

Memorandum 89-52

Subject: Study L-1029 - Marital Deduction Gifts (Qualified Domestic Trusts)

California law seeks to save gifts that are intended to take advantage of the federal estate and gift tax marital deductions but that are defectively drafted. The current California statute saving defective marital deduction gifts is found at Probate Code Sections 21520-21526. See Exhibit 1. The statute was last revised by the Law Revision Commission in 1987, with the assistance of Robert A. Mills of San Francisco, to bring the statute into conformity with current federal law governing marital deduction gifts.

Mr. Mills has now written to us (Exhibit 2) to point out a recent change in the federal law that may call for supplementation of the California statute. The estate and gift tax marital deduction provisions, Internal Revenue Code Sections 2056 and 2523, have been modified by the new limitation that no deduction shall be allowed if the spouse of the transferor is not a citizen of the United States. IRC §§ 2056(d)(1), 2523(i), enacted by the Technical and Miscellaneous Revenue Act of 1988 (Nov. 10, 1988) and applicable to estates of decedents dying after the date of enactment.

The new citizenship requirement does not apply to any property passing to the surviving spouse of a decedent in a qualified domestic trust. 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.
IRC § 2056A(a).

The new federal law creates problems in California, according to Mr. Mills, because of California's large immigrant population. He observes that it is not uncommon for a California decedent with a substantial estate to leave a surviving spouse who is not a United States citizen. This concern is echoed in Gerstenfeld, *The QDT: New Solution for a New Problem?*, 10 Estate Planning & California Probate Reporter 113 (1989): "Many long-time permanent residents of this country, including many who moved to this country as a result of marriage to a United States citizen, are not citizens. Standard marital deduction estate plans involving such persons are now obsolete and may produce very unfortunate results for the client--not to mention the practitioner who may be blamed for those results."

Moreover, under the new federal law as written, the trust instrument might name a United States citizen or a domestic corporation as trustee, but the trust would not be a qualified domestic trust unless the instrument also happened to include the additional requirement that all trustees be citizens or domestic corporations. This is obviously a problem for marital deduction trusts drafted before the new federal was enacted, as well as for trusts drafted defectively after the new federal law was enacted.

Mr. Mills suggests that the California statute could be supplemented to make it easier to have a qualified domestic trust if one is needed to get the marital deduction. "At the minimum, I think that a California statute could mandate a requirement that all of the trustees be individual citizens of the United States or domestic corporations if that would cause an otherwise unqualified trust to be qualified." To this the staff would add that if the trust instrument names a disqualifying trustee, the disqualifying trustee is 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.

This suggestion could be implemented by the following amendment:

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:

(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 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. 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).

The staff has set this amendment out in the form of a tentative recommendation in Exhibit 3. If the Commission approves the amendment, we will circulate the tentative recommendation for comment.

Respectfully submitted,

Nathaniel Sterling
Assistant Executive Secretary

EXHIBIT 1

Part 5

COMPLIANCE WITH INTERNAL REVENUE CODE

Chapter	Section
1. General Provisions	21500
2. Marital Deduction Gifts	21520
3. Charitable Gifts	21540

For application of Part, see § 21501 and Historical Note thereunder.

CHAPTER 1. GENERAL PROVISIONS

- Section**
- 21500. "Internal Revenue Code" defined.
 - 21501. Application of law to distributions.
 - 21502. Instruments making part inapplicable; incorporation by reference of part provisions.
 - 21503. Formulas to eliminate or reduce federal estate tax; maximum fraction or amount.

For application of Part, see § 21501 and Historical Note thereunder.

Cross References

Application of old and new law, see § 3.

§ 21500. "Internal Revenue Code" defined

As used in this part, "Internal Revenue Code" means the Internal Revenue Code of 1986, as amended from time to time. A reference to a provision of the Internal Revenue Code includes any subsequent provision of law enacted in its place. *(Added by Stats.1987, c. 923, § 101.)*

For application of Part, see § 21501 and Historical Note thereunder.

§ 21501. Application of law to distributions

(a) This part applies to a distribution made on or after January 1, 1988, whether the transferor died before, on, or after that date.

(b) A distribution made on or after January 1, 1983, and before January 1, 1988, is governed by the applicable law in effect before January 1, 1988. *(Added by Stats. 1987, c. 923, § 101.)*

For former provisions relating to distributions in satisfaction of certain bequests, and marital deduction gifts, see § 1030 et seq.

