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1/8/86

Third Supplement to Memorandum 86-1

Subject: 1986 Legislative Program (Proration of Estate Taxes)

One of the changes in the proration of estate taxes recommendation made by the Commission at the December 1985 meeting was to delete the words "fair market" from the definition of value. Ken Klug has written us that the reference to "fair market" must be preserved if the proration formula is to work properly. See letter attached as Exhibit 1. Accordingly, the staff has made the changes noted in the letter.

Respectfully submitted,

Nathaniel Sterling

Assistant Executive Secretary

EXHIBIT 1

THOMAS, SNELL, JAMISON, RUSSELL AND ASPERGER

A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW

HOWARD B. THOMAS  
OLIVER M. JAMISON  
PAUL ASPERGER  
ROGER E. FIPPS  
JAMES E. LA FOLLETTE  
JAMES O. DEMSEY  
JOHN G. MENGSHOL  
KENNETH M. KLUG  
JOHN J. MCGREGOR  
STEVEN M. MCCLEAN  
BRUCE D. BICKEL  
DENNIS L. BECK  
DAVID M. GILMORE  
RUSSELL O. WOOD

WILLIAM N. SNELL  
T. NEWTON RUSSELL  
CHARLES E. SMALL  
PHILIP H. WILE  
SAMUEL C. PALMER III  
ROBERT J. TYLER  
NICKOLAS J. DIBIASO  
GERALD D. VINNARD  
WILLIAM A. DAHL  
JEFFREY P. KANE  
E. ROBERT WRIGHT  
TRACY A. AGRALL  
DONALD P. ASPERGER  
DAVID A. DIAMOND  
FENTON WILLIAMSON, JR., OF COUNSEL

2445 CAPITOL STREET  
POST OFFICE BOX 1461  
FRESNO, CALIFORNIA 93716  
TELEPHONE (209) 442-0600

CONFERENCE OFFICES:  
DELANO  
MERCED  
MODESTO  
VISALIA

December 18, 1985

Mr. Nathaniel Sterling  
Assistant Executive Secretary  
California Law Revision Commission  
4000 Middlefield Rd., Room D-2  
Palo Alto, CA 94303

Dear Nat:

I reviewed the December 5 version of the recommendation relating to proration of estate taxes. The changes from the earlier versions are fine, with the exception of the deletion of the references to "fair market" value.

As I indicated during our telephone conference, the words "fair market" are essential to the operation of the statute. By deleting the "fair market" from the definition of value, the proration formula is changed, and will increase the estate tax to persons who do not receive specially valued property if an election under IRC Section 2032A is made. This unintended result arises from the fact that there can be two values determined for federal estate tax purposes. One is the fair market value of the property at the date of decedent's death (or on the alternate valuation date if the alternate valuation election is made); the other is the special value of qualified real property under IRC Section 2032A.

If a special valuation election is made, the special value is used for calculating the tax. The fair market value is used for determining eligibility to elect special valuation, for determining the amount of the potential additional tax under IRC Section 2032A(c), and for determining

Mr. Nathaniel Sterling  
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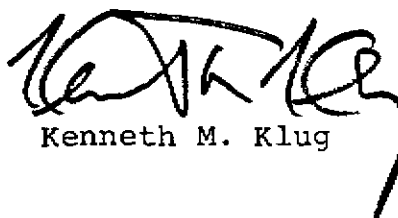
the limit on the reduction in value under IRC Section 2032A. Thus, there are two values determined for Federal Estate Tax purposes. The definition contained in the December 5 draft of Section 20100(e) creates the question of which value applies: the fair market value or the special value? For the statute to operate correctly, the definition must refer to fair market value.

I understand that the confusion arose as a result of a question from Mr. Moore referring to the operation of an alternate valuation date election on the definition of value. (Note that the alternate valuation date election under IRC Section 2032 is different from the special valuation election under IRC section 2032A.) Mr. Moore's question is answered by Treasury Regulation Section 20.2031-1(b).

For your convenience, I am returning to you copies of pages 2, 3 and 4 on which I have indicated where the appropriate insertions should be made.

Best wishes for a happy holiday season.

