#L-830

0049b
11/27/85

First Supplement to Memorandum 85-99

Subject: Study L-830 - Estates and Trusts Code (Proration of Estate Taxes--Ken Klug's discussion of comments on tentative recommendation)

Attached to this supplementary memorandum as Exhibit 1 is a letter from Ken Klug discussing policy questions raised in letters we have received concerning the tentative recommendation on proration of estate taxes. We will take up the letter at the December meeting as we discuss the specific provisions to which it relates.

Also attached as Exhibit 2 is a letter from Francis J. Collin, Jr., forwarded to us by Ken Klug, commenting on the tentative recommendation. Most of Mr. Collin's points are already addressed in the staff notes on the tentative recommendation draft in Memorandum 85-99. Mr. Klug in his letter also deals with a point raised by Mr. Collin.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

EXHIBIT 1

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November 25, 1985

California Law Revision Commission
4000 Middlefield Road, Room D2
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Re: Tentative Recommendation Relating To Probate Law (Proration of Estate Taxes)

Dear Commissioners:

After a review of the responses received on the Tentative Recommendation on Proration of Estate Taxes, Nat Sterling and I were able to identify five policy issues which should be considered by the Commission before making the final recommendation. Nat Sterling and I also discussed the technical suggestions received, and we suggest that you implement many of them in your final recommendation. Nat will address the technical matters, and I will discuss the policy issues in this letter.

1. Should the ability to direct a manner of proration different from the statute be broadened? The letter of Hal Koontz (on behalf of the Kern County Bar Association Probate & Estate Planning Section) raises this issue. San Francisco attorney William L. Hoisington also raised this issue during a telephone call to me. Existing California law provides that a testator may, by will, direct another means of proration; and by written instrument may direct another means of proration of estate tax within the fund created by the written instrument. Perhaps the primary issue should be considered in those two contexts.

a. Should the testator, by will, be allowed to direct that non-probate assets bear all or a disproportionally large share of the estate tax? I would think not. A will applies only to the testamentary, or probate, assets. Thus, a will can charge probate assets with all of the estate tax (including estate tax attributable to non-probate assets); within the probate estate, the will should be able to allocate the estate tax in any proportion whatsoever. To allow a testator, by will, to charge non-probate assets (such as joint tenancy property, life insurance, pension funds, etc.), with a disproportionate share of tax estate tax would be tantamount to allowing the testator to dispose of those assets by will. Present California Law does not permit a will to dispose of joint tenancy property or of life insurance or pension proceeds, unless the testator's estate is named as beneficiary of the life insurance or pension proceeds. (An American Bar Association Committee is studying a concept of a "blockbuster will" which could alter beneficiary designations on life insurance contracts, alter the effect of joint tenancies, alter pension plan beneficiary designations, etc. That study is not complete.) Unless the overall question of what property may be disposed by will is to be reconsidered, a testator should not be allowed by will to charge a disproportionate amount of estate tax to non-probate assets. (A minor exception may be where the will exercises a general power of appointment. In that case, the will is the dispositive instrument, and should be able to direct the tax to be charged against the assets it disposes.)

b. <u>Should a person, by inter-vivos instrument, be entitled to direct that a disproportionate share of the estate taxes be charged against non-probate assets?</u> Existing law and the tentative recommendation allow for a written instrument which establishes a fund (such as a living trust agreement) to provide for allocation within the fund of the estate tax chargeable to the fund. A literal reading of the existing law would not allow the settlor of a living trust to direct that the trust pay a disproportionate share of the estate tax. The present law should be expanded to allow the settlor of a trust to direct that the trust bear a disproportionate share of the tax, in addition to directing the manner of allocation of the tax among the persons interested in the trust. The ability to direct that the estate tax be disproportionately charged to a particular fund (such as a living trust or life insurance proceeds) should be limited to a designation within the instrument which creates or disposes of the fund, or an amendment thereto. A person should not be permitted to direct that a fund bear a disproportionate amount of tax by any instrument which does not create or amend the fund.

I understand that Nat Sterling will propose a redraft of §971.010 for your consideration. Similar policy issues relate to proposed §976.010, dealing with proration of generation skipping transfer taxes.

2. Should persons who receive lifetime gifts which are not subject to estate tax under federal law be charged with a prorata share of the estate tax? This issue was raised by Mr. Koontz (on behalf of the Kern County Bar Association Probate and Estate Planning Section). I touched upon it briefly in my original recommendation. The federal estate tax law divides gifts into two categories. The first category is gifts included in the gross estate for federal estate tax purposes under IRC §§2035(d), 2036, 2037, 2038, or 2042. These sections will include in a decedent's gross estate certain transfers in which he decedent retained a life estate (IRC §2036); certain transfers taking effect at death (IRC §2037); certain revocable transfers (IRC §2038); and certain transfers relating to life insurance (IRC §2042). All of these types of transfers are includable in the decedent's gross estate, are subject to estate tax, and are chargeable with the prorata share of estate tax pursuant to existing law and pursuant to §§971.010 and 971.020 of the tentative recommendation.

