Tax Consequences of Settling Fiduciary Litigation

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I. Effect of a settlement on the federal estate tax – governing law

1. The interpretation of federal statutes is governed by federal law.

Lyeth v. Hoey, 305 U.S. 188 (1938), involved a determination of the income tax consequence of payment to an alleged heir of estate in compromise of his claim. The Supreme Court ruled that the question of whether the amount the heir received was "acquired by inheritance" is a federal question, not determined by local characterization, and it should be uniform regardless of which state's local law is involved:

"The question as to the construction of the exemption in the federal statute is not determined by local law. We are not concerned with the particularities and special incidences of state taxes or with the policies they reflect. Undoubtedly, the state law determines what persons are qualified to inherit property within the jurisdiction. The local law determines the right to make a testamentary disposition of such property and the conditions essential to the validity of wills, and the state courts settle their construction. . . . Petitioner's status as an heir was thus determined by the law of Massachusetts. . . . But when the contestant is an heir and a valid compromise agreement has been made and there is a distribution to the heir from the decedent's estate accordingly, the question whether what that heir has thus received has been "acquired by inheritance" within the meaning of the federal statute is necessarily a federal question. It is not determined by local characterization. . . . We think that it was the intention of Congress in establishing this exemption to provide a uniform rule." 305 U.S. at 193-94.

2. State trial court interpretations of state law following adversarial proceedings are not binding for federal estate tax purposes.

Comm'r v. Bosch, 387 U.S. 456 (1966), involved a state court interpretation of whether a wife's release of a general power into a special power was effective. The state court ruled that the release was not

effective; therefore wife still had a general power. The Supreme Court held that decrees of state trial courts are not conclusive and binding on the computation of federal estate tax:

"We hold that where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by the determination made of such interest by a state trial court." 387 U.S. at 457.

"Thus, under some conditions, federal authority may not be bound even by an intermediate state appellate court ruling. It follows here then, that when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should a fortiori not be controlling. This is but an application of the rule of Erie R. Co. v. Thompkins, supra, where the state law as announced by the highest court of the State is to be followed. This is not a diversity case but the same principle may be applied for the same reasons, viz., the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." 387 U.S. at 465.

3. <u>Good faith settlements reached during adversarial proceedings are not binding for federal estate tax purposes</u>.

a. In *Ahmanson Foundation v. US*, 674 F.2d 761 (9th Cir. 1981), the court held that a good faith settlement must be based on an enforceable right under properly interpreted state law in order to qualify as a "passing" pursuant to the estate tax marital deduction:

"The government argues that if a state court adjudication as a result of a good faith adversarial proceeding is not binding for estate tax purposes, then *a fortiori* a private good faith settlement cannot be either. We conclude that the government is correct." 674 F.2d at 774.

". . . a good faith settlement or a judgment of a lower state court must be based on an enforceable right, under state law properly interpreted . . ." 674 F.2d at 775.

b. Enforceability of the right at issue must be based upon the claim as it existed at the time the settlement was reached. *Estate of Brandon,* 828 F.2d 493, 499 (8th Cir. 1987).

c. Reg. § 20.2056(c)-2(d)(2): If as a result of a 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 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 will contest. 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.*

d. In *Estate of Hubert v. Comm'r*, 101 T.C. 314 (1993), *aff'd* 63 F.3d 1083 (11th Cir. 1995), *aff'd* 520 U.S. 93 (1997), the court held that although a bona fide settlement reached following adversarial proceedings is not binding, it should not necessarily be ignored either:

