THE MORNING AFTER: AVOIDING TAX SURPRISES IN TRUST & ESTATE LITIGATION

Income Tax Considerations in Settlements and Judgments

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Joint Fall CLE Meeting
of the
Section of Taxation &
Section of Real Property, Trust & Estate Law
Saturday, September 29, 2007
Vancouver, British Columbia

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ABA JOINT FALL MEETING
SEPTEMBER 28-30, 2007
VANCOUVER, BRITISH COLUMBIA

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I. SCOPE OF ARTICLE[1]

Contested probate and trust matters are often resolved prior to trial. A few are resolved by summary judgment, however, the majority settle by agreement. In settlements involving estate and trust litigation, the impact of estate, income and gift taxes should be considered at the initial states of negotiation, if possible, and prior to finalizing a settlement, at a minimum. Professionals involved in these settlements must recognize and address basic income tax concepts such as distributable net income, income in respect of a decedent, recognition of gain on funding separate shares, etc. For example, the structure of the payout to a party may be deemed income and, thus, subject to income tax by the recipient unless properly structured.

This outline is intended to provide an overview of these various income tax issues relating to settlement agreements reached in (i) will contests, (ii) trust disputes, and (iii) breach of fiduciary duty lawsuits.

II. STATE LAW CONSIDERATIONS

A. Why State Law Matters

In 1967, the United States Supreme Court considered the issue of whether the Internal Revenue Service in an estate tax controversy is conclusively bound by a state court adjudication of property rights when the United States was not a party. *See* Comm'r v. Estate of Bosch, 387 U.S. 456 (1967).

In reaching its decision, the Court reiterated its longstanding holding that property rights are determined by state law. *See 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, however, 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 Internal Revenue Service is not "conclusively bound" by a state court ruling as to a property interest. Rather, the Court formulated a new test which essential 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;

(ii) When a state law property right has not been decided by the highest court of the state, federal authorities (be it the Internal Revenue Service 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 recognized that it's ruling will require the deciding authority to sit "as a state court." *Id.* (citing Bernhardt v. Polygraphic Co., 350 U.S. 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.

B. State Law Favors Timely Settlement Agreements

It is the public policy of state courts to encourage resolution of disputes and the early settlement of pending litigation through voluntary settlement procedures. A number of appellate courts have expressly stated that they favor and support family settlement agreements. *See, e.g.,* Shepherd v. Ledford, 962 S.W.2d 28 (Tex. 1998*);* In Re Estate of Hodges, 725 S.W.2d 265, 267 (Tex. App. – Amarillo 1986, writ ref'd n.r.e.); Estate 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* 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).

The rationale underlying the validity of family settlement agreements is explained by the Court in Pitner v. United States, 388 F.2d 651, 656 (5th Cir. 1967), which states that:

> This approach is made possible by section 37 of the [Texas] Probate Code which provides that when a person dies leaving a will, . . . all of his estate devised or bequested by such will shall vest immediately in the devisees or legatees; . . . subject to the payment of the decedent's debts. This provision leaves the beneficiaries of an estate free to arrange among themselves for the distribution of the estate and for the payment of expenses from that estate.

Thus, upon an individual's death, his or her property immediately vests in the beneficiaries named in their will, if any. This principal of immediate vesting allows the beneficiaries to divide the estate, subject to any creditor claims, as they may agree and

[1] This article is derived from an article authored by Sarah Patel Pacheco and Mickey R. Davis entitled "Tax Considerations in Settlements and Judgments" presented to the 2005 State Bar of Texas Advanced Estate Planning and Probate Course. The material from that article is used here with permission of the authors.

enter into a family settlement agreement to that effect. The family settlement agreement may result in a formal administration or provide a means to avoid it altogether. *See, e.g.*, Estate of Hodges, 725 S.W.2d at 267.

III. OVERVIEW OF FUNDAMENTAL TAX CONSIDERATIONS

A. General Overview of Amounts Received in Settlement of Will Contest

Amounts received in settlement of a will contest are generally not subject to income taxes. *See* Lyeth v. Hoey, 305 U.S. 188 (1938) (settlement amount not subject to income tax under I.R.C. Section 102). The tax effect of the settlement depends, however, on the existence of a bona fide dispute, the nature of the transfers involved, and the existence of an enforceable right as between the settling parties.

B. Enforceable Right Under State Law

A party to a settlement should not automatically assume that the property and proceeds received or paid in settlement will automatically be deemed to have "passed" from the Decedent to a person pursuant to a settlement agreement. It is particularly important with regard to property to be received by a spouse or charity under a settlement agreement. The failure to meet the passing requirement can result in the property being subject to estate tax notwithstanding the identity of the recipient.

The Supreme Court held in *Bosch* that 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." Estate of Brandon v. C.I.R, 828 F.2d 493, 497 (8th Cir. 1987) (citing Bosch at 774). Thus, the availability of deductibility depends on whether the settlement payment is made pursuant to an enforceable right, i.e. in *Brandon* whether the spouse's claims were based on an enforceable state law.

C. Bona Fide Dispute Requirement

Likewise, a party to a settlement should not automatically assume that the property and proceeds received or paid in settlement will not be subject to income or gift tax. The Internal Revenue Service 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* Priv. Ltr. Rul. 8902045 (Oct. 21, 1988).

To avoid future issue, the settlement agreement should reflect that an actual bona fide dispute exists between the parties. It is advisable to expressly set out the basis for each person's claim in the settlement agreement. In a will contest scenario, the agreement should identify the name of each party, and their interest or standing in the proceeding, i.e., spouse, common law spouse, heir, beneficiary under prior will, etc. This allows the IRS to determine from the settlement agreement the validity of each person's potential claim and possibly avoid a full tax audit.

1. Bona Fide Dispute Does Not Require Full Scale War

Truly adverse positions must be settled, but the courts have held that a settlement in favor of the surviving spouse will qualify for the marital deduction where the disagreement is short of a full scale war. *See* Citizens and Southern Nat'l Bank v. United States, 451 F.2d 221 (5th Cir. 1971); *see also* Estate of Hubert v. Comm'r, 101 T.C. 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); Estate of Dutcher v. Comm'r, 34 T.C. 918 (1960), acq., 1961-1 C.B. 4; Ducan v. United States, 236 F. Supp. 747 (D. Md. 1965); First Nat'l Bank v. United States, 328 F. Supp. 1339 (N.D. Ala. 1971); Estate of Barrett v. Comm'r, 22 T.C. 606 (1954).

2. Lack of Bona Fide Dispute May Result in Transfer Being Subject to Taxes

Settlements derived from collusive or spurious suits may not qualify as a bona fide disputes. For example, property passing to a spouse under an agreement where there was not a bona fide dispute will not qualify for the marital deduction because property passing under these agreements is not deemed to have passed from the decedent, but merely by agreement of the parties. Obviously, any amounts that the surviving spouse gives up in the settlement will not qualify for the marital deduction. Treas. Reg. § 20.2056(c)-2(d)(2).

IV. INCOME TAX CONSIDERATIONS

A. Taxation of Will Contest Settlement

1. General Rule

Under the general rule of Section 102 of the Internal Revenue Code, "gross income does not include the value of property acquired by gift, devise, or inheritance." I.R.C. § 102(a). Similarly, the portion of an estate received by an heir in compromise of his will contest against the decedent's will is generally exempt from federal income tax. *See* Lyeth v. Hoey, 305 U.S. 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 I.R.C. Section 102. Because the property was received via a settlement instead of pursuant to a will or heirship statute, the Internal Revenue Service 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 and regardless of any subsequent settlement agreement. *Id.* at 190. The Supreme Court held that property was properly excluded from income because:

> 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).

Furthermore, Section 663(a)(1) provides that a gift or bequest of a specific sum or property will not be taxable as follows:

> There shall not be included as amounts falling within I.R.C. Sections 661(a) or 662(a) if the amount paid, 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*.

I.R.C. § 663(a)(1)(emphasis added); *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").

2. <u>Exception: Distributable Net Income</u>

The structure of the payments or distribution may subject the beneficiary to income tax. For example, the payment of an amount from the residuary of an estate could carry out distributable net income (i.e. income) while the payment of a specific sum will not. *See* I.R.C. § 663(a)(1)(DNI does not include "[a]ny 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"). Distributable net income, commonly referred to as DNI, is a fundamental concept of income taxation of trusts, estates and their beneficiaries. It is a concept uniquely applicable to the taxation of trusts and estates and is necessary 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. Taxable income must be modified in several respects in order to serve as an effective measure of the maximum allowable deduction to estates or trusts for distributions to beneficiaries and amounts which beneficiaries must include in their gross income. As modified, the taxable income of an estate or trust is labeled DNI.

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 gross income, excluding net capital gains allocated to principal, but including net tax exempt income, minus allowable deductions and losses. I.R.C. § 643(a). Distributable net income serves three functions. First, trust or estate DNI establishes the maximum amount that a trust or estate can deduct under I.R.C. Sections 651 and 661. Likewise, DNI determines the maximum amount that the trust or estate beneficiaries can be taxed under I.R.C. Sections 652 and 662. Finally, 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. The character of a distribution may also affect the maximum deduction allowed to the fiduciary and the maximum portion of the distribution included in gross income by the beneficiary.

Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's DNI. 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. I.R.C. § 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 subject to some important exceptions.

a. Distributions of Assets to Fund Pecuniary Gifts

A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount," including a pecuniary bequest or a formula bequest. 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 gifts 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 C.B. 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 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. I.R.C. § 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 Section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under Section 646 of the Code.

b. Distributions To Satisfying the Estate's Obligations

Distributions that satisfy an 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, and 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 C.B. 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.

c. Separate Share Rule

Section 663 of the Internal Revenue Code provides that when multiple beneficiaries have substantially separate and independent shares of a trust or estate, each beneficiary's "separate share" may be treated as separate trust or unit for the limited purpose of determining the amount of net income distributed to each beneficiary during the tax reporting period. The question of what constitutes "substantially separate and independent shares" is not resolved by the I.R.C. but is instead expressly left to be determined by the Treasury Regulations. I.R.C. § 663(c).

The separate share rule provides a certain measure of relief from the automatic application of the tier system and from the restricted nature of the gift and bequest exclusion. It can prevent one beneficiary being taxed on a corpus distribution as though that beneficiary had received income when the income, in reality, is accumulated for the benefit of another.

Prior to the passage of the Taxpayer Relief Act of 1997, the separate share rule only applied to trusts. The adoption of the separate share rule for estates results in more equitable shifting of estate income as between and among its beneficiaries. The disadvantage is that it will also lead to increased complexity when determining each beneficiary's share of estate income.

3. Exception: Bequest of Income

Section 102 also does not apply to amounts required to be paid pursuant to a settlement agreement from income. If the bequest or inheritance is the right to receive income, the amounts are taxable to the beneficiary. *See* I.R.C. § 102(b). Specifically, Section 102(b) provides that:

> (b) Income.--Subsection (a) *shall not exclude* from gross income—
>
> (1) the income from any property referred to in subsection (a); or

> (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

I.R.C. § 102(b) (emphasis added); *see also* Harte v. United States, 252 F.2d 259 (2d Cir. 1958); Tree v. United States, 55 F. Supp. 438 (Ct. Cl. 1944), *cert. denied*, 324 U.S. 852 (1945).

In settlements, an issue whether the settlement will be characterized as a bequest of income when the original bequest was of income. When the settlement is in lieu of an income interest, the courts have generally held the settlement amount is includable in gross income under I.R.C. Section 102(b). *See* Getty v. Commissioner, 91 T.C. 160, 176 (1988), rev'd. 913 F.2d 1486, 1492 n. 7 (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. United States, 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. Commissioner, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779, 65 S.Ct. 192, 89 L.Ed. 622 (1944)); *see also* Spangler v. Commissioner, 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. Commissioner, 61 T.C. 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 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. Comm'r, 913 F2d 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 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 I.R.S argued that the son's claim was for income from property because in his complaint the son characterized the benefit he sought in 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 I.R.S. 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. 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.

4. Exception: Bequest for Services Rendered

Bequests made to compensate for services rendered to the decedent are not excluded from income. *See* Cotnam v. C.I.R., 263 F.2d 119 (5th Cir.1959); *see also* Wolder v. Comm'r, 493 F.2d 608 (2nd Cir., 1974), *cert. den*. 419 U.S. 828 (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. C.I.R., 23 TC 524 (1954); Estate of Braddock v. U.S., 434 F2d 631 (9th Cir. 1970); Jones v. C.I.R., T.C.M. 1958- 191 (CCH) (1958); Priv. Ltr. Rul. 67-375 (1967)(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 their gross income in the taxable 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 a heir or beneficiary under a prior will. When Cotnam failed to include the judgment in her gross income, the Internal Revenue Service assessed a deficiently for the amount of the judgment. Cotnam claimed the amount of the judgment was exempt as a bequest under Section 102. The Fifth Circuit Court of Appeals 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 U.S. 88, 56 S.Ct. 353, 80 L.Ed. 500; Arcadia Refining Co. v. Comm'r, 5 Cir., 1941, 118 F.2d 1010. 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, 1918, 247 U.S. 231, 38 S.Ct. 497, 62 L.Ed. 1094). Only when services are not required as a condition of payment of the legacy is the property is acquired by bequest and, therefore, excluded from income. *Id.* at 123 (citing United States v. Merriam, 263 U.S. 179, 44 S.Ct. 69, 70, 68 L.Ed. 240 (1923)). As Cotnam had not standing as an heir or beneficiary, the judgment represented payment for services rendered. *See Id.*

In fact, Internal Revenue Publication 525 now 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."

B. Taxation 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 Section 102 of the Internal Revenue Code, will yield no tax benefit to the estate.

2. Debts

If the payment takes the form of the payment of a debt owed by the decedent to the claimant/beneficiary, the payment of the claim may be deductible as a debt of the decedent, deductible for federal estate tax purposes. *See* I.R.C. § 2053. For example, in Bailey v. Commissioner, 741 F.2d 801 (5th Cir. 1984), when a father died, the son inherited property, but the mother never set up a separate account for the son's benefit and did not acknowledge his inheritance rights. In administering the mother's estate, the son first became aware of his inheritance rights in his father's estate, and the son took a section 2053 deduction as a claim against the mother's estate. The son contended that the amount of this claim was the current value of the property he should have inherited from his father's estate, and that on these facts the Texas courts would impress a constructive trust in his favor. Although the Tax Court found for the government, the Fifth Circuit Court of Appeals reversed, allowing the Section 2053 deduction but remanding for a determination of the current value of the son's inheritance from his father. Such a debt is not generally deductible for federal income tax purposes.

3. Exception: Payments to Employees

Section 102(c) of the Code 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 Sections 162 or 212 of the Internal Revenue Code, or for estate tax purposes as a debt of the estate under 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. I.R. C. § 691(b).

4. Exception: Administration Expenses

Litigation expenses are commonly deducted as expenses of administration under Internal Revenue Code § 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* Estate of Dutcher v. Comm'r, 34 T.C. 918 (1960); Estate of Landers v. Comm'r, 38 T.C. 828 (1962); Estate of Baldwin v. Comm'r, 59 T.C. 654 (1973). Deduction not taken on the death tax returns is generally available as an income tax deduction. I.R.C. § 642(g).

a. Estate Settlements

The Internal Revenue Code allows a will contestant's fees and expenses to be deducted, *see* Sussman v. United States, 236 F. Supp. 507 (E.D.N.Y. 1962). State law often allows the attorneys fees of will contestants to 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. PROB. CODE ANN. § 243 (Vernon 2003). Such allowance is limited to good faith actions based on 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); Alldrige 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.).

A deduction is not allowed, however, for fees incurred by a beneficiary or heir to establish his or her share of the decedent's estate. *See* I.R.C. § 212. Treasury Regulation 1.212-1(k) provides that:

> (k) 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).

b. Trust Settlements

Depending on the facts and circumstances, a portion of the attorney fees and expenses paid by the trust may be deductible. Treasury Regulation § 1.212 provides as follows:

> (i) 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 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 section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

Treas. Reg. § 1.212-1(i).

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 not deductible. *See* Treas. Reg. § 1.212-1(k)

C. Non-Pro Rata Distributions

If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries, the Internal Revenue Service 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. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 C.B. 159. For example, suppose an 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 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 fails to authorize non-pro rata distributions,* the Internal Revenue Service takes the view that A and B each received one-half of each asset from the estate. A then "sold" his 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. To avoid this result, the settlement agreement or other governing instrument should expressly authorize non-pro rata distributions.

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 step up or down. For most assets, 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, the estate of a decedent receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. I.R.C. § 1014. In most cases, the basis is the date-of-death value of the property. However, if the alternate valuation date for estate property has been validly elected, that value fixes the cost basis of the estate's assets. I.R.C. § 1014(a)(3). The basis adjustment rule also applies to a decedent's assets held by a revocable trust used as an estate surrogate, since they are deemed to pass from the decedent pursuant to Sections 2036 and 2038 of the Code. 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. Note that 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. I.R.C. § 1014(b)(6).

2. Exception: Income in Respect of A Decedent

There is no specific definition of "income in respect of a decedent," commonly referred to as IRD, in the Internal Revenue Code. Essentially, it 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. 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. 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. Estate of Putnam v. Comm'r, 324 U.S. 393 (1945);
- Death payments made to beneficiaries under an Individual Retirement Account or an exempt deferred compensation plan. Hess v. Comm'r, 271 F.2d 104 (3d Cir. 1959), rev'g 31 T.C. 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 T.C. 619; Bausch's Estate v. Comm'r, 186 F.2d 313 (2nd Cir. 1951); Rev. Rul. 68-124, 1968-1 C.B. 124.
- Renewal commissions owed a deceased life insurance agent. Findlay v. Comm'r, 332 F.2d 620 (2nd Cir. 1964); Rev. Rul. 59-162, 1959-1 C.B. 224;
- Amounts recovered by a decedent's estate as damages for the decedent's lost profits. Estate of Carter v. Comm'r, 35 T.C. 326 (1960), aff'd, 298 F.2d 192 (8th Cir.) cert. denied 370 U.S. 910 (1962);
- Alimony arrearages owing to a decedent at the time of his or her death and paid after death. Estate of Narischkine v. Comm'r, 14 T.C. 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 T.C. 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. Estate of Bickmeyer v. Comm'r, 84 T.C. 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; (iv) the decedent, had he or she lived, received the proceeds of the sale. Estate of Peterson v. Comm'r, 74 T.C. 630 (1980) aff'd, 667 F.2d 675 (8th Cir. 1981).

3. Exception: No New Basis for Deathbed Transfers to Decedent

Section 1014(e) of the Code provides a special exception for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor 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.

4. Considerations In Settlement of Trust Funding Claims

In certain circumstances, a claim against a decedent's estate may relate to assets held by the decedent that rightfully belong to others. A common source of this claim is the failure of the surviving spouse to fully fund the trusts established under the Will of the deceased spouse. When the second spouse dies, some of the assets held in the name of that spouse may actually belong to the trust(s) established under the Will of the predeceased spouse. In those circumstances, the beneficiaries of those trusts may assert that the decedent owed them a debt at the time of death by virtue of the failure to fund the trusts. *See* Bailey v. Commissioner, 741 F.2d 801 (5th Cir. 1984). Alternatively, the trust beneficiaries may seek to exclude assets properly traceable to the predeceased spouse from the decedent's estate, asserting that the assets are the subject of a constructive trust. *See* Stansbury v. United States, 543 F. Supp 154 (N.A. Iff. 1982), aff'd by 735 F.2d 1367 (7th Cir. 1984).

a. Debt Approach

The approach of including the property in the surviving spouse's gross estate and taking a Section 2053 deduction permits a second step-up in basis for all of the assets held in that spouse's name. However, if the bypass trust is funded with property that has appreciated subsequent to the surviving spouse's date of death, his estate will be satisfying a claim against the estate with appreciated property which will be a recognition event for capital gains purposes (measured, however, only by the difference in value from the second spouse's death to the date of funding). Rev. Rul. 74-178, 1974-1 C.B. 196.

b. Constructive Trust Approach

If the constructive trust approach is employed, the assets traceable to the bypass trust are really excludable from the surviving spouse's estate as belonging to the (constructive) bypass trust, they are treated as having passed from the estate of the first spouse. Basis therefore will depend upon the fair market value at the date of the first spouse's death. I.R.C. § 1014. Since the bypass assets are not included in the estate of the surviving spouse, no second step-up (or down) in basis applies.

