

# Tax Consequences of Settling Estate Disputes

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## Acknowledgements

- ❑ This hypothetical was part of a larger problem posed to the Tax Section by Shirley Whitenack, Esq.
- ❑ Steve Perlis, Esq. assisted with the refinement of the issues and the specific questions to be addressed



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## The goals and purpose

- ❑ Designed to serve as a "road map" or quick reference guide for tax issues in settling estate disputes
- ❑ Although focused on marital deduction, can be used for other types of disputes as well
- ❑ Help you recognize when to call in a tax expert in the settlement process



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## The Scenario

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- ❑ **March 1, 2000** – Dagwood marries Blondie
- ❑ **March 10, 2000** – Dagwood executes a will prepared by his longtime attorney
- ❑ **2006** – Dagwood becomes seriously ill and dependent upon Blondie for his care and well being
- ❑ **December 20, 2008** – Dagwood signs new will drafted by Blondie's attorney



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## The 2000 will

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- ❑ Established a minimum elective share trust for Blondie
  - Income quarterly for Blondie's life
  - Remainder to Dagwood's two children – Alexander and Cookie
- ❑ Named Alexander as Executor and Trustee



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## The 2008 will

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- ❑ Established a minimum elective share trust for Blondie
  - Income quarterly for Blondie's life
  - Principal invasions for Blondie's benefit
  - Remainder to Alexander and Cookie
- ❑ Named Blondie's attorney as executor



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## January 10, 2009 – Dagwood Dies

- ❑ Blondie files 2008 will
- ❑ Alexander and Cookie contest
- ❑ After nearly two years, mediation results in a proposed settlement
- ❑ As usual, at the 11<sup>th</sup> hour, just before signing the agreement, one attorney calls for tax advice



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## Proposed Settlement

- ❑ Distribution of sum certain to Blondie outright and free of trust
- ❑ Remainder of estate to Alexander and Cookie



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## What We're Not Talking About

- ❑ Not going to cover any income tax issues
  - Distributable net income
  - Income in Respect of a Decedent
- ❑ Capital gains tax issues/Basis issues
- ❑ State tax issues
- ❑ Issues of validity of settlement under state law



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## Assumptions

- ❑ Dagwood died during 2009, so a \$3.5 million estate tax exemption applies
- ❑ Assume estate is taxable



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**WILL THE SETTLEMENT  
DISTRIBUTION TO BLONDIE  
QUALIFY FOR THE ESTATE  
TAX MARITAL DEDUCTION?**

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What are the basic requirements for the marital deduction?

- ❑ Found in IRC §2056
- ❑ Three basic requirements
  - The interest must be includable in the decedent's gross estate
  - The interest must pass to the spouse. The interest cannot be created by the actions of third parties
  - The interest must not be a terminable interest. It must be included in the surviving spouse's estate and cannot terminate as a result of time or an event



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### Exceptions to terminable interest rule

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- ❑ A survival requirement
- ❑ Certain annuity interests
- ❑ Income interests in a charitable trust
- ❑ Qualified Terminable Interest Property



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### What are the requirements for a marital trust?

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- ❑ Income paid to spouse
  - No power to accumulate income
- ❑ Spouse may have either
  - Right to withdraw principal; or
  - Testamentary power of appointment
- ❑ Spouse must have the right to require trustee to make unproductive property income producing



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### What is a QTIP trust?

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- ❑ Income paid to spouse
- ❑ Spouse may have a limited power of appointment
- ❑ Spouse must have the right to require trustee to make unproductive property income producing
- ❑ Executor must elect QTIP treatment



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Would the distributions under either will have qualified?

- ❑ We don't actually have enough information
- ❑ Assuming that both attorneys were competent, the trusts will contain necessary language and powers
- ❑ However, always read the document carefully, never assume the trust qualifies



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How does a settlement distribution qualify?

- ❑ Pursuant to §20.2056 (c)-2(d)(2) any settlement must be a "bona fide recognition of an enforceable right"
- ❑ A distribution pursuant to court judgment is assumed to meet this requirement
- ❑ §20.2056(c)-2(d)(2) says "If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse."



