# ***TAXATION IN CONTESTED ESTATES***

by Curtis E. Shirley

## *BACKGROUND*

The victor in a lawsuit generally pays tax on any winnings because gross income includes "income from whatever source derived." IRC Section 61; Commr. v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). It does not matter whether the lawsuit went to judgment or settled. See Longino Estate v. Commr., 32 T.C. 904 (1959) (settlement); Levens v. Commr., 10 T.C.M. 1083 (1951) (arbitration award). Once you determine that a settlement or judgment is taxable, a more interesting issue is whether to define it as ordinary income, capital gain, or a return of capital. This becomes even more difficult in cases where the victor has two or more causes of action with no clear allocation between them.

From the loser's perspective, payments made pursuant to a judgment or settlement are usually deductible as trade or business expenses under IRC Section 162, or as production of income expenses under IRC Section 212. If the victor treats the winnings as capital gain (such as where the lawsuit involved the sale or exchange of capital assets, see IRC Section 1221), the loser may be required to capitalize the payments over extended periods of time. Attorney fees and expenses usually follow the same allocation. See McKay v. Commr., 102 T.C. 465 (1994), vac'd., 96-1 USTC Para.50, 279 (5th Cir. 1996); Church v. Commr., 80 T.C. 1104 (1983).

So how do we answer these questions? Is it income, if so which kind? Is it deductible, if so which kind and how soon? The easy answer is to study the origin of the claim. See Hort v. Commr., 313 U.S. 28 (1941); U.S. v. Gilmore, 372 U.S. 39 (1963). If the winner was after lost wages, he usually pays ordinary income tax and the loser gets an immediate business expense deduction. If the winner was after damages for converted inventory, he or she will have part of the winnings attributed to a return of capital for the cost basis of the widgets in the first place.

In addition to the origin of the claim, such as a contract or tort theory, the question of how to allocate between various causes of action can be answered by reviewing the complaint, the settlement negotiations, the agreement, and the trial Court's orders. See Bagley v. Commr., 105 T.C. 396 (1995), aff'd., 121 F.3d 393 (8th Cir. 1997); Threlkeld v. Commr., 87 T.C. 1294 (1986), aff'd., 848 F.2d 81 (6th Cir. 1988) (finding allocations in a settlement agreement binding if the result of good faith disputes among adversaries).

As with any general rule involving the tax code, exceptions are hazardous. For example, the tax code excludes most winnings involving a personal injury. See IRC Section 104. Simply put, the government permits victims to receive tax free compensation for the loss of physical functions, apparently because the government would have had nothing to tax had the injury not occurred, and such compensation cannot be seen as placing the person in a better position had the injury not occurred. It's not so easy to understand why the government excludes lost wages in these cases. See O'Gilvie v. U.S., 519 U.S. 79 (1996); Schleier v. Commr., 515 U.S. 323 (1995).

Although the tax code contains a specific section concerning winnings in personal injury cases, there is no corresponding code section concerning a non-personal injury case. The undersigned believes that the only situations where payments received in non-personal injury cases are excludible from gross income are those involving gifts and inheritances. In looking to the origin of the claim, the ultimate winnings are simply a substitute for amounts which would have otherwise been excluded. That is because gross income "does not include the value of property acquired by . . . bequest, devise, or inheritance." IRC Section 102(a). Just because you ultimately acquire such property through use of litigation should not change the character of your winnings.

## DISPUTES OVER DEBT OWED TO THE DECEDENT

If a person borrows money and later is discharged from all or a portion of the obligation to repay the loan, taxable income results. See IRC Section 61(a)(12). If liability is contested a settlement of the amount due changes the tax consequences. Yet this rule has a different application if a decedent forgives a child's debt as part of specific bequest in a Will. The government would rather apply the gift and estate tax rules to determine if any tax is due and owing. So the decedent's estate is increased by the amount owed, and the son receives value without any income tax consequences.

