INCOME TAXATION ON CLAIM RECOVERY IN EXCESS OF ESTATE TAX RETURN VALUATION

by

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Trust and tax lawyers often debate whether the filing of an amended estate tax return or supplemental estate tax return is necessary or allowed.¹ If the return was prepared and filed in good faith, no statute requires the executor (or trustee if no executor was appointed) to file an amended or supplemental return if he discovers new information that any items on the return were undervalued or incorrect.² This issue is of particular concern when the estate involves a litigation or claim that was resolved after the estate tax is filed.

If the decedent had an interest in pending litigation or a pending claim to recover property, the estate tax return must include in the gross estate the decedent's interest in the pending litigation or claim, and its value, even if contingent on future outcome.³ The uncertainty of the outcome of the litigation or claim bears on its valuation for estate tax purposes.⁴ The value of the claim is not controlled by recovery or occurrence of the event after the decedent's death, rather, the executor must report the fair estimate of the value of the claim at time of death.⁵ Where subsequent events show that some assets, such as contingent claims, were worth more than reported in good faith on Form 706, the law does not require the executor to disclose the later learned facts to the IRS by supplementing or amending the estate tax return.⁶

For example, assume a case where the estate tax return valued a pending litigation claim against a party at $100,000. After extensive pre-trial maneuvering, the
case was settled for $1,000,000. The executor does not have to amend or supplement the estate tax return to show the $900,000 gain, but is the estate home free?

While the estate may not have additional estate tax liability, the estate has a potential income tax liability as a result of the settlement or other conclusion of the litigation. The Internal Revenue Code requires that certain items received by the executor after the death of the decedent be included in gross income. Under IRC §691, any post-death recovery on account of a claim is normally treated as income in respect of a decedent, includible in gross income, unless the amount would have been excluded from gross income under specific provisions of the Internal Revenue Code. If, under the income tax law, the decedent was entitled to assert an exclusion, the executor can assert that exclusion in place of the decedent. When the executor makes a claim based on the estate’s rights as an heir to another estate, the executor has the same standing as if it was the heir.

Whether income taxes have to be paid on the recovery depends on the underlying purpose of the litigation or claim. In certain cases, the executor may be able to exclude such amounts from income. The results may differ depending on the underlying cause of action in the litigation, for example, for physical injuries, breach of contract, or to recover an interest in an estate.

Physical injury recoveries. Among the exclusions are amounts recovered for physical injury as provided in IRC §104. Several courts examined the limits of the exclusion under IRC §104(a)(2). The United States Supreme Court outlined a two-prong test to determine whether a taxpayer may exclude income under IRC §104(a)(2). The taxpayer must demonstrate that (1) the underlying claim is based
upon tort or tort-type rights, and (2) damages received are on account of physical injuries or sickness.\textsuperscript{11}

Further, in determining whether the payments was as a result of physical injuries, in the absence of an express physical injury settlement agreement, the intent of the payor's purpose in making the payment is significant.\textsuperscript{12} Where there was a settlement agreement, several cases considered the payor's intent as expressed in the agreement.\textsuperscript{13}

While the payors' intent is a factor in any analysis respecting apportionment in cases involving exemption of proceeds received on account of physical injuries, under \$104(a)(2),\textsuperscript{14} the payer's intent was not a factor in cases determining the taxability of any part of the settlement proceeds of an inheritance contest under IRC \$102(a)\textsuperscript{15}

The exclusion from gross income for physical injuries is narrowly construed and does not include amounts received for punitive damages,\textsuperscript{16} emotional distress,\textsuperscript{17} or proceeds from the settlement of an Age Discrimination in Employment Act claim.\textsuperscript{18} Further, the definition of physical injuries does not include physical restraint, detention or deprivation of personal freedom.\textsuperscript{19} Nor does the term apply to a corporation which may claim damage to its business reputation.\textsuperscript{20} In some states, recoveries for defamation are not considered physical injuries. Courts in some states hold that defamation is physical injury, and, therefore, compensatory damages for defamation in those states are excludible under IRC \$104(a)(2).\textsuperscript{21}

