ORANGE Bank&Trust COMPANY

ESTATE PLANNING REPORT

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PLANNING THOUGHTS

When is a grandchild not a grandchild?

In 1980 Peter Bing created six almost identical irrevocable, 30-year trusts. The first trust was for his first future grandchild (Peter had no grandchildren at that time), the second for his second grandchild, and so on. The trusts were initially each funded with $15,000. The record is silent on additional trust contributions, or how large the trusts were when they terminated in October 2020.

Peter had two children, Mary and Stephen. Mary's two children each were entitled to a trust. Stephen had led a less conventional life. After he had reportedly inherited $600 million from his grandfather at age 18, Stephen dropped out of college. He reportedly dated supermodels and actresses, including Farrah Fawcett, Sharon Stone, and Elizabeth Hurley. Stephen fathered two children out of wedlock, Damian Hurley with Elizabeth and Kira Kerkorian with Lisa Bonder, and had no other children. He initially denied paternity in both cases, but DNA tests ultimately proved he was the father, ending the dispute. Stephen had no contact with his offspring as children, met Kira when she was an adult, and apparently never met Damian at all.

Peter acknowledged Mary's children to be his grandchildren, but he denied that status to Stephen's children. To make his wishes known to the trustee, on September 18, 2018, Peter signed a written declaration, stating, "when I created the 1980 [Grandchildren's] Trusts, I believed that they would not benefit any person born out of wedlock unless that person had lived for a substantial period of time while a minor as a regular member of the household of the natural parent who is a child of mine. I . . . am executing this Affid[av]it to ensure that my intent in this regard is clear." He claimed that this was his intent when the trusts were created, not simply an attempt to disinherit two of his descendants.

The court case

With Peter's declaration in hand, the trustee sought a legal opinion about whether Stephen's children had any legal interests in the trusts. Counsel said that it was reasonable, under California law, to exclude from the class of "grandchildren" those who were born out of wedlock and never resided as a regular member of Stephen's household. The trustee filed a petition to seek approval of his conclusion that only Mary's children were trust beneficiaries. Stephen's children opposed the petition.

The lower court dismissed Peter's affidavit as "irrelevant" and held that the term "grandchild" was not ambiguous. All four children were grandchildren, and all would inherit.

The appeal

The California Court of Appeal adopted a narrower rule for evaluating the trustee's request [*Ellis v. Hurley*, c/w B300806 (Cal. Ct. App. Nov. 20, 2020)]. The trust authorized the trustee to interpret the terms of the trust, and the exercise of that power will be upheld if it is "reasonable." Two elements of extrinsic evidence led the Court to conclude that the trustee was reasonable.

First, Peter's declaration in 2018, although not determinative, is relevant, contrary to the lower court's decision. The idea that children born out of wedlock did not have inheritance rights from their biological grandparents was a common understanding of the law in 1980. It is possible that Peter did not feel the need to state the obvious, and did not consider a technical definition of "grandchild" to be needed.

Second, California Probate Code Section 21115 is consistent with the trustee's conclusion. "In construing a transfer by a transferor who is not the natural parent, a person born to the natural parent shall not be considered the child of that parent

unless the person lived while a minor as a regular member of the household of the natural parent or of that parent's parent, brother, sister, spouse, or surviving spouse." Kira and Damian did not meet this requirement. This was not the law when the trust was created in 1980, but it was enacted in 1983.

The Court concluded: "Looking at it another way, we underscore that we are not interpreting the trust document itself, but only determining whether the trustee's interpretation of "grandchild" is a reasonable one. To say that it is not reasonable would be to say that, three years after the trust was executed, the Legislature adopted a rule of construction which was, at the time, not a reasonable reflection of the general intent of trustors. This we cannot do."

The result is that Mary's two children will share all six trusts.

Several questions suggest themselves. Why did Peter fund irrevocable trusts for unborn beneficiaries? This is not a usual estate planning strategy—was he trying to avoid future transfer taxes? Why did Stephen's grandfather not use a trust to protect Stephen's inheritance? Reportedly he squandered the $600 million, and was left with only $300,000 when he committed suicide in 2020.

CASES AND RULINGS

Executor's assertion of ignorance as a defense to a failure to file an estate tax return survives a motion to dismiss.

Frank T. Leighton et al. v. United States; No. 1:21-cv-00840

David Leighton's sons, Frank and David Jr., were nominated as co-executors after David Sr.'s death in 2017. David Jr. refused the nomination to serve, leaving Frank as the sole executor. Frank diligently sought out professional advice for administering the estate, which he expected to be worth $1 million to $2 million. He properly filed the decedent's final income tax return and was advised that no estate tax return would be needed if the estate did not exceed $5.49 million. Accordingly, he let the time for filing an estate tax return expire without filing a return.