". . . courts must look behind any settlement agreement to ensure that the claim on which it is based is valid. . . . While we agree that we are not bound by the settlement agreement for our decision of Mrs. Hubert's enforceable rights, we conclude that the agreement should not be ignored here. We have looked at the adversarial or nonadversarial nature of the proceedings in the State Courts to determine the weight to be given such settlement agreements. . . . In addition, this is not a circumstance in which respondent's [IRS'] interests were hurt by the compromise reached by the parties. . . . Taking all of the circumstances surrounding the settlement into consideration, we are convinced that what Mrs. Hubert received under the settlement agreement is in satisfaction of enforceable rights in decedent's estate. Although the regulations state that the settlement agreement will not *necessarily* be accepted as a bona fide

evaluation of such rights, they do not require rejection of such a settlement agreement. In this instance, we think it is appropriate to recognize amounts passing to Mrs. Hubert under the settlement agreement as passing from decedent, especially in the absence of any suggestion that the settlement agreement was entered into for post mortem tax planning purposes." 101 T.C. at 319-20 (emphasis in original).

e. Only good faith adversarial proceedings are required, not "an Armageddon." *Citizens & So. Nat'l Bank v. US*, 451 F.2d 221, 226 (5th Cir. 1971).

f. Settlement reached between decedent's child and decedent's surviving spouse, made during decedent's lifetime, was not proven to be a resolution of an actual controversy. The burden is on the taxpayer to establish that the estate is entitled to the deduction, and to prove the enforceable rights allegedly surrendered in the settlement. *Estate of Suzuki*, 62 T.C.M. (CCH) 1550 (1991).

g. Summary:

- Is the interest or right in accordance with state law, properly interpreted by the highest state appellate court?
- Were the proceedings truly adversarial in nature and not merely nominally adverse?
- What does the claimant receive relative to his or her claim, both as to nature and extent?
- Are the interests of the government prejudiced by the settlement?

- Is there a suggestion that the settlement is really just post mortem estate planning?

- The burden is on the taxpayer to prove entitlement to the deduction.

II. Effect of a settlement on the marital deduction

1. Introduction - Two significant issues need to be considered when compromising a dispute with the surviving spouse: whether the interest "passes or has passed from the decedent" and the amount of the deduction that will be allowed.

2. Relevant Provisions of the Internal Revenue Code and Regulations

   a. Section 2056(a): For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property *which passes or has passed from the decedent to his surviving spouse*, but only to the extent that such interest is included in determining the value of the gross estate.

   b. Section 2056(b)(4): In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section -

      (A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and

      (B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

c. Reg. § 20.2056(c)-2(d): Will contests. -

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

(2) If as a result of a 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 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 will contest. 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.

3. Settlement of will contests

a. Is the dispute a "will contest" within the meaning of Reg. § 20.2056(c)-2(d)?

- In *US Trust Co. of NY v. Comm'r*, 321 F.2d 908 (2nd Cir. 1963), the decedent left a portion of his residuary estate in trust for his wife with a general testamentary power of appointment and separately attempted to give his wife certain real estate in France. French law required decedent's daughters to approve the gift. Following negotiations, the wife relinquished her general power of appointment in exchange for the daughters' filing the required French documents. The Court held that Reg. § 20.2056(c)-2(d) was applicable and that the "medium by which the property passes, whether it be by intestacy, one or more testamentary documents or even by a partial intestacy, is irrelevant."

- *US Trust* was followed by the court in *Citizens & So. Nat'l Bank v. US*, 451 F.2d 221 (5th Cir. 1971), wherein it held Reg.

§ 20.2056(c)-2(d) applicable and stated "[w]e think that the Second Circuit's broad interpretation of the regulation is entirely proper and we conclude that because the settlement agreement in the instant case 'resolv[ed] a controversy over the decedent's property," the regulation is applicable.

- *US Trust* and *Citizens & So. Nat'l Bank* were criticized by the court in *Schroeder v. US*, 924 F.2d 1547, 1554 (10th Cir. 1991). There, the court ruled that Reg. § 20.2056(c)-2(d) "is inapplicable to property passing to a surviving spouse by statutory election or under the law of survivorship because the regulation speaks only in terms of a controversy involving a bequest or devise under decedent's will."

