

#L-1026

5/22/85

Second Supplement to Memorandum 85-35

Subject: Study L-1026 - Probate Code (Payment of Demands--additional
comments)

Attached to this supplementary memorandum as Exhibit 1 are comments of the Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association concerning the draft statute on payment of demands.

Attached as Exhibit 2 is a new draft of the provisions governing proration of estate taxes, supplied by Ken Klug. The draft is preceded by commentary prepared by Mr. Klug. Mr. Klug's cover letter notes that the draft is supported by the State Bar's Estate Planning, Trust and Probate Law Section. We plan to consider Mr. Klug's draft at the Commission meeting in place of the comparable provisions of the draft statute prepared by the staff.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

**Los Angeles County
Bar Association**

EXHIBIT 1

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Probate and Trust Law Section

Mailing address:
P.O. Box 55020
Los Angeles, California 90055

May 7, 1985



California Law Revision Commission
4000 Middlefield Road, Room D-2
Palo Alto, California 94306

Re: May Meeting

Dear Commissioners:

The Executive Committee of the Probate and Trust Law Section of the Los Angeles County Bar Association submits the following comments on various studies which are scheduled for discussion at your meeting, May 16-17.

Study L-1026 - Probate Code (Payment of Demands)
(Memorandum 85-35)

Section 8602:

Under subpart(b) the person or representative should pay the claims listed therein as soon as there are sufficient funds on hand after retaining amounts sufficient to pay anticipated expenses of administration as well as federal and state priority claims.

Section 8606:

Under subpart (b) of this section, a creditor whose claim is established but is not due is entitled to payment if he assents to a deduction from the claim of the legal interest for the time the claim has yet to run. This section should be expanded to include a required waiver of prepayment penalties as well as interest.

Section 8609:

Subpart (b) of this section permits a creditor to recover on the bond of the personal representative if he has failed to give notice to creditors as prescribed by law. Presently, Letters will not issue unless proof has been made that notice to creditors has been given. This subpart should be removed.

Section 8632:

This section continues the substance of former section 971 requiring the proration of death taxes in proportion to the value of the property received. Internal Revenue Code section 2207A(a) gives the personal representative the right to recover from a QTIP Trust (a non-probate asset) the amount of the federal estate tax at the highest marginal rate. This is contrary to the requirement of the proposed code section.

We trust that these comments will be useful in your work. If you require clarification on any points, please contact Richard L. Stack, Darling, Hall & Rae, 606 South Olive Street, Suite 1900, Los Angeles, California 90014; telephone (213) 627-8104.

Sincerely,

EXECUTIVE COMMITTEE, PROBATE
AND TRUST LAW SECTION

By:


Richard L. Stack

EXHIBIT 2

THOMAS, SNELL, JAMISON, RUSSELL AND ASPERGER

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April 29, 1985

Mr. Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

Re: Memorandum 85-35 (Proration of Estate Taxes)

Dear Nat:

As a followup to our telephone conversation, I am enclosing my suggested statute for Chapters 3 and 4 of Part 8, dealing with proration of estate taxes and generation-skipping taxes. The California proration statute was originally enacted in 1943, and has not been updated to reflect the substantial changes to the federal estate tax law since 1943. Last year a minor bandage was placed on the California statute to provide for proration of the California estate tax. The statute needs major surgery.

In order that you might readily contrast my suggestions with the language contained in Memo 85-35, I have maintained your numbering system. I have added several new sections. After the language is finalized, I would recommend reorganizing all of these sections so that they flow in a logical sequence.

In the rest of this letter, I will explain the reasons for my recommended changes.

Chapter 3 - Proration of Estate Taxes

Section 8630

Federal law includes "adjusted taxable gifts" in the calculation of the estate tax in order to increase the bracket at which the estate is taxed. The adjusted taxable gifts, themselves, are not subject to estate tax.

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The definition of gross estate contained in Memo 85-35 would have the effect of prorating taxes to "adjusted taxable gifts."

A definition of gross estate is not necessary if the term is followed by the language "for federal estate tax purposes."

Definitions of "value" and "property" are helpful.

Section 8631

The existing California statute requires (i) that the tax actually be paid before the proration is made and (ii) that a court order the proration. Federal law allows for deferral of estate taxes for up to 15 years in certain cases. Once the amount of tax is determined, the proration should be made, even though the tax hasn't been paid. My version refers to estate tax "payable" rather than "paid."