\textit{Inheritance rights.} The deceased may have had a claim to an interest in assets previously owned by a deceased ancestor. IRC \$102(a) excludes from gross
income "the value of property acquired by gift, bequest, devise, or inheritance." The statute was applied in the taxpayer’s favor in Getty v. Comm’r., in which J. Ronald Getty prayed for a judicial declaration that the trustees of the Getty Museum hold in constructive trust for him assets received from J. Paul Getty's estate in an amount equal to the "amount of income received by or credited to each of J. Paul's other children" from the death of J. Paul until the termination of the trust. In holding that the payment to Ronald was excluded, the court said:

We agree that the taxpayer bears the burden of establishing that proceeds of a settlement are what the taxpayer contends them to be, in this case property rather than income from property…

Even though Ronald did not show that, had J. Paul remedied the inequality he "necessarily" would have done so with a bequest of property, This is all that the burden of persuasion by a preponderance of the evidence requires in this case.

Because we conclude that Ronald carried his burden of proof as to the merits of his claim, we hold that the $10 million settlement payment was excludable from Ronald's 1980 gross income.

In Getty, the Commissioner argued that Ronald's claim against the trustees was for income from property citing Ronald's complaint which characterized the benefit he sought in enforcing his father's promise as a claim to income. Ronald alleged in his action against the trustees that his father promised his sister to provide in his will for "income" to Ronald in amounts equal to what the other children received from the 1934 trust following J.Paul’s death. The Commissioner argued that the settlement
amount based on a bequest of income from property is not excluded from gross income, under IRC §102(b)(2).

The Court of Appeals held that it was not bound by the Commissioner’s narrow interpretation. Although the allegations in Ronald's complaint indicated the nature of the claim, “we employ a broad approach in determining the true nature and basis of a party's claim.” (p. 1491) The Court defined the decisive question:

In characterizing the settlement payment for tax purposes, we ask, "In lieu of what were the damages awarded?" (p. 1490)

The Court cited Raytheon Prod. Corp. v. Comm’r, which decided whether an amount received by the taxpayer in compromise settlement of a suit for damages under the Federal Anti-Trust Laws, was a non-taxable return of capital or income. That decision declared that the test is not whether the action was based in tort or contract but “In lieu of what were the damages awarded?” Spangler v. Comm’r, applied the same test in determining whether the taxpayer’s recovery in a suit against the managing officers and controlling stockholders of a corporation, who induced the taxpayer to sell her stock to them by fraud, was a return of capital or ordinary income.

Getty v. Comm’r: was heard as a claim to exclusion by the taxpayer himself, not his executor. However, if Ronald had died before the settlement was finalized, his executor could have asserted the same exclusion. The principles determined in that case and the following cases will apply whether the exclusion is sought by the taxpayer or the taxpayer’s executor.

A similar result was determined by the Court of Appeals for the Ninth Circuit in an earlier case. In U.S. v. Gavin, the court held that a payment received by an heir in settlement of her claimed interest in a decedent's estate was excluded by IRC
§102(a) even though the payment was made by the other heirs and not by the decedent's estate. The court observed that had the claimant established her heirship, the amounts disgorged by the other heirs in satisfaction of the judgment would not be taxable as gross income.

Courts in several cases excluded amounts received on account of one claiming to be an heir. In, perhaps, the leading case, the Supreme Court confirmed the principle that property received from the estate of a decedent by an heir in compromise of his claim as an heir is treated the same as an inheritance and excluded from gross income. This principle applies equally to a cash settlement received in lieu of an in-kind distribution of an heir's share of a decedent's estate. Moreover, Lyeth applies to all amounts received because of the recipient's standing as an heir, even if those amounts are greater than actually due under a will, in intestacy or pursuant to the recipient's own claim as to the value of his inheritance.