Note, if the executor of the surviving spouse's estate settles the claim by now funding a pecuniary bypass bequest with appreciated assets based upon their date-of-distribution value, a substantial capital gain (measured by the difference in value from the first spouse's death to the date of funding) could result. Treas. Reg. § 1.661(a)-2(f)(1).

If this approached is used, the surviving spouse's estate may be below the filing threshold. If no return is filed, but the IRS somehow later is successful in asserting that a return was due and tax owed, the executor of the surviving spouse's estate would be personally liable for estate tax, penalties, and interest until discharged from liability. I.R.C. §§ 2002 and 2204. The statute of limitations for estate and gift tax is three years from the date the return is filed. I.R.C. §6501(a). In addition, if there is an omission on an estate tax return that exceeds 25% of the gross estate, the statute of limitations is extended to six years from the date of filing of the return. I.R.C. §6501(e)(2). However, there is an exception (i.e., there is no statute of limitations) if no return is filed.

Thus, if the bypass trust is funded after the surviving spouse's death, and Form 706 is never filed for that estate, the statute of limitations never begins to run; exposure, theoretically, never ends. If no Form 706 is required because the surviving spouse's estate is less than the filing requirement, but the executor chooses to file a Form 706 anyway, would the executor succeed in tolling the statute of limitations? Would a closing letter for a return that was not required be effective?

If the surviving spouse's estate exceeds the filing threshold, even if the assets traced to the bypass trust are excluded from the estate, (or if the executor simply decides to file a return anyway), how should information about the late funding of the "constructive" bypass trust be disclosed on the Form 706? The Form 706 instructions request attachment of all instruments creating a trust for the benefit of the surviving spouse. Therefore, the first spouse's Will or revocable trust agreement creating the bypass trust should be attached. The Form 706 instructions do not request information regarding the funding of the trust, or even the value of the predeceased spouse's bypass trust at date of the second spouse's death. Obviously, if the "debt" approach is utilized, and the assets of the surviving spouse's estate exceed the filing threshold, and the amount of the debt must be listed. Full disclosure of how the "debt" is computed may be warranted, especially in view of the fact that debts owed to related parties are on the "hit" list of IRS examining attorneys. See IRS ESTATE TAX EXAMINER'S HANDBOOK § (16)33(3), (4).

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 Internal Revenue Service 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 Section 61(a) in her gross income in the year of sale. Rev. Rul 70-60 (1970). It is notable that the Internal Revenue Service Publication 525 provides that the seller of an interest in an expected inheritance from a living person is required to report the entire amount receive in gross income in the year of sale.

F. Sale of an 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 merger the income and remainder interests in the hands of the "buyer," thereby cause the trust to terminate. See RESTATEMENT OF TRUSTS THIRD, §§ 69. *See also, e.g.,* Tex. Prop. Code § 112.034(b). For example, if a decedent's Will established a QTIP trust for a second spouse, with the remainder interest passing to children from a first marriage, the surviving spouse might purchase the remainder interest from the children, causing the trust to merge (subject to any spendthrift provisions) and removing the sales price from the estate of the surviving spouse.

In a Field Service Advisory issued on July 6, 1995, the Internal Revenue Service 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 I.R.C. Section 61 relating to the assignment of an expectant remainder interest in a trust in exchange for the cancellation of indebtedness. The Service advised that "the transfer of the remainder interest was a taxable event resulting in income to the petitioner husband."

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 Section 2519, and as a result, the spouse may be treated as having made a taxable gift to the children equal to the value of the purchase price. Rev. Rul. 98-8, 1998-1 C.B. 541. Naturally, the gift may be sheltered by the spouse's remaining gift tax exclusion.

G. Life Insurance

1. General Rule

Generally speaking, life insurance proceeds are income tax free to the beneficiary of the policy. I.R.C. 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 that party with tax free income upon the death of the insured.

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. Section 101(a)(2) of the Internal Revenue Code provides, "In 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." I.R.C. § 102(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).

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. 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 excess proceeds received upon the insured's death.

H. Taxation of Other Settlements

1. Tort Actual Damages

Prior to the enactment of the Small Business Job Protection Act of 1996 ("the 1996 Act"), Section 104(a) of the Internal Revenue Code provided a global exclusion for any damages received (whether by suit or agreement) on account of personal injury or sickness. *See* I.R.C. 11 U.S.C. § 104(a)(1)-(2). The exclusion from income was interpreted to include personal injuries whether or not the injury related to actual physical sickness or injury. Thus, certain courts have held that damage awards relating to injury to reputation or employment discrimination were excluded from the recipient's gross income. Additionally, the courts were split on the issue whether the exclusion applied to punitive damages awarded in a case involving personal injury related to actual physical injury or sickness. *See* O'Gilvie v. U.S., 66 F.3d 1550 (10th Cir. 1995), aff'd 519 U.S. 79 (1996) (Supreme Court (held punitive damages received in tort suit for personal injuries were not excluded from taxable gross income).

Section 104(a), as amended and currently in effect, now provides:

> (1) Amounts received under workmen's compensation acts as compensation for personal injuries or sickness;
> (2) The amounts of any 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*;
> . . .
> For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraphs (A) and (B) of Section 213(d)(1)) attributable to emotional distress.

I.R.C. § 104(a)(1)-(2) (emphasis added).

Section 104(a), as amended, applies to amounts received after the date of enactment (August 20, 1996) in taxable years ending after such date. H.R. 3448 § 1605(d)(1). The amendment does not apply to amounts received under a written binding agreement, court decree or mediation award in effect on (or issued on or before) September 13, 1995. H.R. 3448 § 1605(d)(2). Thus, any amounts received subsequent to August 20, 1996, including those resulting from a structured settlement, etc., which relate to an agreement or judgment in existence on September 13, 1995, would continue to be taxed in accordance with prior law.

a. Damages Relating to Non-Physical Injury or Sickness

Damages received on account of non-physical injuries or sickness are includible in a claimant's income and subject to income taxes. These include damage recoveries based on a claim of employment discrimination or injury to reputation. Further, Section 104(a) now clearly provides that an emotional distress claim made in conjunction with a claim for non-physical injuries will not be treated as a physical injury or sickness. In fact, the legislative history indicates that the amendment was predicated on the belief that these recoveries compensate the claimant for lost wages or profits and, as such, should be includible in the claimant's taxable income.

b. Damages Relating to Physical Injury or Sickness

Section 104(a), as amended, now limits the income tax exclusion to recoveries "on account of" personal physical injury or sickness. The pivotal language being "on account of." The Conference Committee Report provides the following explanation:

> The bill provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow there from are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to physical injury or physical sickness of such individual's spouse are excludible from gross income. In addition, damages (other than punitive damages) received on account of a claim for wrongful death continue to be excludible from taxable income as under present law.

House Conference Committee Report 104-586, REVENUE OFFSETS (5) (May 20, 1996).

Note that Section 104(a), as amended, now states that for the purposes of Section 104(a)(2) (relating to the exclusion of personal physical injuries or sickness), emotional distress shall not be treated as a physical injury or physical sickness. This language appears to provide that damages recovered for a claimant's emotional distress may be taxable income to the claimant. The legislative history indicates, however, that a recovery for emotional distress "on account of" a physical injury is still excluded from gross income. Specifically, the Conference Committee Report provides that:

> Because all of the damages received on account of physical injury or physical sickness are excludible from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.

House Conference Committee Report 104-586, REVENUE OFFSETS (5) (May 20, 1996).

Therefore, based on the legislative history, it appears that all damages (except punitive damages) recovered in a lawsuit that arises from a physical injury or sickness will continue to be excluded from a claimant's gross income. This would include a damage recovery by a claimant who actually suffered physical injury or sickness and any person (such as a spouse, parent, child, etc.) who may recover damages "on account of" the injured claimant's physical injury or sickness. The exclusion extends to recoveries for physical injury or sickness pursuant to Texas' wrongful death and survival statutes. *See* TEX. CIV. PRAC. & REM. CODE Ann. § 71.002, -.004 (cause of action for actual injury arising from an injury that causes an individual's death) (Vernon 1997); *See Id*. § 71.021 (cause of action for personal injury to health).

2. Punitive Damages

As a general rule, any punitive damage recovery will constitute taxable income to the claimant. The legislative history evidences Congress' belief that punitive damages are intended to punish and do not compensate a claimant and are, thus, a windfall to the claimant. This includes punitive damages whether or not they arise from a claim involving physical injury or sickness. 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* I.R.C. 11 U.S.C. § 104(a).

V. SETTLEMENT AND DRAFTING CONSIDERATIONS

A. Use Recitals to Establish Bona Fide Dispute and Enforceable Rights

The settlement agreement is often the first document reviewed by the Internal Revenue Service when determining the taxation of related transactions and payments. Therefore, this document should be drafted to both copiously cover the terms of the settlement and educate the examiner as to the structure of the agreement. In the agreement it is advisable to:

- Describe the parties and their interest in the estate – their standing as an heir, beneficiary, creditor, etc.;
- Describe the nature of the controversy – will contest, trust dispute, fiduciary claims, etc.;
- Describe claims involved – the enforceable rights at issue.

B. Identify Estate Assets

1. Disclosure of Assets

To protect the personal representative, it is often advisable to include a representation among the parties that they have disclosed all known estate assets. For example, the agreement may provide as follows:

> Each Party represents to every other Party that, to the best of his or her knowledge, the existence of all of the property, real and personal, community and separate, belonging to Decedent as of her/his date of death has been disclosed as described on Exhibit A attached.

2. Disclosure of Prior Gifts

Parties to a will contest often challenge prior gifts allegedly made by a decedent. These gifts are frequently made pursuant to powers of attorney and, even though taxable, the required gift tax returns are not filed. The parties should consider acknowledging the gift to avoid future disputes and to provide the personal representative a good faith basis to file any necessary tax returns including 709s and the 706. For example, the agreement may provide that:

> A and C agree that the gift deed dated December 31, 2002, and recorded under Film Code No. 000-00-0000, executed by B, and conveying 1.00 acres of land to A, as a gift, is valid and they have no claim to the real property described therein and will not attempt to set aside said deed for any reason. The Parties represent they are not aware of any other gifts made by the Decedent during his lifetime and all taxes due as a result of the preceding described transfer will be paid by the Decedent's estate without tax apportionment to A.

3. Characterization of Assets

When the surviving spouse owns separate property, and the spouse is not the sole or residuary beneficiary of the estate, the agreement should identify and confirm her/his separate estate to avoid property characterization issues. This, obviously, is particularly important in second, third, etc., marriage situations. For example, the agreement could provide that:

> The Parties agree that A owned significant property prior to her/his marriage to Decedent and such property continued to be owned by A as her/his separate property, and Decedent's Estate has no interest in or claim against such property which is described in Exhibit B. The Parties acknowledge that the property listed on Exhibit B is A's separate property free of any and all claims of Decedent, Decedent's Estate, or B, C, or D, including but not limited to those relating to the separate character of the property or the community estate.

C. Clearly Provide for the Payment of Legal Fees From the Estate

1. Separate Bequests from Fees

If attorneys' fees and expenses are to be paid to a party's counsel, it is preferable to provide for the estate to pay them directly rather than include these fees and expenses in the amount paid to such party. This allows the estate at least the opportunity to deduct the fees on the death tax return or estate income tax return. For example, the agreement may provide that:

> Each party's attorneys' fees and expenses relating to the administration, preservation and settlement of Decedent's estate shall be paid from Decedent's Estate as follows:
>
> (i) Decedent's Estate shall pay J, K & L law firm the sum of $_____ in settlement of A and J, K & L's claims for attorneys fees and expenses relating to Decedent's Estate and the Litigation within ___ days of the effective date of this agreement; and
>
> (ii) Decedent's Estate shall pay M, N & O law firm the sum of $_____ in settlement of B and M, N & O's claims for attorneys fees and expenses relating to Decedent's Estate and the Litigation within ___ days of the effective date of this agreement; and
>
> (iii) Decedent's Estate shall pay all fees and expenses incurred by the law firm of P, Q & R through the delivery of the remaining assets of Decedent's Estate pursuant to the terms of this Agreement; provided, however, that the total attorney fees and expenses to be paid under this subparagraph (iii) shall not exceed $_____.

If the parties anticipate a personal representative will continue to act on behalf of the estate, the agreement should clarify that the payment of his or her future fees are not capped or prohibited by the agreement. For example:

> Notwithstanding any provision in this agreement to the contrary, the personal representative of Decedent's Estate shall have the right to seek payment of his reasonable and necessary attorneys' fees and expenses from the Decedent's Estate.

2. Provide for the Entry and Execution of Supporting Documentation & Judgments

It is helpful to address in any settlement documents what additional actions and/or documents may be requested or required to support the potential deductibility of the legal fees paid by the estate.

a. Judicial Findings & Judgments

When a judicial proceeding is pending, it is advisable for the attorney's fees to be incorporated in an order or judgment. The Court should find that the representative has met the applicable state law requirements for payment. For example, in a will contest the court may find as follows:

> The attorneys' fees and expenses incurred by X in the amount of $_________ are necessary and essential expenses for the proper prosecution of the probate of the Last Will and Testament of Decedent dated July 1, 20XX, and the settlement, partition and distribution of the Estate. The attorneys' fees are reasonable in amount with respect to the services performed and are necessary expenses and proper expenses relating to the probate of the Last Will and Testament of Decedent dated July 1, 20XX, and the defense of the contest to such will filed by Y. The court finds that the payment of such fees are proper under the Texas Probate Code and that such fees and expenses were required to properly administer and settle this Estate.

Likewise, in the Court may enter a judgment that provides as follows:

> ORDERED, ADJUDGED and DECREED that X acted in good faith and with just cause in seeking the probate of the Last Will and Testament dated July 1, 20XX, of Decedent, and that he shall be reimbursed from the

personal representative of the Estate of Decedent the sum of $___________ for legal fees and expenses, including court costs, relating to the prosecution and defense of such Will in this cause and shown to be reasonable and necessary. It is further,

Note, however, that court approval of attorneys' fees and expenses to be paid by an estate will not preclude a challenge to their deductible as administration expenses on the Form 706 as Internal Revenue Service takes the position that it can independently determine the reasonableness of the fees.

b. Supporting Documentation

Finally, it is advisable for the attorneys to agree to execute all necessary forms or affidavit's as may be required by Internal Revenue Service to support the deductibility of such fees and expenses. For example, the agreement may provide:

> The parties agree that to the extent requested by the Internal Revenue Service or otherwise deemed advisable by the Executor of Decedent's Estate, each such party's attorney shall complete and execute a Form 4421 (Declaration of Executor's Commissions and Attorney's Fees) and such other document as may be required at audit to document and support the deductibility of legal fees paid to such party's attorney(s).

D. Address Taxes Considerations To Avoid Future Disputes

As previously discussed, parties to a family settlement agreement should always consider the tax liabilities and consequences arising out of the settlement. These tax considerations should be clearly addressed in the settlement documents to avoid future disputes. These are not limited to estates but also gift and income tax issues. For example, agreeing to receive $40,000 from the *residuary* may result in some portion being characterized as distributable net income and, thus, subject to income tax. A provision that simply provides for the payment of $40,000, however, will generally be deemed to be a payment of a specific sum and not subject to income taxation. *See* discussion, *supra*. Some commonly drafting considerations are discussed below.

1. <u>Estate Tax Assumptions</u>

Under the appropriate circumstances, it may be advisable to expressly state in the agreement the parties' understandings of how the payments under the agreement will be reported in any tax filings. For example, the agreement may provide as follows:

> For purposes of this Agreement the Tax Assumptions shall be as follows:
>
> (i) All of the Decedent's Estate and Property which, pursuant to this Agreement, passes to either Spouse or the QTIP Trust will qualify for the marital deduction under Section 2056(a) of the Internal Revenue Code of 1986, as amended (the "Code");
>
> (ii) No portion of the Former Spouse Marital Trust established under the Will of Former Spouse shall be liable for or bear any federal estate tax as a result of the Decedent's death; and
>
> (iii) A copy of the Agreed Judgment approving this Agreement shall be attached to the U.S. Estate Tax Return - Form 706 filed on behalf of the Estate.

2. <u>Income Taxes Relating to Distributions</u>

To avoid a future dispute as between the parties regarding whether a distribution under the agreement carried out income, the parties may acknowledge in their agreement that the payment is intended to constitute a specific sum and therefore does not carry out distributable net income. Note, however, that this provision is not binding on the Internal Revenue Service, but will at least discourage clever probate lawyers from attempting to effectively reduce a party's interest in the estate. Such a provision may provide that:

> The Parties agree and confirm that they believe that all distributions and/or property passing to A and any other amounts passing under the terms of this Settlement Agreement should be treated for income tax purposes as a settlement of a claim and/or as a gift or bequest of *a specific sum of money or of specific property* not payable in installments and are not punitive, not for services rendered, and no portion represents income or interest relating to such specific sum of money; *i.e.*, none of the distributions will constitute distributable net income to A. _______ agrees that _he will not report any portion of this payment as distributable net income of the Estate.

3. <u>Tax Responsibilities and Notice Requirements</u>

Considerations should be given to including in the agreement clear procedures as to which parties are responsible for handling and tax audits or disputes.

However, a party that is not directly involved in certain tax filings may be affected by an audit or any resulting adjustments. For example, estate taxes allocated to such parties share may be increased. Therefore, it is advisable to include in the settlement agreement provisions that clearly provide who is responsible for all filings and when other parties are entitled to receive notice of such filings. For example, the agreement may provide as follows:

> X shall notify Y in writing within twenty (20) days or such shorter period as may be required thereby of receipt of written notice of any pending or threatened tax examination, audit or other administrative or judicial proceedings (a "Tax Contest") that could reasonably be expected to result in an indemnification obligation for taxes, interest and penalties pursuant to the Rule 11 Agreement and failure to timely give such notice shall mean that no indemnification is due to such defaulting party. If a Tax Contest relates to any taxes for which Y could be liable hereunder, Y shall have the option to use legal counsel of her choosing and to control and handle the defense and settlement of such Tax Contest at her expense. If Y elects to control and handle the defense and settlement of such Tax Contest, X agrees not to interfere with Y's defense and settlement of such Tax Contest. If Y elects not to control the defense and settlement of such Tax Contest, any other party may elect, in writing to Y, to control and handle the defense and settlement of such Tax Contest and Y shall indemnify such party for all reasonable and necessary fees and expenses, including experts.

4. <u>Access to Federal and State Death Tax Returns</u>

Finally, a party receiving estate assets should seek a copy of the filed death tax returns. This provides the beneficiary evidence of his or her tax basis. The beneficiary should also request a copy of the “closing letter” to evidence the release of any death tax liens. The settlement agreement can simply provide that:

> A and the then acting personal representative of Decedent’s Estate shall deliver to a copy of any federal and state death tax returns and any federal and state closing letters or agreements for Decedent’s Estate. A or the then acting personal representative shall deliver a copy of the returns within five (5) business days of the date they are filed and the letters within ten (10) business days of receipt.

5. <u>Income Tax Issue Relating to Deceased and Surviving Spouse’s Income Tax Returns</u>

When the surviving spouse is not the personal representative of his or her deceased spouse’s estate, it may be advisable to address the deceased and surviving spouse’s income tax liabilities and responsibilities. This is particularly important when the spouses have significant income or have been tax aggressive.