There is probably no reason to involve the court in making the proration if all of the persons interested in the estate agree. Accordingly, the suggested draft eliminates the mandate of §8631 and substitutes an optional procedure for obtaining a court determination.

The language in subparagraph §8631(b) of Memo 86-35 is taken from Probate Code §970. That language is cumbersome, and I have rewritten it in my proposed Section 8631(b)(1). Internal Revenue Code §§2205, 2206, 2207, and 2207A provide for proration of estate tax. Section 2207A provides that the tax on a QTIP trust will be at the highest incremental bracket, with the effect that other property of a decedent's estate is taxed at the lower brackets. This conflicts with the present California statute. California law ought to defer to the federal law if there is a conflict.

Section 8632

My recommended version eliminates the requirement that the proration be made by the court.

Section 8633

Prior to 1977, the federal estate tax had a \$60,000 exemption. Since January 1, 1977, the exemption no longer

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exists. Now, a unified credit against the tax is allowed. The federal estate tax laws also allow for other credits. I have changed the reference in Section 8633 from exemptions to credits.

My proposed Section 8633(c) is new. Under IRC §2032A, an election may be made to specially value certain qualified real property. The special value may be as much as \$750,000 less than the fair market value of the qualified real property. If the election is made, the persons who receive the real property must continue to use the real property as a farm or other trade or business for ten years. If they dispose of the property or cease the qualified use, then the estate tax savings resulting from the special value is lost, and an additional tax is imposed under IRC Section 2032A(c). The additional estate tax is equal to the amount of the tax savings resulting from the special election. The federal law imposes personal liability for the additional tax on the heirs who receive the specially valued property. IRC §2032A raises two proration problems not addressed by the present California law. First, how is the estate tax savings from the special valuation election to be allocated? Second, how is the additional tax (if imposed) to be allocated?

There appear to be two alternative solutions, neither of which is entirely satisfactory. The first possible solution would be to prorate the actual estate tax payable when a §2032A election is made (thus sharing the benefit of the special value among all persons interested in the estate), and if an additional tax is imposed as a result of a cessation of use or early disposition of the qualified real property, then prorate the additional tax among all persons interested in the estate. I do not recommend this alternative. Because the additional tax may be imposed as late as twelve years following the decedent's death, it is not practical to prorate the additional tax at that time. The federal law imposes personal liability upon the qualified heirs who receive the specially valued property (secured by a lien on the qualified real property), but there is no effective means of ensuring that persons who are not qualified heirs and who receive other property from the estate will be available to pay their share of the tax twelve years from the date of death.

I recommend a second alternative. The proration statute should give the persons who receive the specially valued real property the full benefit of the tax savings

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resulting from the special valuation (§8633(c)) and charge them with the full additional tax, if one is imposed (§8638). Since those persons are the ones consenting to the election and are required to use the property for a qualified use, they should be the ones who benefit from the election. This solution is not entirely satisfactory because (depending upon the relative tax brackets) the additional tax imposed on the qualified heir may be calculated at a higher rate than the estate tax assessed against the other persons interested in the estate. Furthermore, those charged with the additional tax under IRC §2032A(c) will not receive allowance for deductions and credits. Such results are not objectional, because the qualified heirs have control over whether or not the additional tax will be imposed.

Section 8636.1 through 8636.3

These sections establish the optional procedures for obtaining a court order determining the proration.

Section 8636.2 specifies the required notice. Mailed notice is deemed sufficient insofar as property subject to probate administration is adjusted for a beneficiary's share of the prorated tax. Mere notice is probably not sufficient to acquire jurisdiction over someone who is not beneficially interested in the probate estate, e.g., someone who receives only life insurance proceeds. In such event, a citation is probably required to obtain in personam jurisdiction.

I also share the concern that the California Superior Court may not be able to assert jurisdiction over a nonresident. It may be necessary for the executor to bring an action against the non-resident in federal court under the proration provisions of the Internal Revenue Code.

Nonetheless, the apparent technical problems of notice do not seem to have generated any practical problems. It may be desirable to leave the technical problems alone until experience dictates a change. If the Commission wishes to address the technical notice problems, I suggest that the most workable solution may be to provide for 10 days mailed notice to any person whose chargeable tax is less than the value of the beneficial interest of such person which is subject to probate; and provide for service of citation only if the chargeable tax requires that the court assert jurisdiction over non-probate assets. Thus, the expense of service of citation would be avoided in most estates.

