

No. 45658-3

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON



In the Matter of the Guardianship of:

LEON V. JENSEN,
Deceased,

In Re the JENSEN 1980 TRUST AGREEMENT dated July 23, 1980

JOSEPHINE JENSEN PAPALEO,
Trustee/Appellant,

NOVEMBER PAPALEO, beneficiary,
Appellant,

JODI WICKS, JUDY BARRETT and CHAD JENSEN, beneficiaries,
Respondents.

APPEAL FROM THE SUPERIOR COURT
FOR CLARK COUNTY
THE HONORABLE ROBERT A. LEWIS

REPLY BRIEF OF APPELLANTS

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I. INTRODUCTION

In making his Will and Trust, Leon Jensen intended that the recipients of non-probate assets, which included pay-on-death assets, be exempt from the burden of estate taxes. Leon's Will clearly requires that taxes associated with non-probate assets be paid from his probate estate. Contemplating that there might be no available probate assets from which to pay those taxes upon his death, as was the case, Leon directed the Trustee "in its discretion" to pay "any federal or state taxes [] arising by reason of [his] death" from the Trust instead.

In paying the estate taxes associated with pay-on-death assets from the Trust, the Trustee was complying with Leon's intent to benefit the beneficiaries of those assets, including the Trustee and her daughter, by relieving them of the burden of paying estate taxes. The trial court erred in concluding that the plain language of the Will and Trust was inadequate to avoid statutory apportionment, and ordering that the Trustee could not pay those taxes from the Trust. The trial court's ruling undermines Leon's stated intent and violates RCW 83.110A.020 and the general policy that a settlor's intent controls. This Court should reverse, and direct the trial court to approve the Trustee's request to pay all the

taxes “arising by reason of [Leon]’s death” from the Trust as was intended by Leon and directed in the Trust.

If this Court affirms the trial court’s decision that the estate taxes must be ratably apportioned under RCW 83.110A.030, this Court should reverse the trial court’s decision failing to require the beneficiaries of lifetime gifts, whose interests increased the federal estate tax, to also contribute to their share of the estate taxes incurred by reason of their gifts.

In either event, this Court should deny respondents’ request for attorney fees, and award appellants their attorney fees.

II. REPLY ARGUMENT

A. **Respondents do not dispute that the standard of review is *de novo*.**

Respondents do not dispute that the standard of review in this Court is *de novo*. In other words, the issue before this Court is not whether the trial court abused its discretion in ordering estate taxes to be ratably apportioned to the beneficiaries of the pay-on-death assets, nor must this Court give deference to any credibility determinations made by the trial court. Instead, this Court must determine *de novo* whether the trial court erred in concluding that the Trust did not “provide for the apportionment of an estate tax”

under RCW 83.110A.020 when the Trust directed the “Trustee in its discretion” to “first pay out of any of the principal of the Survivor’s Trust not so appointed [] any federal or state taxes including penalties and interest arising by reason of said Trustor’s death.” (CP 292-93, 395-97) *See Department of Ecology v. Campbell & Gwinn, LLC*, 146 Wn.2d 1, 9, 43 P.3d 4 (2002); *Advanced Silicon Materials, LLC v. Grant County*, 156 Wn.2d 84, 89, ¶ 10, 124 P.3d 294 (2005); *In re Washington Builders Benefit Trust*, 173 Wn. App. 34, 75, ¶ 70, 293 P.3d 1206, *rev. denied*, 177 Wn.2d 1018 (2013) (*discussed* App. Br. 11-12).

B. The intent of the Trustor was for the Trust to bear the liability for all federal or state taxes arising from his death. The trial court undermined that intent by ratably apportioning the estate taxes to the beneficiaries of pay-on-death assets.

“In construing the terms of a trust, the settlor’s intent controls.” *In re Washington Builders Benefit Trust*, 173 Wn. App. at 75, ¶ 70. If a will or trust provides for the apportionment of an estate tax, “the tax must be apportioned accordingly.” RCW 83.110A.020; *see Estate of Mumby*, 97 Wn. App. 385, 395-96, 982 P.2d 1219 (1999). Here, the Trustor, Leon Jensen (“Leon”), directed the Trustee to pay, “in its discretion,” all federal or state taxes “arising from the Trustor’s death” from the Trust. (CP 292)

Respondents do not dispute that the estate taxes associated with pay-on-death assets “arise from the Trustor’s death.” Accordingly, these taxes should have been paid from the Trust, as contemplated by the Trust and as intended by Leon.

