Beverly Hills Bar Association – Trusts & Estates' Section

Legal Updates for August of 2018

Case Updates

Cochrum, Personal Representative v. Costa Victoria Healthcare, LLC et al (Filed July 12, 2018) Case Number G052934, Fourth Appellate District, Division Three of Court of Appeal of the State of California (Isolated incident of negligence insufficient to establish Elder Abuse Act violation.)

Harvey Cohoon was residing in a skilled nursing facility while recovering from injuries sustained in falls that ultimately resulted in the diagnosis of treatable colon cancer. Although for 19 days Mr. Cohoon progressed well, he subsequently developed problems swallowing. He was placed on a restricted diet with orders for supervised meals, but the appropriate forms were not completed and the kitchen was not advised of the change. Mr. Cohoon was served a dinner that did not comport with the restricted diet and was not supervised. Twenty minutes after being served dinner, Mr. Cohoon was found in respiratory arrest. In attempts to intubate Mr. Cohoon, the paramedics removed large pieces of chicken from Mr. Cohoon's airway, as did the emergency room doctor. Mr. Cohoon suffered brain damage from lack of oxygen and died the following day.

Cochrum, as the representative of Mr. Cohoon's estate and as his personal representative sued for elder abuse, negligence, violation of the patients' bill of rights and wrongful death and alleged that insufficient staffing and training recklessly caused Mr. Cohoon's death. The jury returned a verdict on all counts (other than the patient's bill or rights claim, which had settled before trial). The trial court granted the defendants' motion for judgment notwithstanding the verdict as to the elder abuse claim on the grounds that there was no substantial evidence of recklessness as required to support the elder abuse claim. Cochrum appealed.

In upholding the trial court, the appellate court stated that a claim for Elder Abuse under Welfare & Institutions Code Section 15600 et seq requires that the plaintiff prove by clear and convincing evidence that a defendant is liable for neglect or physical abuse because the defendant acted with recklessness, oppression, fraud or malice. In reviewing the case law, the appellate court stated that recklessness involves a deliberate disregard of the high degree of probability that an injury will occur. In reviewing the evidence, the appellate court stated that, although understaffing if sufficiently egregious can rise to the level of recklessness, there was no evidence that the staffing levels in this matter created a safety hazard or imminent hazard. The appellate court upheld the trial court's judgment notwithstanding the verdict, finding that because Mr. Cohoon had done well under the facility's care until the miscommunicated diet change and failure to supervise the first meal on that diet, those errors alone were insufficient to support recklessness.

Slone v Commissioner of Internal Revenue, Slone Family GST Trust UA Dated August 16, 1998, Transferee, D. Jack Roberts, Trustee v. Commissioner of Internal Revenue (Filed July 24, 2018) United States Court of Appeals for the Ninth Circuit Case No. 16-73349, Case No. 16-73351 (Form over Substance doctrine applied to recharacterize stock sale as liquidating distribution resulting in transferee liability.)

Slone Broadcasting Co. sold essentially all of its assets to Citadel Broadcasting Co. for $45 million. As a result, Slone Broadcasting realized an estimated capital gain of roughly $38 million and incurred federal and state taxes of roughly $15 million. Of that roughly $15 million in tax, Slone Broadcasting paid a $3.1 million installment of federal income tax. Before the Citadel sale closed, Fortrend International, LLC expressed interest in merging with Slone and then restructuring the combined company as an asset recovery firm. On December 10, 2001, the Slone shareholders (the Trustees of each of the Slone Revocable Trust and the Slone Family GST Trust) sold their shares to a Fortrend affiliate, Berlinetta, for $35.8 million and Berlinetta agreed to assume Slone Broadcasting's income tax liabilities. After closing, Slone Broadcasting and Berlinetta merged to form Arizona Media Holdings, Inc. A shareholder of Arizona Media Holdings contributed Treasury bills with a basis of $38.1 million, which it then sold for $108,731. For the 2002 tax year, Arizona Media Holding filed its tax return reporting a $37 million gain on the asset sale and an offsetting loss of $38 million from the sale of the Treasury bills. Arizona Media Holdings filed for refund of the $3.1 million payment made by Slone Broadcasting, which the IRS granted. Subsequently, the Arizona Media Holding used its cash assets to retire the debt used to acquire Slone Broadcasting, leaving it with insufficient cash to pay liabilities.

