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Volume V, Number 1, August 1983 Page 1

HIGHLIGHTS

6 **Federal Estate Tax**

8 **Federal Gift Tax**
8 *Estate of Miriam B. Kolker*
No annual exclusion for gift to trust distributing $3000 per beneficiary on trustor's birthday

9 **Federal Income Tax**
9 *Hardee v U.S.*
No income to stockholder borrower of corporate interest-free loan
10 *Rosenfeld v Commissioner*
Second Circuit approves gift and leaseback of professional building

13 **Generation-Skipping Tax**
Treasury proposes major revisions

14 **California Developments**

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Creditors' Rights to Reach Nonprobate Assets

by Nancy A. Chillag

Enactment of the new Enforcement of Judgments Act (Stats 1982, ch 1364), effective July 1, 1983, as well as other recent developments, make it appropriate to review the tangled state of California law pertaining to the rights of a decedent's creditors to reach nonprobate assets. Such assets run the gamut from inter vivos trust estates to life insurance proceeds.

The law of creditors' rights affects predeath and post mortem estate planning decisions in a variety of ways. Unexpected client indebtedness arising from last illness medical expenses and convalescent hospital care can seriously disrupt an intended disposition plan where nonprobate assets would have been more suitable for payment of debts than the probate estate. Estate planning actions can inadvertently destroy an asset's apparent immunity from the reach of creditors. Whether property is subject to claims may affect the federal estate tax deduction for administration expenses under IRC §2053. Executors may be required to collect property transferred in fraud of creditors under Prob C §579. In addition, the possibility that an asset may be vulnerable to a future claim of a creditor may dictate probating the asset when the claim is unlikely to be presented in the probate proceeding. This step can be very important in insulating heirs of deceased professionals from claims based on professional malpractice which may be discovered long after death. Finally, estate planners are frequently placed in the awkward position of being asked to counsel clients concerning gifts and other transfers which may be fraudulent as to creditors.

Fraudulent Conveyances

Before discussing the law pertaining to specific types of transfers, it is important to review the effect of the Uniform Fraudulent Conveyance Act (UFCA) (CC §§3439-3439.12). As illustrated by *Headen v*

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Miller (1983) 141 CA3d 169, 190 CR 198, the UFCA affects virtually all kinds of transfers and serves as a qualification to whatever rules otherwise apply.

In *Headen,* the owner of a life insurance policy changed the beneficiary designation from his partner to his wife three months before his death. Decedent's creditors and his partnership sued the surviving spouse to recover the proceeds of the policy, alleging that decedent was insolvent at the time of the change of beneficiary and that the changed designation constituted a fraudulent conveyance. The trial court sustained the wife's demurrer without leave to amend. The appellate court reversed, holding that plaintiffs had stated a cause of action.

Almost any kind of transfer of property rights can result in a fraudulent conveyance. This includes the purchase of life insurance, creation of joint tenancies, transfers in trust, conveyances of remainder interests, and outright gifts. The one type of transfer which arguably cannot be a fraudulent conveyance is a disclaimer. Under California common law, a disclaimer could be fraudulent as to creditors. See *Estate of Kalt* (1940) 16 C2d 807, 108 P2d 401. However, language in the California disclaimer statute (Prob C §§190-190.10) appears to contradict the former rule. The issue should be resolved in the current session of the legislature. The new disclaimer statute (Stats 1983, ch 17) expressly provides that a disclaimer is not fraudulent as to creditors. The chapter will not take effect unless AB 24 (1983) is also chaptered, in which case both bills would become operative on January 1, 1984.

Under the UFCA, the following transfers, when not made for a fair consideration, are fraudulent as to creditors:

1. A conveyance made while the transferor is insolvent or which renders him insolvent. CC §3439.04. "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." CC §3439.02.
2. A conveyance made by a person engaged in or about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital. CC §3439.05.
3. A conveyance made by a person who intends or believes that he will incur debts beyond his ability to pay as they mature. CC §3439.06.
4. A conveyance made with actual intent (as opposed to intent presumed in law) to hinder, delay, or defraud either present or future creditors. CC §3439.07. (Under the other sections, actual intent to defraud or hinder creditors is not a necessary element of a fraudulent conveyance.)

