



TAX ISSUES WHEN SETTTLING A TRUST OR ESTATE DISPUTE: A GUIDE FOR THE LITIGATOR

By Brian G. Fredkin, Esq.,* and Ryan J. Szczepanik, Esq.**

The merits of the claims typically drive the negotiations to resolve a trust or estate dispute. Tax issues often are a secondary focus. It is not uncommon for the litigator to wake up the morning after reaching a settlement wondering if she or he neglected to appreciate a significant tax issue. The purpose of this article is to help trust and estate litigators identify the tax issues most likely present in a trust or estate dispute, so they can be sensitive to these issues when guiding their clients through settlement.

The trust and estate litigator advising on a settlement strategy should always consider the impact that taxes may have on the value of a claim. If a property right or interest is transferred, modified, or terminated in a settlement, the client may be subject to unanticipated tax exposure. For example, the client may receive an IRS Form K-1 or 1099 in the year following a settlement requiring the client to report as taxable income all or part of the settlement payment. The IRS may notify the client who is the surviving spouse that a lump-sum payment he or she received in a settlement terminating the surviving spouse's interest in the deceased spouse's estate has triggered an estate or gift tax. The IRS may notify the client that the partition through settlement of a trust that was exempt from the generation-skipping transfer tax has caused the trust to lose its exempt status. The local county assessor may notify the client that real property received in the settlement will be reassessed for property tax purposes.

This article focuses on the relevant tax laws and techniques an attorney may employ to: (1) avoid an unexpected tax surprise when guiding the client through settlement of a trust or estate dispute; and (2) reach a settlement agreement that the IRS and federal courts are more likely to respect for federal tax purposes.

Part I of this article summarizes the tax laws that the authors anticipate may be involved in a typical trust or estate dispute.

Part II discusses the factors the IRS and federal courts will apply to determine whether to respect a settlement agreement and the principles that have emerged from the relevant case law.

Part III presents a hypothetical to illustrate the tax laws and factors discussed in Parts I and II.

Part IV evaluates the scrutiny the IRS will give to the pleadings, discovery, and settlement documents in deciding whether to respect the tax-related provisions of a settlement agreement. Part IV concludes with strategies an attorney may employ to obtain a favorable decision on those tax provisions.

I. RELEVANT TAX LAWS

A. Federal Income Tax

1. Gross Income

Gross income means "all income from whatever source derived" unless specifically excluded by law.¹ Property received by "gift, bequest, devise, or inheritance" is excluded from gross income and is therefore not subject to income tax,² although the income generated by such property after receipt is included in gross income and subject to income tax to the recipient.³ A gift, bequest, devise, or inheritance of income from property, as opposed to the property itself, is also included in gross income and therefore, subject to income tax.⁴

2. Income Tax Basis

"Basis" is the amount of a taxpayer's investment in property for tax purposes.⁵ Basis of property is used to figure depreciation, amortization, depletion, casualty losses, and gain or loss on the sale or other disposition of property.⁶

The donee's basis of property received by gift during a donor's lifetime equals the donor's basis at the time of the gift, plus any gift tax paid by the donor.⁷ The basis of the property in the hands of the donor immediately prior to the gift "carries over" to the donee and is commonly referred to as a "carryover basis." However, if the basis of the property exceeds its fair market value⁸ at the time of the gift, the donee's basis in the property will be its fair market value at the time of the gift if the donee later sells or disposes of the property for a loss.⁹

The basis of property received by reason of a decedent's death is generally equal to the property's fair market value on the date the decedent died, or the alternate valuation date.¹⁰ In general, the basis of all community property held by the decedent and the surviving spouse, as well as the decedent's separate property, is adjusted to the fair market value of the property on the applicable valuation date.¹¹ The date of death basis adjustment is typically referred to as a "step-up" in basis since the basis of the property in the hands of the decedent is usually lower than the fair market value at the date of death,



resulting in an increase in basis. However, if the fair market value of the property on the decedent's date of death is lower than its basis in the hands of the decedent, the basis will be reduced or "stepped down."¹²

Commonly held property interests that may be eligible for a date of death basis adjustment include real estate, personal property, stock, and entity interests. Deathbed transfers¹³ and payments of income in respect of a decedent, commonly referred to as "IRD"¹⁴ (e.g., qualified retirement plans,¹⁵ IRAs,¹⁶ unpaid wages,¹⁷ accrued interest¹⁸), do not receive a date of death basis adjustment.¹⁹

When property is sold or disposed of, the amount realized in excess of the property's basis results in a capital gain.²⁰ Conversely, if the amount realized is less than the property's basis, a capital loss results.²¹ For federal income tax purposes, capital gain or loss can be either short-term (for property held for one year or less) or long-term (for property held for more than one year).²² Short-term capital gain is taxed at the same rate as ordinary income.²³ Long-term capital gain is taxed at a more favorable rate (0%, 15%, or 20%, depending on the taxpayer's taxable income).²⁴ California taxes capital gain, both short term and long term, at the same rate as it taxes ordinary income.²⁵ The highest tax rate in California is 13.3%.²⁶

When a remainder interest is sold or otherwise disposed of, the basis of the remainder interest is not disregarded.²⁷ However, when a "term interest" (i.e., a life interest in property, an interest in property for a term of years, or an income interest in a trust)²⁸ is sold or disposed of, the basis of the term interest is disregarded; the full sales price is taxable.²⁹ If the entire interest (i.e., the term interest and the remainder interest) in the property is sold or disposed of in a single transaction, the property's basis is not disregarded.³⁰

3. *Income Tax Deductions*

Expenses paid or incurred to protect or assert one's right to the property of a decedent as an heir or beneficiary are not deductible from gross income.³¹ Ordinary and necessary expenses paid or incurred for the production or collection of income, on the other hand, are deductible.³² Ordinary and necessary business expenses are also deductible.³³ Administration expenses include fiduciary fees, accounting expenses, and legal expenses paid by a fiduciary from a decedent's trust or estate to defend a claim against the trust or estate. Those expenses are generally deductible from the trust or estate's gross income if they are ordinary and necessary and paid from the trust or estate in connection with the performance of the duties of administration.³⁴

B. *California Real Property Tax*

1. *Reassessment*

In California, property taxes are based on the assessed value of real property. Property taxes are assessed and collected by local county assessors and tax collectors. Property taxes are limited to 1% of the property's assessed value, charged annually.³⁵ Absent a change of ownership, the assessed value may be adjusted annually for inflation at a rate not to exceed 2%.³⁶

In general, California real property is reassessed when a "change in ownership" occurs.³⁷ A "change in ownership" is defined as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest."³⁸ A change in ownership occurs on the transfer of property by sale, gift, or inheritance, unless a statutory exclusion applies.

2. *Statutory Exclusions*

There are a number of exclusions from a change in ownership.³⁹ Two common statutory exclusions from a change in ownership are the interspousal exclusion⁴⁰ and the parent-child exclusion.⁴¹

The interspousal exclusion provides that any interest in real property that is transferred between spouses or registered domestic partners, either during lifetime or at death, is excluded from reassessment.⁴² Qualified interspousal transfers also include transfers of interests in a legal entity (e.g., corporation, partnership, limited liability company) that holds real property.⁴³ The parent-child exclusion is more limited. It excludes from reassessment only the following transfers of real property between a parent and child: (i) the transfer of a principal residence;⁴⁴ and (ii) the transfer of the first \$1 million of assessed value of real property other than a principal residence, measured in the aggregate.⁴⁵ For purposes of the parent-child exclusion, "real property" does not include interests in a legal entity that holds real property.⁴⁶ For purposes of the exclusion, "children" include sons and daughters, sons-in-law and daughters-in-law, stepchildren, and children adopted before age eighteen.⁴⁷

When real property is transferred to or from a trust, the assessor will look "through" the trust at who has the present beneficial interest to determine whether a change in ownership has occurred.⁴⁸ A transfer in trust will qualify for a statutory exclusion if the present beneficial interest in the trust passes from a deceased spouse to a surviving spouse, or from a deceased parent to a surviving child.



3. *Transfer of Base-Year Value for Persons Over Age 55 or Who Are Permanently Disabled*

If a homeowner is over age 55 or severely and permanently disabled, that individual can sell their home and transfer the assessed value of that home to a qualifying principal residence of “equal or lesser value” located in the same county, or in one of the following counties: Alameda, Los Angeles, Orange, Riverside, San Bernardino, San Diego, San Mateo, Santa Clara, Tuolumne, and Ventura.⁴⁹ If a principal residence is held in an irrevocable trust created upon the death of the deceased spouse, the surviving spouse who has a beneficial interest in such trust may qualify for the transfer of base-year value to a new residence.⁵⁰

4. *Legal Entities that Own Real Property*

Real property is often held in a legal entity. An attorney for a client contemplating the transfer of an interest in a legal entity that holds real property should investigate whether a “change in control”⁵¹ or a “change in ownership”⁵² will occur. A “change in control” occurs when a person or legal entity obtains more than a 50% ownership interest in a legal entity.⁵³ When a change in control occurs, all real property owned by the entity as of the date of change in control is reassessed.⁵⁴ A “change in ownership” occurs when there has been a cumulative transfer of more than 50% of the original co-owners’ interests.⁵⁵ When a change in ownership occurs, only the interests that were excluded upon a transfer of real property to the entity are reassessed.⁵⁶

Form BOE-100-B must be filed with the State Board of Equalization within 90 days of an event that constitutes a “change in control”⁵⁷ or a “change in ownership,”⁵⁸ or upon written request by the Board of Equalization.⁵⁹ Penalties for late filing apply.⁶⁰

C. Federal Transfer Taxes

1. *“Transfer Taxes” and Liability for Payment*

The federal gift, estate and generation-skipping transfer (“GST”) taxes are assessed on the transfer of property and are often referred to as “transfer taxes.” The transferor or the transferor’s estate is generally liable for the payment of a transfer tax.⁶¹ However, the transferee can be liable for such tax if the transferor or the transferor’s estate does not or cannot pay.⁶² California no longer imposes transfer taxes.⁶³

2. *History*

The Tax Reform Act of 1976 (“1976 Tax Act”) unified estate and gift taxes with one rate schedule and one federal estate and gift tax exclusion. Lifetime taxable gifts in excess of applicable exclusions and deductions reduce the exclusion amount available at death. The 1976 Tax Act also established the GST tax. Prior to the 1976 Tax Act, individuals would use trusts to skip transfer taxes on one or more generations. The Economic Recovery Tax Act of 1981 (“1981 Tax Act”), effective beginning in 1982, established unlimited gift and estate tax marital deductions for transfers between spouses. The purpose of these deductions is to treat a married couple as a single economic unit and defer the gift or estate tax until the death of the surviving spouse. The 1981 Tax Act updated the Internal Revenue Code (the “Code”) to qualify certain terminable interests as deductible for purposes of the unlimited gift and estate tax marital deductions.⁶⁴

3. *Applicable Exclusion and Exemption Amounts*

The 2017 Tax Cuts & Jobs Act doubled the estate and gift tax exclusion amount available to each individual U.S. citizen or resident from \$5 million (applicable to tax years 2011 through 2017)⁶⁵ to \$10 million (applicable to tax years 2018 through 2025).⁶⁶ After adjustments for inflation, the estate and gift tax exclusion amount is \$11.4 million per individual in 2019.⁶⁷ The GST exemption is also \$11.4 million per individual in 2019.⁶⁸ The maximum estate and gift tax rate is 40% in 2019,⁶⁹ while the GST tax rate is a flat rate equal to the maximum federal estate and gift tax rate (*i.e.*, 40% in 2019).⁷⁰

4. *Gift Tax*

The federal gift tax applies to property transferred for less than full and adequate consideration while the donor is living.⁷¹ Donative intent is not required.⁷² If property is “transferred for less than adequate and full consideration in money or money’s worth,” the gift for federal gift tax purposes is the excess of the fair market value of the transferred property on the date of the gift over the value of consideration received.⁷³

The gift tax does not apply to transfers that occur “in the ordinary course of business”; a transaction which is bona fide, at arm’s length, and free from donative intent will be considered as made for an adequate and full consideration in money or money’s worth.⁷⁴ Transfers between spouses,⁷⁵ to charitable organizations,⁷⁶ educational organizations for tuition,⁷⁷ medical care providers,⁷⁸ political organizations,⁷⁹ and gratuitous services (*e.g.*, trustee’s waiver of their right to a trustee fee)⁸⁰ are also excluded from the gift tax.