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Section 8637

Frequently, the estate tax is adjusted after the estate tax return is filed. This may be done as a result of audit, or as a result of filing an amended estate tax return upon locating additional property or discovering additional deductions. In such event, the court should modify the proration order.

A question arises as to whether or not the statute should contain a limitations period during which the petition for modification must be filed. If there is a limitations period, it should be referenced to some period following the later of the payment of tax or the date the tax becomes final. Possible language may be: "The petition for modification shall be filed within one year of the later of the date of payment of the tax or the date the amount of tax becomes final."

Personally, I have serious reservations about the merit of a limitations provision. The general rule is that the time for assessment of tax expires three years after the filing of the return. But there are so many exceptions to the rule that the rule is almost meaningless. For example, the limitations period is tolled while payment of tax is extended (IRC §6503(d)) or while a petition is pending in Tax Court (§6512). Non-statutory doctrines allow for taxes or refunds to be adjusted or offset with respect to certain taxpayers notwithstanding that the period for collection of the tax may have run. A decision by the California Superior Court that the federal tax had become final may conflict with a later determination made by the federal courts or administrative agencies. I recommend that there be no statutory limitations period imposed, but rather leave the limitations period to be addressed by the doctrine of laches and other judicial equitable powers in each case.

Section 8639

The federal estate tax law allows the payment of a portion of the estate tax attributable to specified property (such as a closely held business or a remainder interest) to be extended. The present California proration statute does not require that the extended tax follow the property. The proration statute should make it clear that where tax attributable to a closely held business is extended, the privilege to pay the tax in installments goes to the person who receives the closely held business.

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Chapter 4 - Proration of Generation-Skipping Taxes

Federal law provides that the generation-skipping tax be paid by the trust or other property giving rise to the tax. The present California proration statute does not deal with equitable proration of the generation-skipping tax among trust beneficiaries. My suggestions for Chapter 4 generally follow my suggestions for Chapter 3, with technical changes necessitated by differences in terminology and tax structure between the federal estate tax and the federal generation-skipping tax.

There is a strong possibility that Congress may restructure the generation-skipping tax this year. If so, Chapter 4 may need to be substantially redrafted.

The State Bar's Estate Planning, Trust and Probate Law Section supports the attached proposals.

I would be happy to meet with the staff or the Commission when the estate tax proration provisions are discussed. Thank you for giving my comments your consideration.

Very truly yours,

A handwritten signature in black ink, appearing to read "Ken M. Klug", written over the typed name below.

Kenneth M. Klug

CHAPTER 3. PRORATION OF ESTATE TAXES

§ 8630. Definitions

8630. Except where the context otherwise requires, as used in this chapter:

(a) "Person interested in the estate" means any person who receives, or is the beneficiary, or is in possession of any property which is subject to a tax imposed by any federal or California estate tax law, now existing or hereafter enacted.

(b) "Property" means all property included in the gross estate for federal estate tax purposes.

(c) "Value" means fair market value as determined for federal estate tax purposes.

Comment. Section 8630 continues the substance of former Section 977.

§ 8631. Proration among persons interested in estate

8631. (a) Except as provided in subdivision (b), if an estate tax is payable to the federal government or the State of California under the provisions of any federal or California estate tax law, now existing or hereafter enacted, the tax, and interest on any deficiency, shall be equitably prorated among the persons interested in the estate.

(b) This section does not apply in any of the following cases:

(1) Where a testator directs otherwise by will or written instrument.

(2) Where federal law directs otherwise.

Comment. Section 8631 continues the substance of former Section 970, but recognizes that federal law may provide for a different means of proration. Section 8631 allows proration of deferred estate tax prior to the actual payment of tax. Cf. §8639. Cf. Section 8630 (definitions); Internal Revenue Code §2207A.

§ 8632. Manner of proration

8632. The proration required by this chapter shall be made in the proportion, as near as may be, that the value of the property received by each person interested in the estate bears to the total value of all property received by all persons interested in the estate.

Comment. Section 8632 continues the substance of former Section 971, but does not require a court order to make the proration. Cf. Sections 8636-8637 for optional court procedure to determine proration.