The rights of the creditors of someone who has made a fraudulent conveyance vary depending on whether their claim has matured, and include having the conveyance set aside, restraining the debtor from disposing of property, disregarding the conveyance and levying on the property in the hands of a third party, and appointment of a receiver. CC §§3439.09 and 3439.10. In the case of a deceased debtor, Prob C §579 permits creditors to obtain an order requiring the executor of the estate to bring suit to recover fraudulently conveyed property to the extent necessary to satisfy creditors' claims presented in the probate proceeding.

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There are two important exceptions to the fraudulent conveyance rules. First, a conveyance of property exempt from execution in the hands of the debtor cannot be fraudulent as to creditors. The creditors lose nothing as a result of the transfer. *Headen v Miller* (1983) 141 CA3d 169, 177, 190 CR 198, 203. Second, a conversion of nonexempt property into exempt property is not a fraudulent conveyance. Exemption and homestead laws were created for the protection of debtors. Creditors are not permitted to complain when a debtor uses the rights conferred by the legislature. See *Putnam Sand & Gravel Co. v Albers* (1971) 14 CA3d 722, 92 CR 636. This rule also applies in the case of bankruptcy. The debtor is permitted to use nonexempt property to make an eleventh hour acquisition of exempt property immediately before filing a bankruptcy petition. 11 USC §522(b). See also HR Rep No. 595, 95th Cong, 1st Sess 361 (1977), reprinted in 1978 US Code Cong & Ad News 5787, 6317.

Other Statutes

In addition to the UFCA, several other statutes apply to gifts by insolvent donors. Under CC §1153, a "gift in view of death" can be reached by creditors. *Adams v Prather* (1917) 176 C 33, 41, 167 P 534, 537. In addition, under CC §3440 a transfer of personal property without a change of possession is "conclusively presumed fraudulent and void as against the transferor's creditors." Practitioners should also be aware of Welf & I C §14015. Frequently, elderly clients faced with enormous convalescent care costs will attempt to give their property to their children in order to qualify for Medi-Cal without consuming the estate or incurring a lien for reimbursement on their real property. Under Welf & I C §14015, persons who have made such gifts may be disqualified from Medi-Cal for a period based on the capital value of the transferred property. The validity of the statute was formerly open to dispute but, under §132 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub L 97-248, 96 Stat 371), states are expressly permitted to consider property transferred without consideration as being assets of the donor for purposes of determining eligibility. 42 USC §1396p(c). Finally, Welf & I C §14009.5 gives the state Department of Health Services rights to reach property for reimbursement of Medi-Cal payments which are not available to other creditors generally. "[T]he department may claim against the estate of the decedent, or against any recipient of the property of that decedent by distribution or survival an amount equal to the payments for the health care services received." The statute only applies to services rendered after age 64 and does not apply if decedent was survived by a spouse or children under age 21.

Life Insurance

Assuming there has not been a fraudulent conveyance, a decedent's creditors normally cannot reach the death benefit of a life insurance policy unless they levy on the policy before death. Express authority for this proposition is sparse, but it appears to be the common law rule, and *Headen v Miller* (1983) 141 CA3d 169, 190 CR 198, and its predecessors have consistently followed it by implication.

When there is a fraudulent conveyance resulting from a change of beneficiary while insolvent, a question arises regarding the percentage of the proceeds that can be reached. Under *Headen,* the creditor could reach the entire proceeds of the policy less the portion attributable to the statutory exemption under former CCP §690.9. That section provided a complete exemption for insurance policy rights attributable to payment of annual premiums of $500 or less, or an exemption proportional to the ratio of $500 to the annual premium paid in excess of that amount. This formula may no longer apply. Under the new Enforcement of Judgments Act, unmatured life insurance policies are completely exempt except for the loan value. The loan value itself is exempt to the extent of $4000 ($8000 for a married couple). CCP §704.100. Arguably, *Headen* is already obsolete and creditors proving a fraudulent conveyance will be limited to recovering the loan value in excess of the statutory limit. This would be the logical result of applying both the rule that there cannot be a fraudulent conveyance of exempt property and the new statute's provision for a complete exemption excluding the loan value. Under the same theory, it can also be argued that recovery by a creditor who levies before death is limited to the amount he would have received if the debtor had survived.

