jerry Kasner pointing out that the policy of the legislation is sound and any tinkering should be limited to clarifying and fine tuning and should not change policy.

With the experts in disagreement over the matter, the staff has been circumspect about suggesting any changes in the enacted legislation. We have tried to start a colloquy among the experts by circulating their comments to each other for review, but so far without much success except as discussed immediately below.

EXERCISE OF POWER OF APPOINTMENT UNDER A TRUST

Some practitioners have been concerned that the statute may be read to create adverse tax consequences and other problems where there is a trust instrument with a power of appointment to be exercised by the surviving spouse. Specifically, the concern is that a joinder in or consent to a trust that includes a power of appointment in the surviving spouse could be construed as an agreement to a modification that triggers an outright transfer to the surviving spouse, or that exercise of the power of appointment under the trust is a modification within the meaning of the statute. See, e.g., Edith M. Doyle, *Analysis of AB 1719* (Exhibit pp.1-10).

There appears to be a consensus that this issue should be clarified. See, e.g., Professor Kasner's letter (Exhibit p. 11). The State Bar has introduced legislation to address the matter. Assembly Bill 908 (Horcher) now includes language to make clear that the power of appointment under a trust does not trigger Section 5023:

> 5023. (a) As used in this section "modification" means revocation of a provision for a nonprobate transfer on death in whole or part, designation of a different beneficiary, or election of a different

benefit or payment option. As used in this section, "modification" does not mean, and this section does not apply to, the exercise of a power of appointment under a trust.

The staff has reviewed this language and it appears to do the job. The bill looks like it is headed for enactment.

CONCLUSION

The staff is continuing to follow developments on this difficult but important matter. The Commission thought when it proposed the legislation that there were unresolved issues that would have to be dealt with down the line, and this is coming to pass. We are hoping the experts will arrive at a consensus on this before we jump in and stir the pot. This memorandum may stimulate further interchange.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

ANALYSIS AND APPLICATION OF A.B. 1719

BY

EDITH M. DOYLE

For purposes of analyzing A.B. 1719 (the "Statute"), certain examples will be considered. In the examples, we will assume that husband (H) is the "married person" as identified under the Statute and his wife (W) is the "person's spouse" or, in certain situations, the "consenting spouse" or "nonconsenting spouse." All references to Code sections hereunder are to the California Probate Code unless otherwise identified.

I. Application to IRA

A. Assumption

H has established an IRA with community property funds. H has named his son as the beneficiary of death benefits. W has signed a consent to the designation. W has predeceased H, and at W's death, the value of the IRA is $500,000.

B. Result at W's Death Under Statute

Since W predeceased H, her consent became irrevocable (§ 5030(c)). Thereafter, if H modifies his beneficiary designation, and names his daughter as the beneficiary of death benefits from his IRA, H will have executed a "modification" under the

Statute (§ 5023(a)). At H's death, W's one-half of the IRA will be distributable to son, and H's one-half of the IRA will be distributable to daughter (§ 5023(b)(3)).

On W's death, a 706 return will be filed showing that a $250,000 interest in the IRA is in W's taxable estate, and the interest probably does not qualify for a marital deduction.

C. Intent

In some cases, the result described above will be the result desired by H and W. If, however, W intended that H would own the IRA at her death with full powers of disposition, she has the following options:

(1) W could revoke her consent and leave her interest in the IRA to H. If W revokes her consent in a writing, including her Will, and if the revocation is served on H before H's death, the revocation will be effective (§ 5031(a)). Thereafter, however, a designation of a beneficiary by H will not be effective as to W's one-half of the IRA (§ 5020). Her one-half interest would be distributable under her Will (§ 5032). Therefore, W must also leave her interest in the IRA to H under her Will. (See Exhibit A-1, attached, for a sample provision.)

At W's death, a 706 will reflect a $250,000 interest in the IRA, and, since she leaves the interest outright to her husband, it will qualify for a marital deduction under IRC § 2056.

(2) A second option available to W is to include, in the written consent to H's designation of death benefits, a provision authorizing H to execute a "modification" after her death.

When W dies, since her written consent to the designation on the IRA authorized H to execute a modification after her death, W's interest in the community property IRA is deemed transferred to H on W's death, and any modification made by H after her death will be effective as to both halves of the community property (§ 5023(b)(3)).