The agreement may provide how the final income tax return will be filed and each spouse’s responsibility for any income taxes due. For example, the agreement may provide as follows:

> A shall file his 2004 income tax return as a married individual filing separately. Any taxes, interest or penalties that A may owe to the federal government for all items reported on his 2004 personal income tax return as well as all taxable periods subsequent to the date of Decedent’s death shall be the sole liability and obligation of A to be satisfied and paid solely from his property, and from which A shall forever hold harmless, indemnify and defend Decedent and Decedent’s Estate. If there is an audit of Decedent and A’s joint 2003 personal income tax return or any prior years joint personal income tax returns, Decedent’s Estate and A shall each be responsible for and shall pay one-half (1/2) of any tax due, including any penalties, interest and costs of defending the claim and A shall forever hold harmless, indemnify and defend Decedent and Decedent’s Estate from his one-half (1/2) of such liability, penalties, interests and costs. All liabilities and obligations incurred by A are the sole liabilities and obligations of A, to be satisfied and/or provided for by A and from which A shall forever hold harmless, indemnify and defend Decedent and Decedent’s Estate. B, as Independent Executor of the Estate, shall file, as may be due, Decedent’s 2004 income tax return as a married individual filing separately. Any taxes, interest or penalties that Decedent or Decedent’s Estate may owe to the federal government for all items reported on Decedent’s 2004 personal income tax return as well as all taxable periods subsequent to the date of Decedent’s death shall be the sole liability and obligation of Decedent’s Estate,

> B and C, to be satisfied and paid solely from Decedent's Estate, and from which Decedent's Estate, B and C shall forever hold harmless, indemnify and defend A. If there is an audit of Decedent and A's joint 2003 personal income tax return or any prior years joint personal income tax returns, Decedent's Estate and A shall each be responsible for and shall pay one-half (1/2) of any tax due, including any penalties, interest and costs of defending the claim and Decedent and Decedent's Estate shall defend A from Decedent's one-half (1/2) of such liability, penalties, interests and costs. Except as otherwise provided by this Settlement Agreement, all liabilities and obligations incurred by Decedent or Decedent's Estate are the sole liabilities and obligations of Decedent's Estate, to be satisfied and/or provided for by Decedent's Estate and from which Decedent's Estate, B and C shall forever hold harmless, indemnify and defend A.

To facilitate the release of information necessary to prepare the respective returns, the agreement may provide that:

> B and C agree to release to A or such other persons as he may specify (i) all tax records and tax documentation regarding Decedent and A in their possession or under their control within ten (10) days of such written request by A or A's accountant if, as, and when such information is requested by A or his accountant, and (ii) all financial records of A, including but not limited to, all bank statements, credit card statements, insurance information, and real estate records in his or her possession or under either of their actual or constructive control, if any, within ten (10) days of such written request by A. Furthermore, A agrees to release to B, as Independent Executor of the Estate, or any such other person as he may specify all (i) tax records and tax information of Decedent in A's possession or under his actual or constructive control on or before April 1, 2004, which is reasonably necessary to prepare Decedent's final income tax return; and (ii) financial records of the Decedent, including but not limited to, bank statements, credit card statements, insurance information, and real estate records in his possession of under his control, if any, within ten (10) days of such written request by B.

E. Address Apportionment of Federal and State Death Taxes

The parties should attempt to agree on the apportionment of federal and state death taxes. As previously discussed, the agreement when properly entered into, takes the place of the Will, if one existed. Thus, an issue exists whether any tax apportionment language in the Will is applicable to the terms and provisions of a settlement agreement unless the administrative provisions of the Will are incorporated into the agreement by reference. For example, the agreement may provide as follows:

> Wife, individually and as Successor Independent Executor of the Estate (once appointed) hereby agrees to be liable for (i) all estate, generation-skipping, gift and inheritance taxes (defined herein as "Transfer Taxes") (if any are owed), including any interest and penalties, thereon (if any) in respect of the Decedent, the Decedent's Estate, the Property, the devises under the Will as modified under this Agreement, and (ii) all income taxes and penalties attributable to any withdrawal or deemed withdrawal from any IRA or other account transferred or assigned to the Spouse. As between Wife and Children, Children shall not be liable, directly or indirectly (including, without limitation, any transferee liability), for any tax, including any interest and penalties, thereon (if any) imposed on Wife or the Estate, or resulting from any withdrawal or deemed withdrawal from any IRA or other account transferred or assigned to the Wife, nor shall they be liable for any income, gift or estate tax, including any interest and penalties, thereon (if any) imposed on Wife or the Estate.

In the absence of a provision addressing tax allocation, it appears that the default provisions set forth in Texas Probate Code Section 322A will apply. *See* TEX. PROB. CODE ANN. § 322A (Vernon 2003).

F. Tax Indemnity

An indemnity serves as protection against liability on cross-actions, liens, and other potential claims by third parties, and is an important factor in facilitating and/or permitting a full or partial settlement of litigation. In some instances, defendants would be imprudent to settle without the protection of an indemnity agreement, particularly if the future assessment of taxes may be an issue.

The tax liability issue principally arises in settlements involving decedent's estates. A personal representative has a duty to pay death taxes when due. *See* I.R.C. § 2002. This includes taxes attributable to non-probate assets. *See* Treas. Reg. § 20.2002-1. A personal representative is also responsible for preparing and filing the death tax return, if necessary. Certain other persons may also be subjected to personal liability for the payment of any unpaid death taxes to the extent of the value of the property received. Internal Revenue Code Section 6324 imposes personal liability on a decedent's spouse, transferees, trustees, surviving tenants, holders of appointed properties, insurance beneficiaries and others who receive or hold estate assets.

Furthermore, the government has priority to be paid debts owed to it before other debts or expenses of the estate. *See* 31 U.S.C. 3713 (priority of government debts). Taxes are debts due the government. *See* Price v. U.S., 269 U.S. 492 (1926). The obligation to pay taxes includes both known and unknown income, gift and death taxes. The distribution of a beneficiary's interest in an estate before the payment of any death or other taxes may subject the personal representative and the beneficiary to liability. *See* Leuthesser v. Comm'r., 18 T.C. 1112 (1952); Posey v. Comm'r., 10 T.C.M. 383 (1951); *but see* Schwartz v. Comm'r., 560 F.2d 311 (8th Cir. 1977) (executor's personal liability limited to distributions made after estate became insolvent).

Thus, when distributing estate assets, both the personal representative distributing and distributee receiving the assets under a settlement agreement should address such person's tax responsibilities and protections. For example, the agreement may include the following indemnity:

> A, individually and as successor personal representative of Decedent's Estate and her Successors, B, C, and D hereby agree to INDEMNIFY, DEFEND and HOLD HARMLESS E, and her Affiliates and Successors, from any and all liability, transferor, transferee or otherwise, (i) relating to her serving as personal representative of Decedent's Estate or A's appointment as the successor representative of Decedent's Estate, including any and all past, current or future federal or state income gift or death taxes, and any related interest and penalties which may be claimed, or assessed, relating to Decedent's Estate, (ii) relating to any and all past, current or future federal or state income, gift or death taxes, including any interest, and penalties, imposed by reason of the distributions provided for in this Agreement, and (iii) arising from all claims, costs, expenses, including but not limited to attorneys fees and expenses, accountant fees and expenses, experts, litigation costs and bond premiums, relating to any attempt by the Internal Revenue Service or other persons or entities to assess, collect or enforce any claims, demands, assessments or judgments against E, or her Affiliates or Successors, for past, current or future federal or state income, gift or estate taxes, and any related penalties and interest.

Parties drafting and relying on indemnification clauses should bear in mind that such clauses are construed strictly against an indemnitee. Failure to draft clear indemnification, duty to defend and hold harmless clauses can result in unanticipated liability for the indemnitee.

VI. CHECKLISTS

A. Generally

Most settlements are reached at the end of a long and grueling day of mediation. Counsel is then left with the dilemma of agreeing to exchange settlement documents at a later date (after some sleep) or drafting feverishly into the night. The first option allows for "buyers remorse" and the second often leads to later construction disputes. Both options and possible results should be explained to a client. In the end, however, most clients prefer to secure a binding agreement (that may later require construction) than leave without the basic deal. To assist the weary and malnourished lawyer, we have attached a checklist to serve as a reminder to the drafting lawyers.

Note that the following lists are non-exclusive and are meant to be for illustration purposes only. The actual facts and circumstances of the case (which in probate and trust litigation are always unique) should dictate the actual provisions and agreements.

B. Will Contests

The following is a basic checklist for settlement of a will contest:

A. Parties
- State all names
- State all relevant capacities (i.e. executor, trustee, etc.)
- Define appropriately (make sure definition includes all capacities)

B. Recitals
- Identify decedent and date of death
- State facts giving rise to contest or dispute
- State facts evidencing each settling party's standing and validity of his or her claim
- Identify pending legal action, including court, style of case, etc.
- State settlement to avoid continued litigation and buy peace

C. Definitions and scope
- Define claims
- Define relevant entities and persons included in settlement, i.e. trusts, businesses, etc.
- State what claims or matters, if any, are excluded from agreement
- Define relevant terms – including successor, affiliates, predecessors, litigation, transactions, etc.

D. Recite consideration
- Good and valuable
- Other payments provided under terms negotiated

E. Terms of settlement
- Division of estate assets
  - ⇒ Describe property each person or party to receive
  - ⇒ Time to deliver
  - ⇒ Manner to divide – bid, lots, etc.
  - ⇒ Whether appraiser must be obtained and, if so, who is responsible
  - ⇒ Who pays shipping and delivery costs
  - ⇒ Who pays/responsible for storage and insurance pending distribution
  - ⇒ Should a bill of sale be prepared and, if so, who prepares
  - ⇒ Who prepares deeds for real property
  - ⇒ How disputes should be settled
  - ⇒ Disclaimers or assignments
  - ⇒ Method to divide unknown, undisclosed or lost assets
- Continued administration of estate
  - ⇒ Who will be appointed or continue to serve as the personal representative of the estate
  - ⇒ Limitation on personal representative's powers, if any
  - ⇒ Reporting requirements to parties or third parties
  - ⇒ Time period to close estate
  - ⇒ Payment of fees and expenses
  - ⇒ Right to compensation
  - ⇒ Responsibility to execute conveyance documents
- Waiver of statutory rights
  - ⇒ Homestead
  - ⇒ Family allowance
  - ⇒ Exempt property

F. Taxes and debts
- Who is responsible for preparing and filing last income tax return, any gift tax returns and death tax returns
- Surviving spouse's responsibility to pay income taxes for period prior to spouse's death
- Who is responsible for payment of taxes, penalties and interest
- How and when debts and administration expenses will be paid
- Who is responsible for payment of debts and administration expenses
- Disclosures as to known debts and taxes due
- Tax apportionment – residuary, Section 322A, otherwise
- Will parties be entitled to request copy of death and income tax return
- Right to access tax records and, if so, periods to be provided
- Indemnity for income, death, and gift taxes and related penalties and interest
- Payments do not constitute distributable net income to recipient
- How will court costs and appointee fees be paid

G. Representations
- Capacity of parties
- Disclosure of assets
- Authority to act in stated capacity
- Party has not assigned, pledged or disclaimed interest
- Discharge any reliance on statement by any other party's attorney or advisor
- Include disclaimer of reliance other than expressly stated in written settlement agreement

H. Release and indemnities
- Release claims
- Limitations in release of parties and/or attorney or other advisors if desired
- Exclude obligations under settlement agreement from release
- Verify all required parties are releasing and being released in all desired capacities
- Verify successor, affiliates and predecessor are released, if desired
- Verify all agents, heirs, etc. are bound

- Indemnities for taxes, third party claims, tenant claims, environmental claims, alleged spouses, etc.

I. Disposition of litigation
- Dismissal with prejudice
- Consent judgment
- Time to dispose
- Who is responsible for preparation of paperwork
- Rights of counsel to review
- Whether parties must attend hearing

J. Remedies in default
- Settlement agreement enforced as contract
- Settlement agreement to be incorporated in judgment and enforced accordingly
- Specific performance
- Right to attorneys fees and expenses

K. Miscellaneous
- Agreement supersedes any oral or prior agreements (exclude any agreements to remain in effect)
- Agreement must be modified in writing
- Choice of law
- Incorporate exhibits
- Advice of own counsel
- Whether agreement can be executed in multiple counterparts
- Whether facsimile signature same as original
- Where future notices should be sent
- Confidentiality agreement
- Heading and titles are for descriptive purposes only
- Agreement to mediate/arbitrate future disputes
- Statement that parties and counsel in good faith and just cause
- Effective date
- Court approvals

C. Trust Suits

The following is a basic checklist relating to a lawsuit involving the administration, modification, or termination of a trust:

A. Parties
- State all names
- State all relevant capacities
- Define appropriately
- State how minors and unknown beneficiaries are bound
- State any ad litems joining as parties

B. Recitals
- Identify trust or trusts at issue
- Identify trustees
- State facts giving rise to contest or dispute
- State facts evidencing each settling party's standing and validity of his or her claim
- Identify pending legal action, including court, style of case, etc.
- State settlement to avoid continued litigation and buy peace

C. Definitions and scope
- Define claims
- Define relevant entities and persons included in settlement, i.e. other trusts, partnerships, businesses, etc.
- State what claims or matters, if any, are excluded from agreement
- Define relevant terms – including successor, affiliates, predecessors, litigation, transactions, etc.

D. Recite consideration
- Good and valuable
- Other payments provided under terms negotiated

E. Terms of settlement
- Resignation of Trustee
  - ⇒ Basis for resignation
  - ⇒ Time for resignation
  - ⇒ Any contingent events or actions
  - ⇒ Appoint successor trustee
  - ⇒ Means to qualify
  - ⇒ Who must bring suit to seek appointment, if necessary
- Distribution standard issues
  - ⇒ How future distributions will be determined
  - ⇒ Documentation beneficiaries must submit to support future distributions
  - ⇒ Property to be distributed in settlement of claims for failure to distribute sufficient amounts in past
  - ⇒ Whether payments are from income or principal
  - ⇒ How past, current and future payments will be accounted for
- Disclosure, discharge and redress
  - ⇒ Disclosures of Books, Records and Accounts
  - ⇒ Successor trustee has no duty to redress
  - ⇒ Judicial accounting
  - ⇒ Indemnify successor trustee from claims of unknown or minor beneficiary or third parties
  - ⇒ Time and place books and records will be made available
- Breach of fiduciary duty

- ⇒ Payment from fiduciary to trust and/or beneficiary
- ⇒ Return of trustee fees and expenses paid by trust
- ⇒ Return of compensation by trustee
- ⇒ Whether payment to trustee and property taken by trustee will constitute income to trustee
- ⇒ Note or other means to secure payments
- Continued administration of trust
  - ⇒ Who will be appointed or continue to serve as the trustee of the trust
  - ⇒ Future reporting requirements to parties or third parties
  - ⇒ Payment of trustee's fees and expenses
  - ⇒ Right to compensation

F. Termination or modification of trust
- Termination
  - ⇒ Basis for termination
  - ⇒ Means to terminate – agreement or by court
  - ⇒ Who prepares paperwork and pleadings
  - ⇒ Payment of any debt, obligations and taxes
  - ⇒ How pending debts, notes, leases, contracts or other obligations will be handled
  - ⇒ Tax effects of termination – income and GST
- Modification
  - ⇒ Provision to be modified
  - ⇒ Basis for modification
  - ⇒ Means to modification – agreement or by court
  - ⇒ Who prepares paperwork and pleadings
  - ⇒ Tax implications
  - ⇒ GST considerations

G. Tax matters
- Consider tax implications
- Obtain tax opinions
- Request private letter rulings
- Who is responsible for filing tax returns
- Whether distributions will take into account the amount of taxes the beneficiary must pay
- Will settlement result in loss of GST "grandfathered" status

H. Representations
- Capacity of parties
- Disclosure of assets
- Authority to act in stated capacity
- Party has not assigned, pledged or disclaimed interest
- Discharge any reliance on statement by any other party's attorney or advisor
- Include disclaimer of reliance other than expressly stated in written settlement agreement

I. Release and indemnities
- Release claims
- Limitations in release of parties and/or attorney or other advisors
- Exclude from release obligations under settlement agreement
- Verify all required parties release and are released in all desired capacities
- Verify successor, affiliates and predecessor are released, if desired
- Verify all agents, heirs, etc. are bound
- Indemnities for taxes, third party claims, tenant claims, environmental claims, alleged spouses, etc.

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- Agreement supersedes any oral or prior agreements (exclude any agreements to remain in effect)
- Agreement must be modified in writing
- Choice of law
- Incorporate exhibits
- Advise of own counsel
- Whether agreement can be executed in multiple counterparts
- Whether facsimile signature same as original
- Where future notices should be sent
- Confidentiality agreement
- Heading and titles are for descriptive purposes only
- Agreement to mediate/arbitrate future disputes
- Effective date
- Court approvals, if any

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THE MORNING AFTER: AVOIDING TAX SURPRISES IN TRUST & ESTATE LITIGATION

Transfer Tax Aspects of Settlements

by
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Joint Fall CLE Meeting
of the
Section of Taxation &
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Saturday, September 29, 2007
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TRANSFER TAX ASPECTS OF SETTLEMENTS

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I. Introduction

Parties negotiating the resolution of their disputes regarding interests in trusts or estates may not be aware of the transfer tax consequences that may impact the economic results of the settlement. A settlement that does not take into account the transfer tax consequences may significantly shift or reduce the parties' actual beneficial interests in the estate or trust. In addition, while it may be impossible to assure certainty regarding those tax consequences, the settlement provisions can be designed to maximize such certainty and to address the allocation of tax risks among the parties. This outline provides a summary overview of the gift, estate and generation-skipping transfer ("GST") tax considerations to consider in trust & estate litigation.[1]

The gift, estate and GST tax authorities discussed in this outline generally *only* address the transfer tax issues relating to settlements of contested trust & estate disputes – they do not address or govern the resulting consequences of other taxes not included in this outline, e.g., income tax, excise taxes potentially applicable to exempt organizations, partnership or corporate tax applicable to business entities, foreign taxes or other taxes. Any settlement or other disposition of a contested matter should take into account the relevant additional tax consequences, and whether a private letter ruling request seeking guidance on these issues is prudent.

See accompanying materials prepared by Mickey R. Davis addressing income tax aspects of trust and estate litigation, and materials prepared by Stephanie Loomis-Price addressing tax procedures relevant to trust and estate litigation.

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[1] All references herein to the "Code" refer to the Internal Revenue of Code of 1986, as amended. Unless otherwise specified, all references to "Sections" herein refer to Sections of the Code. All references to "Regulations" refer to Treasury Regulations.

II. Federal Recognition of State Court Action

State law, and not federal law generally determines the nature and extent of property interests, while federal tax law prescribes the rules governing taxation of such property. However, federal courts and the IRS are bound only by decisions of the highest court of the state under Comr. v. Est. of Bosch, 387 U.S. 456 (1967). In Bosch, a state court concluded that a surviving spouse's release of her general power of appointment over a trust was a nullity such that the deceased spouse's estate was entitled to a marital deduction for amounts passing to the trust. The Commissioner of the IRS was not included as a party in those state court proceedings.

The Tax Court and Second Circuit Court of Appeals affirmed the state court, but the Supreme Court reversed: "We hold that where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such property interest by a state trial court." The Supreme Court reviewed the legislative history relating to enactment of the federal estate tax marital deduction provisions and found that "proper regard," but not finality, "should be given to interpretation of the will" by state courts and only when entered by a court in a "bona fide adversary proceeding." Thus, the Court concluded that federal courts and the IRS are free to interpret state law in the absence of a decision from the highest state court, acknowledging that the federal authority "[i]n this respect, it may be said to be, in effect, sitting as a state court." Under Bosch, the federal authority also may disregard those decisions they determine that the highest state court would determine otherwise.

