

Memorandum 2018-45

**Disposition of Estate Without Administration:
Property Return Provisions**

In this study, the Commission¹ is evaluating revision of three statutory procedures that, in limited circumstances, allow a beneficiary to acquire property from a decedent without administration.² The procedures permit transfer of personal property from an estate of a relatively small value,³ transfer of real property of small value,⁴ and transfer of property to a decedent's surviving spouse.⁵

The impetus for the study was a letter from the Executive Committee of the Trusts and Estates Section of the California Lawyers Association ("TEXCOM"), submitted in a separate Commission study on revocable transfer on death deeds.⁶ A part of the TEXCOM letter commented on provisions applicable to that procedure⁷ that were directly drawn from the procedures in this study, suggesting the comments may be relevant to those procedures as well.⁸

This memorandum continues a discussion of provisions that require a transferee making use of one of these procedures to return the property or its equivalent to the estate.⁹ The staff will continue in this memorandum to refer to these provisions as "property return provisions."

1. Any California Law Revision Commission document referred to in this memorandum can be obtained from the Commission. Recent materials can be downloaded from the Commission's website (www.clrc.ca.gov). Other materials can be obtained by contacting the Commission's staff, through the website or otherwise.

The Commission welcomes written comments at any time during its study process. Any comments received will be a part of the public record and may be considered at a public meeting. However, comments that are received less than five business days prior to a Commission meeting may be presented without staff analysis.

2. The provisions comprising these procedures were recommended to the Legislature by the Commission, in conjunction with the Commission's recodification of the entire Probate Code. See *Disposition of Estate Without Administration*, 18 Cal. L. Revision Comm'n Reports 1005 (1986).

3. See Prob. Code §§ 13100-13116.

4. See Prob. Code §§ 13200-13210.

5. See Prob. Code §§ 13500-13564.

6. See Memorandum 2017-35, Exhibit.

7. See Prob. Code § 5676.

8. See Memorandum 2017-35, pp. 9-10; Minutes (Aug. 2017), p. 8.

9. See Memorandum 2018-37.

Unless otherwise indicated, all statutory references in this memorandum are to the Probate Code.

OVERVIEW

Ordinarily, property of a decedent that would pass by will or intestacy must be administered in a probate proceeding. In that proceeding, the decedent's estate is first used to pay the decedent's debts, family protections, and certain expenses, and the remainder is then distributed to devisees or heirs.

The procedures that are the subject of this study permit a decedent's property, in limited circumstances, to be transferred to a recipient without probate administration.¹⁰ The procedures thereby offer a decedent's heir or devisee an opportunity to expeditiously receive property of the decedent without the corresponding cost and delay of a probate proceeding.

However, each procedure also provides that, if a proceeding to administer the decedent's estate is opened within three years of a transfer,¹¹ the decedent's personal representative can require the transferee to make restitution to the estate, by returning the transferred property (or its equivalent).¹²

The provisions compelling this return of property require different types or amounts of restitution, depending on what the transferee has done with the transferred property since acquiring it. However, in each addressed scenario, the primary policy objective of the property return provision appears to be the same: restoring the estate to the condition it would have been in, but for the transfer.

At the same time, the provisions also appear to recognize a second important policy objective, relating to the rights of the transferee. As written, the procedures themselves reasonably convey to a transferee that property transferred pursuant to one of these procedures *belongs* to the transferee, who may do what he or she chooses with the property.¹³ If it later turns out that transferred property or its equivalent must be returned to the estate, the property return provisions also seek to avoid placing the transferee in a worse state than

10. For ease of reference, this memorandum will use the term "transferee" to refer to a person who receives property from a decedent pursuant to a procedure in this study.

11. See Sections 13111(e), 13206(f), and 13562(e).

12. See Sections 13111, 13206, and 13562.

13. None of the procedures the Commission is studying appear to require the assistance of counsel. In addition, neither the respective code sections describing what the transferee needs to do to implement a procedure, nor any paperwork needed to be completed by the transferee, warn a transferee of this somewhat counter-intuitive possibility. See Sections 13101, 13200 (and implementing Judicial Council form DE-305), and 13500.

he or she would have been in, had the transfer not been made. More specifically, if a property return provision would compel a transferee to return the transferee's *own* property that had become comingled with the originally transferred property, a corresponding reduction in restitution liability is also mandated.¹⁴

Based on the comments of TEXCOM as well as its own evaluation, the staff has concluded that adjustments or additions to a number of these property return provisions might better facilitate the two overarching policy objectives of the provisions.