  The court went on to note, however, that rationale set forth in Reg. § 20.2056(c)-2(d) is persuasive in the determination of whether property "passes or has passed" from the decedent within the meaning of Section 2056(a):

  "To the extent a surviving spouse surrenders her share of the decedent's property to other beneficiaries not entitled to the marital deduction in order to avoid litigation concerning her rights, it defies common sense to conclude that this property "passed" to the surviving spouse. Not only is the ultimate recipient of the property a person other than the surviving spouse, but the transfer comprising the settlement could altogether escape taxation applying to gratuitous transfers of wealth. . . . The marital deduction was designed to eliminate the 'double-taxation' that would result when the same property became subject to tax upon the death of each spouse. Once property passes outside of the interspousal unit, however, this exception no longer applies. . . . Congress clearly did not intend to replace double-taxation with tax avoidance." 924 F.2d at 1554-55.

b. Where spouse retains benefits under the disputed will, but other parties receive a payment to settle the dispute, the amount received by the other parties does not pass from the decedent to the surviving spouse and no marital deduction is allowed for such property.

- Reg. § 20.2056(c)-2(d)(1): If as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having "passed from the decedent to his surviving spouse."

- The deduction is limited to the amount actually passing to the surviving spouse under the settlement agreement, rather than the amount claimed under the will. Stated otherwise, the amount the surviving spouse surrenders in order to settle the will contest does not pass to the surviving spouse within the meaning of Section 2056(a). *Estate of Sikler v. Comm'r*, 42 T.C.M. (CCH) 1389 (1981); *see also* PLR 9005003.

- Where a spouse relinquishes a power of appointment over trust and a terminable interest results no marital deduction is allowed. In *US Trust Co. of NY v. Comm.'r*, 321 F.2d 908 (2nd Cir. 1963).

- In *Estate of Carpenter v. Comm'r*, 52 F.3d 1266 (4th Cir. 1995), the decedent made a holographic will wherein he essentially created a trust for the benefit of his wife, with the remainder upon her death to his daughter. The parties settled their dispute by agreeing to have all the property distributed outright and divided equally between them as tenants in common. The estate claimed a marital deduction for the one-half share of the assets passing outright to the spouse pursuant to the agreement. The Court held that such property did not pass to the surviving spouse within the meaning of Section 2056(a), because the interest the spouse relinquished - the interest in trust - would not have qualified for the marital deduction in the first instance:

"Property transferred pursuant to a settlement agreement - - even a bona fide arm's length settlement agreement - - will not qualify for the marital deduction if the surviving spouse did not, *prior* to the settlement, have an enforceable right under state law to an interest deductible under § 2056."

c. Transfers by other beneficiaries to the spouse

- There must be a legitimate controversy regarding the validity of the decedent's will, and amounts transferred to the surviving spouse which are not made in consideration of a legitimate controversy do not pass to the surviving spouse from the decedent. *Estate of Wegman*, 36 T.C.M. (CCH) 497 (1977).

d. Special attention must be paid if the interest the spouse receives in settlement is different in nature than the spouse's "enforceable right".

- In PLR 9733017, the surviving spouse compromised a contest over decedent's will and revocable trust premised on undue influence and lack of capacity by receiving an outright lump sum payment, which the IRS ruled qualified for the marital deduction. *See also* PLR 9610018 (same).

4. Settlement of disputes regarding joint property

a. Where spouse placed joint property received upon decedent's death into trust for benefit of spouse and decedent's children in settlement of dispute regarding such property, no "vested rights" arose at decedent's death and such property is not considered to have passed to surviving spouse from decedent. *Schroeder v. US*, 924 F.2d 1547, 1554 (10th Cir. 1991). The court also noted that to adopt the "vested rights" argument under state law "would transgress the Supreme Court's holding in *Lyeth v. Hoey*, . . . that federal law controls the incidence of federal taxation of property acquired under state law." *Id*. at 1554.