Trusts and Life Estates Not Established by Debtor

If decedent was the beneficiary of a trust created by another without consideration being given by decedent, creditors will normally have no right to reach the trust estate. This rule assumes decedent's interest terminated at his death. The same rule applies to a legal life estate. However, depending on the terms of the trust instrument, certain assets of the trust may belong to decedent's estate. For example, it is common for the estate to be entitled to undistributed income, and a trust may expressly provide for distribution of remaining corpus to the beneficiary's estate. In the case of a legal life estate in income-producing property, the probate estate will usually be entitled to undistributed income earned before death. It also appears that, in appropriate cases, decedent's executor may recover from the trust money which a trustee would have been

required to pay decedent under the terms of the trust if decedent had lived (*e.g.*, support for the period immediately preceding death). See *Elliott v Superior Court* (1968) 265 CA2d 825, 71 CR 807. *Elliott* further suggests that, if a trust is established for purposes of support and maintenance, the executor can compel the payment of funeral and last illness expenses.

There is a major qualification to the basic rule. If the deceased beneficiary was given a testamentary general power of appointment (or a general power of appointment otherwise exercisable at death), creditors may reach the property subject to the power to the extent decedent's estate is insufficient to satisfy claims and the expenses of administration of the estate. CC §§1390.1-1390.5.

Revocable Inter Vivos Trusts

The liabilty of revocable trust estate assets for a decedent trustor's debts is at best undecided in California. *Estate of Heigho* (1960) 186 CA2d 360, 9 CR 196, has been cited for the proposition that a decedent's creditors cannot proceed against the inter vivos trust estate unless the transfer of property to the trust was one in fraud of creditors. See 1 California Decedent Estate Administration §4.60 (Cal CEB 1971). However, the unusual facts of this case presented numerous issues of estoppel and waiver that weaken the authority of any general rule.

It is arguable that revocable trusts are subject to attack by creditors under several theories. First, whenever a substantial portion of the client's assets have been transferred to the trust, the risk of a fraudulent conveyance is very high. For an elaboration of this argument and its effect on claiming federal estate tax deductions under IRC §2053 for post mortem expenses incurred by a trustee of a living trust, see Wyatt, *Selected Administrative Problems,* Estate Planning Institute 1979 §4.19 (Cal CEB 1979).

A second avenue of creditor attack is based on the theory that the power to revoke or amend a trust constitutes a general power of appointment. If the power to revoke or amend is a general power of appointment, creditors can reach the trust under CC §§1390.3-1390.5 (discussed above). At least two state courts have held that the power to revoke a trust is a general power of appointment. See *State Street Bank & Trust Co. v Reiser* (Mass App 1979) 389 NE2d 768, and *Johnson v Commercial Bank* (Or 1978) 588 P2d 1096. For a discussion of this theory and a trust drafting strategy for coping with the uncertainty of the law in this area, see Dennis-Strathmeyer, *Simple Probate-Avoidance Trusts: Higher Stakes and Old Problems,* 4 CEB Est Plan R 69, 73 (1983).

Finally, a creditor might simply advance the argument that it is against public policy to permit a man to retain total control of his property during his life in a way which prevents his creditors from reaching it on death. Authority for this position is contained in the following discussion of irrevocable trusts.

None of these arguments have been ruled on in California, and the right of a decedent's creditors to reach the trust must be viewed as an open question.

Irrevocable Trusts

In the absence of a fraudulent conveyance, a transfer to an irrevocable trust is normally a completed gift, and the grantor's creditors will not be able to reach the trust estate. This general rule requires substantial qualification. It is well settled that one cannot effectively create a spendthrift trust in favor of oneself. Restatement (Second) of Trusts §156 (1957). "It is against public policy to permit a man to tie up his property in such a way that he can enjoy it but prevent his creditors from reaching it, and when a settlor makes himself a beneficiary of a trust any restraints in the instrument on the involuntary alienation of his interests are invalid and ineffective." *Nelson v California Trust Co.* (1949) 33 C2d 501, 202 P2d 1021. If the trustor retains the beneficial interest in the property, it will be treated as his own and may be levied on by his creditors. *McColgan v Magee, Inc.* (1916) 172 C 182, 155 P 995. It is not clear how far courts might go in extending this doctrine, but dicta in one case suggest that it might be applied when a trust can be used for the support of the trustor's dependents. See *Sheehan v Michel* (1936) 6 C2d 324, 57 P 127. The doctrine could arguably be applied when the trustor retains powers to sprinkle income among his dependents together with similar powers to invade and appoint corpus for their benefit. (Obviously, if a general power of appointment is retained creditors can reach the property under CC §§1390.1-1390.5 as discussed above.) It should be noted that all of these cases involved living trustors, but nothing in the rationale of the decisions would preclude application of the same public policy argument after a trustor's death.

