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Tax Consequences of Trust and Estate Litigation and Settlement Agreements

By Philip N. Jones
Duffy Kekel LLP

The tax consequences of trust modifications, litigation awards, and settlement agreements in estate and trust matters have been the subject of many litigated cases in the federal courts. The tax consequences of will contest settlements have been described as early as 1938 as "irritatingly elusive of definition." Paul, "Tax Status of Will Contestants," Selected Studies in Federal Taxation (2d Series), pp. 305, 328.

The parties interested in a probate estate are permitted to agree to distribute the estate in a manner that is contrary to the will or contrary to the intestacy statutes, if the court approves that agreement. ORS 116.113(3). That statute is a very useful tool, in situations varying from small items such as the disposition of the decedent's motor vehicle to major changes to the dispositive plan. Other changes can be carried out through a will contest or other causes of action. But all of those changes need to take into account the tax consequences of such changes.

Similarly, the Oregon Uniform Trust Code permits trusts to be modified, terminated, reformed, divided, or merged, either judicially or otherwise. See ORS 130.200 through 130.230. Although the Oregon Uniform Trust Code permits those various ways of modifying trusts, those provisions do not alter the tax consequences of such modifications, as noted in the official comments to ORS 130.225.

I. Examples of Modifications and Settlements. Here are some examples of situations that might invoke the tax rules discussed in this paper:

1. The family of a decedent decides that they would like to divide up his estate in a manner that is different than that provided for in his will, and they ask the probate court to approve that division.
2. The beneficiaries of a trust decide to modify a trust by agreeing on a nonjudicial settlement agreement that carries out certain modifications to the trust.
3. A family decides to obtain a judicial order modifying a trust in order to improve the estate tax consequences of the trust, or to improve the income tax consequences.
4. A petitioner files a will contest, and the matter is settled by changing the manner in which the estate will be distributed, and the probate court approves that settlement.

These are just a few examples. All of these involve changing the beneficial interests in a will or a trust. As a result, all of these involve economic benefits shifting from one person to another. The central question is whether such changes will be honored by the tax authorities, and whether those changes will have gift tax consequences, estate tax consequences, and/or income tax consequences.

In some cases, the parties who made the changes are seeking certain tax consequences which they view as more favorable than the tax consequences that existed before the changes. In other cases, the parties may be contending

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that the changes have no tax consequences whatsoever, or the parties might not be aware of the tax consequences.

A transaction that does not appear to be a gift, or was not intended to be a gift, can nevertheless be treated as a gift, because §2511 defines gifts as both direct and indirect. For example, the IRS has ruled that when a trust transfers funds to a bank account owned by a third party at the direction of the trust's sole beneficiary, the transfer to the bank account was deemed to effectively be a transfer to the beneficiary and then a gift by the beneficiary to the owner of the bank account. CCA 202045011.

In another example of an indirect gift, the surviving spouse and all of the remainder beneficiaries of a QTIP marital trust agreed to terminate the trust and distribute all of the assets to the surviving spouse. The IRS concluded that the surviving spouse had made a gift to the remaindermen due to the provisions of §2519, which provides that any transfer of an income interest in a QTIP trust will be deemed to be a transfer (a taxable gift) of the reminder interest; the remaindermen will then be deemed to have made a taxable gift of the remainder interest back to the surviving spouse. As a result, the remainder interest was deemed to have constituted a taxable gift twice as a result of one transaction.

Note that the gift tax consequences of a settlement might be minimal or nonexistent, since Oregon does not have a gift tax, and the federal gift tax exemption is currently extremely high. §2505. As a result, in many cases the parties will not care what the gift tax consequences might be. But the parties nevertheless need to be advised about the tax consequences, and they need to be advised whether a gift tax return needs to be filed.

If the settlement merely shifts assets among siblings, then gift tax consequences are likely to result, but that situation is unlikely to alter the estate tax consequences. If the settlement shifts assets in a manner that impacts the amount to be received by a surviving spouse or a charity, then the estate tax is likely to be impacted (or not impacted, if the agreement is disregarded).

In any event, the question becomes what those tax consequences might be.

II. The Need for a Bona Fide Dispute. The first question is whether any settlement is a legitimate settlement of a bona fide dispute. If not, then it is not a settlement, but instead is merely a shifting of economic interests among the parties that should be viewed as a gift or as a form of income. Once that decision is made, then the next question (discussed later in this paper) is how the legitimate settlement should be treated for tax purposes.

The tax consequences of a settlement agreement are oftentimes entirely unintended. For example, two siblings who are to receive an estate in equal shares under the terms of a will might agree pursuant to ORS 116.113(3) to divide the estate unequally. In that event, one sibling will most likely be deemed to have made a gift to the other sibling, with resulting gift tax consequences. In fact, the statute itself seems to support that result, because it expressly provides that a general judgment of final distribution issued by the court pursuant to such an agreement "operates as a transfer of the property between those persons." However, in some cases, circumstances might eliminate those tax consequences. For example, if a bona fide dispute exists between the beneficiaries, and the agreement is intended to resolve that dispute, then the resulting transfer will not constitute a gift, but instead will constitute a settlement amount in satisfaction of the dispute. In such a situation, the settlement agreement should recite the nature of the dispute and the fact that the altered division of the property is intended to resolve that dispute. For somewhat greater certainty that the result will be honored by the IRS, the aggrieved beneficiary should consider first filing a will contest, a petition for instructions, an objection to the final account, or some other appropriate pleading to lend greater credence to the notion that a bona fide dispute exists.