The gift tax annual exclusion in 2019 allows a donor to give up to \$15,000 of cash or other property to each of an unlimited number of individuals in a calendar year without reducing the donor's lifetime estate and gift tax exclusion and without having to file a federal gift tax return (IRS Form 709).⁸¹ Gifts in excess of the annual exclusion must be reported on a Form 709 for the year in which the gifts occur and will reduce the donor's estate and gift tax exclusion cumulatively.

5. Estate Tax

The federal estate tax applies to transfers of property or retained interests in property held by a decedent at death. The estate tax is imposed on the value of the decedent's "taxable estate."⁸² The taxable estate is the decedent's "gross estate"⁸³ as reduced by allowable deductions.⁸⁴ As noted above, after adjustments for inflation the estate and gift tax exclusion is \$11.4 million per individual in 2019. The exclusion available to a decedent's estate is reduced by the amount of the exclusion the decedent used on lifetime taxable gifts.⁸⁵ Certain lifetime transfers that are subject to gift tax may be included in the decedent's gross estate for estate tax purposes.⁸⁶ Taxable gifts previously reported with respect to such lifetime transfers are disregarded to the extent that the transferred property is included in the gross estate, and the value of those taxable gifts does not reduce the estate tax exclusion.⁸⁷

a. IRS Form 706

A federal estate tax return (IRS Form 706) must be filed by an executor or administrator when a decedent's gross estate, adjusted for taxable gifts, is more than the exclusion amount (currently \$11.4 million).⁸⁸ A Form 706 must also be filed, even if the decedent's gross estate is less than the exclusion, when the executor elects to transfer the deceased spouse's unused exclusion amount to the surviving spouse.⁸⁹ The Form 706 must be filed within nine months of the decedent's date of death.⁹⁰ The executor or administrator may request a six-month extension of time to file the return,⁹¹ but the full amount of the estate tax must be paid by the original due date to avoid the assessment of interest and penalties.

The IRS has three years from the date the return is filed to assess additional tax.⁹² If upon examination of the return the IRS allows additional estate tax deductions within the assessment period, the attorney may file supplemental information to the estate tax return⁹³ or a Form 843 Claim for Refund and Request for Abatement.⁹⁴

b. Marital Deduction

One of the most common deductions from the estate tax is the marital deduction, which provides that the fair market value of property passing to the decedent's spouse is deductible from the decedent's gross estate.⁹⁵ To qualify for this marital deduction, the surviving spouse may receive such property either outright or in trust.⁹⁶ On the surviving spouse's death, the remaining amount of that property is included in the surviving spouse's gross estate for estate tax purposes.⁹⁷

c. Charitable Deduction

If, on the death of a decedent, property is transferred to an organization operated for exclusively public, religious, charitable, scientific, literary, or educational purposes, the fair market value of such property on the decedent's date of death may be deducted from the value of the decedent's gross estate.⁹⁸ The value of property transferred to a charitable remainder unitrust, charitable remainder annuity trust, or a pooled income fund may also be deducted.⁹⁹

d. Deductible Expenses

Funeral expenses, estate and trust administration expenses, unpaid mortgages and other indebtedness, and claims against the decedent's estate may be deducted from the value of the decedent's gross estate.¹⁰⁰ Executors' commissions, trustees' fees, attorneys' fees, and miscellaneous expenses that are "actually and necessarily" incurred in the administration of the decedent's estate may be deducted on either the estate or income tax return.¹⁰¹ A claim against the decedent's estate may be deducted if the claim is bona fide and actually paid.¹⁰² Attorneys' fees that a beneficiary personally incurs are generally not deductible unless "essential to the proper settlement of the estate."¹⁰³

6. Generation-Skipping Transfer Tax

The GST tax is imposed, in addition to the gift or estate tax, on the transfer of property that constitutes a "direct skip."¹⁰⁴ A direct skip occurs when a transferor, either during life or at death, transfers property to a trust for the benefit of or directly to an individual who is two or more generations younger than the transferor (*i.e.*, a "skip person"¹⁰⁵). A "skip person" is typically a grandchild of the transferor or an unrelated individual who is more than 37.5 years younger than the transferor.¹⁰⁶

The GST tax may also be imposed, without the imposition of estate or gift tax, if the transfer of property constitutes an "indirect skip."¹⁰⁷ An indirect skip is a transfer to a "skip person" that involves an intermediate step before the "skip person"



receives the property. There are two types of indirect skips: “taxable termination”¹⁰⁸ and “taxable distribution.”¹⁰⁹

A “taxable termination” occurs when the interests of all non-skip persons in a trust terminate.¹¹⁰ For example, if a grandparent creates a trust for the benefit of his or her child and grandchildren, and the grandchildren (*i.e.*, skip persons) are the only remaining beneficiaries when the child dies, a “taxable termination” occurs.¹¹¹

A “taxable distribution” occurs when income or principal is distributed from a trust to a skip person other than pursuant to a taxable termination or a direct skip.¹¹² Assuming the same facts as in the taxable termination example, if, during the child’s lifetime, a distribution of income or principal is made to a grandchild, that distribution would be a “taxable distribution.”¹¹³

Generation-skipping transfers must be reported to the IRS.¹¹⁴ The GST tax does not apply to transfers made directly to educational or health care providers,¹¹⁵ or to transfers which fall within the gift tax annual exclusion.¹¹⁶

II. FACTORS THE IRS AND FEDERAL COURTS WILL APPLY TO DETERMINE WHETHER TO RESPECT A SETTLEMENT AGREEMENT

A. The Four-Part Test

For federal tax purposes, state law defines property interests and rights. The federal revenue acts designate what interests or rights, so created, will be taxed.¹¹⁷

When parties resolve their dispute pursuant to a settlement agreement, the IRS or a federal court may later scrutinize that agreement to determine whether it is the product of a collusive effort. The IRS and federal courts are concerned with parties colluding to gain a tax benefit the parties could not otherwise obtain had they litigated to a final judgment on the merits.¹¹⁸ The following four-part test (“Four-Part Test”) generally controls whether the IRS or a federal court will respect the characterization of the parties’ legal interests and rights in the settlement agreement.¹¹⁹

(1) *Bona Fide Dispute*. The settlement agreement must resolve a bona fide dispute.¹²⁰ The IRS and federal courts apply special scrutiny to intrafamily transfers to settle a family dispute.¹²¹ The IRS and federal courts will not treat a settlement agreement as bona fide unless the parties’ claims are satisfied, to the extent feasible, on an economically fair basis.¹²² If a genuine dispute does not exist, the

IRS or a federal court may conclude that a property interest transferred in settlement constitutes a gift,¹²³ or that the transfer constitutes a sale or exchange for full and adequate consideration.¹²⁴

(2) *Bona Fide Claim*. The amount received must be premised on a bona fide claim under state law.¹²⁵ The settled claim should be based on an “enforceable right under state law, properly interpreted,” to be treated as “passing from the decedent” for federal tax purposes.¹²⁶ The parties may not disregard or misapply state law in an attempt to receive a favorable tax outcome.¹²⁷ A payment to settle a claim that is not enforceable under state law may constitute a taxable gift,¹²⁸ or taxable income.¹²⁹

(3) *Quantitative Test*. The amount received must not be greater than what the party could have obtained by proceeding to a final judgment on the merits.¹³⁰ The agreement should reflect the economic values of the parties’ claims, with appropriate allowance given the uncertainty of litigation.¹³¹ For example, if the reasonable value of a claim brought by an heir is \$100,000, and the heir receives \$150,000 in settlement, a portion of the excess may be treated as not “passing from the decedent,” and thus income taxable to the heir or subject to gift tax.

(4) *Qualitative Test*. The amount received must be of a character and nature of what the party could have obtained by proceeding to a final judgment on the merits.¹³² For example, if a QTIP trust limits the surviving spouse’s interest to income, and in settlement the spouse receives an outright distribution of principal in exchange for the termination of the spouse’s interest in the QTIP trust, the IRS or a federal court might not treat that outright distribution of principal as “passing from the decedent.” The distribution therefore might not qualify for the estate tax marital deduction.¹³³

The cases that established the Four-Part Test, and the implications arising out of those cases, follow.

B. Income Tax Issues: *Lyeth*

In 1938 the U.S. Supreme Court in *Lyeth v. Hoey*¹³⁴ addressed whether, pursuant to an agreement to settle a will contest, property received by an heir constitutes property



acquired by “inheritance” thereby excluding the value of the property from gross income.¹³⁵ The Court determined that the claimant’s standing as an heir and his claim in that capacity, not state law, controlled the federal income tax consequences.¹³⁶ The Court thus held that property received pursuant to the settlement of a bona fide will contest is treated as passing directly from the decedent by inheritance and is therefore excluded from gross income.¹³⁷

For *Lyeth* to apply, there must be a compromise of a disputed claim by the estate or its heirs, as opposed to a voluntary rearrangement of property interests among heirs.¹³⁸ Under *Lyeth*, the taxability of an amount a taxpayer receives in settlement of a lawsuit is determined by reference to the origin and character of the claim which gave rise to the lawsuit.¹³⁹ The court will examine the settlement agreement to determine the underlying nature of the claim.¹⁴⁰ If the agreement does not contain express language stating the basis of the payment, the court will review the allegations contained in the taxpayer’s complaint, and the history of the parties’ negotiations when characterizing a settlement for federal tax purposes.¹⁴¹ The critical question is: what was the settlement amount paid in lieu of?¹⁴²

The following principles flow from *Lyeth*: Amounts received in settlement of a claimant’s undisputed status as an heir to settle a will or trust contest,¹⁴³ including the portion of that amount that represents legal fees incurred in pursuit of that claim,¹⁴⁴ are excluded from gross income.¹⁴⁵ Amounts received to settle a claimant’s alleged status as an heir are also excluded from gross income.¹⁴⁶ The settlement does not have to constitute a portion of the same assets the heir would have received by inheritance or by prevailing in a lawsuit to recover such inheritance, such as receipt of a cash settlement in lieu of an in-kind distribution.¹⁴⁷ However, payments to settle a claim for lost profits,¹⁴⁸ services provided as an employee of the decedent,¹⁴⁹ and punitive damages¹⁵⁰ are taxed as ordinary income.

