September 2, 1955

Memorandum to the Commission

Subject: Inheritance and Gift Tax Law Study.

I have received a communication from a lawyer friend whose opinion I solicited concerning the Commission's assignment to study the possibility of achieving conformity between the State inheritance and gift taxes and their Federal counterparts. My friend has the following to say:

"Since last writing to you I have given a little further thought to the problems presented by ACR No. 33.

"The first thing I discovered was that I do not know very much about the inheritance tax law, particularly the administrative procedures involved. I have therefore taken the liberty of talking the matter over with George Cronin and Bill Farrell of our office, who as you know are much closer to these problems than am I, and whatever merit there may be in any of the suggestions I have to make is largely attributable to their thinking.

"I should preface what I have to say with the thought that you will no doubt consider some of the comment as an invasion of the "policy field", but I thought the simplest way to handle the matter was to set down my thoughts and let you make what use of them you can.

"1. The plain fact is that your initial memorandum correctly poses the one overriding problem involved, namely, the fact that California has an inheritance tax law which operates on fundamentally different premises than the estate tax law, and there is a policy question as to whether California should switch to an estate tax law. The more I look at the problem the more it seems to me your committee could perform a useful function by pointing out some of the policy considerations involved for the benefit of the legislature. In this

connection I think you might bear in mind the following fact: While California has an inheritance tax law under which the tax is determined not only by the amount of property involved but by the relationship of the devisee to the decedent, and while this is apparently a policy decision on the part of the lawmakers, the policy is departed from in the case of the so-called "pick-up tax". As you know, Sections 13441 and 13442 of the Revenue and Taxation Code provide that if the maximum state tax credit allowed by the federal estate tax law exceeds the inheritance tax as computed under California law, then a "pick-up estate tax" is imposed, measured by the difference. The net effect is that the final tax burden is measured by the maximum state tax credit allowed under the federal estate tax law. The net effect of this is that, in a substantial number of estates with a value in excess of $500,000, California does impose an estate tax measured by the maximum credit allowed under the federal estate tax law. The main reason for this is that the inheritance tax law allows a deduction for federal estate taxes paid, and the inheritance tax is imposed upon the residue. In large estates, the federal estate tax burden is so large that it reduces the amount subject to inheritance tax to the point where the inheritance tax becomes less than the maximum state tax credit allowed under the federal estate tax law (the maximum state tax credit is based upon the entire estate without deduction for federal estate taxes). It is no doubt true that most estates do not exceed $500,000, but a surprising number do (the Controller probably has figures on this), and I think this situation points up the fact that the "basic policy" behind the inheritance tax law is not so basic as it might

appear, since that policy is only adhered to in the smaller estates.

"The result of the foregoing is that, after going through all the mechanics of determining the inheritance tax, the ultimate tax which is paid bears no relationship to the inheritance tax as so determined.

"2. I think the second fundamental difference between the two taxes is that the federal estate tax is a self-assessed tax whereas the California inheritance tax is not self-assessed. I think you will find that many lawyers prefer the inheritance tax procedure because it transfers the burden from their shoulders to the appraiser's and the controller's office. Likewise, if the inheritance tax were changed to a self-assessed tax there would probably be a good deal of opposition on the part of the inheritance tax appraisers and the controller's office. It might, however, be possible to eliminate some of the opposition on the part of the appraiser's and controller's offices by converting their job into an auditing or reappraisal function, but I think any such change as this would be ridiculous unless a basic change from inheritance tax to the estate tax were made. My only thought is that it might be easier to make the switch-over from the inheritance tax to the estate tax if some provision were made for keeping alive the appraiser's and the controller's function -- not because this is the best way to handle it but because of the practical politics involved. Obviously, the best procedure would simply be to have a self-assessed estate tax with the same type of auditing procedure as that used by the Federal Government.

"3. Assuming no fundamental change is to be made in the California inheritance tax, I think there are certain changes which might be made in

the interest of simplicity. The first of these is to convert the present California marital exemption contained in Section 13805 of the Revenue and Taxation Code from an exemption to a deduction. As the law now stands, since the concession for property passing to a spouse is cast in the form of an exemption, the balance of the property passing to the surviving spouse in excess of the marital exemption is taxed at higher rates than it would be if a marital deduction was provided. For example, if a husband has $200,000 of separate property and leaves it all to his wife, she would be entitled to a $100,000 marital exemption and the balance (after the specific $24,000 exemption) would be subjected to tax in the 7% bracket. This seems to us to be a departure from the basic theory of the marital deduction. If the marital exemption were a deduction, then the remaining property passing to the surviving spouse would under Section 13404 of the Revenue and Taxation Code be subjected to tax at the lower rates, commencing at 2% (after deducting the specific exemption contained in Section 13015 of the Code).

"Another feature of the present inheritance tax law which creates complications is the necessity of obtaining a refund of tax where a higher tax has been paid based on the highest rate possible on a transfer subject to a contingency. See Section 14411 of the Code. Where property is transferred to A for life with remainder over, it is necessary in the usual case either to pay a tax based on the highest contingency possible under the terms of the trust and then get a refund or refunds as the facts unfold in later years, or to compromise the tax at the time it is initially paid. This complication in the inheritance tax law is of course only a phase of the whole problem of taxing on the basis of the amount and the relationship of the beneficiary,

and if a major change in the law is not to be made, it probably is immaterial.

"Another problem relates to transfers in contemplation of death. The California cases are not entirely in accord with the federal cases. This is the kind of confusion that seems utterly unnecessary even under the present statute.

In conclusion I think I might quote what Bill Farrell had to say after considering this problem:

> 'To me one thing stands out, and that is that it is very undesirable to attempt to make the state and federal laws conform when there are such major differences inherent in the two systems. It appears to me that California should either adopt an estate tax law or should forget the federal law entirely and seek to establish a stable state law, with changes being made therein only where some basic change appears for good reason to be warranted. The present system of attempting to copy all of the technical federal changes without adhering to the basic federal pattern results in untold confusion. I believe California should either go all the way or drop the whole business of copying the federal law, and simply pursue its own course.'

"I note that the Law Revision Commission is scheduled to have a meeting at the Bar Convention, and perhaps we can have a chat at that time. I take it that this communication is considered confidential. I wouldn't want to be placed in the position of posing as an expert on the California inheritance tax law, particularly if toes are being stepped on."

Respectfully submitted,

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Executive Secretary