

Memorandum 89-99

Subject: Study L-1029 - Qualified Domestic Trusts (Approve to Print)

Attached to this memorandum is a draft of the recommendation relating to qualified domestic trusts. The recommendation is to add curative legislation to the marital deduction statute to save the marital deduction for a surviving spouse who is not a United States citizen.

The recommendation was circulated for comment in September and October as part of the tentative recommendation relating to miscellaneous probate revisions. The recommendation received no comment, other than as part of comments generally approving the entire tentative recommendation package.

There is federal legislation pending that, if enacted, would substantially alter the federal law governing qualified domestic trusts. See HR 3150. However, this measure was introduced August 4, 1989, and referred to the Committee on Ways and Means, where it continues to reside as of November 8, 1989.

The staff does not believe we should delay enactment of our curative legislation, which is needed immediately. We can offer appropriate amendments if and when necessary to conform to any federal legislation that ultimately is enacted. Meanwhile, the staff recommends that the qualified domestic trust recommendation be printed and sent to the Legislature, possibly as an urgency measure.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

RECOMMENDATION

relating to

Qualified Domestic Trusts

December 1989

**CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739**

NOTE

This recommendation includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were enacted since their primary purpose is to explain the law as it would exist (if enacted) to those who will have occasion to use it after it is in effect.

Cite this recommendation as *Recommendation Relating to Qualified Domestic Trusts*, 20 Cal. L. Revision Comm'n Reports 579 (1990).

STATE OF CALIFORNIA

GEORGE DEUKMEJIAN, Governor

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December 1, 1989

To: The Honorable George Deukmejian
Governor of California, and
The Legislature of California

The legislation recommended by the Commission would, to the extent practicable, validate the estate plan of a California decedent who makes a marital deduction gift to the decedent's noncitizen spouse. If the gift is intended to qualify for the marital deduction and is made in trust, the recommended legislation would ensure that the trust is a qualified domestic trust by requiring that all trustees be individual citizens of the United States or domestic corporations. If the trust instrument names a disqualifying trustee, the recommended legislation would require that the disqualifying trustee be replaced by a qualified successor trustee named in the trust instrument or, if no qualified successor trustee is named in the instrument, by a qualified successor trustee named by the disqualifying trustee. The recommended legislation also would require that the trust comply with relevant federal regulations for qualified domestic trusts.

The Commission is aware of pending federal legislation to revise the law governing qualified domestic trusts (H.R. 3150) and will make corresponding revisions in the recommended California legislation if federal revisions are enacted.

This recommendation is submitted pursuant to Resolution Chapter 37 of the Statutes of 1980.

Respectfully submitted,

Edwin K. Marzec
Chairperson

RECOMMENDATION

The federal estate and gift tax marital deduction provisions¹ were modified in 1988 by the new limitation that a marital deduction is not allowed for property passing to the surviving spouse unless the surviving spouse is a citizen of the United States.² The new citizenship requirement does not apply if property passes to the surviving spouse in a "qualified domestic trust."³

The new federal law creates problems in California because of California's large immigrant population. It is not uncommon for a California decedent with a substantial estate to leave a surviving spouse who is not a United States citizen.⁴ Standard marital deduction estate plans involving such persons are now obsolete and may produce unfortunate results for many California residents.⁵

While the new federal law allows a marital deduction for property that passes to a surviving noncitizen spouse under a "qualified domestic trust," the law as written appears to require the trust instrument to include an express statement that all trustees must be citizens or domestic corporations.⁶

1. IRC §§ 2056, 2523.

2. IRC §§ 2056(d)(1), 2523(i), enacted by the Technical and Miscellaneous Revenue Act of 1988 (Nov. 10, 1988). The new provision applies to estates of decedents dying after the date of enactment.

3. IRC § 2056(d)(2). A trust is a qualified domestic trust if all of the following conditions are satisfied:

(1) the trust instrument requires that all trustees of the trust be individual citizens of the United States or domestic corporations,

(2) the surviving spouse of the decedent is entitled to all the income from the property in such trust, payable annually or at more frequent intervals,

(3) such trust meets such requirements as the Secretary may by regulations prescribe to ensure the collection of any tax imposed by subsection (b), and

(4) an election under this section by the executor of the decedent applies to such trust.

See IRC § 2056A(a).

4. See, e.g., Gerstenfeld, *The QDT: New Solution for a New Problem?*, 10 Est. Plan. & Cal. Prob. Rep. 113 (1989).

5. *Id.*

6. See note 3, *supra*. This rule appears to apply even though the trust instrument actually names a United States citizen or a domestic corporation as trustee.