The IRS began investigating Arizona Media Holdings in 2005. In 2008, Arizona Media Holdings failed to pay the assessed tax deficiency of $13.5 million for the December 2000 sale of Slone Broadcasting's assets, along with a penalty of $2.7 million and interest of $7.3 million. In 2009, the State of Arizona administratively dissolved Arizona Media for failure to file an annual report. The IRS then sent notices of deficiency to the Slone shareholders asserting that the transactions should be characterized as a liquidating distribution to the Slone shareholders. Accordingly as transferees under IRS Section 6901, the Slone shareholders were liable for the taxes owed and not paid by Arizona Media Holdings.

The Tax Court held that the form of the transaction should be respected and that the Slone Broadcasting shareholders were not transferees under Section 6901. The IRS appealed. In Slone v Commissioner, 810 F. 3d 599 (2015), the Court of Appeals agreed with the IRS and held that the Tax Court applied the wrong standard in determining whether the Slone shareholders were transferees. Directing the Tax Court to determine if the Slone shareholders were (1) transferees under IRC Section 6901 and (2) then liable under Arizona law for payment of the obligations of the distributor, the appellate court remanded the case to the Tax Court.

The Tax Court held that the Arizona Uniform Fraudulent Transfer Act required liability only if the Slone Broadcasting shareholders knew the transactions with Fortrend/Berlinetta was intended to avoid taxes. The IRS appealed.

In rejecting the Tax Court's conclusions, the appellate court held that the record established that the purpose of the Berlinetta transaction was tax avoidance and that the Slone Broadcasting shareholders were on at least constructive notice of that purpose. Further, the appellate court held that when the Slone Broadcasting shareholders sold the stock and the tax liability to Berlinetta, they in substance received a tax-free liquidating distribution from Slone Broadcasting. The appellate court further found that Berlinetta's immediate repayment of the loan used to acquire the Sloan Broadcasting shares without retaining sufficient capital to sustain an ongoing business was further evidence that the only purpose for the transaction was tax avoidance. In examining the Arizona Uniform Fraudulent Transfer Act, the appellate court determined that the Slone Broadcasting shareholders were liable for the tax owed because they received a payment from Slone Broadcasting that left it unable to pay its taxes and that Slone Broadcasting received no reasonably equivalent value in exchange. Based on this two-step inquiry, the appellate court determined that the Slone Broadcasting shareholders were transferees under IRC Section 6901 and were liable for payment of the income tax owed in connection with the transfer.

Blech v. Blech, Comerica Bank, as Trustee (Filed August 6, 2018) Case Number B268326, Second Appellate District, Division Three of Court of Appeal of the State of California, certified for publication in part as to Section VI of that opinion (When real estate is included in a residuary gift, that real estate is not a specific gift).

Arthur Blech died in 2011, leaving an estate in excess of $65 million. He was survived by his four children, namely, Robert, Richard, Raymond and Jenifer. His estate was administered through a probate of his Will and the Arthur Blech Living Trust to which the Will poured most of the probate assets. In Article 5.4 of the Trust, the remainder of the Trust estate was to be divided so Richard received 35% of the residue, which was to include any interest Arthur owned at his death in the San Luis Obispo County Ranch. The Trust further provided that all estate taxes payable by the Trust shall be paid by the residuary beneficiaries in proportion to their respective percentage shares, and that income taxes payable by any sub-trust shall be paid by the beneficiary of that sub-trust.

Arthur owned the San Luis Obispo Ranch at his death, and it was then valued at roughly $7.2 million. It was sold in 2013 for $14 million, resulting in realization of a capital gain of approximately $6.8 million and income taxes of about $2.3 million. The Trustee used the sale price in determining the value of the residue on its accounting and sought to characterize the Ranch as a specific gift. Richard objected and asserted that the Ranch was part of his residuary gift, such that the expenses and costs of that gift should be borne by the Trust as a whole. The Probate Court rejected this position and affirmed the Trustee's deduction of the income tax and other expenses attributable to the Ranch from the sale proceeds and Raymond's residuary share because the Ranch was a specific gift. Raymond then appealed and asserted on appeal that the Probate Court erred in allocating the post death appreciation in the Ranch to the residue so that it was shared among the shares for all the Blech Children (and Richard's share of the appreciation was limited to his 35% residuary gift) while charging Raymond with all of the post-death taxes and expenses of the Ranch's sale.