Courts agreed with the taxpayer's claim for exclusion under IRC §102(a) in a number of other cases. Comm'r. v. Estate of Vease held that "[p]roperty received from the estate in settlement of a bona fide challenge or claim of this kind, in whatever amount and however conditioned as to disbursement or otherwise, may properly be said to be received by reason of such standing." In Chait, the court held that any excess distribution a widow received from her husband's estate was exempt on account of her standing as an heir.

There is a point of caution. If the settlement includes interest or a provision for delivery of something other than property acquired by gift, bequest, devise, or inheritance, the amount received for those items are not excludable under IRC §102.
Only amounts distributed in lieu of principal are exempt.\textsuperscript{34} Amounts attributable to interest or income of the estate will be subject to income tax.\textsuperscript{35}

The nature of the underlying action determines the tax consequences of property received in settlement of a claim.\textsuperscript{36} The question the court thus asks is "in lieu of what were the damages awarded?"\textsuperscript{37} Answering this question necessarily requires an analysis of the claims compromised by the settlement agreement. In other words, "the classification for tax purposes of amounts received in settlement of litigation is to be determined by the nature and basis of [the] action settled."\textsuperscript{38}

Although courts focus on the allegations made by an heir seeking his or her rightful share of an estate in determining the tax consequences of a settlement amount, the court may also consider whether the payment was received for something other than settlement of a claim to an inheritance, e.g., an agreement to relinquish a right. The court may have to determine whether a part of the property received in settlement of an inheritance contest was payment for the claimant's express agreement to release the opposing parties "from all manner of actions, causes of actions, suits, proceedings, [etc.]" and to forgo "institut[ing] any suit or action" against the opposing parties, or whether that language in the written settlement agreement was "mere boilerplate."\textsuperscript{39}

No set formula exists for allocating the proceeds of a settlement among the various claims in order to determine the portion of the settlement that would be exempt under IRC §102(a). The factors considered and the analysis applied thereto varies with each case. Nevertheless, in its effort to determine the "true nature and
basis” of a claim, a court will often closely examine the parties' pleadings. The court is not required to accept the parties' allocations of the settlement proceeds.

A few other cases determined the extent of the exempt nature of inheritance rights on income in respect of a decedent when the person claiming the exemption was not the estate of the heir, but the heir itself. Property received by the natural daughter and pretermitted heiress of the deceased in compromise of a claim against the estate of her alleged father was exempt from income tax as "property acquired by gift, bequest, devise, or inheritance," although the compromise agreement stated that she was not an heir.

Payments received by the taxpayer in settlement of a lawsuit which set aside gratuitous transfers of real property were treated as a gift or bequest since the character of the claim was in lieu of any inherited interest in real property.

A decedent's daughter was not taxed, as income in respect of decedent, on payments received by her under her parent's marital property settlement agreement even though for two taxable years her parents treated the annual payments as alimony, but the property settlement agreement clearly showed them to be settlement of property rights and not alimony. Where a contract executed by a decedent during his lifetime was still contingent, he had no right to the proceeds during his lifetime, and the post-death proceeds were not income in respect of a decedent.

Claims based on contracts or other non-exempt activities. Some taxpayer attempts to exclude income under IRS §102(a) failed. Where at death the deceased had a claim against a corporation, counsel for the executors and for the Commissioner stipulated to the fair market value of the claim at the time of the deceased's death in an
amount less than its face value. The executors collected more than the stipulated value on the claim. The court held that the difference between the date of death value and the subsequent amount received constituted taxable gain to the estate.\textsuperscript{46}

Amounts paid as distributions from a trust estate, arising from post-death settlement of litigation under antitrust laws, were income in respect of decedent, and not entitled to a stepped-up basis in the hands of the taxpayers who were beneficiaries of the trust to which the grantor's interest in the litigation was assigned.\textsuperscript{47}

Shares of stock received by the taxpayer from the executrix of his brother's estate in settlement of claim for services were taxable income based on a contract for services and not as a claimed legatee.\textsuperscript{48} Settlement proceeds received by a trust beneficiary who filed an action against the trustee to recover loss in value of his interest, and not to challenge the validity of the will or share of the estate, are not excludable since they were not received under a will contest.\textsuperscript{49}