About two years after David Sr.'s death, David Jr. revealed that a substantial trust had been created and funded with more than $5 million in assets, and a gift tax return had been filed reporting the transfer in 2012. Frank promptly arranged for the preparation of an estate tax return and paid estimated taxes, penalties, and interest on the overdue filing. He paid too much, and the IRS refunded an overpayment of roughly $50,000.

The IRS calculation included a late-filing penalty of $85,000. Frank objected that the penalty was improper, as he had acted reasonably with all the information that he had been given about his father's assets and giving history. When the IRS failed to respond to his request for abatement, he took the matter to the Court of Federal Claims.

The IRS moved to dismiss, arguing essentially that executors have no defense against failing to file a return. The Court rejected the motion, holding that the key question to be settled by a trial is "should the Executor or his tax advisors have known about the Decedent's funded trusts prior to their unveiling in 2019?"

Had David Sr. simply survived to 2018, his estate would have been free of estate tax. Given that Frank took the initiative to call the failure to timely file to the attention of the IRS, it would seem to be a better tax policy to not impose a penalty so as to encourage forthrightness in taxpayers.

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Putative donee is not responsible for an erroneous gift tax payment.

Ronald H. Pratte v. Jeffrey Bardwell et al.; No. 2:19-cv-00239

Businessman Ronald Pratte hired Jeffrey Bardwell in 2001 to manage a Phoenix lumberyard. During the next four years, the two became close friends. Ronald sold his construction business. He then met with Jeffrey and four other men at the Las Vegas airport. At that meeting, he gave each man a check for $2 million, and expressed the wish that each would start a home construction business. Ronald reported the transfers as taxable gifts and paid the gift taxes on them. No, it's not the setup for a Hollywood movie—this really happened.

Ronald claims that, in exchange for the check, Jeffrey had promised to work for him for the rest of Ronald's life. Jeffrey counters that he made no such promise and that he understood the transfer to be an unrestricted gift. Ronald filed a lawsuit for breach of contract, and among the damages he claimed was his payment of gift taxes. Both sides moved for summary judgment.

The trial court held that the pleadings were sufficient to allow a jury to conclude that there had been an enforceable contract. However, if there was a contract, then there was no gift, and no

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need to pay the gift tax. Ronald apparently thought he had paid the gift tax for Jeffrey, but the obligation to pay the tax falls on the donor, not the donee. The court dismissed any damage claim based upon the erroneous gift tax payment.

Ronald might look to the IRS for a refund of the gift tax, but the statute of limitations has likely expired.

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An amended will in violation of a mutual will contract is admitted to probate, but the contract claim of disinherited beneficiary survives.

Estate of McHugo, 237 A. 3d 1239 (Vt. 2020)

Patricia and John Bixby had three children together before their divorce in 1978. Despite no longer being married, in 1997 the couple executed mutual wills in Arizona that included this language: "This Will is executed in consideration of a mutual Will simultaneously executed by [the other] and the parties have agreed not to revoke or alter these Wills except with the mutual consent of both." Each will provided for lifetime support of the surviving ex-spouse, with the remainder divided among the three children.

In 2006, while a resident of Vermont, Patricia executed a new will, disregarding her 1997 promise. The new will disinherited one child and the ex-spouse. John died in 2010, mooting the issue for him. Patricia died in 2016. The two favored children offered the 2006 will for probate, and the disinherited one argued for the 1997 will because John had not consented to the revocation.

The Vermont appellate court holds that the revocation of the 1997 will by the execution of a new one in 2006 was effective, and the later will was admitted to probate. However, the court also held that contracts for testamentary dispositions are enforceable in Vermont, so the disinherited child may make a claim for damages for the violation of the contract.

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Non-willful FBAR penalty is not extinguished at death.

U.S. v. Amarjit Gill; No. 4:18-cv-04020

Jagmail Gill became a green card holder and immigrated to the U.S. in 1984. Jagmail became a U.S. citizen in 2008. He was financially successful, and accumulated foreign accounts with balances from $7.6 million to $18.1 million. Unfortunately, from 2005 to 2010 he did not comply with the FBAR (Foreign Bank Account Report) reporting requirements. The IRS assessed an FBAR penalty of $740,848 on Jagmail. The penalty was stipulated to be non-willful, perhaps because all income taxes had been paid and only the reporting was deficient. The Service later assessed another $55,304 penalty on Jagmail's wife, Amarjit.