§8633. Allowance for credits, deductions and other adjustments

8633. (a) In making a proration of the federal estate tax, allowances shall be made for credits allowed for the purpose of determining the tax payable and for deductions allowed for the purpose of determining the taxable estate.

(b) In making a proration of the California estate tax, allowances shall be made for (1) credits (other than the credit for state death taxes paid) allowed by the federal estate tax

law and attributable to property located in this state, and
(2) deductions allowed by the federal estate tax law for the purpose of determining the taxable estate and attributable to property located in this state.

(c) For purposes of this chapter, a reduction in federal or California estate tax resulting from an election pursuant to §2032A of the Internal Revenue Code of 1954 shall be treated as a credit attributable to the qualified real property to which such election applies.

Comment. Section 8633 continues the substance of former Section 972, and adds a new provision dealing with specially valued real property. Where an election is made to specially value qualified real property under IRC §2032A, the qualified heirs who receive the qualified real property are subject to certain obligations, and to personal liability for additional estate tax if those obligations are not fulfilled. Only those receiving the qualified real property and subject to the obligations and potential additional estate tax should benefit from the election, and the persons not receiving qualified real property should not receive a windfall by sharing in the tax reduction. Cf. Section 8638.

§ 8634. Trusts and temporary interests

8634. If a trust is created, or other provision made whereby a person is given an interest in income, or an estate for years, or for life, or other temporary interest in any

property or fund, the federal and California estate taxes on both the temporary interest and on the remainder thereafter shall be charged against and paid out of the corpus of the property or fund without apportionment between remainders and temporary estates.

Comment. Section 8634 continues the substance of former Section 973.

§ 8635. Where property not in possession of personal representative

8635. If property required to be included in the gross estate for federal estate tax purposes does not come into the possession of the personal representative, the personal representative is entitled, and has the duty, to recover from the persons interested in the estate, the proportionate amount of the federal and California estate taxes with which the persons interested in the estate are chargeable under the provisions of this chapter, and the court may by order direct the payment of the amount of taxes by such persons to the personal representative.

Comment. Section 8635 continues the substance of former Section 975.

§ 8636.1 Who may commence proceedings

8636.1 (a) The personal representative or any person interested in the estate may file a petition to have a court

determine the proration pursuant to this chapter.

(b) Proceedings under this chapter shall be commenced in the superior court of the county of which the decedent was a resident at the time of death or in the superior court of any county in which the property is situated.

(c) Proceedings under this chapter shall be commenced by filing a verified petition that sets forth all of the following information:

(1) The jurisdictional facts.

(2) Other facts necessary for the court to determine the proration of estate taxes.

(d) If proceedings for the administration of the decedent's estate are pending, proceedings under this chapter shall be combined with the administration proceedings. If the petition is filed at any time before final distribution, there shall be no additional filing fee.

§ 8636.2 Notice of hearing

8636.2 At least 10 days before the hearing the petitioner shall cause notice of the hearing and a copy of the petition to be mailed to each person against whom any tax may be prorated.

§ 8636.3 Court order to effectuate proration

8636.3 The Court, upon making a determination as provided in this chapter, shall make an order:

(a) Directing the personal representative or other fiduciary to charge the prorated amounts against the persons against whom the federal and California estate taxes have been prorated insofar as the personal representative or other fiduciary is in possession of property or interests of the persons against whom the charge may be made.

(b) Summarily directing all other persons against whom federal and California estate tax have been prorated to make payment of the prorated amounts to the personal representative or other fiduciary.

Comment. Section 8636 continues the substance of former Section 976.

§ 8637. Modification of court order

8637. Upon petition by the personal representative or any person interested in the estate, the court shall modify an order made pursuant to this chapter whenever it appears that the amount of federal or California estate tax as actually determined is different from the amount of federal or California estate tax on which the court based such order.

Comment. Section 8637 provides for the possibility that subsequent to the making of an order, the taxes may be adjusted as a result of audit or the filing of an amended return. Section 8637 does not apply to any additional tax under IRC §2032A(c) resulting from a disposition or cessation of qualified use of specially valued property. Cf. Section 8638.

§ 8638. Proration of additional tax on certain qualified real property

8638. If additional estate tax is imposed under Internal Revenue Code Section 2032A(c) by reason of early disposition or cessation of qualified use, such additional tax shall be a charge against the portion of the qualified real property to which the additional tax is attributable, and shall be equitably prorated among the persons interested in such portion of the qualified real property in proportion to their interests.

