KNOWING THE ROPES & BINDING THE IRS: INCOME & TRANSFER TAX ISSUES OF SETTLEMENTS & MODIFICATIONS THAT EVERY FIDUCIARY SHOULD KNOW

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KNOWING THE ROPES & BINDING THE IRS: INCOME & TRANSFER TAX ISSUES OF SETTLEMENTS & MODIFICATIONS THAT EVERY FIDUCIARY SHOULD KNOW[1]

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I. INTRODUCTION

Every aspect of estate and trust administration has one or more transfer tax (gift, estate, inheritance, and generation-skipping transfer tax) and fiduciary or personal income tax ramifications, even if those ramifications are that certain of these taxes do not apply. Litigation and other dispute resolution measures in estate, trust, and guardianship administration are no different. Virtually every action taken, from the filing of the complaint to the settling of a lawsuit or other dispute, and even modification of a trust, has some potential implication for both transfer and income tax purposes.

Dealing competently with the tax ramifications is the responsibility of the fiduciary, and it is often treated as a non-delegable responsibility, so neither the fiduciary nor the fiduciary's lawyer (or, for that matter, the non-fiduciary who is a plaintiff or defendant serving his or her own interests) can successfully avoid the responsibility by claiming to have delegated it to a third party, such as an accountant. Therefore, it is important for any party to actual or threatened litigation to consider the transfer and income tax consequences of any matter or issue that arises in any stage of the controversy.

These materials are designed to provide an overview to focus attorneys and other estate planning professionals on the significant federal tax issues that arise through various aspects of resolving estate and trust controversies. Obviously, a detailed analysis of these topics would require volumes and is beyond the scope of this paper; state income and transfer tax issues are not addressed, nor are controversies directly with the IRS. These materials should not be viewed as a substitute for in-depth analysis. Instead, they can be used as a guideline to familiarize the attorney or other professional with tax problems that need to be addressed given the nature of the controversy or litigation.

A. Federal Transfer Taxes.

The federal estate tax has changed significantly in the past decade and a half. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. No. 107-16, 115 Stat. 38 (2001) ("EGTRA"), which significantly changed the federal transfer tax laws, and provided for the ultimate repeal of the estate and generation-skipping transfer ("GST") tax beginning in 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. No. 111-312, 124 Stat. 3296 (2010) ("TRA 2010"), restored the estate and GST tax in 2011 and made additional changes that have an impact on estates of decedents dying, gifts made, and generation-skipping transfers made after 2010. The American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013) ("ATRA"), made "permanent" changes to the transfer tax system enacted by EGTRA and TRA 2010, and the maximum transfer tax rate increased to 40 percent, rather than 35 percent as it had been under TRA 2010. In addition, many states modified their state estate and inheritance tax laws. Now, with the enactment of the Tax Cut and Jobs Act of 2017, P.L. 115-97, ___ Stat. ___ (2018) ("TCJA 2017") on December 22, 2017,[2] additional significant changes have been made to the income and transfer tax laws. TCJA 2017 essentially doubled the estate, gift and generation-skipping transfer tax exclusions for persons dying and transfers made between 2018 and 2025. As a result, we have unified estate, gift and GST tax laws with an exclusion temporarily set at $10,000,000, adjusted annually for inflation after 2010[3] (scheduled to return to $5,000,000 after

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[1] Portions of this paper were derived from Baker and Davis, *Tax Aspects of Estate and Trust Litigation,* 2015 Annual Meeting of The American College of Trust and Estate Counsel, and from Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 EST. PLAN. & COMMUNITY PROP. L.J. 35, 2013 (For a more recent version of this paper, although not updated since publication, see Willms, *Decanting Trusts: Irrevocable, Not Unchangeable,* presented to the Corpus Christi Estate Planning Council (March 2015), available at http://tinyurl.com/o7rnh7w.).

[2] The technical name of the Act is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018", but "AAPRPTIIVCRBFY 2018" seems to be a remarkably unhelpful acronym. Some have suggested "the Act Formerly known as TCJA 2018," or perhaps its abbreviation, "AFKATCJA."

[3] Prior to TCJA 2017, inflation was measured by changes to the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics. TCJA 2017 modified the index to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"),

2025, adjusted for inflation after 2010), and a top transfer tax bracket of 40%. For 2018, after applying the inflation adjustment, the exclusion is $11,180,000.[4]

The executor of a decedent's estate is required to pay federal estate tax if the decedent died owning property worth more than the amount of his or her estate tax applicable exclusion amount. The estate tax is due nine months after death. *See* IRC § 2001. Living individuals who make taxable gifts (i.e., gifts other than the direct payment of tuition and medical expenses for others, to the extent that the value of the gifts exceed the applicable annual exclusion amount), must report those gifts annually, and pay any resulting gift tax if the aggregate lifetime total of those gifts exceeds the individual's available gift tax applicable exclusion amount. *See* IRC § 2501. In addition, if an individual makes a taxable gift, or transfers property at death, in a manner that vests property in persons that occupy the generation of the transferor's grandchildren, without subjecting that property to gift or estate tax in the children's generation (or makes a transfer to an unrelated person more than 37½ years the transferor's junior), a GST tax must be paid when the property passes to the transferee, to the extent that the aggregate value of that property exceeds the transferor's available GST tax exemption. *See* IRC § 2601. Since 2011, the amount of the gift, estate and GST tax exemptions available to an individual are the same ($5.49 million in 2017, $11.18 million in 2018). A table outlining historical estate, gift and GST tax exemption amounts, the gift tax annual exclusion, and top tax rates from 1916 through 2017 (and estimated for 2018) is attached as Exhibit A.

B. Federal Trust and Estate Income Taxation

For federal income tax purposes, trusts and estates are treated as though they were entities, and must pay tax on their undistributed taxable income. For this purpose, trusts and estates use tax rules applicable to individuals, with certain modifications. IRC § 641. The most important difference is that trusts and estates are entitled to deduct the amount of income that they distribute (or are required to distribute) in any year to their beneficiaries. IRC §§ 651, 661. The beneficiaries must report a corresponding amount of the distributions as taxable income. IRC §§ 652, 662.

II. FEDERALISM AND THE INTERPLAY BETWEEN FEDERAL TAX LAW AND STATE LAW

A. Overview

In general, despite the fervent wish of litigants and their counsel, private parties cannot simply agree as between themselves what the tax consequences of resolving their dispute will be. The shifting of valuable property rights as a result of litigation, or in compromising bona fide disputes between adverse parties, will have tax consequences to the parties that are largely dependent upon the nature of the underlying claim. *See Lyeth v. Hoey*, 305 US 188 (1938). Thus, for example, as discussed in more detail below, amounts received in settlement of a will contest are generally treated as amounts received in the nature of an inheritance, and as a result, are not subject to income tax. *Id.* If a dispute is resolved by means of a settlement agreement instead of a final judgment, the IRS will generally respect the outcome so long as the settlement agreement resolves a bona fide dispute and the participants are bona fide claimants. Conversely, if there is no actual dispute, a settlement agreement that is a voluntary rearrangement of property interests may not be recognized by the IRS. *Reed's Est. v. Comm'r*, 171 F.2d 685 (8th Cir. 1948); *Centerre Trust Co. of St. Louis v. U.S.*, 676 F. Supp. 928 (E.D. Mo. 1988); *Comm'r v. Vease*, 314 F.2d 79 (9th Cir. 1963). In most cases, a shift of property rights as the result of a bona fide settlement of a dispute does not give rise to the imposition of gift tax. Treas. Reg. § 25.2512-8. *See also* PLR 8902045 (bona fide settlement does not result in gift tax under Section 2501 of the Internal Revenue Code ("Code")[5]). Thus, the tax effect of a settlement of the property rights at issue depends on the existence of a bona fide dispute, the transfers involved, and the existence of an enforceable right as between the settling parties. *See Ahmanson Found. v. U.S.*, 674 F.2d 761 (9th Cir. 1981); PLRs 201606002, 8902045.

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which generally grows more slowly than CPI. Using CPI, the 2018 figure would have been $11.20 million instead of the $11.18 million that appears to result from using C-CPI-U. Although many of the provisions related to individuals in TCJA 2017 are only effective for years 2018-2025, Chained CPI as the method of inflation adjustment is "permanent."

[4] This figure is unofficial, and represents the authors' best estimate using the Chained CPI figures published by the Bureau of Labor Statistics.

[5] References herein to “Section(s)” or to “Code” are to the Internal Revenue Code of 1986, as amended.

B. Getting the IRS to Respect the Result

Is the IRS bound by a state court adjudication of property rights when the United States was not a party to the state court action? To resolve any doubt, the taxpayer could seek a private letter ruling asking the IRS to approve the tax consequences of the action. *See* Rev. Proc. 2018-1, 2018-1 IRB 1. Such a ruling would bind the IRS, and in fact, the principles discussed herein are used in making those rulings. However, seeking a private letter ruling is not the only way to bind the IRS. The U.S. Supreme Court expressly addressed the issue of the effect of state court decisions in *Commissioner v. Estate of Bosch*, 387 US 456 (1967). In reaching its decision, the Court reiterated its longstanding holding that property rights are determined by state law. *Id.* at 467 ("it is incumbent upon federal courts to take state law from state court decisions when federal tax consequences turn on state law"). The Court also held that when federal estate tax liability as it related to a settlement was contingent on the character of a property interest held and transferred by a decedent under state law, the IRS is not "conclusively bound" by a state court ruling as to a property interest. The Court formulated a new test which essentially provided that: (i) when a state law property right has been decided by the highest court of the state, the decision should be followed and respected as the best authority for that state's law; and (ii) when a state law property right has not been decided by the highest court of the state, federal authorities (be it the IRS or a tax court deciding the issue) "must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." *Id.* at 465. The Court in adopting this rule recognized that it requires the deciding authority to sit "as a state court." *Id.* (citing *Bernhardt v. Polygraphic Co.*, 350 US 198 (1956)). Thus, a fundamental requirement of any settlement agreement is that it meets state law requirements, and is based on valid rights of the parties under state law. *See* PLRs 201634015 (citing *Bosch* in ruling judicial reformation would be respected for estate and gift tax purposes), 201544005.

1. Resolution of Bona Fine Dispute

The threshold test for IRS acceptance of tax treatment of settlement interests is that there must be an actual, bona fide dispute or controversy that is resolved. The IRS will not consider a family settlement agreement to be a bona fide compromise agreement unless the parties' claims are (i) bona fide and (ii) satisfied on an economically fair basis. *See* PLRs 201606002, 8902045. While truly adverse positions must be settled, the courts have held that a settlement among the parties may be honored even in those situations where the disagreement is short of a "full scale war." *See Citizens and Southern Nat'l Bank v. U.S.*, 451 F.2d 221 (5th Cir. 1971); *see also Est. of Hubert v. Comm'r*, 101 TC 314 (1993), *aff'd*, 63 F.3d 1083 (11th Cir. 1995) (marital deduction allowed for payments to spouse in settlement of bona fide will contest); *Est. of Dutcher v. Comm'r*, 34 TC 918 (1960), *acq*., 1961-1 CB 4; *Ducan v. U.S.*, 236 F. Supp. 747 (D. Md. 1965); *First Nat'l Bank v. U.S.*, 328 F. Supp. 1339 (N.D. Ala. 1971); *Est. of Barrett v. Comm'r*, 22 TC 606 (1954).

If the IRS concludes that there is no such controversy, it can either (i) conclude that the exchange of a property interest was a gift and impose transfer tax if it appears that parties with significant interests have sacrificed their interests for donative purposes and without adequate consideration; or (ii) conclude that there has been a sale or exchange if full and adequate consideration for the property interest compromised appears to have changed hands. *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940); *Allen v. First Nat'l Bank & Trust Co.*, 157 F.2d 592 (5th Cir. 1946); *Comm'r v. Brinckerhoff*, 168 F.2d 456 (2d Cir. 1948); *Bell's Est. v. Comm'r*, 137 F.2d 454 (8th Cir. 1943); Rev. Rul. 72-243, 1972-1 CB 233; Rev. Rul. 69-486, 1969-2 CB 159, *distinguished by* Rev. Rul. 83-61, 1983-1 CB 78; PLRs 9649015, 9830017; TAM 8145026; *see also* CCA 201651013 (aff'd by CCA 201747005).

If, on the other hand, interests are surrendered, increased, or diminished as a result of what is deemed to be a bona fide controversy, the IRS will generally respect the transaction and will apply the tax treatment in accordance with the principles applicable to the interests of the parties under the settlement or other disposition of the dispute. *See, e.g.*, PLRs 199948014, 9848009; TAM 9005003.

2. Enforceable State Law Rights

A party to a settlement should not assume that the property and proceeds received or paid in settlement will automatically be deemed to have passed in accordance with the stipulations of the parties in a settlement agreement. For example, in settling a dispute about a will contest or an action regarding ownership of property, the IRS may well argue that the property passed not from the decedent, but among the heirs as a settlement of their disputes. If the claim results in the passage of property among the heirs, and not from the decedent, the result may be that the property may nevertheless be subjected to estate tax in the decedent's estate. Where there is no adequate consideration for the settlement agreement, gift tax consequences may arise. *See Nelson v. U.S.*, 89-2 USTC ¶ 13,823 (D. N.D. 1989) (unreported); *see also* PLR 8902045 (intra-family settlements should not result in shifts between the parties' economic rights, determined "with appropriate allowances for uncertainty," and that "differences may be justified on the basis of compromise."). Whether bona fide property law rights are established is a matter of state law. For example, as the Supreme Court noted in *Bosch* in the context of a marital deduction bequest, the "test of 'passing' for estate tax purposes should be whether the interest reaches the spouse pursuant to state law, correctly interpreted [by the federal court]—not whether it reached the spouse as a result of a good faith adversary confrontation." *See Est. of Brandon v. Comm'r*, 828 F.2d 493, 497 (8th Cir. 1987) (citing *Bosch* at 774). Thus, the federal estate tax issue regarding the deductibility of the payment of a marital or charitable bequest or a debt was dependent on the state law property issue of whether the settlement payment was made pursuant to an enforceable state law right.

Although part of the *Bosch* test references a state property right as determined by the highest court of that state, the timing of the state court decision related to the event that triggers the tax that is later at issue could be a factor in determining whether the IRS will be bound to a decision of a lower court, even a decision contrary to that of the state's highest court. In Revenue Ruling 73-142, a trust was modified during the grantor's life and the grantor participated in the judicial modification. As a result of the modification, trust assets that would otherwise be includible in the grantor's estate would no longer be includible, which was consistent with the grantor's intent. The lower state court's decision regarding the modification was contrary to holdings of that state's highest court. The grantor died after the lower court's decision was no longer appealable. An issue was raised regarding whether the IRS was bound to the lower court's decision and whether the trust assets should in fact be included in the grantor-decedent's estate. The IRS pointed out that *Bosch* does not state that just because a lower court's decision is inconsistent with a decision of that state's highest court, the lower court's decision is void. The IRS noted that as to the grantor and the other parties to the proceeding, the modification occurred before the grantor's death and the lower court's decision became final and binding before the event giving rise to the tax at issue, i.e. estate taxes. Since the issue in the ruling involved powers held by the grantor at the time of his death, the IRS was bound to the decision of the lower court despite the fact that it would be contrary to a decision of the state's highest court. Rev. Rul. 73-142, 1973-1 CB 405. *Cf. Est. of Rapp v. Comm'r*, 140 F.3d 1211 (9th Cir. 1998) (probate court order reforming will after testator's death to reform trust to qualify as a QTIP trust not binding on IRS when order not confirmed by state's highest court and terms of will were unambiguous).

Even in fully litigated cases, the IRS does not consider itself bound by the decision of a trial court or intermediate appellate court. Citing the first part of the *Bosch* decision, the IRS often asserts that it is not bound by any court determination short of one entered by the highest appellate court of the state. Unfortunately, the IRS sometimes neglects the second part of that test, which requires federal authorities to give "proper regard" to relevant rulings of other courts of the state. If the resolution of the case results from the parties' proper application of relevant state law, the outcome should bind the IRS without the need to have the local highest court weigh in on the specific case at issue. Note that seeking a ruling from the highest court, even where available, can be a two-edged sword. *Compare Carlson v. Sweeney*, 895 N.E.2d 1191 (Ind. 2008) (in suit by trust beneficiaries for malpractice of drafting attorney that failed to achieve decedents' tax objectives, Indiana Supreme Court adopted substantive change to state law recognizing trust reformation for mistake of law, noting "as for the I.R.S., it is clear that the agency as well as the federal courts are bound by this Court's determination that the Testators' wills were properly reformed in accordance with the laws of this State", *id.* at 1201, citing *Bosch*) *with In re Trust of Darby*, 234 P.3d 793 (Kan. 2010) (Kansas Supreme Court, reviewing trial court's reformation of trust agreement under statute authorizing opinion to thereby make law of case binding on IRS, rejected trial court's modification of trust agreement under Kansas statutes regarding trust modifications).

3. Quantitative Issues

Once the IRS has determined that there is an actual dispute or controversy being resolved, and that the dispute was resolved based upon the proper application of state law rights, the IRS may further scrutinize the outcome to ensure that any amount received or paid does not substantially exceed the value of property that the party could have received if the party had pursued all legal claims to judgment and had succeeded on all of them. In other words, someone who had a right to contest a will and obtain an intestate share of $100,000 may have any interest received in excess of $100,000 disregarded by the IRS in determining the tax treatment of the settlement. *Est. of Myers v. Comm'r,* TC Memo 1968-200 (1968); *Est. of Brandon v. Comm'r,* 828 F.2d 493 (8th Cir. 1987); *Citizens & Southern Nat'l Bank v. U.S.*, 451 F.2d 221 (5th Cir. 1971); *Pastor v. U.S.*, 386 F. Supp. 106 (E.D.N.Y. 1974); *Est. of Tebb v. Comm'r,* 27 TC 671 (1957); Rev. Rul. 83-107, 1983-2 CB 159.

4. Qualitative Issues

In addition to the quantitative limitation on settlement interests, the IRS generally will not recognize the tax treatment of an interest created pursuant to settlement that qualitatively departs from the nature of the property rights that the party could have obtained if all claims were litigated pursuant to state law. In other words, someone whose only right in the litigation or controversy would have been to sue to obtain a greater share in trust for life would generally not have a settlement interest recognized that grants significant and immediate property rights or distributions outright. *Est. of Agnello v. Comm'r,* 103 TC 605 (1994); TAM 9610004; *Bel v. U.S.,* 73-1 USTC ¶12,925 (W. D. La. 1972); *Citizens & Southern Nat'l Bank v. U.S.,* 451 F.2d 221 (5th Cir. 1971); *Est. of Tebb v. Comm'r,* 27 TC 671 (1957). Naturally, it may be difficult to ascertain the exact qualitative rights to which vying parties may be entitled. Nevertheless, the IRS will generally accept settlements that are within the range of reasonable outcomes that the parties might expect in litigation, after giving appropriate effect to allowances for uncertainty and compromise. *See, e.g.,* PLRs 201606002, 201528024, 8902045; Treas. Reg. § 26.2601-1(b)(4)(i)(B).

C. Does a Lawsuit Need to Be Filed?

While state law controls a person's property rights, a judicial determination is not necessarily required in order to establish those rights. In fact, most states have rules or statutes expressly adopting a policy of encouraging resolution of disputes and early settlement of pending litigation through voluntary settlement procedures. *See, e.g.,* TEX. CIV. PRAC. & REM. CODE § 154.002. *See also Shepherd v. Ledford*, 962 S.W.2d 28 (Tex. 1998); *In Re Est. of Hodges*, 725 S.W.2d 265, 267 (Tex. App.–Amarillo 1986, writ ref'd n.r.e.); *Est. of Morris*, 577 S.W.2d 748, 755-56 (Tex. Civ. App.–Amarillo, 1979, writ ref'd n.r.e.). Encouraging settlement and compromise is in the public interest. *See, e.g., Bass v. Phoenix Seadrill/78, Ltd*., 749, F.2d 1154, 1164 (5th Cir. 1985); *Knutson v. Morton Foods, Inc.*, 603 S.W.2d 805, 808 (Tex. 1980); *Gilliam v. Alford*, 69 Tex. 267, 6 S.W. 757, 759 (Tex. 1887). From a tax standpoint, the settlement of a bona fide dispute should be accorded the same effect as a judgment. *Est. of Barrett v. Comm'r*, 22 TC 606 (1954). According to the court in *Estate of Barrett v. Commissioner*:

> In *Lyeth v. Hoey*, the Supreme Court found too formal for substance the distinction between a payment made to an heir pursuant to judgment in a proceeding contesting a will and a payment made in compromise, in advance of trial, of the claims made in the proceeding. We think, similarly, that the distinction pressed by the respondent, on the basis of his regulations, between a payment made pursuant to an order of a local court after a fully litigated proceeding and a payment made in settlement of claims that avoids a will contest is without merit. A will contest can exist without full blown legal proceedings and we have no doubt that the executor in this case recognized the threat made on his sister's will. If the proceeding had ever come to issue and trial, the executor may well have opposed Barrett's claim, though recognizing as a danger that there was a possibility that Barrett might succeed and be awarded a substantial sum of money. If Barrett had litigated his claim and been awarded a judgment, the amount received by him would qualify as a marital deduction as an interest passing by inheritance. We find nothing in the statute or in logic that would deny similar treatment to a settlement payment made in advance of the contest where there is sufficient basis for a reasonable belief that only such payment would avoid a serious and substantial threat to the testamentary plan provided by the decedent.

Id. at 610.

If the estate seeks to take an estate tax deduction for a claim against the estate, an executor can rely for tax purposes on a court decree establishing the amount of a deductible claim, but only if a court of competent jurisdiction actually passed on the facts on which deductibility depends. Treas. Reg. § 20.2053-1(b)(3). A court decree is not necessary, however, if not required by applicable law. *Id*. An executor can rely on a consent decree if it resolves a bona fide issue in a genuine contest. That requirement is presumed to be satisfied if all parties with an adverse interest consent. The amount determined by the decree is subject to the general rule that a deduction will be allowed only to the extent the claim is actually paid. *Id*. The executor similarly can rely on a settlement agreement if it resolves a bona fide issue in a genuine contest and results from arm's-length negotiations by parties with adverse interests. Treas. Reg. § 20.2053-1(b)(3)(iv); *see also* Treas. Reg. § 20.2053-4(d)(7), Ex. 7; PLR 201606002. A deduction generally will not be allowed for a claim while it is being contested by the estate. Treas. Reg. §§ 20.2053-1(b)(2), 20.2053-1(b)(3), 20.2053-1(d), 20.2053-4.

D. No Independent Property Law Purpose

As discussed, the shifting of interests in a settlement document from those to which the parties would otherwise be entitled, effected without proper substance and made solely to bring about a change in tax characterization, will be ignored by the IRS. PLRs 200004014, 9716011, 9423015. For example, someone entitled to receive a residuary share of an estate worth approximately $100,000 who settles for a specific bequest of $100,000 generally will not be entitled to avoid the fact that the distribution will carry out DNI when made, even though the party has "agreed" to turn its residuary stake (which carries out DNI to the beneficiary on funding) into a specific bequest (which does not). Likewise, an estate may recognize gain on the funding of a pecuniary bequest, even if the estate is not sufficient to fund that bequest and the beneficiary in effect agrees to accept the residue of the estate in satisfaction of the bequest. *See* Rev. Rul. 82-4, 1982-1 CB 99. Therefore, many parties who negotiate to achieve tax advantageous property interests on substantially equivalent economic terms as those to which the parties would have otherwise been entitled will not qualify for the intended tax status. Moreover, the parties are generally bound by the terms of their agreement, and cannot, having characterized the transaction among themselves, argue that the transaction should be recharacterized in a different (more favorable) fashion when the transaction is reported to the IRS. *See Insilco Corp. v. U.S.*, 53 F.3d 95 (5th Cir. 1995); *Comm'r v. Danielson*, 378 F.2d 771 (3rd Cir. 1967).

III. ISSUES THAT ARISE IN REPRESENTING FIDUCIARIES

A. Overview

There are a number of obligations imposed by federal and state tax laws on an estate's representative or a trustee in administering an estate or trust. Many of these obligations do not directly relate to the subject matter of this paper. Instead, the obligations addressed are made up of various tax return filing requirements and duties to bring the decedent, in the case of a decedent's personal representative, into compliance with tax law. These obligations can often cause liability for a fiduciary independent of other matters involving fiduciary litigation. Although not directly related to the topic of this paper, a brief overview of those subjects is appropriate here.

1. Duty to File and Duty to Pay

The executor of a decedent's estate, which for tax purposes may include both a state law executor or administrator and a trustee administering estate property, generally has an obligation to file four sets of tax returns for a decedent and the decedent's estate: (a) an estate tax return addressing estate tax liability (IRC § 6018), and perhaps for making an estate tax "portability" election (IRC § 2010(c)(5)); (b) any gift tax returns due and unfiled at the date of death representing transfers during life by the decedent for less than full and adequate consideration (IRC § 6019); (c) any personal income tax returns outstanding for the decedent on the date of death, including a final income tax return for income earned in the calendar year of the death and through the date of death (IRC § 6012(b)(1)); and (d) any fiduciary income tax returns for income generated by any estate or trust for which the fiduciary acts (IRC §§ 6012(a)(3)-6012(a)(5), 6012(b)(4), 6012(b)(5)).