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Applying the law and regulations to our case

- ❑ Case law
- ❑ IRS precedential rulings
- ❑ IRS non-precedential rulings
- ❑ Relevant state law



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## Applicable Case Law

- ❑ Commissioner v. Est. of Bosch, 387 U.S. 456 (1967)
- ❑ Ahmanson Foundation v. U.S., 674 F.2d761 (9<sup>th</sup> Cir. 1981)
- ❑ Carpenter v. IRS, 52 F.3d1266 (4<sup>th</sup> Cir. 1995)
- ❑ DePaoli v. Commissioner, 62 F.3d 1259 (10<sup>th</sup> Cir. 1995)
- ❑ Est. of Mergott v. U.S., 86 AFTR 2d 2000-5778 (U.S. Dist. N.J. 2000)



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## Bosch case

- ❑ When a question of taxation is contingent upon a determination of the nature of a property interest transferred by a decedent pursuant to state law, the IRS is not bound by a state court ruling on the nature of the interest
- ❑ Court created a test as to whether the IRS should follow a state court decision



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## Bosch test

- ❑ If a determination is made by the highest court of the state, the court's determination should be followed
- ❑ If no determination is made by the highest court, the IRS must give "proper regard" to relevant decisions of lower state courts



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## Ahmanson case

- ❑ Rules of *Bosch* apply to settlements as well as court decisions
- ❑ In order to meet the “passing to” requirements a settlement must be:
  - In good faith
  - Based upon an enforceable right under state law “properly interpreted”



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## Carpenter case

- ❑ Holographic will, very unclear, didn't dispose of entire estate
- ❑ Husband left property in trust for wife's lifetime
  - Life estate interest
  - No power of appointment
- ❑ Interest did NOT qualify for the marital deduction



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## The Carpenter settlement

- ❑ Wife and daughter settled on an outright split of the estate
- ❑ 4<sup>th</sup> Circuit held that, since the initial bequest to the wife did not qualify for the marital deduction, the settlement amount would not qualify
- ❑ Can't save a bad will with a settlement



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## DePaoli Case

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- ❑ Dad left estate entirely to son, disinheriting wife
- ❑ Son probated will and then suddenly filed a joint motion with stepmother to set aside will
- ❑ Claimed that there was a new will, drafted, but not executed, which left exemption amount to son, remainder to stepmother



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## DePaoli holdings

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- ❑ Settlement gave son the exemption amount, wife the remainder of the estate
- ❑ Tax Court held that if son had partially disclaimed his interest his share would go to his children, not stepmother
  - Not clear argument, all of son's children were illegitimate
- ❑ 10<sup>th</sup> Circuit reversed on the basis of the fact that the lower court had not properly considered the illegitimacy of the son's children and that, under state law, they were not necessarily intestate heirs



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## Mergott Case

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- ❑ IRS denied deduction where:
  - Will left real estate to son, 1/2 of remaining estate in trust for wife's benefit for her lifetime and remainder to other children
  - Wife dropped elective share claim
  - Wife filed additional claims against estate, took cash settlement of \$135,000
  - Wife filed dower claim against real estate, settled for stepson giving her a piece of property



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## Court's holding

- ❑ "The settlement must be based on an enforceable right under state law property interpreted"
- ❑ Mrs. Mergott did not have a "bona fide enforceable right" under New Jersey law
  - No right to terminate "a trust bequeathed to her for life" in exchange for a lump sum
  - No right to dower when she accepts a bequest from the estate which was intended to be provided in lieu of dower



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## IRS Precedential Rulings

- ❑ Revenue Ruling 83-107
  - Even though court proceedings were not initiated, spouse asserted her dower rights
  - The settlement which resulted from her assertion was deductible as a marital distribution
  - The deduction was limited to the fair market value of her dower rights



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## IRS Non-Precedential Rulings

- ❑ Private Letter Ruling 9251002
- ❑ Private Letter Ruling 9246002
- ❑ Private Letter Ruling 9546004
  