Comment. Under Section 8633, the persons receiving qualified real property receive the benefit of the estate tax reduction resulting from special valuation. Section 8638 provides that any additional tax under IRC §2032A(c) will be imposed only upon those who benefited from the election.

§ 8639. Proration of deferred estate tax

8639. Where the payment of any portion of the estate tax is extended under the provisions of the federal estate tax law, the amount of extended tax and interest thereon shall be a charge against the specific property which gives rise to the extension.

Comment. Section 8639 ensures that the persons who receive property which gives rise to the deferral of estate tax are the persons who benefit from the deferral privilege and from any favorable interest rate on the deferred tax. Section 8639 makes it clear that where a decedent's estate consists of a closely held business with respect to which the estate taxes may be extended, the deferred tax and interest thereon follow the business.

CHAPTER 4. PRORATION OF TAXES ON GENERATION-SKIPPING TRANSFERS

§8650. Definitions

8650. Except where the context otherwise requires, as used in this chapter:

(a) "Transferee" means any person who receives, who is deemed to receive, or who is the beneficiary of any property which is subject to a tax on generation-skipping transfers imposed by any federal or California tax law, now existing or hereafter enacted.

(b) "Property" means all property on which a generation-skipping transfer tax is imposed.

(c) "Value" means fair market value as determined for generation-skipping transfer tax purposes.

(d) "Trustee" means any person who is a trustee of a trust subject to a generation-skipping tax.

§8651. Proration among transferees

8651. (a) Except as provided in subdivision (b), if a generation-skipping transfer tax is payable to the federal government or the State of California under the provisions of any federal or California generation-skipping transfer tax law, now existing or hereafter enacted, the tax and interest on any deficiency shall be equitably prorated among the transferees.

(b) This section does not apply in any of the following cases:

(1) Where the written instrument which makes the transfer directs otherwise.

(2) Where federal law directs otherwise.

§8652. Manner of proration

8652. The proration required by this chapter shall be made in the proportion, as near as may be, that the value of the property received by each transferee bears to the total value of all property received by all transferees.

§8653. Allowance for credits and deductions

8653. In making a proration required by this chapter, allowances shall be made for credits and deductions allowed for the purpose of determining the tax payable.

§8654. Trusts and temporary interests

8654. If a trust is created, or other provision made whereby a transferee is given an interest in income, or an estate for years, or for life, or other temporary interest in any property or fund, the tax on both the temporary interest and on the remainder thereafter shall be charged against and paid out of the corpus of the property or fund without apportionment between remainders and temporary estates.

§8655. Where property not in possession of trustee or transferee

8655. If property does not come into the possession of the trustee or other person liable for tax, such person is entitled to recover from the person in possession, or from each transferee, the proportionate amount of the tax with which the transferee is chargeable under the provisions of this chapter, and the court may by order direct the payment of the amount of tax by the transferee to the trustee or other person.

§8656.1. Who may commence proceedings

8656.1. (a) The trustee or any transferee may file a petition to have a court determine the proration pursuant to this chapter.

(b) Proceedings under this chapter shall be commenced in the Superior Court of the county in which the decedent was a resident at the time of death or in the Superior Court of any county in which the property is situated.

(c) Proceedings under this chapter shall be commenced by filing a verified petition that sets forth all of the following information:

- (1) The jurisdictional facts.
- (2) Other facts necessary for the court to determine the proration of the generation-skipping transfer tax.

§8656.2. Notice of hearing

8656.2. At least 10 days before the hearing, the petitioner shall cause notice of the hearing and a copy of the petition to be mailed to each transferee against whom any tax may be prorated.

§8656.3. Court order to effectuate proration

8656.3. The court, upon making a determination as provided in this chapter, shall make an order:

(a) Directing the trustee to charge the prorated amounts against the transferees against whom the generation-skipping transfer tax has been prorated insofar as the trustee is in possession of property or interests of the transferee against whom the charge may be made.

(b) Summarily directing all other transferees against whom the generation-skipping transfer tax has been prorated to make payment of the prorated amounts to the trustee or petitioning transferee.

§8657. Modification of court order

8657. Upon petition by the trustee or any transferee, the court shall modify an order made pursuant to this chapter whenever it appears that the amount of generation-skipping transfer tax as actually determined is different from the amount of tax on which the court based such order.