§ 21502. Instruments making part inapplicable; incorporation by reference of part provisions

(a) This part does not apply to an instrument the terms of which expressly or by necessary implication make this part inapplicable.

(b) By an appropriate statement made in an instrument, the transferor may incorporate by reference any or all of the provisions of this part. The effect of incorporating a provision of this part in an instrument is to make the incorporated provision a part of the instrument as

though the language of the incorporated provision were set forth verbatim in the instrument. Unless an instrument incorporating a provision of this part provides otherwise, the instrument automatically incorporates the provision's amendments. *(Added by Stats.1987, c. 923, § 101.)*

For application of Part, see § 21501 and Historical Note thereunder.

§ 21503. Formulas to eliminate or reduce federal estate tax; maximum fraction or amount

(a) If an instrument includes a formula intended to eliminate the federal estate tax, the formula shall be applied to eliminate or to reduce to the maximum extent possible the federal estate tax.

(b) If an instrument includes a formula that refers to a maximum fraction or amount that will not result in a federal estate tax, the formula shall be construed to refer to the maximum fraction or amount that will not result in or increase the federal estate tax. *(Added by Stats. 1987, c. 923, § 101.)*

For application of Part, see § 21501 and Historical Note thereunder.

CHAPTER 2. MARITAL DEDUCTION GIFTS

- Section**
- 21520. Definitions.
 - 21521. §§ 21524 and 21526 not to apply to estate trusts.
 - 21522. Instruments containing marital deduction gifts; construction; acts of fiduciary.
 - 21523. Economic Recovery Act of 1981; instruments intending to maximize allowable marital deduction.
 - 21524. Marital deduction trusts.
 - 21525. Condition in instrument that spouse survive transferor; time limitations.
 - 21526. Liability of fiduciary.

For application of Part, see § 21501 and Historical Note thereunder.

Cross References

Application of old and new law, see § 3.

§ 21520. Definitions

As used in this chapter:

(a) "Marital deduction" means the federal estate tax deduction allowed for transfers under Section 2056 of the Internal Revenue Code or the federal gift tax deduction allowed for transfers under Section 2523 of the Internal Revenue Code.

(b) "Marital deduction gift" means a transfer of property that is intended to qualify for the marital

deduction. (Added by Stats.1987, c. 923, § 101. Amended by Stats.1988, c. 113, § 20.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21521. §§ 21524 and 21526 not to apply to estate trusts

Sections 21524 and 21526 do not apply to a trust that qualifies for the marital deduction under Section 20-2056(e)-2(b) of the Code of Federal Regulations (commonly referred to as the "estate trust"). (Added by Stats.1987, c. 923, § 101. Amended by Stats.1988, c. 113, § 21.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21522. Instruments containing marital deduction gifts; construction; acts of fiduciary

If an instrument contains a marital deduction gift:

(a) The provisions of the instrument, including any power, duty, or discretionary authority given to a fiduciary, shall be construed to comply with the marital deduction provisions of the Internal Revenue Code.

(b) The fiduciary shall not take any action or have any power that impairs the deduction as applied to the marital deduction gift.

(c) The marital deduction gift may be satisfied only with property that qualifies for the marital deduction. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21523. Economic Recovery Act of 1981; instruments intending to maximize allowable marital deduction

(a) The Economic Recovery Act of 1981 was enacted August 13, 1981. This section applies to an instrument executed before September 12, 1981 (before 30 days after enactment of the Economic Recovery Tax Act of 1981).

(b) If an instrument described in subdivision (a) indicates the transferor's intention to make a gift that will provide the maximum allowable marital deduction, the instrument passes to the recipient an amount equal to the maximum amount of the marital deduction that would have been allowed as of the date of the gift under federal law as it existed before enactment of the Economic Recovery Tax Act of 1981, with adjustments for the following, if applicable:

(1) The provisions of Section 2056(c)(1)(B) and (C) of the Internal Revenue Code in effect immediately before enactment of the Economic Recovery Tax Act of 1981.

(2) To reduce the amount passing under the gift by the final federal estate tax values of any other property that passes under or outside of the instrument and qualifies for the marital deduction. This subdivision does not apply to qualified terminable interest property under

Section 2056(b)(7) of the Internal Revenue Code. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21524. Marital deduction trusts

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 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. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

Cross References

Estate trust, this section inapplicable, see § 21521.