## WILL CONTESTS

As a general rule, winnings from a will or trust contest are excluded just as if the property was inherited. Whether such a settlement qualifies under Section 102, however, is a question only of federal law. See Lyeth v. Hoey, 305 U.S. 188, 59 S.Ct. 155 (1938) ("In exempting from the income tax the value of property acquired by 'bequest, devise, or inheritance,' Congress used comprehensive terms embracing all acquisitions in the devolution of a decedent's estate."). So a good ultimate question is whether the winnings received came from the estate because of a person's status as an heir, or by some other means? In other words, did the testator make a gift because of generosity, or for some other reason? See Braddock v. U.S., 434 F.2d 631 (9th Cir. 1970).

As a warning, consider the recent case of Mergott Estate v. U.S., 2000-2 USTC Par. 60,383 (D.N.J. 2000), which denied a marital deduction to a surviving spouse who settled a will contest. Evidently she accepted a sum certain from the Estate rather than accept the benefits of a trust that could have qualified for QTIP treatment. Because the parties could not terminate the residuary trust, the settlement was not "based on an enforceable right under state law properly interpreted."

## CONTRACTUAL WILLS INVOLVING GIFTS

Suppose husband and wife sign contractual wills that cannot be revoked. Each leaves their estate outright to the other, and then to their child. Husband dies first and wife remarries. She then has a second child.

Even without litigation the tax aspects in this situation are confusing. At the husband's death, his outright gift to his wife may not qualify for the marital deduction because it is a terminable interest. See Estate of Krampf v. Commr., 464 F.2d 1398 (3d Cir. 1972). Or it may qualify. See Dobris, *Do Contractual Will Arrangements Qualify for Qualified Terminable Interest Treatment Under ERTA?*, 19 Real Property, Probate and Trust Law Journal, 625 (1984). His property could also be taxed in his wife's estate as well because she had the power to consume it during her lifetime. See Phinney v. Kay, 275 F.2d 776 (5th Cir. 1960). Or the wife could be held to have made a gift of a remainder interest in all of the property at the death of her husband. See Pyle by Straub v. U.S., 766 F.2d 1141 (7th Cir. 1985).

But let's ignore the marital deduction question and focus on the tax aspects of the contractual wills. If husband and wife agree to contractual wills, any beneficiaries inherit and are taxed as if the contract did not exist. See Getty v. Commr., 913 F.2d 1486 (9th Cir. 1990), rev'g 91 T.C. 160 (1988); Marcus v. Commr., T.C. Memo 1996-190 (settlement payments excludible as an inheritance under §102); Vincent v. Commr., T.C. Memo 1992-21 (settlement payments excludible as a gift under §102). If a contract itself were to cause an inheritance to otherwise be classed as a "income from whatever source" rather than as a "bequest, devise, or inheritance," the entire realm of trust law (based on contract law rather than probate codes) would be called into question. See also DiLeonardo v. Commr., T.C. Memo 2000-120 (trust beneficiary could deduct her court-ordered payments to trustee and other beneficiaries for their litigation costs to dispute her frivolous objections to the trustee's accounting because the origin of the claim resulting in the payments was the trustee's filing of the accounting).

In John Davies, 23 T.C. 524 (1954), the taxpayer sued the decedent's Estate for breach of contract to devise and filed a claim for services. The tax Court found that both causes of action relied upon the taxpayer's services to the decedent. Note that the tax Court made these findings on its own as a matter of federal law, no matter what any settlement agreement might have stated. Simple enough; but the tax Court went on to rule that the taxpayer could not rely on the decedent's unsupported promise to make a Will. This is unfortunate. If the decedent had simply given the taxpayer a specific bequest without mention of the services, he would have inherited tax free. But the law now does not permit enforcement of a promise to do that without converting the controversy into a taxable event. See Braddock v. U.S., 434 F.2d 631 (9th Cir. 1970); Davis v. U.S., 1985 WL 6368 (U.S.D.C. Montana).