- ❑ Although they cannot be cited as precedent, PLRs are useful tools to determine how the IRS views particular fact patterns
- ❑ They often lay out the legal groundwork for the ruling in a clear and concise manner



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## PLR 9251002

- ❑ Surviving spouse filed in probate court to receive elective share (value of \$546,000)
- ❑ Settlement resulted in \$420,000 in trust for the spouse
  - Income for life
  - Remainder to Decedent's daughter
- ❑ IRS allowed a deduction for \$269,363, based upon the present value of the income interest in trust
- ❑ No value was assigned to the life estate in real estate



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## PLR 9246002

- ❑ Spouse elected to take against the will (life estate in 1/3 of real estate + 1/3 of the net personal estate)
- ❑ In a settlement, the real estate was sold and the spouse given the commuted value of her life estate + 1/3 of the personal property
- ❑ Marital deduction was allowed because state law allows for a surviving spouse to seek to either partition the real estate or seek the commuted value of a life estate



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## PLR 9546004

- ❑ Wife was completely disinherited and filed seeking her elective share
- ❑ Settlement of the dispute resulted in the creation of a QTIP trust
- ❑ Trust funding was deductible



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## State law

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- ❑ Need to consider what the surviving spouse's rights are under the applicable state law
  - Elective share
  - Ability to commute or partition real estate
  - Ability to terminate a trust



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## EXAMINING OUR SETTLEMENT UNDER THESE EXAMPLES

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## What would Blondie's rights have been under the 2000 will

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- ❑ Income interest
- ❑ How would this have been valued for marital deduction purposes?
  - Does it qualify as a QTIP trust?
  - Was a QTIP election made?
    - ❑ If so, fully deductible
    - ❑ If not, only the present value of her income interest may be deductible



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What would Blondie's rights have been under the 2008 will?

- ❑ Income interest
- ❑ Right to invade proceeds
- ❑ How would this have been valued for marital deduction purposes?
  - Does it qualify as a QTIP trust?
  - Was a QTIP election made?
    - ❑ If so, fully deductible
    - ❑ If not, only the present value of her income interest may be deductible



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What is she receiving under the settlement?

- ❑ Outright distribution, not in trust
  - Is there any state law precedent for collapsing the trust?
    - ❑ If yes, entire distribution may be deductible
    - ❑ If no, need to find legal basis for outright distribution
- ❑ Is it more or less than her elective share?
  - If less, likely fully deductible
  - If more, deduction may be limited to elective share



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How does the settlement relate to the will distributions?

- ❑ If settlement is more than she was likely to receive under either "best case" scenario, deduction may be limited to what her best case would have been
- ❑ If settlement is less, likely fully deductible



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How is the settlement substantially different from the wills?

- ❑ Total right to funds
- ❑ No income interest only
- ❑ No trustee overseeing distributions



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What are the options?

- ❑ Figure her "life interest" value of what would have been placed in trust
- ❑ Use her elective share amount as a basis for a settlement amount



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Does it matter how settlement is paid?

- ❑ Will real estate be included?
- ❑ Is there sufficient cash or cash equivalent in the estate?



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## Potential Gift Tax Consequences

- ❑ If either child needs to “kick in” cash?
- ❑ If settlement is more than Blondie’s interest would have been valued at?
- ❑ If Blondie is viewed as terminating a QTIP trust interest?



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## If another heir needs to contribute cash

- ❑ Transaction may be collapsed under the step transaction doctrine, and treated as a direct gift from children to Blondie
- ❑ If this is necessary, two ways to structure:
  - Spell out in the agreement that the children are buying certain assets directly from the estate
  - Or, that certain assets are being distributed to Blondie and the children are buying from her
- Either scenario could create capital gains issue



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## If the settlement is more than Blondie could have expected

- ❑ Additional amount may be treated as a gift from other heirs
- ❑ Set forth reasons for the additional amount
  - Reimbursement of expenses
  - Payment of fees
  - Additional amount necessary to generate income, etc.
  - Or, accept the gift tax results and clearly apportion gift amounts between other heirs



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### If QTIP is viewed as being created, then commuted

- ❑ Under §2519, a termination of a QTIP trust is treated as a gift to the remaindermen
- ❑ If Blondie terminates her right to income, possible gift to children
- ❑ Avoid allowing the trust to exist prior to the settlement



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### How to provide certainty of tax result

- ❑ Request a Private Letter Ruling from the IRS
- ❑ Wait to distribute until a tax closing letter is received from the IRS
  - IRS website says likely a 4-6 month wait
  - Longer if return is audited
  - What happens to settlement if IRS doesn't approve deduction?