RECAP FROM LAST MEETING

At the last Commission meeting, the staff discussed ways in which these property return provisions may not adequately address the interests of the transferee. The staff memorandum framed the discussion by asking the following question:

If a transferee is required to return property to the probate estate, to what extent should the transferee be reimbursed for payments made by the transferee to satisfy decedent obligations or increase the value of the returned property?¹⁵

The memorandum then offered examples of circumstances in which the provisions appropriately called for that reimbursement, and also identified instances in which reimbursement appeared warranted but had not been included in the provisions.

The Commission made the following decisions:¹⁶

- An existing rule, which reduces a transferee's liability to the estate for any payments made toward a pre-existing encumbrance, should be generalized, so that it applies to property that was significantly improved by the transferee.¹⁷

14. See Sections 13206(c)(1)(B), 13562(b)(1)(B) (amount paid by transferee toward pre-existing liens or encumbrances; Sections 13111(c), 13206(d), and 13562(c) (amount paid by transferee to creditor of decedent, or person asserting superior claim to property).

15. See Memorandum 2018-37, p. 4.

16. See Memorandum 2018-37, pp. 6-10; Minutes (June 2018), p. 14.

17. This reduction in restitution liability *is* provided by the existing procedures in a scenario in which the transferee has made a significant improvement to the transferred property, and is then required to return the property. The Commission's addition would extend that reduction to a scenario in which the transferee acquired the property, made one or more payments on an existing lien or encumbrance, but did *not* significantly improve the property.

- A transferee's liability to the estate should be reduced for any value that the transferee added to returned property, if that value accrued to the estate rather than the transferee.
- Transferee reimbursement should have priority over all other estate obligations.

This memorandum begins a discussion of circumstances in which the property return provisions appear to inadequately protect the interests of the *estate*, by failing to restore it to the condition it would have been in had the transfer of property outside of probate not occurred.

POST-TRANSFER ENCUMBRANCE

In addition to requiring return of the transferred property or its equivalent, the property return provisions generally require a transferee who encumbers transferred property before returning it to also remit to the estate an amount needed to satisfy the encumbrance.¹⁸ This requirement further implements the basic goal of restoring the estate to the condition it would have been in, but for the transfer. Since the new encumbrance decreases the value of the returned property (and thereby the value of the estate), the encumbrance must be paid and eliminated in order to restore that value. This also avoids a windfall to the transferee, which would occur if the transferee were allowed to retain value that was extracted from the returned property.

However, that approach is not applied across the board. In a scenario in which a transferee makes a significant improvement to transferred property before being required to return it, that remittance is not required by the property return provisions.¹⁹

The staff does not see any good reason for disparate treatment of the two scenarios — the required return of significantly improved property, or property that is not significantly improved — with respect to post-transfer encumbrances. If a transferee is required to make restitution to the estate for encumbering the transferred property, there is no obvious reason why that same restitution should not be required if the property was improved by the transferee.

It is worth noting that the memorandum presented at the last Commission meeting discussed a similar lack of parallelism between the rules governing transferred property generally, and significantly improved property, with

18. See Sections 13111(a)(1)(B), 13206(a)(1)(B), 13562(a)(1)(B).

19. See Sections 13206(c)(1), 13562(b)(1).

respect to reimbursement of a transferee for payments made toward a *pre-transfer* encumbrance.²⁰ After consideration of that issue, the Commission decided to revise existing law so that the two scenarios would be treated in the same way.²¹

The staff recommends that the rule requiring a transferee to pay the estate an amount sufficient to pay off any post-transfer encumbrance should apply to all transferred property, whether improved or not (i.e., the provision governing transferee-improved property should be revised to include such a requirement).

If the Commission agrees, the staff will prepare implementing language for consideration in a future memorandum.

RESTITUTION OF "NET INCOME"

Another example of the general issue of restoring value to an estate can arise with respect to the transfer of income-producing property. Suppose, for example, that a transferee uses one of these procedures to take title to shares of stock. Over the next year, the transferee receives \$1,000 in dividends from those shares. Later, the personal representative determines that the stock should be returned to the estate; it is needed to pay creditors or there is a person with a superior claim to the asset. The personal representative invokes the property return provisions and the stock is returned to the estate. Should the transferee be allowed to keep the \$1,000 in dividend payments?