The other category into which federal law classifies lifetime gifts are gifts which are not includable in the gross estate of the decedent, and which are not subject to federal estate tax. Such gifts are, however, taken into account in determining the rate at which the federal estate tax applies to assets which are still owned by decedent at the time of death. This is accomplished under IRC §2001(b). Mechanically, the estate tax chargeable to the property included in the gross estate is calculated as follows: a tentative tax is calculated on the sum of the taxable estate plus adjusted taxable gifts (which are lifetime gifts not subject to estate tax); from the tentative tax, there is deducted an amount which would be equal to what the gift tax on the adjusted taxable gifts would have been (at the rates in effect at the date of decedent's death) if those rates "had been applicable at the time of such gifts." The difference is the gross estate tax.

The important thing to note is that these lifetime gifts, themselves, are not subject to estate tax. They only result in consuming the unified credit (lifetime exemption) which was available to the decedent's estate. Mr. Koontz suggests that because the adjusted taxable gifts increase the estate tax to be paid by other property, the adjusted taxable gifts should be charged with some portion of the estate tax. Such policy would be an attempt to do something which the federal law does not: i.e., impose an estate tax on this category of lifetime gifts. There should be no doubt that such a proration statute would be an unconstitutional deprivation of property with respect to gifts made prior to the enactment of the proration statute. There may also be constitutional problems with respect to gifts made after the enactment of the proration statute. If Mr. Koontz' suggestion were adopted, the California proration statute would impose an estate tax on gifted property where federal tax law does not impose that tax; such is probably a violation of California's prohibition of estate tax. (Initiative adopted June 8, 1982.)

As a matter of policy, the proposal suggested by Mr. Koontz is improper. When a donor makes a gift, the donor does not intend for the property to be subjected to estate tax. One of the purposes of the gift is to get the property out of the donor's estate. If the property is subject to gift tax, the donor is charged with the gift tax, not the donee. An attempt by California to impose liability for federal estate tax on such gifts would be contrary to the intent of the donor, and would be improper.

3. <u>If a special valuation election reduces the estate tax which would otherwise be payable by persons who do not receive specially valued real property, should they be required to pay to the qualified heir who receives the specially valued property the amount of their tax saving?</u> This issue was raised by both the Kern County Bar Association Probate and Estate Planning Section, and by Dick Kinyon in his letter of October 2, 1985. I addressed this problem when I first made the proration recommendation to the Commission. Strong arguments can be made for or against any further adjustment, but my preference was to not require any further adjustment. In enacting IRC §2032A, Congress intended to provide estate tax relief for persons who receive qualified real property. Basically, Congress determined that the property should be taxed at its special value rather than its fair market value where the decedent had a history of using the specially valued real property as a farm or other closely held business, and where the heirs will continue to use the qualified real property for that

purpose. Congress recognized that the heirs should not be required to pay estate tax on a higher value if they will keep the property and not realize that higher value. Nonetheless, if the heirs cease to use the property for the required period, or if they dispose of it during that period, then the tax savings is lost, and the heirs receiving the qualified real property are personally liable for the additional tax.

In commenting on the purpose for assessing the additional tax, the Senate Committee and the House Committee stated they wanted to prevent a windfall to heirs who may cease farming the property. In its explanation to the Tax Reform Act of 1976 (which first enacted IRC §2032A), the Joint Committee had the following explanation of the recapture provision:

> The Congress believed that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, the Congress believed it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.
>
> However, the Congress recognized that it would be a windfall to the beneficiaries of

> an estate to allow real property used for farming or closely held business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm or business purposes, at least for a reasonable period of time after the decedent's death. Also, the Congress believed that it would be inequitable to discount speculative values if the heirs of the decedent realize these speculative values by selling the property within a short time after the decedent's death.
>
> For these reasons, the Act provides for special use valuation in situations involving real property used in farming or in certain other trades or businesses, but has further provided for recapture of the estate tax benefit where the land is prematurely sold or is converted to nonqualifying uses.

I believe that my recommendation that there be no further adjustment (See Comment to §971.050) is in line with the intent of Congress to prevent a windfall to the qualified heirs. Congress intended to reduce the estate tax payable with respect to the qualified real property. Congress did not intend that the special valuation election result in an additional payment to the qualified heirs. It would be inappropriate for California to establish, as public policy, something which Congress did not intend. Certainly, a testator can direct in the will for a positive adjustment if the testator deems appropriate. Even if the testator does not provide for such an adjustment by will, the persons interested in the estate can, by private agreement among themselves, allow for such an adjustment.