The appellate court upheld the Order of the Probate Court but on alternate grounds. Specifically, the appellate court found that because the Trust's Article 5.4 distributions were made after all other gifts were made, Article 5.4 was intended to dispose of the remainder of the Trust. Further, the appellate court stated that gifts made from the assets which remain in an estate are gifts of remainder or residuary interests, consistent with Probate Code Section 21117's definition of residuary gift. The appellate court further held that the transfer of the Ranch was a funding mechanism for the actual gift to Richard, which was the 35% share of the residue or remainder of the Trust assets. Although the Probate Court incorrectly labeled the Ranch as a specific gift, the appellate Court upheld the Probate Court's Order approving the allocation of the sales price as part of the residue and allocating the expenses against the appropriate sub-trust as required by the Trust.

Knutson v. Foster (Filed August 8, 2018) Case Number G054247, Fourth Appellate District, Division Three of Court of Appeal of the State of California (Fraud, Breach of Fiduciary Duty Burden of Proof not the same as Legal Malpractice)

Plaintiff, Dagny Knutson, had a scholarship for swimming at Auburn University. At the end of her freshman year, Mark Schubert, the head coach of USA Swimming, orally promised Knutson full support until she completed her undergraduate degree through the 2016 Olympics and without performance markers or other evaluation if she relocated to Fullerton, California. Knutson accepted the oral offer and moved to Fullerton. At Schubert's suggestion, Knutson hired Evan Morgenstern to be her sports agent. Shortly after Knutson moved, Schubert was terminated, without having his agreement with Knutson reduced to writing. Knutson became concerned when she had not received support payments from USA Swimming, and at Morgenstern's suggestion hired attorney Richard Foster to represent her, as a lawyer, in efforts to have USA Swimming honor the oral agreement made by Schubert. Foster had many close personal ties with leaders at USA Swimming and other similar organizations, but he did not disclose those relationships to Knutson. In the ensuing negotiations, Foster provided confidential information about Knutson to USA Swimming without her knowledge or consent. Further, Foster made representations to USA Swimming including that he did not want the dispute to go to trial and that he would not litigate against USA Swimming, which he did not disclose to Knutson. The deal offered by USA Swimming included impossible standards and was less economically beneficial to Knutson than the scholarship she gave up. Foster told Knutson this deal was the best she could hope to get, but did not consult experts to before making that representation. Further, Foster never met with Knutson during his representation of her interests and did not discuss the terms of the agreement with her. In 2014, Knutson learned of Foster's conflicts of interest and hired a new lawyer.

Knutson sued Foster for fraudulent concealment and breach of fiduciary duty. The jury found in favor of Knutson on both causes of action. The trial court granted Foster's motion for a new trial on grounds that Knutson filed to adduce evidence of causation. Each of Knutson and Foster filed appeals.

The appellate court first distinguished the showing of causation between attorney malpractice and the showing required for fraud. Fraud requires that the defendant's conduct be proved to be a substantial factor in the plaintiff's harm, unlike legal malpractice which requires that the plaintiff show but for the alleged malpractice it is more likely than not the plaintiff would have obtained a more favorable result. The appellate court found that the trial court had incorrectly applied the malpractice standard and that under the correct standard for fraud, the jury's verdict on the fraud claim was supported by sufficient evidence. For the breach of fiduciary duty claim, the appellate court found that the trial court had incorrectly applied the standard of proof required for legal malpractice and that when the correct standard for breach of fiduciary duty was applied, there was sufficient evidence to support the jury's verdict. In addition to remanding to the trial court with directions to reinstate the judgment, the appellate court ordered its clerk to forward a copy of its opinion to the State Bar.

Powell v. Tagami (Filed August 6, 2018) Case Number D072566 and D073083, Fourth Appellate District, Division One of Court of Appeal of the State of California (To the extent that Local Rules of Court require more than the statutory content requirements for accountings, the compliance with the Local Rules may be viewed as optional.)

Matzao and Kazu Tagami, as the grantors of the Trust, initially appointed their grandson as Trustee. Subsequently, the grantors removed their grandson and appointed Claudia Powell, a professional fiduciary, to serve as successor Trustee. Matzao died in 2012, and Kazu died in 2015. Their children, Kenneth, Barbara and Charles, survived them.