The executor of any estate that is required to file an estate tax return under Code Section 6018 (i.e., the executor of an estate that is over the estate tax filing threshold) must furnish to the IRS and to each person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes a statement identifying (1) the value of each interest in that property as reported on the estate tax return, and (2) any other information about the interest that the IRS might require. IRC § 6035(a)(1). In addition, each person required to file a return under Code Section 6018(b) (persons other than executors holding estate property) must furnish to the IRS and to each other person who holds a legal or beneficial interest in the property to which that return relates a statement identifying the information described above. IRC § 6035(a)(2). In January 2016, the IRS issued Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent" to be used to provide the required information to the IRS, and Schedule A to Form 8971 to provide the required information to beneficiaries. The IRS is required to prescribe any regulations that are necessary to carry out these rules, including rules applicable to estates for which no estate tax return is required to be filed, and for situations where a surviving joint tenant or other recipient might have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b). On March 4, 2016, the IRS issued proposed and Temporary Regulations under Code Sections 1014(f) and 6035. *See* TD 9757. Pursuant to the proposed regulations, Form 8971 is termed an Information Return, and Schedule A is termed a Statement. Prop. Treas. Reg. § 1.6035-1(g). The statement must be furnished at the time that IRS requires, but in no case at a time later than the earlier of (1) 30 days after the date on which the estate tax return is required to be filed (including extensions), or (2) 30 days after the date the estate tax return is filed. IRC § 6035(a)(3)(A). If there is an adjustment to the information required to be included on a statement already filed, a supplemental statement must be filed no later than the date 30 days after the adjustment is made. IRC § 6035(a)(3)(B).[6]

The duty to file the tax returns, as described above, and to pay any associated taxes is non-delegable, absent exceptional circumstances. *U.S. v. Boyle*, 469 US 241 (1985) (also addressing what meets the "reasonable cause" exception); *Specht v. U.S.*, 118 AFTR2d ¶ 2016-5906 (6th Cir. 2016); *Smith v. U.S.*, 82-1 USTC ¶13,471 (D. Minn. 1982), aff'd, 702 F.2d 741 (8th Cir. 1983); *Millette & Assoc. v. Comm'r*, 594 F.2d 121 (5th Cir. 1979); *Ruel v. U.S.*, 430 F. Supp. 1122 (E.D.Wis. 1977); *Est. of Duttenhofer v. Comm'r*, 410 F.2d 302 (6th Cir. 1969); *Ferrando v. U.S.*, 245 F.2d 582 (9th Cir. 1957). In other words, if the executor hires an accountant or attorney and employs that agent to prepare and file any or all of these returns, failure to adequately file returns (and pay tax due with the returns) will typically subject the fiduciary to liability even if the agent was charged with preparing and filing the tax returns. *See U.S. v. Boyle*, 469 US 241 (1985); *Leigh v. Comm'r*, 72 TC 1105 (1979); *McMurren v. U.S.*, 82-1 USTC ¶13,446 (C.D. Cal. 1981); *Ferrando, supra; Specht v. U.S.*, 118 AFTR2d ¶ 2016-5906 (6th Cir. 2016) (estate was liable for $1.2 million in late filing penalties and interest on federal estate taxes, despite executor relying on attorney who was suffering from brain cancer and who erroneously failed to file the return as directed). *See also* Treas. Reg. § 301.6651-1. Beneficiaries who suffer damages or costs associated with failure to file these returns or failure to pay the taxes in whole or in part have a sustainable cause of action against the fiduciary that is not mitigated or alleviated by the fiduciary's reliance on counsel or accountants. The fiduciary's remedy is to countersue those agents for malpractice if their failure to file or pay is due to professional negligence. *Sarto v. U.S.*, 563 F. Supp. 476 (N.D. Cal. 1983).

A complete breakdown of all applicable penalties for failure to file or pay fiduciary taxes is beyond the scope of this section. However, in the estate tax area alone, there are separate penalties for failure to file a tax return and for failure to pay tax (IRC § 6651), additional penalties for negligence or fraud in preparing the return (IRC §§ 6662, 6663), penalties for asset valuation overstatements (geared to maximizing basis and minimizing income tax) (IRC § 6659(c)) or of pension liabilities (IRC § 6662(f)), and penalties for understatement of estate or gift tax valuation (IRC § 6662(g)). There are also interest obligations for any unpaid amount and any penalties assessed pursuant to Section 6621 of the Code. The combined impact of these penalties, with either of the understatement or overstatement valuation penalties (which are difficult to incur simultaneously) can have the impact of increasing the tax due by over 50 percent, and these penalties generally are not deductible for any purpose. Rev. Rul. 81-154, 1981-1 CB. 470; *People ex re. Burris v. Boeger*, 644 N.E.2d 435 (Ill. App. Ct. 1994). In contrast, interest on deferred federal estate tax, deficiencies and penalties (but not on estate taxes deferred under Code Section 6166) is generally deductible for federal estate tax purposes. IRC § 2053(a)(2); Rev. Rul. 79-252, 1979-2 CB 333. Note that deduction of the interest, may reduce overall taxes and penalties, which may thereby decrease the interest due, thereby increasing taxes and penalties, etc., requiring an interrelated or simultaneous set of equations to solve for the actual interest owed. Moreover, the rate on this interest is such that the impact of the deduction may be no more than to render the interest rate a functional equivalent of market rate returns on fixed-income investments.

Although there are statutory means to defer payment of estate taxes without penalty (IRC §§ 6161, 6166), interest on deferred taxes continues to accrue. Moreover, the ability to defer the payment of estate taxes is in some cases a matter of discretion, and its availability should not be taken for granted. *See, e.g., Est. of Hartsell v. Comm'r*, TC Memo 2004-211 (2004) (executor liable for additions to tax under Code Section 6651(a)(2) for failure to timely pay federal estate tax when executor failed to seriously pursue financing to pay the tax).

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[6] The foregoing is a very brief description of the filing requirements under Code Section 6035 and is not intended to be a comprehensive discussion.

2. Fiduciary Liability to Taxing Authority for Payment and Distribution

a. Rules for Imposing Fiduciary Liability

Federal taxing authorities, to a large extent, use executors as their collection agents. They do so primarily through the notion of "fiduciary liability." Pursuant to the concept of fiduciary liability, the executor is personally liable for tax liabilities of the decedent, at least to the extent that assets of the decedent come within the reach of the executor. 31 USC § 3713(b) (tax claim priority); *see also* IRC §§ 6321-6323 (federal tax liens), 6901(a)(1)(B) (transferee liability). Code Section 2002 expressly imposes upon an executor the obligation to pay estate taxes. If the IRS has recorded tax liens against a decedent, then the payment of the lien takes priority over other debts of the decedent as well as expenses for the administration of the decedent's estate. *See* IRC §§ 6321, 6323; *In re Est. of Simmons,* 120 AFTR 2d ¶ 2017-5368 (S.D. Ind. 2017). More broadly, fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes a living or deceased debtor's property to other creditors before he or she satisfies a debt due to the United States. 31 USC § 3713(b); Treas. Reg. § 20.2002-1; *U.S. v. Holmes*, 119 AFTR 2d ¶ 2017-2174 (S.D. Tex. 2016) (amended district court judgment finding (1) executor liable for unpaid estate tax; (2) beneficiaries, one of whom is the executor, personally liable for estate tax per 31 USC § 3713 and state law; and (3) estate property received by the beneficiaries could be seized to satisfy the state law liens). The extent of the IRS's priority for satisfaction of its lien may come down to whether the lien is for a tax liability of the decedent for which a federal tax lien has been recorded. While a liability is normally focused upon a court-appointed executor where one exists, where there is none, a wider net may be cast. *See, e.g., U.S. v. Paulson*, 118 AFTR 2d ¶ 2016-5665 (D.C. Cal. 2016) (after removal of court-appointed executor, IRS could pursue claim against surviving spouse-distributee as "executor" under Code Section 2002).

(1) Priority of Recorded Federal Tax Liens

If the IRS has recorded a tax lien against the property of the decedent prior to the decedent's death, that lien may take priority over all claims against the property except for choate claims of a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. IRC § 6323; *Sgro v. U.S.*, 609 F.2d 1259, 1261 (7th Cir. 1979); *In re Est. of Simmons*, 120 AFTR 2d ¶ 2017-5368 (S.D. Ind. 2017). Courts who have reached this conclusion interpret Code Section 6323 as giving the federal government super-priority for its claims over all other claims but for those of the creditors listed in the statute. *Id*. The federal government's super-priority may take precedence over such items as funeral and estate administration expenses, although the IRS "may in its discretion not assert priority of its federal tax lien over reasonable administrative expenses of the estate." IRM 5.5.2.4(3) (Apr. 5, 2012).

(2) Exceptions to Fiduciary Liability

For IRS claims, other than those that have been recorded as discussed above, 31 USC § 3713 establishes the IRS's priority in relation to other creditors for claims against a decedent's estate and its fiduciary. On its face, Section 3713(a) seems to impose absolute liability upon an executor. It essentially provides that debts due to the United States must be paid before the debts of any other creditor. No exceptions are made in the statute for the payment of administrative expenses or for the satisfaction of earlier liens out of the debtor's property or estate. However, courts and the IRS have held that this apparent absolute priority is subject to a number of exceptions. First, costs of administering an estate may be paid before a tax claim. *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943) (priority given to expenses for administration, funeral, and headstone). These expenses include court costs and reasonable compensation for the fiduciary and attorney. *See Champlin v. Comm'r*, 6 TC 280, 285 (1946). The theory for permitting the payment of these items is that they were not incurred by the debtor but are for the benefit of all creditors, including the United States. *See Abrams v. U.S.*, 274 F.2d 8 (8th Cir. 1960). Second, funeral expenses and widow's allowances may be paid before the government's claim, as may doctor's bills from last illness and wages due household employees. Rev. Rul. 80-112, 1980-1 CB 306. The basis for allowing these payments is less clear than for administration expenses, but the rationale seems to be that because funeral expenses and the widow's allowance are considered charges against the estate, the executor, in effect, never actually had possession of this property. *Id*. However, payments of state income taxes, general creditors, and other claims constitute the payment of debts in derogation of the government's priority. Rev. Rul. 79-310, 1979-2 CB 404. Likewise, distributions to beneficiaries are not "charges" against the estate, but are treated as the payment of a "debt." In addition, a distribution to the executor-beneficiary cannot be treated as the payment of "administration expenses" unless the executor demonstrates that the expenses were used for that purpose. *U.S. v. McNicol*, 829 F.3d 77 (1st Cir. 2016). As a result, liability arises if the executor makes distributions to beneficiaries from an insolvent estate before payment of estate or gift taxes. Treas. Reg. §§ 20.2002-1 (estate tax), 25.2502-2 (gift tax). State law may impose an independent source of liability for an executor. *See, e.g.,* TEX. ESTS. CODE § 355.113 (liability if payment not made after court orders claim to be paid).

In recent Chief Counsel Advice 201723018, the IRS has been given instructions as to how it should approach its involvement in a state probate proceeding. Specifically, the IRS is advised that if it participates in a state action, such as by filing a claim in the probate proceeding, then by doing so, it will be bound by that state court's final decision as to the priority of its claim as against other creditors and with regard to potential fiduciary liability. The IRS is further advised that it may be bound to the state court's decision, even if that decision differs from what would apply under federal law, but if the IRS had not participated in the proceeding, it will preserve its right to seek remedy under either the federal priority statute of Code Section 6323 or to impose fiduciary liability pursuant to 31 USC § 3713(b). Therefore, the recommendation is made for the IRS to consider its options and make a conscious decision to either not participate at all, or to participate, but if the latter choice is made, then to participate fully so that all rights to remedies may be preserved.

(3) Insolvency of Estate

Fiduciary liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate (or of the insolvency and collective creditor proceeding involving a living debtor), the priority of 31 USC § 3713(a) is applicable. *See U.S. v. Coppola*, 85 F.3d 1015 (2d Cir. 1996).

(4) Limited to Distributions

The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States is paid, and then only to the extent of distributions made after the estate's insolvency but including if the distributions make the estate insolvent. 31 USC § 3713(b); *Schwartz v. Comm'r*, 560 F.2d 311 (8th Cir. 1977); *Singer v. Comm'r*, TC Memo 2016-48 (2016) (Tax Court emphasized the burden of proof lies with the IRS).

(5) Knowledge Described

Although a literal reading of 31 USC Section 3713 seems to impose strict liability on a fiduciary when he makes a distribution which leaves the estate with insufficient funds from which to pay a debt owing to the United States, courts have long departed from such a rigid interpretation. *See Singer v. Comm'r*, TC Memo 2016-48 (2016) (non-probate assets and state law contribution requirements of beneficiaries to pay portion of taxes taken into account to find estate was solvent at time distributions were made from probate estate). In order to render a fiduciary personally liable, he or she must first be chargeable with knowledge or notice of the debt due to the United States at a time when the estate had sufficient assets from which to pay the debt. *U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Leigh v. Comm'r*, 72 TC 1105 (1979); *Want v. Comm'r*, 280 F.2d 777 (2d Cir. 1960).

(6) Deferring Distributions

Fiduciaries will frequently delay making distributions until they are sufficiently sure they are no longer liable for the decedent's income tax and estate tax liabilities. Refunding agreements with beneficiaries and state law provisions allowing fiduciaries to get back prior distributions to settle estate liabilities are sometimes relied upon, but these solutions protect the fiduciary only to the extent that the beneficiaries still have the funds in their possession to refund to the estate.

(7) Priority of Tax Claims

In a probate setting, the state law rules relating to the time and place for filing claims do not apply to the tax claims of the United States. *Board of Comm'rs of Jackson County v. U.S.*, 308 US 343 (1939); *U.S. v. Summerlin*, 310 US 414 (1940); *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943). Federal law generally provides that a debt due to the United States be satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors. 31 USC § 3713(a). As mentioned above, however, although no exceptions are made in Section 3713(a) for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943); Rev. Rul. 80-112, 1980-1 CB 306; GCMs 35849, 38159.

b. Lien for Estate and Gift Taxes

In addition to fiduciary liability, the Code imposes an automatic special lien for unpaid estate and gift taxes which arises without assessment, notice, demand for payment, or filing. The special lien for estate taxes attaches to the gross estate, and lasts for ten years from the date of the decedent's death, unless the tax is paid or otherwise discharged before that time, such as by seeking a discharge if need be by filing IRS Form 4422, "Application for Certificate Discharging Property Subject to Estate Tax Lien." IRC § 6324(a). It attaches to the extent of the tax shown to be due by the return and for any deficiency in tax found to be due. Treas. Reg. § 301.6324-1(a)(1). A similar lien attaches for gift taxes for a period of ten years from the date of the gift, making the donee personally liable for unpaid gift taxes to the extent of the fair market value of the gifted property. IRC § 6324(b); s*ee La Sala v. Comm'r*, TC Memo 2016-42 (2016) (Tax Court found estate liable for interest on gift taxes because issue was not specifically included in settlement documents with IRS).

Not all property is subject to the estate tax lien. Specifically, the lien does not apply to: (i) the part of the gross estate that the executor can demonstrate was used to pay charges against the estate and the costs of administration, which have been allowed by a court of competent jurisdiction (IRC § 6324(a)(1)); (ii) non-probate property included in the gross estate under Code Sections 2034 through 2042, which is transferred by the recipient of the non-probate property to a buyer or holder of a security interest, although the lien then attaches to all of the transferor's remaining property (IRC § 6324(a)(2)); (iii) probate property transferred to a bona fide buyer or holder of a security interest, but only if the executor of the estate has been discharged from personal liability under Code Section 2204, in which event the consideration received is subject to the lien (IRC § 6324(a)(3)); and (iv) property released by certificate under Code Section 6325 (Treas. Reg. § 301.6324-1(a)(2)(iv)).

Note that when taxes are deferred under Code Section 6166 (permitting the payment over ten years of taxes attributable to an interest in a closely held business if more than 35 percent of the value of the adjusted gross estate is attributable to that business), the deferred amount of estate tax, plus any interest, penalties, and costs, becomes a lien in favor of the United States. In that event, the executor may identify "section 6166 lien property" which, with the consent of each person having an interest in that property, becomes subject to the lien in lieu of the general lien imposed under Code Section 6324. IRC § 6324A(b), (c). Like the general lien under Code Section 6324, the Section 6324A lien is not valid against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor if the executor of the estate has been discharged from personal liability under Code Section 2204. Like the Section 6324 lien, however, once the lien is recorded, it takes priority over all claims except a purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor whose interest is recorded before the filing of the tax lien. IRC § 6324A(d). Also like a recorded Section 6324 lien, a recorded Section 6324A lien has no exception for administration expenses paid ahead of the taxes. *See U.S. v. Spoor*, 118 AFTR 2d ¶ 2016-6018 (11th Cir. 2016).

If a decedent's property is subject to an existing income or other tax lien that had arisen before death, such as a recorded lien found to have priority under Section 6323, that property will remain subject to the lien as well as the IRS's power to seize the property to satisfy the lien. *U.S. v. Davis, Sr.*, 119 AFTR 2d ¶ 2017-1122 (5th Cir. 2017). In *United States v. Davis, Sr.*, the court recognized that state law will determine the property to which the tax lien will attach, and in so doing, found that what had been former community property of a decedent-spouse remained subject to a tax lien and subject to seizure, regardless of the fact that the property passed to beneficiaries other than the surviving spouse. *Id*.

c. Transferee Liability Contrasted

Fiduciary liability should be contrasted with transferee liability. Transferee liability may make the transferee: (1) of property of a taxpayer personally liable for income taxes, (2) of property of a decedent personally liable for estate taxes, and (3) of property of a donor personally liable for gift taxes. IRC §§ 6324(a)(2), 6324(b), 6901(a)(1)(A).

(1) Transferee Liability "at Law or in Equity"

Under Code Section 6901(a)(1)(A), the IRS can impose liability for unpaid income, gift or estate taxes "at law or in equity" upon a transferee of the decedent's property. Code Section 6901(a)(1) is a procedural provision, which applies only when state or federal law imposes liability on the transferee for debts or taxes owed by the person from whom the transferee received property. *See Comm'r v. Stern*, 357 US 39 (1958); *see also, Feldman v. Comm'r,* 779 F.3d 448 (7th Cir. 2015); *Diebold Fd. v. Comm'r,* 736 F.3d 172 (2d Cir. 2013); *Sawyer Trust of May 1992 v. Comm'r*, 712 F.3d 597 (1st Cir. 2013); *Swords Trust v. Comm'r*, 142 TC 317 (2014); *Hawk v. Comm'r*, TC Memo 2017-217 (2017); *Alterman Trust v. Comm'r,* TC Memo 2015-231 (2015). Federal law that imposes personal liability for unpaid estate tax on a transferee can be found in Section 6324(a)(2). Specifically, recipients of non-probate property included in the gross estate under Sections 2034-2042 are personally liable for any estate tax to the extent of the property they received, however, distributees of the decedent's probate estate are not. IRC § 6324(a)(2); *see, e.g., Baptiste v. Comm'r*, 29 F.3d 1533 (1th Cir. 1994); *Beaty v. U.S.*, 937 F.2d 288 (6th Cir. 1992); *U.S. v. Johnson*, 121 AFTR 2d ¶ 2018-341 (D.C. Ut. 2018); *Street v. U.S.*, 310 F.Supp. 657 (S.D. Tex. 1969). Distributees of the probate estate are only personally liable if the IRS can identify some other source of liability under federal or state law, such as a state fraudulent conveyance statute. Federal law that imposes personal liability for unpaid gift tax on a transferee can be found in Section 6324(b). For liability to be imposed in a proceeding other than one under Section 6324, the IRS must prove the elements specific to that proceeding, which typically would include that the estate became insolvent as a result of the transfer. S*ee, e.g.*, TEX. BUS. & COMM. CODE, Title 3, Ch. 24 (Texas Uniform Fraudulent Transfer Act).

(2) Applicable Law

As discussed above, transferee liability for estate and gift taxes may be imposed by Code Section 6324. Generally, if that section does not apply, the liability of a transferee "at law or in equity" is a question of state, not federal, law. *See Comm'r v. Stern*, 357 US 39 (1958); *see also, Feldman v. Comm'r*, 779 F.3d 448 (7th Cir. 2015); *Diebold Fd. v. Comm'r*, 736 F.3d 172 (2d Cir. 2013); *Sawyer Trust of May 1992 v. Comm'r*, 712 F.3d 597 (1st Cir. 2013); *Swords Trust v. Comm'r*, 142 TC 317 (2014); *Hawk v. Comm'r*, TC Memo 2017-217 (2017); *Alterman Trust v. Comm'r*, TC Memo 2015-231 (2015). Even though state law may govern whether a person is liable as a transferee (and if so, the extent of a transferee's liability), the principle is subject to important qualifications. First, when state law does not definitively answer a question relating to the transferee's liability in a particular case, federal courts consult judicial principles to protect private creditors as well as the body of federal transferee liability law in federal courts. *See Starnes v. Comm'r,* 680 F3d 417 (4th Cir. 2012). Second, although state law controls, it is a federal court, not a state court, that independently determines the result under state law. *Id; see also U.S. v. Kimball*, 117 AFTR 2d ¶ 2016-2234 (D.C. Me. 2016) *citing U.S. v. Kraft*, 535 US 274 (2002). Third, the supremacy of the federal government prevents state law from being applied to limit some transferee liability issues. Thus, for example, the IRS's claim may not be cut off by a state statute of limitations when the federal period of limitations is still open. Code Section 6901(c) establishes the statute of limitations for the assessment of transferee liability. *See, e.g., U.S. v. Summerlin*, 310 US 414, 416 (1940). In addition, claims for deductions that may be available to the fiduciary in determining the amount of the tax may not be available to the transferee. *U.S. v. Cowles-Reed*, 114 AFTR 2d 2014-5612 (9th Cir. 2014) (unpublished opinion). Moreover, a transferee cannot avoid liability by arguing that there are pending cross- or counter-claims against the estate's personal representative, or, apparently, by seeking to raise reasonable-cause defenses that might be available to the estate's personal representative. *See U.S. v. Whisenhunt,* 2014-2 USTC ¶ 60,681 (N.D. Tex. 2014). At least in the context of liability for gift taxes, transferee liability does not include liability for interest on the tax that exceeds the amount of the gift. *See U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Poinier v. Comm'r*, 858 F.2d 917, 920 (3d Cir. 1988); *cf. Baptiste v. Comm'r*, 29 F.3d 1533, (11th Cir. 1994) (holding that liability limitation of Code Section 6324(a)(2) applies only to underlying estate tax obligation and not to interest accruing after liability arose). Note that transferee liability may not extend to trust beneficiaries because it is the trustee who receives the property on the date of a decedent's death, not the trust beneficiaries. Thus, the trustee is considered the "transferee." *U.S. v. Paulson*, 118 AFTR2d ¶ 2016-5665 (D.C. Ca. 2016); *U.S. v. Johnson*, 112 AFTR2d 2013-5474 (D.C. Ut. 2013). Nevertheless, property distributed to a trust beneficiary as a subsequent transferee may still be subject to the general tax lien of Code Section 6324. Furthermore, the time period for the IRS to seek personal liability against a transferee is separate and distinct from the time period available to the IRS to go against property subject to an outstanding special Section 6324 tax lien (which lasts ups to ten years). *U.S. v. Botefuhr*, 309 F.3d 1263 (10th Cir. 2002); *U.S. v. Kulhanek*, 106 AFTR2d ¶ 2010-7263 (D.C. Pa. 2010).

d. Avoiding Fiduciary Liability

Fiduciaries typically seek to avoid fiduciary liability for tax obligations owed by the decedent or by the estate by withholding sufficient estate assets until taxes are finally determined and paid, notwithstanding the fact that the demands of state law regarding claims payment and the practical demands of beneficiaries for distributions can make that process difficult. Additional pressure to distribute assets to beneficiaries may be brought to bear as a result of the recently enacted basis reporting rules under Code Section 6035. That section requires executors of estates for which a federal estate tax return is required to notify beneficiaries of the assets to which they are entitled, and the income tax cost basis of those assets, within thirty days of the due date for filing the estate tax return, with extensions. The result of this notification will likely be a heightened sense of entitlement to distributions by beneficiaries, and heightened threats of claims of breach of fiduciary duty if the assets listed on the disclosure form are not the assets actually distributed, or are not distributed promptly. There, are, however, some relief provisions available which can reduce an executor's personal exposure to the IRS for taxes resulting from distributions of estate assets, discussed below.

e. Statutes of Limitations for Assessments of Tax

Taxes must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC § 6501(a). The normal three-year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC § 6501(e)(1). A similar rule applies if assets are underreported for estate and gift tax purposes. IRC § 6501(e)(2). There is no limit on the statute of limitations where a false return was filed, there is a willful attempt to evade tax, or no return was filed. IRC § 6501(c).

The normally applicable statute of limitations is extended as to transferees—for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC § 6901(c). The taxpayer and government can agree to indefinitely extend an income or gift tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC § 6501(c)(4). Importantly, an executor may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the executor by separately filing IRS Form 4810, "Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)," or by submitting a written request containing the information required on the form. Treas. Reg. § 301.6501(d)-1(b). The request is to be filed with the same IRS center where the return is filed and should be filed after the return. It is not believed that this increases the audit exposure on such returns. Note that the statute of limitations may work against the taxpayer for purposes of claiming a deduction, such as for interest or other administration expenses. *See, e.g., La Sala v. Comm'r*, TC Memo 2016-42 (2016) (statute of limitations had expired for claiming an estate tax deduction for interest owed on unpaid gift taxes determined through a settlement with the IRS).

f. Requests for Discharge from Personal Liability

In addition, an executor may request a discharge from personal liability for estate, income, and gift tax liabilities of the decedent (which gives the IRS nine months to notify the executor of the amount of the relevant tax) by making a request for such a discharge (IRS Form 5495, "Request for Discharge from Personal Liability Under Internal Revenue Code Section 2204 or 6905") pursuant to Code Section 2204 (as to estate tax), or 6905 (as to income and gift tax). If the notice is not provided within the time period, or if notice is provided and the executor pays the tax, the executor is discharged from personal liability for any deficiencies. IRC §§ 2204(a), 6905(a). Although Code Section 2204(b) provides that for must purposes the term "executor" means any person in actual or constructive possession of any property of the decedent, in the case of a request for discharge from income and gift tax liabilities of a decedent, the request may only be made by a court-appointed personal representative. IRC §§ 2203, 6905(b).

In the case of estate tax, the time period is shortened to six months for a fiduciary other than an executor (such as, for example, the trustee of a post-death revocable trust). IRC § 2204(b). These requests do not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that the requests increase the audit exposure on such returns. A more limited, but nonetheless important, discharge from personal liability is afforded to executors who rely in good faith on the decedent's gift tax returns as furnished to the executor by the IRS in determining adjusted taxable gifts for computing the estate tax. The executor is relieved of personal liability for any estate tax deficiency attributable to gifts that were made more than three years before the decedent's death and are not shown on those returns. IRC § 2204(d).

g. Estate Tax Closing Letters

For estate tax returns filed prior to June 1, 2015, the IRS routinely issued an Estate Tax Closing Letter confirming that if a request for discharge of personal liability under Code Section 2204 was made and the executor paid the amount shown as due, the executor was released from personal liability. The letter further provided that the IRS would not reopen the return for further review absent (1) evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact, (2) a clearly defined substantial error based upon an established IRS position, or (3) a serious administrative error. *See* Rev. Proc. 2005-32, 2005-1 CB 1206. In June, 2015, the IRS issued an administrative announcement indicating that, commencing with estate tax returns filed on or after June 1, 2015, it will only issue estate tax closing letters upon request by the taxpayer. Taxpayers are advised that they should wait at least four months after filing the return before requesting a closing letter in order to allow sufficient time for the IRS to process the return, and then they should call 1-866-699-4083 to request the closing letter. Recently, the announcement was updated to provide information regarding obtaining an account transcript using an IRS Form 4506-T, "Request for Transcript of Tax Return," and such transcript can serve as a substitute for a closing letter. Notice 2017-12, 2017-5 IRB 742 provides authority that a transcript may serve as a substitute for a closing letter. For more information on this issue, see http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Frequently-Asked-Questions-on-Estate-Taxes. Note that for a time, the IRS was providing practitioners a way to register to obtain online estate tax transcripts, but that service has been suspended, at least temporarily.