Thus, W's 706 will show that there is a $250,000 interest in an IRA in her estate, and since she signed a beneficiary designation and authorization for modification by H, then, under California law, W's interest in the community property IRA is deemed transferred to H and qualifies for a marital deduction under IRC § 2056.

(3) W could enter into a transmutation agreement with H satisfying the provisions of California Civil Code § 5110.730,

and the IRA will be H's separate property, subject to his designation of beneficiary for death benefits. This solution would not be recommended unless there is a MacDonald situation in which both parties are in agreement regarding the designation and W is terminally ill. In most cases, the parties should be represented by separate counsel before they enter into any transmutation agreement affecting marital rights.

II. Application to Living Trust

A. Assumption

H and W create a living trust that divides into Trust A (Survivor's Trust), Trust B (QTIP), and Trust C (By-pass Trust) at the first death. W will be assumed to be the first trustor to die. The trust provides that the surviving trustor, H, has the power to modify distribution of Trust B and Trust C among the issue of the trustors' marriage, and H is given a limited power to invade the principal of Trust B and Trust C subject to an ascertainable standard under IRC § 2041.

B. Result Under Statute

Since H and W created the living trust and both executed the document as Trustors, their interest is subject to the

provisions of the Statute, since, under § 5000, a trust is considered a nonprobate transfer, and the Statute deals with nonprobate transfers. Under the Statute, W's "joinder" in the creation of the trust is considered a "consent" (§ 5010).

On W's death, her consent to the terms of the trust will become irrevocable (§ 5030(c)). Thus, the provisions regarding her one-half of the property allocated to Trust B and Trust C become irrevocable.

Since the trust also provides that H has the power to modify distribution of Trust B and Trust C among the issue of the Trustors' marriage, H will have been authorized to execute a "modification" after W's death (§ 5023(a)); and since H is allowed to invade the principal of Trust B or Trust C, the authorization for such a power would also be considered a "modification." This result follows from application of the Law Revision Comment that the election of a different benefit or payment option by H is considered a "modification" because "the choice of benefit or payment options can substantially affect the rights of the parties." Applying that Comment to the living trust, H's limited power to consume principal could substantially affect the rights of the children to inherit the remainder of Trust B and Trust C, and, thus, H's power would be considered a "modification."

Therefore, upon W's death, her one-half community property interest in Trust B and Trust C will be includable in her estate, but, because, in the written consent to the provision for the transfer of the property (i.e., her joinder in the creation of the trust), W authorized H to execute a modification after W's death, W's interest in the community property is deemed transferred to H on W's death, and any subsequent modification by H is effective as to both W and H's interest in the community property.

At W's death, the Form 706 will show W's one-half interest in the community property as part of her taxable estate. Under California law, W signed a consent (joinder) regarding the transfer of her one-half community property interest at her death, and in her written consent she allowed her husband to execute a "modification" with regard to the property. Therefore, the property is deemed transferred to H, and any subsequent modification by H will affect both W's and H's interest in the community property. If the Statute is applicable in the same manner as it is for purposes of the IRA, the Trust B and Trust C will be deemed transferred to H. Thus, W's 706 will reflect that the property qualifies for a marital deduction under IRC § 2056. Since Trust B and Trust C are deemed transferred to H, and thereafter subject to modification by H, they will be in H's estate at his death. We will have lost the ability to exclude

Trust C from H's estate, and we will have lost W's generation-skipping tax exemption if it is applied to the Trust B and Trust C, since H will become the transferor of Trust B and Trust C for generation-skipping tax purposes.

The above-described result is not the intent of the parties. For the present time, I would recommend implementation of the right to avoid the new law, as provided under § 5011. Under § 5011(c), the rights of the parties are subject to a written expression of intent in the provision for transfer of the property. My recommendation is that a statement in the trust document be included that, pursuant to the rights of § 5011, the trustors waive application of § 5023; and, in particular, the trustors agree that no power given to the surviving trustor shall be an authorization for the surviving trustor to execute a modification as described under § 5023(b)(3). I have attached suggested language as Exhibit A-2. However, since the law is retroactive, it is critically important that the issue of the application of the Statute to living trusts be clarified so that it will not be necessary to amend all of our existing trusts.