Neither the IRS nor the courts will respect a settlement based on "friendly" litigation where no bona fide dispute is present. For example, in *Grossman v. Campbell*, 368 F.2d 206, 18 AFTR2d 6251 (5th Cir. 1966), the court held that a settlement agreement had been reached in a situation where no real dispute existed, and thus the settlement would be ignored for estate tax purposes. The Ninth Circuit reached a similar result in *Commissioner v. Vease*, 314 F.2d 79, 11 AFTR2d 1800 (9th Cir. 1963), rev'g. 35 T.C. 1184 (1961). In that case, the court concluded that a settlement agreement had not resulted from a bona fide will contest, but instead had resulted from "nothing more than a voluntary rearrangement of property interests acquired under an admittedly valid will." See also *Wolfsen v. Smyth*, 223 F.2d 111 (9th Cir. 1955); *Bath v. Commissioner*, T.C. Memo 1975-102. Other examples of settlements that were disregarded for tax purposes include *Aronson v. Commissioner*, T.C. Memo 2003-189; *Brandon v. Commissioner*, 86 T.C. 327 (1986), rev'd on other grounds, 828 F.2d 493 (8th Cir. 1987), on remand 91 T.C. 829 (1988); *Simpson v. Commissioner*, T.C. Memo 1994-259; CCA 201651013. See also Rev. Rul. 89-31, 1989-1 C.B. 277 and PLR 9308032.

In a case originating in Oregon, the taxpayer estate obtained an order from the local probate court pursuant to friendly litigation, but the order was disregarded by the IRS, the U.S. Tax Court, and the Ninth Circuit Court of Appeals, and penalties were imposed. *Dieringer v.*

Commissioner, 917 F.3d 1135, 123 AFTR 2d 2019-1020 (9th Cir. 2019), affirming 146 TC 117 (2016).

[Keep in mind that if a court order is obtained, oftentimes the most valuable element of that order is not the signature of the judge. The most important element is often the fact that all interested parties were given notice of the proposed order and an opportunity to object, and none of them objected. As a result, they are bound by the result. If an interested party had not been given notice, then the signature of the judge would be of little value.]

In CCA 201651013, the IRS disregarded a state court modification of a trust. The ruling was protested by the recipient taxpayer, but the IRS declined to change their position, and issued CCA 201747005, which reaffirmed the IRS position and contains an excellent summary of the applicable cases and rulings regarding judicial modifications.

The Service has occasionally approved trust modifications, and given effect to the modified provisions, when a mistake occurred in the original drafting. See PLR 202009012 and ORS 130.220.

Sometimes inaction can be treated as a gift. In Revenue Ruling 1984-105, the Internal Revenue Service ruled that the failure of a beneficiary to object to a final accounting in a probate constituted a gift, since the accounting had erroneously underfunded a bequest. See also Rev. Rul. 86-39, 1986-1 CB 300; PLR 9308032.

For an excellent discussion in a case where the Tax Court found that the settlement of a family dispute did not result in a gift, even though the settlement resulted in the transfer of assets from a father to his children, see *Redstone v. Commissioner*, 145 T.C. 259 (2015). In that case, the court found that the transfer resulted from the settlement of a bona fide dispute in the ordinary course of business after adversarial negotiations, at arm's length and free of any donative intent. The court noted that transactions between family members are usually scrutinized and found to be gifts, but in this case no donative intent was found. Although a donative intent is not a prerequisite to a gift, a "donative intent will be found to be lacking when a transfer is not actuated by love and affection or other motives which normally prompt the making of a gift." As a result, the court found the transfer to have been made in the ordinary course of business for full consideration under §2512(b); the consideration was the settlement of a bona fide dispute.

In most cases of transfers between family members, a gift is presumed, and the Service will scrutinize any attempt to not treat the transfer as a gift. In *Dynamo Holdings Ltd. Partnership v. Commissioner*, TC Memo 2018-61, the Tax Court stated: "We apply special scrutiny to intrafamily transfers and transactions between entities in the same corporate family or with shared ownership. Transfers between family members are presumed to be gifts." See also *Smaldino v. Commissioner*, T.C. Memo 2021-127 and the cases cited therein.

III. Deductibility of Payments Made Pursuant to a Settlement. Just as the Service will scrutinize a settlement to determine whether a gift has taken place, the Service will also scrutinize a settlement to determine whether payments made pursuant to the settlement are deductible, either as a claim, a marital bequest, or on other grounds. Under Proposed Regulation §20.2053-1(b)(3) (REG-143316-03, 72 F.R. 20080-20087, April 23, 2007), payments made pursuant to a settlement will be deductible only if the matter involved an enforceable claim, a bona fide dispute, an actual contest, arm's length negotiations, and the settlement is within the range of reasonable outcomes consistent with local law. That requirement of being within a range of reasonable outcomes was omitted from the final regulations, which merely require that a settlement of an unenforceable claim will not be honored. Reg. §20.2053-1(b)(3).