B. Deductible Administration Expenses

Perhaps the tax issue most often confronted by attorneys representing or defending fiduciaries is the classification of attorneys' fees and representatives' fees for tax purposes and their deductibility. There is a fiduciary obligation to obtain the tax deductions that are available to the fiduciary, and in addition, objections to fiduciaries' and attorneys' fees are less likely, particularly in the estate tax context, when they can be deducted against the estate assets at an effective rate of 40 percent (or in states with state inheritance taxes, perhaps in excess of 50 percent). Not surprisingly, a great deal of federal law has been generated in recent years regarding the deductibility of these fees, particularly in the extraordinary circumstances in which litigation increases the amount of fees incurred.

1. Reasonableness Standard

Generally, for fiduciaries' and attorneys' fees to be deductible for federal estate tax purposes, they must be classified as administration expenses and chargeable against the fiduciary under local law. IRC § 2053; Treas. Reg. § 20.2053-3. In addition, the fees must be reasonable under the circumstances. While the reasonableness standard has both state and federal elements, a determination of reasonableness in a state court, and therefore chargeability against the fund for property law purposes, is not necessarily binding or determinative on the IRS. *U.S. v. White,* 853 F.2d 107 (2d Cir. 1988). As noted above, a state court determination is not binding on the IRS unless it is a party to the proceeding or unless the order issues from the supreme authority in the state. *Comm'r v. Est. of Bosch,* 387 US 456. The IRS may assert that it has even more authority to depart from the underlying state court determination in the area of deductibility of fees for estate tax purposes. In *Bosch*, the IRS maintained, and certain courts following the *Bosch* holding have upheld, the IRS's right to independently judge the reasonableness of attorneys' and representatives' fees for purposes of allowing those fees as deductions under Code Section 2053. *White, supra,* 853 F.2d at 112.

2. Focus of Internal Revenue Service

While there does not appear to be a separate body of federal law regarding the guidelines for the reasonableness standard, the IRS has focused its inquiry in two areas. First, the IRS is concerned about collusive or allegedly collusive agreements to pay fees in the state court proceeding, in which the parties do not raise objections due to the desire to have the fees allowed by the court so they will become tax deductible. Second, the IRS has focused on fees for services not directly related to the ordinary and necessary administration of an estate or trust that are nonetheless buried in a fee invoice that is subsequently approved by the state court or payable by the fiduciary without objection by the beneficiaries. As a consequence, an increasing part of any estate tax audit includes a request by the auditing agent for detailed time records and other information to document the proper deductibility of fees charged as administration expenses. At the conclusion of an estate tax examination, the IRS routinely requests executors and attorneys to execute IRS Form 4421, "Declaration - Executor's Commissions and Attorney's Fees," which sets forth the name, address, taxpayer identification number, and amount paid or agreed to be paid to each executor and attorney whose fees have been claimed as an estate or income tax deduction. In allowing a deduction of attorneys' fees, the IRS takes the position that the billing information is not privileged even if it has otherwise been kept confidential between the attorney and the fiduciary (*i.e.*, there has been no public court proceeding disclosing the invoices as part of a fee petition). *U.S. v. Osborn*, 561 F.2d 1334 (9th Cir. 1977). The descriptions in the invoices are privileged, however, to the extent that they may reveal the motive of the client in seeking representation, litigation strategy, or the specific nature of the services provided, such as researching particular areas of law. *Clarke v. Am. Commerce Nat'l Bank*, 974 F.2d 127, 129 (9th Cir. 1992). While many fiduciaries and their counsel are reluctant to give this information to the IRS, the IRS has sufficient subpoena power to obtain the information, absent the claim of privilege. IRC § 7608(b)(2)(A).

C. Doubling Up on Income and Estate Tax Administration Expense Deductions

1. Double Deduction in General

Most expenses of administration of a decedent's estate or trust, including attorneys' and fiduciaries' fees, qualify for both an estate tax deduction under Code Section 2053 and for an income tax deduction relating to management or preservation of income-producing property under Code Section 212. To prevent the representative and beneficiaries from getting a double benefit from these expenses, Code Section 642(g) and the Treasury Regulations promulgated thereunder provide for an election, the effect of which is to force a fiduciary to ultimately claim those expenses either only against estate taxes or only against fiduciary income taxes. The operation of the election and the impact of this provision are complicated and can create exposure for the fiduciary. In most instances, the estate is best served by taking the deduction on the tax return that saves the most overall tax.

Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the estate tax return. Between 1993 and 2001, the analysis was more difficult since income tax rates might or might not exceed effective estate tax rates in those years. For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%). In 2018, with a top income tax rate of 37% and a possible additional net investment income tax of 3.8%, fiduciaries are faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 40.8%) may be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%. The application of state income and estate taxes may make the analysis more complex. Ultimately, one must "run the numbers" on both returns to determine which offers the most tax savings.

Attention has focused on the interaction of state law and federal tax rules in determining whether estate administration expenses are chargeable to principal or income, particularly in estates seeking an estate tax marital or charitable deduction. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124 (1997) where the executor charged administration expenses to estate income for both state law and federal tax law purposes. The IRS held that such an allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. The Supreme Court disagreed, holding that the Treasury regulations in place at the time justified the Tax Court's finding that the marital deduction was not jeopardized. In response to the *Hubert* decision, the IRS announced new regulations providing guidance on this issue. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3; 20.2056(b)-4(d). Unlike the "material limitation" rules under the prior regulations, the current regulations permit deductions depending upon the nature of the expenses in question. The regulations provide that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" require a dollar for dollar reduction in the amount of any marital or charitable deduction, regardless of whether the expenses are deducted on the estate's income tax return or on the estate tax return. *Id*. If an estate tax return is required and these expenses are taken on the estate's income tax return, the expenses are deemed to reduce any marital and charitable deduction taken on the estate tax return, thus causing an estate tax that might not otherwise be due. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i); 20.2056(b)-4(d)(1)(i). Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses are deemed to reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and estate taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executors' commissions and attorneys' fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii); 20.2056(b)-4(d)(1)(ii). *See also Brown v. U.S.*, 329 F.3d 664 (9th Cir. 2003) (discussing *Hubert* and the procedures for properly determining the deduction for administration expenses).

2. Procedure for Code Section 642(g) Election

There appears to be some confusion among tax return preparers about how the Code Section 642(g) election is made. Technically, the Code and Treasury regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Code Section 2053 or 2054, and that all rights to have such items allowed at any time as deductions under Code Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors protectively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter (or other confirmation that the estate tax has been finally determined) and deductions on the estate tax return have proven unnecessary. The election is not treated as made and final until a "fee waiver" (a sworn declaration) making the election is filed with a fiduciary income tax return. Therefore, the election need not be made until filing a final, amended fiduciary return for the year in which the expenses are paid. The only declaration regarding the election in the estate tax proceeding occurs when an agreed deficiency assessment is obtained in the estate tax audit process with the request by an agent for the fiduciary to sign an IRS Form 890, "Waiver of Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment–Estate, Gift, and Generation-Skipping Transfer Tax." Pursuant to Form 890, the fiduciary waives notice and formal process on a deficiency assessment. The form contains a declaration regarding the fee waiver that binds the representative to the decision on where to claim these expenses. One might argue, however, that protective elections on both the income and estate tax return might be dangerous if the estate receives a closing letter (or other confirmation that the estate tax has been finally determined) without examination of or adjustment to the return. Under these circumstances, even though no IRS Form 890 would have been filed, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

IV. INCOME TAX CONSIDERATIONS ARISING FROM SETTLEMENTS

A. Taxation of Will Contest Settlements

1. General Rule – An Inheritance is Not Taxable

Under the general rule of Code Section 102, "gross income does not include the value of property acquired by gift, devise, or inheritance." IRC § 102(a). Similarly, the portion of an estate received by an heir in compromise of a will contest against the decedent's will is generally exempt from federal income tax. *See Lyeth v. Hoey*, 305 US 188 (1938); *Quigly v. Comm'r*, 143 F.2d 27 (7th Cir. 1944). In *Lyeth*, the Supreme Court addressed for the first time the issue of whether property received by a person from the estate of a decedent in compromise of his claim as an heir was subject to income tax under the predecessor to Code Section 102. Because the property was received via a settlement instead of pursuant to a will or heirship statute, the IRS took the position that the property was subject to income tax because the then-applicable state law provided that state successor taxes applied to property passing under the will as written, regardless of any subsequent settlement agreement. *Id.* at 190. Rejecting the IRS's position, the Supreme Court held that property was properly excluded from income. According to the Court:

> There is no question that petitioner obtained that portion, upon the value of which he is sought to be taxed, because of his standing as an heir and of his claim in that capacity. It does not seem

> to be questioned that if the contest had been fought to a finish and petitioner had succeeded, the property that he would have received would have been exempt under the federal act. Nor is it questioned that if in any appropriate proceeding, instituted by him as heir, he had recovered judgment for a part of the estate, that part would have been acquired by inheritance within the meaning of the act. *We think that the distinction sought to be made between acquisition through such a judgment and acquisition by a compromise agreement in lieu of such a judgment is too formal to be sound, as it disregards the substance of the statutory exemption*.

Id. at 196 (emphasis added). Thus, as a general proposition, amounts received by beneficiaries which constitute an inheritance, or a payment or settlement in lieu of or in the nature of an inheritance, are income tax free to the recipient. *Id.* The general rule, however, is subject to a number of exceptions which must be kept in mind when characterizing trust and estate distributions.

2. Exception: Distributable Net Income

Broadly speaking, income earned by a trust or estate in any year is taxed to the trust or estate to the extent that the income is retained, but is taxed to the beneficiaries to the extent that it is distributed to them. Executors and trustees must work with state law definitions of "income" that are different from the tax law concept of "taxable income." For example, capital gains are typically principal for state law purposes, even though they are taxable as income. On the other hand, tax-exempt interest constitutes income under state law, even though it is not taxable income. The Code makes an effort to reconcile these differing definitions by using the concept of distributable net income ("DNI").

The Code sets forth a detailed method to determine which trust or estate distributions carry income out to the beneficiaries. Thus, the structure of the payments or distribution from a trust or estate may subject the beneficiary to income tax. For example, the payment of an amount from the residuary of an estate will typically carry out income that has been earned by the estate in the year of payment (i.e., distributable net income) while, as discussed below, the payment of a specific sum will not. *See* IRC § 663(a)(1). DNI is a basic concept of income taxation of trusts, estates and their beneficiaries. It is used as a "measuring rod" for allocating income among the trust or estate and the beneficiaries, and is a concept uniquely applicable to the taxation of trusts and estates. It is the fundamental tool used to implement the conduit principle, that is, a trust or estate is often nothing more than a conduit for property to pass to its beneficiaries. In computing DNI, the personal representative begins with the trust or estate's taxable income, which then must be modified in several respects in order to serve as an effective measure of the maximum allowable deduction to the estate or trust for distributions to beneficiaries (and which beneficiaries must then include in their gross income).

DNI is basically the amount of trust or estate income available for distribution in a particular tax reporting year. It can be classified as a trust's taxable income (before application of the distribution deduction), excluding net capital gains allocated to principal, but including net tax-exempt income, minus allowable deductions and losses. IRC § 643(a). DNI serves three functions. First, trust or estate DNI establishes the maximum amount that a trust or estate can deduct under Code Sections 651 and 661 as a distribution to its beneficiaries. Second, DNI determines the maximum amount that the trust or estate beneficiaries can be taxed upon under Code Sections 652 and 662. Third, DNI determines the character of a distribution by a trust or estate. Specifically, it is used to characterize and divide distributions into different "classes" of income (such as qualified dividends, rent, passive income, tax-exempt income, etc.). The character of a distribution as taxable or tax-exempt may also affect the maximum deduction allowed to the trust or estate, and the maximum portion of the distribution included in gross income by the beneficiary, because trusts and estates may not deduct (and beneficiaries do not pay tax on) net tax-exempt income when distributed.

Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's DNI. An exception can be found in Code Section 663. Code Section 663(a)(1) provides that a gift or bequest of a specific sum or property will not be included in determining taxable income of a trust, estate, or beneficiary:

> There shall not be included as amounts falling within section 661(a) or 662(a) any amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments.

IRC § 663(a)(1); *see also* Treas. Reg. § 1.102-1(d) ("[a]ny amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance"). Importantly, for this purpose, amounts paid pursuant to a settlement agreement are typically treated as though they were paid "under the terms of the governing instrument." *See Middleton v. U.S.*, 99 F. Supp. 801 (D.C. Pa. 1951) (amounts paid to charity in settlement of a will contest were paid "pursuant to the terms of the will" for purposes of the predecessor to IRC § 642(c)).

Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the lesser of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is also subject to some important exceptions.

a. Distributions of Assets to Fund Pecuniary Gifts

A distribution of assets to fund a bequest of "a specific dollar amount," including a pecuniary bequest or a formula bequest may cause the estate or trust to recognize gain (or perhaps loss). For example, an agreement requiring an executor to distribute $400,000 worth of property, if funded with assets worth $400,000 at the time of distribution, but worth only $380,000 at the date of death, will cause the estate to recognize a $20,000 gain. The rules governing this area should not be confused with the "specific sum of money" rules that govern DNI carry outs. Unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). Such bequests are, however, treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a result, gains or losses will be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f)(1) (no gain or loss recognized unless distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed); *see also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 CB 286. For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997, P. L. 105-34, 111 Stat. 787 (1997) ("TRA 1997") repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has declined in value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates as a result of the related party rules of Code Section 267(b)(6), except for qualified revocable trusts electing to be treated as estates under Code Section 645.

b. Separate Share Rule

Generally, in the context of estate or trust distributions made to multiple beneficiaries, DNI is carried out pro rata among the distributees. For example, unless the separate share rule or the tier rules of Code Sections 661 or 662 apply, in a year in which an estate has $10,000 of DNI, if the executor distributes $15,000 to A and $5,000 to B, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. TRA 1997 made a substantial modification to the pro rata rule by applying the "separate share rule" to estates. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's DNI. IRC § 663(c). The Committee Report describing this change provides that there are separate shares of an estate "when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries." Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's or trust's DNI. IRC § 663(c). The IRS and Treasury issued final regulations applying the separate share rule to estates. *See* Treas. Reg. § 1.663(c)-4. As a result of this change, an executor or trustee must determine whether the will, trust agreement, or state intestate succession laws create separate economic interests in one beneficiary or class of beneficiaries. Distributions to beneficiaries who don't have "separate shares" continue to be subject to the former pro-rata rules.

If the separate share rule applies, it is mandatory. The executor or trustee cannot elect separate share treatment, nor may the executor or trustee elect out of it. Application of the separate share rule to estates was one of a host of small statutory changes enacted in 1997 that sought to bring the taxation rules for trusts and estates in line with one another. In practice, application of the separate share rule to estates is often quite complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. The residuary estate (and each portion of a residuary estate) is a separate share. Treas. Reg. § 1.663(c)-5, Exs. 3-11. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share. Treas. Reg. § 1.663(c)-4(c). A bequest of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Code Section 663(a)(1)) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares. *Id.* A revocable trust that elects to be treated as part of the decedent's estate is always a separate share, and may itself contain two or more separate shares. Treas. Reg. § 1.663(c)-4(a).

c. Distributions to Satisfy the Estate's Obligations

Distributions to creditors that satisfy a pecuniary obligation of the estate are recognition events for the estate. The fair market value of the property is treated as being received by the estate as a result of the distribution; therefore, the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, for example, if the estate agrees to pay a debt of $10,000 pursuant to a settlement agreement, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

3. Exception: Bequest of Income

Code Section 102's general rule that an inheritance is not taxable also does not apply to bequests of income. If the bequest or inheritance is the right to receive income, the amounts are taxable to the beneficiary. *See* IRC § 102(b). Specifically, Code Section 102(b) provides that:

> (b) Income.—Subsection (a) shall not exclude from gross income—
>
> (1) the income from any [property acquired by gift, bequest, devise, or inheritance]; or
>
> (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

IRC § 102(b); *see also Harte v. U.S.*, 252 F.2d 259 (2d Cir. 1958); *Tree v. U.S.*, 55 F. Supp. 438 (Ct. Cl. 1944).

In resolving a disputed fiduciary matter, whether through judgment or through settlement, an issue may arise as to whether a payment will be characterized as a bequest of income when the basis of the original claim at issue was a claim to income. When the judgment or settlement payment is in lieu of an income interest, the courts have generally held that the settlement amount is includable in gross income under Code Section 102(b). *See Getty v. Comm'r*, 91 TC 160, 176 (1988), rev'd. 913 F.2d 1486 (9th Cir. 1990). In *Getty*, the court noted that:

> [W]hether a claim is resolved through litigation or settlement, the nature of the underlying action determines the tax consequences of the resolution of the claim." *Tribune Publishing Co. v. U.S.*, 836 F.2d 1176, 1177 (9th Cir. 1988). In characterizing the settlement payment for tax purposes, we ask, "'In lieu of what were the damages awarded?"' *Id.* at 1178 (quoting *Raytheon Prod. Corp. v. Comm'r*, 144 F.2d 110, 113 (1st Cir. 1944); *see also Spangler v. Comm'r*, 323 F.2d 913, 916 (9th Cir. 1963) (question was what the taxpayer would have received had sums wrongfully withheld been paid when due); *Victor E. Gidwitz Family Trust v. Comm'r*, 61 TC

> 664, 673-74 (1974) (question was what the taxpayer would have received in a merger had the consideration for the taxpayer's shares been adequate).

Id. at 176.

For example, in *Harrison v. Commissioner*, 119 F.2d 963 (7th Cir. 1941), *aff'g*. 41 B.T.A. 1217 (1940), the deceased spouse's will did not comply with a prenuptial agreement that required the decedent to establish a trust that would pay all of its income to the surviving spouse for life. The surviving spouse was entitled, under applicable state law, to renounce the will and take one-half of the estate. The surviving spouse ultimately entered into a settlement whereby she received (i) a specific sum of money, and (ii) an additional cash payment relating to the delay in funding the testamentary trust. The court held that the payment of the specific sum was exempt under Code Section 102 as it related to her right to renounce the will and take one-half of the estate, however, the remaining amount was subject to income tax because it related to her right to receive income from date of death forward. *See id.* at 1124.

More recently, in *Getty v. Commissioner*, 913 F.2d 1486 (9th Cir. 1990), *rev'g* 91 TC 160 (1988), the Ninth Circuit considered whether the settlement of the testator's son's suit, seeking to impose a constructive trust to enforce the testator's promise to remedy the inequality of the financial treatment of his various children during his lifetime, was excludable from gross income as being in the nature of a bequest, devise, or inheritance. Under the testator's will, the son was only entitled to a nominal bequest and the son sought to impose a constructive trust on estate assets in an amount equal to the income received by the testator's other children. The son and the other beneficiaries entered into a settlement under which the son received $10,000,000 in settlement of his claims. The IRS argued that the son's claim was for income from property because in his complaint the son characterized the benefit he sought to enforce as a claim for income. The son's complaint alleged that the testator promised to provide for the son, in his will, an amount equal to the income received by the testator's other children prior to the testator's death. The IRS argued that the settlement amount was not excluded from the son's gross income because the claimed bequest was one of income. The court, however, declined to review the son's pleadings so narrowly and instead expressly employed a broader approach in determining the true nature and basis of the son's claim. The court construed the claim to be a claim for inheritance equal to the amount of income the other children received, not of income itself. Because the testator could have remedied the inequality with a bequest of property as opposed to a bequest of income, the court held the settlement amount was excludible from income as a bequest. *Id*. at 1491. *Getty* emphasizes the importance of properly characterizing the claim from its inception.

4. Exception: Bequest for Services Rendered

Bequests made to compensate for services rendered to the decedent are not excluded from income. *See Cotnam v. Comm'r.*, 263 F.2d 119 (5th Cir. 1959); *see also Wolder v. Comm'r*, 493 F.2d 608 (2nd Cir. 1974), (payment to lawyer in the form of bequest was method that parties chose to compensate lawyer for his legal services and was subject to taxation); *Davies v. Comm'r.*, 23 TC 524 (1954); *Est. of Braddock v. U.S.*, 434 F.2d 631 (9th Cir. 1970); Rev. Rul. 67-375, 1967-2 CB 60) (distribution of property under will in satisfaction of written agreement under which taxpayers were required to perform services for testator is compensation for services includible in gross income in year of receipt).

In *Cotnam*, the taxpayer won a contract action against the decedent's estate based on her claim that the decedent had promised Cotnam one-fifth of his estate in return for her serving him as an attendant. Cotnam was not an heir or beneficiary under a prior will. When Cotnam failed to include the judgment in her gross income, the IRS assessed a deficiency for the amount of the judgment. Cotnam claimed the amount of the judgment was exempt as a bequest under Code Section 102. The Fifth Circuit disagreed finding that the judgment was not exempt as a bequest but, rather, was taxable income for services rendered to the decedent. *Id.* at 121. In finding the payments should be taxed as income, the court noted that:

> The nature of the transaction underlying the judgment, not the judgment itself, controls the tax effects. *United States v. Safety Car Heating Co.*, 1936, 297 US 88, 56 S.Ct. 353, 80 L.Ed. 500; *Arcadia Refining Co. v. Comm'r*, 5 Cir. 1941,118 F.2d 1010 [*sic*]. The amount received is taxable or nontaxable according to what it represents. If the judgment was for an amount due under a contract for personal services, a reference in the judgment or the opinion supporting it to the sum recovered as 'in the nature of a bequest' will not change the compensation from

> taxable income to an exempt bequest. Thus, in order to acquire property by inheritance, a party must bring suit against the estate as an heir. He must participate in the proceeds as an heir.

Id. at 121.

The court further noted that it found "no difference between a contract to compensate for one's personal service in the form of a bequest, and one in which the contractor agrees to pay for the services during his life." *Id.* at 123 (citing *Ex parte Simons*, 247 US 231 (1918). Only when services are not required as a condition of payment of the legacy is the property acquired by bequest and, therefore, excluded from income. *Id.* at 123 (citing *U.S. v. Merriam*, 263 US 179 (1923)). As Cotnam did not have standing as an heir or beneficiary, the judgment represented payment for services rendered.

In line with these holdings, IRS Publication 525 states that "[I]f you receive cash or other property as a bequest for services you performed while the decedent was alive, the value is taxable compensation." IRS Pub. 525, p. 31 (Jan. 16, 2018).

B. Deduction of Payments by Estate

1. General Rule

As a general rule, the payment of a bequest to a beneficiary is not deductible by the estate, unless the bequest qualifies for the estate tax marital or charitable deduction. Therefore, characterizing a claim as taking the form of an inheritance, while preserving favorable income tax treatment for the beneficiary under Code Section 102, will often yield no income tax benefit to the estate.

2. Exception: Payments to Employees

Code Section 102(c) provides that the exclusion from income for bequests does not apply to any amount transferred by or for an employer to or for the benefit of an employee. In the context of settling claims against an estate from an employee or former employee, those claims may be deductible by the estate for income tax purposes under Code Sections 162 or 212 (and as discussed in Part VI.A, below, may be deductible for estate tax purposes as a debt of the estate under Code Section 2053(a)(3)). If the liability arose prior to the decedent's death, and would have been deductible by the decedent had it been paid during lifetime, it may constitute a "deduction in respect of a decedent," for which both an income and an estate tax deduction may be permitted. IRC § 691(b).

3. Exception: Administration Expenses

Litigation expenses are commonly deducted as expenses of administration under Code Section 2053(a)(2) if they are actually and necessarily incurred in the proper administration and settlement of a decedent's estate and are allowable under applicable state law. Expenses of administration are not generally deductible when incurred for the individual benefit of heirs, legatees, or devisees. *See Est. of Dutcher v. Comm'r*, 34 TC 918 (1960); *Est. of Landers v. Comm'r*, 38 TC 828 (1962); *Est. of Baldwin v. Comm'r*, 59 TC 654 (1973). A deduction not taken on an estate tax return is generally available as an income tax deduction. See the discussion of Code Section 642(g) at Part III.C.2., above.

The Code sets out a separate category of deductible administration expenses payable from property "not subject to claims" under state law but otherwise included in the tax base. Therefore, if debts, claims, or administration expenses are to be paid from a trust includible in the tax base but not generally chargeable under state law with such expenses, those expenses nonetheless can be deducted if (1) the property is included in the tax base; (2) the expenses are paid before the expiration of the three-year period for assessment of estate tax provided under Code Section 6501; (3) the obligation arises from an agreement or other contractual obligation of the decedent; and (4) the agreement was backed by full and adequate consideration. For example, payments pursuant to marital settlement agreements or divorce decrees are considered to be backed by full and adequate consideration. *See* IRC § 2053(b)(2).

a. Contestant Fees

The Code allows a will contestant's fees and expenses to be deducted for estate tax purposes. IRC § 2053; Treas. Reg. § 20.2053-3(c); *see, e.g.*, Rev. Rul. 74-509, 1974-2 CB 302; *Sussman v. U.S.*, 236 F. Supp. 507 (E.D.N.Y. 1962). In some jurisdictions, attorneys' fees of will contestants may be charged to the estate where the contestant is a devisee, legatee, or beneficiary of a will or an alleged will or an administrator with will annexed. *See, e.g.,* TEX. ESTS. CODE. § 352.052. Such allowance may be limited to actions filed in good faith and for just cause. *Id.; see also Wick v. Fleming*, 652 S.W.2d 353 (Tex. 1983) (holding that a good faith and just cause finding must be made in the original proceeding); *Alldridge v. Spell*, 774 S.W.2d 707 (Tex. App.–El Paso 1989, no writ) (requiring jury finding of good faith before awarding attorney's fees); *Currie v. Drake*, 550 S.W.2d 736 (Tex. Civ. App.–Dallas 1977, writ ref'd n.r.e.).

In contrast, an income tax deduction is not allowed for attorney's fees incurred by a beneficiary or heir to establish his or her share of the decedent's estate, or to perfect title to property. *See* IRC § 212. Specifically, Treasury Regulations provide that:

> Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. *Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.*

Treas. Reg. § 1.212-1(k) (emphasis added). Similar to a beneficiary of an estate, expenses paid or incurred by a beneficiary of a trust to protect or assert his or her right to property as beneficiary under a testamentary trust are generally not deductible. *Id.*

b. Estate and Trust Fees

Depending on the facts and circumstances, a portion of the attorney fees and expenses paid by the estate or trust may be deductible for income tax purposes, so long as the fees do not relate to the production of tax-exempt income. Treasury Regulation § 1.212-1(i) provides as follows:

> Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under Code Section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see Code Section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under Code Section 2053 or 2054 in computing the net estate subject to the estate tax.