In general, the property return provisions would require that the dividend income be returned along with the stock. A transferee who is required to return property or its equivalent to the estate must also return "the net income the person received from the property...."²²

The staff believes that is the proper result. The dividend payments were derived entirely from the property. In a sense, they are an element of the property. If the property is to be returned, then the derivative income should also be returned. Allowing the transferee to keep it would create a windfall. This seems clearest in the situation where it was an error for the transferee to have

20. Memorandum 2018-37, p. 7.

21. Minutes (Aug. 2018), p. 14 ("The recipient should be reimbursed for any amount that the recipient paid toward a decedent debt that was secured against the property when the transferor died. That rule should apply regardless of whether the recipient improved the property before it was returned to the estate.")

22. See Sections 13111(a)(1)(A), (a)(2)(A); 13206(a)(1)(A), (a)(2)(A); 13562(a)(1)(A), (a)(2)(A).

received the property at all. It should have gone to another person. In that instance, the proper recipient of the asset should also receive any derivative income that accrued during the process of administration.

However, there are three issues regarding this rule that should be discussed.

Lack of Parallelism

Once again, existing law does not apply this general rule to property that has been significantly improved by a transferee.²³

The staff sees no good reason for that difference in treatment. The fact that a transferee has made an improvement to property seems to have no bearing on whether the transferee should be required to return any net income that was derived from the property (unless the improvement is somehow the source of the income received — issues like that are discussed below, under the heading “Meaning of ‘Net Income’”).

As a general rule, the staff recommends that the rule requiring restitution of net income should apply to all transferred property, whether improved or not (i.e., the provision governing transferee-improved property should be revised to include such a requirement). If the Commission agrees, the staff will prepare implementing language for consideration in a future memorandum.

Meaning of “Net Income”

As noted above, existing law generally requires that a transferee return any “net income” received from property, when that property or its equivalent must be returned to the estate. However, the law does not define the term “net income.” TEXCOM comments that the “net income” requirement should be made more precise:

Ambiguity of the phrase “net income”. The measure of a RTODD beneficiary’s liability to creditors includes “the net income the beneficiary received from the property.” The statute would benefit from a definition of “net income.” While one might expect that “net income” would include a reduction for maintenance expenses actually incurred, seemingly less clear are issues of reasonable repairs, depreciation, income tax liability on rental income, the value of the beneficiary’s personal labor that created the income received, etc.²⁴

23. See Sections 13206(c), 13562(b).

24. See Memorandum 2017-35, Exhibit p. 8.

The last point made by TEXCOM — deducting the transferee’s own labor when calculating net income — is particularly important and suggests a broader issue.

There are some situations where it is clear that income derived from transferred property was an innate component of the property; regardless of who owned the property, no expenditure of labor or money was required to realize the income. Stocks that pay a fixed dividend are a good example. A transferee need do nothing to receive this type of income. It simply flows to whoever holds title to the stock, whether the transferee, the estate, or a person with a superior claim. In that clear-cut scenario, it would seem correct to require the transferee to return the income.

However, the staff sees a wide range of circumstances in which the amount of income received by a transferee from transferred property would be affected by the efforts or investment of the transferee. The simplest example is the one described by TEXCOM, where the transferee personally performs labor required to generate the income. In that instance, it seems reasonable to deduct compensation for the transferee’s labor when calculating the net income that must be returned to the estate. The estate would presumably have needed to pay *someone* to perform the labor required to produce the income. Allowing the transferee to keep that compensation would appear to do the estate no harm, and avoids unfairly depriving the transferee of earned compensation.

But suppose the transferee’s expenditure of time or money was responsible for an *increase* in the revenue generated by the property. For example: The property received by the transferee was a vacant lot. The transferee sought out a billboard company, which built a billboard and paid the transferee a monthly rent. But for the transferee’s actions, the property would not have generated *any* income. Nevertheless, existing law still appears to require the transferee to return all of the billboard income to the estate (with a possible deduction for the transferee’s own labor and expenses).

That does not seem like a fair result. If the transferee is required to return the billboard income, the estate would seem to receive a windfall — income it would not have received had the property not been transferred. And the transferee would suffer the loss of income derived largely from the transferee’s own initiative and efforts.

In short, it appears that a property return rule that inflexibly requires a return of all net income received from transferred property could produce unreasonable

results. To avoid unfairness, the law could perhaps distinguish between income that would have been generated by the property without any intervention by the transferee, and income that can be attributed to the transferee's intervention. Arguably, the former should be returned to the estate, because the income was an inherent element of the property itself; the latter should not be returned because it was *added* to the property through the transferee's own initiative and efforts.