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### The PLR request process

- ❑ Revenue Bulletin 2010-01
  - Each year the IRS promulgates a new ruling outlining the procedures for requesting a PLR
    - ❑ Includes a list of subjects they will not issue a ruling on
    - ❑ Gives a general outline of what to include in a request
  - Fees
    - ❑ Dependent upon value of estate
    - ❑ May be as high as \$14,000



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## Timing of PLR request

- Generally should be requested prior to filing return
  - IRS should make contact within 21 days
  - IRS said request should be issued within 4 months
- If filed after return is filed, Service “will make every effort” to issue a ruling within 3 months of the filing date of the return or will request an extension from the field office processing the return



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## Using the IRS to help you settle

- The IRS generally will not rule on the tax effects of ongoing litigation
- They may be willing to rule in a situation where a settlement is contingent upon a favorable ruling
- You can request a pre-submission conference
  - The Revenue Bulletin includes the phone numbers to request such a conference



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## Drafting the settlement agreement

- Keep in mind that the settlement agreement will be attached to the 706 (or the amended 706)
- Give the IRS the groundwork that it needs to rule that the distribution is deductible
- Use recitals to lay out all of the necessary elements for deductibility



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## Laying out the elements

- State clearly
  - Who the parties are and their interest in the estate
  - The specific terms of the dispute being settled
    - What documents or parts of documents are at issue
    - What is each parties position or interpretation
  - All of the enforceable rights involved
  - What is each party's worst day in court
  - Could also be used as a framework for a PLR request



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## Naming the parties

- The parties to this settlement agreement are as follows:
  - Blondie, as surviving spouse of the decedent and beneficiary under both the 2000 and 2008 wills
  - Alexander, as son of the decedent, beneficiary under the 2000 and 2008 wills, and named personal representative under the 2000 will
  - Cookie, as daughter of the decedent and beneficiary under the 2000 and 2008 wills
  - Attorney Smith as named personal representative under the 2008 will



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## Explaining the dispute

- Use the Probate Court to "create" your dispute
  - File your action
  - Get court approval for the settlement



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### Laying out the dispute in the agreement

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- ❑ This settlement agreement arises from a will contest filed on February 1, 2009 by Alexander and Cookie disputing the validity of the will admitted to probate on January 28, 2009 by Blondie.
- ❑ They have alleged that the probated will is invalid as a result of undue influence exerted by Blondie over Dagwood



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### Give a brief summary of the arguments and each party's position

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- ❑ Alexander and Cookie contend that their father's health was in severe decline at the time of the will signing, that he was entirely dependent upon Blondie for his well being and that Blondie effectively isolated him from his children and prior attorney
- ❑ Blondie argues that two physicians signed affidavits as to Dagwood's mental capacity, that she was not present when the will was signed and that Dagwood increased her share of the estate in recognition of her care during his illness.



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### What are the enforceable rights?

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- ❑ Pursuant to the 2000 will, Blondie would be entitled to a lifetime income interest with a present value of \$x.
- ❑ Under the terms of the 2008 will, Blondie would receive a life estate interest in the trust with a present value of \$y.
- ❑ Under state law, if Blondie chose to receive her elective share, she would be entitled to \$z.



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How do the parties intend for the estate to be taxed?

- ❑ Include specific recitals in the agreement regarding the tax ramifications of the settlement
- ❑ Will it be assumed that any distribution to the spouse will qualify for the marital deduction?
  - On what basis
  - Set forth tax rules and applicable case law



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Personal liability of transferees

- ❑ IRC §6324 provides:
  - If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, . . . or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax.
- ❑ Acknowledge this in the agreement, so that everyone is aware of the possibility



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Who bears the burden of paying taxes due?