4. Exception: Charitable Deductions

For federal income tax purposes, distributions from a trust or an estate to charity are not considered distributions to beneficiaries for purposes of computing the trust or estate's distribution deduction. Treas. Reg. § 1.663(a)-*2. See also U.S. Trust Co. v. Comm'r*, 803 F.2d 1363 (5th Cir. 1986)*; Mott v. Comm'r*, 462 F.2d 512 (Ct. Cl. 1972); Rev. Rul. 68-667; Rev. Rul. 2003-123. Rather, distributions to charities are deductible only if they meet the requirements of Code Section 642(c). Under Code Section 642(c)(1), a trust or estate is allowed a deduction in computing its taxable income for any amount of gross income, without limitation, that under the terms of the governing instrument is, during the tax year, paid for a charitable purpose. For this purpose, if pursuant to a settlement agreement in a will contest, a portion of the estate is transferred to charity, the income from the transferred portion may be deductible under Code Section 642(c)(1). Rev. Rul. 59-15, 1959-1 CB 164. In contrast, absent a bona fide dispute involving the trust or an ambiguity in the terms of the trust, the IRS may ignore a trust modification that purports to do nothing more than gain a charitable income tax deduction. CCA 201651013 (aff'd by CCA 201747005). Because a charitable deduction is available only if the source of the contribution is gross income, tracing the contribution is required to determine whether the source of the bequest to the charity is the gross income of the trust or estate. *See Van Buren v. Comm'r*, 89 TC 1101, 1109 (1987).

The source-of-payment rules can also apply when the estate uses an IRD asset to fund a charitable bequest. For example, in Private Letter Ruling 200633009, the IRS ruled that where IRAs were payable to an estate, and where the decedent's will provided that the residue of the estate was payable to a charity, the assignment of some or all of the IRAs to the charity in satisfaction of its share of the residue of the estate was not a transfer within the meaning of Code Section 691(a)(2) requiring the estate to recognize the income associated with the IRA. As a result, only the charity was required to include the amounts of IRD included in the IRAs in its gross income when the distributions from the IRAs were received by the charity. In contrast, in Chief Counsel Advice 200644020, IRS Chief Counsel examined a situation in which the decedent's revocable trust was the beneficiary of certain IRAs. The trustee used funds payable to the trust from the IRAs to satisfy a pecuniary bequest to a charity. The Chief Counsel cited *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940) for the proposition that if a trust or an estate satisfies a pecuniary (dollar amount) bequest with property, the payment is treated as a sale or exchange of property by the trust or estate, requiring the trust or estate to recognize the income. Therefore, the trust was required to recognize the IRD associated with the IRAs. Since distributions to charity do not carry out trust DNI, no distribution deduction was available to the trust with regard to the income recognized.

A charitable income tax deduction is permitted to an estate (but not a trust unless the trust was irrevocable on or before October 9, 1969) not only for amounts of gross income paid for a charitable purpose, but also for amounts that the estate permanently sets aside for a charitable purpose. IRC § 642(c)(2). Treasury Regulations require that in order to obtain this deduction, the estate must prove that the possibility that the amount set aside for the charitable beneficiaries would go to noncharitable beneficiaries is so remote as to be negligible. Treas. Reg. § 1.642(c)- 2(d). In the context of a will contest, the IRS argues that an estate cannot permanently set aside funds as a matter of law when there is a pending will contest or active litigation, the result of which might distribute the estate's funds to noncharitable beneficiaries. *See Est. of Wright v. US*, 677 F.2d 53 (9th Cir. 1982) (income from estate cannot be permanently set aside during pendency of will contest); *Est. of Belmont v. Comm'r*, 144 TC 84 (2015) (brother's "serious [legal] claim based on alleged events that predated" taxable year-end demonstrated that prolonged legal controversy which might deplete permanently set-aside funds was not so remote as to be negligible); *Est. of DiMarco v. Comm'r*, TC Memo 2015-184 (2015) (ongoing litigation at time of return filing that made additional legal expenses and commissions likely to deplete estate assets meant that possibility estate income would not go to noncharitable beneficiaries was not so remote as to be negligible).

C. Non-Pro Rata Distributions in Kind

If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries (meaning unauthorized under the terms of the governing instrument or local law), the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. (See Texas Estates Code Section 405.0015 for local law giving an independent executor the authority to make such distributions in certain instances.) This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 CB 159. For example, suppose a decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm was worth $110,000. At the date of distribution, each is worth $120,000. If the executor gives the stock to A and the farm to B *and if the will or local law fails to authorize non-pro rata distributions*, the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" her interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. *See* PLR 9429012. To avoid this result, local law or the governing instrument must expressly authorize non-pro rata distributions. *See* PLRs 9422052, 9523029 (no gain recognized).

D. Income Tax Basis in Property Received under Settlement

1. General Rule

Most practitioners describing the impact of death upon basis use a kind of short-hand by saying that assets get a "step-up" in basis at death. In inflationary times, this oversimplification is often accurate. However, it is important to remember that the basis of an asset may be stepped up or down, and therefore, it is more appropriate to say that a basis adjustment occurs, whereby the assets receive a new cost basis at the date of death. In community property states, both halves of the community property receive a basis adjustment as of the death of either spouse. IRC § 1014(b)(6).

Other than for persons dying in 2010[7], the original cost basis in the hands of the decedent is simply irrelevant. It is equally important to remember that the basis adjustment rule is subject to some important exceptions. Stated generally, a decedent's estate receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. IRC § 1014. The basis adjustment rule also applies to a decedent's assets held by a revocable trust used as an estate surrogate, since those assets are deemed to pass from the decedent pursuant to Code Sections 2036 and 2038. IRC § 1014(b)(2). In most cases, the basis is the date-of-death value of the property. However, for estates that qualify, if the alternate valuation date has been validly elected, the value on that date fixes the cost basis of the estate's assets. IRC § 1014(a)(3).

The adjustment to the basis of a decedent's assets occurs regardless of whether the estate is large enough to be subject to federal estate tax. Original basis is simply ignored and federal estate tax values are substituted. And, as stated above, the new cost basis applies not only to the decedent's separate property but also to *both halves* of the community property owned by a married decedent. IRC § 1014(b)(6).

2. Exception: Income in Respect of a Decedent

The Code does not provide a specific definition of "income in respect of a decedent," commonly referred to as IRD. Essentially, IRD consists of income earned by a decedent before death, but not recognized until after death. It may be included in the gross income of the decedent's estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the item of income. An estate is not entitled to an adjusted tax basis on IRD assets includible in a decedent's estate. IRC § 1014(c). Likewise, a beneficiary (by will or agreement) is generally not entitled to an adjusted tax basis on IRD assets to be received by the beneficiary. *Id.* The following are common examples of IRD:

- Dividends declared on stock owned by a decedent that is payable to shareholders of record on a date before the decedent's death but not actually paid until after death. *Est. of Putnam v. Comm'r*, 324 US 393 (1945).
- Death payments made to beneficiaries from an IRA or an exempt deferred compensation plan. *Hess v. Comm'r*, 271 F.2d 104 (3d Cir. 1959), rev'g 31 TC 165 (1958).
- Compensation for the decedent's services, including a bonus paid after death, that the employer had no obligation to pay. *Rollert Residuary Trust v. Comm'r*, 752 F.2d 1128 (6th Cir. 1985) aff'g, 80 TC 619; *Bausch's Est. v. Comm'r*, 186 F.2d 313 (2nd Cir. 1951); Rev. Rul. 68-124, 1968-1 CB 124.
- Renewal commissions owed to a deceased life insurance agent. *Findlay v. Comm'r*, 332 F.2d 620 (2nd Cir. 1964); Rev. Rul. 59-162, 1959-1 CB 224.
- Amounts recovered by a decedent's estate as damages for the decedent's lost profits. *Est. of Carter v. Comm'r*, 35 TC 326 (1960), aff'd, 298 F.2d 192 (8th Cir.).

[7] For decedents dying in 2010, Congress passed an eleventh hour re-enactment of the temporarily repealed federal estate tax, but gave executors the right to elect whether to have the estate tax apply. In most cases, executors chose to allow the estate tax to apply, since the federal estate tax exemption was a generous $5 million. But for larger estates, the "cost" of electing to pay no estate tax was to subject the assets of the estate to modified "carry-over basis" rules. Thus, the income tax basis of inherited property for those decedents did not change. Instead, the beneficiaries received the decedent's basis as though the property was acquired by gift. IRC § 1022. A special rule allowed the executor to apply a limited $1,300,000 to "step-up" basis in assets (plus an amount equal to the decedent's unused built-in losses and loss carryovers). In addition, the basis of property passing to a surviving spouse or QTIP-like trust could be increased by an additional $3,000,000. The executor was required to file a tax return (IRS Form 8939) electing out of the estate tax and specifying which assets would receive the step-up. For beneficiaries of these estates, except to the extent increased by the $1.3 million and other adjustments, the heir's basis is the lower of the deceased owner's basis or the date-of-death fair market value of the assets. Thus, parties to a settlement involving 2010 decedents may want to consider negotiating for the allocation of basis in a settlement agreement, to the extent allowable.

- Alimony arrearages owing to a decedent at the time of his or her death and paid after death. *Est. of Narischkine v. Comm'r*, 14 TC 1128 (1950), aff'd, 189 F.2d 257 (2nd Cir. 1951).
- Accrued, but unreported, interest on United States Treasury Series E bonds owned by a decedent at the time of his or her death. *Apkin v. Comm'r*, 86 TC 692 (1986).
- Income realized by an estate on nonqualified or nonrestricted stock options owned by decedent at the time of his or her death. Rev. Rul. 53-196, 1953-2 CB 178.
- Insurance reimbursements of previously deducted medical expenses received after the decedent's death. Rev. Rul. 78-292, 1978-2 CB 233.
- Liquidating distributions if the decedent had the right to any liquidation proceeds. *Est. of Bickmeyer v. Comm'r*, 84 TC 170 (1985).
- Sales proceeds received after death if: (i) the decedent had, before his or her death, entered into a legally binding contract regarding the sale item; (ii) the decedent had performed all of the substantive acts required by the terms of the contract; (iii) on the date of the decedent's death, no economic material contingencies existed that could have disrupted the sale; and (iv) the decedent, had he or she lived, would have received the proceeds of the sale. *Est. of Peterson v. Comm'r*, 74 TC 630 (1980) aff'd, 667 F.2d 675 (8th Cir. 1981).

The fact that an asset representing the right to IRD passes to a beneficiary as a result of the settlement of a dispute as opposed to passing pursuant to a will or by inheritance does not change the character of the asset or the underlying tax treatment to the recipient. Thus, a person who receives a right to IRD as part of a judgment or in settlement of disputed claims must generally pay income tax on the income associated with the receipt. *See, e.g.*, Rev. Rul. 55-463, 1955-2 CB 277.

3. Exception: No New Basis for "Re-inherited" Deathbed Transfers to Decedent

Code Section 1014(e) provides an exception for appreciated property given to a decedent within one year of death, which then passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. This rule is presumably designed to prevent avaricious taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis. In the litigation context, passing these assets back directly or indirectly to the original donor as a result of a judgment or settlement would presumably deny him or her of a basis adjustment. IRC § 1014(e).

4. Considerations in Settlement of Trust Funding Claims

The impact of basis in the context of settlements of trust claims illustrates the importance of how the claim is couched. Suppose that a trust was to have been funded prior to the decedent's death, and the claim at issue is the failure of the executor or trustee to fund that trust, or to properly segregate trust assets. Suppose that the fiduciary has commingled trust and personal funds, and has now passed away.

a. Debt Approach

If the claim is couched as a direct claim for damages against the decedent (when, for example, the decedent had been an executor of an estate prior to death and failed to fund a trust or otherwise distribute estate property), the commingled property would be included in the decedent's gross estate. This analysis uses the remedy of requiring the estate of the deceased executor to pay money to remedy the breach of trust as mandated by Section 1001(b)(3) of the Uniform Trust Code. *See also* RESTATEMENT OF TRUSTS 2d § 202 (1959); *Est. of Bailey v. Comm'r*, 741 F.2d 801 (5th Cir. 1984). The amount of the damage claim would be claimed as a deduction by the estate of the deceased executor under Code Section 2053, which would effectively remove the value of the assets from the decedent's estate. In other words, including the assets but offsetting their value by a corresponding deduction would effectively be a wash. Having the wrongfully withheld assets treated as owned by the decedent permits a second basis adjustment for the assets. But, if the claim is for a pecuniary amount, and is satisfied with property that has appreciated subsequent to the decedent's date of death, the estate will recognize gain on funding (measured, however, only by the difference in value from the decedent's death to the date of funding). Treas. Reg. § 1.661(a)-2(f)(1); Rev. Rul. 74-178, 1974-1 CB 196.

If the amount of the debt owed includes accrued interest, that interest, when paid, will constitute ordinary income to the claimant. Rev. Rul. 73-322, 1973-2 CB 44. Payment of this interest is treated for income tax purposes not as a distribution of DNI, but as an interest expense to the estate and interest income to the beneficiary. *Id.* Under Code Section 163(h), interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. The effect of this characterization would be to cause the recipient to report taxable interest income, with no offsetting interest deduction for the payor-estate.

b. Constructive Trust Approach

If, instead, the claim seeks to impose a constructive trust over the commingled asset, the assets traceable to the trust should be excludable from the decedent's estate as belonging to the (constructive) trust. As a result, the assets would be treated as having passed from the estate of the original transferor. Basis therefore will depend upon the fair market value at the date of the prior decedent's death. IRC § 1014. Since the constructive trust assets are not included in the estate of the deceased fiduciary, no basis adjustment applies. *Stansbury v. U.S.*, 543 F. Supp. 154 (N.D. Ill. 1982), *aff'd* 735 F.2d 1367 (7th Cir. 1984).

c. "Vested" Approach

In *Estate of Richard v. Commissioner*, TC Memo 2012-173 (2012), Victoria Richard died in 1997 owning 140 shares of preferred stock in a family business. Her will, which wasn't admitted to probate, left the stock to a bypass trust for her husband Alfred. Alfred died in 2004, and the estate tax return filed for his estate in March, 2006 listed the 140 shares among his assets, valued at $140,000. Just before the running of the statute of limitations in March, 2009, the IRS issued a notice of deficiency valuing the 140 shares at just over $27 million. Albert's children found Victoria's will in September, 2010, and had it admitted to probate in November of that year. The IRS argued that Florida state court proceedings establishing Victoria's bypass trust as the owner of the stock were not controlling, because Alfred effectively became the owner of the stock after Victoria's death, despite lack of formal transfer of ownership to him. In ruling for the taxpayer, the Tax Court noted that title to the shares remained in Victoria's name until after Alfred's death, and Alfred never took any overt actions (such as voting the shares or receiving dividends) to indicate that he was the owner of those shares. The court found that the decedent's children didn't take steps to enforce the rights of the bypass trust because they did not know of its existence until more than thirteen years after their mother's death. The court noted that the admission of Victoria's will to probate in 2010 caused the bypass trust's ownership of the 140 shares of stock to date back to the date of Victoria's death, and therefore, the shares were not properly included in Alfred's estate. *See also* PLR 201429009 (all of joint revocable trust assets not included in surviving spouse's estate even though assets were not split at death of first spouse; corrective measures through tracing to segregate were begun before surviving spouse's death).

d. "By Their Fruits" Approach

The Tax Court, apparently without taking any of the foregoing options into consideration, recently applied a practical, if somewhat confusing, analysis to the issue of an unfunded bypass trust. In *Estate of Olsen v. Commissioner*, TC Memo 2014-58 (2014), wife died in 1998 with a tax-planned revocable trust. The estate tax return filed by husband as personal representative reported that $600,000 passed to a bypass trust, $1,000,000 passed to a GST-exempt QTIP trust, and about $500,000 passed to a non-exempt QTIP trust. The bypass trust granted the husband an inter vivos power to appoint property from that trust to charity. While the husband didn't commingle the wife's assets with his own, neither did he segregate those assets into separate trusts as required by the terms of the revocable trust agreement. By the end of 2000, the balance in the wife's (combined) trusts was over $2.6 million. Subsequently, the husband withdrew nearly $1.5 million from the collective trusts, so that at the time of his death, the total value of the remaining trust property was about $1.1 million ($1 million on the alternate valuation date). The executor of husband's estate (son) discovered husband's failure to fund. Noting language in the trust agreement evidencing a desire by wife to minimize taxes, the son determined to treat all of the distributions as having come from the QTIP trusts (exhausting those trusts), treating the entire remaining $1.1 million as belonging to the bypass trust. The IRS observed that of the $1.5 million withdrawn by husband, about $1.1 million was used to make charitable gifts. Noting that only the bypass trust permitted charitable gifts (and that the funds went straight from wife's trust to the charities), the IRS argued that those funds must have come from the bypass trust (exhausting that trust), and as a result, the remaining $1.1 million belonged to the QTIP trusts and should be taxed in husband's estate. The Tax Court accepted the IRS's reasoning that the funds paid to charity must have come from the bypass trust. It noted, however, that the other $400,000 went straight to husband, and it was therefore reasonable to conclude that $400,000 came from the QTIP trusts. As a result, the Tax Court reduced the inclusion in husband's estate to $600,000. While the court's crediting the distribution made directly to husband resulted in a partial victory to the taxpayer, it is difficult to justify. Had the growth in wife's estate been apportioned to the three trusts pro rata, the maximum value of the bypass trust would likely never have exceeded about $760,000. The finding of the court that the $1.1 million paid to charity came from the bypass trust would necessitate a finding that that trust was exhausted, and the remaining $1 million must have belonged to the QTIP trusts.

E. Sale of an Expected Inheritance

In Revenue Ruling 70-60, a daughter sold a partial interest in her expected inheritance from her father, who was living at the time of sale and had made no will. The IRS held that "the entire amount received by the [daughter] for the relinquishment of her right to inherit the interest from her father" was includible under Code Section 61(a) in her gross income in the year of sale. Rev. Rul. 70-60, 1970-1 CB 11. It is notable that IRS Publication 525 provides that the seller of an interest in an expected inheritance from a living person is required to report the entire amount received in gross income in the year of sale. IRS Pub. 525, p. 31 (Jan. 16, 2018).

F. Sale of a Remainder Interest in a Trust

One settlement technique used in controversies between the income and remainder beneficiaries of a trust involves a "sale" of the interest of one set of beneficiaries to the other. One effect of the sale is to merge the income and remainder interests in the hands of the "buyer," thereby causing the trust to terminate. *See* RESTATEMENT OF TRUSTS 2d § 341; UNIF. TR. CODE § 401(a)(5). For example, if a decedent's will established a QTIP trust for a second spouse, with the remainder interest passing to children from the first marriage, the surviving spouse might purchase the remainder interest from the children. Because the spouse now owns both the income and the remainder interests, the trust interests merge (subject to any spendthrift provisions). At the same time, the surviving spouse has transferred by sale an amount equal to the purchase price paid to the children for the remainder interest, thereby reducing the value of the estate of the surviving spouse.

In a Field Service Advisory issued on July 6, 1995, the IRS addressed a request for advice regarding the proper income tax treatment of petitioners' assignment of a remainder interest in a trust in exchange for the canceling of certain indebtedness. Specifically, the taxpayer inquired whether he was required to recognize taxable income under Code Section 61 relating to the assignment of an expectant remainder interest in a trust in exchange for the cancellation of indebtedness. The IRS advised that "the transfer of the remainder interest was a taxable event resulting in income to the petitioner husband." FSA 1995-22. Importantly, under Code Section 1001(e), in determining gain or loss from the disposition of a term interest, generally, the adjusted basis of the interests determined under Code Sections 1014 (inheritance), 1015 (gift), or 1041 (transfers between spouses) is disregarded. A "term interest" for this purpose means a life interest, an interest for a term of years, or an income interest in a trust. IRC § 1001(e)(2). An exception to this rule applies where the sale or disposition is part of a transaction in which the entire interest in property is transferred. IRC § 1001(e)(3). However, where a beneficiary sells an income or a remainder interest in a trust, under Code Section 1001(e)(1), the portion of the adjusted uniform basis assigned to the seller's interest in the trust will be disregarded because it was a term interest, and the seller will be required to recognize the entire amount received as income. *See* Rev. Rul. 72-243, 1972-1 CB 233; *McAllister v. Comm'r*, 157 F.2d 235 (2d Cir. 1946); PLR 200231011.

It should be noted that in the context of a QTIP trust, the purchase of the remainder interest may be treated as a "disposition" of that interest by the spouse pursuant to Code Section 2519, and, as a result, the spouse may be treated as having made a taxable gift to the remainder beneficiaries equal to the value of the purchase price. Rev. Rul. 98-8, 1998-1 CB 541. *See also* PLR 201426016. Of course, the gift may be sheltered by the spouse's remaining applicable gift tax exclusion amount, which would include any deceased spousal unused exclusion ("DSUE") amount.

G. Trust Severances

One tool in resolving disputes among trust beneficiaries or among beneficiaries and trustees includes severing a single trust into multiple trusts. One concern of such a severance is that the beneficiaries of the single trust are in effect "selling" their interest in that trust in exchange for an interest in the new trust. For trust severances occurring on or after August 2, 2007, Treasury Regulations provide that the severance of a trust (including without limitation a qualified severance of a trust for generation-skipping transfer tax purposes under Treasury Regulation Sections 26.2642-6 or 26.2654-1(b)) is not an exchange of property for other property differing materially either in kind or in extent if (i) an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) any non-pro rata funding of the separate trusts resulting from the severance, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument. Treas. Reg. § 1.1001-1(h). The Regulation authorizes (but does not require) taxpayers to apply its provisions to trust severances occurring on or after August 24, 2004, and before August 2, 2007.

H. Life Insurance

1. General Rule

Generally speaking, life insurance proceeds are income-tax free to the beneficiary of the policy. IRC § 101(a)(1). The acquisition of a policy of life insurance by one party to a dispute on the life of another will normally provide the acquiring party with tax-free income upon the death of the insured. *Id.*

2. Exception: Transfer for Value

When an existing policy of insurance is among the assets to be divided upon the settlement of an estate dispute, an important exception to the foregoing rule must be considered—the transfer-for-value rule. Code Section 101(a)(2) provides, "[i]n the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income . . . shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee." IRC § 101(a)(2); *see also Tennessee Foundry & Mach. Co. v. Comm'r*, 399 F.2d 156 (6th Cir. 1968) (death proceeds subject to income tax when beneficiary/employer received life insurance policy purchased with funds embezzled by employee and received in settlement of beneficiary/employer's claims of embezzlement). Under this provision, the IRS might take the position that insurance transferred to a party other than the insured is a "transfer for a valuable consideration" (i.e., the value of the settlement attributable to the insurance policy—presumably its then cash value), and seek to tax the beneficiary on any proceeds received in excess of the policy's basis upon the insured's death.

The foregoing provisions do not apply in the case of a transfer to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. IRC § 101(a)(2)(B).

V. GIFT TAX CONSIDERATIONS ARISING FROM SETTLEMENTS

A. In General

Code Section 2501 imposes a tax on property transferred by gift. In addition, Code Section 2512(b) provides that where a transfer of property is made for less than adequate and full consideration, the amount in excess of the consideration will be treated as a gift. Generally, a transfer of property by an individual in compromise and settlement of a trust or estate dispute is a transfer for full and adequate consideration in money or money's worth. Thus, it is not a gift for federal gift tax purposes. *See Lampert v. Comm'r*, TC Memo 56-226 (1956); *see also Righter v. U.S.*, 258 F. Supp. 763 (8th Cir. 1966), *rev'd and remanded on other grounds* 400 F.2d 344 (8th Cir. 1968).

B. Unintended Gifts

The effect of a settlement on estate or gift taxation of the property at issue often depends on the existence of a bona fide dispute, the transfers involved, and the existence of an enforceable right as between the settling parties. *See Ahmanson Found. v. U.S.*, 674 F.2d 761 (9th Cir. 1981). As noted previously, where there is no adequate consideration for the settlement agreement, gift tax consequences may arise. *See Nelson v. U.S.*, 89-2 USTC ¶ 13,823 (D. N.D. 1989) (unreported).

A transfer of property will be regarded as occurring "in the ordinary course of business" and thus will be considered to have been made "for an adequate and full consideration in money or money's worth" only if it satisfies the three elements specified in Treasury Regulation Section 25.2512-8. To meet this standard, the transfer must have been bona fide, transacted at arm's length, and free of donative intent. In applying this regulation to settlements of family disputes, the courts have identified several subsidiary factors that may also be relevant. For example, they have considered: (i) whether a genuine controversy existed between the parties; (ii) whether the parties were represented by and acted upon the advice of counsel; (iii) whether the parties engaged in adversarial negotiations; (iv) whether the value of the property involved was substantial; (v) whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and (vi) whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. *See, e.g., Est. of Natkanski*, TC Memo 1992-380 (1992); *Est. of Noland*, TC Memo 1984-209 (1984).

Private Letter Ruling 8902045 involved the settlement of a trust dispute and considered the issue of whether transfers pursuant to the settlement were subject to gift tax. The ruling indicates that the IRS has fully adopted the *Ahmanson Foundation* reasoning that settlement of a bona fide dispute based on the enforceable rights of the parties will not subject someone to gift tax. In particular, the IRS opined that intra-family settlements should not result in shifts between the parties' economic rights, that the economic values of the parties' claims should be determined "with appropriate allowances for uncertainty," and that "differences may be justified on the basis of compromise." PLR 8902045.