It is not necessary for the persons who receive the qualified real property to elect special valuation on all of the real property they receive. They may choose to elect special valuation on an amount of real property that would reduce their estate tax to zero, without reducing the tax of persons who do not receive qualified real property. (Indeed by doing so, the qualified heirs will limit their liability as to the amount of potential recapture tax in the event of early disposition or cessation of use.) If the qualified heirs decide to elect special valuation on all of the qualified real property in order to reduce the tax of other beneficiaries, they can agree with the other beneficiaries for payment of consideration. Thus, I favor leaving the matter of further adjustment to either the testator's direction, or to private agreement among the beneficiaries, rather than to establish a California public policy which is probably contrary to the Congressional intent. I have discussed this matter with Dick Kinyon, and he is in agreement.

With respect to the manner in which the tax savings from special valuation is to be allocated, I am enclosing a copy of a letter dated October 30, 1985, which I received from Francis J. Collin, Jr. In paragraph 3 of Mr. Collin's letter, he suggests redrafting the second sentence of §971.050(b). Mr. Collin's recommendation is a good one. It is easier to understand, and it explicitly covers the issue of what should be done with the excess tax savings when the tax attributable to the qualified real property is reduced to zero. I endorse Mr. Collin's suggestion, and recommend that §971.050(b) be redrafted to read as follows:

> If an election is made pursuant to §2032A of the Internal Revenue Code, the proration shall be based upon the amount of the federal estate tax that would be payable but for the election. The amount of the reduction in federal estate tax resulting from an election under §2032A of the Internal Revenue Code shall reduce the tax that is otherwise attributable to the qualified real property that is the subject of the election. If the tax that would otherwise be attributable to the qualified real property is reduced to zero under the foregoing sentence, then any excess amount of reduction shall reduce the tax otherwise payable with respect to the other property, such amounts to be equitably prorated in accordance with §971.020.

4. <u>If any portion of the prorated tax is uncollectible against any person, should the uncollectible amount be paid by residue or be prorated against all persons interested in the estate?</u> This issue is raised in the letter from Mr. Koontz on behalf of the Kern County Bar Association's Probate and Estate Planning Section. Neither result is entirely satisfactory, but a practical solution is suggested in the letter from Daniel B. Crabtree (writing on behalf of the Legislative Subcommittee of the Estate Planning Trust and Probate Section of the San Diego County

Bar Association), and in paragraph 11 of the letter from Mr. Koontz. A court order for proration should have the effect of a judgment. The right of the executor to collect from the recalcitrant beneficiary should be deemed to be an asset of the estate. That asset may be distributed to the residuary beneficiaries of the estate. They would then be entitled to pursue the recalcitrant beneficiary, as suggested by Mr. Crabtree. Typically, the residuary beneficiaries of the estate are few in number. The residuary beneficiary may be a spouse, may be several children, or may be a testamentary trustee. In either case, it would be easier for a limited number of residuary beneficiaries to pursue the recalcitrant person, as suggested by Mr. Crabtree, rather than to fractionalize the receivable among all specific devisees and legatees, which would make pursuing a claim much more complicated.

The Uniform Estate Tax Apportionment Act similarly provides that unrecoverable amounts shall be paid by residue.

5. <u>Should there be finality to a court order prorating estate tax, or should the authority of the court to modify an order be open-ended, subject to the equitable doctrine of laches?</u> This issue is raised by Mr. Robert K. Maize, Jr. I addressed this issue in my original recommendation to the Law Revision Commission. The problem can arise by a number of different methods, but will usually take one of two forms.

One form is where there is an estate tax deficiency assessed, either as a result of the discovery of additional property, an increase in the valuation of property as the result of audit, or the disallowance of claimed deduction. Normally, these matters will be resolved within three years of the filing of the return, unless there is a dispute which goes to Tax Court. Typically, we are not concerned about collecting additional tax from beneficiaries of the estate, because a cautious executor would not distribute the estate to the beneficiary without first obtaining an agreement or some other commitment to secure a payment of the beneficiary's share of estate taxes. The executor has no such control over a person who receives life insurance proceeds or joint tenancy proceeds. The tax to be prorated against those persons cannot be finally determined until the estate tax is finally determined. Nonetheless, the tax shown due on the return will normally be paid by the executor nine months from the date of death. It may be helpful to obtain an order of proration based on the estate tax return as filed, in order that the executor may collect from the life insurance beneficiary the prorated tax shown on the return; if the amount of tax is changed on audit, there needs to be a procedure to change the proration. Mr. Maize's suggestion to allow the court to retain jurisdiction on petition by a person interested in the estate may resolve the problem to the extent that persons actually request the probate court to retain jurisdiction to modify the order. My recommendation would automatically give the probate court jurisdiction to modify a court order, without requiring any person interested in the estate to make the affirmative request. Frankly, I believe requiring an affirmative request to be made is a trap for the unwary. Skilled practitioners will always request that jurisdiction be retained. Attorneys not skilled in probate and persons acting in pro per would probably overlook requesting the court to retain jurisdiction. I believe the statute would better serve the public by providing an automatic retention of jurisdiction as I earlier suggested.

