



TRUSTS & ESTATES SECTION

THE STATE BAR OF CALIFORNIA

MARITAL DEDUCTION TRUSTS

LEGISLATIVE PROPOSAL (T&E-2016-04)

TO: Office of Governmental Affairs

FROM: Patrick A. Kohlmann, Executive Committee, Trusts and Estates Section

DATE: August 1, 2015

RE: Proposal to Revise Probate Code section 21524 (Marital Deduction Trusts)

SECTION ACTION AND CONTACT(S):

Date of Approval by Section Executive Committee: September 14, 2014
Aye: 31; No: 0; Abstain: 0

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SUMMARY OF PROPOSAL

This legislative proposal would give California marital deduction trusts the benefit of both flexible investment strategy under modern definitions of income, and the statutory backstop to ensure that the trust qualifies for the estate tax marital deduction. The proposal would reduce the administrative burden on marital deduction trusts by eliminating unnecessary requirements to qualify for that deduction.

Current federal law imposes an estate tax on all the assets of United States citizens and residents. An estate tax at the rate of 40% is assessed on the value of assets above the estate exclusion (\$5,340,000 for year 2014, indexed annually for inflation). Federal law allows a decedent's estate an unlimited estate tax marital deduction for property that passes to a surviving spouse. Qualifying for the estate tax marital deduction is a primary goal of many estate plans because that qualification may reduce or eliminate the estate tax due on the first death, and defers payment of that tax, if at all, until the death of the surviving spouse. Gifts in trust for the surviving spouse may qualify for the estate tax marital deduction, subject to the requirements in federal tax regulations.

Probate Code section 21524 was enacted as a statutory backstop to marital deduction trusts drafted under California law. That statute grafts the federal regulatory requirements onto marital deduction trusts that may not otherwise qualify due to unartful drafting. The purpose of the statute is to rescue possibly defective marital deduction trusts and insure their qualification of the estate tax marital deduction and thereby reduce or eliminate the estate tax on a decedent's estate. To accomplish this rescue mission, section 21524 should mirror the requirements for marital deduction trusts in federal tax regulations.

Federal law regarding marital deduction gifts has changed in the nearly twenty-five years since the enactment of section 21524, without any substantive change to that statute. Two important changes have been made to federal tax regulations in the interim: (1) a revised definition of income for a qualifying marital deduction trust that reflects modern portfolio theory and investment approaches and (2) evolving case law and government announcements regarding income of a marital deduction trust that is accrued but undistributed prior to the death of the surviving spouse.

Federal regulations now allow a marital deduction trust to pay a unitrust amount, which may be less than actual net income, and still qualify for the estate tax marital deduction. The intent of section 21524 appears to be to preserve the marital deduction, so it should mirror the definition of income in current federal tax regulations. Section 21524 now provides a default rule that a trustee must distribute all of the income, without reference to unitrust payments. Without that specific reference "income" under the existing statute may be construed in accordance with the definition of income in Probate Code section 16324, or traditional notions of income.

When section 21524 was enacted in 1990, federal tax law was unsettled as to whether a surviving spouse's estate had to receive income that was accrued or

undistributed prior to the surviving spouse's death to qualify a marital deduction trust for the estate tax marital deduction. Section 21524 took the conservative approach to avoid inadvertent disqualification, and mandated distribution of such "stub" income. The law is now settled in the Ninth Circuit that a trust qualifies for the marital deduction without a mandatory distribution of that income. In addition, the California Uniform Principal and Income Act provides for a default distribution of undistributed income to the beneficiary's estate. The proposed changes are intended to conform section 21524 to current federal law.

The legislature amended the Probate Code in 2005 to conform it to the definitions of income in the federal tax regulations, and specifically unitrust conversions and the trustee adjustment power. The legislative history of that enactment refers to trusts for a surviving spouse, but does not appear to consider the related issue of the estate tax marital deduction.

ISSUES AND PURPOSE:

This legislative proposal addresses the following issues:

1. Expanding the provisions of a qualifying marital deduction trust to include a trust that requires distribution of all income to the surviving spouse, including income determined pursuant to an adjustment power or a unitrust payment.
2. Eliminating an unnecessary requirement to pay undistributed income to the estate of the surviving spouse.

A detailed discussion of these issues follows.