Very truly yours,



Kenneth M. Klug

Enclosures

SEC. 2. Division 10 (commencing with Section 20100) is added to the Probate Code, to read:

DIVISION 10. PRORATION OF TAXES

CHAPTER 1. PRORATION OF ESTATE TAXES

Article 1. General Provisions

§ 20100. Definitions

20100. Except where the context otherwise requires, as used in this chapter:

(a) "Estate tax" means a tax imposed by any federal or California estate tax law, now existing or hereafter enacted, and includes interest and penalties on any deficiency.

(b) "Person interested in the estate" means any person, including a personal representative, entitled to receive, or who has received, from a decedent while alive or by reason of the death of the decedent any property or interest therein.

(c) "Personal representative" includes guardian, conservator, trustee, or other person charged with the responsibility of paying the estate tax.

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

(e) "Value" means value as determined for federal estate tax purposes.

*(fair market)*  
Comment. Section 20100 supersedes former Section 977. The definition of "gross estate" in former Section 977(b) erroneously had the effect of prorating taxes to adjusted taxable gifts.

The definition of "person interested in the estate" in subdivision (b) includes but is not limited to persons who receive property by nonprobate transfer, such as a joint tenant or the beneficiary of a trust.

Subdivision (c) defines "personal representative" broadly to include more than an executor, administrator, administrator with the will annexed, or special administrator.

The definition of "property" in subdivision (d) makes clear that the term includes property transferred by the decedent during life if included in the gross estate for federal estate tax purposes. See, e.g., I.R.C. § 2035; cf. subdivision (b) ("person interested in estate" includes person who received property from a decedent while alive).

Subdivision (e) defines the term "value" to mean value as determined for federal estate tax purposes. Thus where an alternate valuation is elected pursuant to Section 2032 of the Internal Revenue Code, "value" means the value determined as of the alternate valuation date for federal estate tax purposes. *fair market* *See Treas. Reg. § 20.2031-1(b).*

#### § 20101. Transitional provision

20101. (a) This chapter applies to persons interested in the estate of a decedent who dies on or after January 1, 1987.

(b) Notwithstanding the repeal of any provision by this act, the applicable law in effect before January 1, 1987, remains in effect and applicable to persons interested in the estate of a decedent who dies before January 1, 1987. No inference as to the applicable law in effect before January 1, 1987, shall be drawn from the enactment of this chapter.

### CROSS-REFERENCES

#### Definitions

Person interested in the estate § 20200(b)

### Article 2. Proration

#### § 20110. Proration among persons interested in estate

20110. (a) Except as provided in subdivision (b), any estate tax shall be equitably prorated among the persons interested in the estate in the manner prescribed in this article.

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

(1) To the extent the decedent in a written inter vivos or testamentary instrument disposing of property specifically directs that the property be applied to the satisfaction of an estate tax or that an estate tax be prorated to the property in the manner provided in the instrument. As used in this paragraph, an instrument disposing of property includes an instrument that creates an interest in property or an amendment to an instrument that disposes of property or creates an interest in property.

(2) Where federal law directs otherwise.

Comment. Section 20110 restates former Section 970 without substantive change, but recognizes that federal law may provide for a different manner of proration. Section 20110 allows proration of an extended estate tax prior to actual payment of the tax. Section 20115 (proration of extended estate tax). Cf. I.R.C. § 2207A. Penalties and interest on an estate tax are prorated pursuant to Section 20112 (allowance and charges for credits, deductions, interest, and other adjustments).

#### CROSS-REFERENCES

##### Definitions

Estate tax § 20100(a)  
Person interested in the estate § 20100(b)  
Property § 20100(d)

#### § 20111. Manner of proration

20111. The proration required by this article shall be made in the proportion 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, subject to the provisions of this article.

Comment. Section 20111 continues former Section 971 without substantive change, but does not require a court order to make the proration. Cf. Sections 20120-20125 for optional court procedure to determine proration. The proration is made against all property included in the decedent's gross estate for federal estate tax purposes, including gifts includible in the estate pursuant to Section 2035 of the Internal Revenue Code. See Sections 20100 (definitions) and 20110 (proration among persons interested in estate) and Comments thereto. The proration is based on value as determined for federal estate tax purposes, even though the estate tax may be based on a special value. Adjustments for interest and penalties may be made on an equitable basis. See Section 20112 (allowance and charges for credits, deductions, interest, and other adjustments).

#### CROSS-REFERENCES

##### Definitions

Person interested in the estate § 20100(b)  
Property § 20100(d)  
Value § 20100(e)

*fair market*