The IRS has issued a number of favorable private letter rulings in which no gift tax exposure has been found in a wide variety of contexts. For example, a modification to a trust as part of the settlement of a bona fide dispute will not result in a gift if the settlement is reflective of the parties' rights under state law. *See, e.g.*, PLRs 201342001 (division and modification of trust as part of settlement of dispute); 201104001 (early termination of trust with complex distribution provisions); 200845028 (resolution of conflicting provisions regarding interest of beneficiary's surviving spouse); 200825007 (division and modification of trust as part of settlement of dispute); 200638020 (division of a trust and an allocation of trust assets); 200631008 (dispute regarding distribution of remainder interest); 200615006 (court-approved settlement clarifying ambiguous trust terms); 200209008 (complex settlement of dispute including commutation of the income beneficiary's interest and acceleration of income distributions to presumptive remainder beneficiaries). The IRS has also ruled that the division of a discretionary trust into separate trusts for different branches of a family did not have gift tax consequences. *See, e.g.*, PLRs 201419001, 201349002, 201245007, 201243006, 201238004, 201218003, 201205001. Similar rulings have been issued regarding the gift tax treatment of mergers of trusts. *See, e.g.,* PLRs 201025026, 201024044, 201024017-201024024. *See also* PLR 201050008 (approving both the merger of a set of trusts and the method adopted by the parties for dealing with differences in the perpetuities periods for the trusts). A reformation or construction of a trust to reflect or determine the settlor's original intent or to affect administrative changes will similarly not, in most cases, result in gift tax liability for any of the parties. *See, e.g.,* PLRs 201737001 and 201737008 (judicial reformation of trusts by grantor to correct scrivener's error making spouse's general powers of appointment limited powers of appointment was not a release of a general power and did not cause gift by spouse); 201732029 (reformation of trust to correct scrivener's error as to distribution of share of predeceased grandchild); 201342001 (division and modification of trust as part of settlement of dispute); 201223012 (division of trust and correction of scrivener's error relating to distributions on termination); 201220030 (clarification of ambiguity regarding distributions on termination of a trust); 201216010 (merger of trusts and change in law governing administrative matters); 201210002 (changes in trustee arrangements and other administrative arrangements); and 201147010 (reformation of trust to include mistakenly omitted provisions for distributions during the settlor's lifetime).

The foregoing rulings should not be construed, however, as an indication that the IRS will not seek to impose gift tax where warranted, as can best be illustrated by the two *Redstone* cases decided in late 2015. In *Estate of Redstone v. Commissioner*, 145 TC 259 (2015), the IRS alleged that a gift resulted from the settlement of a lawsuit between a father and son regarding the ownership of stock. Briefly, in 1971, a dispute arose regarding the ownership by Edward Redstone of stock in a family-owned entertainment business. Edward had a legitimate claim that his father Mickey had given him 100 shares of the company, but stock certificates representing the alleged gift were never delivered. Mickey passionately believed that an "oral trust" had been created with regard to the shares, and that they were to be held for the benefit of Edward's children. Edward was genuinely estranged from his father, and the parties had legitimate business disputes. After lengthy negotiations and the filing of two lawsuits, the parties in 1972 reached a settlement on advice of their respective counsel. Pursuant to the settlement, Edward transferred 1/3 of the disputed shares into a trust for his children, in consideration of which he was acknowledged as outright owner of 2/3 of the disputed shares, which the Company redeemed for $5 million. After Edward's death, the IRS asserted that the transfer of shares to the trust was a gift. While agreeing that Edward transferred the stock in settlement of a bona fide dispute, the IRS contended that the transfer was not made "in the ordinary course of business" or "for a full and adequate consideration in money or money's worth," since no consideration was furnished by the trustee or by Edward's children, who were the transferees of the stock. The Tax Court held that Edward's transfer of stock was made in the ordinary course of business and for full and adequate consideration in money or money's worth, namely, recognition by Mickey and Edward's brother Sumner that Edward was the outright owner of 2/3 of the disputed shares. The Court ruled that Edward received adequate consideration in the form of the settlement of claims, even though that consideration was not furnished by his children. As a result, the Court held that Edward did not make a taxable gift and was not liable for any gift tax.

As it turns out, Edward's brother Sumner also transferred a third of his shares into trust for his children in 1972. In 2006, in litigation between Edward and his son, Sumner testified that his doing so was completely voluntary, saying, "Nobody sued me. I gave my kids a third of the stock voluntarily, not as the result of a lawsuit. In [s]o doing, I did what I wanted and appeased my father too." He testified that "[t]here was a big difference between Eddie's position and mine" because Edward "was resisting doing what my father wanted," whereas Sumner was simply trying to maintain good family relations. He later testified to the same effect: "Eddie was sued. I was not. And Eddie had to find a justification for what he was doing in transferring. I wasn't sued. I just made an outright gift." Not surprisingly, the Tax Court had little difficulty in the latter case in finding that although prompted by a settlement agreement resolving a lawsuit over ownership of his brother's shares in the company, the transfers were made neither for adequate and full consideration nor in the ordinary course of business, but were motivated by the taxpayer's kinship and donative intent toward his father and/or children. The Court held that the evidence, including the taxpayer's own testimony, showed that there was no claim against the taxpayer, that there were no arm's length negotiations, and that he received no consideration for the transfers. *Sumner Redstone v. Comm'r*, TC Memo 2015-237 (2015). The court noted that the statute of limitations never ran against the gift, since no gift tax return had ever been filed. Moreover, the IRS was not precluded from seeking the tax under the doctrine of laches, which does not apply to the federal government in claims governed by a statute of limitations. *Id.* The Court noted that in any event, Sumner's argument that laches barred the over 40-year old assessment failed where evidence showed that the IRS wasn't aware of transfers until recent litigation involving the gift, and commenced its gift tax examination promptly thereafter, and where the taxpayer had not advanced the argument in his pretrial memorandum or post-trial briefs. *Id.*

C. Use of Surviving Spouse's Applicable Exclusion Amount

In a settlement involving a surviving spouse, the overall tax effect of the settlement may be improved by having other parties agree to forgo claims so that property passes to the surviving spouse in a manner that qualifies for the unlimited estate tax marital deduction. It may be easier to obtain the agreement of others to forgo claims if the surviving spouse is willing to make donative transfers to those persons, perhaps utilizing his or her own federal gift tax applicable exclusion amount. While the marital deduction may be disallowed if the IRS determines that the surviving spouse purchased an interest from the other claimants, properly structured, such a technique effectively allows the use of both the decedent's estate tax exclusion and the surviving spouse's gift tax applicable exclusion amount (which might include all or part of the deceased spouse's unused exclusion amount if a "portability" election was made for the decedent's estate under Code Section 2010(c)). Using the spouse's applicable exclusion amount would permit property to pass to persons other than the spouse or charity without paying any current transfer tax.

Naturally, the surviving spouse must feel comfortable that the loss of his or her gift tax applicable exclusion amount (and effectively, a corresponding amount of estate tax applicable exclusion amount at his or her death), will not work an undue hardship on the spouse's intended beneficiaries. With current tax laws and the anticipation of continued inflation adjustments to the estate and gift tax exclusions, younger spouses may be willing to bet that future increases will be sufficient to avoid estate taxes for heirs, even after the current use of some or all of the gift tax applicable exclusion amount.

VI. ESTATE TAX CONSIDERATIONS ARISING FROM SETTLEMENTS

A. Deduction of Debts

One of the most significant estate tax questions arising from the administration of claims against estates involves the allowance of the estate tax deduction under Code Section 2053 for claims against a decedent's estate. An estate tax deductible claim must be timely asserted so that it is valid under state law and must be payable from property included in the estate tax base. IRC §§ 2053(a), 2053(b); Treas. Reg. § 20.2053-1(a)(1). Therefore, pursuant to the general rule, claims that are paid and could have been barred under state law but were not, are not deductible. Rev. Rul. 60-247, 1960-2 CB 272; *In re Est. of Hagmann,* 492 F.2d 796 (5th Cir. 1974).

In *Estate of Thompson v. Commissioner,* 730 F.2d 1071 (7th Cir. 1983), however, the Seventh Circuit held that the claim of a creditor under a settlement agreement with the decedent's estate was an enforceable, deductible claim even though the creditor failed to file the claim before the expiration of the claims period under state law. Similarly, in *Greene v. United States,* 447 F. Supp. 885 (N.D. Ill. 1978), the United States District Court allowed a deduction for a claim filed after the claims period had expired, stating that the enforceability of the claim arose at the decedent's death, not at the time of filing. The court, however, refused to allow a deduction for loans to the decedent when the statute of limitations had run on the collection of such loans prior to the decedent's death. In contrast, the Tax Court has held that if a claim is enforceable against more than one entity and not filed against an estate, it is not deductible. *Est. of Courtney v. Comm'r*, 62 TC 317 (1974). An enforceable claim that is not formally filed with the court within the claims period but is presented to a representative within the claims period and paid pursuant to an agreement with the beneficiaries of the estate is deductible for estate tax purposes. Rev. Rul. 75-24, 1975-1 CB 306.

In addition, claims that have been timely filed or asserted but not finally determined or paid at the time the estate tax return must be filed create deductibility issues. When the full extent of the liability has not been legally determined, the IRS takes the position that only the part finally determined is allowable and that the estate must pay tax and claim a refund when a final determination is made. *Est. of Sachs v. Comm'r*, 856 F.2d 1158 (8th Cir. 1988); *Greene v. U.S.,* 447 F. Supp. 885 (N.D. Ill. 1978); *Russell v. U.S.*, 260 F. Supp. 493 (N.D. Ill. 1966); *Est. of Cafaro v. Comm'r,* TC Memo 1989-348 (1989). This issue becomes important when a dispute is ongoing. If a significant claim is filed but the final adjudication is still pending when the return is due, the fiduciary must take care to docket the limitations period during which a claim for refund of estate tax can be made. This limitations period is generally the later of three years from the date the estate tax return is filed or, for amounts later paid, two years from the date of payment. IRC § 6511.

Considerable litigation occurred regarding the deductibility of contingent claims and the use of hindsight in establishing the amount of claims reported for decedent's dying prior to October 20, 2009. The IRS took the position that events occurring after a decedent's death should be taken into account in determining the value of the claim. Rev. Rul. 60-247, 1960-2 CB 272; *Eyler v. Comm'r,* 88 F.3d 445 (7th Cir. 1996). In a number of cases, taxpayers were successful in arguing that only events known at the date of the decedent's death could be used in setting the value of the claim. *See Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) (estate may deduct amount owing at decedent's death instead of lower amount later paid pursuant to settlement of claim with estate). *Est. of Smith v. Comm'r,* 198 F.3d 515, 517-18 (5th Cir. 1999) (Tax Court was to admit and consider only evidence of pre-death facts and occurrences relevant to the date-of-death value of claim); *see also Est. of McMorris v. Comm'r,* 243 F.3d 1254 (10th Cir. 2001); *O'Neal v. U.S.,* 258 F.3d 1265 (11th Cir. 2001) (post-death events should not be considered in making valuations), *but see Est. of Foster v. Comm'r,* TC Memo 2011-95 (2011), *aff'd* 113 AFTR 2d 2014-1519 (9th Cir. 2014).

Regulations issued effective October 20, 2009 address the effect of post-death events on the deductibility of claims against an estate and provide other rules relating to the deductibility of claims. *See* Treas. Reg. §§ 20.2053-1(b)(2), 20.2053-1(b)(3), 20.2053-1(d), 20.2053-4. Under the regulations, deductible claims are limited to bona fide claims that are enforceable against the decedent's estate and meet other requirements set out in the regulations. Treas. Reg. §§ 20.2053-1(d)(1), 20.2053-4(a)(1)(i). In addition, the deduction is limited to the amount actually paid to satisfy the claim. Treas. Reg. § 20.2053-1(d)(3).

Generally, no deduction can be taken for a claim that is merely potential or has not matured. Treas. Reg. § 20.2053-1(d)(1). However, a deduction can be taken prior to payment if the amount of the claim is ascertainable with reasonable certainty and the claim will be paid. Treas. Reg. § 20.2053-1(d)(4). A claim is not ascertainable with reasonable certainty if it is contested or contingent. *Id*.

As noted above and consistent with the earlier Revenue Ruling, if a claim is initially not deductible because it has not been paid and cannot be determined with reasonable certainty, the executor can subsequently file a timely refund claim when the claim is actually paid. Treas. Reg. § 20.2053-1(d)(4)(ii). If necessary, the executor can file a protective refund claim if the time for filing a refund claim would otherwise expire. Treas. Reg. §§ 20.2053-1(d)(4)(ii), 20.2053-1(d)(5)(i); *see also* Treas. Reg. § 20.2053-1(d)(7), Ex. 2.

The IRS has established a few exceptions to the foregoing rules for administrative convenience. Under one exception, claims can be deducted when the return is filed to the extent the full value of the claims in the aggregate does not exceed $500,000. *See* Treas. Reg. § 20.2053-4(c)(1). Importantly, the value of the claims must be determined by a qualified appraiser under the rules that apply in determining the value of a charitable contribution for income tax purposes. Treas. Reg. § 20.2053-4(c)(1)(iv). The amount of the deduction is subject to adjustment for post-death events. Treas. Reg. §§ 20.2053-4(b)(3), 20.2053-4(c)(2). In addition, the estate can preserve its right to a greater deduction if the claims are not resolved until after the expiration of the period for filing refund claims by filing a protective claim. *Id.*

In Revenue Procedure 2011-48 the IRS prescribed two procedures for submitting protective claims for refunds attributable to claims or expenses that cannot be deducted currently under the regulations for estates of decedents dying after 2011. A protective claim can be made on the estate tax return by including a Schedule PC, a form that is part of IRS Form 706 for estates of decedents dying in 2012 or later years (IRS Form 706, as revised beginning August 2013 and thereafter). Rev. Proc. 2011-48, § 4.04(1), 2011-42 IRB 527. Alternatively, after the estate tax return has been filed, a protective claim can be filed by submitting a Form 843 that is identified by noting "Protective Claim for Refund under Section 2053" at the top of the form. *Id.*

Each Code Section 2053 claim or expense must be subject to a separate refund claim. A protective refund claim does not need to state a specific dollar amount, but the claim or expense must be clearly identified. *Id.* at § 4.04(2). The protective refund claim must also identify and describe the reasons and contingencies preventing determination or payment of the liability. *Id.* at § 4.05(1). The taxpayer must notify the Commissioner within ninety days after the reason or contingency delaying the payment of the claim or expense has been resolved or the amount of the deduction has been established. If notification occurs after that time, reasonable cause for the delay must be given. *Id.* at § 5.02(2).

B. Marital and Charitable Deductions

The availability of the unlimited federal estate tax marital and charitable deductions mean that payments made to a surviving spouse or to charity pursuant to a settlement agreement can have a significant impact on the amount of estate taxes ultimately paid. IRC §§ 2055, 2056. The availability of marital or charitable deductions depends not only on the amount but also on the form and substance of the agreement.

1. The Marital Deduction

The marital deduction should be considered whenever there is a settlement agreement involving a surviving spouse. For this purpose, "spouse" may include persons other than those ceremonially married in the jurisdiction in which the decedent died. For example, persons who are married under the common law may be recognized as married for federal tax purposes, even if they later move to a jurisdiction that does not recognize common law marriage. *See* Rev. Rul. 58-66, 1958-1 CB 60 (couple married under common law and filing income tax returns as married-filing-jointly will continue to be treated as married, even after moving to a jurisdiction that doesn't recognize common-law marriages). In addition, same-sex couples who are lawfully married in the jurisdiction in which the marriage ceremony is celebrated will be considered spouses for federal tax purposes, even if they reside in a jurisdiction that purports not to recognize same-sex marriage. Rev. Rul. 2013-17, 2013-38 IRB 201 (individuals of the same sex will be considered to be lawfully married under the Code as long as they were married in a state whose laws authorize the marriage of two individuals of the same sex, even if they are domiciled in a state that does not recognize the validity of same-sex marriages). Subsequent to the issuance of this Revenue Ruling, the U.S. Supreme Court ruled that the Fourteenth Amendment of the U.S. Constitution requires states to license marriages between two people of the same sex, and to recognize all marriages between two people of the same sex when their marriage was lawfully licensed and performed out-of-state. *Obergefell v. Hodges*, 135 S. Ct. 2584 (2015). As a result, it appears that the marriage of a same-sex couple that is lawful in the state in which the marriage was performed cannot be ignored in other states for purposes of applying their laws. The constitutional basis for this holding likely means that laws in states that purport to limit marriage to one man and one woman can never have had valid application. Thus, for example, a same-sex couple married in Iowa but residing in Texas or Arizona would presumably have acquired interests in community property during the entire course of their marriage, even though neither state purports to recognize same-sex marriage.

a. Code Section 2056

Code Section 2056 requires that in order to qualify for the marital deduction, property must have passed from the decedent to the surviving spouse, and that it must not pass in a manner such that it is characterized as a non-deductible terminable interest. IRC § 2056.

A potential pitfall arises in an estate that is large enough to be exposed to the federal estate tax if the surviving spouse agrees to reduce his or her outright ownership interest in property to some form of terminable interest (i.e., an interest in property that terminates at the time of the spouse's death, with the property then passing to someone else). In those situations, the terminable interest the spouse retains will not qualify for the estate tax marital deduction. *See Est. of Tebb v. Comm'r*, 27 TC 671 (1957); *see also U.S. Trust Co. v. Comm'r*, 321 F.2d 908 (2d Cir. 1963).

(1) Qualified Interests

Interests that qualify for the marital deduction include:

- An outright transfer to a surviving spouse who is a United States citizen, so long as the spouse's interest is not conditioned upon survival for a period of more than six months. IRC § 2056(b)(3)(A).
- An interest passing to a trust for the surviving spouse that provides the spouse with the exclusive right to all income for life, and grants to the spouse a general power of appointment over the trust property at death (a so-called "life estate-power of appointment" or "LEPA" trust). IRC § 2056(b)(5).
- An interest passing to a trust for the surviving spouse that provides the spouse with the exclusive right to all income for life, and for which an election is made causing the property remaining in the trust at the time of the spouse's later death to be taxed in the spouse's estate (a so-called "qualified terminable interest property" or "QTIP" trust). IRC § 2056(b)(7).
- An interest passing to a trust for the surviving spouse that provides the spouse with the exclusive right to all income for life, and provides that upon the death of the surviving spouse, the remaining trust property vests in a qualified charity (a so-called "spousal charitable remainder" trust). IRC § 2056(b)(8).
- Insurance or annuity proceeds held by the insurer subject to an agreement either to pay the proceeds in installments, or to pay interest on them, during the surviving spouse's life only to the surviving spouse, so long as the installments are payable at least annually, beginning not later than 13 months after the decedent's death, and the surviving spouse has the power to appoint the amounts to the surviving spouse or his or her estate. IRC § 2056(b)(6).

Each of the foregoing interests are subject to detailed additional requirements designed to ensure that the spouse receives the income from the property, that no person has the ability to appoint property to anyone other than the surviving spouse during his or her lifetime and (except in the case of a QTIP trust) that the spouse has the unrestricted right to dispose of the property at death, alone and in all events. *See* IRC § 2056.

(2) Passing Requirement

The principal issue in the context of an estate involved in actual or threatened litigation involves the *passing* requirement. The regulations state that under certain conditions, if an interest is assigned or surrendered to the surviving spouse as a result of a controversy, the interest will be treated as having passed from the decedent to the surviving spouse. Treas. Reg. § 20.2056(c)-2(d)(2). Specifically, Treasury Regulation Section 20.2056(c)-2(d)(2) provides as follows:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving

> spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a *bona fide recognition* of *enforceable rights* of the surviving spouse in the decedent's estate. Such a bona fide recognition will be *presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contes*t. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. 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.

Treas. Reg. § 2056(c)-2(d)(2) (emphasis added); *see also Brandon*, 828 F.2d at 499; *Bel v. U.S.*, 452 F.2d 683 (5th Cir. 1971); *Est. of Barrett v. Comm'r*, 34 TC 606 (1954).

The Supreme Court has held that the test of "passing for estate tax purposes" is "whether the interest reaches the spouse pursuant to state law, correctly interpreted [by the federal court]—not whether it reached the spouse as a result of a good faith adversary confrontation." *Brandon*, 828 F.2d at 499 (citing *Bosch*, 387 US at 774).

(3) Enforceable Right

In order to qualify for the estate tax marital deduction, the surviving spouse must have an "enforceable right" under state law. *Brandon*, 828 F.2d at 499 (citing *Ahmanson Found. v. U.S.*, 674 F.2d 761, 774 (9th Cir. 1982)). Keep in mind that the Supreme Court in *Bosch* held that the IRS is bound only by the decision of the highest state court as to a spouse's enforceable property rights. Absent such a ruling, federal authorities are to determine property rights by applying what they find to be state law after giving proper regard to relevant state court rulings. *Comm'r v. Est. of Bosch*, 387 US 456, 465 (1967). Furthermore, in *Ahmanson Foundation*, the Ninth Circuit held that property distributed to a spouse pursuant to a compromise settlement will be treated as passing from the decedent for marital deduction purposes, only if the distribution represents a good faith settlement of an enforceable claim. 674 F.2d 761. Relying on *Bosch*, the court stated that:

> [E]ither a good faith settlement or a judgment of a lower state court must be based on an *enforceable right under state law properly interpreted*, in order to qualify as 'passing' pursuant to the estate tax marital deduction.

Ahmanson Found. v. U.S., 674 F.2d 761, 775 (9th Cir. 1981) (emphasis added).

More recently, in Private Letter Ruling 200417030, the IRS stated that:

> In view of *Ahmanson*, property passing to a spouse (or charity) pursuant to the settlement of a claim will be treated as passing from the decedent, to the extent the compromise is a *bona fide settlement* of a *legally enforceable claim*. The claim must be settled pursuant to arm's length negotiations.

PLR 200417030 (allowed marital deduction when either party could have prevailed at trial).

b. Interest Released by Surviving Spouse

The estate is not entitled to a marital deduction for property or other interests released, assigned or surrendered by the surviving spouse. Treas. Reg. § 20.2056(c)-2(d). Treasury Regulation Section 2056(c)-2(d)(1) provides:

> If as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having "passed from the decedent to his surviving spouse."

Treas. Reg. § 2056(c)-2(d)(1); *see also* Schroeder *v. U.S.*, 924 F.2d 1547 (10th Cir. 1991).

c. Settlement Agreement versus Judicial Determination

Payment made to a surviving spouse pursuant to a settlement agreement will be afforded the same treatment as one made pursuant to a judicial decree. For example, in *Estate of Barrett v. Commissioner*, 22 TC 606 (1954), a settlement was reached with the surviving spouse prior to the initiation of formal litigation regarding his forced share of the deceased spouse's estate. The IRS claimed that the payments made pursuant to the settlement agreement did not qualify for the marital deduction. The Tax Court, however, disagreed noting that:

> In *Lyeth v. Hoey*, the Supreme Court found too formal for substance the distinction between a payment made to an heir pursuant to judgment in a proceeding contesting a will and a payment made in compromise, in advance of trial, of the claims made in the proceeding. We think, similarly, that the distinction pressed by the respondent, on the basis of his regulations, between a payment made pursuant to an order of a local court after a fully litigated proceeding and a payment made in settlement of claims that avoids a will contest is without merit.

Id. at 610.

More recently, the IRS issued Private Letter Ruling 9347003, in which it confirmed that:

> [A] settlement of a claim asserted by the surviving spouse for a share of the decedent's estate must be based on a legally enforceable claim and paid pursuant to a bona fide compromise agreement. The claim must be asserted in good faith and settled in arm's length negotiations and may be arrived at without court action. *See Est. of Barrett v. Comm'r*, 22 TC 606 (1954), and *Citizens & So. Nat'l Bank v. United States*, 451 F.2d 221 (5th Cir. 1971).

PLR 9347003 (amounts paid to surviving spouse to settle will contest were eligible for marital deduction, but only to extent they did not exceed value of spouse's community claim against decedent's estate under Texas law). *Cf. Est. of Rapp v. Comm'r*, 140 F.3d 1211 (9th Cir. 1998) (probate court order reforming will after testator's death to reform trust to qualify as a QTIP trust not binding on IRS when order not confirmed by state's highest court and terms of will were unambiguous).

2. Other Claims by or Payments Made to the Surviving Spouse

a. Community Property Claims

When community property is involved, the surviving spouse effectively owns an undivided one-half interest in the community property remaining at the time of the first spouse's death. The decedent's gross taxable estate includes only the decedent's one-half interest in the property. *See* IRC § 2033. A common claim in estate litigation involves the claims of the surviving spouse as to the character of the assets that exist at the death of the first spouse.

In *Ahmanson Foundation*, the Ninth Circuit considered the availability of the marital deduction or exclusion of assets paid to a surviving spouse in settlement of her community property claims. *Ahmanson Found.*, 674 F.2d 761, 773 (9th Cir. 1982). The IRS argued that the marital deduction or community property exclusion was limited to the value of qualifying property that the surviving spouse had a right to receive under state law at the time of the decedent's death. *Id.* at 772. The Court stated that "the effect of the [marital deduction and community property exclusion were] the same" and that the two were "intended to play parallel and complimentary roles." *Id.* The Court held that neither a binding non-supreme court adjudication nor a private settlement agreement were binding on the IRS; instead, as noted above, the test of "passing" for estate tax purposes should be when it reached the spouse as a result of a good faith adversary confrontation. By equating the marital deduction and community property claims, the Court suggested that the value of a spouse's claim under state law "properly applied" is not limited solely to rights under the will. *See id.* The case was ultimately remanded by the Ninth Circuit for fact findings and a determination of California law as to the value of the claim.

b. Claims for Contribution and Reimbursement

Code Section 2053(a)(3) allows a deduction from the value of the gross estate for claims against the estate provided that the claim is "allowable by the laws of the jurisdiction, . . . under which the estate is being administered." Section 20.2053-4 of the Treasury Regulations further provides that only claims that are enforceable against the decedent's estate may be deducted under Code Section 2053.

When one spouse expends his or her separate property to benefit the couple's community property estate, the spouse whose funds were expended may have a claim for reimbursement. Likewise, when community property is used to enhance the value of one spouse's separate property, the other spouse may have a claim for economic contribution against the benefitted spouse's estate. The resulting claim may be an asset or liability of the estate of a deceased spouse.

For example, assume a surviving spouse has a $100,000 claim for economic contribution relating to the expenditure of her separate property to reduce the mortgage on a community property asset. The surviving spouse would presumably have a claim "allowable" under local law equal to $100,000. On the decedent's estate tax return, the executor would be entitled to take a deduction equal to $50,000 (i.e., the decedent's one-half of the $100,000 obligation owed to the community), assuming such amount is timely presented and paid, on Schedule K. Assume instead that the surviving spouse claimed that the community estate had a $100,000 claim for economic contribution relating to the expenditures of community property to reduce the mortgage on separate property of the decedent. In that situation, the decedent's estate would most properly (i) include a $100,000 community asset on Schedule F (of which $50,000 would be included in the gross estate, i.e., the decedent's one-half community property interest), and (ii) take a deduction equal to $100,000 assuming such amount is timely presented and paid, on Schedule K. The net effect of including $50,000 and deducting $100,000 would be to reduce the decedent's taxable estate by $50,000—the amount owed to the surviving spouse.

c. Homestead Claims

State law may grant a surviving spouse the right to occupy the residence used by him or her and the deceased spouse for as long as he or she desires (i.e., a homestead right). *See, e.g.*, TEX. ESTS. CODE § 102.005. If the homestead right can be abandoned (for example, if the surviving spouse remarries or relocates to a different residence), the homestead right may constitute a non-deductible terminable interest. *See* IRC § 2056(b)(1). In that event, the marital deduction would not be available for a homestead right. *See* PLR 8736004.