4. Settlement of elective share, dower and marital agreement claims

a. In *Schroeder v. US*, 924 F2d 1547, 1554 (10th Cir. 1991) the court ruled that Reg. § 20.2056(c)-2(d) "is inapplicable to property passing to a surviving spouse by statutory election or under the law of survivorship because the regulation speaks only in terms of a controversy involving a bequest or devise under decedent's will." Therefore, the Court must determine under the language of Section 2056 whether the interest "passes or has passed" from the decedent to the surviving spouse. *Estate of Ransburg*, 800 F. Supp. 716, 721 (D.S.D. Ind. 1991).

b. Revenue Ruling 66-139, 1966-1 C.B. 225, provides that the amount paid to a surviving spouse pursuant to a bona fide compromise agreement in recognition of her alleged rights in decedent's estate qualifies for the marital deduction "to the extent that the interest that would have passed to her as a result of the completed exercise of such rights would have been deductible."

c. Revenue Ruling 72-7, 1972-1 C.B. 308, provides that where the spouse had the state law right to the commuted value of her dower rights, the outright payment of such amount to the spouse qualifies for the marital deduction.

d. Revenue Ruling 83-107, 1983-2 C.B. 159, provides that an amount paid to a decedent's spouse pursuant to a negotiated settlement of the spouse's deductible dower claim is deductible if the amount paid is a bona fide compromise resulting from the spouse's assertion of an enforceable right whether or not a claim was filed pursuant to local law. To the extent Revenue Ruling 72-7 stated that a formal judicial proceeding for the commutation was required, it is modified accordingly. The deduction, however, is limited to the fair market value of the spouse's dower interest as of the date of decedent's death. *See also* TAM 9246002.

e. If surviving spouse claims and receives an elective share, but then in settlement of litigation places such property received into a trust for the surviving spouse and decedent's children, the property received is not considered as having "passed" to the surviving spouse from the decedent. *Schroeder v. US*, 924 F.2d 1547, 1554 (10th Cir. 1991).

f. Special attention must be paid if the interest the spouse receives in settlement is different in nature than the spouse's "enforceable right".

- In PLR 9040032, the marital agreement required decedent to provide certain interests for the surviving spouse, including a non-deductible terminable interest trust. Decedent failed to make such provisions and the surviving spouse asserted a claim against the estate, which was settled on the basis of trust similar to that provided in the marital agreement, except that the interests were not terminable interests and the value was greater than the value the surviving spouse would have received had decedent complied with the marital agreement. The interest the spouse received was received as a bona fide compromise of the spouse's enforceable rights and the income interest received qualified under Section 2056(b)(7).

- In PLR 9546004, the surviving spouse claimed an elective share against decedent's estate where decedent's will made no provision for her. In settlement of that claim, the executor created a trust for the lifetime benefit of spouse with the remainder to decedent's son, and made the QTIP election. The IRS ruled that the property passing in trust pursuant to the settlement agreement is deemed to have passed from the decedent to the trust for purposes of 2056(a) and 2056(b)(7).

- In TAM 8236004, the surviving spouse received a terminable interest under decedent's will and revocable trust which did not qualify for the marital deduction. Decedent's child disputed the nature of spouse's interest which was settled by distribution to spouse of a fee interest in certain property in exchange for a relinquishment of all property rights under decedent's will and revocable trust. Although there was a bona fide controversy, that controversy involved only the exact nature of spouse's interest under the will and trust. As

spouse's rights arose solely from decedent's will, the spouse's only enforceable rights were to a terminable interest, and cannot be "converted" to an outright fee interest that qualifies for the marital deduction. Note that a marital agreement prevented the claim of an outright interest, unlike PLR 9040032.