In a Technical Advice Memorandum, the Internal Revenue Service has indicated that the presence of a good-faith adversarial proceeding, by itself, will not necessarily cause a resulting settlement to be honored by the Service. In TAM 200306002, a decedent's nieces, nephews and a charity filed a will contest. The decedent had signed seven wills over a period of thirty-five years, but only the first will left a bequest to charity. When the charity received a portion of the settlement proceeds, the Service disallowed a charitable deduction. The TAM stated, "...the appropriate inquiry is whether the interest at issue reaches the charity under correctly interpreted and applied state law, and not whether the interest reached the charity as a result of a good-faith adversary proceeding." The TAM concluded that "...there existed little probability that a state court would admit the first will for probate." See also *Terre Haute First Nat. Bank v. U.S.*, 67 AFTR2d 91-1217 (S.D.Ind. 1991).

The reasoning employed by TAM 200306002 may be more conservative than has been employed by the courts. While the courts might limit their inquiry to the question of whether a legitimate dispute was present, the Service apparently will try to convince the court to actually judge the chances that the contestant might have prevailed. That conservative approach advocated by the IRS ignores the possibility that a legitimate contestant with a less-than-perfect case might receive a modest settlement that should be respected by the IRS. Nevertheless, practitioners are forewarned: the Service will not respect a settlement that

does not reflect the merits of the dispute, regardless of how bona fide the parties believe the dispute to be.

That position taken by the IRS is consistent with *Commissioner v. Bosch*, 387 U.S. 456 (1967), in which an estate, faced with an estate tax deficiency resulting from the disallowance of a marital deduction, sought and obtained an order from a state trial court which interpreted state law in a manner that supported the allowance of the deduction. The Supreme Court held that neither the IRS nor the federal courts are bound by a state trial court determination of state property law rights that affect the application of federal tax laws. The Supreme Court reasoned that although "proper regard" must be given to the rulings of state trial courts and intermediate state appellate courts, only rulings of the highest court of the state will be binding on federal agencies and federal courts, partly due to the potential for non-adversarial ("friendly") litigation. For an example of a case in which the courts relied on extrinsic evidence to support a marital deduction despite disqualifying language in the will, see *Sowder v. U.S.*, 251 Fed. Appx. 444, 2007 WL 3046287, 100 AFTR2d 2007-6379, 2007-2 USTC ¶60,550 (9th Cir. 2007; unpublished opinion).

The Ninth Circuit has held that the allowance of an estate expense by a local probate court does not necessarily make the expense deductible for tax purposes. *Hibernia Bank v. U.S.*, 581 F.2d 741, 78-2 USTC ¶13,261 (9th Cir. 1978). In a concurring opinion, one judge was particularly succinct:

> There is no inducement to a … state court to restrict the allowance of claimed administrative expenses in order to prevent improper reductions of the federal estate tax. Indeed, many state judges would probably be pleased to assist the representative of the estate and the heirs in thus reducing the estate tax. … I do not believe that Congress intended to give the game away in that fashion.

Occasionally a party will propose a settlement in which the decedent's spouse will be paid certain sums, but only on the condition that she agree to gift some of those sums to certain other persons, such as the children of the decedent. Such a proposal is occasionally encountered in disputes between the decedent's children and their stepmother, the decedent's second wife. The purpose of such an arrangement is to maximize the marital deduction for estate tax purposes, while simultaneously providing an economic benefit to the stepchildren. However, such a proposal is contrary to the rules governing the marital deduction. A marital deduction is not available if funds are restricted, or are required to be gifted to a third party. The restrictions in a QTIP trust are some of the few restrictions that may be placed on assets while still receiving the benefit of a full marital deduction. §2056(b)(7). If the restrictions do not fall into one of those exceptions, then the amount of the marital deduction will be reduced to the amount of funds that are not restricted. §2056(b)(4). A personal representative should not sign an estate tax return that violates that rule, nor should an attorney or CPA prepare such a return.

In 2007 the IRS issued proposed regulations that would prohibit taking an estate tax deduction for claims that are potential, unmatured, or contested for which a settlement has not been reached. Once the claim is resolved, an amended estate tax return (formally known as a supplemental return) should be filed. If that return shows a refund due, then that return will constitute a refund claim, but the filing of a Form 843 should also be considered. If the tax refund statute of limitations is about to expire before the claim is resolved, a protective refund claim should be filed. Exceptions are allowed for estimated attorney fees and fiduciary fees, but if such deductions are allowed and are later paid in lower amounts, the estate is required to notify the IRS. This is contrary to the general rule that amended returns are generally not legally required to be filed. Reg. §1.451-1(a); *Broadhead v. Commissioner*, T.C. Memo 1955-328. The same proposed regulations would provide that claims filed by family members are rebuttably presumed to be not legitimate or bona fide. REG-143316-03, proposing amendments to Reg. §20.2053-1, §20.2053-3 §20.2053-4, and §20.2053-6. That presumption was omitted from the final regulations issued in 2009. T.D. 9468; 2009-44 IRB 570, 74 F.R. 53652-53665 (10/20/09).