Payments of IRD¹⁵¹ or net income from a trust¹⁵² are included in the gross income of the recipient. If a beneficiary receives a right to IRD by reason of the decedent’s death, a subsequent transfer of that right pursuant to a settlement agreement may constitute a sale or exchange; the beneficiary would be taxed on either the consideration received or the fair market value of such right at the time of the transfer, whichever is greater.¹⁵³

When beneficiaries exchange properties pursuant to a settlement agreement, unless an exclusion applies,¹⁵⁴ gain or loss must be recognized if the properties exchanged are

“materially different.”¹⁵⁵ Properties are “materially different” if “their respective possessors enjoy legal entitlements that are different in kind or extent.”¹⁵⁶ Dividing a trust and re-allocating assets into separate trust shares, however, is not an exchange of property for other property differing materially in kind or extent if the severance and non-pro rata allocation is permitted by state statute or the governing instrument.¹⁵⁷ Reformation of a trust *ab initio* (i.e., retroactive to the date the trust was created) to correct drafting errors and to effectuate the original intent of the grantor will also not result in gain or loss.¹⁵⁸

If a beneficiary under a will or a trust has a right to a specific sum of money, and that right is satisfied with property in kind that has appreciated in value since the decedent’s date of death (e.g., publicly traded securities), the recipient must recognize gain.¹⁵⁹ If an individual unrelated to the decedent makes a claim against a specific asset (e.g., real property), and that claim is satisfied with property of a different type (e.g., cash), the amount received may constitute taxable income.¹⁶⁰

C. Transfer Tax Issues: *Bosch* and *Ahmanson*

In 1967 the U.S. Supreme Court in *Commissioner v. Estate of Bosch*¹⁶¹ held that the IRS and federal courts are not bound by a lower state court determination of state law property rights for federal tax purposes.¹⁶²

The Court in *Bosch* considered whether a state trial court’s characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court established a framework, called the “proper regard” test, to address the deference the IRS or a federal court should apply to a lower state court adjudication of state law property rights or interests that have a federal tax consequence. The Court concluded that the decision of a state trial court concerning an underlying state law issue shall not be controlling when applied to a federal statute.¹⁶³ The highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter, but if there is no decision by that court (i.e., the California Supreme Court), then the federal authority must apply what it finds to be state law after giving “proper regard” to the state trial court’s determination and to relevant rulings of other courts of the state.¹⁶⁴ The federal authority will, in effect, sit as a state court.¹⁶⁵

In *Ahmanson Foundation v. United States*,¹⁶⁶ the U.S. Court of Appeals for the Ninth Circuit examined whether the marital deduction applied to property passing to a surviving spouse under a settlement agreement. Applying *Bosch*, the court found that a good faith settlement between adversarial parties was not enough to qualify for the marital deduction.¹⁶⁷



The settlement payment to the surviving spouse must be based on an enforceable right under state law, correctly interpreted by the federal court, to qualify as “passing” from the decedent for purposes of the marital deduction.¹⁶⁸ The court concluded that since a federal court is not bound by a lower state court, it also is not bound by a settlement agreement among the parties to a dispute.

D. Post-Ahmanson Principles

A review of the federal courts’ application of the “proper regard” test since *Bosch* was decided in 1967 found that federal courts have held in over one-half of the cases that the lower state court misapplied state law.¹⁶⁹ “At best, the federal courts give mere lip service to the *Bosch* ‘proper regard’ standard. In most cases, the federal courts engage in a *de novo* review of state law without giving any weight to the state court decision. In addition, many federal courts also have reverted to a pre-*Bosch* focus on the adversariness of the state court decision.”¹⁷⁰

In general, the IRS and federal courts apply the *Bosch* doctrine when analyzing transfer tax issues and the *Lyeth* doctrine when analyzing income tax issues.¹⁷¹

The following principles flow from *Bosch* and *Ahmanson*.

1. *Whether a Settlement Payment to a Surviving Spouse Qualifies for the Estate Tax Marital Deduction*

In the context of a will or trust contest, the IRS and federal courts are likely to treat a settlement payment to a surviving spouse that meets all four elements of the Four-Part Test as one that “passed from the decedent;” and thus, the payment should qualify for the estate tax marital deduction.¹⁷² In accordance with the Four-Part Test: (i) the dispute between the parties must be genuine; (ii) the payment must represent a “bona fide recognition of enforceable rights of the surviving spouse in the decedent’s estate” (*i.e.*, the surviving spouse must have an enforceable right under state law);¹⁷³ (iii) the surviving spouse must not receive an amount that is greater than what she or he is entitled to under state law; and (iv) the surviving spouse’s settlement payment must be qualitatively similar to the surviving spouse’s interest in the decedent’s estate.

If the surviving spouse assigns or surrenders an interest in the decedent’s estate to another party, that assigned or surrendered interest will not be considered to have “passed from the decedent,” and thus, will not qualify for the estate tax marital deduction.¹⁷⁴ The estate tax marital deduction is limited to what the surviving spouse actually receives.¹⁷⁵

2. *Whether a Settlement Payment to a Charity Qualifies for the Estate Tax Charitable Deduction*

In the context of a will or trust contest, the IRS and federal courts are likely to treat a settlement payment to a charity that meets all the elements of the Four-Part Test as one that “passed from the decedent”; thus, the payment should qualify for the estate tax charitable deduction.¹⁷⁶ The IRS and federal courts apply a similar analysis as above in the case of a transfer to a surviving spouse,¹⁷⁷ except for one difference: a settlement payment to a charity that represents a qualitative departure under part 4 of the Four-Part Test may still be treated as “passing from the decedent.” Thus, the payment may qualify for the estate tax charitable deduction as long as the other elements of the Four-Part Test are met.¹⁷⁸

If a charity assigns or surrenders a part of a transfer to it, the amount so assigned or surrendered is not deductible as a transfer to that charitable organization.¹⁷⁹ The estate tax charitable deduction is limited to the amount actually received.¹⁸⁰ If the charity receives a settlement payment that exceeds what the charity would have been entitled to under state law, the excess amount is not deductible for estate tax purposes.¹⁸¹

3. *Whether a Settlement Payment Triggers Gift Tax*

The IRS will deem a transfer of property exempt from gift tax if the transfer is bona fide, at arm’s length, and free from donative intent.¹⁸² As noted earlier, the IRS applies special scrutiny to transfers of property to settle a family dispute.¹⁸³ The IRS will not regard an intrafamily settlement of litigation as a bona fide compromise agreement unless the parties’ claims are recognized under state law and are satisfied, to the extent feasible, on an “economically fair basis.”¹⁸⁴ The settlement should reflect the economic values of the parties’ claims, with appropriate allowance for litigation uncertainty.¹⁸⁵ In *Estate of Redstone v. Commissioner*,¹⁸⁶ the tax court applied the following subsidiary factors to determine whether an intrafamily transfer is subject to gift tax: (1) whether a genuine controversy existed between the parties; (2) whether counsel represented and advised the parties; (3) whether the parties engaged in adversarial negotiations; (4) whether the value of the property involved was substantial; (5) whether the parties’ desire to avoid the uncertainty and expense of litigation motivated the settlement; and (6) whether a judicial body supervised the settlement and incorporated that settlement in a judicial decree.¹⁸⁷



If the settlement involves the transfer by sale or gift of an income or remainder interest in a QTIP or bypass trust, there may be gift or income tax exposure (as discussed in Part IV).

III. HYPOTHETICAL TO ILLUSTRATE TAX LAWS AND FACTORS

The following hypothetical estate and trust dispute illustrates the application of some of the relevant tax laws discussed in this article.

Father, a U.S. citizen age 80, died in 2016 when the maximum estate and gift tax exclusion was \$5.45 million. Father was survived by his spouse of a second marriage, Stepmother, age 55, and his two adult children from his first marriage: Son and Daughter. Father died with a net worth of \$20 million, consisting of the following separate property assets (date of death fair market values shown):

- A principal residence (\$5 million);
- All outstanding shares in ABC Corp., an S corporation holding a business operated by Son (\$2 million);
- Stock and bank accounts (\$8 million);
- Life insurance policy with a face amount of \$3 million naming Stepmother, Son, and Daughter as equal one-third (1/3) beneficiaries (\$3 million); and
- IRA naming Stepmother as the sole beneficiary (\$2 million).

With the exception of the life insurance policy and the IRA, all of Father's assets were titled in the name of the Father Living Trust. Shortly before his death, Father amended the trust to provide for the following distributions and administration after his death:

- A specific bequest of \$1 million to a named and qualified charitable organization;
- An amount not to exceed the exclusion available to Father's estate to the bypass trust; and
- The balance of the trust assets to the QTIP trust;
- Stepmother is named as the sole trustee and beneficiary of the bypass trust and the QTIP trust. Stepmother is to receive all the QTIP trust income annually and may receive discretionary distributions of principal for her health, support, or maintenance. Stepmother may receive discretionary distributions of income and

principal from the bypass trust for her health, support, or maintenance; and

- When Stepmother dies the remaining trust estate must be divided into equal shares for Son and Daughter and held in trust for their lifetimes.

Son and Daughter accuse Stepmother of committing financial elder abuse against their father. They file a trust contest alleging that Father lacked capacity when he amended the trust. They argue that the original trust instrument that Father executed, naming Son and Daughter as equal beneficiaries, should control over the amendment that Father subsequently executed. They also argue that the original beneficiary designation for the IRA that Father executed, which named Son and Daughter as equal beneficiaries, should control over the beneficiary designation that Father subsequently executed naming Stepmother as sole beneficiary. Daughter and Stepmother dispute whether Son is competently managing ABC Corp.

Several months after Father's death, the guardians of a minor child previously unknown to all the parties file a claim against Father's estate claiming the share of an omitted child. Father's caretaker, who is unrelated to Father and assisted with his care and maintenance in the last few years before he died, files a claim against Father's estate for unpaid wages.

Stepmother filed Father's estate tax return timely and made a QTIP election. She funded the bypass trust with the ABC Corp. stock (\$2 million) and a portion of the bank and stock accounts (\$3.45 million), fully utilizing Father's available estate tax exclusion and GST exemption amounts. She allocated the remaining trust assets to the QTIP trust. Because of the pending litigation, however, she deferred making the \$1 million distribution to the charity. She also deferred taking minimum required distributions from the IRA until the issues regarding the beneficiary designation were resolved. Father did not withdraw the minimum required distribution for 2016 before he died.

After two years of litigation, the parties—each of whom was separately represented—negotiated a settlement agreement to avoid the uncertainty, delay, and expense of litigating to a judgment on the merits. After two months of negotiations, the parties finalized their agreement, and it was subsequently approved by the local superior court.

Pursuant to the agreement, the parties agreed to distribute Father's assets as follows:



- The named charitable beneficiary will receive a cash distribution of \$600,000.
- The omitted minor child will receive a cash distribution of \$2 million, to be held in trust for her lifetime.
- Father's caretaker will receive \$200,000, representing the full amount of unpaid wages, plus interest.
- Son and Daughter each receive \$150,000 in resolution of their claim against Stepmother for financial elder abuse.
- The bypass trust will be divided into Trust One and Trust Two. Trust One will hold the shares of ABC Corp. (\$2 million date of death value) and cash (\$725,000). Trust Two will hold cash and stock (\$2.725 million date of death value). Stepmother will remain as the sole current beneficiary of Trust One and Trust Two. Son will be the sole remainder beneficiary of Trust One. Daughter will be the sole remainder beneficiary of Trust Two. The purpose of the division is to avoid a future conflict between Son and Daughter regarding the ownership and operation of ABC Corp. after Stepmother dies.
- The remaining trust assets will be allocated to the QTIP trust. Stepmother will remain as the sole beneficiary of such trust.
- Stepmother will receive the IRA in accordance with Father's most recent beneficiary designation.
- The life insurance policy will be distributed consistent with Father's beneficiary designation: in equal one-third shares to Stepmother, Son, and Daughter.