Ahmanson Foundation v. U.S., 674 F.2d 761 (9th Cir. 1981) applied the Bosch rule in denying marital and charitable estate tax deductions. The Ahmanson court noted that the taxpayer's demonstration that the settlement resolved a bona fide adversarial dispute was not sufficient to qualify for the deductions. Instead, the "test" of whether assets pass from a decedent for estate tax purposes is "whether the interest reaches the spouse pursuant to state law, correctly interpreted – not whether it reached the spouse as a result of good faith, adversary confrontation." Id. at 774. Accord Est. of Brandon v. Comr., 828 F.2d 493 (8th Cir. 1987). Applying Bosch, the Ahmanson court concluded that since a federal court is not bound by a lower state court determination, it also is not bound by a private settlement agreement among parties to the dispute. Consequently, the Ahmanson court held that property distributed to charity or to a surviving spouse pursuant to a compromise settlement is only treated as "passing" from the decedent to qualify for deductions if the settlement is based on an enforceable right under a proper interpretation of state law.

Unless parties obtain a judgment from the highest state court, any resolution approved by a lower state court or effectuated by private settlement agreement may not be recognized by a federal authority for tax purposes. Parties should consider whether certainty regarding the tax aspects is so crucial to the settlement that it is worthwhile to obtain a private letter ruling from the Internal Revenue Service ("IRS") as a condition of enforceability of the settlement. See, e.g., PLRs 200350012, 200127027, 200032010. The first IRS Revenue Procedure issued each year provides the procedures to request a private letter ruling, and describes the limitations on the issues and circumstances which the IRS will address in such rulings. <u>See</u> Rev. Proc. 2001-1, 2007-1 IRB 1.

III. <u>Gift Tax</u>

Section 2501 generally imposes the federal gift tax on every transfer of property by lifetime gift during the calendar year by any citizen or resident of the United States. In any settlement, parties may compromise or relinquish their rights or interests in the estate or trust property, thereby affecting the interests of each other and other beneficiaries. The federal gift tax applies to any transfer of property by gift by an individual, regardless of whether the transfer is in trust or otherwise, and whether the gift is direct or indirect. Internal Revenue Code ("IRC") §§2501, 2511.

Where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeds the value of the consideration constitutes a taxable gift. IRC §2512. If applied mechanically, this test would require the review of each settlement to assess whether the values of the resulting respective benefits for all parties were equal and any discrepancy could result in a taxable gift. However, "a sale, exchange or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth" and, therefore, not subject to gift tax. Treas. Reg. §25.2512-8. Thus, if there is a measurable change in the value of an individual's interest in the subject property when compared before and after the settlement, the change in value may constitute a taxable gift unless the exception for business transactions applies. <u>Id</u>.

In early cases prior to <u>Bosch</u> and <u>Ahmanson</u>, the emphasis in reviewing the gift tax consequences of transfers between parties to litigated controversies was on the adversarial nature of the proceedings. The primary consideration was whether the final resolution resulted from a genuine and active contest among the parties, and the existence of a bona fide claim was considered but given less weight. For example, in <u>Beveridge v. Comr.,</u> 10 TC 915 (1948), <u>nonacq.</u> 1948-2 C.B. 5, <u>nonacq. withdrawn and acq.</u> 1949-1 C.B. 1, the court concluded that no gift resulted from the taxpayer's transfer of $120,000 in trust for the benefit of her daughter to settle the dispute between them regarding the validity of the daughter's prior transfer of real estate to her mother. The court reasoned that the testimony of the taxpayer's attorneys and advisors convinced the court that she was "not actuated by love and affection or other motives which normally prompt the making of a gift" and that "[s]he acted, in our opinion, as one would act in the settlement of differences with a stranger." The court also recognized the economic value of ridding oneself of outstanding claims, given the costs and uncertainty of ongoing litigation. "The release from unliquidated claims, moreover, has a recognizable value in money or money's worth, for, as said in <u>Comr. v. Mesta</u>, [123 F.2d 986 (3rd Cir. 1941)]: . . . a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth." <u>See also</u> <u>Friedman v. Comr.,</u> 40 T.C. 714 (1963), <u>acq.</u> 1964-2 C.B. 5 (relying on <u>Beveridge</u> analysis to conclude that taxpayer was not subject to gift tax on transfer of remainder interest to stepchildren to settle threatened litigation).

After <u>Bosch</u> and <u>Ahmanson</u>, the importance of an adversarial controversy diminished in determining the tax consequences of a settlement agreement, and the focus shifted to the legitimacy of the claims underlying the dispute. Apparently, the economic benefit of disposing of an existing dispute and potentially costly litigation does not suffice as consideration for a transfer in settlement of the dispute. Based on Bosch and its progeny, the IRS has adopted the rule that a settlement agreement among family members may subject the parties to gift tax unless they establish that it is a bona fide compromise of legitimate, enforceable claims and, to the extent possible, produces an economically fair result.

> Thus, state law must be examined to ascertain the legitimacy of each party's claim. If it is determined that each party has a valid claim, the Service must determine that the distribution under the settlement reflects the result that would apply under state law. If there is a difference, it is necessary to consider whether the difference may be justified because of the uncertainty of the result if the question were litigated. . . . We recognize that, because of the uncertainty of litigation over the issues presented, determining a precisely correct allocation of trust assets is difficult. We believe the settlement agreement provides an allocation of the trust assets that is within a range of reasonable settlements considering the state court decisions that address the issues. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) are consistent with the relative merit of the claims asserted by the parties. PLR 9716011.

In PLR 9716011, family members disputed the proper construction of the ambiguous terms governing the division of trust property upon termination and agreed upon a settlement adopting a combination of the parties' respective proposed formulas for distribution. The IRS concluded that no taxable gift would result from the proposed settlement after examining "the settlement agreement in the context of the state court decisions and treatises that address the issues presented," because it fairly reflected the relative merits of parties' claims. Distributions from the trust at its termination would be treated as transfers directly from the decedent to the beneficiaries because "the settlement agreement is regarded for transfer tax purposes as properly reflecting the substantive rights of the parties under the decedent's testamentary trust." See also PLRs 200127027 (no taxable gifts resulted from settlement because interests reflect the enforceable rights and provides an allocation within the range of reasonable settlements); 8902045 (no taxable gift where settlement did not change value of parties' interests in trust property).

In contrast, taxable gifts will result from settlements where parties surrender rights to benefit adversaries to a greater extent than the amounts that those adversaries could have recovered under local law. In PLR 9308032, Decedent executed his will in 1955 and created two separate trusts, one for the benefit of each of his two daughters, and each trust provided that it would be distributed "in equal shares to her children and to the issue of deceased children" upon the daughter's death. Decedent's Daughter 1 thereafter adopted two children and it was unclear whether they would be entitled to the balance of Daughter 1's trust upon her death. To resolve any potential disputes, Daughters 1 and 2 and their adult children entered into an agreement in December, 1982, to treat Daughter 1's adopted children as her children for purposes of the Decedent's will. In 1986, Daughter 2's Child 3 reached the age of majority and all parties executed another agreement substantially identical to the 1982 agreement. Finally, the parties entered into a third agreement in 1991 to reaffirm that the prior 1982 and 1986 agreements remained binding upon the family members. In addition, the state legislature adopted a new statute providing that an adopting parent and adopted persons shall have rights of inheritance from and through each other as if the adopted person was the genetic child of the adopting parent, which applied to Decedent's will by its effective date provisions.

However, under the applicable state law in effect at Decedent's death in 1956, adopted children would not be considered Daughter 1's descendants or purposes of the will. "Hence, upon Daughter 1's death, we would necessarily conclude that, under applicable local law and in the absence of the 1982 and 1986 agreements, Daughter 2 or her family would in all likelihood have succeeded to Daughter 1's trust if Daughter 1 had died thereafter (but before the 1991 legislation)." As a result, Daughter 2 an the adult members of her family who entered into the 1982 and 1986 agreements were treated as making taxable gifts to the adopted children of Daughter 1 of their respective contingent remainder interests in Daughter 1's trust.[2] The 1991 agreement was deemed to have no effect because Daughter 1's adopted children had the right at that time to succeed to Daughter 1's trust at her death under the 1991 legislation granting rights of inheritance to adopted persons.

Accordingly, any settlement should be reviewed for any departure from the range of reasonable amounts that parties could recover as legitimate claims under state law that may subject the parties to gift tax.

IV. <u>Estate Tax</u>

Section 2001 generally imposes the federal estate tax on the taxable estate of every decedent who is a citizen or resident of the United States, which generally includes the value of all property in which the decedent has an interest at the time of the decedent's death, real or personal, tangible or intangible, wherever situated under Section 2031.

A. <u>Marital Deduction</u>.

The marital deduction from estate tax reduces the gross estate by "the value of any interest in property which passes or has passed from the decedent" to his surviving spouse. IRC §2056. The initial requirement that the property "passes to" the spouse from the decedent has been narrowly construed and is not satisfied merely because the spouse receives property included in the decedent's taxable estate. The passing requirement is not satisfied if the resolution of a controversy is not respected for transfer tax purposes, such that a resulting transfer of property to the surviving spouse is re-characterized as a transfer from other parties to the spouse, or from the decedent to other parties instead of the spouse.

[2] Note also that the taxable gift from Child 3 resulting from the 1986 agreement, executed after the enactment of the GST tax, caused Child 3 to become the transferor of a portion of Daughter 1's trust in the amount of his contingent remainder interest in the trust, which thereby lost its exempt character as a portion of the trust grandfathered from GST tax.

Regulation §20.2056(c)-2(c) addresses the effect of elections that the surviving spouse may have under applicable state law on the marital deduction:

> (c) *Effect of election by surviving spouse*. This paragraph contains rules applicable if the surviving spouse may elect between a property interest offered to her under the decedent's will or other instrument and a property interest to which she is otherwise entitled (such as dower, a right in the decedent's estate, or her interest under community property laws) of which adverse disposition was attempted by the decedent under the will or other instrument. If the surviving spouse elects to take against the will or other instrument, then the property interests offered thereunder are not considered as having "passed from the decedent to his surviving spouse" and the dower or other property interest retained by her is considered as having so passed (if it otherwise so qualifies under this section). If the surviving spouse elects to take under the will or other instrument, then the dower or other property interest relinquished by her is not considered as having "passed from the decedent to his surviving spouse" (irrespective of whether it otherwise comes within the definition stated in paragraph (a) of this section) and the interest taken under the will or other instrument is considered as having so passed (if it otherwise so qualifies). As to the valuation of the property interest taken under the will or other instrument, see paragraph (b) of §20.2056(b)-4.

Consistent with the general rule reflected in the regulation, the IRS has permitted the marital deduction for amounts that the spouse receives by electing to renounce the decedent's will to take the statutory share, or amounts that the spouse receives to substitute for the statutory share. See Rev. Rul. 83-107, 1983-2 C.B. 159 (allowing marital deduction for lump sum payment to spouse to substitute for lifetime dower interest as permitted under state law that did not exceed the commuted value of the dower interest that she could have recovered in a judicial proceeding); Rev. Rul. 72-8, 1972-1 C.B. 309 (allowing marital deduction for statutory share that spouse elected to receive); Rev. Rul. 66-139, 1966-1 C.B. 225 (allowing marital deduction for settlement payment to spouse based on her claim to a dower interest in the estate).

Regulation §20.2056(c)-2(d) addresses the effect of will contests on the marital deduction:

> (d) *Will contests*. (1) 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." (2) 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 contest. 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.

This regulation is limited by its plain terms to will contests, and not other types of controversies, as acknowledged by the court in Schroeder v. U.S., 924 F. 2d 1547 (10th Cir. 1991). However, the Schroeder court reasoned that the regulation illustrated the general legislative intention to limit deferral of estate tax to inter-spousal transfers of wealth, citing prior cases that had interpreted the regulation broadly to apply to controversies in general. See Citizens & Southern Nat'l Bank v. U.S., 451 F.2d 221 (5th Cir. 1971); United States Trust Co. v. Comr., 321 F.2d 908 (2nd Cir. 1963). Thus, the Schroeder court concluded that the surviving spouse's surrender of her share of decedent's joint tenancy property to other beneficiaries to resolve litigation regarding her rights did not qualify for the marital deduction, even though the controversy was not a will contest and the regulation did not squarely apply to the facts of the case. See also Est. of Frost v. Comr., T.C. Memo. 1993-94 (1993) (no marital deduction allowed where surviving spouse surrendered interest in real property included in elective share to settle dispute with decedent's sons because controversy based on election was sufficiently similar to will contest); PLR 9005003. However, the regulation regarding "will contests" does not apply to bar the marital deduction where there is no challenge to the decedent's testamentary provisions for the direct benefit of the spouse. See Est. of Ransburg v. U.S., 765 F. Supp. 138 (1990) (regulation did not apply and marital deduction was allowed for distribution to spouse in settlement of dispute regarding apportionment of death taxes which did not directly challenge testamentary bequests to spouse).

The marital deduction is only available to the extent of property that the spouse actually receives in a settlement of a bona fide adversarial dispute that is based on spouse's enforceable rights under state law. See Est. of Hubert v. Comr., 101 T.C. 314 (1993), aff'd. 63 F.3d 1083 (11th Cir. 1995), cert. granted. 517 U.S. 1166 (1996), motion granted, 518 U.S. 1054 (1996), aff'd. 520 U.S. 93 (1997); Ahmanson, supra (specifying that the "test" for marital estate tax deduction is whether the interest passes to spouse by correct interpretation of state law, not whether it results from good faith, adversary confrontation); Est. of Brandon v. Comr., 828 F. 2d 493 (8th Cir. 1987); Rev. Rul. 66-139, 1966-1 C.B. 225 (private settlement of claim qualifies for marital deduction if claim was valid and settlement was made in good faith); PLRs 9610018, 9253006, 9101034, 910125, 8706014, 8715004. Thus, the IRS has reviewed the terms of settlements closely and compared them to the parties' enforceable rights under state law to see whether parties had sufficient incentive to defend their interests and actually compromised and surrendered rights in the settlement. See PLRs 200417030; 9610018. While the mere existence of an adversarial controversy is insufficient, the discussions in the relevant cases and rulings seem to favor taxpayers who can demonstrate active and contentious litigation among the parties.

As the marital deduction must be based on legitimate rights under state law, no marital deduction will be allowed for amounts passing to spouse that exceed the amount reflecting the spouse's enforceable rights under state law. See Lyeth v. Hoey, 305 U.S. 188 (1938) (a settlement payment is traceable to the underlying rights that are the source of the compromise); Est. of Mergott, 86 AFTR 2d 2000-5778 (U.S. Dist. N.J. 2000) (settlement did not qualify for marital deduction because spouse had no right under state law to termination of trust contrary to decedent's intent); Est. of Menkus v. Comr., T.C. Memo 1962-101, 21 T.C.M. 559 (denying marital deduction for $6,000 payment to surviving spouse from inter vivos trust for release of her claims against the estate and other beneficiaries because $6,000 amount exceeded the probate estate and amount that she could have received in successful will contest); PLRs 9101025 (denying marital deduction for QTIP trust to substitute for the statutory share on settlement where no probate assets existed against which spouse could elect statutory share); and 8706014 (denying a marital deduction for a trust reformed to qualify as a QTIP trust because the IRS determined that it was not bound by the lower state court determination and concluded that there was no clear and convincing evidence of a mistake in the original document).[3]

In Carpenter v. IRS, 52 F.3d 1266 (4th Cir. 1995), the court denied the marital deduction for an outright distribution to spouse in settlement of a potential intra-family dispute, whereas the decedent's will originally provided her with a mere life estate in trust. The surviving spouse's original life estate was not deductible under Section 2056 due to the lack of a qualifying general power of appointment. However, a potential dispute arose between the surviving spouse and the decedent's daughter due to the lack of a residuary clause in the will. As a result, they negotiated and executed a settlement agreement agreeing that all of the trust property and other undesignated property should be divided equally between them as tenants-in-common. The court explained that:

> Even good faith settlements of genuine adversarial will disputes do not establish that under state law, a settling party is entitled to rights under the will itself for estate tax purposes. [Hubert, supra, at 319.] Rather, a court must examine the basis for the settlement to ensure the claims on which it is grounded are valid, enforceable rights under the will. [Brandon, supra, at 499; Ahmanson Foundation, supra, at 774.] . . . Therefore, the proper focus is on the rights a widow received under the terms of the testamentary trust, not on any subsequent rights she may have received from the settlement itself.

Accordingly, because the court had concluded that the surviving spouse did not inherit an interest qualifying for the marital deduction under the will as a matter of applicable state law, the court held that no qualifying interest could pass to her under the settlement

[3] But cf. Est. of Hubert, supra (marital deduction based on settlement was not limited to amount surviving spouse would have received under will as it resulted from bona fide adversary proceeding); PLRs 9733017 (marital deduction allowed for outright distribution to spouse under settlement whereas spouse's interest under the will was held in trust); and 9610018 (marital deduction allowed for outright distribution to spouse under settlement whereas spouse's interest under the will was held in trust).

agreement. Thus, under the Carpenter analysis, if a spouse does not have an enforceable right under state law to an interest qualifying for the marital deduction prior to a settlement agreement, the agreement cannot convey a perfected interest that qualifies for the deduction.

Of course, a settlement payment to the surviving spouse must in all cases be in a form qualified for the marital deduction, regardless of the validity of a settlement that otherwise would be respected for purposes of the deduction. See United States Trust Co. v. Comr., 321 F.2d 908 (2nd Cir. 1963), cert. den'd. 376 U.S. 937 (1964) (denying the marital deduction for a trust where the surviving spouse surrendered her general power of appointment over the trust necessary to qualify under Section 2056); Tebb v. Comr., 27 T.C. 671 (1957), acq. 1957-2 C.B. 7. (denying the marital deduction for a terminable interest that surviving spouse received upon settlement of a will contest which did not satisfy the requirements under Section 2056).

B. Charitable Deduction.

Section 2055(a) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all transfers for charitable purposes. The "passing" requirement discussed above in the marital deduction context also applies to qualification for the charitable deduction. In fact, Regulation §20.2055-2(e) specifies that, generally, "[t]he principles of Section 2056 and the regulations thereunder shall apply for purposes of determining under this subparagraph whether an interest in property passes or has passed from the decedent." Thus, many of the cases and rulings addressing qualification of settlements for the charitable deduction reference authorities such as Ahmanson and the marital deduction regulations. As in the marital deduction context, the inquiry focuses on whether the transfer to charity truly "passes" from the decedent pursuant to the decedent's testamentary plan, or actually passes from other parties in settlement of a dispute. In addition, an amount passing to charity from the decedent's estate will not qualify for the charitable deduction to the extent that the charity assigns or surrenders a part of a transfer to it pursuant to a compromise agreement in settlement of a controversy. Regulation §20.2055-2(d).

The amount passing to charity pursuant to a good-faith settlement of a bona fide controversy based on an enforceable claim under state law that results in terms within the range of reasonable outcomes typically qualifies for the charitable deduction. See Hubert, supra; Est. of Warren v. Comr., 981 F. 2d 776 (5th Cir. 1993); PLRs 200032010, 9845015, 9812014. Conversely, the charitable deduction has been denied where the alleged controversy appears to be manufactured for the sole purpose of obtaining the deduction. In Burdick v. Comr., 979 F. 2d 1369 (9th Cir. 1992), the court denied the charitable deduction for a direct payment to charity in satisfaction of interest in split-interest trust. In Burdick, a charity had a remainder interest in a split-interest trust that did not qualify for the charitable deduction under Section 2055(e)(2). The taxpayer had contacted the charity a year after receiving the deficiency notice regarding the denial of the charitable deduction and proposed an immediate termination of the trust with a lump sum payment to the charity in satisfaction of its remainder interest. The charity accepted the proposal and the taxpayer attempted to deduct the lump sum payment that charity received on termination of the trust. The Burdick court agreed with the IRS in denying the charitable deduction for the payment to charity because sole purpose of termination was to obtain charitable deduction and no actual controversy existed among parties.

In addition, as in the marital deduction context, the charitable deduction has been denied where the charity had no enforceable claim to recovery under state law. The Tax Court has explained:

> [I]f the amount received by a charity under a settlement in a will contest would have been received under the will had the contest continued and the charity been successful, then the amount received under the settlement is received as an inheritance and gives rise to a charitable deduction in computing the net taxable estate. On the other hand, if no valid gift is made by the will to the charity so that the settlement is in effect a gift by an heir or devisee to the charity, the amount received by the charity under such a settlement is not a charitable deduction in computing the net taxable estate.