Because both Leon’s Will and Trust “provides” for the apportionment of estate taxes by directing that either the probate estate or Trust bear those taxes, the Estate Tax Apportionment Act, RCW 83.110A.030, does not apply. RCW 83.110A.020(1)(a) (“to the extent that a provision of a decedent’s will provides for the apportionment of an estate tax, the tax must be apportioned accordingly”); RCW 83.110A.030(1) (to the extent that the apportionment of an estate tax is not controlled by an instrument, “the estate tax is apportioned ratably to each person that has an interest in the apportionable estate”).

Respondents ignore the plain language of the Trust to claim that “the Trust was not to bear the estate tax liability attributable to POD [pay-on-death] assets.” (Resp. Br. 14) Respondents also wrongly claim that neither the Will nor Trust “expressly exonerate the POD assets from apportionment of estate taxes.” (Resp. Br. 12) The plain language of the Will clearly shows Leon’s expressed intent to have his probate estate - not the beneficiaries of those assets -

bear the taxes associated with non-probate assets, which included the pay-on-death assets:

All inheritance, estate, or other death taxes that may, by reason of my death, be attributable to my probate estate or to any other property not a part of my probate estate shall be paid by my executor out of the residue of my probate estate....

(CP 260) While it is undisputed that there were no assets available in the probate estate from which to pay the estate taxes by the time Leon died (*See Resp. Br. 13-14*), Leon clearly contemplated this situation by vesting discretion in the Trustee to pay those taxes (“any federal or state taxes [] arising by reason of said Trustor’s death”) from the Trust:

Any of the Survivor’s Trust not effectually appointed by the Survivor as set forth above shall be added to the principal of the Family Trust and administered in accordance with the provisions thereof; provided that the Trustee in its discretion may first pay out of any principal of the Survivor’s Trust not so appointed (i) any last illness and funeral expenses of the Survivor, (ii) any expenses incurred in the administration of the affairs of said Trustor, including attorneys’ and accountants’ fees for general or special services rendered and any other probate fees, and (iii) any federal or state taxes including penalties and interest arising by reason of said Trustor’s death.

(CP 292-93, *emphasis added*) The likely reason that the Trust does not make payment of taxes mandatory was that in the event there were probate assets available to satisfy the taxes associated with the

probate and non-probate assets, then under the Will those taxes must be paid from the probate estate.

As previously described, respondents' claim that Leon did not specifically set out a "source of funds required to be used to pay tax attributable to POD assets" (Resp. Br. 15) is simply wrong. The Will clearly expresses Leon's intent that taxes associated with non-probate assets be paid from his probate estate, rather than by the beneficiary. (CP 260) Further, the Trust provides that "any" taxes "arising from his death," which include taxes associated with the non-probate assets be paid from the Trust. (CP 292) Thus, the intent was for the beneficiaries of the non-probate assets to be exempt from the payment of estate taxes, and those taxes were to be paid from either the probate estate or the Trust. While the provisions in the Will and Trust "could have been more specific against apportionment," taken as a whole, it is clear it was Leon's intent to have his estate – whether from the probate estate or the Trust estate – pay the taxes associated with the pay-on-death assets. *See Mumby*, 97 Wn. App. at 400.

In *Mumby*, the beneficiaries made a similar argument as the one made by respondents here. The beneficiaries claimed that the trust's provision directing the trustee to pay "all estate, inheritance,

succession or other death taxes” was insufficient to avoid statutory tax apportionment because it “failed to specify the fund from which the taxes should be paid.” *Mumby*, 97 Wn. App. at 396, 398. This Court rejected this argument by holding that the general rule is that “when the nonspecific tax clause is grouped along with a provision for the payment of debts and other expenses of administration of the estate, the result is to shift the tax burden to the same fund designated” to pay the debt and expenses of the estate. *Mumby*, 97 Wn. App. at 398.