The tax consequences to the parties may vary, as follows:

1. *Will dividing the bypass trust into two separate trusts constitute a taxable disposition of trust assets for income tax purposes, thereby resulting in capital gain or loss?*

The division will not result in a capital gain or loss as long as Stepmother has the authority under state law or pursuant to Father's Trust to: (i) divide the trust; and (ii) distribute the assets non-pro rata to the resulting trusts.¹⁸⁸ California law provides that Stepmother may petition the court to divide the bypass trust for good cause, if the division will not defeat or substantially impair the trust's purpose.¹⁸⁹ California law also permits Stepmother to distribute the assets non-pro rata unless the trust instrument forbids it.¹⁹⁰

Nevertheless, if Father's Trust prevents non-pro rata funding, the division will be treated as a pro rata funding followed by an exchange of assets between Trust One and Trust Two.¹⁹¹ Such an exchange would result in taxable income to the beneficiary of the trust to the extent the amount received exceeds the trust's basis in the amount exchanged or surrendered pursuant to the settlement.¹⁹²

2. *Will the IRS treat the division of the bypass trust into two separate trusts as a taxable gift?*

The division appears to have been made without donative intent and pursuant to a settlement agreement entered into at arm's length with each party represented by separate counsel. The division also appears to be economically fair to the parties. Accordingly, the division will constitute a transfer for full and adequate consideration and will not be treated as a taxable gift.¹⁹³

3. *Will dividing the bypass trust into two trusts cause the loss of GST exemption, thereby resulting in the assessment of GST tax?*

A trust that is exempt from GST tax may lose its exempt status as a result of modifications that change the quality, value, or timing of any beneficial interests, rights, or expectancies provided for under the terms of the original trust instrument.¹⁹⁴ Nevertheless, the bypass trust will not lose its status as a GST exempt trust as a result of dividing it into Trust One and Trust Two because: (1) the division will not shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than Stepmother who held the beneficial interest prior to the division; and (2) the division will not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.¹⁹⁵

If the settlement agreement modifies the GST exempt trust in a manner that differs from one of the safe harbors provided in Treasury Regulations section 26.2601-1(b)(4)(i)(E),¹⁹⁶ the parties should obtain court approval of the settlement agreement. The parties may consider obtaining a favorable private letter ruling prior to entering into the settlement agreement that confirms the IRS will not deem the modified trust as nonexempt from GST tax. A settlement agreement that disqualifies the trust for GST tax exempt status would cause the loss of 40% of its assets at the current GST tax rate.



4. *What is the tax result if Stepmother sells her income and principal interests in Trust One of the bypass trust to Son for a single cash payment representing the actuarial value of that interest, and the trust is terminated so that Son receives the ABC Corp. shares outright?*

Stepmother has an income tax basis in her principal interest, but not in her income interest, in Trust One of the bypass trust.¹⁹⁷ If the sale occurs more than one year after Father's death, Stepmother will recognize a long-term capital gain to the extent the amount she receives exceeds the basis of her principal interest.¹⁹⁸

If, with respect to Stepmother's income interest in Trust One of the bypass trust, she receives a settlement payment that exceeds the actuarial date of death value of that interest, the excess may constitute a taxable gift by Son. If Stepmother receives a payment that is less than the actuarial date of death value of the income interest, the deficit may constitute a taxable gift by Stepmother.

If, with respect to Stepmother's principal interest in Trust One of the bypass trust, she receives a settlement payment that exceeds the fair market value of that interest, the excess may constitute a taxable gift by Son. If Stepmother receives a payment that is less than the value of that principal interest, the deficit may constitute a taxable gift by Stepmother.

Stepmother's gift and income tax exposure will be reduced because of the trust division. Trust Two of the bypass trust would avoid an income recognition event or gift tax if Stepmother sells to Son her income and principal interest only in Trust One of the bypass trust.¹⁹⁹

5. *How will the tax result vary in questions 1 through 4 if the trust involved is a QTIP trust instead of a bypass trust?*

The tax result likely will be the same as under questions 1 through 3.²⁰⁰ The outcome under question 4, however, will be different. Stepmother will recognize a long-term capital gain for the amount received that exceeds the basis of her principal interest. In addition, the IRS likely would treat the sale as a deemed gift by Stepmother of the entire value of the QTIP trust, as reduced by the actuarial value of Stepmother's qualifying income interest for life on the transfer date, the amount paid to Stepmother for the release of her right to principal distributions, and the amount of gift tax that Stepmother may recover under section 2207A(b) of the Code.²⁰¹

The payment to Stepmother for her income and principal interests in the QTIP trust likely would not qualify for the estate tax marital deduction. Even though the payment satisfies parts 1 through 3 of the Four-Part Test, the payment fails part 4. An outright payment is not the same form to which Stepmother would be entitled had she litigated to a final judgment on the merits—an income and principal interest in a QTIP Trust, with distributions only for her health, support, or maintenance. The payment, or at least a portion of it, would not be treated as “passing from the decedent.” As a consequence, an estate tax would be due on the portion of the payment to Stepmother that does not qualify for the estate tax marital deduction. If Father's Trust does not direct the payment of estate tax, the default proration rules under California law would apply. In that case Stepmother may be charged with the portion of the estate tax that is attributable to the property she receives.²⁰² Payment of the estate tax would further reduce the allowable marital deduction.²⁰³

6. *How would the proposed settlement agreement be impacted, if at all, if Father's Trust includes a spendthrift clause?*

The parties must first obtain a state court order to modify or terminate any trust that has a spendthrift clause.²⁰⁴ The parties could obtain such an order if they demonstrate to the court that “continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust.”²⁰⁵

7. *Will Father's estate receive a charitable deduction for the full amount distributed to the charity?*

An estate tax charitable deduction applies to the settlement payment from Father's estate to the charity because the payment satisfies the Four-Part Test: (i) the dispute appears to be genuine, given the nature of the dispute and the fact that each party is represented by counsel; (ii) the charity appears to have an enforceable claim of \$1 million, the amount provided in Father's amended and restated trust, and the payment recognizes that claim; (iii) the charity will not receive an amount greater than what it would receive under the terms of the trust; and (iv) the charity will receive the payment in the same form (*i.e.*, outright) as provided in the trust. As discussed earlier, the IRS likely will not deem a failure to meet part 4 of the Four-Part Test as disqualifying a settlement payment to a charity from being deductible for federal estate tax purposes.²⁰⁶ Nevertheless, the estate tax charitable deduction will be limited to \$600,000, the amount the charity actually receives.²⁰⁷



8. *Are the life insurance proceeds taxable?*

Distribution of the life insurance proceeds in equal shares to Stepmother, Son, and Daughter consistent with Father's beneficiary designation will not subject the proceeds to income tax. Life insurance proceeds paid "by reason of the death of the insured" are excluded from gross income and are nontaxable to the recipient.²⁰⁸ Nevertheless, if the parties shift their interests in the life insurance—for example, if Stepmother agrees to transfer her share of the proceeds to Son and Daughter—the shifting of those interests may result in taxable income.²⁰⁹

9. *Will the \$200,000 payment to Father's caretaker for unpaid wages constitute taxable income?*

The IRS likely would deem the payment as taxable income to Father's caretaker.²¹⁰ It could, however, be deducted on Father's estate tax return. If Father's caretaker qualifies as a household employee providing domestic services, Father's estate may also be liable for employment-related withholding taxes.²¹¹ Those payments could, however, be deducted on Father's estate tax return.²¹²

10. *What if Father's caretaker based her claim on Father's promise that he would amend his trust to compensate the caretaker for services rendered during Father's lifetime and that the caretaker relied on that promise?*

The IRS likely would deem the payment as taxable income to the caretaker.²¹³ However, if the caretaker can prove that Father did not require the caretaker's services as a condition to receive the bequest, the IRS likely would deem the payment as excluded from income.²¹⁴ In turn, the payment could not be deducted on Father's estate tax return.

11. *Are the parties' legal fees deductible?*

Legal and professional fees that Stepmother paid in her capacity as trustee may be deducted from Father's estate as ordinary and necessary expenses of administration.²¹⁵ The IRS likely would treat the legal fees incurred by the beneficiaries as a personal expenditure and therefore, not deductible.²¹⁶ Nevertheless, the legal fees that Son incurs to protect his interest in ABC Corp. may be deductible as an ordinary and necessary business expense.²¹⁷

12. *Son and Daughter each receive \$150,000 from Stepmother personally in satisfaction of their claim for financial elder abuse. Will these payments constitute taxable income?*

Yes, if the amounts received are in lieu of an award for punitive damages, because such damages are taxable to the recipient as ordinary income.²¹⁸

13. *Will the distribution of \$2 million in trust to satisfy the omitted child claim constitute taxable income?*

The distribution would likely be excluded from income provided that the distribution is made in lieu of the claimed status as an heir pursuant to a good faith compromise.²¹⁹

14. *May Stepmother request the waiver of the penalty (50% excise tax) assessed for failure to take required minimum distributions (RMDs) from the IRA in 2016, 2017, and 2018?*

Yes. Stepmother should remedy the shortfall in RMDs for 2016, 2017, and 2018 by withdrawing them in 2019.²²⁰ She should also file Form 5329 with the IRS to request that the IRS waive the penalty for her failure to take the RMDs timely due to the pending litigation.²²¹

15. *What if on Stepmother's death, after paying all the expenses to administer Stepmother's estate and distributing all the assets, the successor trustee realizes they did not set aside enough money to pay the estate tax liability?*

When an estate has insufficient funds to pay all debts, the administrator of the estate must pay the tax liability to the IRS first.²²² The administrator of the estate is personally liable for any unpaid amounts, subject to indemnification from the beneficiaries up to the amount distributed to each.²²³ An administrator is likewise personally liable for the trust's unpaid state taxes.²²⁴ The IRS can also collect unpaid taxes from the beneficiary of a trust²²⁵ or an estate.²²⁶

16. *What remedies are available to Son and Daughter if Stepmother commingled the bypass trust property with her separate property and died before funding the bypass trust?*

Son and Daughter, as the remainder beneficiaries of the bypass trust, could file a petition for return of trust property.²²⁷ The nature of the remedy imposed would determine the income tax basis of the property returned to the bypass trust. If Son and Daughter bring a direct claim for damages against



Stepmother's estate, asserting that she owed them a debt by failing to fund the bypass trust, the property may be includable in Stepmother's estate. The property would receive a basis adjustment on Stepmother's date of death if it is included in her estate.²²⁸ If Son and Daughter seek a constructive trust, the property would likely not be includable in Stepmother's gross estate and would not receive a basis adjustment on her death. Imposing a constructive trust on the property would, however, avoid estate tax on Stepmother's death.²²⁹

IV. PLEADING AND SETTLEMENT AGREEMENT DRAFTING ISSUES

The characterization of a claim in the pleadings and the settlement agreement, as well as in discovery leading up to the settlement, may impact how the claim is treated for federal tax purposes. From the commencement of drafting the initial pleading, the attorney must be mindful of the critical question: what will the settlement amount be paid "in lieu of"?²³⁰

The "origin of the claim" doctrine requires that tax consequences be based upon the facts presented.²³¹ The IRS has explained that the initial pleading is the most persuasive evidence of the tax treatment of an amount subsequently recovered by way of settlement.²³² Therefore, in preparing the initial pleading, the attorney should rely on the strongest theory under state law that supports the client's claim and achieves favorable tax results.²³³

A trust or estate's distribution of property is excluded from gross income under section 102(a) of the Code as property acquired by gift, bequest, devise, or inheritance. The same exclusion applies to settlement amounts paid to contesting beneficiaries in compromise of a claim as an heir.²³⁴ Thus, if possible, the claim should be pled for a portion of the estate as an heir, for instance, through a contest to a trust or will.