Powell successfully settled two accountings covering periods through September 30, 2014. Approximately a year after Kazu's death, Charles, through his attorney, requested a third accounting with supporting documentation. The Trustee's lawyer provided a Third Accounting in the format required by the Probate Code with an explanation of the accounts where the Trust assets were held. Charles's attorney continued to demand bills, statements, engagement letters for the Trustee and lawyers, and their invoices.

Subsequently, the Trustee filed her Third Account with the Probate Court for approval. Charles objected to the Third Accounting claiming that (1) the accounting miscalculated the time between October 1, 2014 and June 20, 2015; (2) the no fee declaration was submitted in support of the fees as required by Local Rule 4.16.2(C)(4); and (3) the Trustee's conduct was unacceptable. In response, the Trustee filed a supplement to the Third Accounting. After the Court continued the matter to allow for discovery, the Trustee's attorney filed a declaration responding to Charles's requests for documents and lodged his engagement letter with the Trustee, bank statements reconciling the balances of the accounts at the closing of the accounting period and redacted billing statements for the law firms and the mediator's firm, as well as bank letters and account statements. The Court agreed to take the matter under submission and set a briefing schedule for a supplemental objection and reply. Charles filed a supplemental objection of roughly 200 pages. The Trustee responded to the objections, both in her capacity as Trustee and as an individual. The Trustee stated that she did not think a fee declaration was required by the Local Rules because Court approval was not required by statute for a Trustee to receive compensation. The Probate Court overruled all of Charles's objections and held that in a disputed case, it was wise for a Trustee to rely more extensively on counsel than might otherwise be necessary. Further, the Probate Court ordered Charles to pay the Trustee's fees and attorney's fees and the costs to defend the Third Accounting because Charles's objections were without reasonable cause and brought in bad faith. Further, such payments were to be made from Charles's share of the Trust or from his personal funds if his share was inadequate.

Charles appealed, asserting in part, that the Probate Court could not approve the Third Accounting without a fee declaration in accordance with Local Rule 4.16.2(C)(4) and that the Probate Court erred in concluding his objections were without reasonable cause and in bad faith justifying an award of costs and fees under Probate Code Section 17211.

The appellate court upheld the Probate Court's orders. First the appellate court stated that the Probate Court had determined that the Local Rule did not apply because the declaration was not required by statute, and fee approval was not specifically sought in the Third Accounting as the Third Accounting itemized the disbursement already made, including disbursements to pay legal fees, Trustee's fees and mediator fees. The appellate court stated that even if the Local Rule applied, the Probate Code governs all accounts to be filed with the Court and to the extent a local rule requires more than the statute, compliance with the local rule is optional.

In considering Charles's assertion that his objections were not unreasonable and not made in bad faith, the appellate court stated that the Probate Court had advised the parties at each hearing of Section 17211 and ultimately found that (1) the objections were without merit and that the only reasonable explanation for those unreasonable objections was that Charles intended to perpetuate family disputes or gain a personal advantage in Trust distributions or both. The appellate court found that the Probate Court's finding of unreasonableness and bad faith was supported because (1) Charles's objections continued even after he was provided with the documentation he demanded; (2) his objections were over amounts far less than the cost of the Trustee's time and expense in responding to the objections and/or were over events outside the time covered by the Third Account; and (3) his objections made unfounded and inflammatory personal attacks on the Trustee, the grantors' lawyer, his siblings and their lawyers.

Internal Revenue Notice 2018-61

In Notice 2018-61, the IRS confirms that, notwithstanding new IRC Section 67(g), which suspends the deductibility of miscellaneous itemized deductions through the year 2025, non-grantor trusts and estates may continue to take deductions under IRC Section 67(e)(1) for certain administrative expenses, including trustee and attorney's fees. The IRS reasoned that miscellaneous itemized deductions do not include any above-the-line deductions, such as those authorized by Section 67(e)(1) so that the 67(g) suspension does not apply to Section 67(g) deductions.

IRC Section 199A Guidance

On August 8, 2018, the IRS issued proposed regulations under IRC Section 199A. That Section permits a deduction of 20% for pass through businesses, subject to certain phase outs. The proposed regulations include definitions and guidance for computations and anti-avoidance, as well as proposed regulations for IRC Section 643 limiting the use of trusts to avoid application of thresholds under Section 199A. Comments on the proposed regulations will likely be due by mid-October 2018.

Simultaneously with the release of the proposed regulations, Internal Revenue Notice 2018-64 was released in which the IRS provides three methods for calculating W-2 wages for the purposes of the limitations imposed under new IRC Section 199A.