Est. of Morris v. Comr., T.C. Memo 1966-191, 25 T.C.M. 974

Thus, a settlement payment to a charity generally will not qualify for the charitable deduction if the testamentary plan did not provide a charitable transfer that would have provided that deduction. For example, in Terre Haute First Nat. Bank v. U.S., 67 AFTR 2d 91-1217 (S.D. Indiana, 1991), a settlement agreement resolving a will contest provided for a $250,000 charitable transfer whereas the actuarial value of the charitable gift under the decedent's will of the remainder interest in a pooled income fund was $14,746 as of his death. The court denied the charitable deduction for the actual settlement payment to the charity to extent it exceeded the original $14,746 amount that the charity would have received under the will and trust, citing Lyeth, supra, and Bosch, supra. The court reasoned that "the parties to a settlement should not be able to disregard or misapply state law and receive favorable federal estate tax benefits. The parties to a settlement are only entitled to federal estate tax deductions to the extent that they have an enforceable right under properly applied state law." The court also noted that the existence of a bona fide will dispute and arm's length negotiations among the parties in reaching the settlement could not expand the charity's enforceable interest under the original will to deduct the full settlement payment to charity. As a result, the excess amount was treated as a transfer from the decedent's heirs, instead of from the decedent, and did not qualify for the charitable deduction.[4]

In Warren, supra, the court reviewed Bosch and concluded that the relevance of a state

[4] See also Est. of Dumont v. Comr., 150 F.2d 691 (3rd Cir. 1945) (noting that charitable bequest under invalid will would not be deductible, even if other beneficiaries agreed to permit the payment of the void bequest, because the charitable transfer under those circumstances would pass "through the agreement of the residuary legatees and not under the will of the testator."); Robbins v. Comr., 111 F. 2d 828 (1st Cir. 1940) (denying the charitable deduction for settlement payment to charitable beneficiary where will provided that original charitable bequest would be determined by decedent's daughter with no specified required minimum). See also TAM 200306002; PLR 9812014 (noting that the charitable deduction is only allowable for amounts actually received by the charity and cannot exceed what the charity would have received if it had pursued its rights in litigation).

court's judgment to resolution of a federal tax question will vary. Upon reviewing the record, the Warren court concluded that the Tax Court erred in disregarding the probate court judgment where the settlement was not collusive and resolved adversarial, non-tax bona fide disputes. As a result, the court allowed the charitable deduction for the distribution to charity pursuant to the settlement. Thus, Warren reinforces the requirement that, while federal authorities are not bound by lower court determinations, they must give proper regard to the decisions of courts in state proceedings.

An issue that generated significant dispute in the past involved outright distributions to charities to settle disputes over interests in split-interest charitable trusts that did not qualify for the charitable deduction. The IRS originally refused to recognize such settlements as qualifying for the charitable deduction, adopting the position that they constituted reformations that did not comply with the requirements for an effective reformation under Section 2055. See Rev. Rul. 77-491, 1977-2 C.B. 332. The IRS retreated slightly in Revenue Ruling 78-152, 1978-1 C.B. 296, where it allowed the charitable deduction for an outright distribution to charity pursuant to settlement of will contest regarding a split-interest trust where the spouse with the life estate elected to take against the will. Finally, after losing a series of cases litigating this issue further, the IRS capitulated and issued Revenue Ruling 89-31, 1989-1 C.B. 277, providing that the charitable deduction is allowed for an immediate outright distribution to charity in settlement of a bona fide will contest regarding the charity's claim to the remainder of a split-interest trust. See Flanagan v. U.S., 810 F.2d 930 (10th Cir. 1987); Oetting v. United States, 712 F. 2d 358 (8th Cir. 1983); Est. of Strock v. U.S., 655 F. Supp. 1334 (W. D. Pa. 1987); Northern Trust Co. v. U.S., 1977 U.S. Dist. LEXIS 13038 (N.D. Ill. 1977); Rev. Rul. 89-31, supra (revoking Revenue Ruling 77-491, supra, and modifying Revenue Ruling 78-152).[5] However, the IRS warned in Revenue Ruling 89-31 that "settlements of will contests will continue to be scrutinized in order to assure that the settlement . . . is not an attempt to circumvent Section 2055(e)(2) by instituting and settling a collusive contest."

C. Claims & Expenses.

1. In general.

Section 2053 describes deductions for administration expenses, debts, taxes and claims against the estate. Any expenses that do not fall within the categories described in Section 2053(a) or (b) are not deductible for federal estate tax purposes, even if payment is authorized under local law. Treas. Reg. §20.2053-1(b)(1). The provisions of Section 2053 and tax regulations thereunder that are particularly relevant to trust and estate controversies are discussed below.

Section 2053(a) generally provides that the value of the taxable estate is determined by deducting from the gross estate amounts payable from property subject to claims for funeral

[5] But cf. PLR 200350012 (denying charitable deduction for proposed reformation to create qualified charitable remainder annuity trust because it is not a qualified reformation under Section 2055 and distinguishing Rev. Rul. 89-31 because settlement resolved dispute over decedent's brokerage account rather than a dispute regarding the trust).

expenses, administration expenses, claims against the estate and mortgages and indebtedness encumbering property which is included in the decedent's taxable estate without reduction for such mortgage or indebtedness, in each case to the extent allowable by applicable law. The deduction for such amounts is disallowed to the extent they exceed the value as of the decedent's death of "property subject to claims" and are paid after the due date for filing the federal estate tax return. Section 2053(c)(2). For purposes of Section 2053, "property subject to claims" means property included in the decedent's gross estate which would bear the burden of the payment of such deductions upon final settlement of the estate under applicable local law (typically, probate property), reduced by the amount of any deductions under Section 2054 for certain uncompensated losses. Id.

Section 2053(b) generally authorizes deductions for expenses incurred in administering properties included in the gross estate for federal estate tax purposes that are not subject to claims, to the extent they would be allowable under Section 2053(a) if the property was subject to claims.

The decision of a local court regarding the amount and allowability of a claim or expense under local law ordinarily will be accepted "if the court passes upon the facts upon which deductibility depends." However, if no evidence indicates that the court considered the claim or that the claim was in controversy, the court's decree will not necessarily be recognized to determine deductibility. Treas. Reg. §20.2053-1(b)(2). See Est. of Cole v. Comr., T.C. Memo 1989-623, 58 T.C.M 71, rev'd on other grounds, 963 F.2d 280 (9th Cir. 1992) (denying the deduction because "the record contains no evidence that the [state court] in any way passed on the merits of any of the claims here in issue and, a fortiori, how any such decisions were reached. The [state court] appeared merely to approve the claims as previously approved by the executrix. . . . [F]or all the record shows, this was not an adversarial proceeding."); Est. of Nesselrodt v. Comr., TC Memo 1986-286, 51 T.C.M. 1406 (denying the deduction because taxpayer "presented no evidence that the approval of the probate court . . . was based upon a contest of the validity of the claim that would support reliance upon [Regulation § 20.2053-1(b)(2)]. We, therefore, cannot rely upon the judgment of the probate court as proof that the claim was a valid claim.").

In addition, a court decree will not be recognized to determine deductibility if the judicial determination is inconsistent with applicable local law. See Est. of Tehan v. Comr., T.C. Memo 2005-128 (limiting the deduction for personal representative commissions to maximum amount allowable under state statute despite judicial approval of higher fees); Nesselrodt, supra (limiting deduction for remaining annual payments under separation agreement to commuted value allowed under applicable state law rather than full amount of payments allowed by probate court). Thus, if local law limits the amount of the expenditure, as is often true for attorney's fees or executor's commissions, no deduction in excess of that limitation is allowed. Id.; see also Treas. Reg. §20.2053-1(b)(1).

Administration expenses include executor's commissions, attorney's fees and other miscellaneous expenses actually and necessarily incurred in collection of assets, payment of debts and distribution of property to the proper recipients. Treas. Reg. §20.2053-3. In particular, such amounts of attorney's fees as the executor actually has paid or may reasonably be expected to be paid may be deducted on the federal estate tax return. Treas. Reg. §20.2053-3(c). If the attorney's fees claimed have not been awarded by the proper court and paid upon final audit of the return, the deduction will nevertheless be allowed if the district director is reasonably satisfied that the amount claimed will be paid and "that it does not exceed a reasonable remuneration for the services rendered, taking into account the size and character of the estate and the local law and practice." Id.

The IRS has adopted the position that if the standard under applicable state law for "reasonableness" of attorney's fees and executor's commissions is different from the "federal standard" for purposes of Section 2053, then the federal standard will be applied unless the case would be appealed to a federal Circuit Court of Appeals that has held otherwise. See TAM 8838009. The IRS has explained that the allowance of a deduction under state law is insufficient for deductibility under Section 2053, as the deduction must also be an "administrative expense" as defined for purposes of that Section under federal law. Id. The IRS reasoned that in most (but not all) cases, the federal government's interest in protecting its revenue coincides with the state's interest in protecting its citizens and state law usually will provide the appropriate measure of the federal deduction; however, a separate federal standard is required in cases where state law fails to adequately represent the federal government's interest. Id. (citing Hibernia Bank v. U.S., 581 F.2d 741 (9th Cir. 1978); Estate of Smith, 510 F.2d 479 (2nd Cir. 1975); Pitner v. U.S., 388 F.2d 651 (5th Cir. 1967)).

Expenditures that are not essential for proper settlement of the estate or are incurred for the individual benefit of heirs, legatees or devisees, may not be taken as deductions. Treas. Reg. §20.2053-3(a). Thus, attorneys' fees incurred by beneficiaries incident to litigation regarding their respective interests are not deductible if the litigation was not "essential to the proper settlement of the estate" within the meaning of the regulations, even if approved by the probate court as an expense properly payable from the estate. Treas. Reg. §20.2053-3(c)(3). Based on this criterion, courts have reviewed the nature and effect of will contests to evaluate whether the attendant costs may be deducted under Section 2053. These costs may not be deductible if the litigation does not facilitate "proper settlement of the estate" or is found to impede effective administration of the estate. See Baldwin v. Comr., 59 T.C. 654 (1973) (denying deduction for payment from estate for administratrix/beneficiary's attorney's fees paid to oppose probate of the decedent's will primarily to benefit herself, as her actions "complicated effective administration" of the estate). However, a judicial allowance of the costs of a will contest will be allowed if genuinely necessary to determine the proper distribution of the estate. See Dulles v. Johnson, 273 F.2d 362 (2nd Cir. 1959), cert. den'd, 364 U.S. 834 (1960); Est. of Reilly v. Comr., 76 T.C. 369 (1981), acq. 1981-2 C.B. 2; Est. of Pridmore v. Comr., TC Memo 1961-12, 20 T.C.M. 47.

Enforceable claims against the decedent's estate that represent personal obligations existing at the time of decedent's death, whether or not matured at that time, are deductible. Section 2053(a)(3); Treas. Reg. §20.2053-4. Thus, the claims must be enforceable under local law to be deductible. See Chagra v. Comr., T.C. Memo 1990-352, 60 CCH TCM 104 (denying deductions for unenforceable claims against the estate for gambling debts).[6] Accordingly, deductions have been denied where the controversy regarding a "claim" was not a bona fide adversarial proceeding and was instigated solely to deduct amounts for estate tax purposes. See Wolfsen v. Smyth, 223 F. 2d 111 (9th Cir. 1955); Est. of Bath v. Comr., T.C. Memo 1975-102, 34 T.C.M. 493. The executor should be able to take into account contingencies in determining the value of a deductible claim; however, if a claim is so contingent that the likelihood of ultimate payment from the estate cannot be determined, then no deduction will be allowed. See Coleman v. Comr., 52 T.C. 921 (1969), acq. 1978-2 C.B. 1 (no deduction allowed for potential obligation to return security deposit at termination of lease upon expiration of 93 years after decedent's death). See the discussion of new proposed regulations substantially expanding the guidance regarding deductibility of claims in Section IV.C.2 of this outline below.

Section 2053(c) imposes certain limitations applicable to all deductions described in Section 2053(a) or (b). In particular, the deduction for claims against the estate, mortgages or any indebtedness will be limited to the extent they were contracted bona fide and for an adequate and full consideration in money or money's worth when founded on a promise or agreement, unless the claim is founded on a promise to make a charitable gift in which case the deduction is only reduced by the amount deducted under Section 2055. Section 2053(c)(1)(A). In addition, no deduction is allowed for a claim against the estate by a remainderman relating to any property in a QTIP marital trust described in Section 2044.

Under the current regulations, the executor may deduct estimated amounts that have not yet been paid and even though the exact amount remains unknown as long as it is ascertainable with reasonable certainty and will be paid at a future date. Treas. Reg. §20.2053-1(b)(3). However, "no deduction may be taken upon the basis of a vague or uncertain estimate." Id.

2. Proposed Regulations: Deductibility of Claims.

a) Background.

The question of the proper valuation of deductible claims under Section 2053(a)(3) has been the subject of frequent litigation, leading to a current split among the Circuit Courts of Appeals. Unlike Section 2031 addressing valuation of assets in the gross estate, Section 2053(a)(3) does not specify that the deductible claim must be valued as of the date of decedent's death. Neither the Code nor the regulations provide clear guidance regarding the extent to which post-death events may be taken into consideration in valuing deductible claims for estate tax purposes.

One line of cases descends from Ithaca Trust v. Comr., 279 U.S. 151 (1929), holding that the estate tax charitable deduction for a charitable remainder interest is valued as of the

[6] However, a valid and enforceable claim informally presented to executor with the consent of the beneficiaries within statutory period was deductible because the executor could not be surcharged under those circumstances and, therefore, the claim was deemed to be enforceable under state law. Rev. Rul. 75-24, 1975-1 CB 306.

date of death.[7] Thus, courts following Ithaca have adopted valuation as of date of death for claims, generally refusing to consider events following the decedent's death in determining the properly deductible amount of the claim.[8] However, even courts valuing claims as of date of death have recognized that events after death must be taken into account in certain circumstances, such as where the claim is contested, contingent, becomes unenforceable after the decedent's death or is not formally presented for payment.

The court in Jacobs v. Comr., 34 F.2d 233 (8th Cir. 1929), cert denied., 280 U.S. 603 (1929), adopted the opposite approach after considering the Ithaca method. Instead, the Jacobs court reasoned that the legislative intent underlying Section 2053(a) was to allow deduction of actual claims, not theoretical claims. The Jacobs court distinguished Ithaca Trust by likening deductible claims to funeral and administration expenses, which the executor is never able to ascertain at the time of death and can only identify at some time afterwards. Thus, the court held that only claims presented and determined to be valid against the estate and actually paid are deductible under Section 2053(a)(3).[9] The IRS has generally adopted the Jacobs approach, in taking account of post-death events and limiting deductions to enforceable claims that are actually paid. See Rev. Rul. 60-247, 1960-2 CB 272 (denying a deduction for claims against the estate which have not been or will not be paid because creditor waives payment, fails to timely file claim or otherwise fails to enforce claim, but providing an exception for claims in favor of the sole beneficiary of the estate where formal presentation and formal payment are "futile acts.").

Citing the lack of consistency among the authorities governing the proper identification and valuation of deductible claims, the IRS recently promulgated new proposed regulations under Section 2053.[10] As noted in the preamble, these Proposed Regulations reflect the premise that an estate may only deduct amounts actually paid in settlement of claims against the estate. If the resolution of a contested or contingent claim cannot be accomplished with finality prior to the expiration of the period of limitations for claims for refund of estate tax, the executor must file a protective claim for refund to preserve the right to claim a deduction under Section 2053(a)(3). Overall, the Proposed Regulations reflect the general approach reflected across deductions that settlements are only accepted if they result

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[7] See Est. of McMorris v. Comr., 243 F.3d 1254 (10th Cir. 2001); O'Neal v. Comr., 258 F.3d 1265 (11th Cir. 2001); Est. of Smith v. Comr., 98 F.3d 515 (5th Cir. 1999).

[8] See Est. of Smith v. Comr., 198 F.3d 515 (5th Cir. 1999), rev'g 108 T.C. 412 (1997); on remand, T.C. Memo 2001-303, aff'd per curiam in unpub. opin., 90 AFTR2d 2002-7445 (5th Cir. 2002), nonacq. AOD 2000-04, 2000-19 I.R.B. (distinguishing Ithaca Trust on the basis that it involved a §2055 charitable deduction); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) (also basing conclusion in part on the reference to "time of death" in Regulation §20.2053-4); Greene v. U.S., 447 F. Supp. 885 (N.D. Ill. 1978); Russell v. U.S., 260 F. Supp. 493 (N.D. Ill. 1966); Winer v. U.S., 153 F. Supp. 941 (S.D. N.Y. 1957).

[9] See also Will of Carrie Jacobs Brown v. Comr., 95 F. 2d 1006 (6th Cir. 1938); Est. of Metcalf v. Comr., 7 T.C. 153 (6th Cir., 1947); Est. of Greenberg v. Comr., 76 T.C. 680 (1981); Est. of Courtney v. Comr., 62 T.C. 317 (1974); Est. of Hagmann v. Comr., 60 T.C. 465 (1973), aff'd per curiam, 492 F.2d 796 (5th Cir. 1974); Est. of DuVal v. Comr., 4 T.C. 722, aff'd. 152 F.2d 103 (9th Cir. 1945), cert. den'd. 328 U.S. 838 (1946); Est. of Nesselrodt v. Comr., 51 T.C.M. 1406 (1986).

[10] Guidance Under Section 2053 Regarding Post-Death Events, Notice of Proposed Rulemaking REG-143316-03, 72 Fed. Reg. 20080 (April 20, 2007).

from bona fide negotiations between adverse parties with valid claims enforceable under state law.

The Section of Real Property, Probate and Trust Law of the American Bar Association submitted detailed comments regarding the Proposed Regulations (the "RPPT Section Comments") in response to the Treasury Department's request for comments from the public.

b) Deductions: General Rule.

Treasury Regulation §20.2053-1 generally applies to all deductions under Section 2053. The preamble notes that the major purpose in issuing the Proposed Regulations is to require that post-death events be considered in determining the amounts deductible under Section 2053. To implement this new approach, Proposed Regulation §20.2053-1(b)(1) now limits deductions under Section 2053 to "the total amount actually paid."

c) Effect of Court Decree.

Proposed Regulation §20.2053-1(b)(2)(i) permits the executor to rely on certain final judicial decisions regarding expenditures for expenses and claims to determine the deductible amount. Section 2053(a) permits deductions for expenses and claims only if they are "allowable by the laws of the jurisdiction . . . under which the estate is being administered." Accordingly, both the existing and Proposed Regulation require that the decree must be consistent with local law, providing that "if the decision reached by the court is inconsistent with local law, the estate may not rely on the court's decree to establish the amount deductible for estate tax purposes." However, the consistency requirement effectively eliminates the regulation's authorization for executors to rely on judicial decrees as the executor may be required to retry the local law substantive issues with the IRS. To minimize such retrials, the RPPT Section Comments recommended that the entry of the decree should initially establish the deductibility of the claim or expense and shift the burden of proof on this issue to the IRS.

d) Effect of Consent Decree.

Proposed Regulation §20.2053-1(b)(2)(ii) permits the executor to establish a deductible amount in certain cases by relying on a "local court decree rendered by consent." This rule requires consent that is "a bona fide recognition of the validity of the claim." Consent given "by all parties having interests adverse to that of the claimant will be presumed to be recognition of the claim's validity." However, parties seeking to resolve litigation will often consent to entry of an agreed order disposing of the matter without affirmatively conceding the validity of any other party's claim. For example, an executor may conclude that a consent decree best preserves the estate for its beneficiaries after evaluating the likelihood and potential amount of any recovery on a claim and the costs of defending against the claim. Thus, an executor may consent to a decree to resolve the dispute while declining to acknowledge the validity of the claim. To preclude the IRS from denying the validity of the consent decree due to the lack of affirmative concession of validity from a single party, the RPPT Section Comments suggested that consent by any one or more parties with interests adverse to that of the claimant should suffice to establish the claim's validity. Interestingly, the Proposed Regulations omit the existing requirement that a consent decree that is relied on to establish a deduction must be consistent with local law. This omission presumably was an oversight that will be remedied in the Final Regulations.

e) Effect of Settlement Agreement.