In *Marcus v. Commissioner*,²³⁵ the tax court gave significant weight to the IRS's admission in its pleadings that an agreement to pay the taxpayer from the net proceeds from the sale of property was a substitute for a bequest of property. The taxpayer received the proceeds in settlement of claims against her stepfather's estate. The court held this amount to be excluded from gross income as an inheritance.²³⁶

If, in contrast, the claim as pled is for compensation for services rendered to a decedent, the tax character likely will be income to the recipient and thus taxable.²³⁷ In *Green v. Commissioner*,²³⁸ for example, a woman filed suit against her boyfriend's estate for the value of "wifely" services she rendered to him during his lifetime. The court held that the

settlement amount she received was compensation and thus taxable.²³⁹ If the claim as pled is for income from property, the tax character also likely will be income and thus taxable.²⁴⁰

Some lawsuits implicate both income and amounts in compromise of a claim as an heir. For example, in *Getty v. Commissioner*,²⁴¹ the court held that a \$10 million lump-sum settlement to the eldest son of J. Paul Getty was excluded from gross income under section 102(a) of the Code as property acquired by gift, bequest, devise, or inheritance. The eldest son, J. Ronald Getty, was an income beneficiary under the trust instrument. J. Paul Getty assured his eldest son that he would make him a co-equal income beneficiary with his brothers under the trust, but he never did so. After J. Paul Getty's death, J. Ronald Getty asserted a claim against the remainder beneficiary, the J. Paul Getty Museum, seeking a constructive trust over an amount equal to the amount J. Ronald Getty would have received from the trust had his father carried out his promise. In holding that the \$10 million settlement payment was excludable from gross income, the court reasoned that had J. Paul Getty performed his promise to remedy the inequality, he probably would have done so by a bequest of property. The court explained that when contesting a deficiency determined by the Commissioner of Internal Revenue, the taxpayer must show the merits of his claim by a preponderance of the evidence. The taxpayer need not prove the proceeds are "clearly classifiable" as either property or income from property.²⁴²

During discovery, the petitioner's attorney should identify as specifically as possible (in its answers to interrogatories, for example) the amount of damages incurred for each category of claim being asserted. Such evidence may be helpful in substantiating the tax treatment of the recovery in a subsequent tax case.

The attorney should document the settlement negotiations and the method used to calculate the value of the client's claim.²⁴³ Federal governmental authorities might not be barred by a state's mediation privilege from obtaining mediation testimony and documents by subpoena. The Supremacy Clause of the U.S. Constitution may enable the IRS to override the state confidentiality statutes.²⁴⁴ Neither the statutes nor decisional law of a forum state controls the admissibility of evidence in federal court, where common law as interpreted by the federal courts govern the nature and scope of evidentiary privileges.²⁴⁵

A settlement agreement that resolves a party's claim as an heir should state that the settlement proceeds are "in lieu and instead of" any inheritance. The tax court in *Vincent v. Commissioner*,²⁴⁶ held that settlement proceeds in a dispute between the stepmother and her stepson as to the ownership



of real property were excluded from gross income under section 102(a) of the Code as property acquired by gift, bequest, devise, or inheritance. The tax court noted that the settlement agreement stated the payment was “in lieu and instead of any inherited interest,” thereby suggesting that language in the settlement agreement will be respected by the courts.²⁴⁷

The settlement agreement should, within a reasonable range,²⁴⁸ reflect the economic value of the parties’ claims.²⁴⁹ The settlement agreement should include recitals of facts that support the strongest theory under state law for the client’s claim that achieves favorable tax results. The settlement agreement should also reference supporting state statutes or decisions of the highest court of the state. On the other hand, the settlement agreement should omit tax avoidance or tax deferral recitals, which may raise red flags to the taxing authorities. If the settlement amount cannot reasonably be allocated to a claim that is excluded from gross income, the settlement agreement should include a specific allocation of the settlement amount among the claims being released.²⁵⁰

The parties should seek court approval of the settlement agreement unless circumstances strongly suggest otherwise. The order approving the settlement agreement should identify findings of fact that support the strongest theory under state law for the client’s claim that achieves a favorable tax result. The order also should include conclusions of law that track the legal requirements under decisions of the highest court of the state or state statutes.²⁵¹ Nevertheless, court approval does not provide finality on the tax treatment of the settlement. The IRS is not bound by findings of a state court with regard to property rights, with the exception of the state’s highest court.²⁵²

When federal estate or GST taxes are an issue, the settlement agreement should include a tax apportionment clause. The parties may choose to adopt the California default rule, which provides that estate and GST taxes are to be equitably prorated among those persons interested in the decedent’s estate, in accordance with the value of the property transferred.²⁵³ In the alternative, the settlement agreement may specifically allocate the tax burdens in a manner agreed to by the parties.²⁵⁴

Unless the parties obtain a judgment from the highest state court, any resolution from a lower state court or settlement agreement may not be recognized for federal tax purposes.²⁵⁵ If a client needs certainty regarding a tax outcome, the attorney may consider obtaining a private letter ruling from the IRS. The letter ruling would allow the attorney to find out in advance how the IRS would characterize a proposed settlement from a federal tax perspective. While such rulings can be expensive²⁵⁶ and may delay the settlement by three to six months (the typical

time for the IRS to review a letter ruling request), the ruling binds the IRS. A private letter ruling is limited to the presented facts and is binding only as to the taxpayer who requested it.²⁵⁷

V. CONCLUSION

Reaching a settlement agreement that has certainty from a tax perspective may not always be possible. Nevertheless, by identifying the relevant tax consequences early, an attorney may tailor the pleadings, the negotiations with the other parties, and the terms of the settlement agreement to increase the likelihood the IRS or federal court will respect the agreement.

The authors recognize the valuable contribution of Hartog, Baer & Hand, A.P.C. to the preparation of this article. Brian G. Fredkin was an associate at Hartog, Baer & Hand, A.P.C. when the authors wrote this article. Ryan J. Szczepanik is a principal at Hartog, Baer & Hand, A.P.C.

* Venable LLP, Los Angeles, California

**Hartog, Baer & Hand, A.P.C., Orinda, California

- 1 IRC, section 61(a).
- 2 IRC, section 102(a). The Internal Revenue Code does not define “bequest,” “devise,” or “inheritance.”
- 3 IRC, section 102(b)(1).
- 4 IRC, section 102(b)(2).
- 5 IRS Publication 551, Basis of Assets (Dec. 2018).
- 6 *Ibid.*
- 7 IRC, section 1015.
- 8 Treas. Reg. section 20.2031-1(b) defines “fair market value” as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.”
- 9 IRC, section 1015(a).
- 10 IRC, section 1014(a).
- 11 IRC, sections 1014(a), 1014(b)(6).
- 12 IRC, section 1014(a).
- 13 IRC, section 1014(e). If a decedent acquires appreciated property by gift within the one-year period prior to the decedent’s date of death, and the original donor (or the donor’s spouse) re-acquires that property (e.g., by decedent’s will or trust), the property’s basis will be its basis in the hands of the decedent immediately before the decedent’s death.
- 14 IRD is included in the gross income of the recipient. IRD does not receive a basis adjustment at the death of a decedent. The Internal Revenue Code does not give specific examples of IRD. IRD is generally understood to refer to untaxed income that was earned or accrued during the decedent’s lifetime but not received until after the decedent’s date of death. IRD items may include: (1) distributions to a beneficiary from a decedent’s qualified retirement plan or IRA (to