The preceding discussion deals with the situation where an estate tax deficiency as assessed. The problem is more likely to arise where there is a refund or a reduction in estate tax. For example, it may be discovered that the previously taxed property credit or some deduction was overlooked when the return was prepared. A refund may also result from a reduction of estate tax by claiming an additional deduction. For example, present law allows interest on deferred estate tax to be deducted for estate tax purposes. The estate tax must be recalculated each year as the interest is paid. This will not only reduce the estate tax chargeable to residue, but, depending upon the relative estate tax brackets, may reduce the tax chargeable to persons who receive joint tenancy property or life insurance. Those persons will have already paid the tax based on the higher amount, and when a lesser amount of tax is ultimately determined to be due, their share of the tax should be adjusted.

If a refund of the estate tax is received, what should be done with the refund? Typically, the refund will be paid to the executor, because the executor will have paid the estate tax. The executor may have collected a share of tax from joint tenants and life insurance beneficiaries. If the court does not have authority to modify the proration, will the entire refund go the residuary beneficiary of the probate estate? If the residuary beneficiary is the spouse, the spouse will have paid none of the tax as a result of the unlimited marital deduction. It appears that the only resolution to these problems is to provide as the tentative recommendation does, that the probate court may modify its proration order at any time when it appears that the actual tax is different from the tax on which the proration order is based.

In weighing the merits of finality against the merits of achieving accuracy, we need to bear in mind that we are not dealing with trifling amounts. For deaths in 1985, there is no estate tax if the estate is less than $400,000; in 1987 that minimum increases to $600,000. In 1987, estates come into the tax table at the 37% bracket. Any adjustments in assets or deductions can affect the estate tax (and the tax prorations) significantly. We need to take into account those possibilities by establishing a procedure whereby the Court will modify an order if the amount of tax is changed. Most estates will not be affected by leaving the period for modification open. For those estates that are affected, the finality would work a substantial injustice.

I hope these comments are of assistance to you in making your final recommendation. I appreciate the opportunity to make these comments, and will be happy to discuss any further questions you may have.

Very truly yours,

Kenneth M. Klug

cc: Hal M. Koontz
Robert K. Maize, Jr.
Daniel B. Crabtree
Richard S. Kinyon
William L. Hoisington
Francis J. Collin, Jr.

EXHIBIT 2

FRANCIS J. COLLIN, JR.

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October 30, 1985

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Re: Proration of Estate Taxes

Dear Ken:

I have reviewed Law Revision Commission memorandum 85-69 and with respect to that memorandum I have the following comments:

1. Perhaps an additional definition should be added to Section 970.010. Specifically, I am thinking of the term "estate." As you know, this term can relate to the taxable estate or to the probate estate. The term "estate" appears in a number of places throughout the proposed statute, the most important being in Section 971.020. It seems to me that the word "estate" as used in that section refers to the taxable estate, not the probate estate, so a definition of estate to mean the taxable estate would be helpful.

2. Section 971.010(b)(2) could be drafted in a clearer fashion. I think I know what this sentence is trying to say but I don't think it says it very clearly.

3. The second sentence of Section 971.050(b) is a very important one which I don't think is as clear as it ought to be. I think the troublesome words are "shall be attributed to." Is the following any clearer?

   "The amount of the reduction in federal estate tax resulting from an election under Section 2032A of the Internal Revenue Code shall reduce the tax that is otherwise attributable to the qualified real property that is the subject of the election. If the tax which would otherwise be attributable to the qualified real property is reduced to zero under the foregoing sentence, then any excess amount of reduction shall reduce the taxes otherwise payable with respect to the other property of the taxable estate, such amount to be equitably prorated in accordance with Section 971.020."

4. Should some section state that references to Section 2032A shall refer to any successor section?

5. I am not sure that paragraph 972.010(c) conforms with the general rules of probate jurisdiction. It seems to me that this section should merely make a cross-reference to the general jurisdictional section of the Probate Code.

6. Paragraph 972.030(b) refers to a "summons." Is a "citation" a more accurate term to be used in a probate context?

I hope these comments are helpful.

Best regards,

Frank Collin

Francis J. Collin, Jr.

FJC:jb-s