Income and Principal Adjustments and Unitrust Payments. Treasury Regulation (Regs.) section 20.2056(b)-5(f) defines when the surviving spouse is deemed to be entitled to the entire income of a trust, thereby qualifying that trust or interest in a trust for the estate tax marital deduction. The regulation applies to life estate with power of appointment trusts under Internal Revenue Code section 2056(b)(5). That regulation was modified by T.D. 9102 (1/2/2004) to reflect changes in the definition of trust accounting income under state laws, and the concurrent change in federal income tax law under Internal Revenue Code section 643 and applicable regulations. The Treasury Decision adopts a definition of fiduciary accounting income that reflects allocations between income and principal in a fiduciary's discretion based upon total return from a trust investment portfolio, as provided in Probate Code section 16336. Section 16336.5 also allows a conversion to a 3% to 5% unitrust as an equivalent distribution to the income beneficiary. The relevant provision in the current Regs. section 20.2056(b)-5(f)(1) states:

In determining whether a trust evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for the administration of the trust. In addition, the surviving spouse's interest shall meet the condition set

forth in paragraph (a)(1) of this section if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of 1.643(b)-1 of this chapter.

Regs. section 20.2056(b)-7(d)(2) incorporates by reference the definition in an income interest in section 20.2056(b)-5(f) and applies it to QTIP Trusts. In addition, Regs. section 20.2056(b)-7(d)(1) expressly states that the trustee's exercise of the adjustment power under applicable state law is not a power to appoint the trust property to a person other than the surviving spouse for QTIP purposes, provided that the adjustment power meets the requirements of Regs. 1.643(b)-1.

The proposed legislative change would amend section 21524(b) to allow the income payment determined under the trustee's adjustment power or a unitrust payment to qualify as a marital deduction gift. The proposed change incorporates by reference Internal Revenue Code section 643 and applicable regulations. The specific reference to section 643 in the proposed statutory language is meant to be user friendly to courts and practitioners, and to eliminate the necessity to cross check federal tax regulations. Qualification under section 643 would include complying adjustments in Probate Code section 16336(a) and unitrust conversions in Probate Code section 16336.4, but includes broader requirements and allowances, such as consistency of reporting or actual distributions to the income beneficiary.

Stub Income. Section 21524(d) appears to be a relic that attempted to address the decision in *Estate of Rose D. Howard* (1988) 91 T.C. No. 26, holding that a QTIP Trust did not qualify for the estate tax marital deduction because the trust provisions did not provide for payment of accumulated income to the surviving spouse's estate. The Ninth Circuit overturned the decision of the Tax Court (*Howard v. Commr.* (1990) 910 F.2d 633). In addition, Regs. section 20.2056(b)-7(d)(4) provides:

An income interest does not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse. See Section 20.2044-1 relating to the inclusion of such undistributed income in the gross estate of the surviving spouse.

The Internal Revenue Service would be bound by its published regulation. *See also* Notice 89-4, 1989-1 C.B. 624 extended by Notice 90-46, 1990-2 C.B. 337 (the government affirms that the position in its regulations is correct). Given this regulatory background and the opinion of the Ninth Circuit, section 21524(d) appears superfluous. The cross reference in subsection (b) is also deleted from the proposed statute.

HISTORY:

There have not been any prior legislative proposals on this topic.

PENDING LITIGATION:

None known.

LIKELY SUPPORT & OPPOSITION:

The Executive Committee of the Trusts and Estates Section supports this proposal.

There is no known opposition.

FISCAL IMPACT:

Unknown fiscal impact.

GERMANENESS:

This proposal requires the special knowledge, training, experience and technical expertise of the members of the Trusts and Estates Executive Committee because it relates to estate administration matters which are the special purview of the Committee.

DISCLAIMER:

This position is only that of the Trusts and Estates Section of the State Bar of California. This position has not been adopted by either the State Bar's Board of Trustees or overall membership, and is not to be construed as representing the position of the State Bar of California.

Membership in the Trusts and Estates Section is voluntary and funding for section activities, including all legislative activities, is obtained entirely from voluntary sources.

TEXT OF PROPOSAL:

SECTION 1. Section 21524 of the Probate Code is amended to read:

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:

- (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~~ 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. As used in this section, income shall be mean income as defined in Internal Revenue Code section 2056(b) or 2523(f), including a unitrust payment or other allocation of income determined pursuant to a reasonable apportionment of total investment return that meets the requirements of Internal Revenue Code section 643 and the regulations under that statute.

(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 Section 16347, 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.~~