- the extent not made from a previously taxed contribution); (2) stock dividends declared and payable before death but not actually paid until after death; and (3) accounts receivable from a business interest, such as a sole proprietorship, partnership, or a limited liability company. See, e.g., IRC, section 691 (a); Treas. Reg. Section 1.691 (a)-(1)(b).
- 15 *E.g.*, Keogh plan, 401(k) plan, 403(b) plan, profit-sharing plan, simplified employee pension (SEP), employee stock ownership plan (ESOP).
 - 16 Rev. Rul. 69-297, 1969-1 C.B. 131; Rev. Rul. 92-47, 1992-1 C.B. 198.
 - 17 Treas. Reg. sections 1.691(a)-1(b)(1), 1.691(a)-2(b), Ex. 1.
 - 18 Treas. Reg. section 1.691(a)-1(b)(1).
 - 19 IRC, section 1014(c).
 - 20 IRC, sections 1001(a), 1011.
 - 21 *Ibid.*
 - 22 IRC, section 1222.
 - 23 IRC, section 1(h).
 - 24 *Ibid.*
 - 25 Rev. and Tax. Code, section 17041.
 - 26 Rev. and Tax. Code, sections 17041, 17043.
 - 27 Treas. Reg. section 1.1014-5; PLR 200442019 (basis not disregarded when trust beneficiary sold their remainder interest).
 - 28 Treas. Reg. section 1.1001-1(f)(2).
 - 29 IRC, section 1001(e); PLR 200231011 (basis disregarded when trust beneficiary sold their income interest).
 - 30 IRC, section 1001(e)(3).
 - 31 Treas. Reg. section 1.212-1(k).
 - 32 IRC, section 212(1); Treas. Reg. section 1.212-1(a).
 - 33 IRC, section 162(a); Treas. Reg. section 1.162-1(a).
 - 34 Treas. Reg. section 1.212-1(i).
 - 35 Cal. Const., art XIII A, Section 1.
 - 36 Cal. Const., art XIII A, Section 2.
 - 37 Rev. & Tax Code, section 110.1.
 - 38 Rev. & Tax. Code, section 60.
 - 39 Rev. & Tax Code, section 62, et. seq.
 - 40 Rev. & Tax. Code, section 63.
 - 41 Rev. & Tax. Code, section 63.1.
 - 42 Rev. & Tax. Code, section 63.
 - 43 Cal. Code Regs., tit. 18, section 462.220(a).
 - 44 Rev. & Tax. Code, section 63.1, subd. (a)(1)(A).
 - 45 Rev. & Tax. Code, section 63.1, subd. (a)(2).
 - 46 Rev. & Tax. Code, section 63.1, subd. (c)(8); Letter to Santa Clara County Assessor dated October 6, 1987, Annotation No. 625.0180 (regarding section 63.1(c)(6), the precursor to section 63.1(c)(8)).
 - 47 Rev. & Tax. Code, section 63.1, subd. (c).
 - 48 <https://www.boe.ca.gov/proptaxes/faqs/propositions58.htm> (as of April 6, 2019).
 - 49 Rev. & Tax. Code, section 69.5; California State Board of Equalization, Assessor's Handbook, Section 401 *Change in Ownership*, chapter 14: Base Year Value Transfer – Over 55 or Severely and Permanently Disabled Persons (Sept. 2010: reprinted Jan. 2015); State Board of Equalization Letter to County Assessors dated February 9, 2018, No. 2018/013.
 - 50 Rev. & Tax. Code, section 69.5; California State Board of Equalization, Assessor's Handbook, Section 401 *Change in Ownership*, chapter 14: Base Year Value Transfer – Over 55 or Severely and Permanently Disabled Persons (Sept. 2010: reprinted Jan. 2015).
 - 51 Rev. & Tax. Code, section 64, subd. (c).
 - 52 Rev. & Tax. Code, section 64, subd. (d).
 - 53 Rev. & Tax. Code, section 64, subd. (c); Cal. Code Regs., tit. 18, section 462.180, subd. (d)(1).
 - 54 *Ibid.*
 - 55 Rev. & Tax. Code, section 64, subd. (d); Cal. Code Regs., tit. 18, section 462.180, subd. (d)(2).
 - 56 *Ibid.*
 - 57 Rev. & Tax. Code, section 480.1, subd. (a).
 - 58 Rev. & Tax. Code, section 480.2, subd. (a).
 - 59 Rev. & Tax. Code, sections 480.1, subd. (b), 480.2, subd. (b).
 - 60 *Ibid.*
 - 61 IRC, section 2002 and Treas. Reg. section 20.2002-1 (regarding the executor or administrator's liability for payment of the estate tax); IRC, section 2502(c) and Treas. Reg. section 25.2511-2(a) (regarding the donor's liability for payment of the gift tax); IRC, section 2603 (regarding liability for payment of the GST tax, as determined by whether the transfer constitutes a "taxable distribution," "taxable termination," or "direct skip").
 - 62 IRC, section 6901(a)(1)(A)(ii) (regarding the transferee's liability for payment of the estate tax); IRC, section 6901(a)(1)(A)(iii) (regarding the transferee's liability for payment of the gift tax); IRC, section 2603 (regarding liability for payment of the GST tax, as determined by whether the transfer constitutes a "taxable distribution," "taxable termination," or "direct skip").
 - 63 https://www.sco.ca.gov/ardtax_estate_tax.html (as of Apr. 6, 2019).
 - 64 IRC, sections 2056(b)(3), (b)(5), (b)(6), (b)(7).
 - 65 IRC, section 2010(c)(3).
 - 66 IRC, section 2010(c)(3)(C). The basic exclusion amount is scheduled to revert to \$5 million on January 1, 2026.
 - 67 *Ibid.*; Rev. Proc. 2018-57.
 - 68 IRC, section 2631(c).
 - 69 IRC, section 2001(c).
 - 70 IRC, section 2641.
 - 71 IRC, sections 2501,2512; Treas. Reg. section 25.2512-8.



- 72 Treas. Reg. section 25.2511-1(g)(1); *Commissioner v. Wemyss* (1945) 324 U.S. 303, 305-307.
- 73 IRC, section 2512(b).
- 74 Treas. Reg. section 25.2512-8.
- 75 IRC, section 2523.
- 76 IRC, section 2522.
- 77 IRC, section 2503(e)(2)(A).
- 78 IRC, section 2503(e)(2)(B).
- 79 IRC, section 2501(a)(4).
- 80 Rev. Rul. 66-167, 1966-1 C.B. 20.
- 81 IRC, section 2503(b); Rev. Proc. 2018-57.
- 82 IRC, section 2001.
- 83 IRC, section 2031, et. seq.
- 84 IRC, section 2051, et. seq.
- 85 IRC, Section 2001(b).
- 86 IRC, sections 2035 (certain transfers within 3 years of death), 2036 (transfers with a retained interest), 2037 (certain transfers taking effect at death), 2038 (transfers with a retained power).
- 87 IRC, section 2001(b)(2).
- 88 IRC, section 6018.
- 89 IRC, section 2010(c)(5)(A).
- 90 IRC, section 6075(a).
- 91 Treas. Reg. section 20.6081-1.
- 92 IRC, section 6501(a).
- 93 Treas. Reg. section 20.6081-1(d).
- 94 Rev. Proc. 2011-48; Treas. Reg. section 20.2053-1(d)(5)(i).
- 95 IRC, section 2056(a).
- 96 IRC, section 2056. A transfer from a decedent to a surviving spouse who is not a U.S. citizen qualifies for the marital deduction if the transfer is to a qualified domestic trust, as defined in IRC, section 2056A.
- 97 IRC, section 2044.
- 98 IRC, section 2055(a).
- 99 IRC, section 2055(e)(2).
- 100 IRC, section 2053(a).
- 101 IRC, sections 642(g), 2053(a); Treas. Reg. section 20.2053-3.
- 102 Treas. Reg. section 20.2053-4(a)(1).
- 103 Treas. Reg. sections 20.2053-3(a), 20.2053-3(c)(3); *Estate of Gill v. Commissioner* (2012) T.C. Memo 2012-7 (expenses incurred for individual beneficiary's benefit rather than estate's benefit were not essential to the proper settlement of the estate, and therefore, could not be deducted on decedent's estate tax return).
- 104 IRC, sections 2611(a)(3), 2612(c).
- 105 IRC, section 2613(a).
- 106 IRC, section 2651; Treas. Reg. section 26.2612-1(d).
- 107 IRC, section 2632(c)(3)(A).
- 108 IRC, section 2612(a); Treas. Reg. section 26.2612-1(b).
- 109 IRC, section 2612(b); Treas. Reg. section 26.2612-1(c).
- 110 Treas. Reg. section 26.2612-1(b).
- 111 Treas. Reg. section 26.2612-1(f), Example 6.
- 112 Treas. Reg. section 26.2612-1(c).
- 113 Treas. Reg. section 26.2612-1(f), Example 10.
- 114 *E.g.*, IRS Forms 709, 706, 706-GS(D), 706-GS(D-1), 706-GS(T).
- 115 IRC, section 2611(b)(1).
- 116 IRC, section 2642(c)(3).
- 117 *Morgan v. Commissioner* (1940) 309 U.S. 78, 80.
- 118 Rev. Rul. 89-31, 1989-1 C.B. 277 ("settlements of will contests will continue to be scrutinized in order to assure that the settlement in question is not an attempt to circumvent [the estate tax charitable deduction rules regarding a split-interest transfer] by instituting and settling a collusive contest"); *Terre Haute First Nat'l Bank v. United States* (S.D. Ind. 1991) 91-1 USTC 88,261 at p. 267, fn. 2 (government asserted that settlement "reflected a collusive effort to gain tax benefits"); *Marcus v. Commissioner*, T.C. Memo 1996-190 (for *Lyeth v. Hoey* (1938) 305 U.S. 1988, to control, "there must be a compromise of a disputed claim by the estate or its heirs, as opposed to a voluntary rearrangement of property interests among heirs").
- 119 Willms and Davis, *Knowing the Ropes and Binding the IRS When Fiduciaries are Involved in Settlements and Modifications: Income and Transfer Tax Issues Every Fiduciary Should Know*, 51 Heckerling Est. Pl. Inst. Ch. 14 (2017) at pp. 14-6 to 14-9.
- 120 Treas. Reg. section 20.2056(c)-2(d)(2) (payment to a surviving spouse must constitute "a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate" to qualify for the marital deduction); TAM 200132004 ("payment pursuant to settlement agreement will constitute bona fide recognition of enforceable rights of surviving spouse in decedent's estate only if settlement is based on an enforceable right under state law properly interpreted"); TAM 9347003 ("parties must at least have adversarial interests and a controversy must have existed prior to the settlement" for payment to surviving spouse to qualify for the marital deduction); *Commissioner v. Estate of Vease* (9th Cir. 1963) 314 F.2d 79, 87 (amount received pursuant to settlement agreement that appeared to be "nothing more than a voluntary rearrangement of property interests acquired under an admittedly valid [testamentary instrument]" was not treated as "passing from the decedent"); *Estate of Allen v. Comm'r*, T.C. Memo 1990-514 (distribution to surviving spouse did not qualify for marital deduction because "petitioner failed to introduce any persuasive evidence of a family conflict"); *Estate of Simpson v. Commissioner*, T.C. Memo 1994-259 (lower court's order that distributions qualified for marital and charitable deductions not binding on tax court because settlement agreement not adversarial in nature); *Bath v. United States* (5th Cir. 1973) 480 F.2d 289, 292 (payment to decedent's son constituted taxable income rather than a tax-free bequest; court based its decision in part on lack of an adversarial dispute: "Especially suspect are characterizations, such as we have here, not the result of bona fide adversary



