

Memorandum 82-58

Subject: Study L-604 - Probate Law (Item or Aggregate Theory of Community Property Ownership)

Under California's "item theory" of community ownership, the surviving spouse has a one-half interest in each item of community property. If the deceased spouse has made an inter vivos or testamentary gift of community property to a third person, the surviving spouse becomes a tenant in common with the third person in each item of community property so given.

At the last meeting the Commission considered and approved a staff proposal to authorize the probate court to award to the surviving spouse the whole interest in certain kinds of community property (community real property, a community property business being operated or managed by the surviving spouse, and community personal property having sentimental or psychological value to the surviving spouse), to value the interest thus awarded, and to make an offsetting award to the person whose interest is taken. The approved section is attached to this Memorandum as Exhibit 1.

Personal Property Residence

The approved section (Exhibit 1) provides for community real property, including the family residence, to be awarded to the surviving spouse in the court's discretion. Should this be broadened to include a personal property residence such as a mobilehome or a houseboat? (The probate homestead provisions only provide for a life interest to the surviving spouse, while the section under consideration would permit an award in fee.)

Questions Raised at the Last Meeting

The Commission requested the staff to give further thought to the following two problems:

(1) Whether item theory ownership combined with the bar against dead-hand management may invalidate half of many pecuniary legacies as Professor Reppy has suggested.

(2) The valuation problem in the case of a community property business caused by the fact that the third person's half interest is worth more to the surviving spouse than it would be to a stranger, since that interest will give the surviving spouse control of the business.

These problems are discussed below. The staff has concluded that neither problem should be treated statutorily in the proposed section.

Pecuniary legacies. If the estate is entirely community property and the decedent's will makes a \$5,000 gift to his alma mater, there is no problem so long as there is at least \$10,000 of community cash available: The gift may be given effect out of the decedent's half interest in the fund without interfering with the half interest of the surviving spouse. However, if there is less than \$10,000 of community cash available, item theory ownership requires that the gift be given effect only to the extent of half of the available fund.

Professor Reppy poses the situation where the legacy is \$5,000, the community cash is \$4,800, and all of the remaining community assets are invested in stocks. Under the item theory, the gift may be given effect only to the extent of \$2,400 unless some stock may be sold to raise enough cash to pay the legacy. According to Professor Reppy, the possibility that the gift in the decedent's will might be construed as an implied direction to sell stock to pay the legacy is foreclosed by the community property principle that the decedent's will may not restrict the right of the surviving spouse to manage and control the surviving spouse's half interest in community property (i.e., the bar on dead-hand management).

The staff has had an exchange of correspondence with Professor Reppy concerning this problem and has given the matter additional thought. It is the staff's conclusion that to authorize a sale of an item of community property in which the surviving spouse has a half interest causes at least as many difficulties as the problem of invalidating a pecuniary legacy because there is insufficient cash in the community estate. For example, the community property item may be one which has sentimental or psychological value to the surviving spouse. The approved section (Exhibit 1) is solely for the benefit of the surviving spouse, and does not authorize a sale or award to a third person. The staff is inclined not to broaden the section to authorize a sale generally.

Valuing a half interest in a community property business. If one spouse is operating or managing a community property business and the other spouse makes a will which gives half of the business to a third person, on the death of the testator the surviving spouse and the third person become tenants in common in the business. The draft statute (Exhibit 1) permits the probate court to award the whole business to the

surviving spouse and to make an offsetting award to the third person. The valuation problem is caused by the fact that the third person's half interest is worth more to the surviving spouse than it would be to a stranger, since that interest will give the surviving spouse control of the business but would not give control to a stranger. Which value should the court use?

According to IRS estate tax regulations, the value is determined on the basis of the net worth of the business, prospective earning power, dividend-paying capacity, and other relevant factors, including goodwill, the economic outlook in the industry, the business' management and position in the industry, the control offered by the interest to be valued, and the market value of stock of corporations in the same or similar lines of business that are listed on an exchange. Georgeson & Morgan, Valuation of Interest, in Business Buy-Out Agreements § 2.36, at 55 (Cal. Cont. Ed. Bar 1976). The relative importance of each of these factors depends on the nature of the business. Id. A similar rule is followed for state inheritance tax purposes. See, e.g., In re Estate of Felton, 176 Cal. 663, 169 P. 392 (1917); 42 Am. Jur.2d Inheritance, Estate, and Gift Taxes § 263, at 472-76 (1969).

In the staff's view, the draft statute should not specify the valuation method to be used to determine the fair market value of the half interest to be awarded to the surviving spouse. This should be determined by the court, taking into account whatever expert valuation testimony may be presented, including testimony as to the valuation method used. Cf. Evid. Code § 814 (valuation testimony may be based on matter of a type that "reasonably may be relied upon by an expert"; this rule persuasive but not controlling for valuation of intangible personal property such as a partnership interest or goodwill of a business--see Evid. Code § 810 and Comment thereto).

Overall Desirability of the Section

The staff remains uncertain whether the section in Exhibit 1 is desirable. At the last meeting, the Commission's view was that it would be useful to retain the section in order to get comments from interested persons. Is this still the Commission's view?

Respectfully submitted,

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EXHIBIT 1

Probate Code § 690 (added). Award to surviving spouse of specific items of community property

690. (a) On petition of the surviving spouse, the court may award to the surviving spouse the entire interest in one or more items of the following kinds of community property:

(1) Community real property, including the family residence.

(2) A community property business being operated or managed by the surviving spouse.

(3) Community personal property which has sentimental or psychological value to the surviving spouse.

(b) If the court makes an order under this section, the court shall determine, as of the date of the award, the fair market value of the interest to be awarded to the surviving spouse, and shall make its order subject to the condition that the order will be given effect only if the surviving spouse pays, within the time fixed in the order, to the person whose interest is taken the fair market value of that interest. The person whose interest is taken may agree to accept the surviving spouse's interest in other items of property in the estate in full or partial satisfaction of the amount to be paid under this subdivision. The fair market value of such other items may be determined by agreement or by the court.

Comment. Section 690 is new and may be used to avoid practical difficulties arising from the general rule that if the decedent's will purports to dispose of community property to someone other than the surviving spouse, the surviving spouse and the beneficiary under the will become tenants in common as to each item of community property. See *Dargie v. Patterson*, 176 Cal. 714, 169 P. 360 (1917) (inter vivos gift); W. Reppy & W. deFuniak, *Community Property in the United States* 444 (1975).

If the family dwelling is awarded to the surviving spouse under this section, the surviving spouse becomes the absolute owner of the property in fee. This is in contrast to the probate homestead which terminates no later than the death of the surviving spouse or when the children reach majority. Prob. Code § 661.