Taxpayers, who sued trustees, estate administrators, and accountants, alleging numerous claims, including breach of duty of care and loyalty, negligence, self-dealing, and other matters with respect to the administration of an estate or trust, were not entitled to exclude from gross income funds they received in settlement of the lawsuit because they did not receive settlement funds as a bequest, devise, or inheritance under IRC §102(a).\textsuperscript{50}

CONCLUSION

In summary, if the executor can show that it made a good-faith determination of the value of a claim based on the deceased’s rights as an heir, the recovery of a larger amount will not be taxable income under IRC §102(a). If the
recovery is based on physical injuries which the deceased received, the amount received is excluded under IRC §104. However, the IRS may succeed in taxing any part of the recovery proven to be interest, lost compensation, or any other nonexempt category.

1 See for example Pratt and Karibjanian, “Filing a Supplemental Estate Tax Return after Probate Litigation” 36 Estate Planning No. 9 (September 2009) page 17.

2 The concept of an amended estate tax return does not appear anywhere in the Code or Regulations. Internal Revenue Code, §6018 and Regulations §§20.6018-1, 20.6018-2, 20.6018-3, 20.6018-4. This does not prevent the executor from seeking to recover the difference if subsequent events show that the taxes paid were more than required. While many practitioners file amended or supplemental estate tax returns, another path is filing a claim for refund on Form 843.

3 Regulations § 20.2031–1(b).

4 Regulations §20.2033-1(b).


6 See note 2.

7 Regulations §1.691(a)-1(d). Items excluded from gross income. Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

8 See, for example, Uniform Probate Code, Sections 3-709, 3-711 and 3-715.

9 See PLR 8740042.


12 Knuckles v Comm’r., 349 F2d 610 (CA 10, 1965).

13 See Agar v. Comm’r., 290 F.2d 283, 284 (CA 2, 1961) and Stocks v. Comm’r., 98 TC 1, 17 (1992)

14 See notes 11 – 12.

15 See notes 32 - 34.

16 Comm’r. v Miller, 914 F2d 586 (CA 4, 1990).

17 Murphy v IRS, 362 F Supp 2d 206 (D Col., 2005).


21 Roemer v Comm’r., 716 F2d 693 (CA 9, 1983) (superseded by statute as stated in Rice v United States, 834 F Supp 1241 (ED Cal, 1993) and Hawkins v United States, 30 F3d 1077 (CA 9, 1994). See also Threlkeld v Comm’r., 848 F2d 81 (CA 6, 1988)

22 913 F.2d 1486 (CA 9, 1990).

23 Id. at 1492.
24 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779, 65 S.Ct. 192, 89 L.Ed. 622 (1944).
26 323 F.2d 913 (9th Cir. 1963).
27 See notes 7 and 8.
28 159 F.2d 613, 615 (CA 9, 1947).
31 See Lyeth, 59 S.Ct. at 160 (holding that the property received by the petitioner was exempt even though it was of greater value than his devise under a will).
32 314 F.2d 79, 86 (CA 9, 1963).
34 See e.g., Getty v. Comm’r., 913 F.2d at 1491-1492; Parker, 573 F.2d at 49.
35 Ibid.
36 Vease, 314 F.2d at 86.
37 Getty, 913 F.2d at 1490; Shook v. U.S., 713 F.2d 662, 666 (CA 11, 1983); Parker, 573 F.2d at 47.
40 See Getty, 913 F.2d at 1491; Parker, 573 F.2d at 49-50; Shook, 713 F.2d at 668.
41 Bagley, 105 T.C. 396, 406 (1995) which stated, "an express allocation set forth in the settlement is not necessarily determinative if other facts indicate that the payment was intended by the parties to be for a different purpose."
42 United States v Gavin,159 F2d 613 (CA 9, 1947).
45 Keck v Comm’r. 415 F2d 531 (CA 6, 1969).
46 Herbert’s Estate v Comm’r., 139 F2d 756 (CA 3, 1943).
50 Clayton v United States, 98 AFTR 2d 5839 (ND W Va, 2006).