The unavailability of the federal estate tax marital deduction attributable to a homestead right should be considered when structuring a settlement with a spouse. If possible and appropriate, consideration should be given to the surviving spouse receiving the property outright or, alternatively, as a life estate with a general power of appointment. Both of these interests have a greater chance of meeting the requirements of Code Section 2056.

d. Family Allowance Claims

In some jurisdictions, a surviving spouse may have a right to seek a family allowance relating to the costs of support for the first year following the deceased spouse's death. The Tax Court has held that the payment of a family allowance will not qualify for a marital deduction. *See Est. of Snider v. Comm'r*, 84 TC 75 (1985) (family allowance under Texas law is contingent on determination by Texas court that spouse's separate property is inadequate for her maintenance for one year after husband's death, and therefore not indefeasible and unconditional as of the moment of husband's death; as a result, allowance is a nondeductible terminable interest.); *see also Jackson v. U.S.*, 376 US 503 (1964), aff'g 317 F.2d 821 (9th Cir. 1963) (family allowances generally do not qualify because they are not fixed rights vested at death); *but see Radel Est. v. Comm'r*., 88 TC 1143 (1987) (family allowance under Minnesota law was not discretionary and contains no contingencies, therefore, the 'spouse allowance' was non-terminable interest under Minnesota law and qualified for marital deduction).

While not deductible, a separate tax consideration is that a spouse's right to a family allowance generally has priority over the government's priority for payment under 31 USC § 3713 as family allowance claims generally are not debts but are charges against the property of the decedent to be deducted before payment of debts. *See* Rev. Rul. 80-112, 1980-1 CB 306.

3. The Estate Tax Charitable Deduction

The rules involving the estate tax charitable deductions in the family settlement context are typically less complex than those involving the marital deduction. Nevertheless, important issues arise that may impact the amount, timing and availability of the charitable deduction.

a. Code Section 2055

Code Section 2055 permits an unlimited estate tax deduction for qualifying bequests made to charities. Amounts passing as "split interests" involving both charitable and non-charitable beneficiaries (for example, life estate to child, remainder to charity, or trust paying all income to child for life, remainder to charity) generally do not qualify for an estate tax charitable deduction unless the split interest meets specific requirements. IRC § 2055(e)(2). Specifically, in the case of a charitable remainder interest, no deduction is allowed unless the interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (as described in Code Section 664) or a pooled income fund (as described in Code Section 642(c)(5)). IRC § 2055(e)(2)(A). In the case of any other split interest, it must be in the form of a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly). IRC § 2055(e)(2)(B). For a discussion regarding reforming charitable gifts to comply with these requirements, see the discussion in Part X.C., below. Amounts passing to charities pursuant to settlement agreements are generally deductible so long as the settlement arises from a bona fide dispute. *See* Rev. Rul. 145, 1953-2 CB 273; Rev. Rul. 89-31, 1989-1 CB 277.

b. Deductible Amount

The amount deductible for estate tax purposes is typically measured by the amount the charity actually receives under the settlement agreement. *See id.*; *see also Reed v. U.S.*, 317 F. Supp. 1242 (D.C. Cir. 1970); *Irving Trust Co. v. U.S.*, 221 F.2d 303 (2d Cir. 1955); *Heim v. Nee*, 40 F. Supp. 594 (D.C. Ohio 1960). If the charity is to receive a direct payment or specific property, recent cases and rulings support the availability of the charitable deduction. When, however, the charity will receive a split interest, for example a legal remainder interest or an interest in a trust, the rules for allowing the deductions are more technical, and as a result, one can expect that the IRS will scrutinize these transactions more closely.

Note, where the charitable beneficiary is taking the residue of the estate, certain special, although logical, rules apply. In that circumstance, any amount paid to satisfy a non-charitable beneficiary's claim reduces the charitable deduction. *See Reed v. U.S.*, 317 F. Supp. 1242 (D.C. Cir. 1970). If the amount the charity pays directly to the non-charitable beneficiary is paid from estate income, however, the portion attributable to estate income does not reduce the estate tax charitable deduction. *See Oldham v. Campbell*, 217 F. Supp. 819 (E.D. Tex. 1963). As noted in Part III.C.1. above with regard to the estate tax marital deduction, under current IRS regulations, "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the charitable deduction. Expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of the charitable deduction. Treas. Reg. § 20.2055-3(b)(1). Furthermore, if a charity's interest is contingent upon an event to occur, the charitable deduction is not available "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." Treas. Reg. § 20.2055-2(b)(1).

c. Charity Must Have a Bona Fide Claim

The IRS has stated that it will scrutinize the settlement of will contests to be sure that the litigation was not collusive or instituted merely to obtain the charitable deduction. However, if in settlement of a bona fide will contest, a charity receives an outright accelerated payment in lieu of an otherwise non-deductible split interest, the IRS will allow an estate tax deduction for the amount paid to the charity. Rev. Rul. 89-31, 1989-1 CB 277; *cf.* TAM 8945004 (valid charitable lead annuity trust converted to a single fixed-sum payment to charity received no estate tax charitable deduction where facts indicated that threatened will contest was not bona fide).

C. Tax Apportionment Issues

When drafting a will, the draftsman must pay special attention to the apportionment of estate and inheritance taxes to ensure that the intended net after-tax benefit comports with the client's wishes. Likewise, in advising clients about the tax impact of a proposed settlement, the apportionment of estate and inheritance taxes should be carefully thought through, and the "net" numbers examined. It is often important to remind clients about the tax impact of settling the case (and of not settling the case) so that they enter any dispute with a realistic expectation of the net after-tax amount that might reasonably be expected at the conclusion of the dispute. To the extent that the settlement is structured with a view toward minimizing or eliminating transfer taxes, more funds will be left on the table to be divided among the parties. Even in those circumstances, however (and perhaps especially in those circumstances), thought should be given to who will bear the tax risk if the IRS is successful in re-characterizing some component of the transaction, and as a result, taxes are owed. In this setting, the parties may wish to negotiate an indemnity for taxes ultimately assessed, and provide notice and an opportunity to participate in the tax dispute for the party who may ultimately be charged with the tax.

VII. ACCOUNTINGS IN ESTATES AND TRUSTS

Proceedings in which accountings are submitted for approval are noteworthy only when the accounts of the fiduciary are not approved as presented. A court generally has two remedies available when ruling on a representative's account. First, it can surcharge the fiduciary for an action taken, which generally requires an infusion into the estate or trust account of personal funds by the fiduciary to make up for some loss. Second, the court can "state an account," or order the representative to change the accounting and any underlying transaction to reflect proper treatment of some otherwise improperly handled aspect of estate or trust administration. While surcharge has no particular tax impact on an estate or trust (unless it is recovery of an income item that is subjected to income tax upon receipt by the estate or trust), stating an account can have a dramatic impact on fiduciary income taxes and the beneficiaries' personal income taxes.

When the court orders a fiduciary to state an account, distributions may be recast and beneficiaries may ultimately receive greater or lesser amounts than previously distributed. Similarly, expenses previously claimed and deducted at the estate or trust level, or impacting the amount of income reported to beneficiaries in a year in which distributions were made, can be disallowed and tax liability increased across the board. In either case, the fiduciary and the beneficiaries may be forced to amend their income tax returns to reflect the proper amounts taxable as income to any of them pursuant to the restated account. The amended return should arise not in the year in which the order stating the account is entered but in the year the actual redistribution of property or re-crediting of nondeductible expenses occurs. Generally, claim of right doctrine relief should be allowed to the beneficiaries to the extent they previously reported property in gross income that it has now been determined they were not entitled to receive. *Bohan v. U.S.*, 456 F.2d 851 (8th Cir. 1972); *Gaddis v. U.S.*, 330 F. Supp. 741 (S.D. Miss. 1971); *Phillips v. Comm'r*, 262 F.2d 668 (9th Cir. 1959); *Easley Trust v. Comm'r*, 228 F.2d 810 (9th Cir. 1955); *Crellin's Est. v. Comm'r*, 203 F.2d 812 (9th Cir. 1953). This could be important if the tax years in question are old enough to preclude filing a claim for refund by a beneficiary who may have overpaid income tax.

A taxpayer who is subject to the claim of right doctrine has a deduction in the year in which the repayment is made. However, if the taxpayer's marginal tax rate has decreased from the year in which the income was included to the year of repayment, the taxpayer would be at a disadvantage. To mitigate this situation, Congress enacted Code Section 1341. That Section allows the taxpayer to reduce his or her tax liability by the greater of the amounts calculated under two approaches: computing the tax liability for the year of repayment after deducting the amount of the repayment; or computing the tax reduction that would have occurred in the prior year had the amount received under the claim of right doctrine been excluded from income. IRC § 1341(a).

VIII. CONTRACTS TO MAKE WILLS; JOINT WILLS, MUTUAL WILLS

As with other matters regarding valuable property rights, most states permit persons to enter into contracts regarding the ultimate disposition of their property, so long as the contracts do not violate public policy. Where such contracts are recognized, legal action can be taken to remedy their breach. There are generally three types of actions to enforce a contract to make a will: (1) those that arise as compensation agreements to provide services such as caring for the decedent prior to death; (2) those that arise pursuant to joint and mutual wills in consideration for an agreement of the second to die not to change his or her will after the death of the first contract maker; and (3) those that arise from marital property-related settlements. The first of these categories has a significant and often overlooked income tax ramification.

A. Contracts Based on Consideration for Services Rendered

As noted earlier, a claim to enforce a contract to make a will or provide a bequest based on consideration for services rendered (*i.e.*, the traditional "you agreed to make a will leaving me your estate in exchange for my agreement to care for you until your death" contract claim) should in effect convert the share of the estate received by the successful claimant from an otherwise tax-free gift or bequest under Code Section 102 to a payment in compensation for services rendered subject to income tax as ordinary income. *U.S .v. Merriam*, 263 US 179 (1923); *Wolder v. Comm'r*, 493 F.2d 608 (2d Cir. 1974); *Est. of Law*, 1964-257 (1964); *Est. of Cavett v. Comm'r*, TC Memo 2000-91 (2000); *Est. of Stern v. Dept. of Treas.*, 81 AFTR2d (P-H) ¶ 98-501 (S.D. Ind. 1998); *Est. of Wilson v. Comm'r,* TC Memo 1998-309 (1998). While this result may seem harsh, an analysis of the underlying property rights giving rise to the contract show it to be both logical and fair. An individual who decides for donative reasons, with no consideration, to leave property to a person pursuant to a will has made the type of gift (albeit occurring at death) excludible from income under Code Section 102. *See* IRC § 102; Treas. Reg. § 1.102-1. An estate that is charged as a creditor with paying a portion or all of its assets to a claimant who, in exchange for services rendered, obtained a contractual agreement to receive the estate at death is being paid pursuant to that contract for services rendered and is receiving compensation taxable under Code Section 61 as income. *U.S .v. Merriam,* 263 US 179 (1923); *Wolder v. Comm'r,* 493 F.2d 608 (2d Cir. 1974).

Contract assertions within this category are usually based on oral agreements and therefore are viewed with a degree of skepticism by the courts. While this factor diminishes the value of these claims in settlement negotiations, the added income tax component, which renders the property considerably less valuable in the hands of the claimant than in the hands of the estate, is often overlooked in negotiating and settling these claims. While the interplay of the potential estate tax deduction for paying such a claim and the income tax treatment of the distribution of the claim is somewhat complicated since payment of one of these claims is not necessarily based on good and valuable consideration to the full extent of the claim payment, the income tax ramifications should nonetheless be carefully considered by any fiduciary facing such a claim, and by the claimant.

B. Claims not Based on Compensation for Services Rendered

1. In General

Claims based on matters other than compensation for services should not inherently make the recovery subject to income tax in the hands of the claimant. For example, joint and mutual will and divorce property settlement cases impact primarily the areas of estate and gift taxation.

2. Joint and Mutual Wills

It is unlikely that the consideration exchanged pursuant to a joint and mutual will will constitute full and adequate consideration and render a disposition by the second estate pursuant to a beneficiary's claim under a contract to make a will fully deductible. *Est. of Huntington v. Comm'r,* 16 F.3d 462 (1st Cir. 1994). Beneficiaries who seek to enforce a joint and mutual will contract are in essence saying that the second decedent promised to leave them property in exchange for the second decedent having received property (or a favored disposition of property) under the will of the first decedent. No case law suggests that a third party enforcing this contract obtained that right by full and adequate consideration; logically it would seem that the third party provided no consideration. Therefore, not surprisingly, when the so-called "children of the first marriage" come in to enforce a joint and mutual will after the second decedent has altered the will in favor of new beneficiaries following the first decedent's death, a successful claim under the joint and mutual will theory should not render the entire amount paid to those claimants deductible for federal estate tax purposes. *See, e.g., Bank of N.Y. v U.S.,* 526 F.2d 1012 (3rd Cir. 1975); *Luce v. U.S.*, 444 F. Supp. 347 (D.C. Mo. 1977) (No deduction allowed for amount estate paid in settlement of claim by decedent's step-children based on decedent's breach of alleged agreement to leave her estate to child and step-children equally in return for predeceased husband's promise to bequeath his estate to her. Deduction wasn't allowable since the step-children took as beneficiaries, not as creditors; the payments to them were of a testamentary nature rather than contractual).

A joint and mutual will or a contract between spouses to make a will may well result in the denial of the estate tax marital deduction. *See, e.g., Bartlett v. Comm'r*, 937 F.2d 316 (7th Cir. 1991) (bequest under contractual Will grants life estate but not general power of appointment under Illinois law, thereby precluding marital deduction under Code Section 2056(b)(5); *U.S. v. Stapf*, 375 US 118 (1963) (bequest to wife conditioned upon her leaving her community property into trust for children was reduced by the value by which her community property was so encumbered); c*f. Harter's Est. v. Comm'r*, 39 TC 511 (1962) (voluntary gift by surviving spouse, intended to conform to decedent's wishes, did not reduce interest passing to spouse, who elected against will). Thus, settlement agreements that restrict the surviving spouse's ability to dispose of the property passing to that spouse must be reviewed carefully to ascertain whether the restricted property may qualify for the marital deduction, perhaps under the QTIP rules of Code Section 2056(b)(7).

3. Marital Property Settlements

The situation is potentially different in the context of marital property settlement cases giving rise to contracts to make a will. In *Estate of Kosow v. Commissioner*, 45 F.3d 1524 (11th Cir. 1995), the court held, against the IRS, that a contract to leave property to a particular person (who can even be a child of the decedent) pursuant to a divorce settlement can cause the entire balance of the decedent's estate to be deductible for transfer tax purposes as long as the consideration for the promise to ultimately leave property to that person was full and adequate compared to the property rights given away pursuant to the contract. If, at the time of a divorce, one spouse agreed not to pursue recoverable marital property rights against a second spouse in exchange for that second spouse agreeing to leave his or her entire estate to the first spouse's children at death, using the holding in *Kosow*, if adequate proof of the value of the marital rights given up can be shown to roughly balance out the inheritance rights obtained, the estate can end up in the seemingly incongruous situation of passing entirely to the decedent's children without the imposition of any estate tax. The property passes pursuant to a contractual obligation backed by consideration, as opposed to by whim or gift. *Id; see also Florida Nat'l Bank & Trust Co. v. U.S.*, 182 F. Supp. 76 (S.D. Fla. 1960).

This doctrine should be regarded carefully. *Kosow* arose in an unusual setting. In that case, the executor of the estate subject to the divorce obligation was able to establish, many years after the divorce, the nature and extent of the property rights relinquished, their relative value to the inheritance rights established years earlier, and, therefore, the likelihood of full and adequate consideration for the agreed bequest occurring many years later. While that theoretical possibility usually exists in marital settlement cases, it would be a mistake to conclude that any such promise, particularly when made in favor of a third-party beneficiary who is a natural object of the decedent's bounty, will always support a claim that effectively causes the promisor's estate to be exempt from estate tax. Moreover, while not raised in *Kosow*, where one party agrees to accept a lesser amount in a divorce in exchange for a promise by the other party to leave property to children or others, the party accepting less will presumably have made a gift of the forgone amount (or of the value of the future gift) to the children or other persons at the time of the divorce. *See, e.g.,* Rev. Rul. 79-363, 1979-2 CB 345.

IX. HEIRSHIP, ADOPTION, AND PATERNITY CLAIMS

Claims of parties seeking to establish property rights in a decedent's estate or trust pursuant to a claim of heirship, inclusion of adopted children in a class gift, or inclusion of an illegitimate child as a beneficiary are generally treated as taking by inheritance and not by purchase. In other words, the amounts those individuals receive do not qualify as deductions or exclusions from the estate for federal estate tax purposes, are not generally treated as income to the beneficiaries (except to the extent they also recovered rights to IRD and received that income), and do not otherwise alter the tax treatment of post-death administration. *Irving Trust Co. v. U.S.,* 221 F.2d 303, 305 (2d Cir. 1955); *Est. of Lazar v. Comm'r,* 58 TC 543 (1972); *Est. of Howard v. Comm'r,* 1 TC 781 (1943).

X. CONSTRUCTION, REFORMATION, REVOCATION, RESCISSION, DECANTING, AND MODIFICATION OF WILLS AND TRUSTS[8]

A. Overview

As noted above, the U. S. Supreme Court has described the circumstances in which the IRS may be bound by a state court adjudication of property rights when the United States is not a party. *See Comm'r v. Est. of Bosch*, 387 US 456 (1967). The Court confirmed its longstanding holding that property rights are determined by state law. The

[8] States are not consistent in the terminology used in these matters, so it is important when reviewing case law to determine the underlying nature of the action. For example, in Texas, we use the term "reformation" for a cause of action that in many states is termed a "construction" proceeding.

Court ruled, however, that when federal estate tax issues are dependent upon the state-law character of property interests, the IRS is not "conclusively bound" by a state trial court ruling regarding those property interests. Instead, the Court formulated a new test providing that: (i) when a state law property right has been decided by the highest court of the state, the decision should be followed and respected as the best authority for that state's law; and (ii) when a state law property right has not been decided by the highest court of the state, federal authorities (be it the IRS or a tax court deciding the issue) "must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." *Id.* at 465. The Court in adopting this rule recognized that it requires the deciding authority to sit "as a state court." *Id*. (citing *Bernhardt v. Polygraphic Co*., 350 US 198 (1956)). Thus, a fundamental requirement of any settlement agreement is that it meets state law requirements, and is based on valid rights of the parties under state law.

Disputes among parties in fiduciary matters may often be settled or adjudicated by an action for construction, reformation, revocation, rescission, modification, or increasingly more common, perhaps decanting of trusts involved in the dispute. Whether the dispute is resolved by construction or reformation vs. revocation or rescission vs. modification vs. decanting can affect the resulting tax treatment arising from any change that occurs. For example, a construction or reformation action involves a determination of the true, and therefore original, meaning of the document at the time of execution, while judicial modification or rescission involves a modification of the original document to effect some judicially recognizable basis for that change. Since a construction or reformation action is simply a judicial declaration or recognition of what was present at the time of execution of the document while modification or rescission are acknowledged changes, the IRS and the courts have been more willing to recognize a construction or reformation as having the same tax consequences as the terms of the original document, while often treating modifications and revocations as new (post-death) transfers for estate, gift, and GST tax purposes. While taxpayers may have scored some victories in arguing to the contrary, this distinction still generally holds, at least as to the IRS's initial approach. *Est. of Reddert v. U.S.,* 925 F. Supp. 261 (D. N.J. 1996); *In re Est. of Tuthill,* 754 A.2d 272 (D.C. App. 2000). These distinctions can be critically important in matters relating to marital and charitable estate tax deductions, as well as issues of inclusion or exclusion for gift or estate tax purposes. Similarly, the avoidance of adverse income tax consequences may be is easier to achieve in construction or reformation actions.

B. Construction

A will or trust construction action is treated as relating back to the effective date of the instrument, which is the date of death for wills or revocable trusts and the date of execution for irrevocable documents. *Am. Nurseryman Publ'g Co. v. Comm'r,* 75 TC 271 (1980), *aff'd without opinion,* 673 F.2d 1333 (7th Cir. 1981); *Est. of LaMeres v. Comm'r,* 98 TC 294 (1992). This means that a gift construed to pass to a spouse or a charity will ordinarily maintain its marital or charitable deduction qualification. Similarly, a power or other interest construed by a state court so that it is not included in the decedent's gross estate should be recognized by the IRS. While the underlying decision of the state trial court in such a matter is not binding on the IRS, the courts and the IRS are required to give due deference to any such proceeding that is not fraudulent or a sham. *Comm'r v. Est. of Bosch,* 387 US 456 (1967).

Therefore, one important aspect of construction proceedings is that they present the fiduciary with a so-called "return position," so that an item can be placed or not placed on a tax return with a given argument about its taxable nature without significant fear of penalty. Even if the result of the proceeding and the tax position taken may be at odds with the face of the document, the assumed meaning on the date of death, or some position on the issue espoused by the IRS, the construction justifies the taxpayer's stance. *See* IRS Form 8275, "Disclosure Statement" (used to disclose positions not otherwise adequately disclosed on a tax return for the purposes of avoiding certain penalties) and IRS Form 8275-R, "Regulation Disclosure Statement" (used to disclose positions taken on a tax return that are contrary to Treasury Regulations).

C. Reformation and Judicial Revocation

Trust modifications and judicial revocations may be retroactively binding only on parties to the proceeding, and not necessarily on the IRS, even in situations where state courts refer to their actions as "reformation" actions. *Am. Nurseryman Publ'g Co. v. Comm'r,* 75 TC 271 (1980), *aff'd without opinion,* 673 F.2d 1333 (7th Cir. 1981); *Van Den Wymelenburg v. U.S.,* 397 F.2d 443 (7th Cir. 1968) (reformation to qualify for annual exclusion was not effective for federal tax purposes); *Straight's Trust v. Comm'r,* 245 F.2d 327 (8th Cir. 1957) (reformation not effective retroactively for federal income tax purposes). Therefore, relying on *Bosch*, the IRS takes the position that it will give tax effect to a legal action construing or reforming a document only if (i) a state law property right has been decided by the highest court of the state; (ii) the IRS or a tax court finds that the reformation accurately applies state law after giving "proper regard" to relevant rulings of other courts of the state; or (iii) some provision in the Code or the Treasury Regulations specifically authorizes recognition of the tax treatment arising from the reformed document. Most state courts have held that reformation must be based upon a mistake of fact, not a mistake of law. *See, e.g., Community Mut. Ins. Co. v. Owen*, 804 S.W.2d 602 (Tex. App.–Houston [1st Dist.] 1991, writ denied). However, this limitation on reformation has usually been applied to mistakes of fact regarding the general rules of law, and not to a mistake regarding particular private legal rights and interests. In other words, if parties contract under a mutual mistake and misapprehension as to their specific rights, the agreement may be set aside as having proceeded upon a common mistake. *See, e.g., Furnace v. Furnace*, 783 S.W.2d 682, 686 (Tex. App.-Houston [14th Dist.] 1989, writ dismissed w.o.j). In some jurisdictions, courts have extended the doctrine of reformation to mistakes of law made by the scrivener of the trust agreement, where the settlor relied on the scrivener and could not reasonably be expected to have known the legal implications of language in the trust agreement. *See, e.g., Carlson v. Sweeney*, 895 N.E.2d 1191 (Ind. 2008).

Convincing the IRS that a state law reformation accurately applies state law is the key to having the action respected for tax purposes, unless the parties find a way to have the action heard by the state's supreme court, or unless a statute or regulation permits the reformation. *See, Carlson v. Sweeney*, 895 N.E.2d 1191 (Ind. 2008) (Indiana Supreme Court substantively changed state law to recognize that a testamentary trust could be validly reformed by court to correct a mistake of law, noting that the IRS was thereby bound, citing *Bosch*); *see also* PLRs 201737001 and 201737008 (judicial reformation of trusts by grantor to correct scrivener's error making spouse's generals power of appointment limited powers of appointment was consistent with applicable state law as it would be applied by highest state court and did not cause gift by or estate inclusion for spouse), 201630145 (IRS ruled judicial reformation removing beneficiary's potential general power of appointment was consistent with applicable state law as it would be applied by highest state court, no estate or gift tax consequences to beneficiary), 201544005 (IRS determined judicial reformation to correct scrivener's error consistent with state law), 201442042 (IRS gave effect to judicial reformation of GRAT where there was clear and convincing evidence of scrivener's error).

A common area giving rise to tax-motivated reformations involve modifications to obtain an estate tax charitable deduction under Code Section 2055(e). The actions usually involve reformations of non-qualified, so-called "split interest" trusts, with partial charitable and non-charitable interests, pursuant to the regulations under Code Section 664. Treas. Reg. § 1.664-1. These provisions are relatively unusual and are cumbersome to satisfy. Nevertheless, it is important to note that the reformations that are recognized by federal tax statutes or regulations are often available for interests that might not appear to qualify for split interest or exempt status, or that might lack significant tax-qualifying requirements. This is true because these reformations or constructions are not based on the intent expressed by the testator in structuring the original gift, but instead are efforts to restructure the gift into the form statutorily mandated to obtain an estate tax deduction. For example, a legal life estate in real estate or other property not in trust with remainder passing to charity may be reformed into a qualified split-interest "trust equivalent" that generates a current income or estate tax deduction for the charitable remainder. The reformation is allowed and the resulting favorable tax treatment is recognized, even though the intervening life estate was not originally couched by the testator in terms of a so-called "unitrust" or "annuity trust" amount as is generally required for a qualified, split-interest trust treatment. *Id.*

Finally, the same qualifying charitable deduction can arise from a document construction that finds the document to effectively "include" otherwise missing provisions since construction orders are effective as of the effective date of the document. However, achieving this result pursuant to a construction order (the only way to obtain such relief if the federal law mandated reformation dates has been missed) may involve an up-hill battle to persuade the IRS to accept the construction as legally binding and effective to bring about the desired charitable deduction. See Chief Counsel Advice 201651013 (aff'd by CCA 201747005) for an example of where the IRS took the position that a judicial modification of a trust did not make distributions pursuant to the additional charitable terms qualify for a charitable income tax deduction because the distributions were not being made pursuant to the terms of the original governing instrument, but only pursuant to the modified terms.