While that principle is relatively easy to state, it would be difficult to apply in practice. The value of the transferee's contributions would be hard to quantify definitively. It seems likely that the state and transferee would often disagree. Judicial adjudication would likely be required in those cases.

In short, we have an existing rule that could produce results that seem unfair. But avoiding that unfairness might complicate a process that is intended to be expedited.

The Commission should consider whether to preserve the existing rule, work toward developing a more nuanced rule, or do something else. Once that decision has been made, the staff will prepare a memorandum discussing implementation (which will likely include a closer look at TEXCOM's suggestion that the definition of "net income" be defined).

Reduction of Revenue

While the property return provisions require a transferee to remit whatever net income the transferee received from transferred property, the provisions say nothing about what happens when a transferee makes changes to the use of the transferred property that reduce or eliminate an already existing income stream.

Suppose a transferee receives property with a billboard in place, and an existing rental contract with a billboard company. The transferee decides to terminate the contract and thereafter receives *no* income from the property. If the personal representative later requires the return of the property to the estate, the estate will recover title, but will not receive any restitution for the loss of income that the estate would have received but for the transferee's actions.

That result is in tension with the primary policy objective of the property return provisions, as described above. It falls short of restoring the estate to the condition it would have been in, if the property had never passed outside of

probate. The estate would lose income it otherwise would have received, if it had instead retained the property.

An obvious way to address that problem would be to require the transferee to reimburse the estate for income that *would* have been received from the property, but for the transferor's actions. In effect, that would impose a duty on the transferor to maintain any existing income generation at the time the property is transferred. A failure to do so would cause the transferee to be liable to the estate for the shortfall.

The imposition of such a duty would have significant downsides.

First, it would tend to lock in existing uses, by creating financial exposure for any transferee who decides to change the use of transferred property. That would restrict beneficial enjoyment of the property, and could also be economically counter-productive. For example, suppose a transferee decides to develop a piece of property to substantially increase its long-term value. As a first step in that process, an income-producing billboard is removed. That may be an economically rational decision, but could expose the transferee to out-of-pocket liability for the lost billboard income, if the law were changed along the lines discussed above.

Second, such a rule could create a trap for those who do not fully understand the law. Recall that these procedures are designed to facilitate the transfer of property outside of probate, in circumstances where judicial supervision would presumably result in more burden than benefit. Two of the three procedures in this study are limited to property of relatively small value. It therefore seems likely that many transferees will be people of limited means, operating without benefit of counsel. Imposing a duty on such persons to maintain any existing income production, with out-of-pocket liability for a shortfall, could cause significant surprise, with unduly harsh results.

The Commission should consider whether it wishes to develop such a rule. Bear in mind that this is not an issue that was raised by TEXCOM or any other person. It was identified by the staff, in the course of analyzing the operation of the property return provisions.

Casualty Insurance

In its letter, TEXCOM identified another situation in which a transferee might realize value that is lost from property that is returned to the estate:

Casualty insurance proceeds not contemplated. The provisions dealing with the beneficiary's liability to the transferor's estate do not require the beneficiary to restore to the transferor's estate the proceeds, if any, of any casualty insurance claims. This should be reconsidered, lest a devastating fire on property received by a RTODD beneficiary result in a windfall to that beneficiary.²⁵

This does seem to be another example of the general issue discussed in this memorandum. Under the facts described by TEXCOM, the transferee would retain value that was lost from the property.

Based on the policies discussed above, it would seem correct to require that the transferee return the insurance proceeds along with the damaged property, if that property is returned to the estate. **Does the Commission agree?**

If so, the Commission should also consider whether the transferee should be allowed to deduct costs associated with recovery of the proceeds (e.g., premium payments, time and effort required to perfect claim).

That could involve some difficult line drawing, in determining the kinds of costs are compensable.

CONCLUSION

The next memorandum in this study will consider how to implement any decisions made by the Commission in connection with this memorandum and Memorandum 2018-37. The staff anticipates that there may be a way to synthesize all of the individual decisions into a simplified statutory approach, perhaps with a catch-all provision that would capture scenarios that are not addressed by existing law or these memoranda.

Respectfully submitted,

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25. See Memorandum 2017-35, Exhibit p. 8.