§ 21525. Condition in instrument that spouse survive transferor; time limitations

(a) If an instrument that makes a marital deduction gift includes a condition that the transferor's spouse survive the transferor by a period that exceeds or may exceed six months, other than a condition described in subdivision (b), the condition shall be limited to six months as applied to the marital deduction gift.

(b) If an instrument that makes a marital deduction gift includes a condition that the transferor's spouse survive a common disaster that results in the death of the transferor, the condition shall be limited to the time of the final audit of the federal estate tax return for the transferor's estate, if any, as applied to the marital deduction gift.

(c) The amendment of subdivision (a) made by the act that enacted this subdivision is declaratory of, and not a change in, either existing law or former Section 1036.

(Added by Stats.1987, c. 923, § 101. Amended by Stats.1988, c. 113, § 21.5.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21526. Liability of fiduciary

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 2523(f) of the Internal Revenue Code. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

Cross References

Estate trust, this section inapplicable, see § 21521.

CHAPTER 3. CHARITABLE GIFTS

Section

21540. Charitable remainder unitrusts; charitable remainder annuity trusts.

21541. Charitable lead trusts.

For application of Part, see § 21501 and Historical Note thereunder.

Cross References

Application of old and new law, see § 3.

§ 21540. Charitable remainder unitrusts; charitable remainder annuity trusts

If an instrument indicates the transferor's intention to comply with the Internal Revenue Code requirements for a charitable remainder unitrust or a charitable remainder annuity trust as each is defined in Section 664 of the Internal Revenue Code, the provisions of the instrument,

including any power, duty, or discretionary authority given to a fiduciary, shall be construed to comply with the charitable deduction provisions of Section 2055 or Section 2522 of the Internal Revenue Code and the charitable remainder trust provisions of Section 664 of the Internal Revenue Code in order to conform to that intent. In no event shall the fiduciary take an action or have a power that impairs the charitable deduction. The provisions of the instrument may be augmented in any manner consistent with Section 2055(e) or Section 2522(c) of the Internal Revenue Code on a petition provided for in Section 17200. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

§ 21541. Charitable lead trusts

If an instrument indicates the transferor's intention to comply with the requirements for a charitable lead trust as described in Section 170(f)(2)(B) and Section 2055(e)(2) or Section 2522(c)(2) of the Internal Revenue Code, the provisions of the instrument, including any power, duty, or discretionary authority given to a fiduciary, shall be construed to comply with the provisions of that section in order to conform to that intent. In no event shall the fiduciary take any action or have any power that impairs the charitable deduction. The provisions of the instrument may be augmented in any manner consistent with that intent upon a petition provided for in Section 17200. (Added by Stats.1987, c. 923, § 101.)

For application of Part, see § 21501 and Historical Note thereunder.

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March 17, 1989

CA LAW REV. COMM'N

MAR 20 1989

RECEIVED

Mr. Nathaniel Sterling
Assistant Executive Secretary
California Law Revision Commission
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Dear Nat:

Since Congress never rests in churning out further grotesque creatures of the Internal Revenue Code, California lawmakers have a continuing challenge. You are doubtlessly aware of new subsection (d) of 2056 of the Code, disallowing the estate tax marital deduction for property passing to a surviving spouse who is not a United States citizen, unless the property passes to a qualified domestic trust. It seems to me that the "Mills Bill" could be added to, to make it easier to have a qualified domestic trust if one is needed to get the marital deduction. At the minimum, I think that a California statute could mandate a requirement that all of the trustees be individual citizens of the United States or domestic corporations if that would cause an otherwise unqualified trust to be qualified.

Please call me if you would like to discuss this.

Best personal regards.

Sincerely,



Robert A. Mills

#L-1029
Memo. 89-52

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05/26/89

Exhibit 3

Tentative Recommendation
relating to
Qualified Domestic Trusts

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

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).

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 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 practical, 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.

4. See, e.g., Gerstenfeld, *The QDT: New Solution for a New Problem?*, 10 Estate Planning & California Probate Reporter 113 (1989) ("Many long-time permanent residents of this country, including many who moved to this country as a result of marriage to a United States citizen, are not citizens.")

5. Ibid.

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

The Commission's recommendation would be implemented by enactment of the following measure:

An act to amend Section 21524 of the Probate Code, relating to marital deduction gifts.

The people of the State of California do enact as follows:

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

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

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:

(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. 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).