

Fourth Supplement to Memorandum 88-43

Subject: Study L-1036/1055 - Compensation of Personal Representative
and Estate Attorney (Taxation of Personal Representative)

Attached to this Supplement as Exhibit 1 is a letter from attorney David Lich for the Legislative Committee of the Probate, Trust and Estate Planning Section of the Beverly Hills Bar Association.

Subdivision (c) of proposed Section 10804 allows the personal representative to employ persons to help perform ordinary services and to pay the expense out of the personal representative's own funds. Mr. Lich is concerned that the personal representative's fee is taxable income, but the expense of hiring assistants may not be deductible. These appear to be "miscellaneous" expenses on Schedule A of Form 1040, deductible only to the extent they exceed 2% of adjusted gross income.

Mr. Lich would allow the court to order disbursement directly from the estate, chargeable against the personal representative's compensation. The staff thinks this is a good suggestion, and would revise subdivision (c) of proposed Section 10804 as follows:

(c) The personal representative may employ any qualified person, including a member of the State Bar of California, to assist the personal representative in the performance of ordinary services and pay for the services of that person out of the personal representative's own funds. The court may order payment directly to that person out of the estate, to be charged against and deducted from the personal representative's compensation.

The staff would add the following to the Comment to Section 10804:

The second sentence of subdivision (c) permits the court to order payment directly to the person performing ordinary services and to charge the payment against the personal representative's compensation. This will avoid having the personal representative's compensation taxable as income to the personal representative, while the expense might not be deductible because of the two percent floor for deductibility of miscellaneous expenses.

Respectfully submitted,

Robert J. Murphy III
Staff Counsel

EXHIBIT 1

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OUR REF. NO.

July 1, 1988

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California Law Revision Commission
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Re: Memorandum 88-43
Study L-1036/1055
Personal Representative &
Attorney Fees in Probate

Dear Mr. Murphy:

The Legislative Committee of the Probate, Trust and Estate Planning Section of the Beverly Hills Bar Association (the "Committee") has reviewed the above-referenced Memorandum and its supplements. I have been requested to comment, on behalf of the Committee, on the provisions of proposed Section 10804(c) with regard to the employment by the personal representative of a qualified person (an "Agent") to assist the representative in the performance of the representative's ordinary services. In particular, the Committee's concern is about the tax effect to the representative of the Agent's compensation.

THE PROBLEM:

The Committee perceives a problem with respect to the taxation of the representative on the commission "earned" by the representative, without the availability of a corresponding and offsetting deduction for the funds paid by the representative to the Agent. This unfortunate effect, caused by provisions of the Tax Reform Act of 1986, might be alleviated by a statutory amendment.

DISCUSSION:

The structure of proposed Section 10804(c) would require the personal representative to receive the representative's normal commission from the probate estate, and thereafter pay the Agent's fee from the representative's own funds. The representative, therefore, would be taxed on the commission received from the estate. As a result of recent changes in the federal income tax law, the representative might not obtain the benefit of a

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corresponding deduction of the fee paid the Agent from the representative's funds. This may, therefore, create a situation where the representative is taxed on funds which he or she immediately disbursed, without receiving an offsetting deduction for the disbursement. (Compare this to the provisions of proposed Section 10804(b) which permit compensation to experts performing extraordinary services "out of the funds of the estate.")

The problem arises because of the disparity between those expenses which an individual taxpayer is entitled to deduct "from adjusted gross income" as opposed to those expenses which are only allowed as itemized deductions. In order to be deducted from adjusted gross income, the expense must arise from a trade or business carried on by the taxpayer. Generally, where a non-professional fiduciary serves as a personal representative, it is not treated as the conduct of a trade or business. The result is that the expense incurred by the non-professional fiduciary to the Agent employed to perform the representative's duties is only an itemized deduction. The Tax Reform Act of 1986 imposed a 2% floor on the aggregate amount of miscellaneous itemized deductions. That is, itemized deductions for other than interest, taxes, casualty and theft losses, charitable contributions, etc., are only deductible to the extent they exceed 2% of the taxpayer's adjusted gross income. Therefore, to the extent the fee paid the Agent (together with the individual's other miscellaneous itemized deductions) is less than 2% of the individual's adjusted gross income, the individual receives no benefit from the deduction.

We are aware that some commentators argue the payment to the Agent is not subject to the 2% floor since the expense would not have been incurred but for the income generated; however, our recommendation would render the issue moot.

RECOMMENDATION:

This Committee suggests the proposed statute empower the Court to allow and approve a disbursement directly from the probate estate to the Agent designated by the estate representative, not to exceed the personal representative's statutory commission, with a commensurate reduction of the statutory commission, up to the whole thereof. This would prevent the receipt and taxability of the commission to the personal representative; the issue of the corresponding deduction of the payment to the Agent by the personal representative would become moot. The representative would not be taxed on the Agent's fee.

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I have discussed these issues with representatives of the Trust and Probate Department of Security Pacific National Bank who indicate that, where the Bank serves as a probate agent, it has been successful in obtaining in the probate decree an order that all or the applicable part of the representative's commission be paid by the estate directly to the Bank, even though the Bank is not the appointed representative. There is no present statutory authority for such an order. Current and proposed law provide only for the payment to the representative of the statutory commission (see proposed Section 10800(a)). The proposed language of Section 10804(c) would appear to expressly preclude an order of compensation directly to the Agent since the Agent's compensation is to be paid "out of the personal representative's own funds." Based upon the procedure currently followed by Security Pacific National Bank, our recommendation might be considered as, in fact, conforming to current practice.

Thank you for your consideration of these matters.

Respectfully submitted,



DAVID E. LICH, Member
Legislative Committee
Probate, Trust & Estate Planning Section
Beverly Hills Bar Association

DEL/smt

cc: Kenneth Petrulis, Chairman
Phyllis Cardoza, Executive Vice Chair
[PERSREP.LTR:s]