When an estate pays an amount based on a claim for a debt owed by the decedent, then the estate will usually be able to deduct the amount of the payment as a claim against the estate for estate tax purposes. §2053. Many claims combine elements of two underlying causes of action which are difficult to separate. In *Roberts v. Commissioner*, T.C. Memo 1995-171, a caregiver had been promised to receive a substantial sum upon the patient's death. After the death, the caregiver brought suit and received $50,000 in a settlement. The IRS argued that the sum was compensation for services rendered, and thus was taxable income to the caregiver, but the caregiver argued that the sum was an inheritance. The Tax Court held that the sum was a nontaxable inheritance, because the underlying claim was for breach of a contract to make a will. That issue appears to be a close one; the court could have easily agreed with the Service that the performance of services resulted in taxable income. Other taxpayers should not assume they will obtain the same result. Of course, that same situation presents tax issues for the estate. If the payment was for services rendered, the estate would be entitled to an estate tax deduction for a debt of

the decedent, but no deduction would be allowed for a payment that constituted an inheritance.

The issue of interest surfaces when a settlement results in installment payments without any allocation to interest. In those cases, a portion of each payment will likely be deemed to be interest income. In a few cases, the taxpayer has been able to convince a court that the payments are entirely principal, but those results are relatively rare. Hopkins v. Commissioner, 13 T.C. 952 (1949). The likelihood of other taxpayers receiving the same result from the Service is illustrated by the fact that the Service issued a nonacquiescence in *Hopkins*. 1950-1 C.B. 7.

A similar close question occurs when an heir sues for an inheritance, but settles for a share of the income of the estate or a trust. In that case, the tax character of the underlying claim is at odds with the tax character of the amount paid in settlement. In *Quigley v. Commissioner*, 143 F.2d 27, 32 AFTR 908, 44-2 USTC Par. 9352 (7th Cir. 1944), the court held that the nature of the underlying claim resulted in the income payments being treated as an inheritance, although the court also required the recipient to demonstrate the value of her claim, in order to determine whether a gain had been realized.

IV. Summary of Necessary Factors. The following discussion assumes that the litigation or settlement agreement resulted from a bona fide dispute. If not, see the discussion above concerning the fact that the IRS and federal courts may disregard rulings of state trial courts.

Assuming a bona fide dispute has been settled, several factors influence the tax consequences of the settlement. The three primary factors are (in descending order of importance) (a) the nature of the underlying claim or claims, (b) the characterization of the payments by the parties, and (c) the source of the payments.

A. Nature of the Claim

The tax consequences of the underlying claim should be carefully considered when drafting the initial petition to the probate court, because the tax consequences of any future settlement (or any future court ruling) will largely follow the nature of the claim. *U.S. v. Burke*, 504 U.S. 229, 237 (1992); *Seay v. Commissioner*, 58 T.C. 32, 37 (1972). In essence, if the settlement proceeds are paid in lieu of a particular type of income, those proceeds will be taxed in the same manner. *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), aff'd. 121 F.3d 393 (8th Cir. 1997). For example, a will contest claiming an inheritance does not usually result in taxable income, because an inheritance is excludable from gross income by §102(a). *Lyeth v. Hoey*, 305 U.S. 188, 21 AFTR 986 (1938). In contrast, a claim for compensation for services rendered to the decedent will result in taxable income to the claimant. *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959). And that compensation income might be subject to self-employment tax. Also, if the will or trust (or settlement agreement) requires an amount to be paid from income of the estate or trust, then that amount will be subject to income tax. §102(b). A petition that seeks more than one type of payment, based on different causes of action, will result in an award or a settlement that must be allocated for tax purposes among the various causes of action. *Parker v. U.S.*, 573 F.2d 42, 41 AFTR2d 78-888, 78-1 USTC Par. 9248 (Ct.Cl. 1978), cert. denied 439 U.S. 1046 (1978).

In an interesting case in the Tax Court, a taxpayer attempted to exclude from her income a settlement she received. She had been injured in a hospital, and she sued the hospital for her personal injuries. Her attorney allegedly made an error that prevented her from recovering her damages, so she sued the attorney for legal malpractice. The attorney settled the case and agreed to make a cash payment to the injured woman. The woman excluded the payment from her income under §104, which excludes damage payments made on account of personal injury. The IRS disagreed, and the IRS prevailed in the U.S. Tax Court. *Blum v. Commissioner*, TC Memo 2021-18, and the Ninth Circuit affirmed. *Blum v. Commissioner*, ___ Fed. App. ___, Dckt. No. 21-71113, (unpublished opinion, 3/22/22). Some commentators have questioned that result, because the ultimate underlying cause of the damages was personal injury. However, in that case the injured woman had negotiated a settlement agreement that specifically recited that the damages resulted from legal malpractice and not personal injuries. As was discussed at the oral argument in the Ninth Circuit, the injured woman had negotiated that language because a recital that damages resulted from personal injury would have caused her problems associated with her Medicare coverage. In other words, she can't have it both ways.