Here, the payment of taxes is also grouped with the debts associated with the administration of the estate. (See CP 292) The Trust directs the Trustee to pay those debts from the Trust. (CP 292) Thus, like in *Mumby*, the taxes here, including those related to the pay-on-death assets, must be paid from the Trust because they “aris[e] by reason of [Leon’s] death.” (CP 292)

Respondents ignore the clear language of the Trust directing the Trustee to “first pay out of any principal of the Survivor’s Trust not so appointed [] any federal or state taxes, including penalties and interest arising by reason of said Trustor’s death,” and focus solely on the fact that the Trust gives the Trustee “discretion” to do otherwise to claim that this provision was not a “mandate or clear

directive” to avoid statutory apportionment. (Resp. Br. 15, 16, 20) But the mere fact that the Trustee has discretion to do something other than what was directed by the Trustor, makes it no less a “directive.” *Baldus v. Bank of California*, 12 Wn. App. 621, 530 P.2d 1350, *rev. denied*, 85 Wn.2d 1011 (1975).

In *Baldus*, for instance, the beneficiary of a Trust sued the Trustee for failing to diversify stock in violation of the general rule that the trustee “as a prudent man, has a duty to diversify trust investments.” 12 Wn. App. at 625-26. The trust provided, in part, that “should the assets of my estate be so invested as to have a disproportionate, from a trust standpoint, share of the estate invested in stock of the National Lead Company, it is nevertheless my desire that the trustee retain said stock if in the trustee’s judgment it is desirable or to dispose of it as the trustee deems expedient.” *Baldus*, 12 Wn. App. at 623. Under these circumstances, the appellate court held that the expressly stated direction (hold the stock), even though accompanied with a disclaimer that the trustee could act otherwise, still “amounts to a directive rather than a mere authorization.” *Baldus*, 12 Wn. App. at 630.

Here too, the Trust provides an expressly stated direction: to “first pay out of any principal of the Survivor’s Trust not so appointed [] any federal or state taxes including penalties and interest arising by reason of said Trustor’s death.” (CP 292-93) That the Trustee was also given discretion to do otherwise makes it no less of a directive from, or statement of intent by, the Trustor. This is particularly true when read in conjunction with the Will clearly directing that the taxes associated with non-probate assets be paid from the probate estate, and not by the beneficiaries. (CP 260: taxes attributable to property not part of the probate estate “shall be paid by my executor out of the residue of my probate estate”) In other words, there was a clear intention by Leon to relieve the beneficiaries of non-probate assets from the payment of estate taxes.

The trial court’s conclusion that the Trustee cannot pay all estate taxes from the Trust stands the Trust on its head, and violates the longstanding policy, encompassed in the Estate Tax Apportionment Act, that the wishes of the Trustor must be followed. *See In re Washington Builders Benefit Trust*, 173 Wn. App. at 75, ¶ 70; RCW 83.110A.020(a), (b). This Court must reverse the trial court’s decision and remand with directions for the trial

court to approve the Trustee's payment of all of the estate taxes from the Trust, consistent with Leon Jensen's stated intent.

C. The Trustee did not breach her fiduciary duty by complying with the Trustor's intent to relieve the beneficiaries of pay-on-death assets of estate taxes.

The trial court did not order that the taxes be ratably apportioned among all the beneficiaries because it found it would otherwise be a breach of the Trustee's fiduciary duty, but because it improperly concluded as a matter of law that neither the Trust nor Will was specific enough to avoid statutory apportionment. (*See* CP 395-97) (*supra*, § II.B) In fact, the trial court specifically found that the Trustee did not breach her fiduciary duty to the Trust beneficiaries by paying the taxes associated with the pay-on-death assets from the Trust. (CP 396) Because respondents did not cross-appeal, they cannot now challenge this finding on appeal. *Brewer v. Brewer*, 137 Wn.2d 756, 766, 976 P.2d 102 (1999) (failure to assign error to a finding makes it a verity on appeal).