D. Decanting and Other Trust Modifications

Changes in circumstances that arise subsequent to the time that a trust becomes irrevocable may give rise to a modification of an otherwise irrevocable trust, either by the agreement of the parties (where permitted by local law) or through an action for a judicial modification. Under the traditional equitable deviation doctrine, if circumstances unanticipated by the settlor occur, a court may modify the administrative terms of a trust, but only to prevent the unanticipated circumstances from defeating or substantially impairing the accomplishment of the purposes of the trust. *See* RESTATEMENT OF TRUSTS 2d § 167(1) (1959). State statutes often permit modification of trusts under a broader variety of circumstances, permitting the modification of both administrative and dispositive provisions, if the changes have the effect of furthering the purposes of the trust. See, e.g., Unif. Trust Code §§ 410-417 (2004). Modifications may also be effected by the action of a trustee who, acting under its authority to make distributions to or for the benefit of one or more beneficiaries, exercises that discretion to place property into a new and different trust, an action that has come to be referred to as "decanting."

1. General Tax Issues

Although not defined in the Code or Treasury regulations, decanting may be described as the exercise by a trustee of the trustee's discretionary authority to distribute trust property to or for the benefit of trust beneficiaries by distributing assets from one trust to another trust. Although not referred to as decanting, the concept can be found in the Restatement (Second) of Property: Donative Transfers (1986) and the Restatement (Third) of Property: Wills and Other Donative Transfers (2011). Beginning in 2011, the IRS adopted a no-ruling policy which continues today with respect to certain issues relating to decanting arrangements, including the issue of whether the decanting of a trust results in a taxable gift. *See* Rev. Proc. 2018-3, 2018-1 IRB 118 § 5.01(7), (12), (13). The IRS generally will continue to issue rulings in situations where the decanting does not result in any change in beneficial interests or in the applicable perpetuities period. Notice 2011-101, 2011-52 IRB 932 was issued and requested comments on various aspects of the tax treatment of such distributions. Comments were submitted to the IRS by several organizations, including The American College of Trust and Estate Counsel (ACTEC), the American Bar Association's Section of Taxation, the State Bar of Texas Tax Section, the New York State Bar's Tax Section, and Bessemer Trust, however, the IRS has not given a date as to when published guidance can be expected. Until the IRS publishes guidance and case law develops, the following discusses the potential tax issues that practitioners should consider when advising clients about decanting or other trust modifications.[9]

2. Income Tax Issues

In most cases, decanting from one trust to another, trust modifications, and trust combinations should present minimal, if any, unexpected income tax consequences to the trust or the trust beneficiaries.

a. Distributions and DNI

If trust assets are decanted from one trust to another trust, one possibility is that the decanting will be treated as simply a trust modification rather than a termination of the initial trust; consequently, both trusts will be treated as the same trust for income tax purposes. No income tax consequences would be recognized to either trust because of the decanting. Instead, the result would be that the surviving trust will report all income, expenses, and distributions for the entire year. *See* PLRs 200736002, 200723014, 200607015.

A second possibility in the case of decanting follows the general rule that any distribution from a trust will carry with it a portion of the trust's distributable net income ("DNI"). *See* IRC §§ 651, 661. Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI. IRC § 661. If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata. *Id.* If a trust terminates, current income is carried out, as are any unused capital losses, net operating losses, and expenses incurred in excess of income. IRC § 642(h). Thus, when two trusts combine or "merge," no provision of the Code provides that the combination of trusts is tax-free. Therefore, the treatment may be that the terminating trust will be treated as making a terminating distribution, carrying out its DNI, unused losses,

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[9] The discussion herein only addresses tax issues from a federal standpoint. Advisors, however, should consider any state tax issues that may arise. In addition, decanting a domestic trust to a foreign trust, or vice versa, can present its own unique issues that are not addressed herein.

and excess deductions, to the surviving trust. *Id.* In other words, the result would be that the new trust would receive taxable income to the extent of the old trust's DNI and the old trust would receive a corresponding distribution deduction.

If the first trust does not terminate but instead a partial decanting occurs with the first trust retaining a right to withdraw a portion of the second trust, the first trust may be treated as the owner of the retained portion of the second trust. The second trust is treated as a grantor trust in this case. *See* PLR 201633021 (IRC § 678 applied to treat second trust as grantor trust, first trust will report DNI as defined in second trust).

b. Grantor Trusts

Grantor trust treatment for income tax purposes is determined pursuant to Subpart E of Subchapter J of the Code. IRC §§ 671-679. The IRS treats trust property held in a grantor trust as being owned by the grantor for federal income tax purposes. IRC § 671. A transfer of trust property from one grantor trust to another grantor trust should have no federal income tax effect. It has long been the rule in the case of sales transactions between a grantor and a grantor trust that no federal income tax effect will result. Rev. Rul. 85-13, 1985-1 CB 184. More recently, in Revenue Ruling 2007-13, the IRS made it clear that if a life insurance policy held by a grantor trust is transferred to another grantor trust, the grantor will be treated as the owner of the policy for the transfer-for-value rules so that no negative income tax consequences will result. Rev. Rul. 2007-13, 2007-11 IRB 684. It would seem to follow that the act of transferring, "merging," or decanting the assets of a grantor trust to another grantor trust, which is merely a transfer of assets, should have no income tax effect.

When a grantor trust loses its grantor trust status, the grantor is treated as having transferred ownership of the trust property to the trustee of the trust, and a taxable disposition of the trust property by the grantor occurs. *Madorin v. Comm'r*, 84 TC 667 (1985); Rev. Rul. 77-402, 1977-2 CB 222; Treas. Reg. § 1.1001-2(c), Ex. 5. The fact that a disposition of trust property occurs does not necessarily mean that the disposition has any affect for federal income tax purposes. Rather, as the court made clear in *Madorin*, the grantor trust rules operate to determine whether the grantor is the owner of the trust property for federal income tax purposes, but other provisions of the Code, such as the partnership tax rules, must be reviewed to determine if there is any federal income tax effect upon a disposition of the trust property. *Id.*; *see, e.g.,* IRC § 741.

Therefore, the mere transfer of the trust property from a grantor trust to a non-grantor trust through decanting or otherwise should not, in and of itself, cause a realization event for federal income tax purposes. Instead, provisions of the Code other than the grantor trust tax rules may cause a realization event for federal income tax purposes.

In contrast, if a non-grantor trust becomes a grantor trust through decanting or otherwise, there should be no realization event in any case. *See* Rev. Rul. 85-13, 1985-1 CB 184 (trust became grantor trust when grantor acquired trust assets in exchange for unsecured promissory note; transfer not treated as a sale and grantor did not acquire cost basis in assets). In Private Letter Ruling 201730018, the IRS concluded that the conversion of a non-grantor trust to a grantor trust was not a transfer of property for any income tax purposes.

By their terms, Code Sections 671 through 677 can cause a trust that is a non-grantor trust at one point in time to be treated as a grantor trust at a later time. The portion rules in these sections are examples of such events. For example, if a trust allows the use of trust income to pay premiums on life insurance policies insuring the life of the grantor or the grantor's spouse, to the extent the premiums are so used, that portion of the trust will be a grantor trust. IRC § 677(a). In addition, marriage is enough to make an otherwise non-grantor trust become a grantor trust. For example, a trust that allows distributions of income to a grantor's friend does not make the trust a grantor trust, but if the grantor marries the friend, the trust will then be treated as a grantor trust. IRC § 677(a). If a grantor establishes a trust, names his friend as trustee, and gives broad discretionary authority regarding distributions to the trustee, the trust is not a grantor trust. If the grantor subsequently marries the trustee, however, the trust will then become a grantor trust. IRC § 672(e). As shown by these examples, and as can be seen throughout the grantor trust rules, relatively benign actions can cause an otherwise non-grantor trust to become a grantor trust. In addition, in Chief Counsel Advice 200923024, the IRS ruled that for federal income tax purposes, the conversion of a non-grantor trust to a grantor trust is not a transfer of property held by the non-grantor trust to the owner of the grantor trust that requires the recognition of gain by the owner. Based on the foregoing, although who pays tax on the income of a trust may change, the mere act of a conversion from a non-grantor trust to a grantor trust through decanting should not cause a federal income tax realization event.

c. Gains

Treasury Regulation Section 1.1001-1(a) provides that gain from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income. In the case of a trust modification, the issue then is whether property is being sold or disposed of in exchange for property that is materially different. In *Cottage Savings Association v. Commissioner*, 499 US 554 (1991), the Supreme Court found that properties are materially different if their owners "enjoy legal entitlements that are different in kind or extent." *Id.* at 555. In certain situations, the IRS might argue that a decanting or trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes. *See* Rev. Rul. 69-486, 1969-2 CB 159.

In Private Letter Ruling 200231011, the taxpayer asked the IRS to rule on the tax consequences of a proposed trust modification. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing him a 7% unitrust amount plus distributions of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance with the grandson's general testamentary power of appointment. The IRS, citing *Cottage Savings Association v. Commissioner,* 499 US 554 (1991), ruled that an exchange of property results in the realization of gain or loss under Code Section 1001 if the properties exchanged are materially different. The IRS then compared the proposed modification to the modifications in two other cases. The first case, *Evans v. Commissioner*, 30 TC 798 (1958), involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, *Silverstein v. United States*, 419 F.2d. 999 (7th Cir. 1969), found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because the grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling, and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement, and as a result, the modification would be treated as a realization event for federal income tax purposes. *Compare* PLRs 201647001 (because Grantors' status as owners of trust for federal income tax purposes did not change beneficial interests, modification to grant additional trustee powers did not result in transfer); 201528024; 201419001; 200736002 (finding division of trust into three separate trusts on a pro rata basis did not result in gain or loss because new trusts were not materially different, even though trustees would be different in the new trusts); 200615006 (court-approved settlement clarifying ambiguous trust terms to provide that stated distribution amounts were minimums and that trustee should also distribute all trust income to beneficiaries, were not materially different).

In Private Letter Ruling 200743022, the IRS considered whether decanting assets from old trusts to new trusts and the merger of the trusts' assets would cause gain or loss recognition in a situation where both state law and the trust agreement authorized the decanting. Because the decanting was to occur as a result of the discretionary authority of the trustees based on state law and the trust agreement, and not as a result of the beneficiaries' exchange of trust property, the IRS ruled that no gain or loss would be recognized by any of the trusts or the beneficiaries. The exercise of the trustees' discretionary authority and the lack of involvement by the beneficiaries prevented an analysis pursuant to Code Section 1001.

As noted earlier, the severance of a trust occurring on or after August 2, 2007 will not be treated as an exchange of property for other property differing materially either in kind or in extent if (i) an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) any non-pro rata funding of the separate trusts resulting from the severance, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument. Treas. Reg. § 1.1001-1(h).

d. Basis Disregarded

If Code Section 1001 applies due to the beneficiary's involvement in the decanting or modification, that Section provides a special rule for determining gain or loss from the disposition of a term interest in property. As discussed above, under Code Section 1001(e), in determining gain or loss from the disposition of a term interest, generally, the adjusted basis of the interests determined under Code Sections 1014 (inheritance), 1015 (gift) or 1041 (transfers between spouses) is disregarded. Again, a "term interest in property" for purposes of Code Section 1001(e) means a life interest, an interest for a term of years, or an income interest in a trust. IRC § 1001(e)(2). If the entire interest in property is transferred as part of a single transaction, an exception to this "no basis" rule applies. IRC § 1001(e)(3). In Private Letter Ruling 200231011 (discussed above), after concluding that the grandson's interest as modified would entail different legal entitlements from those he possessed under the original agreement, thus resulting in gain recognition, the IRS went on to explain that, under Code Section 1001(e)(1), the portion of the adjusted uniform basis assigned to the grandson's interest in the trust is disregarded because it was a term interest. Accordingly, the grandson was required to recognize gain on the entire amount received.

e. Negative Basis Assets

For beneficiaries, because of Code Section 1001 and *Crane v. Commissioner*, 331 US 1 (1947), a concern may arise if a trustee decants property that has debt in excess of its basis or an interest in a limited partnership or limited liability company with a negative capital account. In *Crane*, an individual taxpayer sold property that was subject to nonrecourse debt. The Supreme Court held that the amount realized on the sale included not only any cash or other property received, but also the amount of taxpayer's debt that was discharged as a result of the sale. In the partnership context, Code Section 752(d) provides that when a taxpayer sells a partnership interest, any partnership liabilities are treated the same as any other liabilities in the context of a sale or exchange of property. In the trust context, Code Section 643(e) provides that upon the distribution of trust property, a beneficiary will receive a carryover basis in the property, adjusted for any gain or loss recognized on the distribution. This Section further provides that gain or loss may be recognized on the distribution, if a trustee elects. Unfortunately, no express authority provides an answer as to whether a distribution of trust property that is subject to debt will cause recognition of gain or loss as would be the case with the sale or exchange of other property under *Crane* and related authority or whether no gain or loss would be recognized unless an election is made by a trustee pursuant to Code Section 643(e). Hopefully, published guidance will answer this question.

3. Gift Tax Issues

a. General Issues

Can the IRS argue that decanting, trust combinations, and the like give rise to taxable gifts? As discussed above, Code Section 2512(b) provides that where a transfer of property is made for less than adequate and full consideration, the amount in excess of fair consideration will be treated as a gift. The notion that a gift arises as a result of decanting or trust modification may be especially important in situations in which the beneficiary must consent to the change, or where the change results from the settlement of litigation. On the one hand, a transfer of property by an individual in compromise and settlement of threatened estate litigation is a transfer for full and adequate consideration in money or money's worth and, thus, is not a gift for federal gift tax purposes. *See Lampert v. Comm'r*, TC Memo 56-226 (1956); *see also Righter v. U.S.*, 258 F. Supp. 763 (8th Cir. 1966) *rev'd and remanded on other grounds* 400 F.2d 344 (8th Cir. 1968). As mentioned above, in Private Letter Ruling 8902045, the IRS stated that settlements of bona fide intra-family disputes should not result in gift tax since a change in the parties' economic rights has not occurred. On the other hand, if no adequate consideration for the settlement agreement is found, the IRS may assert that the settlement gives rise to gift tax consequences. *See Nelson v. U.S.*, 89-2 USTC ¶ 13,823 (D. N.D. 1989) (unreported); PLR 9308032. For example, if a remainder beneficiary agrees to decanting or the termination of a trust and gives up his or her interest in the trust in favor of the income beneficiary, the remainder beneficiary may be treated as having made a gift subject to gift tax. *See* Rev. Rul. 84-105, 1984-2 CB

197. Commentators have suggested filing a court action as a basis for then having a dispute to settle. It would be important to assess whether a true controversy exists in order to avoid a potential IRS argument of substance over form. The gift tax implication may arise notwithstanding the fact that the value of the forgone interest may be difficult to value. This difficulty in valuing the gift could make it possible to value the gift at a relatively low value. *See* PLR 9451049. In the context of a trust reformation to conform a trust to the grantor's original intent, the IRS has found no gift to have arisen, despite a shift of beneficial interests. *See* PLRs 201732029, 200318064. When a modification does not give a grantor the right to change beneficial interests, no deemed transfer by the grantor will be made. PLR 201647001.

Since decanting is based on the discretion of a trustee, gift tax issues can arise if a trust beneficiary is serving as a trustee and exercises the discretion to decant. Treasury Regulation Section 25.2511-1(g)(2) provides that if a trustee is a trust beneficiary and transfers trust property, the transfer will be a taxable gift by the trustee-beneficiary unless the fiduciary power is limited by an ascertainable standard set forth in the trust agreement. Even more certainty is provided in Treasury Regulation Section 25.2511-1(g)(1). The regulation provides that if a trustee distributes property to another beneficiary of the trust and the trustee is not a beneficiary, no taxable gift will occur. Therefore, if a beneficiary is the trustee, the better practice would be to have only an independent trustee exercise discretion to decant.

Similarly, if a beneficiary consents to a decanting, such as through providing a receipt and release, an argument exists that the beneficiary is exercising control over the assets which could give rise to a taxable gift. Again, the purpose for the decanting becomes important, such as when the decanting will shift a beneficial interest to different beneficiaries, to determine whether negative tax consequences may result. PLR 201647001. In a fairly recent private letter ruling, a GST grandfathered trust was modified to include legally adopted issue and descendants in the definitions of issue and descendants. Under the facts, some of the grantor's children and grandchildren were legally adopted. The IRS ruled that, as a result of the modification, each issue of the grantor's child made a gift of their respective future interest in the trust's income and principal to the adopted issue who were now beneficiaries of the trust. PLR 200917004. Interestingly, the IRS ruled that no loss of the trust's GST grandfathered status would occur because the modification did not shift beneficial interests to lower generation beneficiaries or extend the term of the trust. *Id.* Likewise, the concern about gift tax consequences to a beneficiary is especially true in the case of a trust that is set to terminate at a specific date or age and decanting is done to continue the trust. Furthermore, if the beneficiary consents to the decanting, an argument can be made that the beneficiary is a grantor of the new trust pursuant to Treasury Regulation Section 1.671-2(e)(1).

b. Exercise, Release, or Lapse of General Power of Appointment

The exercise, release or lapse of a general power of appointment is deemed a transfer of property by the individual possessing the power. IRC § 2514(b). To avoid gift tax implications when trusts are decanted or modified, one must determine whether trustees who are also beneficiaries possess general powers of appointment over trust property and whether the decanting or modification of the trust results in the creation, exercise, release or lapse of a general power of appointment. *See, e.g.,* PLRs 201702016-201702018, 201634016 (trust modification of trustee succession and distribution provisions did not cause beneficiary to have general power of appointment).

If a beneficiary of a trust exercises a power of appointment to create a new trust with a new power of appointment that can be exercised so that the termination date of the new trust can be extended beyond the perpetuities period provided in the original trust, the exercise of the first power of appointment during the life of the beneficiary may be treated as a taxable gift by the powerholder, or at the death of the beneficiary, may result in inclusion in the estate of the powerholder. IRC §§ 2041(a)(3), 2514(d). This is commonly referred to as the "Delaware Tax Trap." Again, if decanting is only exercised by an independent trustee, these issues should not arise. IRC § 2514(b). As is common when exercising a power of appointment which results in property passing to a new trust, language may be included in the new trust to prohibit triggering of the Delaware Tax Trap.

4. Estate Tax Issues

Does the grantor run any risks in participating in the decanting or modification of an irrevocable trust, either by agreement or by judicial proceeding? In particular, one might be concerned that the state law basis for decanting or trust modification would be used to find that the grantor somehow retained a power of change or revocation when he or she created the otherwise-irrevocable trust. Treasury Regulation Section 20.2038-1(a)(2) provides, however, that Code Section 2038 (power to revoke) does not apply if a power can be exercised only with the consent of all parties having an interest (vested or contingent) in the trust, and if the power adds nothing to the rights of the parties under local law. *See also* PLR 201233008. Therefore, decanting and modifications involving the grantor's participation should not implicate estate tax issues for the grantor. *See* PLRs 200919008-10, 201233008. In Private Letter Ruling 201647001, the IRS ruled that a modification to allow an independent trustee of a grantor trust to reimburse grantors for income tax paid by the grantors would not inclusion for estate tax purposes. In reviewing the reformation of a GRAT to correct a scrivener's error, the IRS concluded that the grantor's retained interest was a qualified interest, thereby preserving the GRAT's qualification. PLR 201652002. Similarly, in Private Letter Rulings 201737001 and 201737008, the IRS concluded that the general powers of appointment judicially reformed by grantor to correct a scrivener's error so that they were limited powers of appointment as intended were not general powers of appointment after the reformation, and therefore, the powers did not cause estate tax inclusion for the spouse. For beneficiaries, there may be an issue with estate inclusion as described above in the context of the Delaware Tax Trap or if it is shown that the beneficiary had such control over the trust assets as to fall within Code Sections 2036 or 2038. Of course, if the new trust grants a beneficiary a general power of appointment over the trust assets, the assets will be included in the beneficiary's estate pursuant to Code Section 2041.

5. Generation-Skipping Transfer Tax Issues

The GST-tax area is the one area where there is a distinction in the Treasury regulations between powers of appointment and trust decanting. Specifically, the regulations address these differences by providing different safe harbors that may be used to protect the exempt status of grandfathered trusts.

a. Grandfathered Trusts

A trust that was irrevocable on September 25, 1985 is exempt from the generation-skipping transfer tax, so long as no additions to or modifications of the trust were made after that date.[10] *See* Treas. Reg. § 26.2601-1(b). Actual or constructive additions to one of these "grandfathered" trusts make a proportionate amount of distributions from and terminations of interests in property in the trust subject to the GST tax. Treas. Reg. § 26.2601-1(b)(1)(v). Examples of constructive additions are the release, exercise, or lapse of a power of appointment. *See id*. In ruling on GST matters, the IRS generally focuses on whether a trust modification results in a change in the value of beneficiaries' interests, in beneficial enjoyment, and/or timing of enjoyment (even an acceleration of the receipt of property by a skip person, which would result in exposing the trust property to transfer taxation more rapidly than if the grandfathered trust held the property for the full term). If such a change occurs, the trust will lose its grandfathered status. *See, e.g.,* PLR 8851017. On the other hand, various administrative changes appear not to jeopardize the grandfathered status. *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D); *see also, e.g.,* PLRs 8902045, 8912038, 9005019, 9849007, 200507002 and 200607015. As a result, one must be extremely careful in modifying or decanting any trust created prior to September 25, 1985, and the GST tax implications should be considered before proceeding with any modification or decanting.

Decanting has been likened to the exercise of a power of appointment and many state statutes treat decanting as the exercise of a power of appointment. However, for GST tax purposes, the Treasury regulations make a distinction between decanting (although this term is not used) and special powers of appointment in that different safe harbors are provided for each. Treas. Reg. § 26.2601-1(b)(4)(i)(A)-(D). For powers of appointment, the regulations focus on whether the exercise of a power of appointment will cause a delay in vesting of a grandfathered trust. Specifically, Treasury Regulation Section 26.2601-1(b)(1)(v)(B) provides that if the exercise of a power of appointment will delay the vesting of the trust beyond a life in being at the date of the creation of the grandfathered trust plus 21 years or 90 years from the date of creation of the trust, the exercise will be treated as an addition to the trust and the trust will lose its GST exempt status. The key is the exercise of the power of

[10] Any trust that was irrevocable on September 25, 1985, the date deemed by the IRS to be the first public notice of the effective date of the tax, is one type of effective date trust. Tax Reform Act of 1986 ("TRA '86"), P.L. No. 99-514, 100 Stat. 2085, § 1433(b)(2)(A). In addition to trusts irrevocable on September 25, 1985, wills and revocable trusts in existence on October 22, 1986, if the decedent died before January 1, 1987, and trusts created by a person under a mental disability on October 22, 1986, who does not regain competence before death also were deemed exempt. *Id*.; TRA '86 § 1433(b)(2)(C).

appointment, not the release or lapse of the power. Treas. Reg. § 26.2601-1(b)(1)(v)(B)(1); PLR 200507002 (exercise of power of appointment not treated as addition).

For decanting or modifying a grandfathered trust, the Treasury regulations have two safe harbors. These safe harbors apply to any modification as a result of a settlement or construction action that does not qualify under Treasury Regulation Section 26.2601-1(b)(4)(i)(B) or (C), discussed below. The first is found in Treasury Regulation Section 26.2601-1(b)(4)(i)(A) and provides that decanting or modification will not cause a grandfathered trust to lose its GST exempt status if (1) the terms of the trust or local law at the time the trust became irrevocable authorized the trustee to make distributions to a new trust, (2) without the consent or approval of a beneficiary or court, and (3) the terms of the new trust do not extend the vesting of any beneficial interest in a way that would suspend or delay the vesting, absolute ownership, or power of alienation beyond a specific perpetuities period. In the case of decanting, since the first state statute that authorized trust decanting was not effective until 1992, which is well after the possible effective date of a grandfathered trust, the trustee would have to look to common law for decanting authority if the trust terms did not authorize the decanting. See Private Letter Ruling 201735009 where trust committee in grandfathered GST exempt trust was given broad authority to amend trust and subsequent amendments as well as construction to clear up ambiguity caused by one amendment did not cause trust to lose exempt status. Note that beneficiary consent and court approval cannot be obtained in order to fall within this safe harbor. In *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013), prior to decanting to a new trust, the trustee obtained a declaratory judgment (from the court of highest jurisdiction in the state, no less) that the old trust gave him authority to distribute assets of the old trust to the new trust without court or beneficiary approval, thereby falling within the first safe harbor. In addition, if the requirements of this safe harbor are met, it is possible to use a modification to shift a beneficial interest down generations, as well as up or across generations. Also, it is possible to extend the vesting of the trust for a term longer than that provided in the original trust in contrast to the next safe harbor.

The second safe harbor applicable to decanting and modifications is found in Treasury Regulation Section 26.2601-1(b)(4)(i)(D)(1) and provides that a trust modification will not cause a grandfathered trust to lose GST exempt status if the modification (1) is valid under state law, (2) will not shift a beneficial interest to a beneficiary who occupies a generation lower than a beneficiary who held the beneficial interest prior to the modification, and (3) the modification does not extend the time for vesting of a beneficial interest beyond the perpetuities period provided for in the original trust. *See, e.g.*, PLRs 201634016 (fairly extensive court-approved modifications of trustee succession and distribution provisions found to meet this safe harbor), 201626016 (termination of grandfathered GST trust by court-approved non judicial settlement agreement did not trigger GST tax), *see also* PLRs 201702016-18. Unlike the first safe harbor, if the requirements of the second safe harbor are met, the modification cannot shift a beneficial interest down generations but may only shift beneficial interests up or across generations. However, it may be possible to use a statute for decanting under this safe harbor since there is no requirement that the statute existed at the time that the trust became irrevocable.