The Internal Revenue Code contains many traps for the unwary, and many of those traps can impact a settlement in which one of the parties gives up an interest in a trust, in return for consideration or otherwise. For example, §2519 provides that if a surviving spouse disposes of an income interest in a QTIP trust, the surviving spouse will be deemed to have transferred (gifted) the principal of the QTIP trust. In

another example, if a beneficiary ever sells an income interest in a trust, see Reg. §1.1014-5 and §1001(e). Those sections might require the beneficiary to disregard any basis and report the entire proceeds as gain. See also Private Letter Ruling 200231011 and the cases cited therein.

B. Characterizations by the Parties.

If a settlement agreement incorporates an agreement by the parties regarding the tax characterization of the payment, that characterization will often be given considerable weight by the IRS and the courts, even though that characterization is not binding on either the IRS or the courts. *Kightlinger v. Commissioner*, T.C. Memo 1998-357. The characterization will be given greater weight if it was negotiated in an adversarial setting than if not. *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), aff'd. 121 F.3d 393 (8th Cir. 1997; *Robinson v. Commissioner*, 102 T.C. 116 (1994). In *Jack A. Rivera v. Baker West, Inc*, 430 F.3d 1253, 96 AFTR2d 2005-7371, 2006-1 USTC 50,195, (9th Cir. 2005), the Ninth Circuit stated:

Thus, when damages are paid through a settlement agreement, we will look first to the underlying agreement . . . If the agreement lacks express language specifying the purpose of the compensation, we will then examine the intent of the payor. . . . The payor's intent can be "based on all the facts and circumstances of the case, including the complaint that was filed and the details surrounding the litigation." (Citations omitted.)

The characterization of the damages by the parties to a settlement agreement will be ignored if the underlying facts are to the contrary, or if the underlying cause of action was to the contrary. In *Healthpoint v. Commissioner*, T.C. Memo 2011-241, the IRS disagreed with the allocations of damages reached in a settlement agreement following a jury verdict. The IRS argued, and the Tax Court agreed, that while the parties might be generally adverse in the underlying litigation, they were not particularly adverse in the allocation of the damages among the various causes of action and elements of damages. As a result, the Tax Court allocated the damages in the same manner that the jury had allocated the damages, and ignored the allocation stated in the subsequent settlement agreement. The jury had awarded $16 million in damages, of which $3 million were punitive damages. If paid, the punitive damages would have been ordinary income to the plaintiff. In a subsequent settlement, the parties allocated none of the damages to punitive damages, but instead allocated all of the damages to elements that would have triggered capital gains, resulting in a tax savings to the plaintiff. In the end, the Tax Court reallocated the damages and awarded the IRS an accuracy-related penalty. Similarly, the courts will look to the underlying cause of action to determine how the proceeds should be taxed. *McKenny v. U.S.*, ___ F.3d ___, 126 AFTR2d ¶2020-5224.

In situations where estate or trust litigation resulted in a court ruling, as opposed to a settlement agreement, in determining the tax consequences the IRS will similarly not be bound by the characterization of the award stated in the ruling of the trial court, nor will the Tax Court be bound by that characterization, *Kightlinger v. Commissioner*, T.C. Memo 1998-357; *Robinson v. Commissioner*, 102 T.C. 116 (1994), aff'd 70 F.3d 34 (5th Cir. 1995), cert. denied 519 U.S. 824 (1996); *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), although that characterization presumably will be given considerable weight.

In *Goode v. Commissioner*, T.C. Memo 2006-48, the Tax Court expressly rejected the provisions of a settlement agreement that recited that the settlement payment was for nontaxable personal physical injuries when the record in the underlying cause of action lacked evidence of such injuries, and the recital was not the result of arm's-length bona fide negotiations. The court then imposed an accuracy-related penalty under §6662(d)(1).

The worst case scenario is a settlement agreement (or an award by the court) that does not attempt to address the tax consequences of the settlement or how the settlement award should allocated among various elements of the underlying causes of action. In those cases, subsequent litigation between the parties and/or with the IRS is often the result, and the pleadings in the original dispute are often relied upon to determine the tax consequences of the agreement. *Parker v. U.S.*, 573 F.2d 42, 215 Ct. Cl. 773, 41 AFTR2d 78-888, 78-1 USTC Par. 9248 (Ct.Cl. 1978), cert. denied 439 U.S. 1046 (1978). In addition to the pleadings, other factors taken into account include the facts surrounding the underlying litigation and the arguments made by the parties in the underlying litigation. *Glover v. Commissioner*, T.C. Memo 2002-186. Regrettably, such disputes with the

IRS could have been prevented in most cases by addressing the tax consequences in the settlement agreement. For examples of cases where extensive tax litigation followed the execution of settlement agreements that did not include tax language, see "Why Every Settlement Agreement Should Address Tax Consequences," 2001 Tax Notes Today 133-52 (7/3/01).