Even if, as respondents argue, the trial court's finding that the Trustee did not breach her fiduciary duty only addressed the Trustee's preliminary payment of the taxes pending hearing, and did not reach the question of "whether the exercise of the Trustee's discretion to pay estate taxes in a manner that only benefited

[appellants] would violate her fiduciary duties to the beneficiaries,” (Resp. Br. 23), this Court should decline to consider this argument as a reason to affirm. Generally, appellate courts should decline to consider an issue that was not addressed by the trial court when respondents filed no cross-appeal. *See Corbin Dist. Prop. Owners Ass’n v. Spokane Cnty. Bd. of Adjustment*, 26 Wn. App. 913, 917, 614 P.2d 1313 (1980).

In any event, there is no basis for this Court to determine as a matter of law that actions taken by the Trustee, consistent with the directions set out in the Trust, which benefit the Trustee over other beneficiaries is an abuse of discretion. A trustee abuses his or her discretion only when the trustee acts arbitrarily, in bad faith, maliciously, or fraudulently. *See Occidental Life Ins. Co. of Cal. v. Blume*, 65 Wn.2d 643, 648, 399 P.2d 76 (1965); *Austin v. U.S. Bank of Washington*, 73 Wn. App. 293, 304, 869 P.2d 404, *rev. denied*, 124 Wn.2d 1015 (1994). Here, while it is undisputed that payment of the taxes associated with the pay-on-death assets primarily benefits the Trustee and her daughter, her doing so under the terms of the Trust is not “bad faith, malicious, or fraudulent.” There is no claim that but for this particular dispute, the Trustee has not acted

faithfully on behalf of and for the benefit of all of the beneficiaries.
(See App. Br. 4-6)

Respondents claim that by making the Trust liable for all taxes, the Trustee is engaging in “self-dealing,” because it serves to benefit both herself and her daughter as non-Trust beneficiaries.¹ (Resp. Br. 24) But it is not impermissible self-dealing if the Trust expressly provides for the Trustee to take the specific action that results in a benefit to the Trustee as a non-Trust beneficiary. For instance, under RCW 11.100.090, a trustee cannot engage in self dealing “unless the instrument creating the trust expressly provides to the contrary.” See also *Estate of Vance*, 11 Wn. App. 375, 385, 522 P.2d 1172 (1974).

In *Vance*, the Will of the decedent named her son as co-executor of her estate. The will granted her son the right to purchase her share of capital stock in a corporation. The son exercised that right and purchased the stock based on an appraised value as directed by the will. The proceeds from the sale of stock became an asset of the estate. The will also provided that the son would be required to pay the difference if the value of stock for

¹ The Trustee is both a beneficiary of the Trust and a beneficiary of non-Trust assets.

federal estate tax purposes is higher than the appraised value. The IRS audited the estate and claimed that the stock was worth significantly more than the appraised value. The son, acting as the executor, appealed the IRS determination. The other heirs filed a petition to prevent the appeal arguing that the appeal was a conflict of interest because any attempt to reduce the value of the stock – even if it would also serve to reduce the estate tax – would diminish the size of the net estate available for distribution and thus benefit only the son/co-executor.

The trial court denied the petition, finding that “a decedent has the right to designate who will administer an estate and is not inhibited by an actual or potential conflict of interest, but can designate someone to act in circumstances that will involve the conflict relationship, and that is within the right of the decedent.” *Vance*, 11 Wn. App. at 382. Division One affirmed, holding that it “is abundantly clear that a testator may authorize his executor or trustee to purchase property from the estate on such terms as may be provided, even though such a purchase may involve a conflict of interest or work to the detriment of the heirs.” *Vance*, 11 Wn. App. at 385. The court held that “if this method of ascertaining the stock’s valuation results in a diminution of the heirs’ distributive

shares, such must be deemed to be the result of the testatrix's specific intent." *Vance*, 11 Wn. App. at 385. The court held that so long as the executor was following a "course consistent with the will" there was no misconduct by the executor constituting a breach of conduct. *Vance*, 11 Wn. App. at 385-86.