- In TAM 9251002, the marital agreement provided for a $50,000 bequest and life estate in the homestead. After decedent's death, surviving spouse filed an election against the will claiming the marital agreement was invalid. The statutory elective share was one-third of the net estate outright, which would have amounted to $546,000. In settlement, the estate placed $420,000 in trust for the surviving spouse for life with remainder to decedent's daughter. The IRS ruled that because the surviving spouse's state law claim was an outright share, only the present value the spouse received outright qualified for the marital deduction. The IRS actuarially computed the present value of the surviving spouse's income interest, and ruled that the balance was deemed to have been transferred to the trust by the remaindermen, not decedent.

g. Settlement of estate or trust administration disputes

- In *Estate of Mergott*, 86 AFTR2d 2000-5877, 2000 WL 1718723 (D.N.J. 2000), decedent's will provided for a trust of one-half of the residuary estate for the benefit of the surviving spouse. The spouse filed an election against the will, but later withdrew the election and filed a demand for an accounting and a claim for her dower interest in certain real property. In settlement of the claims other than the dower claim, the estate agreed to terminate the trust and make an outright distribution to her. In a later settlement of the dower claim the estate transferred certain real property to the spouse. The estate's claimed marital deduction for both interests paid to the spouse was disallowed. The Tax Court ruled that under New Jersey law there was no enforceable right to have the trust terminated, and therefore the settlement was not a bona fide recognition of enforceable rights and such property did not pass to the surviving spouse from the decedent. No QTIP or protective QTIP election had been made. The settlement of the dower claim also did not qualify for the marital deduction,

as the spouse did not have an enforceable right to both take under decedent's will and to claim a dower interest.

6. Protective Elections

   a. Many of the older cases predate the QTIP election under Section 2056(b)(7) and hold that the interest the spouse would have received if successful was a non-deductible terminable interest.

   b. If the estate tax return must be filed prior to settlement of a dispute with the surviving spouse, the estate should make protective QTIP and GST elections as necessary, in order to preserve flexibility for later settlement.

7. Summary:

   a. The nature and extent of the interest the spouse would have received if successful in his or her claim must qualify in the first instance for the marital deduction. A non-deductible claimed interest cannot be converted into a deductible interest via settlement.

   b. Settlements of election and dower claims must be consistent with the "properly interpreted" state law enforceable right being surrendered.

   c. Will contest settlements should be structured, if possible, so that the spouse receives the deductible interest pursuant to the probated will (i.e., marital trust or outright interest) and the other parties receive settlement payments to walk away.

   d. The deduction will be limited to the value of the spouse's claimed interest.

III. Effect of settlement on the charitable deduction

1. Introduction - Two significant issues need to be considered when compromising a dispute with a charity. The first is whether the interest is acquired by the charity by "purchase" or by "inheritance", and in this regard is similar to the issue of whether an interest passes from the decedent to the surviving spouse, discussed above with respect to the marital deduction. The second issue is the amount of the deduction that will be allowed.

2. Relevant Provisions of the Internal Revenue Code and Regulations

   a. Section 2056: The value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers . . . to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes.

   b. Reg. § 20.2055-2(d): "Payments in compromise. If a charitable organization assigns or surrenders a part of a transfer to it pursuant to a compromise agreement in settlement of a controversy, the amount so assigned or surrendered is not deductible as a transfer to that charitable organization."

3. Does the charity take by purchase or inheritance?

   a. In *Dumont's Estate v. Comm'r*, 150 F.2d 691 (3rd Cir. 1945), Lafayette College received an interest in trust under a will that was executed within 30 days of decedent's death. Under the law at that time the charitable gift was void. Lafayette College challenged the will on the grounds of lack of capacity, and asserting that an earlier will, under which it received an identical interest, should be probated. The Tax Court disallowed the deduction on the basis that the College took by purchase and not by inheritance because under Pennsylvania law the bequest in the probated will was void. The Third Circuit reversed, ruling that the because the College was a legatee under the prior will it did not need to rely upon the probated will, and therefore took by inheritance in its settlement.

b. In *Estate of Gilbert v. Comm'r*, 4 T.C. 1006 (1945), decedent left a holographic will leaving his estate to charity. Decedent's heirs challenged the will and a settlement was reached with the result that outright payments were made to the heirs and the balance distributed to charity pursuant to the will. The Tax Court held that the bequest to charity under the will as written was valid, and the amount distributed under the will was received by inheritance, not purchase.