Proposed Regulation §20.2053-1(b)(3) permits the executor to rely on certain settlements to establish deductible amounts. This Proposed Regulation requires that a settlement that may be relied upon must be "within the range of reasonable outcomes under applicable state law" and provides that this requirement will be satisfied if the settlement "results in a compromise between the positions of . . . adverse parties' and reflects the parties' assessments of the relative strengths of their respective positions." The settlement between adverse parties defending their respective interests, by itself, should adequately evidence that the settlement is within the range of reasonable outcomes without adding a requirement based on the state of mind of the parties.

The Proposed Regulation also requires that the settlement be consistent with local law and denies deductions for amounts paid to settle an unenforceable claim. This requirement is likely to be particularly burdensome for settlement agreements because they often specify that no party acknowledge the merits of any other party's claims or representations. In addition, an executor may believe that a claim has little merit, but may decide that prudence requires settlement to preserve the estate for its beneficiaries. Finally, the enforceability of a claim may remain an open question unless the executor litigates the claim to final judgment, exhausting all appeals and other procedural remedies. To minimize the resulting costs and delay of such litigation and to minimize the retrial of local law issues with the IRS, the RPPT Section Comments suggested that a settlement agreement that satisfies the other requirements of this provision should initially establish the deductibility of the claim or expense and shift the burden of proof on this issue to the IRS.

Proposed Regulation §20.2053-1(b)(3) also requires that the settlement be the product of arm's length negotiations. Parties to intra-family disputes may have unique difficulty in establishing that a settlement results from arm's-length negotiations. Family members have independent motives to seek resolution while minimizing acrimony and maintain family harmony, even as they engage in a genuine dispute regarding a bona fide issue and wish to protect their respective interests. Uncertainty that a private settlement will suffice under this regulation will create incentives to seek judicial review to obtain the protection of a court decree, which does not require evidence of arm's-length negotiations under the Proposed Regulations. The RPPT Section Comments suggested that this requirement be eliminated for settlement agreements that satisfy the other requirements under the Proposed Regulations, which should suffice to establish the legitimacy of the settlement agreement.

f) Exception to Actual Payment Rule: Unpaid Estimated Amounts.

Proposed Regulation §20.2053-1(b)(4) creates a limited exception to the actual payment rule for a "claim that satisfies all applicable requirements even though its exact amount is not then known, provided that the amount is ascertainable with reasonable certainty, and will be paid." This exception does not specify that it applies to "expenses" as well as claims, or to future payments of claims the exact amounts of which are known, both categories that seem logical to include in the exception. It is unclear whether these omissions were deliberate or simply oversights that will be remedied in the Final Regulations. The RPPT Section Comments requested additional criteria to determine whether an amount is "ascertainable with reasonable certainty" to enhance the usefulness of this exception.

g) Deductions for Administration Expenses of Estate.

Proposed Regulation §§20.2053-3(b)-(c) maintain the deductions for executor's commissions and attorneys' fees, but both subsections state that the deduction is limited to amounts that are paid in accordance with local practice for estates of similar size and character in the absence of judicial authorization of the payment.

Proposed Regulation §20.2053-3(d)(3) provides that "[e]xpenses incurred in defending the estate against claims described in section 2053(a)(3) are deductible as provided in §20.2053-1 if the expenses are incurred incident to the assertion of defenses to the claim available under the applicable law, even if the estate is not ultimately victorious." The Final Regulations may clarify whether costs of litigating other amounts deductible under Section 2053(a), such as funeral expenses and administration expenses, or whether expenses incurred in connection with prosecution (as well as defense) of the estate's legitimate claims are also deductible.

h) Deduction for Claims Against the Estate.

Proposed Regulation §20.2053-4 addresses the deduction for unsecured claims against the estate and significantly expands current Regulation §20.2053-4. However, the Proposed Regulations did not make parallel changes to current Regulation §20.2053-7, addressing the deduction for claims secured by property included in the gross estate. The RPPT Section Comments suggested the amendment of Treasury Regulation 20.2053-7 to maintain consistent requirements for both secured and unsecured claims.

Proposed Regulation §20.2053-4(a)(1) provides that deductions for claims representing the decedent's personal obligations at the time of his death that are bona fide, legitimate and enforceable are only permitted when the claim is actually paid. This Proposed Regulation expressly recites that "[e]vents occurring after the date of a decedent's death shall be considered when determining the amount deductible against a decedent's estate." The rule may produce especially unfair results when a claim against a decedent's estate is interdependent with the valuation of an asset included in the estate, which must be valued as of the date of death. This conflict is clearest in comparing valuations of a counterclaim owned by the estate and a claim against the estate (though the problem may arise with any property directly underlying the valuation of the claim). Intervening events after death and before payment of the claim may diminish or eliminate the value of the claim against the estate and the corresponding deduction, which also would have reduced the value of the estate's counterclaim.

For example, assume that A is the primary manufacturer of widgets. Competitor C sued A for patent infringement. A responded with a general denial and a counterclaim against C for theft of trade secrets. A died while such litigation remains ongoing. A's counterclaim against C is included in A's gross estate at its estimated value as of the date of A's death. C's claim against A was not paid or sufficiently ascertainable prior to the due date for filing the federal estate tax return to take a deduction under the Proposed Regulations. Accordingly, A's executor E did not take a deduction for it on A's estate tax return and files a protective claim for refund describing the claim. Several years later, after a trial in which neither A's estate nor C was able to prove the validity of their respective claims, the claim and the counterclaim were dismissed As a result C's claim and A's counterclaim are worthless. Because no payment will be made on C's claim, no deduction for it will be available to offset the value of A's counterclaim as of the date of death which was included in A's gross estate.

This inconsistency in valuation methods unfairly subjects the taxpayer to estate tax on the estimated value of a counterclaim or other asset without a corresponding deduction for a separate claim *against* the estate based on the same property interest or subject matter. The RPPT Section Comments suggested an exception to permit a deduction of a claim valued as of the date of death if it is substantially related to the value of an asset included in the taxable estate.

Proposed Regulation §20.2053-4(b)(1) denies any deduction for the payment of a "potential or unmatured claim." However, without additional guidance regarding the definition of these terms, the scope of claims described in this regulation is unclear.

Proposed Regulation §20.2053-4(b)(2) denies any deduction for a claim "to the extent the estate is contesting the decedent's liability" and indicates by cross-reference to Proposed Regulation §20.2053-1(b)(4) that the exception for unpaid estimated amounts could apply to permit a current deduction for contested claims. However, it may be difficult to fulfill the criteria for that exception requiring reasonable certainty of payment for any claim subject to ongoing dispute or litigation.

Proposed Regulation §20.2053-4(b)(3) provides that if the decedent or the decedent's estate is only one of multiple parties against whom the claim is being asserted, then the estate may only deduct the portion of the total claim due from and paid by the estate and reduced by the total amount of any reimbursement from other sources. In addition, the deduction will be reduced by the amount that "the estate could have collected from another party or an insurer but which the estate declines or fails to attempt to collect." Id. However, such reduction will not apply if the executor establishes that the burden of collection efforts would have outweighed the resulting benefit.

i) Claims by Family Members, Related Entities, or Beneficiaries.

Proposed Regulation §20.2053-4(b)(4) attempts to prevent collusive agreements by creating a rebuttable presumption that claims by, or settlements among, the decedent's family members, a related entity, or a beneficiary of the decedent's estate or revocable trust are not legitimate and bona fide and, therefore, such claims or claims payable pursuant to such settlements are not deductible.[11] Treasury has previously abandoned attempts to implement

[11] Prop. Treas. Reg. §20.2053-4(a)(4). "Family members" include grandparents, parents, siblings, and lineal descendants of the decedent or of the decedent's spouse; and the spouse and lineal descendants of any such

family attribution rules that impose different and more onerous rules on related family members for transfer tax purposes after meeting judicial resistance.[12] This presumption subjecting related persons to a greater burden than other similarly situated taxpayers may be unnecessary given that the other requirements for deductions should suffice to prevent abuse. However, if the Final Regulations maintain this presumption, the evidence sufficient to rebut the presumption under the Proposed Regulations ("evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons or non-beneficiaries") may be particularly difficult to obtain in many intra-family disputes. Additional guidance regarding the kind of evidence sufficient to rebut the presumption would be helpful in the Final Regulations.

j) Recurring Payments.

Proposed Regulation §20.2053-4(b)(7) distinguishes between contingent and noncontingent recurring obligations. Proposed Regulation §20.2053-4(b)(7)(i) requires that recurring payments on *non-contingent* obligations likely to continue beyond the final determination of the estate tax liability be deducted at discounted present value. However, Proposed Regulation §20.2053-4(b)(7)(ii) allows recurring payments on contingent obligations to be deducted in the amounts actually paid, without being discounted to present value. This difference in valuation seems unwarranted and may motivate taxpayers to include remote and unlikely contingencies in their obligations if a deduction at the full, undiscounted value of payments will be advantageous. Instead, a consistent valuation rule applicable to all recurring payment obligations would seem appropriate.

Example 7 of Proposed Regulation §20.2053-4(b)(7) also requires clarification regarding the application of this rule. Example 7 describes an estate owing 7 non-contingent annual payments under a divorce decree after a decedent's death. The example states that the executor makes the initial payment before the estate tax return is filed estate and may deduct "these payments" at discounted present value. However, the full amount of the first payment may be deductible as a claim that was actually paid. The Final Regulations may clarify whether a payment due to a non-contingent obligation that is actually made prior to the date of filing the federal estate tax return can be deducted at full value.

The only option under the Proposed Regulations for satisfaction of a recurring obligation (whether contingent or non-contingent) is the purchase of a commercial annuity. See Proposed Regulation §20.2053-4(b)(7)(iii). However, this alternative will be prohibitively expensive in many cases and the pricing designed to produce profits for the commercial providers might distort the parties' relative economic interests in the estate. A negotiation among the parties with adverse interests to agree upon an appropriate amount to satisfy an obligation to make recurring payments may conserve the estate assets and reflect the parties'

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grandparent, parent and sibling. A "related entity" is an entity in which the decedent, directly or indirectly, had a beneficial ownership interest at the time of death or any time during the prior 3-year period, but excluding publicly traded entities or closely-held entities in which the combined beneficial interest, direct or indirect, of the decedent an decedent's family collectively is less than 30% of the beneficial ownership interests, whether voting or non-voting.

[12] *See, for example,* Rev. Rul. 93-12, 1993-1 CB 202

economic interests more effectively. The RPPT Section Comments requested alternative means of satisfying recurring obligations that would be deductible under Section 2053(a)(3).

k) Claims for Refund.

The Proposed Regulations will require executors encountering post-death litigation regarding claims to pay greater amounts of estate tax initially and rely increasingly on protective claims for refund to recover amounts due once the claim is resolved and paid.[13] In fact, the Proposed Regulations specifically direct taxpayers to seek relief by filing protective claims when the amount of the claim cannot be estimated with reasonable certainty or when potential or unmatured claims have not yet ripened sufficiently to be determined. Given the anticipation of a significant increase in the circumstances where claims for refund will be necessary to preserve potential deductions under Section 2053, the IRS should consider revising the United States Estate (and Generation-Skipping Transfer) Tax Return Form 706 ("Form 706") and its instructions to alert executors to the need to make such claims, and to facilitate the submission of such claims.

In addition, Treasury and the IRS historically have asserted the variance doctrine as a defense against refunds based on grounds that allegedly were not described in sufficient detail in the original claims for those refunds.[14] When the government successfully asserts the defense of variance, the claim is barred for lack of judicial subject matter jurisdiction over theories or claims that were not adequately described in the claim. However, if the Final Regulations generally adopt the restrictions under the Proposed Regulations on current deductions, the executor will be filing protective claims for refund that attempt to describe claims against the estate due to the very fact that they could not be identified or determined with certainty. For example, the executor may not know the specific theory of recovery or parties who may receive the refund as proper takers in the executor's place upon the ultimate resolution of the claim against the estate. As a result, the protective claims for refund may not be as specific as most claims for refund in the normal course of estate administration. To avoid forcing the taxpayer into a "no-win" position, the Final Regulations could expressly waive the doctrine of variance that the government otherwise may assert when the executor attempts to recover on a protective claim for refund to deduct an actual payment of an otherwise deductible claim.

l) Executor's Duties to Report and Pay Additional Tax.

The Proposed Regulations impose upon the executor the duties to notify the Commissioner and pay additional tax in several cases in which a deduction under Section 2053 is allowed in advance of payment and the payment is thereafter waived or otherwise unpaid. See Proposed Regulation §2053-1(b)(4) (reasonably certain estimated amounts),

[13] A claim for refund must be filed within the later of three years after the return is filed, or two years from the time the tax is paid. Code §6511(a). The amount of tax that can be refunded is limited to the amount of tax paid within that same period. Code §6511(b)(2).

[14] The variance doctrine is based on Code §7422(a).

§2053-3(b)(3) (executor's commissions),[15] §2053-6(g) Example 2. However, final determination of a claim against the estate may occur after the IRS issues a closing letter regarding the federal estate tax return. An executor typically distributes the estate to appropriate takers upon receipt of the closing letter from the IRS when the executor reasonably may conclude that no additional estate tax remains due. However, the Proposed Regulations indicate that the executor could remain liable for payment of estate tax for an indefinite period and could suggest that the executor must continue to monitor or seek facts verifying whether the deducted claim ultimately will be waived or unpaid. This uncertainty may discourage executors from making distributions that facilitate proper, efficient estate administration.

Under Section 3713 of Title 31 of the United States Code, a fiduciary can be personally liable for payment of taxes to the extent that estate assets are insufficient. Thus, the IRS still may recover estate tax directly from an executor acting in bad faith who knows that additional estate tax remains due when distributing the subject property to third parties. Under Code §6324, the IRS also may recover estate tax from the transferees receiving the distributions for ten years after the decedent's death, even after discharge of the executor. Given that the IRS retains the ability to recover the estate taxes after distribution in the course of estate administration, the Final Regulations could clarify that an executor may distribute property subject to payment of estate tax upon receipt of the closing letter without personal liability. Any subsequent obligation to pay estate tax pursuant to the Proposed Regulations would continue to apply to property remaining in the executor's possession or control when the obligation arises. The Final Regulations also could clarify that the executor must notify the Commissioner and pay additional tax after the issuance of the closing letter only at such time when the executor actually knows, or knows facts that would lead a reasonable person to inquire as to whether, the deducted claim will be waived or unpaid. These clarifications would relieve the executor from indefinite liability for payment of estate tax and reporting obligations and promote expeditious estate administration without undue prejudice to the IRS.

m) <u>Effect on Marital and Charitable Deductions</u>.

Many testamentary plans provide for disposition of the residue intended to qualify for the marital or charitable deduction. The Proposed Regulations do not address the effect of these new rules on the amount of such marital or charitable deductions when the executor is unable to take deductions immediately because the amounts at issue are uncertain, contested or unmatured. If the Proposed Regulations deny such deductions on the federal estate tax return as if they will never be realized, then fairness would seem to require that such amounts should not reduce the marital or charitable deduction on the federal estate tax return. Instead, adjustments to the marital and charitable deductions could be made at such time when the deductions under Section 2053 are finalized, if ever, upon payment of the claim or expense. Alternatively, if the Final Regulations require a reduction of the marital or charitable deduction due to claims or administrative expenses under Section 2053 that are not

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[15] The Section notes that Proposed Regulation §2053-3(c) regarding attorney's fees does not include a provision requiring notification and payment of additional tax parallel to such provision under Proposed Regulation §2053-3(b)(3) regarding executor's commissions. This disparity may be remedied in the Final Regulations.

immediately deductible, the executor should be allowed to preserve the right to recover the benefit of the full marital or charitable deduction with a protective claim for refund.

More importantly, the marital or charitable deduction may be difficult to preserve to the extent that the Final Regulations under Section 2053 postpone final determination of the deductions for claims and expenses. Under the Proposed Regulations, the marital or charitable deduction for residuary dispositions may always be subject to change, depending on whether the Section 2053 deduction ultimately is allowed and recovered. However, marital and charitable transfers generally must be fairly certain in amount and likelihood to qualify for the corresponding deductions. These deductions generally will be denied for conditional transfers unless the likelihood that the transfer will not occur is so remote as to be negligible.

For example, Section 2056(b) and Treasury Regulation §2056(b)-1(b) define a "terminable interest" in property as "an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency." A marital residuary transfer subject to potential future adjustment for Section 2053 deductions may constitute a non-deductible terminable interest. Similarly, Treasury Regulation §2055-2(b)(1) addressing the charitable deduction provides:

> If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity at the time of a decedent's death and the estate or interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appeared at the time of the decedent's death to be so remote as to be negligible, the deduction is allowable.

Thus, a charitable residuary transfer subject to potential future adjustment for Section 2053 deductions may constitute a conditional transfer that does not qualify for the charitable deduction, unless the executor can establish that the likelihood of obtaining the pending Section 2053 deduction is so remote as to be negligible. It is unclear whether the amount of the disallowance of the marital or charitable deduction would be limited to the maximum potential amount of the postponed Section 2053 deduction, or would encompass the entire transfer. If the Final Regulations under Section 2053 limit deductions to amounts actually paid, then Treasury must reconcile those regulations with the regulations under Section 2055 and 2056 and the statutory language of Section 2056 describing nondeductible terminable interests to ensure fair coordination of those rules.

V. <u>GST Tax</u>

In addition to the gift tax or estate tax, Section 2601 generally imposes a GST tax on each "generation-skipping transfer" – generally transfers that convey property directly to or in trust for donees two or more generations below the transferor. The GST tax is imposed on each dollar of the transfer at a flat rate equal to the highest federal transfer tax rate in effect when the transfer occurs. Consequently, the costs arising from the failure to consider the GST tax consequences of settlements that provide for severances or other changes to trusts exempt from GST tax can be unusually costly, particularly where trusts may endure for several generations and otherwise could have escaped transfer taxes at each generation. Settlement agreements that might change or otherwise affect GST exempt trusts with an inclusion ratio of 0, or trusts that are entirely grandfathered and not subject to GST tax, should be carefully structured to avoid exposing exempt trust property to GST taxation.

A. Qualified Severances.

The terms of a settlement may provide for division of a trust that is partially or wholly exempt from GST tax due to prior allocations of GST exemption to transfers to the trust. Under the law prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[16], the only severances recognized for GST purposes were those dividing single trusts already treated as separate trusts under Section 2654(b), based on the different beneficiaries' separate and independent shares or its multiple transferors.[17] Thus, if a single trust was severed into separate trusts recognized under applicable state law to resolve disputes among interested parties, the severance was not recognized for GST tax purposes and parties would remain yoked together for GST tax purposes. In addition, even if the severance of a single trust with an inclusion ratio between zero and one was recognized, it resulted in separate trusts with the same inclusion ratio as the original single trust.[18]

EGTRRA introduced Section 2642(a)(3), which describes "qualified severances" that will result in trusts that will be treated as separate trusts thereafter for GST purposes.[19] In addition, certain severances of trusts with inclusion ratios between zero and one will result in separate trusts with inclusion ratios of zero and one. Section 2642(a)(3) applies to severances occurring after December 31, 2000. Section 2642(a)(3) also states that the trusts resulting from a qualified severance will be treated as separate trusts "thereafter" for GST tax purposes, indicating that the qualified severance becomes effective at the time when it occurs.[20]

On August 2, 2007, the Treasury Department issued both Final Regulations (T.D. 9348) and Proposed Regulations (Notice of Proposed Rulemaking REG-128843-05, 72 Fed. Reg. 48249 (August 2, 2007)) relating to qualified severances, to be effective from August 2, 2007.

