

Second Supplement to Memorandum 84-22

Subject: Study L-640 - Trusts (Comments on Trustees' Powers)

Attached to this supplement is a letter reporting the views of an ad hoc committee of the Executive Committee of the State Bar Estate Planning, Trust and Probate Law Section on tax problems that might result from an automatic powers scheme. In its review of Memorandum 84-22 (to be completed at the September meeting), the Commission approved the notion of granting powers automatically, with the qualification that any particularly sensitive or dangerous powers should be removed to a separate category of powers that may be granted on petition or incorporated by a trust instrument. In the attached letter, the State Bar Committee identifies two powers as potentially causing problems in relation to the marital deduction trust.

Draft § 4422. Collecting and holding property

The problem with regard to draft Section 4422, the power to hold property, was noted at the meeting, at which time the Commission decided to note in the comment that Probate Code Section 1035(d) provides a limitation on the general power to retain property in a marital deduction trust. (See Minutes of June 21-22 meeting.) The cross-reference in the comment was thought to be sufficient because of the wording of Section 1035 which reads in part as follows:

1035. If a will indicates the testator's intention to make a marital deduction gift in trust, in addition to the other provisions of this article, each of the following provisions shall also apply to the trust:

. . . .

(d) The income beneficiary shall have the right to require that the trustee of the trust make any unproductive property productive or to convert it into productive property within a reasonable time.

. . . .

This provision would operate independently of any grant of a power to hold property. However, if the Commission concludes that a cross-reference in the statute would be preferable, it might be best to add a subdivision (b) to draft Section 4422 reading substantially as follows: "In the case of a marital deduction gift in trust, the exercise of the

power provided in subdivision (a) is subject to the right of the income beneficiary provided by subdivision (d) of Section 1035."

Draft § 4474. Distribution to beneficiaries under legal disability

The State Bar Committee is also concerned about the power in draft Section 4474 to make distributions to a relative of a beneficiary. It should be remembered that Section 4474 is a power, not a duty. The power to pay to a relative for the benefit of the beneficiary is intended to avoid the need to appoint a guardian or conservator. The State Bar Committee suggests, however, that the existence of this power may run afoul of the federal requirements for marital deduction trusts. Probate Code Section 1035 provides that the surviving spouse is to be the sole income beneficiary entitled to all the trust income. Presumably federal law recognizes the necessity of paying income to a conservator in a situation where the beneficiary is incompetent. The reference to paying to a relative in draft Section 4474 does not make the relative a beneficiary in any sense, so it is difficult to see how the power, even if used, would violate the terms of a marital deduction trust. However, if it is felt to be a serious problem, the same solutions to the problem exist as are discussed above in relation to draft Section 4422. The relation to Probate Code Section 1035 could be explained in the comment, or a subdivision could be added excluding the power to pay to a relative in the case of a marital deduction trust.

Section 4474 should also be revised to recognize the power to pay to the custodian under the Uniform Transfers to Minors Act (1984 Cal. Stats. ch. 243) or the Uniform Gifts to Minors Act of another state. Perhaps the best way to accomplish this is to delete the language "appointed by the court" which qualifies "legal representative" in draft Section 4474. Reference to the Uniform Transfers and Uniform Gifts to Minors Acts could then be made in the comment to the section. It would also be appropriate to recognize the possibility that the beneficiary may have executed a power of attorney in which case it would be appropriate to pay the attorney in fact.

Respectfully submitted,

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August 24, 1984

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Re: Memorandum 84-22 - Trustee Powers

Dear John:

At the June meeting of the California Law Revision Commission when Memorandum 84-22 was discussed, we requested an opportunity to review the proposed automatic powers for any tax problems that might relate thereto. An ad hoc committee was created to review those powers. It was chaired by K. Bruce Friedman of San Francisco, a member of our Executive Committee. There appear to be only two powers that cause some concern.

Proposed Section 4422 authorizes a trustee to retain trust property. Regulations under Section 2056 [Section 20.2056(b)-5(f)(4)(5)] provide that if trust assets consist substantially of unproductive property, the surviving spouse, in order to qualify for the marital deduction, must have the power to compel the trustee to make the property productive or to convert it within a reasonable time. The Estate Planning, Trust and Probate Section of the State Bar several years ago sponsored the legislation now found in Probate Code Sections 1030-1039. Section 1035(d) provides "the income beneficiary shall have the right to require that the trustee of the trust make any unproductive property productive or to convert it into productive property within a reasonable time."

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Perhaps similar language should be added to Section 4422 whenever a marital deduction trust is created or there should be a clear cross-reference to Section 1035(d) with an indication that that section would control over this more general section, whenever a marital deduction trust is involved.

A related problem arises under Proposed Section 4474. This proposed section provides as follows:

"The trustee may pay any sum distributable to a beneficiary under legal disability by paying the sum to the beneficiary or by paying the sum for the use of the beneficiary either to a legal representative appointed by the court, or if none, to a relative."

The language that concerns us is the phrase "to a relative."

In order to qualify for a marital deduction, the sole income beneficiary is to be the surviving spouse. The surviving spouse is entitled to all of the trust income during his or her lifetime.

In this context, see Probate Code Sections 1035(a), (b) and (c). These sections provide that only the surviving spouse is to get income from the trust which must be paid at least annually, etc.

Under Section 4474 as proposed, payment to "a relative" would seem to violate the requirements under Internal Revenue Code Section 2056 that the surviving spouse shall receive all of the income from a marital trust.

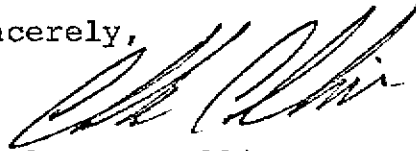
Perhaps language should be added to Proposed Section 4474 saying that the payment "to a relative" does not apply in the case of a marital deduction trust, or perhaps a cross-reference to Section 1035 with an indication that Section 1035 would prevail would suffice.

None of the other proposed automatic powers appear to raise federal income tax problems.

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We appreciated the opportunity to make comments as to the tax aspects of the proposed automatic powers.

Sincerely,



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