This is obviously a problem for marital deduction trusts drafted before the new federal law was enacted, as well as for trust instruments drafted defectively after the new federal law was enacted.

California law should, to the extent practicable, validate the estate plan of a California decedent who makes a marital deduction gift to the decedent's noncitizen spouse. If the gift is intended to qualify for the marital deduction and is made in trust, California law should ensure that the trust is a qualified domestic trust by requiring that all trustees be individual citizens of the United States or domestic corporations. If the trust instrument names a disqualifying trustee, the disqualifying trustee should be replaced by a qualified successor trustee named in the trust instrument or, if no qualified successor trustee is named in the instrument, by a qualified successor trustee named by the disqualifying trustee. The trust also should be required to comply with relevant federal regulations for qualified domestic trusts.

The recommended legislation amends sections of the new Probate Code as it will be proposed to be enacted at the 1990 legislative session by Assembly Bill 759. The recommended legislation will become operative at the same time as the new Probate Code becomes operative.

PROPOSED LEGISLATION

The Commission's recommendation would be effectuated by enactment of the following amendments:⁷

Probate Code § 21524 (amended). Marital deduction gift in trust

21524. If a marital deduction gift is made in trust, in addition to the other provisions of this chapter, each of the following provisions also applies to the marital deduction trust:

7. The Commission is aware of pending federal legislation to revise the law governing qualified domestic trusts (H.R. 3150), and will make corresponding revisions in the proposed California legislation if federal revisions are enacted.

(a) The transferor's spouse is the only beneficiary of income or principal of the marital deduction property as long as the spouse is alive. Nothing in this subdivision precludes exercise by the transferor's spouse of a power of appointment included in a trust that qualifies as a general power of appointment marital deduction trust.

(b) Subject to subdivision (d), the transferor's spouse is entitled to all of the income of the marital deduction property not less frequently than annually, as long as the spouse is alive.

(c) The transferor's spouse has the right to require that the trustee of the trust make unproductive marital deduction property productive or to convert it into productive property within a reasonable time.

(d) Notwithstanding subdivision (d) of Section 16304, in the case of qualified terminable interest property under Section 2056(b)(7) or Section 2523(f) of the Internal Revenue Code, on termination of the interest of the transferor's spouse in the trust all of the remaining accrued or undistributed income shall pass to the estate of the transferor's spouse, unless the instrument provides a different disposition that qualifies for the marital deduction.

(e) In the case of an election under Section 2056A of the Internal Revenue Code that applies to the trust, if the transferor's spouse is not a citizen of the United States:

(1) The trust instrument shall be construed to require that all trustees of the trust be individual citizens of the United States or domestic corporations.

(2) If a person named in the trust instrument or otherwise appointed as trustee is not an individual citizen of the United States or a domestic corporation, the person shall be replaced by an individual citizen of the United States or a domestic corporation named in the instrument as successor trustee or, if none, selected by the person named in the instrument or otherwise appointed as trustee.

(3) The trust shall meet such requirements as the Secretary of the Treasury may by regulations prescribe to ensure the collection of any tax imposed by subsection (b) of Section 2056A of the Internal Revenue Code, and the trustee has the authority necessary to implement this paragraph.

(4) This subdivision applies to estates of decedents dying after November 10, 1988.

Comment. Subdivision (e) is added to Section 21524 to make clear that in the case of a decedent's marital deduction gift in trust to a surviving spouse who is not a United States citizen, the trust instrument is construed to require a trustee who is an individual United States citizen or a domestic corporation, as provided in Internal Revenue Code Section 2056A(a) for a qualified domestic trust. See also Section 15660 (filling vacancy in office of trustee). This is a specific elaboration of the general requirement of Section 21522(a) that the provisions of the instrument be construed to comply with the marital deduction provisions of the Internal Revenue Code. The subdivision is applicable to estates of decedents dying after the date of enactment of the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647, Nov. 10, 1988).

Note. This amendment to Section 21524 is made to Section 21524 of the Probate Code as it will be proposed to be enacted at the 1990 legislative session by Assembly Bill 759.

Probate Code § 21526 (amended). QTIP election

21526. A fiduciary is not liable for a good faith decision to make any election, or not to make any election, referred to in Section 2056(b)(7) ~~or Section, 2056A(d), or 2523(f)~~ of the Internal Revenue Code.

Comment. Section 21526 is amended include an election made under Internal Revenue Code § 2056A(d) (qualified domestic trusts).

Note. This amendment to Section 21526 is made to Section 21526 of the Probate Code as it will be proposed to be enacted at the 1990 legislative session by Assembly Bill 759.