1. Definition of Qualified Severance.

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[16] P.L. 107-16, 107th Cong., 1st Sess. (June 7, 2001).

[17] See Treas. reg. §26.2654-1(a)(3), including Example 8.

[18] Transfers from a trust with an inclusion ratio of 0 are not subject to GST tax, whereas transfers from a trust with an inclusion ratio of one are fully subject to GST tax.

[19] Section 2642(a)(3) permits the issuance of regulations describing severances in addition to those described in the statute that will be treated as "qualified severances."

[20] In contrast, Regulation §26.2654-1(b)(1) recognize some severances of trusts included in a transferor's taxable gross estate as "retroactive" to the date of death, even if the severance is not complete at the time of death or the due date of the federal estate tax return.

Regulation §26.2642-6(b) itemizes the requirements for a qualified severance:

(1) The severance of a single trust (other than a division described in Regulation §26.2654-1(b) which addresses divisions of trusts included in the transferor's gross estate) pursuant to the governing instrument or applicable local law.

(2) The severance is effective under local law. Section 2642(a)(3) states that "any means available under" local law or the trust instrument will be effective. Accordingly, even in the absence of the specific power to sever in the trust instrument or state statute, a severance by judicial order or other means available under local law should suffice for purposes of Section 2642(a)(3).

(3) The date of severance is either the date selected by the trustee as of which the trust assets are to be valued to fund the resulting trusts, or the court-imposed date of funding where the local court with jurisdiction over the trust has ordered the trustee to fund the resulting trusts on or as of a specific date. However, a date will only qualify under the regulation if funding must commence immediately, and funding must occur within a reasonable time (but in no event more than 90 days) after, that selected valuation date. This provision acknowledges the practical impossibility of valuing all of the trust assets, making allocation decisions and completing the actions necessary to transfer assets to fund a non-pro rata division on the same day. However, the regulation does not require notice to the Internal Revenue Service or otherwise detail how the trustee will evidence the selection of the valuation date. Example 11 under the Final Regulations illustrates the operation of this funding provision.

(4) The single trust (original trust) is severed on a fractional basis, such that each new trust (resulting trust) is funded with a fraction or percentage of the original trust, and the sum of those fractions or percentages is one or 100 percent, respectively. The regulation expressly authorizes the use of a formula to determine this fraction or percentage and the non-pro rata division of assets among the resulting trusts based on the fair market value of the assets on the date of severance. However, if funding on a non-pro rata basis, "each resulting trust must be funded by applying the appropriate fraction or percentage to the total fair market value of the trust assets as of the date of severance." Example 5 under the Final Regulations illustrates the method of funding the resulting trusts that conforms to these Final Regulations as required for a qualified severance. The severance of a trust based on a pecuniary amount will not constitute a qualified severance.

(5) The terms of the resulting trusts must provide, in the aggregate, for the "same succession of interests" of beneficiaries as are provided in the original trust. This requirement is satisfied if the beneficiaries of, and their respective beneficial interests in, the original trust remain the same after the severance in the resulting separate trusts when those resulting trusts are viewed collectively.

Thus, the terms of the trusts resulting from a qualified severance are not required to be identical, as long as the trusts collectively preserve the beneficial interests under the original single trust. However, state statutes, to the extent they address trust severances at all, typically require that resulting trusts remain governed by terms "identical" to those terms governing the original, single trust. Thus, a judicial reformation may be required to sever a trust on terms that differ from the original trust if the applicable local law and trust instrument lack express authorization for divisions resulting in trusts with different terms.

Most rulings to date applying Section 2642(a)(3), prior to the issuance of the recent Final Regulations, involve qualified severances resulting in separate trusts with terms identical to the original trust, in most cases because the taxpayers severed pursuant to a state statute or governing instrument authorizing severances on identical terms.[21] Thus, most rulings involving qualified severances have not addressed how trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3). However, the Examples under new Regulation §26.2642-6(j) provide additional guidance in this respect.

Example 1 under the new qualified severance regulation parallels Example 1 under Regulation §26.2654-1(b)(1), as the latter similarly requires preservation of the same succession of beneficial interests after severance of a trust included in the transferor's estate or created under the transferor's will.[22] Thus, the preamble to the regulations under Section 2654 may provide helpful guidance that similarly applies to interpretation of this requirement for qualified severances:

> The Final Regulations provide that the trusts resulting from the severance of a single testamentary trust need not be identical. Thus, if the trust provides income to spouse, remainder to child and grandchild, the trust may be severed to create 2 trusts, 1 with income to spouse, remainder to child and a second with income to spouse remainder to grandchild. This result could be achieved through proper estate planning in any event. However, the regulations make it clear that the resulting trust must provide for the same succession of interests as provided for under the original trusts. Thus, a trust providing for an income

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[21] *__See__* PLRs 200713002, 200713001, 200502036, 200451021, 200441022, 200429004, 200408014, 200403072, 200519008, 200508001, 200502036, 200451029, 200451021, 200441022, 200352011, 200351010, 200340015, 200223016, 200213014. In numerous instances, a trust for which the qualified terminable interest property ("QTIP") election under Section 2056(b)(7) was made is severed on identical terms because the severance is required solely to facilitate an effective reverse QTIP election under Section 2652(a)(3). *__See__* 200540007, 200519008, 200508001, 200451029, 200443025, 200441022.

[22] Example 1 of Regulation §26.2642-6(j) addressing qualified severances parallels the following Example 1 of Regulation §26.2654-1(b)(1), in each case illustrating a trust severance that preserves the succession of beneficial interests in the original trust:

> Example 1. Severance of single trust. T's will establishes a testamentary trust providing that income is to be paid to T's spouse for life. At the spouse's death, one-half of the corpus is to be paid to T's child, C, or C's estate (if C fails to survive the spouse) and one-half of the corpus is to be paid to T's grandchild, GC, or GC's estate (if GC fails to survive the spouse). If the requirements of paragraph [Regulation §26.2654-1](b) of this Section are otherwise satisfied, T's executor may divide the testamentary trust equally into two separate trusts, one trust providing an income interest to spouse for life with remainder to C, and the other trust with an income interest to spouse for life with remainder to GC. Furthermore, if the requirements of paragraph [Regulation §26.2654-1](b) of this Section are satisfied, the executor or trustee may further divide the trust for the benefit of GC. GST exemption may be allocated to any of the divided trusts.

interest to a child, with remainder to a grandchild, could not be divided into 1 trust for the child (equal in value to the child's income interest) and another for the grandchild.

As indicated in the preamble to Regulation §26.2654-1, Example 3 under Regulation §26.2642-6(j) precludes the "horizontal" division of trusts based on the actuarial value of the respective beneficiaries' temporal interests. The Final Regulations regarding qualified severances also provide several additional examples to illustrate the extent to which trusts may differ from the original trust without changing the succession of beneficial interests under the original single trust for purposes of Section 2642(a)(3).

The Final Regulations describe in particular certain severances of wholly discretionary trusts from which distributions may be made to any one or more beneficiaries on a non-pro rata basis that will satisfy this "same succession of beneficial interest" requirement if:

(i) The terms of each resulting trust are the same as the terms of the original trust, though each permissible beneficiary of the original trust is not a beneficiary of all of the resulting trusts;

(ii) Each beneficiary's interest in the resulting trusts (collectively) equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, "on a per-capita basis;"

(iii) The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation (as determined under Section 2651) than the person or persons who held the beneficial interest in the original trust; and

(iv) The severance does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in (or applicable to) the original trust.

The regulation provides an example of a severance of a wholly discretionary trust that maintains the "same succession of beneficial interests." A discretionary trust for the benefit of A, B, and C and their descendants with the remainder to be divided equally among those three families is severed into three separate trusts of equal value: one for the benefit A and A's descendants, one for the benefit of B and B's descendants, and one trust for the benefit of C and C's descendants. This example for severances of discretionary trusts parallels Example 5 under Regulation §26.2601-1(b)(4)(E) addressing permissible modifications of trusts grandfathered from application of the GST tax that will not subject the trusts to such tax.

This provision authorizing certain severances of discretionary trusts facilitates divisions of trusts along family lines, which are often important means of resolving family disputes. However, several aspects of this rule require additional clarification. Under the example, the meaning of "per capita" for purposes of this rule is unclear. If A, B and C described in the example are the transferor's children, then a per capita division treats each family line equally and likely reflects the intention of most transferors or interested parties. However, if A is the transferor's child while B and C represent the transferor's grandchildren born to a deceased child who was A's sibling, then the example results in the allocation to A's trust of only one-half the amount of property allocated to the trusts held for members in A's sibling's family. The division of property "per capita" may significantly differ among separate family lines based on the chance order of deaths of family members and the number of children each individual chooses to have. In contrast, experience suggests that transferors and parties negotiating resolutions to disputes regarding the division of trust property typically prefer a "per stirpes" division of property that preserves the shares of property allocated to each family line, beginning with a per capita division at the children's generation. If such per stirpes division was actually contemplated in this provision, then a technical correction might revise the reference to clarify that a per stirpes measure of the beneficiaries' interests after the severance is appropriate.

The Final Regulations also do not express whether a severance along family lines must preserve current or remainder interests in all resulting trusts so that the members of each family line may resort to the other trusts upon exhaustion of the trust originally held for that family's benefit. This example within Regulation §2642-6(d)(5)(ii) does not appear to require that each of A, B and C and their respective descendants maintain interests in all of the trusts resulting from the severance to the extent that any single trust is exhausted. However, Examples 2 and 7 of the Final Regulations illustrating qualified severances recite facts showing that the beneficiaries retain their interests in the remainders of both trusts resulting from the severance in the event a single trust is exhausted. However, without specific discussion, the Final Regulations remain unclear as to whether the preservation of the original beneficiaries' interests in all of the post-severance trusts is required for a qualified severance.

In addition, the Final Regulations do not provide extensive guidance regarding the standards for the exercise of discretion that would meet the definition of a discretionary trust for purposes of this exception. Example 2 addressing this exception merely states that the trustee may distribute "as the trustee deems advisable." Hopefully, this absolute discretion without qualification is not the only type that satisfies this exception and other discretionary standards considered similarly non-ascertainable for transfer tax purposes (i.e., "best interests and welfare," "comfort" or "happiness") will suffice.

(6) In the case of a qualified severance of a trust with an inclusion ratio as defined in section 26.2642-1 of either one or 0, each trust resulting from the severance will have an inclusion ratio equal to the inclusion ratio of the original trust.

(7) A trust with an inclusion ratio between zero and one must be severed initially into two trusts. One resulting trust must receive that fractional share of the total value of the original trust as of the date of severance equal to the applicable fraction and will have an inclusion ratio of zero. The other resulting trust must receive the remaining fractional share of the original trust and will have an inclusion ratio of one. However, if the applicable fraction of the original trust is .50, the trustee may designate which of the resulting equal trusts will have an inclusion ratio of zero and of one. The regulation confirms that each resulting trust may be further divided in additional qualified severances to create further separate trusts.

2. Qualified Severances of "Grandfathered" Exempt Trusts.

Section 2642(a)(3) addresses the recognition of the creation of separate trusts resulting from a qualified severance for GST tax purposes. However, the GST tax rules, including those authorizing qualified severances, do not apply at all to an "exempt trust" that is grandfathered from the imposition of GST tax.[23] Instead, Regulation §26.2601-1(b)(4) (discussed further below in Section V.B of this outline) describes rules for determining whether a modification, judicial construction, settlement agreement, or trustee action with respect to an exempt trust will cause it to lose its exempt status. Thus, a severance of an exempt trust must satisfy those rules to avoid becoming subject to GST tax.

However, where contributions are added to a grandfathered trust after September 25, 1985, Regulation §26.2601-1(b)(1)(iv)(A) deems the trust to consist of one separate share attributable to contributions before such date that is not subject to GST tax (the "non-chapter 13 portion") and another separate share attributable to contributions after such date that is subject to GST tax (the "chapter 13 portion"). Regulation §26.2642-6(g) confirms that any such trust may be severed into two trusts in accordance with Regulation §26.2654-1(a)(3) to segregate the non-chapter 13 portion from the chapter 13 portion, and that the trust holding the chapter 13 portion may be further divided by qualified severance.

3. Reporting requirements.

Regulation §26.2642-6(e) details the information necessary to report a qualified severance to the IRS. The regulation does not require that a qualified severance be reported to be effective for GST purposes, though reporting is advisable to avoid future confusion when reporting subsequent GST events.

A qualified severance is reported by filing Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations" (or such other form as the IRS may provide for the purpose of reporting qualified severances) by the due date of the gift tax return (including extensions) for gifts made during the year in which the severance occurred, or if no gift tax return is filed, by April 15th of the year immediately following the year during which the severance occurred. Treas. Reg. §2642-6(e), (k)(2). The IRS requests that filers write the words "Qualified Severance" at the top of the return and attach a Notice of Qualified Severance including the basic information regarding the original and resulting trusts and their respective inclusion ratios itemized in the regulation.[24] Treas. Reg. §2642-6(e).

4. Proposed Regulations.

Simultaneous with the issuance of the Final Regulations regarding qualified severances, the Treasury Department issued Proposed Regulations addressing issues that it considered as requiring further consideration. Notice of Proposed Rulemaking REG-128843-

[23] Regulation §26.2601-1(b)(4) defines "exempt trust" as a trust that is not subject to GST tax due to the application of Regulation §26.2601-1(b)(1) to (3).

[24] The notice should identify: the severed trust, the name of the transferor, date of creation, tax identification number, the inclusion ratio of the trust before severance, each of the trusts resulting from the severance, the date of the severance, the fraction of the total assets of the original trust funding each resulting trust and other details explaining the basis for funding the resulting trusts, the inclusion ratio of each resulting trust.

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The most significant change under the Proposed Regulations is the recognition of all severances effective under state law for GST tax purposes. Proposed Regulation §26.2642-6(h) clarifies that separate trusts created in a non-qualified severance (other than a severance described in Regulation §26.2654-1) that are treated as separate under applicable state law will be respected as separate after the date of the severance for all GST tax purposes. However, the inclusion ratio of the resulting trusts will be the same as the inclusion ratio of the original trust immediately before the severance. Thus, the non-qualified severance of a trust with an inclusion ratio between zero and one will not produce separate trusts with the most efficient inclusion ratios of zero and one. However, the proposed regulation confirms that the post-severance recognition of the separate resulting trusts means that the allocation of GST exemption, making of various GST tax elections and occurrence of generation-skipping transfers from one of such trusts will not impact any other such trust for GST tax purposes. Such recognition of non-qualified severances would increase the alternatives for taxpayers to remedy or improve the configuration of trusts creating adverse GST tax consequences. If Treasury ultimately adopts the position recognizing the separate trusts resulting from non-qualified severances, compliance with the requirements for a "qualified severance" will be unnecessary in cases where a change in the inclusion ratio from the original trust is unnecessary.[25]

Proposed Regulation §26.2642-6(d)(4) introduces a new rule providing that if a severance is funded on a non-pro rata basis, each asset is valued solely for funding purposes by multiplying the fair market value of the asset held in the original trust as of the date of severance by the fractional or percentage interest in that asset being distributed to that resulting trust. "Thus, the assets must be valued without taking into account any discount or premium arising from the severance, for example, any valuation discounts that might arise because the resulting trust receives less than the entire interest held by the original trust." Id. However, it is unclear that any basis for this addition exists in the language of Section 2642(a)(3) or its legislative history. Moreover, this regulation will be internally inconsistent to the extent it requires funding at fair market value but denies legitimate discounts or premiums in the valuation of trust assets pursuant to applicable state law. The trustee also may breach its fiduciary duty by complying with this proposed regulation, to the extent compliance results in an allocation different from the allocation that would result from funding based on the fair market values determined under state law.

Proposed Regulation §26.2642-6(d)(7)(ii) also clarifies that a qualified severance of a trust with an inclusion ratio between zero and one may create multiple trusts. Section 2642(a)(3) states that a trust with an inclusion ratio between zero and one must be severed into two trusts, indicating that the statute did not contemplate a severance resulting in multiple trusts and requiring a series of severances to create multiple trusts. However, Section 2642(a)(3)(B)(iii) gives the Treasury the ability to broaden the definition of a qualified

[25] The Proposed Regulations continue to deny the recognition of separate *shares* of a single trust that are not actually severed into separate trusts. See Proposed Regulation 26.2654-1(a)(1)(i). However, the rationale for treating separate shares differently from separate trusts for GST tax purposes is unclear and consistent treatment for both separate types of interests would seem appropriate.

severance by providing that "[t]he term 'qualified severance' includes any other severance permitted under regulations prescribed by the Secretary." Under this delegation of authority, the Proposed Regulation provides that a qualified severance of a trust with an inclusion ratio between zero and one may create more than two resulting trusts if one or more resulting trusts in the aggregate receive that fractional share of the value of the original trust as of the date of severance equal to the applicable fraction of the original trust. The trust or trusts receiving such share will have an inclusion ratio of 0, and each of the other resulting trust or trusts will have an inclusion ratio of one. If two or more of the resulting trusts receives a fractional share of the value of the original trust equal to the applicable fraction, the trustee may designate which of those resulting trusts will have an inclusion ratio of 0 or of one.

B. Modifications of "Grandfathered" Exempt Trusts. [26]

Many disputes regarding the administration or construction of trusts may involve those created prior to the effective date of the GST tax. Generally, the GST tax applies to any GST occurring after October 22, 1986, or inter vivos transfer subject to federal gift tax occurring after September 25, 1985, with several exceptions. Treas. Reg. §§26.2601-1(a). Actions involving trusts that qualify for one of these exceptions ("exempt trusts") require extra caution, to avoid jeopardizing the particularly valuable exempt status of such trusts. In particular, the GST tax does not apply to:

(1) A GST from a trust that was irrevocable[27] on September 25, 1985, to the extent the transfer is not made from trust principal allocable to any addition to the trust after September 25, 1985;

(2) A GST after September 25, 1985, occurring under certain wills or revocable trusts executed before October 22, 1986 (if a GST is not created or increased by any amendment after October 21, 1986, or in the case of a revocable trust, by an addition) if the decedent dies before January 1, 1987; or

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[26] Many rulings addressing changes to exempt trusts that did not affect their exempt status also have concluded that the changes did not result in taxable gifts among beneficiaries or any gain or loss for income tax purposes; in particular, severances of trusts (PLRs 200409003, 200402020, 200352004, 200314007, 200221032, 200119047); merger of trusts (PLR 200314007); changes in administrative provisions (PLRs 200411024, 200410015, 200410014, 200406044, 200406041, 200119047); settlement agreement (PLR 200315015). The IRS also has ruled that certain changes to exempt trusts that did not affect their exempt status also did not result in inclusion of trust property in any beneficiary's taxable estate. See PLRs 200406040 (changes in administrative provisions), 200411024 (changes in administrative provisions and construction regarding per capital distribution on termination).

[27] Regulation §26.2601-1(b)(1)(ii) defines "irrevocable trust" for purposes of GST tax as any trust in existence on September 25, 1985, subject to exceptions for (i) trusts subject to a power held by the settlor on September 25, 1985, that would have caused the value of the trust to be included in the settlor's gross estate for federal estate tax purposes due to Section 2038 if the settlor had died on September 25, 1985, or (ii0 a policy of insurance on an individual's life treated as a trust under Section 2652(b), to the extent that, on September 25, 1985, the insured possessed any incident of ownership (without regard to any incidents of ownership relinquished before September 25, 1985), that would have caused the value of the trust, (i.e., the insurance proceeds) to be included in the insured's gross estate for Federal estate tax purposes by reason of Section 2042, if the insured had died on September 25, 1985.