Even if the entire trust corpus is not treated as belonging to the trustor, the retained interests themselves are subject to execution and levy. Such interests as a reversionary interest under a Clifford trust are property of the debtor.

Joint Tenancy Property

Unless the creation of the joint tenancy involved a fraudulent conveyance (presumably a risk if substantially all assets are held in joint tenancy), decedent's

creditors cannot reach joint tenancy property unless they levied on the property before the debtor's death. *Zeigler v Bonnell* (1942) 52 CA2d 217, 126 P2d 118.

Although the rule itself is subject to little qualification, a substantial amount of property held in joint tenancy form may not be joint tenancy property. The form of title merely creates a presumption. Spouses frequently hold community property in joint tenancy form. If a creditor can prove the property was actually community property, both halves of the property may be liable for decedent's debts under CC §§5116 and 5122. The burden of proof is rather easily met if the parties have recorded a community property declaration or such a declaration is contained in a will filed for probate (assuming a similar declaration appears in the survivor's will). Similarly, there may be instances when a creditor could prove that the joint tenant was a signatory to a financial institution account for purposes of convenience.

Finally, elderly depositors frequently create joint accounts with an adult child for the combined purpose of passing the property at death and having the child pay the parent's expenses. There is no intention that the child has any right to use the property for his or her benefit during the life of the parent. This arrangement does not defeat the validity of the right of survivorship in the absence of proof that the right of survivorship was not intended, but the account becomes subject to the same fraudulent conveyance arguments applicable to a revocable trust.

Legal Life Estates

Unless the remainder interest was created by a conveyance by the debtor which was fraudulent as to creditors, the creditors of a life tenant cannot reach any interest in the property after the death of the life tenant. Under common law, the interests of a life tenant and a remainderman are treated as wholly separate estates, and neither party has a property interest in the estate of the other. This conceptual framework is recognized in CC §1108, which provides that a purported voluntary conveyance of more than a life estate by the life tenant only conveys the estate which the grantor may lawfully transfer. At least when the decedent did not create the life estate, it appears that creditors cannot reach the property after death even when the life tenant had the power to consume the property. See *Adams v Prather* (1917) 176 C 33, 167 P 534.

Totten Trusts

It does not appear that the California courts have ruled on the rights of creditors to reach a financial institution deposit in which the depositor purports to hold the account in trust for another. It is well established that these "tentative trusts" are valid and the beneficiary is entitled to the account on the death of the depositor. In New York, the courts have held that creditors may reach such accounts to the extent the assets of the estate are insufficient to satisfy claims. See *Matter of Halbauer* (1962) 228 NYS2d 786. Whether the same result would be reached in California would appear to depend on what analogy a court chooses to adopt, but substantial optimism is required to believe that such accounts will be held immune from creditors. As with all revocable trusts, such accounts are vulnerable to arguments that they are fraudulent conveyances or constitute general power of appointment property. Further, the beneficiary is not vested with a separate estate akin to that held by a remainderman. Presumably, whatever rule is eventually adopted will equally apply to the new pay-on-death accounts authorized by newly enacted Fin C §852.5.

Retirement Benefits

The new Enforcement of Judgments Act has clarified many issues regarding creditors' rights to reach interests in qualified plans, Keogh plans, and Individual Retirement Accounts.

Public entity plans. The Act provides a complete exemption for retirement plans of public entities, with limited exceptions for spousal and child support claims. The exceptions only apply to amounts currently payable to the beneficiary. The exemption extends to returned contributions. CCP §704.110.

Private plans. The exemption for private plans is essentially the same as for public entity plans. CCP §704.115. It is not necessary for the plan to be a qualified plan under the Internal Revenue Code.

Self-employed (Keogh) plans and IRAs. Under the new Act, Keogh plans and IRAs enjoy the same protection as qualified plans, but only to the extent that the value does not exceed the amount necessary to provide for the support of the judgment debtor and his dependents when the judgment debtor dies. In determining the amount of the exemption, the court is required to take into account the tax effect of the levy. Before the Act, there may have been no protection for Keogh plans and IRAs. Although Keogh plans contain the same prohibitions against assignment and alienation as corporate qualified plans, the effect of the provision has been held to be a matter of state law. Because one cannot create a spendthrift trust for one's own benefit in California, creditors could reach these assets. See *Goff v Taylor* (5th Cir 1983) 706 F2d 574, in which the debtor was denied an exemption in bankruptcy under Texas law.