When a settlement agreement does address the tax consequences of the settlement, subsequent disputes between the parties are almost always avoided, lacking evidence of duress, fraud, or other unusual grounds. The likelihood of a dispute with the IRS is also greatly diminished. When disputes do arise, the most commonly litigated issue is the allocation of the settlement award among various elements of the underlying claims. In the context of an estate, a typical settlement might combine elements of a will contest, a spousal election against the will, spousal support, treatment of an advance as a gift or a loan, or a claim for compensation for services performed for the benefit of the decedent. Similarly, a settlement in a trust dispute could combine many of the same elements. In either case, the tax consequences of the amounts paid for those various claims can vary widely. The consequences can include estate tax, gift tax, and income tax, both fiduciary and personal. For example, amounts paid pursuant to a spousal election against the will typically qualify for the estate tax marital deduction, which can significantly reduce the estate tax liability. In another example, if the litigation involves a cause of action that the decedent could have brought during her lifetime, then the value of the claim on the date of her death must be included in her gross estate for estate tax purposes. *Glover v. Commissioner*, T.C. Memo 2002-186. However, determining the value of that claim as of the decedent's date of death presents significant problems, which are not discussed in this paper.

C. Source of the Payments.

If a trust settlement agreement requires that a particular beneficiary will receive payments to be made from trust income, it will be difficult for that beneficiary to later argue that the payments were not taxable income to the beneficiary. As a result, a settlement agreement should not only address the nature of the claim being satisfied, and characterize the nature of the payments to be made, the agreement should also address the source of the funds to be used (or not used) by the trust to make the payments.

V. Inconsistent Deficiency Cases. In some cases following a settlement, the two parties will report the transaction on their tax returns in inconsistent ways. In those situations, both taxpayers will usually be audited, and statutory deficiency notices will likely be issued by the IRS to both taxpayers. Such cases are known as inconsistent deficiency cases because, by definition, one of the statutory notices is correct, and the other is incorrect. Also by definition, one of the taxpayers is in the right, and the other is in the wrong. The question is: Which one? Such cases are also known as "whipsaw" cases, because the tax is usually owed by one of the taxpayers or the other, but not both, and the Service is trying to avoid the situation where two different courts rule two different ways on the same issue, and both taxpayers avoid paying tax. For that same reason, the IRS will resist reaching a settlement with only one of the taxpayers, out of a fear that the other taxpayer might later obtain a result that is inconsistent with the first result.

The Tax Court has held that the Service is justified in issuing two inconsistent statutory notices, even though one of the two notices is by definition incorrect. *Magpie Management Co. v. Commissioner*, 108 T.C. 430, 446 (1997; *HIE Holdings Inc. v. Commissioner*, T.C. Memo 2009-130; *Universal Trust 06-15-90 v. Commissioner*, T.C. Memo 2000-390; *Wickert v. Commissioner*, T.C. Memo 1986-277, aff'd on other grounds, 842 F.2d 1005 (8th Cir. 1988); *Doggett v. Commissioner*, 66 T.C. 101, 103 (1976); see also *Clapp v. Commissioner*, 875 F.2d 1396 (9th Cir. 1989).

When two inconsistent statutory notices are issued, the two taxpayers often end up docketing their two different cases in the Tax Court. In that event, the Service will usually ask the court to consolidate the two cases (so they can be tried and briefed together) in order to avoid inconsistent results. Once the cases are consolidated, the Service can then take a passive role in the litigation while the two taxpayers battle it out in front of the court.

It might work to the advantage of one of the taxpayers to arrange for his part of the dispute to be resolved in a court other that the Tax Court, such as the federal district court or the Court of Federal Claims. When the one taxpayer reaches trial in the Tax Court, the other taxpayer can provide assistance to the IRS, and hopefully the IRS will prevail.

VI. Income in Respect of a Decedent. Some claims will result in the payment of Income in Respect of a Decedent under §691 ("IRD"), which will have both estate tax and income tax consequences. In general, IRD is income earned by the decedent during his lifetime, but

not received by his estate or his beneficiary until after his death. Such income is reportable as part of the decedent's gross estate for estate tax purposes under §2031, and also reportable as taxable income to the estate or other recipient. §691. Thus double taxation takes place. That double taxation is somewhat ameliorated by the fact that the recipient of the income is entitled to an income tax deduction for the amount of federal (but not state) estate tax attributable to the IRD. §691(c). The most common example of IRD is an IRA or other form of retirement plan or deferred compensation. Another example is a tax-deferred annuity. §72.

The handling of IRAs, and similar accounts that contain IRD, require special care. For example, if the beneficiary of an IRA is a trust or an estate, the fiduciary should not make withdrawals from the account, or close the account, without carefully considering the fiduciary income tax consequences. In many cases, it will be advisable to divide the account into separate smaller "inherited accounts," which can then be distributed to the beneficiaries without actually making any withdrawals from either the original account or from the inherited accounts. By doing so, the beneficiaries will each be able to decide for themselves when to make taxable withdrawals from their separate inherited account. Decisions regarding how to create and handle such accounts require consultation with tax counsel who is familiar with the tax consequences of such accounts.