(3) Where an individual was under a mental disability to change the disposition of his or her property continuously from October 22, 1986, until the date of her death, a GST from a trust to the extent it consists of property, or the proceeds of property, transferred to the trust prior to October 22, 1986, and included in the gross estate of the individual, or which is a direct skip (other than from a trust) that occurs due to her death.[28]

Prior to 2000, no statute or regulation addressed whether changes to exempt trusts forfeit their grandfathered status for GST tax purposes. However, in 1989, the IRS began releasing numerous private letter rulings concluding that any modification after September 25, 1985, that changes the quantity, value, or timing of any powers, beneficial interests, rights or expectancies provided in the original trust loses the exempt status of the trust.[29] Numerous rulings applying this "no change" test were issued,[30] and, although taxpayers generally are not entitled to rely upon private letter rulings, these rulings provided the only available guidance regarding the effect of modifications of exempt trusts until the Final Regulations addressing this issue were issued.

1. Final Regulation §26.2601-1(b)(4).

The IRS released Final Regulation §26.2601-1(b)(4) on December 20, 2000,[31] to provide guidance regarding changes that will not affect the exempt status of a trust. Arguably, since the statutory effective date provisions cite only "additions" as cause for loss of exempt status, modifications that do not constitute additions to a trust should have no effect on exempt status. However, the IRS rejected this argument in the Preamble to these regulations, reasoning that the "statutory effective date provision protects trusts that were irrevocable before the GST tax was enacted and presumably could not be changed to avoid the imposition of the tax." Treas. Dec. 8912.

These regulations provide four "safe harbors" for modifications that will not affect the GST exempt status of a trust. Interestingly, these regulations do not incorporate the "no change" test that many IRS rulings applied when evaluating modifications of exempt trusts

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[28] This exception does not apply to property transferred by gift or reason of death to the decedent or trust after August 3, 1990, or to a direct skip from QTIP trust property transferred into trust after October 21, 1988.

[29] See PLRs 200052007, 200006001, 200015003, 8927026. The IRS has concluded that modifications cause the trust to lose its exempt status even where the changes would have reduced the likelihood or amount of a GST. PLRs 9244019, 8851017.

[30] Several categories of permissible changes that would not affect a trust's exempt status under the "no change test emerged: changes specifically authorized by the trust instrument (PLRs 200010037, 9521008, 8951068, 8926028), severances (PLRs 200104023, 200101015, 200103009, 200050041, 200050016, 200047002, 200046002, 200045028, 200043041, 199922030) and mergers (PLRs 200101011, 200050041, 200049011, 200037017, 200036019, 200031041) that preserve the original beneficial interests under the trust, clarifications of legitimate ambiguities in the governing instrument (PLRs 200102039, 200051004, 2000031022, 199944027, 199411016) and changes that are administrative in nature (PLRs 200050016, 9645030, 9646011, (changes relating to investments); 200052007, 9450036, 9424048 (trustee changes or succession); 9718009, 9247020 (trustee compensation); 9302019 (voting rights)), including a change in trust situs where any change in state law would not affect beneficial interests in the trust (PLRs 200015003, 9450036).

[31] Treas. Dec. 8912 (December 20, 2000).

prior to the issuance of these regulations. However, the safe harbors set forth in the regulations include broad categories of modifications that the IRS had been approving in those private letter rulings.

The safe harbors are not mutually exclusive and failure to qualify for one particular safe harbor does not preclude qualification for another. Unfortunately, the Final Regulations do not articulate an affirmative rule describing actions that will forfeit exempt status. In the absence of a rule, the failure to qualify for a safe harbor should not *necessarily* mean, as a matter of logic, that a modification loses the exempt status. However, Example 4 in the Regulations is the only Example illustrating loss of exempt status and implies that the failure to meet a safe harbor equates with loss of exempt status. *See* Treas. Reg. §26.2601-1(b)(4)(E), Example 4. In addition, the IRS states in the Preamble the belief "that most of the modifications that will not affect the exempt status of a trust will be covered by the safe harbors in the Final Regulations." Treas. Dec. 8912. These clues suggest that the IRS will treat any modification that does not fit neatly into a safe harbor as a change that forfeits exempt status.

In addition, the Regulations do not explain the consequences of losing such exempt status. IRS rulings could be instructive, but few exist illustrating the loss of exempt status because taxpayers typically withdraw their ruling requests upon learning that the outcome may be adverse. Consequently, the continued uncertainty regarding the effect of changes that do not fit within a safe harbor may continue to paralyze taxpayers or require them to seek private letter rulings to gauge the risks of making particular changes to exempt trusts.

The regulations recite that they are effective as of December 20, 2000. However, the Preamble notes that the "IRS will not challenge the exempt status of a trust that was, prior to December 20, 2000, subject to any trustee action, judicial construction, settlement agreement, modification, or other action, if the action satisfies the requirements of the regulations." Id.

2. Safe Harbor #1: Trustee's Exercise of Discretionary Powers.[32]

The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not subject the new or continuing trust to GST tax, if (i) the trust instrument or state law in effect when the trust became irrevocable authorizes the distribution or retention without the consent or approval of any beneficiary or court, and (ii) the terms of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the perpetuities period defined in the regulation.[33] The Preamble clarifies that an action satisfying this safe harbor will not cause

[32] Treas. Reg. §26.2601-1(b)(4)(i)(A).

[33] The trustee's power may not postpone vesting beyond a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. A term of 90 years or less from the date when the trust became irrevocable will not be considered to be beyond this perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

loss of exempt status even if, for whatever reason, the trustee seeks a court's or a beneficiary's approval of such action – the regulations require only that such approval is not *required* for the action. Id.

This safe harbor is limited by its plain terms to trustee's powers relating to trust "principal" but not income. Further, it applies only to a "distribution" or "retention" of trust principal, but not to any other exercise of trustee discretion regarding trust property that might be authorized under the trust instrument or state law. However, the failure to qualify for this safe harbor does not preclude qualification for another safe harbor.

These regulations do not define "vesting." Caution recommends that modifications incorporate distribution of the trust assets to beneficiaries or their estates, or otherwise satisfy state property law requirements for vesting, rather than relying on a general power of appointment or purely tax concept of ownership to ensure qualification under safe harbors with a vesting requirement.[34]

3. Safe Harbor #2: Court-Approved Settlement.[35]

A court-approved settlement of a bona fide issue regarding the administration or construction of the trust will not subject an exempt trust to GST tax if (i) the settlement results from arm's length negotiations and (ii) is within the range of reasonable outcomes under the governing instrument and applicable state law.[36, 37]

The Preamble explains that:

> [T]he purpose of this rule is not to restrict safe harbor protection to only those settlements that reach the result a court could reach if the issue was litigated. Rather, the rule is intended to afford the parties a greater degree of latitude to settle a case than would be available if a court had to decide the issue. . . . The settlement need not (and it is anticipated that in most cases it would not) resolve the issue in the same manner as a court decision on the merits. Id.

The Preamble explained that while parties to a settlement agreement will have significant freedom in negotiating its terms, "[o]n the other hand, as illustrated in the Preamble to the proposed regulations, a settlement that, for example, creates beneficial

[34] However, see PLR 200308045 (implying that a general power of appointment causing trust property to be included in beneficiary's taxable gross estate may satisfy "vesting" requirement).

[35] Treas. Reg. §26.2601-1(b)(4)(i)(B).

[36] A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

[37] See PLRs 200536018 (modification to clarify formula dividing trust property among beneficiaries resolving distribution among them upon termination), 200315015 (prohibition of distributions to persons not living at primary beneficiary's death to resolve dispute regarding scope of power of appointment), 200132016 (partition and recognition of parties as beneficiaries to resolve dispute regarding persons included as descendants), 200119047 (partition and changes to administrative provisions to resolve disputes regarding past distributions to current beneficiary, investments, and entitlements of adopted children).

interests that did not exist under a reasonable interpretation of the instrument will not satisfy the regulations." Accordingly, a settlement that expands the class of beneficiaries under a trust likely would not be permitted under this regulation.

The requirement of court approval may limit the usefulness of this safe harbor, given the reluctance of many parties to incur the financial costs, other burdens and publicity of a judicial proceeding. Parties choosing to settle a dispute by the nonjudicial means available under many state laws cannot seek the shelter of this specific safe harbor. In addition, the plain terms limit this safe harbor to settlements regarding "administration or construction" of the trust, but not other matters (i.e., validity of the trust, scrivener's error). However, parties to the settlement might satisfy the requirements of another safe harbor even if they cannot avail themselves of this specific one for court-approved settlements.[38]

4. Safe Harbor #3: Judicial construction.[39]

A judicial construction of a trust to resolve an ambiguity in the terms or to correct a scrivener's error will not subject an exempt trust to GST tax, if (i) the judicial action involves a bona fide issue and (ii) the construction is consistent with applicable state law that would be applied by the highest court of that state.

The scopes of the safe harbors for court-approved settlements and for judicial orders are not coextensive. The disparity seems odd, given that one would expect the safe harbor for a judicial order encompass the permissible subject matters of the safe harbor for court-approved settlements. Instead, this safe harbor for certain judicial orders addresses only resolutions of ambiguities or scrivener's errors, and excludes other disputes that may arise regarding a trust. Thus, while the court may approve a settlement among parties disputing the administration of a trust without jeopardizing the trust's exempt status, the court apparently cannot resolve a trust administration dispute by judicial order and qualify for this safe harbor.

The Preamble reveals that the IRS specifically declined to adopt the same standard and subject matter for both settlements and judicial decrees. Treas. Dec. 8912. The Preamble notes that the standard for judicial orders was articulated in *Comr v. Bosch*, 387 U.S. 456 (1967), where the court held that the law as it would be applied by the highest state court must control. The Preamble also explains that any judicial decrees addressing subject matters other than ambiguities and scrivener's error are properly addressed in the broader safe harbor for "other changes." Thus, a judicial order regarding an exempt trust might satisfy the requirements of such other safe harbor even if it fails to qualify for this specific one for certain judicial constructions.

5. Safe Harbor #4: Other changes.[40]

A modification of the governing instrument of an exempt trust by judicial reformation,

[38] See PLR 200241041.

[39] Treas. Reg. §26.2601-1(b)(4)(i)(C).

[40] Treas. Reg. §26.2601-1(b)(4)(i)(D).

or nonjudicial reformation that is valid under applicable state law, will not subject an exempt trust to GST tax if the modification (i) does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person(s) who held the beneficial interest prior to the modification, and (ii) does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.

This safe harbor requires that all beneficial interests remain vested by the expiration of the perpetuities period described in the original trust. In contrast, the first safe harbor permits expansion to the maximum perpetuities period allowable based on the lives in being when the trust became irrevocable. These regulations do not define "vesting." Caution recommends that modifications incorporate distribution of the trust assets to beneficiaries or their estates, or otherwise satisfy state property law requirements for vesting, rather than relying on a general power of appointment or other tax concept of ownership to ensure qualification under safe harbors with a vesting requirement.[41]

This safe harbor defines itself by the effects of the modification, and includes a trustee distribution, settlement, or construction that does not satisfy the requirements of the other safe harbors specifically addressing those means of modification.

a) Presumption: Shift to Lower Generation.

A modification of an exempt trust shifts a beneficial interest in the trust to a beneficiary occupying a lower generation if it can create or increase a GST, determined by comparing interests immediately before and after the change.

If the effect of the modification cannot be immediately determined, the regulation *presumes* that it shifts a beneficial interest to a beneficiary in a lower generation, such that the trust loses its exempt status. This presumption may swallow the rule, as it may be difficult to measure the effect of a change upon beneficial interests.

b) Examples.

The examples of the application of this safe harbor in the regulations demonstrate the broad range of changes to beneficial interests in trust that are included within its scope.[42]

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[41] However, *see* PLR 200308045 (implying that a general power of appointment causing trust property to be included in beneficiary's taxable gross estate may satisfy "vesting" requirement).

[42] In addition to examples and rulings in categories described below, see also miscellaneous changes approved in PLRs 200347011 (limiting sole trust beneficiary's annual right of withdrawal to particular month); 200345009 (changing definition of "charitable organizations" as necessary to qualify trust as an electing small business trust under Section 1361); 200308045 (changing outright distribution to retention in lifetime trust for beneficiary); 200229034 (change from per capita to per stirpes distribution).

For brevity's sake, this section only addresses changes that may affect beneficial interests in trust and does not itemize the examples or rulings addressing changes to administrative provisions.

(1) Division of a trust.

Severance of an exempt trust with spray provisions among a group of beneficiaries was one of the most commonly sought changes prior to the issuance of these regulations, as family members sought to reconcile varying positions regarding trust investment and administration. Example 5 confirms that a fairly straightforward division along stirpital family lines should not affect a trust's exempt status, especially when each separate trust continues to be governed by terms largely identical to the original trust terms and will terminate on the same date when the original trust was required to terminate.[43] Treas. Reg. §26.2601-1(b)(4)(E), Example 5.

In Example 5, Grantor established an irrevocable trust in 1980 for the benefit of his two children, *A* and *B*, and their issue. The trust gives the trustee the discretion to distribute income and principal to the beneficiaries in such amounts as the trustee deems appropriate. On the death of the survivor of *A* and *B*, the remaining principal will be distributed per stirpes to the living issue of *A* and *B*. In 2002, the appropriate local court approved the division of the trust into two equal trusts, one for the benefit of *A* and *A's* issue and one for the benefit of *B* and *B* 's issue. The trust for *A* and *A's* issue provides that the trustee has the discretion to distribute trust income and principal to *A* and *A's* issue in such amounts as the trustee deems appropriate. On *A's* death, the remaining principal will be distributed per stirpes to *A*'s issue. If *A* dies with no living descendants, the principal will be added to the trust for *B* and *B*'s issue. The trust for *B* and *B* 's issue contains parallel terms. The division does not shift any beneficial interest in the trust to a beneficiary in a lower generation and or extend the time for vesting of any beneficial interest in the trust beyond that provided for in the original trust. Therefore, the two resulting trusts will be remain exempt trusts. Treas. Reg. §26.2601-1(b)(4)(E), Example 5.

Under the Final Regulations, a "vertical" split of the trust in any proportion also should be permissible where the trustee has unfettered discretion regarding the amounts of distributions among spray beneficiaries under the original trust. See, e.g., PLR 200315013 (severing trusts based on unequal amounts to account for disproportionate amounts of prior principal distributions among beneficiaries). However, note that "horizontal" splits based upon the actuarial values of interests separated by different generation levels likely remain infeasible.

(2) Merger of trusts.

Example 6 of the Final Regulations illustrates a merger of two separate irrevocable trusts with identical terms for Grantor's child and the child's issue, one created by Grantor in 1980 and one created by Grantor's spouse in 1983. In 2002, the two trusts were merged into one trust by judicial proceeding, to save administrative costs and enhance the management of the investments. The resulting trust continues to remain an exempt trust. Treas. Reg.

[43] See PLRs 2007240003, 200719001, 200716024, 200701012, 200543047, 200528009, 200527007, 200539024, 200528016, 200447032, 200446020, 200433011, 200410008, 200409003, 200402020, 200352004, 200346008, 200314007, 200240014, 200238034, 200229034, 200221032.

§26.2601-1(b)(4)(E), Example 6.[44]

(3) Changes in Distributions.

Example 7 of the Final Regulations illustrates a permissible change in distribution provisions. In 1980, Grantor established an irrevocable trust providing for distribution of income to Grantor's grandchildren, A, B, and C in equal shares for life. Upon the death of the first grandchild to die, one-third of the principal will be distributed per stirpes to that grandchild's issue. Upon the death of the second grandchild to die, one-half of the remaining trust principal will be distributed to that per stirpes grandchild's issue. Upon the death of the last surviving grandchild, the remaining principal will be distributed per stirpes to that grandchild's issue. In 2002, A became disabled. Subsequently, in a judicial proceeding with the consent of B and C, an appropriate court modified the trust to increase A's share of trust income. The trust, as modified, remains an exempt trust. Treas. Reg. §26.2601-1(b)(4)(E), Example 7. However, the modification increasing A's share of trust income is a transfer by B and C to A for federal gift tax purposes. Id.[45]

See also PLR 200708001 (replacing outright distribution to grandchildren and more remote descendants with retention in trusts until age 35 subject to general powers of appointment); 200704026 (replacing outright distribution to child with retention in trust with specified payments at various ages and distribution to Foundation upon termination); 200441005 (extending term of trust to grandchild's entire lifetime and distribution to grandchild's estate at death).

c) New Definitions of "Income."

Many states recently have adopted laws changing the traditional definition of trust accounting income, to reflect the modern trustee's duty to invest trust assets for total return and maintain fairness to both the income and remainder beneficiaries. States have adopted one or both of two primary methods of redefining trust income. Some states allow the trustee to convert an interest in trust income to the right to receive a percentage unitrust amount, while some give the trustee the discretionary equitable power to allocate receipts between income and principal. A few states have adopted both options. These provisions can be useful to the fiduciary balancing the interests of income and remainder beneficiaries in avoiding future disputes or devising solutions to a current controversy.

Examples 8 and 9 were included in the original to Regulation §26.2601-1(b)(4)(E), prior to the issuance of final Section 643(b) regulations addressing changes to the traditional definition of income. Examples 8 & 9 illustrate conversion of an income interest to a unitrust

[44] See PLRs 200517006, 200516002, 200513003, 200449020, 200448019, 200448018, 200314007, 200238034 (merger combined with division of resulting trust into separate trusts); 200240014 (merger combined with preceding division of trust); 200209045.

[45] Similarly, the IRS has granted rulings that conversions of discretionary income distribution provisions to require mandatory income distributions to qualify trusts as shareholders of S corporation do not shift beneficial interests to a beneficiary in a lower generation. See PLRs 200243016, 200243015, 200243014, 200243013, 200243012, 200243011, 200243010, 200243008, 200243006.

interest and allocation of capital gain to income that will not affect the grandfathered exempt status of a trust.[46] In concluding that the modification does not shift any beneficial interest to lower generations, each such Example specifically recites that the modification can only operate to increase the amount distributable to *A* and decrease the amount distributable to *A's* issue. Thus, it was unclear whether a conversion to a plain unitrust percentage amount or other equitable adjustments between principal and income which might decrease the amounts distributed to A would fall within a safe harbor under Regulation §26.2601-1(b)(4).

On January 2, 2004, the IRS released Final Regulations revising the definition of income under Section 643(b) to reflect the new definitions of trust accounting income under state laws. Treas. Dec. 9102 (December 30, 2003). Conforming amendments were made to relevant transfer tax regulations. Id. Accordingly, the final safe harbor #4 "other changes" for GST tax purposes was amended to clarify whether the adoption of new definitions of "income" under state laws would subject an exempt trust to GST tax. The amendment provides that administration of an exempt trust pursuant to local law defining "income" as a unitrust amount or permitting the trustee to make equitable adjustments between principal and income will *not* be considered a shift of beneficial interests in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust that meets the requirements of Regulation 1.643(b)-1. New Examples 11 and 12 were added to Regulation §26.2601-1(b)(4)(E) to demonstrate the application of the final Section 643(b) regulations and the effect of such modifications for gift, income and GST tax purposes. See also PLRs 200709003, 200533006, 200532043, 200346008.

d) Effective Date.

Note that this Regulation §26.2601-1(b)(4) generally is effective from and after December 20, 2000. However, these portions of the regulation added by the conforming amendments relating to determination of income pursuant to state law[47] apply to trusts for taxable years ending after January 2, 2004.

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[46] See PLRs 200715001, 200517009, 200448001, 200446002, 200447002, 200437004, 200437003, 200409003 (in each, changes to distribute greater of income or unitrust amount to beneficiary). See also 200403031 (citing this example in determination that changes necessary to qualify trusts as qualified subchapter S trusts under Section 1361 can only operate to increase amount distributable to non-skip beneficiary). See also PLR 200409003 (regarding allocation of capital gain to income).

[47] In particular, the last sentence of Regulation §26.2601-1(b)(4)(i)(D)(2) and Examples 11 and 12 in Regulation §(b)(4)(i)(E).

THE MORNING AFTER: AVOIDING TAX SURPRISES IN TRUST & ESTATE LITIGATION

Procedural Aspects of Tax Settlements

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Joint Fall CLE Meeting
of the
Section of Taxation &
Section of Real Property, Trust & Estate Law
Saturday, September 29, 2007
Vancouver, British Columbia