Here, the Trustee also acted in a "course consistent" with the Trust, because the Trust expressly provides that the Trustee can benefit herself and other non-Trust beneficiaries by paying taxes associated with the pay-on-death assets from the Trust. This provision is consistent with all the other ways in which Leon intended to favor Jo (the Trustee) over other beneficiaries. Leon named Jo as beneficiary of a greater amount of the non-probate assets than any of the other beneficiaries (*See* CP 348-49); Leon directed in his Will that taxes associated with the non-probate assets (of which Jo and her daughter were given a greater share) be paid by the probate estate, rather than by the beneficiaries (CP 260); Leon named Jo as the successor co-Trustee with his wife Colleen and successor Trustee upon Colleen's death (CP 203-04); and he vested in the Trustee (whether it be Colleen, Jo, or anyone else) the authority to pay the taxes associated with the non-probate assets from the Trust. (CP 292-93) If Leon did not intend for the

Trustee (Jo) to benefit from the payment of taxes as directed in the Trust, Leon could have eliminated that provision or named someone other than Jo as Trustee. Regardless of the fact that paying the taxes from the Trust benefits the Trustee, the Trustee is following the primary rule of trust administration — to carry out the perceived intentions of the trustor. *See Vance*, 11 Wn. App. at 379; *Austin*, 73 Wn. App. at 304.

D. If statutory apportionment is required, respondents must contribute to the payment of estate taxes to the extent of the lifetime gifts that they previously received, which increased the federal estate tax.

If this Court affirms, and holds that estate taxes must be apportioned among all the beneficiaries, it should reverse the trial court's decision to exclude the *inter vivos* gifts from that determination, and remand for the trial court to determine the additional amounts owed by the respondents as a result of their receipt of *inter vivos* gifts. Remarkably, while claiming that Jo, November, and Chad, as beneficiaries of non-probate assets should be required to pay a ratable share of the estate taxes associated with those assets, respondents seek to avoid the same treatment with regard to their receipt of *inter vivos* gifts. The respondents each received a total of \$821,870.00 in *inter vivos* gifts in 2008 and

2011, together with additional gifts within the statutory exemption. (CP 358-59) These gifts were made to avoid Washington estate tax, but nevertheless still impacted the federal estate tax due upon Leon's death. (See Resp. Br. 27)

Respondents acknowledge that "lifetime gifting impacts the amount of estate tax owed upon a descendant's death due to the mechanics of the federal unified gift and estate tax credit" (Resp. Br. 26), but they claim that they should avoid statutory apportionment because *inter vivos* gifts are excluded from the "gross estate" under the Internal Revenue Code. (Resp. Br. 26, *citing* IRC § 2031) Under RCW 83.110A.030, estate taxes are apportioned ratably to each person that has an interest in the "apportionable estate," which is defined as the "gross estate" less certain enumerated deductions. The "gross estate," includes "all interests in property subject to the tax." RCW 83.110A.010(3). Under this definition, the *inter vivo* gifts are part of the "gross estate" because they are included in determining the amount of federal estate tax. *See* 26 U.S.C. § 2001(b)(1)(B). Because *inter vivo* gifts increase the federal estate tax, they are "subject to the tax," and any apportionment of estate taxes must include the taxes associated with those gifts under the Estate Tax Apportionment Act.

Respondents' claim that the gifts are only "subject to" the federal gift tax and not the estate tax is baseless. (Resp. Br. 25) Currently, gift tax must be paid on gifts if the total of the gifts is greater than \$5.34 million. 26 U.S.C. § 2010(c); IRS Rev. Proc. 2013-35. Estate tax is reckoned by including all gifts made during the decedent's life in excess of the statutory exemption. 26 U.S.C. § 2001(b)(1). The federal estate tax paid at the death of Leon Jensen was computed based on the *inter vivos* gifts made in 2008 and 2011. That means the *inter vivos* gifts in this case were "subject to" the estate tax.

Requiring the recipients of *inter vivos* gifts to share in the increase in estate taxes due as a result of those gifts is not inconsistent with the Trustee's earlier actions in making those gifts. (Resp. Br. 27-28) As set forth in the Trustee's earlier requests to the superior court, the gifts were only intended to "reduce potential estate tax" by avoiding the Washington estate tax (CP 12, 86), it was not intended to provide the gifts to the beneficiaries entirely "tax free." To the extent those *inter vivos* gifts resulted in increased estate taxes (but less than had those properties remained in Leon's estate at the time of his death), the recipients should share in the

burden if this Court determines that the language of the Trust is not sufficient for the Trustee to pay all of the taxes from the Trust.

