Memorandum 87-40

Subject: Study L-830 - Proration of Estate Taxes (Problems Caused by Int. Rev. Code § 4981)

The Tax Reform Act of 1986 included a new Section 4981 in the Internal Revenue Code that increases the estate tax by an amount equal to 15 percent of a decedent's "excess retirement accumulation." Int. Rev. Code § 4981(d). Although this new tax looks like an excise tax and is located among the excise tax statutes, it is phrased as an increase in the estate tax.

The new statute governing proration of estate taxes was enacted on Commission recommendation and became operative January 1, 1987. The statute applies the general rule that the estate tax is apportioned among the estate beneficiaries in proportion to the value of the property received from the estate. Prob. Code § 20111. Whether this rule is appropriate for the newly enacted tax on excess retirement accumulations is questionable.

We have received a letter addressed to this point from Ken Klug of the Executive Committee of the State Bar Estate Planning, Trust and Probate Law Section. See Exhibit 1. They point out that it is not clear whether the new tax is an estate tax. They believe that to avoid controversy, the proration statute should be amended to deal with the new tax directly. It is their opinion that the new tax should be apportioned among persons who receive retirement distributions rather than among estate beneficiaries generally. They base their argument on the probable intent of Congress in enacting the new tax.

The staff agrees with this assessment. This is a tax on a specific asset, separate from the general estate tax, and it is only fair that it be apportioned to the persons receiving the asset. The staff would adopt the provision suggested by the Bar Commttee, with a few drafting modifications:

Prob. Code § 20114.5 (added). Excess retirement accumulations

SEC. . Section 20114.5 is added to the Probate Code, to read:

20114.5. (a) As used in this section, "excess retirement accumulation" has the meaning given it in Section 4981(d)(3) of the Internal Revenue Code.

(b) If the federal estate tax is increased under Section 4981(d) of the Internal Revenue Code, the amount of the increase shall be a charge against the excess retirement accumulation that gives rise to the increase, and shall be equitably prorated among all persons who receive interests in qualified employer plans and individual retirement plans to which the excess retirement accumulation is attributable.

Comment. Section 20114.5 is new. It specifies the manner of proration of the increase in the estate tax of 15 percent of excess retirement accumulations imposed by Internal Revenue Code Section 4981. This provision was enacted by Section 1133(a) of the Tax Reform Act of 1986, Public Law 99-514.

The staff modifications make this provision into a separate section and simplify references to the Internal Revenue Code, consistent with usage in the marital deduction gift provisions of AB 708. This usage is inconsistent with other proration provisions, but we will conform the other proration provisions at another time.

The Bar Committee points out that the new tax is applicable to estates of persons who die after December 31, 1986. Therefore, they believe it would be desirable to enact proration legislation with an urgency clause. This would not be a simple matter in our current legislative program. AB 362 is already well along in the second house and would have to be referred to a conference committee, causing problems and delay. AB 708 is a possible candidate; however, an urgency clause requires passage by a 2/3 vote, which is a little risky with such a large bill as AB 708. Perhaps Assemblyman Harris has another bill he would like to use; AB 201 (public administrators), for example, already has an urgency clause in it and is not as far along as AB 362.

The staff does not know how serious the urgency is here, but an alternative is simply to enact the new proration provision as part of AB 708, operative January 1, 1988, without an urgency clause. The proration provision could be applied retroactively to the estate of a

decedent who dies on or after January 1, 1987, which is the operative date of both the new federal tax and the Commission's general proration statute. We would not disturb any distribution made before January 1, 1988, however.

Respectfully submitted,

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Re: IRC Section 4981A and California Estate Tax Proration Law

Dear Nat:

Among the Federal tax legislation enacted last year was Internal Revenue Code Section 4981A(d), which increases the Federal Estate Tax with respect to any individual by an amount equal to 15% of the individual's "excess retirement accumulation" as defined in IRC Section 4981A(d)(3). There is a question as to whether IRC Section 4981A is an estate tax or an excise tax. It is located among the excise tax provisions of the Internal Revenue Code, but provides for an increase in the estate tax. If the §4981A tax is an excise tax, then the California estate tax proration law would not apply to it; if it is an estate tax, the proration law would apply to it.

To avoid controversy, we believe that the California estate tax proration statute should be amended to expressly deal with the tax imposed by IRC Section 4981A(d). The policy issue is whether the additional tax under IRC Section 4981A(d) shall fall on residue, shall be apportioned among all estate beneficiaries, or shall be apportioned to the persons who receive the excess retirement accumulations. It is our opinion that the additional tax should be apportioned among persons who receive the excess retirement accumulation. To accomplish that result, we recommend that Probate Code Section 20110 be amended as set forth on the attached proposal.

IRC Section 4981A(d) provides that the unified credit is not available to reduce the 15% tax on excess retirement accumulations. Similarly, the manner in which the tax is imposed prevents the marital deduction from reducing the 15% tax. These two elements indicate that Congress probably assumed that the 15% tax would fall on the "excess retirement accumulation," although that assumption does not appear anywhere. (Bear in mind that the excess retirement accumulation is also subject to the basic estate tax imposed by IRC Section 2001, and the unified credit and the marital deduction are available to be applied against that tax. The California proration statute as presently worded properly provides for proration of the basic estate tax against the retirement accumulation. It is only the additional 15% tax which needs to be addressed.)

The Federal statute is effective for estates of decedents dying after December 31, 1986. We recommend that the proposed amendment, if approved by the Commission, be added to one of the current bills for enactment during this legislative session. We do not believe there is any controversy on this issue, and recommend that the amendment be adopted as urgency legislation, perhaps as a part of AB 362.

The proposed amendment does not deal with collection of the tax. The existing collection provisions are adequate where the excess retirement accumulations are paid to a beneficiary. If the beneficiary elects a deferred payout plan such as an annuity, then the California collection procedures are inadequate to the extent that Federal law preempts the right of the executor to recover those taxes from the plan administrator. This is a problem resulting from a gap in the Federal statutes: the Federal Estate Tax law gives the executor the right to recover certain estate taxes, but the employee benefit laws provide some degree of immunity for employee benefit plans. To the extent there is a collection problem, we don't believe California can solve it, and we will need to address it at the Federal level.

Please let me know if you have any questions.

Very truly yours,

Kenneth M. Klug

§20110. Proration of Estate Tax among Persons Interested in the Estate

(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:

(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. If federal law directs the manner of proration of the federal estate tax, the California estate tax shall be prorated in the same manner.

(3) With respect to the tax imposed by §4981A of the Federal Internal Revenue Code (26 U.S.C. §4981A(d)). If the federal estate tax is increased pursuant to §4981A(d) of the Federal Internal Revenue Code (26 U.S.C. §4981A), the amount of such increase shall be a charge against the "excess retirement accumulation" as defined by Internal Revenue Code §4981A(d)(3). The increased estate tax imposed by §4981A(d) of the Federal Internal Revenue Code (26 U.S.C. §4981A(d)) shall be equitably prorated among all persons who receive interests in qualified employer plans and individual retirement plans which give rise to the tax under §4981A of the Federal Internal Revenue Code.