c. In *Bach v. McGinnes*, 333 F.2d 979 (3rd Cir. 1964), the decedent's will left the residue of his estate in trust for his wife, and after his wife's death outright to certain other named individuals or, if they failed to survive his wife, to Drexel Institute of Technology. The wife reached agreement with the named individuals and Drexel whereby she elected against the will and they in turn received outright cash payments. The estate claimed a charitable deduction for the amount passing to Drexel. The Third Circuit ruled that the estate was not entitled to a charitable deduction as of the date of decedent's death "and nothing which happened thereafter, viz., the compromise settlement, could breathe life into a stillborn non-existent eligibility." The Court further held that "what Drexel Institute received under the settlement agreement it received from the named relatives and not from the testator." 333 F.2d at 983.

d. ". . . if the amount received by a charity under a settlement agreement in a will contest would have been received under the will had the contest continued and the charity been successful, then the amount received under the settlement is received as an inheritance and gives rise to a charitable deduction in computing the net taxable estate. On the other hand if no valid gift is made by the will to the charity so that the settlement is in effect a gift by an heir or devisee to the charity, the amount received by the charity under such a settlement is not a charitable deduction in computing the net taxable estate." *Morris v. Comm'r*, 25 T.C.M. (CCH) 974, 1966 WL 987 (1966).

e. A charitable deduction will not be per se disallowed under Section 2055(e) for a remainder interest in a split-interest trust that passes directly to charity pursuant to a bona fide settlement, even though the split interest did not meet the charitable deduction requirements of Section 2055(e). Revenue Ruling 89-31, 1989-1 C.B. 277; *Robbins v. Comm'r*, 111 F.2d 828 (S.D. Ind. 1991).

f. But where an otherwise non-deductible split interest is involved, the rule stated in subparagraph e. is only one hurdle. Unless state law, properly interpreted, supports the charity's claim for outright distribution, the excess amount over the actuarial date of death value under the disputed document passes by purchase from the other beneficiaries, and not by inheritance, and is not deductible. *Terre Haute First Nat'l Bank v. US*, 67 A.F.T.R. 2d 91-1217 (S.D. Ind. 1991); *see also Robbins v. Comm'r*, 111 F.2d 828 (1st Cir. 1940).

4. <u>The deduction is limited to the amount actually passing to charity</u>.

a. In *Sage's Estate v. US*, 122 F.2d 480 (1941), the decedent bequeathed approximately $42,000 to his incompetent wife and gave the residue to charity. Wife's guardians challenged the will, and in settlement the charity paid her one-quarter of its residuary share. The Court held that the charitable deduction can only equal what the charity actually received after the settlement: "What the widow received as a result of the compromise agreement she took because of her standing, as the testator's widow, to contest the will and, if successful, so deprived the residuary legatee of the benefit."

b. The amount received by the charity must "measure the quantum of the deduction allowable." *Irving Trust Co. v. US*, 221 F.2d 303 (1955).

c. The fact that the settlement payment "permitted the [charity] to operate without interruption free of the expense of litigation" which "in turn, left the [charity] with more time and money to devote to charitable purposes" cannot transform a payment to non-charitable beneficiaries into a charitable deduction. *Lindberg v. US*, 927 F. Supp. 1401, 1406 (D. Co. 1996).

d. It makes no difference whether the non-charitable interest is paid from the estate, or directly by the charities from other funds. *Thompson's Estate v. Comm'r*, 123 F.2d 816, 817-18 (2nd Cir. 1941) ("The fact that the charities, rather than the executor, made the payment is immaterial."); *see also Wilcox v. US*, 185 F. Supp. 385 (D.C.Ohio 1960).