This Court should not be drawn into an exaggerated hypothetical presented by respondents for their claim that the Legislature could not have intended that a person who received a \$100,000 gift in 1980 to pay a portion of the estate tax that would be levied based on what a gift for a decedent who dies in 2014. (*See* Resp. Br. 27) Instead, the facts of this case prove why – absent a specified apportionment in the Trust – the Legislature intended for recipients of *inter vivos* gifts to share in the apportionment of estate tax if the receipt of their gifts increased the overall estate tax upon the death of the decedent. Here, the *inter vivos* gifts were not a gratuitous act by Leon—he was incapacitated at the time of the gifts and subject to a guardianship. Instead, the gifts were intended to reduce the overall estate tax by avoiding the Washington estate tax. The gifts, which were made within three years of Leon’s death, did not avoid the federal estate tax that would be incurred as a result of those gifts when Leon died. It would make no sense that if the Legislature intended that all recipients whose interests are part of the “apportionable estate” from which the estate tax is determined share the burden for those taxes when it enacted the Estate Tax

Apportionment Act that it would exclude beneficiaries of *inter vivos* gifts whose interests also contributed to the estate tax.

At the end of the day, the Legislature's intention is best divined from the language of RCW ch. 83.110A contrasted with the verbiage in *former* RCW ch. 83.110 as described in appellants' opening brief. (App. Br. 24-25) The prior enactment provided for ratable apportionment based on the proportion of the value of each person's interest in the estate. The term estate was at that time tied to the federal definition of gross estate:

"Estate" means the gross estate of the decedent as determined for the purpose of the federal estate tax and the estate tax payable to this state.

RCW 83.110.010(1) (*former*). In enacting the current statute, the Legislature divorced the definition of "gross estate" from the federal definition. *See* RCW83.110A.010(3). Current apportionment is computed based on all interest subject to the tax. RCW 83.110A.010(1), (3). That must include *inter vivos* gifts since they are included in the determination of the federal estate tax.

E. This Court should deny respondents' request for attorney fees and award attorney fees to the appellants.

An award of attorney fees to the respondents under RCW 11.96A.150 is entirely unwarranted. The respondents previously

sought, and were denied attorney fees by the trial court for the same reasons claimed here. (CP 396-97) Even if this Court affirms the trial court's ruling - which it should not - there is no reason why it should exercise its discretion any differently than did the trial court. As the trial court found, the Trustee did not act in bad faith by following a course of action that she believed was consistent with Leon's intent. (See RP 23-24) As there was no basis for an award of attorney fees to the respondents below, there is no basis for an award of attorney fees here.

On the other hand, if this Court reverses, the appellants should be awarded attorney fees by this Court. The Trustee wholly acted within the authority granted to her by the terms of the Trust. Leon favored those beneficiaries of non-probate assets, including appellants, by directing that those taxes be paid from the probate estate or from the Trust. Any increased attorney fees in litigating was a result of respondents seeking to take more than Leon intended. As a result, it is appellants who should be awarded attorney fees under RCW 11.96A.150(1) as this appeal is brought to ensure that the Trustor's intent is carried out by allowing the Trustee to pay all of the estate taxes from the Trust in her discretion.

III. CONCLUSION

This Court should reverse and direct the trial court on remand to approve payment of “any federal or state taxes [] arising by reason of [Leon]’s death” from the Trust. If this Court affirms, this Court should nonetheless reverse the trial court’s decision to exclude the beneficiaries of lifetime gifts from the ratable apportionment of estate taxes arising from those gifts. This Court should award appellants their attorney fees.

Dated this 25th day of July, 2014.

SMITH GOODFRIEND, P.S.

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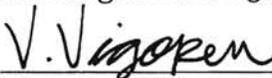
DECLARATION OF SERVICE

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on July 25, 2014, I arranged for service of the foregoing Reply Brief of Appellants, to the court and to the parties to this action as follows:

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DATED at Seattle, Washington this 25th day of July, 2014.



Victoria K. Vigoren