VII. Fiduciary Income Tax. The fiduciary income tax consequences of the settlement should also be considered. In general, residuary distributions from an estate or trust carry out distributable net income to the recipient beneficiaries. More specifically, the estate or trust is entitled to an income distribution deduction, while the beneficiary will be required to report the income on his or her individual income tax return. §661(a); §662(a). Specific bequests, in contrast, generally do not carry out income to the beneficiary, nor are they eligible for the income distribution deduction. §663(a)(1). (Under Oregon probate law, specific bequests include the income generated by the bequeathed property, less the taxes and expenses attributable to the property. ORS 116.007(2)(a).) The reporting of the amount taxable to the beneficiary appears on a Schedule K-1 attached to the annual Form 1041 fiduciary income tax return of the trust or estate. When a settlement agreement is drafted, the parties should take care to agree on the exact manner in which the estate or trust will characterize the payment(s), so that the beneficiary will not be surprised by the K-1 issued by the estate or trust after the tax year has closed. Because the personal representative or trustee will be supervising the preparation of the fiduciary income tax returns for the estate or trust, as well as signing and filing the returns, the personal representative or trustee should be a party to the settlement agreement, in order to secure his or her agreement regarding the tax reporting.

If a trustee or personal representative distributes appreciated property in lieu of a pecuniary bequest or in lieu of a pecuniary damage award, the trust or estate will recognize gain. Reg. §1.661(a)-2(f); Rev. Rul. 67-74, 1967-1 C.B. 194; *Suisman v. Eaton*, 15 F.Supp. 113, 36-2 USTC ¶9443 (D.Conn. 1935), *aff'd* 83 F.2d 1019 (2nd Cir. 1936), cert. denied 299 U.S. 573 (1936); *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940).

For a fuller discussion of the federal and Oregon fiduciary income taxes, see "A Fiduciary Income Tax Primer," *Oregon State Bar Estate Planning and Administration Section Newsletter*, Bonus Issue, October 2014.

VIII. Summary of Tax Allocations. The IRS and the courts will generally look to three factors when reviewing tax language or tax allocations contained in settlement agreements:

5. Whether the tax language or allocation was bona fide and adversarial. If one of two parties to a settlement agreement had no tax motivation regarding how the award should be allocated, and thus the other party was permitted to allocate the award as he saw fit, neither the IRS nor the courts will be inclined to abide by that allocation. For example, in *Robinson v. Commissioner*, 102 T.C. 116 (1994), aff'd 70 F.3d 34 (5th Cir. 1995), cert. denied 519 U.S. 824 (1996), the Tax Court found that the parties to a settlement agreement were adversarial as to the total amount of the settlement, but were not adversarial as to how that amount should be allocated among the underlying claims, resulting in a settlement allocation that was not the product of bona fide adversarial negotiations.
6. Whether the tax language or allocation was consistent with the true substance of the underlying claim(s). If, for example, the probate court petition sought $10,000 as a marital bequest and $90,000 in compensation for services rendered to the decedent, but the settlement agreement allocated the settlement amount 75% to the bequest (and thus eligible for the marital deduction while being free of income tax consequences) and 25% to the compensation (and thus subject to income tax), the IRS will most likely examine the situation further in order to determine whether the facts and circumstances support the settlement allocation, particularly in situations where one of the two parties does not care about the allocation and is merely accommodating the other party.
7. Whether the tax language or allocation had substantive effect, as opposed to being entirely tax motivated.

The Service has cautioned that if any of those criteria are not satisfied, the Service will examine the underlying facts and circumstances in order to reach its own conclusions regarding the correct tax consequences to be applied. In that examination, the Service will look to the underlying pleadings and the arguments made by the parties during the course of the litigation, and the language of the settlement agreement might be disregarded. IRS Field Service Advice 200146008 (4/30/01); PLR 8437084 and PLR 8405018. In Revenue Ruling 85-98, 1985-2 CB 51, the Service concluded that the complaint initially filed in the litigation was the most persuasive evidence of how the award should be characterized or allocated. Again, litigants in estate and trust matters will want to draft their pleadings with the tax consequences firmly in mind.

In some cases, the underlying claim might constitute a single, straightforward bona fide cause of action, and the resulting tax consequences may appear to leave little room for doubt, but the parties should nevertheless review the will or trust for unexpected tax consequences or opportunities for negotiation. Two such considerations are the apportionment of estate tax and the impact of fiduciary income taxation. When an estate or trust will be paying estate tax, the estate tax apportionment language of the document and/or ORS 116.303 et seq. (the estate tax apportionment statute) should be reviewed and a decision made regarding who will bear the estate tax burden of the settlement amount. That statute expressly provides that it may be overridden by the terms of a will, and presumably a settlement agreement or an order of the probate court may similarly override the statute.

