#L-1029 6/7/85

First Supplement to Memorandum 85-63

Subject: Study L-1029 - Probate Code (Distribution and Discharge--marital deduction gifts)

Attached to this supplementary memorandum is a letter from Robert Mills, original draftsman of the Probate Code provisions for construction of marital deduction gifts in instruments. These provisions, which are currently found in Probate Code Sections 1030 to 1039, are continued without substantive change as Sections 6190 to 6199 in Exhibit 2 of Memorandum 85-63 (blue pages). Mr. Mills suggests several changes in the statute. We will discuss the suggested changes at the meeting.

Respectfully submitted,

Nathaniel Sterling
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June 4, 1985

Nat Sterling, Esq.
California Law Revision Commission
4000 Middlefield Road, No. D2
Palo Alto, California 94303

Re: Chapter 41 Statutes of 1983

Dear Mr. Sterling:

Thank you for your call concerning possible revisions in the material which now appears in Sections 1030 through 1039 of the Probate Code. So far, judging by phone calls I have received from various lawyers around the state, these provisions have been used quite often. Thus far, to the best of my knowledge, there is nevertheless no reported court case construing any of the provisions or resolving any conflicts with Internal Revenue Service positions. I think it is only a matter of time before this occurs. As but one example, I received a call last week from an attorney in Anaheim who is probating a will which passed generally everything to the surviving spouse in which there was a nine-month survivorship clause. If Probate Code Section 1036 applies and prevails, the estate will save approximately $100,000 in federal estate taxes.

You asked for specific comments regarding possible changes. I have a few. First of all, let me describe the situation which may commonly exist in which the statute as now drafted is at best ambiguous and perhaps mandates the "wrong" result.

Assume that a client dies with a pre-1981 marital deduction will containing a formula clause. Pursuant to Probate Code Section 1034, the formula clause would pass, in general terms, one-half of the client's adjusted gross estate to his surviving spouse, less property which otherwise passes to her. Assume, however, that the will sets up a so-called B trust which provides income to the surviving spouse

for her life with principal invasion only for her benefit. Let us assume, further, a gift over to the children upon the death of the spouse. Under pre-1981 federal law, this was a common form of estate plan for an individual with significant separate property. It passed as much as could be passed to the surviving spouse for which a deduction could be obtained. The remaining fund was set aside to benefit the surviving spouse. Although the children would ultimately take, it would be after the taxes imposed on the death of the first spouse. The provision for the children would decidedly be secondary. Since 1981, in the absence of a state law, the B trust could be qualified in the above situation as a so-called qualified terminable interest property ("Q-Tip") trust under an election pursuant to Section 2056(b)(7) of the Internal Revenue Code. In the hypothetical fact situation that I have outlined, there might be every reason to make such an election and, in fact, such an election would have no substantial effect except to postpone the taxes on the B trust from the death of the first spouse until the death of the surviving spouse. Most clients faced with this situation would want to make the Q-Tip election for the B trust. The problem that is presented is that under Probate Code Section 1034(c), read literally, the amount passing under the marital deduction formula would be reduced on a dollar-for-dollar basis by whatever property qualified under Section 2056(b)(7) pursuant to the Q-Tip election.

There is a clear statutory solution. Section 1034(c) should be qualified so that the amount of the reduction in the marital bequest would not include the amount which passed from the testator to the testator's surviving spouse solely because of the executor's election pursuant to Section 2056(b)(7) of the Internal Revenue Code.

The way things stand now, one could argue that under the last sentence in Section 1032(a) of the Probate Code the result that I have described is not mandated by current laws. Frankly, I believe that through inadvertence in our drafting, the adverse result actually is mandated and should not be.

Incidentally, there was a potential problem in the Q-Tip election area under Probate Code Section 1035(e) because of the Probate Code exclusion of Q-Tip property from the requirement that when the trust terminated accrued and undistributed income pass either to the income beneficiary (the surviving spouse) or pursuant to the exercise of a general power of appointment granted to the income beneficiary. As written in the Internal Revenue Code, it would appear that Q-Tip income would have to pass to the income beneficiary's estate but, fortunately, the regulations issued by the Treasury do not require this. As a result, Probate Code Section 1035(e) will not have to be amended. This was a potential problem for many Californians who had only community property. In such cases where there were efforts made to Q-Tip the trust which represented the decedent's half of the community property, the Probate Code, absent the regulations, could have caused the wrong result. You will recall that prior to 1981, community property in general did not qualify for marital deduction treatment.

Section 1032(b) of the Probate Code could also be expanded to include charitable lead trusts. As you know, a deduction is allowed for federal tax purposes for a transfer to a lead trust if the income interest is in the form of a guaranteed annuity or a unitrust amount. [For income tax purposes only) there is an additional requirement that the grantor be treated as the owner of the income interest. IRC Section 170(f)(2)(B)]. The same policy considerations that make it useful to have charitable remainders validated should apply equally where the charitable interest is the income interest rather than the remainder. Accordingly, Section 1032(b) of the Probate Code ought to be broadened.

There is one other point of clarification. Probate Code Section 1138.14 applies all of the provisions of Probate Code Sections 1030 through 1039 relating to wills to trusts. My concern is that I have had several persons (one of whom is an eminent estate planning lecturer and law professor) tell me that there is no California provision governing trusts. It turned out in each instance the individual

simply overlooked Section 1138.14 because of its placement in the statutes. To prevent others from making this understandable error, I would suggest that Section 1138.14 be placed with the rest of the provisions or something else done so that someone who attempts to use Probate Code Sections 1030 through 1039 will know without cross-reference that these sections apply to trust provisions as well as will provisions.

If you would like to discuss any of this further, please advise.

Sincerely,

Robert A. Mills

cc: Assemblyman Robert Naylor