Unfortunately, Jagmail died from complications of COVID-19 in April 2020. Settlement of his estate was delayed by the pandemic. After Amarjit was named personal representative, the estate argued that the FBAR penalty was extinguished by Jagmail's death.

Whether the penalty survives the penalized party depends upon whether the penalty is primarily remedial or penal. Remedial penalties survive, penal punishments do not. In what the District Court conceded was a "close case," the non-willful penalty was determined to be remedial, and so did not die with Jagmail.

WASHINGTON TALK

Secure 2.0 makes progress. H.R. 2954, Securing a Strong Retirement Act of 2021, passed the House on a voice vote in May. The legislation follows up on the SECURE Act, providing more changes for qualified retirement plans and retirees. Two bills in the Senate on the same subject are S. 1770 and S.1703. Key items included in one or more of the proposals include:

- automatic enrollment;
- automatic increases in contribution rates;
- phasing in an increase in the age for Required Minimum Distributions from the current 72 to 75;
- enhanced saver's credit;
- increased catch-up contributions for older workers.

In the House bill the larger catch-up contributions are required to be Roth contributions; that is, there is no immediate tax benefit but future withdrawals will be tax free. That bill also would allow employers to designate matching contributions as Roth contributions. These changes were scored as raising government revenue by $26.1 billion over ten years, helping to make the House bill revenue neutral. This scoring is possible because most of the revenue shortfalls of the Roth contributions fall outside the 10-year budget window, while the taxes paid on the contributions are within the window.

The essential elements of these bills appear to enjoy bipartisan support, but it is not clear that Congress will get to them this year.

On another retirement note, some members of Congress are concerned that rich people are getting too much benefit from the IRA rules. Finance Committee Chair Ron Wyden of Oregon reported at a meeting in July that nearly 29,000 Americans have IRAs worth more than $5 million. Some 497 people have $25 million or more in their retirement accounts, totaling $77 billion.

How is that possible? Venture capitalists are able to contribute start-up company stock to an IRA, and they do so when the stock has very little value and is not available to the public. They may do this with many different companies, hoping that some will explode in value—and evidently, some have. If the stock was placed in a Roth IRA, those gains will never be taxed.

Although the legislators want to curb such developments, they have not yet announced a mechanism for doing so.

The IRS and the executors of the Prince estate have compromised on the taxable value of the late singer's real estate. They seemed to have split the difference—where the estate reported a value of $15.7 million for nine real estate parcels and the IRS countered with $21.4 million, both sides settled for $17.7 million.

The more difficult valuation questions still lie ahead, concerning the value of music royalties and Prince's likeness. Where the executor reported a total estate value of $82 million, the IRS tally came to $163 million, and a valuation understatement penalty of $6.4 million was added for good measure.

Three of the six heirs to the Prince estate have sold their interests to New York music company Primary Wave for an undisclosed amount.

All 50 Republican Senators signed a July 21 letter to the White House in opposition to President Biden's proposal to eliminate basis step-up at death, except for an exemption for the smallest estates. Such a change would be "a new backdoor death tax" that would cripple the economic viability of family farms and small businesses, according to the letter. The end result would be further consolidation of major agribusinesses.

Democrats remain supportive of the President's ideas, however, and reportedly are looking for ways to protect family farms and family-owned businesses from the more severe effects of the new rule.

This year the IRS has opened up its Identity Protection PIN program to all taxpayers. In a July release [IR-2021-158] the Service encouraged all professional tax preparers to tell their clients about the program and encourage greater participation. Tax preparers are not allowed to request the PINs on behalf of their clients; every taxpayer must take the initiative to get one.

The Identity Protection PIN is a six-digit number and is good for only one calendar year. The IP PINs are available at https://www.irs.gov/identity-theft-fraud-scams/get-an-identity-protection-pin.

How to encourage more estate planning. Although the benefits of thoughtful estate planning far outweigh the costs, a remarkable number of people continue to put off seeing a lawyer about having a will drafted. The problem was exacerbated during the pandemic, when in-person meetings with attorneys were sharply curtailed.

In a July article in *Tax Notes*, law professor Margaret Ryznar suggested that more incentives for creating a will should be enacted. One approach could be a tax credit for making a will. She speculated that a $50 credit would be enough to push some otherwise reluctant property owners to schedule a meeting with their lawyers. To reduce the cost to the government, the credit could be limited to first-time will creators (along the lines of the first-time home buyers credit), or it could be phased out at higher incomes.

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