Postdeath application. A debtor cannot claim an exemption after death. It appears that a surviving spouse can claim an exemption for community property. CCP §703.020. In other cases, however, it does not appear that the new statutes exempting pension plans apply to postdeath situations. One can only speculate what courts will do if a creditor seeks to reach a plan after death.

For survivor annuities under corporate qualified plans, the rights of the parties are analogous to those under life insurance contracts. It seems reasonable to assume that creditors cannot reach the annuity. More complicated questions are posed by IRAs. An IRA is similar to a revocable trust (not to mention pay-on-death accounts and Totten trusts). However, such analogies are hardly perfect in light of the tax penalties imposed on prohibited transactions.

DEVELOPMENTS

Federal Estate Tax

IRC §2031: Valuation

Nonvoting stock of close corporation is not entitled to discount in estate containing controlling interest of voting stock.

Estate of Curry v U.S. (7th Cir 1983) 83-1 USTC ¶13,518, 51 AFTR2d 83-1232

B. L. Curry owned 800 of the 1500 voting shares of common stock in B. L. Curry & Sons, Inc., and 1360 shares of nonvoting stock. On the federal estate tax return, the executor assigned a substantially lower value per share to the nonvoting stock. The Service disputed both valuations and assessed a deficiency. The estate paid the additional taxes and sued for a refund. *Estate of Curry v U.S.* (SD Ind 1982) 549 F Supp 47 (4 CEB Est Plan R 128 (1983)). At trial, the jury found the value of the stock to be the value claimed by the petitioner's expert witness. On cross-examination at trial, the expert admitted that his analysis assumed the voting stock and the nonvoting stock would be sold separately. Further, his valuation was substantially lower than the admitted liquidation value of the corporation, which he had calculated as the asset values less a 25 percent discount for liquidation expenses.

On appeal, the government challenged the failure to give two proffered jury instructions. It also attacked two instructions given over the government's objection.

The court of appeal first ruled that the trial court had erred in failing to instruct the jury that the voting and nonvoting stock should be given the same value. Relying on *Ahmanson Foundation* (9th Cir 1981) 674 F2d 761 (3 CEB Est Plan R 84 (1982)), the court held that an estate cannot hypothetically bifurcate assets for valuation purposes. Here, the estate was attempting to discount the value of the nonvoting stock on the ground that the shares were not part of a controlling interest. If bifurcation were permitted, executors would "invent elaborate scenarios of disaggregated disposition in order to minimize total value."

Second, the court ruled that the trial court had properly refused to instruct the jury that the minimum value it could assign the stock was its liquidation value. The proffered instruction was based on the premise that the controlling stockholder had the unfettered power to liquidate the corporation. However, it is settled law that the power of a controlling shareholder is subject to fiduciary constraints. The jury could not be forbidden from concluding that the full liquidation value could not be realized because of those constraints.

Third, the court erred in instructing the jury that it could place greater emphasis on earning power and dividend payments than liquidation value if it found that the corporation was prosperous and the chance of liquidation remote. Valuation is to be determined objectively, based on what a hypothetical willing buyer would pay a hypothetical willing seller. The subjective intentions of the deceased were not relevant.

Finally, the trial court properly instructed the jury that stock sale agreement restrictions contained in the articles of incorporation could be considered in valuing the stock. Although the controlling shareholder appeared to have the power to amend the articles, this power was subject to the same fiduciary constraints as the power to liquidate.

Because of the jury instruction errors, the judgment was vacated and the case was remanded for a new trial.

Comment: Because the underlying judgment was vacated, the taxpayer was no longer a prevailing party. Therefore, the court also vacated an award of $39,000 in attorneys' fees under the Equal Access to Justice Act (28 USC §2412(d)(1)(a)) without further comment. A dissenting opinion argued that there was sufficient evidence in the record to enter a modified judgment regarding the value of the stock. This would have permitted review of the attorneys' fees award, which the dissent argued should have been vacated. According to the dissent, valuation of stock in small, closely