IX. Payment of Attorney Fees. If the court or a settlement agreement awards attorney fees to a party, the next question is whether those attorney fees may be deducted for estate tax purposes. Oftentimes, when parties to a trust or estate dispute enter into a settlement, the parties will agree that the attorney fees incurred by both sides will be paid by the estate or trust, and such agreements are often and routinely approved by the trial court. One of the motivating factors of such an arrangement is to obtain an estate tax deduction for the fees of both sides. Thus the IRS bears part of the cost of the litigation. However, the fact that the parties and the court all agreed that the fees would be paid by the estate or trust does not necessarily make those fees eligible for an estate tax deduction. In order for a deduction to be allowed, the expense must pass a two-part test. First, the expense must be one which state law permits to be charged against the trust or estate. Reg. §20.2053-1(a)(1); *Hibernia Bank v. U.S.*, 581 F.2d 741, 745 (9th Cir. 1978). Even though a court may have allowed the fees to be charged to the estate or trust, that fact does not necessarily indicate that the ruling was consistent with state law, particularly if the parties stipulated to the court decree pursuant to a settlement agreement. Reg. §20.2053-1(b)(2); *Kessler v. U.S.*, 100 AFTR2d 2007-5423, 2007-2 USTC ¶60,544, 2007 WL 2261548 (N.D. Cal. 2007). Although a state court order allowing the payment of expenses "will ordinarily be accepted as establishing the validity and amount" of the expenses, "the decree will not be accepted if it is in variance with the law of the State." Reg. §20.2053-1(b)(2).

Second, the expense must qualify as an income tax administration expense under the fiduciary income tax statutes, or as an estate tax administration expense under §2053(a)(2). In order to qualify under §2053, the expense must be "actually and necessarily incurred in the administration" of the estate or trust. The IRS regulations state:

> The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Reg. §20.2053-3(a)(2).
>
> Attorneys' fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate within the meaning of paragraph (a) of this section. An attorney's fee not meeting this test is not deductible as an administration expense under section 2053 and this section, even if it is approved by a probate court as an expense payable or reimbursable by the estate. Reg. §20.2053-3(c)(3).

Thus expenses incurred by two beneficiaries quarreling over the size of their respective shares of an estate are not likely to qualify, but an executor defending a will from a will contest is likely to qualify, partly because the executor has a general duty to defend the will. A contestant who successfully contests a will and is able to gain admission of a different will is also likely to qualify. *Kessler v. U.S.*, 2008 WL 706533 (N.D. Cal. 2008). However, if the estate paid a beneficiary's attorney fees pursuant to a settlement agreement, but then offset those fees (pursuant to the agreement) against that beneficiary's share of the estate, then the estate did not actually bear the economic burden of those fees and may not deduct those fees. *Kessler v.*

U.S., 100 AFTR2d 2007-5423, 2007-2 USTC ¶60,544, 2007 WL 2261548 (N.D. Cal. 2007).

In the *Kessler* case, various beneficiaries of an estate contested two wills that had been signed by the decedent. The parties settled the case by admitting one of the wills and agreeing that the estate would pay the attorneys fees of all of the parties. The court applied California law and held that the executor had authority to pay his own attorney's fees, and also the fees of one of the parties nominated as executor under a will that was admitted to probate as a result of the contest, and thus those fees were deductible, but not the fees of the other beneficiaries. That result might be different under Oregon law, which grants the probate court very broad powers to award attorney fees. ORS 116.183(2); ORS 130.815; *Deras v. Myers*, 272 Or. 47 (1975). A beneficiary who conducts litigation for the benefit of the estate and/or for the benefit of other beneficiaries may, under Oregon law, be reimbursed his attorney fees from the estate. *McNeely v. Hiatt*, 142 Or App 522 (1996); *Schaad v. Lorenz*, 69 Or. App. 16, 26 (1984); McCormick v. Rand, 246 Or. 606 (1967), *Jones v. Kuhn*, 59 Or. App. 135 (1982); *Lowery v. Evonuk*, 95 Or. App. 98 (1989); *Rogers v. Rogers*, 71 Or App 133 (1985). The comments to ORS 130.815 endorse that approach. In a Tax Court case decided under Pennsylvania law, which similarly allowed attorney fees to be awarded to a beneficiary who litigated for the benefit of the estate or other beneficiaries, the attorney fees were held to be deductible for federal estate tax purposes. *Glover v. Commissioner*, T.C. Memo 2002-186.

X. Conclusion. When settling trust or estate disputes, the parties and their counsel often focus on the substantive issues of the dispute, particularly the question of how much (or which assets) each beneficiary will receive. But the tax consequences should be kept firmly in mind throughout the process, and careful planning will pay off for your client when the time comes to report the transaction to the taxing authorities.

Oregon Estate Planning and Administration Section Newsletter

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Questions, Comments, Suggestions About This Newsletter?

Contact: Chris Cline, Editor-in-Chief
(360) 759-2478, chriscline@riverviewbank.com

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Events Calendar

52nd Annual Estate Planning Seminar
Presented by the
Estate Planning Council of Portland, Inc
February 3, 2023

Estate Planning Seminar
Presented by the OSB Estate Planning Section
June 3, 2023

The Editors want to include announcements of upcoming events that are open to the public and may be of interest to our readers. If you know of an event, please send basic information, including point of contact information to Chris Cline at *chriscline@riverviewbank.com* for inclusion in the next issue of the Newsletter.