- proceedings”); *Howard v. Commissioner* (5th Cir. 1971) 447 F.2d 152, 156 (“the proper standard for judging the bona fides of a compromise for tax purposes is not whether the court might decide that the claim is meritorious but whether the taxpayer in good faith thinks that the claim is meritorious”); PLR 8902045 (“an intrafamily settlement of litigation will not be regarded as a bona fide compromise agreement unless the parties’ claims were bona fide and are satisfied, to the extent feasible, on an economically fair basis”); PLR 199948014 (GST exempt trust will continue to be exempt because settlement agreement resolves a bona fide controversy among the parties, fairly reflects the relative merits of the claims by the parties to the dispute, and provides an allocation of trust assets within the range of reasonable outcomes which could result from a court determination of the issues); PLR 9423015 (bona fide dispute cited as necessary to the application of the *Lyeth* doctrine).
- 121 TAM 9736004 (intrafamily transfers presumed not “at arm’s length”); *Fehrs v. United States* (Ct. Cl. 1980) 620 F.2d 255, 260; PLRs 8902045, 201528024.
- 122 *Ibid.*
- 123 *Housman v. Commissioner* (2d Cir. 1939) 105 F.2d 973, 975-976 (gift tax imposed on payments to settle will contest because court did not believe there was bona fide dispute).
- 124 *Kenan v. Commissioner* (2d Cir. 1940) 114 F.2d 217, 219-220; Rev. Rul. 69-486, 1969-2 C.B. 159; Rev. Rul. 72-243, 1972-1 C.B. 233.
- 125 Rev. Rul. 83-107, 1983-2 C.B. 159 (amount surrendered to surviving spouse must be attributable to enforceable claim under state law to be treated as passing from decedent, and thus, entitled to estate tax marital deduction); *The Ahmanson Found. v. United States* (9th Cir. 1981) 674 F.2d 761, 775 (“under even the most narrow reading of [*Commissioner v. Estate of Bosch* (1967) 387 U.S. 456], either a good faith settlement or a judgment of a lower state court must be based on an enforceable right, under state law properly interpreted, in order to qualify as ‘passing’ pursuant to the estate tax marital deduction”); *Estate of Brandon v. Commissioner* (8th Cir. 1987) 828 F.2d 493, 499 (eighth circuit court agreed with the *Ahmanson* court’s analysis and application of the principles set forth in *Bosch*; furthermore, “*Bosch* and *Ahmanson* support the conclusion that the Tax Court was required, in this instance, to make an independent determination as to the enforceability of [surviving spouse’s] claims against the estate under state law at the time the settlement was reached”); TAM 9610004 (payment to surviving spouse failed to qualify for marital deduction because payment not based on an enforceable right under state law properly interpreted); PLR 9101025 (“spouse’s interest must be enforceable and not simply sufficiently plausible to support a good faith arms-length settlement”); PLR 8902045 (“in determining whether the gift tax applies, it is first necessary to determine if the settlement properly reflects the economic values of the claims of the respective parties, with appropriate allowance for uncertainty. If the settlement does not so reflect those values, then it will be necessary to consider whether any differences may be justified on the basis of a compromise. Thus, with respect to each gift tax issue, it is pertinent to examine the law of the applicable jurisdiction to determine the legitimacy of the parties’ claims in the issues that are under our consideration for gift tax purposes”).
- 126 *The Ahmanson Found. v. United States, supra*, 674 F.2d 761 at p. 775; *Terre Haute First Nat’l Bank v. United States, supra*, 91-1 USTC 88,261 at p. 266.
- 127 *Ibid.*
- 128 Rev. Rul. 77-372.
- 129 *Commissioner v. Estate of Vease, supra*, 314 F.2d 79 at pp. 86-87; PLR 200112038.
- 130 Rev. Rul. 83-107, 1983-2 C.B. 159 (marital deduction for amount paid in lieu of dower interest limited to fair market value of spouse’s dower interest as of date of decedent’s death (or alternate valuation date)); *Citizens & S. Nat’l Bank v. United States* (5th Cir. 1971) 451 F.2d 221 (marital deduction not permitted for amount disclaimed by spouse; court provided moderate definition of “controversy”); *cf.* PLR 200417030 (“settlement agreement provides an allocation of the Trust’s assets that is within a range of reasonable settlements. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) reflect the enforceable rights of the parties. Consequently, the property passing to Spouse under the settlement agreement passes from Decedent for marital deduction purposes under section 2056”).
- 131 PLRs 8902045, 201528024.
- 132 *Estate of Carpenter v. Commissioner*, T.C. Memo 1994-108 (marital deduction not permitted for outright transfer when spouse’s enforceable rights limited to a terminable interest under decedent’s will); TAM 8236004 (marital deduction denied for transfer of fee simple interest to spouse when spouse had enforceable rights only to a terminable interest under decedent’s will).
- 133 *Ibid.*
- 134 *Lyeth v. Hoey* (1938) 305 U.S. 188.
- 135 *Ibid.*
- 136 *Id.* at pp. 194-195.
- 137 *Id.* at pp. 196-197.
- 138 *Marcus v. Commissioner*, T.C. Memo 1996-190.
- 139 PLR 200137031.
- 140 *Garrett v. Commissioner*, T.C. Memo 1994-70.
- 141 *Ibid.*; Wood, 522-4th T.M., *Tax Aspects of Settlements and Judgements*, Detailed Analysis, II. Origin of Claim Test.
- 142 PLR 200137031.
- 143 *Lyeth v. Hoey, supra*, 305 U.S. 188.
- 144 *Parker v. United States* (Ct. Cl. 1978) 573 F.2d 42, 51-52.
- 145 *Lyeth v. Hoey, supra*, 305 U.S. 188.
- 146 *United States v. Gavin* (9th Cir. 1947) 159 F.2d 613, 615 (exclusion applied to cash payment in settlement of claimant’s alleged status as an heir because facts indicated such status “commanded the agreement”).
- 147 *United States v. Gavin, supra*, 159 F. 2d at p. 615; *Parker v. United States, supra*, 573 F.2d 42 at p. 47.
- 148 *Estate of Carter v. Commissioner* (8th Cir. 1962) 298 F.2d 192, 194; *Parker v. United States, supra*, 573 F.2d at p. 49.
- 149 *Cotnam v. Commissioner* (5th Cir. 1959) 263 F.2d 119, 121; Rev. Rul. 67-375, 1967-2 C.B. 60 (bequest for services rendered to decedent held to be taxable).
- 150 Rev. Rul. 84-108, 1985-2 C.B. 51; *Parker v. United States, supra*, 573 F.2d at p. 49; *Estate of Carter v. Commissioner, supra*, 298 F.2d at p. 194.



- 151 IRC, section 691(a).
- 152 *Quigley v. Commissioner* (7th Cir. 1944) 143 F.2d 27.
- 153 Treas. Reg. section 1.691(a)-4.
- 154 E.g., like-kind exchange (IRC, section 1031), involuntary conversion (IRC, section 1033), or a transfer between spouses or to a former spouse incident to a divorce (IRC, section 1041).
- 155 *Cottage Savings Assn. v. Commissioner* (1991) 499 U.S. 554.
- 156 *Id.* at p. 565.
- 157 Treas. Reg. section 1.1001-1(h)(1); PLR 200328015 (dividing a QTIP trust into two trusts on a fractional basis does not result in gain or loss, even if the trusts are funded on a non-pro rata basis); cf. PLRs 8902045, 200210029 (partitioning a trust into multiple trusts will not result in gain or loss if the trusts are funded on a pro rata basis).
- 158 PLRs 9743004, 200318064.
- 159 *Kenan v. Commissioner, supra*, 114 F.2d at pp. 219–220.
- 160 *White v. Thomas* (5th Cir. 1940) 116 F.2d 147, 147–148.
- 161 *Commissioner v. Estate of Bosch, supra*, 387 U.S. at p. 457.
- 162 *Ibid.*
- 163 *Id.* at p. 465.
- 164 *Ibid.*
- 165 *Ibid.*; PLR 9308032 (summarizing the holding in *Commissioner v. Estate of Bosch, supra*, 387 U.S. 456).
- 166 *The Ahmanson Found. v. United States, supra*, 674 F.2d at p. 761.
- 167 *Id.* at p. 775.
- 168 *Id.* at p. 775.
- 169 Caron, *The Federal Tax Implications of Bush v. Gore*, 79 Wash. U. L. Q. 749 (2001) at p. 751.
- 170 *Id.* at pp. 763–764.
- 171 Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?*, 48 Emory Law Journal 871 (1999) at pp. 896–897. For a detailed discussion of the differences between the *Lyeth* doctrine and the *Bosch* doctrine in the context of settlement agreements, see *id.* at pp. 892–900.
- 172 PLRs 200417030, 201046004 (property passing to surviving spouse under settlement agreement satisfied Four-Part Test, and was treated as passing from decedent, thus qualifying decedent’s estate for estate tax marital deduction); cf. *Estate of Myers v. Commissioner*, T.C. Memo 1968-200 and TAM 9610004 (settlement payment to surviving spouse did not qualify for estate tax marital deduction because spouse did not assert a bona fide claim).
- 173 *Ahmanson Found. v. United States, supra*, 674 F.2d at p. 775; Treas. Reg. section 20.2056(c)-2(d)(2) provides:
- 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 interest 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.* (Emphasis added.)
- 174 Treas. Reg. section 20.2056(c)-2(d)(1) provides:
- If as a result of a controversy involving the decedent’s will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, *the interest so assigned or surrendered is not considered as having “passed from the decedent to his surviving spouse.”* (Emphasis added.)
- 175 *Estate of Sikler v. Commissioner*, T.C. Memo 1981-587 (estate tax marital deduction limited to amount actually received pursuant to settlement agreement rather than larger amount permitted under terms of decedent’s will).
- 176 PLRs 9812014, 201236022 (settlement payment from decedent’s estate to charity satisfied Four-Part Test, and was treated as passing from decedent, thus qualifying decedent’s estate for estate tax charitable deduction).
- 177 Treas. Reg. section 20.2055-2(e)(1)(i) provides that the “principles of section 2056 and the regulations thereunder shall apply for purposes of determining . . . whether an interest in property passes or has passed from the decedent.”
- 178 Rev. Rul. 89-31, 1989-1 C.B. 277 (immediate payment to charity outright qualified for estate tax charitable deduction even though charity’s claim limited to split-interest remainder; the IRS stated: “In situations involving settlements of bona fide will contests the Service will no longer challenge the deductibility of immediate payments to charities solely on the ground that they were made in lieu of a split interest that would not constitute an allowable deduction under section 2055(e)(2) of the Code. However, settlements of will contests will continue to be scrutinized in order to assure that the settlement in question is not an attempt to circumvent section 2055(e)(2) by instituting and settling a collusive contest”); PLR 8013019 (IRS modified its position on will contests involving settlement payments to charities; charitable deduction allowed even though form of payment different from form specified in will).
- 179 Treas. Reg. section 20.2055-2(d).
- 180 *Dieringer v. Comm’r.* (9th Cir. 2019) 917 F.3d 1135. The amount of the charitable deduction for a gift of closely held stock was limited to the price paid in a post-death redemption agreement, not the higher date of death value. Citing *Ahmanson*, the court held that the charitable deduction is limited to the amount the charity actually receives. *Reed v. United States* (S.D. Ill. 1970) 317 F. Supp. 1242, 1244.
- 181 *Bach v. McGinnes* (3d Cir. 1964) 333 F.2d 979, 984 (estate tax charitable deduction not permitted because decedent’s will did not include a valid charitable gift); *Terre Haute First Nat’l Bank v. United States, supra*, 91-1 USTC 88,261 at pp. 266–267 (charitable deduction for payment to charity in settlement of will contest limited to actuarial date of death value of charity’s interest created under terms of decedent’s will; payment amount that exceeded actuarial value not deductible); TAM