- ❑ Clearly apportion taxes in the agreement
- ❑ Does the will or trust address apportionment?
- ❑ Does state law address apportionment?



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## Who is responsible for filing?

- ❑ Who has the responsibility to file or amend returns?
- ❑ Who has the responsibility to defend against an audit or contest a tax ruling?
- ❑ If the primary issue is the marital deduction, should the responsibility fall on the spouse or the estate?
- ❑ If someone other than the PR or Trustee is responsible, indemnify them against interest and penalties



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## Agreement to cooperate

- ❑ All parties agree to cooperate and provide any documentation or information necessary to file any and all required tax returns, respond to any audit inquiries, or resolve any other tax related matters arising from the settlement of this dispute



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## Access to information

- ❑ All parties shall receive copies of all tax returns filed and the closing letters when received
- ❑ All parties shall be notified of any audit and kept fully apprised of the progress of and resolution of the proceedings.



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## How to ensure funds are available for taxes

- ❑ Hold back an amount sufficient to pay taxes if marital deduction is denied
  - Estate indemnifies spouse against taxes, interest and penalties
- ❑ Distribute all to spouse
  - Spouse indemnifies estate



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## Address what happens if IRS disallows deduction

- ❑ Who pays taxes due?
- ❑ Who bears burden of any interest and penalties?
- ❑ How far do you take the appeal process?



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## What expenses are deductible?

- ❑ 26 CFR §20.2053-3(c)
- ❑ (3) Attorneys' fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate within the meaning of paragraph (a) of this section. An attorney's fee not meeting this test is not deductible as an administration expense under section 2053 and this section, even if it is approved by a probate court as an expense payable or reimbursable by the estate.



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## What expenses are deductible?

- ❑ 26 CFR § 20.2053-3(d)
- ❑ (3) Expenses incurred in defending the estate against claims described in section 2053(a)(3) are deductible to the extent permitted by §20.2053-1 if the expenses are incurred incident to the assertion of defenses to the claim available under the applicable law, even if the estate ultimately does not prevail. For purposes of this paragraph (d)(3), "expenses incurred in defending the estate against claims" include costs relating to the arbitration and mediation of contested issues, costs associated with defending the estate against claims (whether or not enforceable), and costs associated with reaching a negotiated settlement of the issues.



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## Are fees incurred in a will contest deductible?

- ❑ General rule is that if an expense is allowed by a probate court, it will be considered deductible by the IRS
- ❑ Fees paid by an executor or personal representative to defend a will or administer an estate are clearly deductible



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## What if the estate pays fees for beneficiaries?

- ❑ If the estate agrees to pay fees incurred by beneficiaries in the course of advancing their individual interests in the estate – these are NOT deductible
- ❑ Litigation expenses incurred by beneficiaries are also NOT deductible on their personal income tax returns



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### Dealing with fees in the settlement agreement

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- ❑ Clearly set forth which fees will be paid by which party
- ❑ State which fees will be taken as a deduction on which return
- ❑ Consider a clause requiring court approval of fees which are to be deducted by estate
- ❑ Are future attorney fees or PR fees capped?
- ❑ Who bears burden of future fees?



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### How do you address these issues with your client during negotiations?

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- ❑ Prior to mediation, review options with your client
- ❑ Have a rough version of the estate tax return prepared in advance, or have the filed tax return available
- ❑ Look at applicable state tax returns and state tax issues as well



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### Focus as much as possible on the bottom line

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- ❑ In this situation, work through scenarios with client
  - If Blondie gets nothing, you get \$X after taxes
  - If Blondie gets \$X, you get \$Y after taxes
- ❑ How does each different marital deduction amount affect taxes paid and amount available to distribute?



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## Wrapping up the settlement

- ❑ Once you've settled the "big issues," tax issues can be difficult to work through
- ❑ Don't leave tax issues until the last minute
- ❑ Think about tax issues before you get to mediation
- ❑ Have accountant or tax attorney on stand by



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