5. Charitable subscriptions or pledges are deductible in the same manner as a charitable bequest.

a. Section 2053 allows a deduction for "claims against the estate".

b. Reg. § 20.2053-5: A pledge or a subscription, evidenced by a promissory note or otherwise, even though enforceable against the estate, is deductible only to the extent that (a) liability therefore was contracted bona fide and for an adequate and full consideration in cash or its equivalent, or (b) it would have constituted an allowable deduction under section 2055 (relating to charitable, etc., deductions) if it had been a bequest.

IV. Use of disclaimers in settlements

1. Section 2518 of the Code allows qualified disclaimers with respect to any interests in property. A qualified disclaimer must be an irrevocable and unqualified refusal by a person to accept an interest in property and requires, among other things, that "such person has not accepted the interest or any of its benefits". Section 2518(b)(2)(3).

2. If a disclaimer is used as part of the settlement, you need to consider whether the disclaimer is "for consideration".

a. Reg. § 25.2518-2(d)(1) provides that "the acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed." *See also* PLR 8225096.

b. Example 2 of the Regulations states:

"B is the recipient of certain property devised to B under the will of A. The will stated that any disclaimed property would pass to C. B and C entered into negotiations in which it was decided that B would disclaim all interest in the real property that was devised to B. In exchange, C promised to let B live in the family home for life. B's disclaimer is not a qualified disclaimer for purposes of section 2518(a) because B accepted consideration for making the disclaimer."

c. "Consideration as used in the estate and gift tax code does not invoke the common law contract concept of consideration. Rather, consideration as used in the estate and gift tax code means receiving money or something reducible to money's worth." *Estate of Lute v. US*, 19 F. Supp. 1047, 1056 (D. Neb. 1998).

d. "We thus agree with the estate that to have accepted the benefits of a disclaimed interest, the disclaimant must have received actual consideration in return for renouncing his legacy. A disclaimant's mere expectation of a future benefit in return for executing a disclaimer will not render it 'unqualified.' . . . Thus, the question for each disclaimer is whether the decision to disclaim was part of mutually-bargained for consideration or a mere unenforceable hope of future benefit . . . ." *Estate of Monroe v. Comm'r*, 124 F.3d 699, 709-710 (5th Cir. 1997).

V. Deductibility of counsel fees

1. Estate Tax deduction

a. Section 2053(a)(2) of the Code allows a deduction for administration expenses, which includes counsel fees.

b. Reg. § 20.2053-3(a) limits such expenses to those which are "actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payments of debts, and distribution of property to the persons entitled to it. . . . Expenditures not essential to the proper administration of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions."

c. Reg. § 20.2053-3(c) provides:

"Attorneys' fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate with the meaning of paragraph (a) of this section. An attorney's fee not meeting this test is not deductible as an administration expense under section 2053 and this section, even if it is approved by a probate court as an expense payable or reimbursable by the estate."

2. Individual Income Tax Deduction

a. Reg. § 1.212-1(k) provides: "Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible."

VI. Settlement Agreement Drafting Issues

1. The settlement agreement should address the allocation of any tax burden in the event the IRS disallows the marital or charitable deduction. Where the payment to the spouse or charity is a "walk-away" amount, and the estate agrees to bear the burden of any death taxes that might be imposed on that transfer, the settlement agreement should include an indemnification of the spouse or charity for any such tax and any interest and penalties. You might also consider having the agreement provide:

a. That the estate will retain sufficient assets to cover the possible tax liability as security for its indemnification.

b. That you as counsel for the charity or spouse be permitted to review the draft death tax return before it is filed, and that you be provided with a copy of the closing letter once received.

2. For settlements with a charity, you might consider requiring representations and warranties including, as applicable, that the charity:

a. is a not-for-profit corporation in good standing;

b. is recognized by the Internal Revenue Service as a charitable organization exempt from federal income tax under Section 501 (c)(3) of the Internal Revenue Code of 1986, as amended (the "Code");

c. is an organization described in each of the applicable provisions of Sections 170(c), 509, 2055, 2106 and 2522 of the Code; and

d. properly authorized their undersigned officers to execute the agreement on its behalf.