- 200306002 (citing Treas. Reg. 20.2056(c)-2(d)(2), estate tax charitable deduction not permitted for payment to charity to settle will contest because charity “did not have any recognizable, enforceable rights, under State law properly applied, to any portion of Decedent’s estate”).
- 182 Treas. Reg. section 25.2512-8; *Beveridge v. Commissioner* (1948) 10 T.C. 915 at pp. 917–918 (transfer made pursuant to compromise of a bona fide dispute not a taxable gift; transfer of property from mother to her estranged daughter “not actuated by love and affection” but rather “as one would act in the settlement of differences with a stranger”); *Estate of Friedman v. Commissioner* (1963) 40 T.C. 714, 720 (citing court’s reasoning in *Beveridge, supra*, no gift tax imposed for transfer of remainder interest in real properties); *Estate of Redstone v. Commissioner* (2015) 145 T.C. 259, 271 to 275 for tax court’s interpretation of “bona fide,” “arm’s length,” and “absence of donative intent”).
- 183 *Fehrs v. United States, supra*, 620 F.2d 255 at p. 260 (intrafamily transfers have “always prompted special scrutiny by the courts”); *Housman v. Commissioner* (2d Cir. 1939) 105 F.2d 973, 975–976 (gift tax imposed on payments to settle will contest because court did not believe there was bona fide dispute).
- 184 PLRs 8902045, 201528024.
- 185 *Ibid.*
- 186 *Estate of Redstone v. Commissioner, supra*, 145 T.C. 259.
- 187 *Id.* at p. 271.
- 188 Treas. Reg. section 1.1001-1(h); PLR 9523029 (ruling #1) (division of bypass trust not a taxable disposition under section 1001 of the Code).
- 189 Prob. Code, section 15412 permits the court, on petition by a trustee or beneficiary, and for good cause shown, to divide a trust into two or more separate trusts if dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries.
- 190 Prob. Code, section 16246 permits a trustee to distribute assets either pro-rata or non-pro rata if the trust instrument is silent or the power is specified.
- 191 Rev. Rul. 69-486, 1969-2 C.B. 159.
- 192 See also Rev. Rul. 56-437, 1956-2 C.B. 507; PLR 200210029 (Ruling #1); PLR 200231011 (Ruling #1) (proposed trust modification would result in legal entitlements “different in kind or extent” from what beneficiary possessed under trust instrument, thereby resulting in taxable gain to the beneficiary).
- 193 Treas. Reg. sections 25.2511-1(g)(1), 25.2512-8; PLR 9523029 (ruling #2) (division of bypass trust into multiple trusts not a taxable gift under sections 2501 and 2511 of the Code).
- 194 PLR 199951009 (Ruling #1).
- 195 Treas. Reg. section 26.2601-1(b)(4)(i)(E), Ex. 5; PLR 201003015 (Ruling #1) (division of GST exempt trust into separate trusts for different family lines did not cause trust to lose exempt status).
- 196 See, e.g.; PLR 201233008 (ruling #3) (partial termination and modification of GST exempt trust so that grandchildren could receive their shares outright did not cause trust to lose exempt status).
- 197 Treas. Reg. section 1.1001-1(f)(1).
- 198 IRC, section 1001(e)(2); Treas. Reg. section 1.1001-1(f)(1); see PLR 200027001 (regarding the income tax and gift tax consequence of spouse’s sale of spouse’s income interest and principal interest in the QTIP trust).
- 199 PLR 200328015 (ruling #2) (division of QTIP trust into Trust One and Trust Two, including modification of spendthrift clause applicable to Trust One to permit spouse to assign her income interest in Trust One to her issue under state court order, did not constitute a gift or other disposition of Trust Two); PLR 200723014 (rulings #2 and #6) (division of QTIP trust into Trust A and Trust B, followed by termination of Trust B and distribution to life and remainder beneficiaries’ respective interests in Trust B (based on the actuarial present values of such interests) under state court order, was not an income recognition event for Trust B and did not constitute a gift or other disposition of Trust A); PLR 200844010 (division of QTIP trust into five settlement trusts, followed by termination and distribution of settlement trust one did not result in gift tax being imposed on the other four settlement trusts).
- 200 PLR 9523029 (rulings #1 & 2).
- 201 IRC, section 2519; Treas. Reg. section 25.2519-1(c)(1); Treas. Reg. section 25.2519-1(g), Ex. 2; Rev. Rul. 98-8, 1998-7 I.R.B. 24; PLR 200027001 (rulings #4, #5 & #6); PLR 200013015; PLR 200723014; FSA 199916025. For a detailed analysis of the income and transfer tax consequences of the disposition of a QTIP trust interest by sale, gift, or commutation, see generally Rubin, *The Settling of Trust Litigation Involving QTIP Trusts* (2010 Heckerling Institute on Estate Planning Materials), available at: <https://floridatx.com/wp-content/uploads/2015/04/The-Settling-of-Trust-Litigation-Involving-QTIP-Trusts-Heckerling-2010-Outline.pdf>; Rubin, *Tax Results of Settling Trust Litigation Involving QTIP Trusts*, 36 Fla. Bar J. 23 (Jan. 2009); Jones & Thompson, *Maximizing the Benefits of a QTIP Trust*, 34th Annual UCLA-CEB Estate Planning Institute, Estate Planning 2012, (CEB May 2012) at sections 3.25 to 3.48.
- 202 Prob. Code, section 20111. Probate Code section 20112 allows adjustments to the default proration rules only for allowable deductions.
- 203 IRC, section 2056(b)(4).
- 204 Prob. Code, section 15409.
- 205 *Ibid.*
- 206 PLR 201236022 (settlement payment to charity that satisfied Four-Part Test treated as passing from the decedent, and thus, qualified for estate-tax charitable deduction).
- 207 *Dieringer v. Comm’r.* (9th Cir. 2019) 917 F.3d 1135; *Reed v. United States, supra*, 317 F. Supp. 1242.
- 208 IRC, section 101(a)(1).
- 209 IRC, section 101(a)(2).
- 210 *Cotnam v. Commissioner, supra*, 263 F.2d 119.
- 211 IRC, section 3306(a)(3).
- 212 See *Cotnam v. Commissioner* (5th Cir. 1959) 263 F.2d 119.
- 213 *Hansen v. Commissioner*, T.C. Memo. 1974-12.
- 214 *Cotnam v. Commissioner, supra*, 263 F.2d 119.
- 215 IRC, sections 642(g), 2053(a); Treas. Reg. section 20.2053-3.



- 216 Treas. Reg. sections 20.2053-3(a), 20.2053-3(c)(3); *Estate of Gill v. Commissioner* (2012) T.C. Memo 2012-7 (expenses incurred for individual beneficiary's benefit rather than estate's benefit were thus, not essential to proper settlement of estate, and therefore, could not be deducted on decedent's estate tax return).
- 217 IRC, section 162(a); Treas. Reg. section 1.162-1(a).
- 218 Rev. Rul. 84-108, 1985-2 C.B. 51, Rev. Rul. 85-98, 1985-2 C.B. 51, *Parker v. United States, supra*, 573 F.2d at p. 49; *Estate of Carter v. Commissioner, supra*, 298 F.2d at p. 194.
- 219 *United States v. Gavin, supra*, 159 F.2d 613 (exclusion applied to cash payment in settlement of claimant's alleged status as an heir because facts indicated such status "commanded the agreement").
- 220 Treas. Reg. section 54.4974-2, Q&A-7(a) ("reasonable cause" necessary to waive excise tax imposed on late RMDs); PLR 201437025 (taxpayer obtained waiver of penalties for late RMDs attributable to pending litigation). For additional discussion of the tax consequences of IRAs distributed post-death pursuant to a settlement agreement, see Choate, *Planning for Retirement Benefits: Recent Developments and Current Trends* (2018) seminar handout at pp. 9–14, available at: <https://www.ataxplan.com/wp-content/uploads/2018/05/NewDev2018.pdf>; see also PLRs 200127027 (surviving spouse permitted to roll over portion of decedent's IRA in settlement of will contest), 201432029 (taxpayer's transfer of IRA funds to estate of first-named beneficiary and charity in accordance with settlement agreement did not subject taxpayer to gift tax, income tax, and excise tax for late RMDs), PLR 201623001 (surviving spouse not permitted to roll over IRA received in settlement because surviving spouse was not the designated beneficiary of decedent's IRA; the IRC's IRA rules "shall be applied without regard to any community property laws"), 201628004 (court's post-death reformation of beneficiary designation form not recognized by IRS).
- 221 PLR 201437025.
- 222 31 U.S.C., section 3713(a)(1)(B).
- 223 31 U.S.C., section 3713(b); IRC, section 6901(a)(1)(B); PLR 8843011 (regarding executor's payment liability).
- 224 Rev. & Tax. Code, sections 17006, 19071-73.
- 225 *Barnes v. United States* (S.D. Cal. 1965) 65-1 USTC 95,025.
- 226 IRC, section 6901(a)(1)(A)(ii); Treas. Reg. section 301.6901-1(b); *Upchurch v. Commissioner*, T.C. Memo 2010-169.
- 227 Prob. Code, section 850(a)(3)(B).
- 228 *Estate of Bailey v. Commissioner* (5th Cir. 1984) 741 F.2d 801, 804–805.
- 229 *Ibid.*; *Stansbury v. United States* (N.D. III, 1987) 543 F. Supp. 154, 158; Akers, *Tax Complications in Funding Marital Bequests* (Feb. 15, 2011), Financial Planning Journal (BNA), Bessemer Trust Company, N.A. at pp. 3 to 4; Davis, *Funding Testamentary Trusts: Tax and Non-Tax Issues* (2013) State Bar of Texas 19th Annual Advanced Estate Planning Strategies Course, ch. 5.2 at pp. 37 to 38.
- 230 PLR 200137031.
- 231 The "origin of the claim" test was applied by the U.S. Supreme Court in *Hort v. Commissioner* (1941) 313 U.S. 28, and later articulated in *U.S. v. Gilmore* (1963) 372 U.S. 39. As stated by the court in *Alexander v. IRS* (1st Cir. 1995) 72 F.3d 938, 942, under the "origin of the claim" doctrine, it is a "well-settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled," and that "amounts received in compromise of a claim must be considered as having the same nature as the rights compromised."
- 232 Rev. Rul. 85-98, 1985-2 C.B. 51.
- 233 Kovar, *Adversity After Bosch*, ACTEC Journal Vol. 28, No. 2 (Fall, 2002) at p. 99.
- 234 *Lyeth v. Hoey, supra* 305 U.S. 188.
- 235 *Marcus v. Commissioner*, T.C. Memo 1996-190.
- 236 *Ibid.*; Wood, *Tax Treatment of Will Contest Recoveries*, Tax Notes (Nov. 26, 2001) at p. 1200.
- 237 IRC, section 61(a)(1).
- 238 *Green v. Commissioner*, T.C. Memo 1987-503.
- 239 *Ibid.*
- 240 IRC, sections 61(a), 102(b).
- 241 *Getty v. Commissioner* (9th Cir. 1990) 913 F.2d 1486.
- 242 *Id.* at p. 1492; Wood, *Tax Treatment of Will Contest Recoveries*, Tax Notes (Nov. 26, 2001) at p. 1199.
- 243 Kovar, *Adversity After Bosch*, ACTEC Journal Vol. 28, No. 2 (Fall 2002) at p. 99.
- 244 Cf. *United States v. Gullo* (W.D.N.Y. 1987) 672 F. Supp. 99, 104.
- 245 Cf. *United States v. Turner* (10th Cir. 1974) 497 F.2d 406, 407.
- 246 *Vincent v. Commissioner* T.C. Memo 1992-21.
- 247 *Ibid.*; Wood, *Tax Treatment of Will Contest Recoveries*, Tax Notes (Nov. 26, 2001) at p. 1200.
- 248 PLR 200417030 ("the settlement agreement provides an allocation of the Trust's assets that is within a range of reasonable settlements. That is, the interests to be received by the parties (both as to the nature of the interests and their economic value) reflect the enforceable rights of the parties. Consequently, the property passing to Spouse under the settlement agreement passes from Decedent for marital deduction purposes under section 2056").
- 249 *Ibid.*; Kovar, *Adversity After Bosch*, ACTEC Journal Vol. 28, No. 2 (Fall, 2002) at p. 99.
- 250 Kovar, *Adversity After Bosch*, ACTEC Journal Vol. 28, No. 2 (Fall, 2002) at pp. 99 to 100.
- 251 *Ibid.*
- 252 *Commissioner v. Estate of Bosch, supra*, 387 U.S. 456.
- 253 Prob. Code, section 20110, subd. (a) & section 20210, subd. (a).
- 254 Prob. Code, section 20110, subd. (b) & section 20210, subd. (b).
- 255 *Commissioner v. Estate of Bosch, supra*, 387 U.S. 456.
- 256 Rev. Proc. 2019-1 (user fee of \$30,000 for a standard letter ruling request received by the IRS after February 1, 2019).
- 257 Treas. Reg. section 601.201(l)(6). A private letter ruling is binding only for the taxpayer who requested it. Section 6110(k)(3) of the Code provides that such a ruling may not be used or cited by another taxpayer as precedent.