III. Discussion

It has been suggested that the difference between the living trust example and the IRA example, above, is that it is

clear that the clients do not intend the Statute to apply to their living trust, and the Statute will not apply because of the terms of the instrument (§ 5011(a)). However, the same argument could be made with regard to the IRA, above. It is my suggestion that the Statute be amended to unequivocally avoid application of § 5023 to trusts. Alternatively, the provisions of § 5023 should be clarified to state that a limited power of appointment as defined under IRC § 2041 is not a "modification" for purposes of § 5023. However, the drafters of the Statute might have intended that the authorization for H to modify the distributive provisions of the document in <u>any</u> manner (even subject to an ascertainable standard) would trigger § 5023(b)(3). If W in the first example gave H the limited power to modify the IRA beneficiary designation among their issue only, it might have been the intent of the drafters that the IRA was then deemed transferred to H.

In any event, for the present time, it is advisable to review the provisions in clients' Wills regarding these transfers. I have attached language in Exhibit A-1 for a Will provision revoking consents to qualified plans and insurance policies and leaving those interests to the surviving spouse.

Some authors have suggested adding a provision to clients' Wills revoking <u>all</u> consents under Part 1 of Division 5 of the California Probate Code and giving ownership of the

property to the surviving spouse. Since the joinder in the execution of a trust is a "consent" for purposes of the Statute, a blanket revocation of consent and direction for distribution to the surviving spouse could cause Trust B and Trust C to be deemed transferred to the surviving spouse. It is necessary to carefully consider the effect under the Statute of any revocation of consent under a Will, followed by a direction for transfer.

EXHIBIT A-1

SAMPLE WILL PROVISION

THIRD: I give and bequeath to my husband, XXX, if he survives me, otherwise to my children who survive me, in equal shares as they shall agree, all of my tangible articles of a personal nature, all my interest in furniture, furnishings and household equipment, appliances, art objects, and any personal automobiles which I may own at the time of my death, and any insurance thereon. In addition, I give and bequeath to my husband, XXX, if he survives me, all of my interest in any qualified or non-qualified employee benefit plans in which he is or has been a participant, and insurance policies of every type on his life in which I have a community property interest, and I revoke any consent I have given to a nonprobate transfer of such community property interest. As to any such interests for which I hold the right to make such designation, I hereby confirm any beneficiary designation made by me prior to my death and direct that any such interest shall pass in accordance with such designation.

EXHIBIT A-2

SAMPLE TRUST PROVISION

__. Intent

Pursuant to the rights of the Trustors under California Probate Code § 5011, the Trustors waive application of California Probate Code § 5023; and, in particular, the Trustors agree that no power given to the surviving Trustor under this Declaration of Trust shall be deemed an authorization for the surviving Trustor to execute a modification as described under California Probate Code § 5023(b)(3).

ALTERNATIVE SAMPLE TRUST PROVISION

__. Intent

Pursuant to the rights of the Trustors under California Probate Code § 5011, the Trustors waive application of Articles 2 and 3 of Division 5, Part 1, Chapter 2 of the California Probate Code.

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SCHOOL OF LAW

January 20, 1993

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RE: Community Property vs. Joint Tenancy Non Probate Transfers of Community Property - A.B.1719

Dear Nat:

I am writing to indicate I fully support the staff position in your latest memorandum on the joint tenancy/community property issue. It is time to resolve this issue.

It seems to me there are at least two solutions to this problem, and probably more. The solution you picked was not my first choice, but I believe it works. I also believe it resolves the "Property vs. Title" issue. Since it requires an express transmutation to convert the community to so called "true" joint tenancy.

On another issue, I enclose an analysis of A.B. 1719 by Edith Doyle, a Los Angeles attorney. She believes the statute as written applies to trusts created by the joinder of spouses, or by one spouse with the consent of the other. If so, the exercise of any powers over the trust by the surviving spouse, even if expressly authorized by the instrument, would trigger the section. I understand Ed Halbach and Jeff Strathmeyer share this concern.

Since this result was clearly not intended, I suggest a retroactive "technical correction" is in order.

Sincerely,

Jerry A. Kasner
Professor of Law

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