Regulations under both safe harbors seem to provide that mere administrative changes to a grandfathered trust through decanting or modification are acceptable and will not cause a loss of grandfathered status. Treas. Reg. §§ 26.2601-1(b)(4)(i)(D)(1), (D)(2); 26.2601-1(b)(4)(i)(E), Exs. 6 and 10; PLRs 200607015, 200507002. It seems to follow that if modification of a trust does not change the grandfathered or GST tax exempt status of either the old trust or the new trust, the inclusion ratio of the old trust should carry over to the new trust.

b. Non-Grandfathered Trust

As noted, the safe harbors provided in the Treasury Regulations apply to grandfathered trusts. Although no guidance has been published, the IRS appears to have taken the position that the Treasury Regulations applicable to grandfathered trusts should also apply to GST tax-exempt non-grandfathered, or "zero inclusion ratio," trusts. PLRs 200743028, 200919008, 201233008. If this is the case, a decanting or modification that follows the requirements of either of the safe harbors discussed above should preserve the GST tax exempt status and the inclusion ratio of the old trust should carry over to the new trust. In addition, a decanting or modification that is purely administrative in nature should preserve the GST exempt status. Treas. Reg. § 26-2604-1(b)(4)(i)(D)-(E).

c. Loss of GST Status

It is important to work through the GST tax issues carefully when decanting or modifying a trust in order to preserve GST exempt status. However, it is unclear what the result will be if GST tax exempt status is lost. Commentators seem to agree that loss of GST tax exempt status does not mean that all future distributions from the trust will be subject to GST tax. *See* Harrington, Plaine & Zaritsky, GENERATION-SKIPPING TRANSFER TAX: ANALYSIS WITH FORMS ¶ 7.06[3] (2d ed. 2001). At one point, the IRS took the view that the loss of GST tax exempt status through modification or reformation would cause a gift by the beneficiaries to occur. PLRs 9448024, 9421048. A year later, the IRS revised its position to conclude that when a trust loses its GST tax exempt status, the grantor will be the transferor. PLR 9522032 (IRS amending its ruling in PLR 9421048). It appears then that if the trust loses its GST tax exempt status and the grantor is treated as the transferor, one would need to consider the "normal" rules regarding non-exempt trusts, at least as to denying a GST tax benefit that would not be available but for the decanting or modification. It is unclear how GST tax exemption is applied in this circumstance, or whether the "move-down" rule of Code Section 2651(e) would apply. For example, distributions made to skip persons who otherwise would not have been entitled to distributions prior to the loss of GST tax exempt status would presumably be subject to the GST tax after the loss of exempt status.

d. Modifications and Court Proceedings

Final Treasury Regulations under Section 26.2601-1 were issued on December 20, 2000 providing a more liberal standard the IRS will apply regarding the grandfathered status for GST tax exempt trusts that are subject to court proceedings and that impact the disposition of the trust property. 65 Fed. Reg. 79735-01 (Dec. 20, 2000). The new approach which, provided certain safe harbors apply, essentially allows any bona fide, court-ordered construction or modification of a trust to remain exempt from GST tax, and is a significant departure from the prior requirement of no substantive modification of the trust whatsoever. Treas. Reg. § 26.2601-1(b)(4). These safe harbors allow a grandfathered GST trust to preserve its exempt status when the trust is subject to a settlement agreement or a judicial construction or is otherwise modified.

The Treasury regulations provide that a court-approved settlement of a bona fide controversy regarding the administration of a grandfathered GST tax exempt trust or the construction of the trust's terms will not cause the trust to forfeit its exempt status if (a) the settlement is the product of an arm's-length negotiation and (b) the settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. Treas. Reg. § 26.2601-1(b)(4)(i)(B); PLRs 201606002, 201528024, 200615006, 200507002. In addition, the regulations provide that a judicial construction of a grandfathered GST trust's governing instrument will not cause the trust to forfeit its exempt status if (a) the judicial action involves a bona fide issue and (b) the construction is consistent with applicable state law that would be applied by the highest court of the state. Treas. Reg. § 26.2601-1(b)(4)(i)(C). *See, e.g.*, PLR 201735009, 201732029.

E. Ruling Requests for GST Tax-Exempt Trusts

Since the GST tax generally applies at a straight 40% for 2013 and later, exemption from the tax is a critically important feature that could subject the trustee or executor to liability if an action taken by that person disqualifies the trust or interest in trust from grandfathered status. In other words, if a fiduciary sues to construe or reform a document and the effect of that order, if granted, is to cause a change in the document such that the trust will be subject to the GST tax, significant tax liability that was otherwise avoidable may arise and could be chargeable against the fiduciary. Even if it is not chargeable against the fiduciary, it may be a disastrous result for the beneficiaries who otherwise sought a construction or reformation of the document. A routine occurrence, such as the death of the last member of a generation of beneficiaries under the document, could suddenly cause 40% of the trust to be lost to taxes when those funds would have otherwise remained in trust.

Therefore, it is generally considered prudent, particularly with reformations or revocations, to seek a private letter ruling from the IRS that the proposed action will not change the grandfathered status. Although requesting a private letter ruling should not be necessary with a typical construction action since the action does not result in a "change" of the document, there are no cases in which the IRS has acquiesced in this position, so significant constructions also may call for a ruling request.

Ruling requests are fairly complicated undertakings, currently involving a $28,300 fee to the IRS (after February 1, 2015) unless the situation qualifies for a reduced fee. Rev. Proc. 2018-1, 2018-1 IRB 1. Obtaining the ruling may take many months, barring extraordinary and perhaps strategically ill-conceived measures with the IRS. The procedures for the application and the substantial requirements are contained in Revenue Procedure 2018-1. *Id.* Note that the IRS will not provide private letter rulings on whether a grandfathered GST tax exempt trust will retain its GST tax exempt status when there is a modification of a trust, change in the administration of a trust, or a distribution from a trust in a factual scenario that is similar to a factual scenario set forth in one or more of the examples contained in Treasury Regulation Section 26.2601-1(b)(4)(i)(E). Rev. Proc. 2018-3, § 3.01(104), 2018-1 IRB 118. Also, until the IRS resolves the issue through a Revenue Ruling, Revenue Procedure, Regulation, or otherwise, it will not provide a ruling on whether decanting from an irrevocable GST tax exempt trust to another irrevocable trust that results in a change in beneficial interests is the loss of GST tax exempt status or constitutes a taxable termination or taxable distribution under Code Section 2612. Rev. Proc. 2018-3, § 5.01(13), 2018-1 IRB 118. If practical, it may be wise to affirm the retention of grandfathered GST tax exempt status by obtaining a private letter ruling, before finalizing any modification of a grandfathered GST trust.

XI. OTHER ISSUES FOR ESTATES AND TRUSTS

A. Disclaimers

When disputes arise, they are often resolved by shifting value from one beneficiary to another. When the interests or relationships of the parties are properly aligned, one approach to shifting value is through the use of a qualified disclaimer. Suppose, for example, a will devised property to a child from a former marriage, but if the child failed to survive, the property passed to the decedent's spouse. In order to resolve a dispute between the child and the spouse, the parties may agree to transfer property from the child to the spouse. Such a transfer may not qualify for the estate marital deduction, since the property is not passing from the decedent as required by Code Section 2056. If, however, the child disclaims the property, it would be treated as having passed from the decedent to the surviving spouse, thereby resulting in a more favorable estate and gift tax result.

While many aspects of the administration of a decedent's estate or trust carry with them tax ramifications, perhaps the most significant routine aspect that impacts taxes is the disclaimer. In order to have the intended results, a disclaimer must satisfy both the rules for an effective disclaimer under state law, and the specific rules for a qualified disclaimer under Code Section 2518. If the former are not satisfied, the intended shift of property rights may not apply. If the latter are not observed, the IRS may not recognize the transfer as a gift-tax-free disclaimer, and may seek to treat the transfer as a taxable gift by the disclaimant. Therefore, special attention must be given to qualification under federal tax law and Code Section 2518 and the regulations thereunder to ensure qualified disclaimer treatment.

1. Timing Requirements

Timing is often the most significant difference between a tax-qualified disclaimer and a state-law qualified disclaimer. In general terms, Code Section 2518 requires that the disclaimer be fully executed, delivered, and effective within nine months from the effective date of the transfer in order for the disclaimer to be qualified. This date is ordinarily nine months from the date of death for interests passing pursuant to a will or revocable trust or nine months from the creation of the gift for transfers taxed under the gift tax.

Timing is most critical with partial interests in property such as interests in trust. If a remainderman does not disclaim within nine months of the creation of the preceding life interest, even if the remainderman did not know of the existence of the remainder until the termination of the life estate, the disclaimer will not be qualified. Treas. Reg. § 25.2518-2(c)(3). This is a harsh result since many remaindermen do not know of the existence of their interests (or indeed could not know since their interests are not fixed) until the termination of the intervening life estate, term of years, or other interest that postpones their receipt of any trust property.

The timing rule was intended to avoid uncertainty under prior law regarding exactly when a disclaimer was filed too late. The prior law, which relied on a knowledge requirement, resulted in several years of litigation relating to the subject. *See Keinath v. Comm'r,* 480 F.2d 57 (8th Cir. 1973), *rev'g* 58 TC 352 (1972); *Jewett v. Comm'r,* 70 TC 430 (1978), *aff'd,* 638 F.2d 93 (9th Cir. 1980), *aff'd,* 102 S.Ct. 1082 (1982); *Poinier v. Comm'r,* 86 TC 478 (1986), *aff'd in part, rev'd in part,* 858 F.2d 917 (3d Cir. 1988); *Ordway v. U.S.,* 908 F.2d 890 (11th Cir. 1990);

Irvine v. U.S., 936 F.2d 343 (8th Cir. 1991), *vacated, reh'g granted*, 981 F.2d 991 (8th Cir. 1992), *rev'd*, 114 S.Ct. 1473 (1994). For disclaimers of interests created by transfers made before 1977, there can be a postponement of the running of the nine months until the interest holder becomes aware of the existence of the interest in the trust or other property. *See* Treas. Reg. § 25.2511-1(c)(2) (providing that disclaimer must be made within reasonable time after knowledge of existence of transfer).

The timing requirements of Code Section 2518, which are detailed in the related Treasury Regulations, constitute the most significant difference between state law qualification and tax qualification of disclaimers. IRC § 2518(b)(2). Particularly complex are those provisions regarding "partial" interests in property. With a few exceptions spelled out in the Treasury Regulations, a disclaimer of a partial interest must disclaim all benefits in the property so that the property does not continue to inure to the disclaimant's benefit after the disclaimer by virtue of other interests in the trust property. Treas. Reg. § 25.2518-1, -3.

2. Generation-Skipping Transfer Tax Treatment

It is important to note that disclaimers do not generally change the generational identity of the takers of property for GST tax purposes. In general, for purposes of the GST tax, if a person who is a descendant of the transferor's parent predeceases the transferor, the descendants of that deceased individual are each assigned to a generation one higher than the generation to which they would otherwise assigned, commonly known as the "move-up" rule. IRC § 2651(e). This rule allows property to pass free from GST tax to the grandchildren when a child who is the parent of those grandchildren has predeceased his or her parent. Despite the fact that state disclaimer laws often treat the disclaimant as though he or she predeceased the transferor, Code Section 2651(e) applies only in the event of the actual death of the child, not with a disclaimer that treats the child as having predeceased the parent. IRC §§ 2651(e)(1), 2651(e)(2); PLR 199907015. If property passes to a skip person by virtue of a disclaimer, the GST tax will operate as though the property had been bequeathed to that grandchild or a more remote descendant.

B. Personal Injury and Wrongful Death

Absent an express statutory exemption or exclusion, gross income for federal income tax purposes includes all income from whatever source derived. IRC § 61. Code Section 104(a) provides for the exclusion from gross income of several categories of "compensation for personal injuries or sickness," including amounts for damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. IRC § 104(a)(2). The Supreme Court in *Commissioner v. Schleier*, 515 US 323 (1994), and the amendments to Code Section 104(a)(2) enacted as part of the Small Business Job Protection Act of 1996, P.L. No. 104-188, 110 Stat. 1838, narrowed the scope of the income tax exclusion for personal injury and wrongful death settlements and awards. Prior to *Schleier* and the revisions to Code Section 104, damages for personal injuries or sickness were not limited to physical injuries or injuries arising from a physical harm. In addition, prior to the revisions to Code Section 104, it was not clear whether punitive damage awards were excludible from taxation.

1. Wrongful Death Actions

Code Section 2031(a) provides that the value of a decedent's gross estate for federal estate tax purposes includes the value, at the date of death, of all property, real or personal, tangible or intangible, in which the decedent had an interest. IRC § 2031(a). Code Section 2033 provides that the gross estate includes the value of all property to the extent of any interest of the decedent at the time of death. IRC § 2033. Treasury Regulation Section 20.2033-1 provides that any interest of the decedent in property includes the value of property beneficially owned by the decedent at the time of death. Thus, the determination of whether proceeds from a wrongful death claim are taxable for federal estate tax purposes involves a chronological determination of whether the damages received by the estate or the beneficiaries of the decedent were recoverable by the decedent before death so that the decedent possessed an interest in the proceeds during his or her lifetime.

For income tax purposes, damages received in a wrongful death action by the beneficiaries of a decedent are excludible from the gross income of the recipients because such damages are received "on account of personal physical injuries or physical sickness." IRC § 104. The legislative history of Code Section 104 provides that if an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) flowing from the action shall be treated as payments received on account of physical injury or sickness, regardless of whether the recipient of the damages is the injured party. H.R. REP. NO. 586, pp. 142-43, 104th Cong., 2d Sess. (1996). For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or sickness of the individual's spouse are excludible from gross income. *See, e.g.,* PRL 200942011. Therefore, wrongful death proceeds received by the beneficiaries of the estate of a decedent on account of the personal injuries and death of the decedent are excluded from the gross income of the recipients under Code Section 104(a)(2). H.R. CONF. REP. NO. 104-737 at 301 (1996); PLRs 201022009-11.

For estate tax purposes, wrongful death proceeds recoverable by the beneficiaries of the decedent under a "survival type" wrongful death statute, such as the Illinois Wrongful Death Act, 740 ILCS 180/0.01, *et seq.*, are not includible in the gross estate of a decedent as long as the proceeds represent damages for premature death and loss of companionship and do not represent damages to which the decedent had become entitled during his or her lifetime, such as damages for pain and suffering and medical expenses. Rev. Rul. 69-8, 1969-1 CB 219; Rev. Rul. 75-127, 1975-1 CB 297; Rev. Rul. 83-44, 1983-1 CB 228. Wrongful death proceeds are also excluded from the gross estate of a decedent when the applicable state wrongful death statute provides that a new cause of action accrues after the death of the injured party for the benefit of certain beneficiaries. Rev. Rul. 69-8, 1969-1 CB 219. Under Code Section 2033, as stated above, if the decedent possessed any interests in the proceeds prior to death, then the value of those proceeds is includible in the decedent's gross estate. IRC § 2033.

2. Survival Actions

Survival actions relate to damages incurred by the decedent during the time he or she survived the event ultimately causing his or her death. For income tax purposes, damages received in a survival action brought by the estate of the decedent, such as an action under the Illinois survival statute, 755 ILCS 5/27-6, are excludible from the gross income of the recipient because under *Commissioner v. Schleier*, 515 US 323 (1994), such damages are received on account of personal physical injury or sickness under Code Section 104(a)(2). The exclusion includes any pain and suffering of the decedent prior to death. More specifically, the damages represent compensation for the pain and suffering of the decedent prior to death so that as long as these damages do not compensate for emotional suffering or distress, the amounts received by the estate are treated as being received "on account of" the personal injuries of the decedent and are excluded from gross income. IRC § 104(a).

For estate tax purposes, such damages are includible in the gross estate of the decedent because the proceeds represent damages awarded to the estate to which the decedent became entitled during his or her lifetime. *Bryant v. Kroger Co.,* 570 N.E.2d 1209 (3d Dist. 1991); *Wyness v. Armstrong World Industries, Inc.*, 546 N.E.2d 568 (1989); *Howe v. Clark Equipment Co.,* 432 N.E.2d 621 (4th Dist. 1982). The decedent thus possessed a beneficial interest in the proceeds awarded to the decedent through his or her estate for compensation for any pain and suffering occurring prior to death.

3. Tax Aspects of Personal Injury and Wrongful Death Settlements

It is essential for trial counsel to consider the tax aspects of any settlement before entering into negotiations regarding personal injuries or wrongful death. In *Rickel v. Commissioner,* 92 TC 510 (1989), *aff'd in part, rev'd in part on other grounds,* 900 F.2d 655 (3d Cir. 1990), *overruled on other grounds, Downey v. Comm'r,* 97 TC 150 (1991), the court outlined the procedure for determining whether damages awarded in a settlement agreement between the parties are received on account of personal injury or sickness and therefore excludible under Code Section 104(a)(2). The court held that the focus will be first on intent. *Id.* at 516. Therefore, if the payor's intent cannot be clearly discerned from the settlement agreement, the details surrounding the litigation, the allegations contained in the pleadings, the arguments made by the parties, and any prior allocations made by a jury award must all be considered in determining taxability. *Robinson v. Comm'r,* 70 F.3d 34 (5th Cir. 1995); *Paton v. Comm'r,* TC Memo 1992-627 (1992) (holding that proceeds from settlement agreement were not excludible from gross income when settlement payment was essentially severance pay and no claim for personal injury was ever made).

Payments may be re-characterized as income if the facts warrant. In *Britell v. Commissioner,* TC Memo 1995-264 (1995), the court held that a payment made by an employer to a former employee pursuant to a settlement agreement was not excludible from the gross income of the employee because the amounts paid were not in settlement of a viable claim for sex discrimination but were severance payments to reward the employee for past services. In *Robinson,* the court held that when a settlement agreement was unilaterally prepared by the plaintiff employee and indicated that the entire amount was uncontested, non-adversarial, and entirely tax motivated, the proceeds could be reallocated for federal income tax purposes. 70 F.3d at 34.

In light of the requirements of Code Section 104(a)(2) and relevant case law, any settlement agreement should specifically refer to actions sounding in tort and should allocate proceeds to pain and suffering, medical care expenses, and lost wages due to physical injury or sickness. Therefore, a settlement agreement is more likely to be respected by the IRS if the plaintiff (a) allocates the settlement proceeds in a manner consistent with the relative strengths of the claims pleaded and the jury award, if any; (b) documents the adversarial nature of the negotiations, emphasizing the goals both parties have in the allocation; (c) specifies in the settlement agreement the agreed allocations; and (d) identifies in the agreement any claims for which no compensation was provided. In addition, the parties should agree to consistently report the matter for tax purposes.

A further issue arises in the area of the taxation of personal injury and wrongful death claims with respect to the availability and use of structured settlements. Under Code Section 130(a), any amounts received under a qualified assignment are not included in gross income for income tax purposes to the extent that such amounts do not exceed the aggregate cost of the "qualified funding assets." A "qualified assignment" is any assignment of a liability to make periodic payments to satisfy an award of damages whether by lawsuit or by settlement agreement on account of personal injury or sickness. IRC § 130(c). "Qualified funding assets" means an annuity contract that satisfies the requirements under Code Section 130(d). For example, if a plaintiff wins a judgment against a defendant for $100,000 for personal injuries that are properly excluded from taxation and the defendant then purchases an annuity that pays the $100,000 award to the plaintiff over the plaintiff's lifetime, the series of payments to the plaintiff will be excluded from taxation regardless of whether the total amount of the series of payments exceeds $100,000. Under a properly structured settlement to compensate for personal injuries or sickness, a plaintiff who receives periodic payments will receive favorable tax treatment. Because of Code Section 130, no tax will be incurred on the inside buildup of the annuity or investment that is to be paid to the plaintiff over a period of years, so a structured settlement may provide similar protections to a trust. Code Section 130 can further impact the tax treatment and structure of certain settlement agreements regarding personal injury and wrongful death causes of action, but any greater detail on this topic is beyond the scope of these materials.

4. Punitive Damages

As a general rule, any punitive damage recovery will constitute taxable income to the claimant. The legislative history evidences Congress's belief that punitive damages are intended to punish and do not compensate a claimant and are, thus, a windfall to the claimant. Punitive damages are income taxable, whether or not they arise from a claim involving physical injury or sickness. IRC § 104(a). An exception is provided for punitive damages recovered in states in which the applicable law provides that *only* punitive damages may be awarded in wrongful death actions. *See* IRC § 104(c).

5. Segregation of Settlement Amounts

When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under Code Section 104(a)(2). *U.S. v. Burke,* 504 US 229, 237 (1992); *Amos v. Comm'r,* TC Memo 2003-329 (2003). A determination of the nature of the claims is factual. *Robinson v. Comm'r,* 102 TC 116, 126 (1994); *Seay v. Comm'r,* 58 TC 32, 37 (1972).

When claims are settled via an agreement, the nature of the claim is usually made by reference to the settlement agreement. *Seay v. Comm'r,* 58 TC 32, 37 (1972); *Knuckles v. Comm'r,* 349 F.2d 610, 613 (10th Cir. 1965); *Robinson v. Comm'r,* 102 TC 116, 126 (1994). When the settlement agreement lacks express language stating what the settlement amount was intended to settle, the "intent of the payor" is critical to that determination. *U.S. v. Burke,* 504 US 229, 237 (1992); *Robinson v. Comm'r,* 102 TC 116, 126 (1994); *Seay v. Comm'r,* 58 TC 32, 37 (1972); *Knuckles v. Comm'r,* 349 F.2d 610, 613 (10th Cir. 1965). And, while the payee's belief may be relevant, the character of the settlement amount ultimately depends on the primary reason of the settling party for making the payment. *Id.* (*citing Agar v. Comm'r, supra; Fono v. Comm'r,* 79 TC 680, 696 (1982). A determination whether a settlement amount is properly excludable from gross income under Code Section 104(a)(2) depends on the nature and character of the claim asserted, and not upon the validity of that claim. *Id.; Bent v. Comm'r,* 87 TC 236, 244, (1986).

For example, in *Amos v. Commissioner*, TC Memo 2003-329 (2003), the IRS disallowed an income tax exclusion arising from a settlement reached after Dennis Rodman kicked a photographer. The photographer pursued a claim against Rodman for his injuries. Rodman ultimately settled with the photographer and the parties entered into a settlement agreement that included a confidentiality clause and a liquidated damages provision that was equal to the settlement amount. As part of the settlement, the taxpayer agreed that he would not "(1) defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident (collectively, the nonphysical injury provisions)." *Id.* The IRS asserted that all but $1 was includible in the photographer's income. While the Tax Court did not find that liquidated damages provision to be determinative of the nature of the claims, it did consider all of the claims released and determined that $120,000 was excludable and $80,000 was includable in the photographer's gross income.

XII. CONCLUSION

Disputes involving trusts and estates can be impacted by every aspect of income and transfer taxation. Clients involved in these disputes are well served by involving their tax advisors at an early stage in the proceedings. Taking into consideration tax principles applicable to settlements, judgments, and other dispute-resolution measures can have a dramatic impact upon the value of a settlement, and can avoid an unintended shift in tax benefits and burdens among the parties. It is hoped that the foregoing material will be useful in understanding and applying general tax principles involved in resolving disputes and in understanding the estate, income, gift, and GST tax principles that may arise when will contests, trust disputes, and disputes involving a breach of fiduciary duties are resolved by settlement, judgment, or other means.

EXHIIBIT A
Historical Estate, Gift and GST Tax Exemption Amounts and Top Tax Rates (1916-2018)

Year	Estate Tax Exemption	Gift Tax Exemption	Gift Tax Annual Exclusion	GST Tax Exemption	Top Estate (and GST) Tax Rate	Top Gift Tax Rate
1916	$50,000	No Gift Tax	None	No GST Tax	10%	0%
1917-23	$50,000	No Gift Tax	None	No GST Tax	25%	0%
1924-25	$50,000	$50,000	$500	No GST Tax	40%	25%
1926-31	$100,000	No Gift Tax	None	No GST Tax	20%	0%
1932-33	$50,000	$50,000	$5,000	No GST Tax	45%	34%
1934	$50,000	$50,000	$5,000	No GST Tax	60%	45%
1935-37	$40,000	$40,000	$5,000	No GST Tax	70%	53%
1938-40[1]	$40,000	$40,000	$4,000	No GST Tax	70%	53%
1941	$40,000	$40,000	$4,000	No GST Tax	77%	58%
1942-76	$60,000	$30,000	$3,000	No GST Tax	77%	58%
1977[2]	$120,000	$120,000	$3,000	1st GST Tax[3]	70%	70%
1978	$134,000	$134,000	$3,000	1st GST Tax	70%	70%
1979	$147,000	$147,000	$3,000	1st GST Tax	70%	70%
1980	$161,000	$161,000	$3,000	1st GST Tax	70%	70%
1981	$175,000	$175,000	$3,000	1st GST Tax	70%	70%
1982	$225,000	$225,000	$10,000	1st GST Tax	65%	65%
1983	$275,000	$275,000	$10,000	1st GST Tax	60%	60%
1984	$325,000	$325,000	$10,000	1st GST Tax	55%	55%
1985	$400,000	$400,000	$10,000	1st GST Tax	55%	55%
1986	$500,000	$500,000	$10,000	1st GST Tax	55%	55%
1987-97[4]	$600,000	$600,000	$10,000	$1,000,000	55%	55%
1998	$625,000	$625,000	$10,000	$1,000,000	55%	55%
1999	$650,000	$650,000	$10,000	$1,000,000	55%	55%
2000	$675,000	$675,000	$10,000	$1,000,000	55%	55%
2001	$675,000	$675,000	$10,000	$1,000,000	55%	55%
2002	$1,000,000	$1,000,000	$11,000	$1,000,000	50%	50%
2003	$1,000,000	$1,000,000	$11,000	$1,000,000	49%	49%
2004	$1,500,000	$1,000,000	$11,000	$1,500,000	48%	48%
2005	$1,500,000	$1,000,000	$11,000	$1,500,000	47%	47%
2006	$2,000,000	$1,000,000	$12,000	$2,000,000	46%	46%
2007	$2,000,000	$1,000,000	$12,000	$2,000,000	45%	45%
2008	$2,000,000	$1,000,000	$12,000	$2,000,000	45%	45%
2009	$3,500,000	$1,000,000	$13,000	$3,500,000	45%	45%
2010	$5,000,000[5]	$1,000,000	$13,000	GST Tax rate=0%	35% or 0%	35%
2011	$5,000,000	$5,000,000	$13,000	$5,000,000	35%	35%
2012	$5,120,000	$5,120,000	$13,000	$5,120,000	35%	35%
2013	$5,250,000	$5,250,000	$14,000	$5,250,000	40%	40%
2014	$5,340,000	$5,340,000	$14,000	$5,340,000	40%	40%
2015	$5,430,000	$5,430,000	$14,000	$5,430,000	40%	40%
2016	$5,450,000	$5,450,000	$14,000	$5,450,000	40%	40%
2017	$5,490,000	$5,490,000	$14,000	$5,490,000	40%	40%
2018 (est.)	$11,180,000	$11,180,000	$15,000	$11,180,000	40%	40%

[1] 10% surtax added
[2] Unified credit replaces exemption
[3] The 1st GST Tax was retroactively repealed
[4] Graduated rates and unified credit phased out for estates greater than $10,000,000
[5] TRA 2010 permitted the executor of the estate of a decedent dying in 2010 to opt out of the estate tax, at the cost of forgoing in large part an adjustment to the cost basis of the decedent's assets at death.