In Estate of Huntington v. Commissioner, 100 T.C. 313 (1993), aff'd., 16 F.3d 462 (1st Cir. 1994), husband (with two children from a prior marriage) and second wife (they had one child together) agreed to leave their estates to each other and then equally among all three of the children. After husband died, wife changed her Will to exclude the step children, and they sued. They settled the lawsuit a few weeks before wife died, although she had yet to actually sign a new Will in accordance with the new agreement. The step children filed a claim for breach of contract to devise which the Estate settled for $450,000.00. Prior to the ultimate settlement, the Estate had claimed an estimated deduction of $350,000.00.

The IRS did not allow the deduction asserting that the stepsons were beneficiaries, not creditors. The tax Court stated that "where the only consideration supporting reciprocal-will agreements is the donative intent of spouses, such donative intent does not constitute adequate consideration under section 2053(c)." The tax Court did not even inquire into whether the intent of the spouses would be regarded as adequate consideration under state law for enforcement of the reciprocal agreements. On this issue the Court stated that IRC Section 2053(c)(1)(A) limits any deduction by making such claims subject to a consideration requirement. They are "deductible only if the agreement giving rise to the claim was 'contracted bona fide and for an adequate and full consideration in money or money's worth.'" Although the Court recognized that the decedent received a financial benefit from the agreement, the Court held that it was not the kind of "'bona fide' contractual obligation for which section 2053 allows a deduction." Huntington, 16 F.3d at 465-466 & 469.

IRC Section 2053 thus assumes that there is a greater risk of family members attempting to use contracts to transfer wealth to their children and transform what is otherwise subject to estate and inheritance taxes into deductible claims. Obviously transactions between family members are subject to greater scrutiny. In the Huntington case the Court found the agreement, even if supported by consideration, was nothing more than a collaborative effort to devise the family wealth. The Court noted that one of the general tests is whether the claim is against the estate or to a portion of the Estate. But this merely restates the issue and might as well ask if the tail is wagging the dog.

The government expanded its preference for treating such contracts as inheritances rather than claims in a case involving third party, unrelated beneficiaries. In Bank of New York v. U.S., 526 F.2d 1017 (3d Cir. 1975), spouses signed mutual Wills that benefited non-relatives. The second spouse changed her Will and the disinherited third parties filed claims for breach of contract to devise. The Court disallowed a deduction for their settlement because there was no evidence of arm's length bargaining between the spouses. Evidently the Court would permit a claim deduction only where the contracts involved parties with divergent interests or when based on commercial matters. So even though the agreement is a valid one under State law, the Court held that under federal law it was nothing more than a "friendly agreement" to benefit third parties and essentially donative in character.

The undersigned thus believes that in very large estates the government will consistently argue that breaches of contracts to devise will be treated as inheritances. If this is not the case, then the Estate would receive a deduction for paying the claim. The undersigned can think of no circumstances that would permit either the government or the taxpayers (beneficiaries or Estates) to have it both ways; that is, the taxpayer could never receive an inheritance and at the same time an estate get a claim deduction – or the taxpayer having to pay income tax and the estate getting no claim deduction.

## CONTRACTUAL WILLS INVOLVING SERVICES

Unlike an ordinary bequest, a contract to devise property in return for services means that the beneficiary must report the entire amount as ordinary income. See Bernyce Green, 1987 TC Memo 503. In return, the estate may deduct the bequest as if it were a claim. See Matter of Estate of McLeod, 719 P.2d 88 (Wash. 1986); Joseph Mariani, 54 T.C. 135 (1970) (disinherited son who filed a claim for services and did not file a will contest had to report all settlement proceeds as taxable income).

Of interest to attorneys is the case of Wolder v. Commissioner, 493 F.2d 608 (2nd Cir. 1974), which held that a specific bequest to an attorney that represented the Estate was to be treated as compensation -- period. In this case the Will made no mention of the fact that the attorney would represent the Estate, and the attorney had already agreed with the decedent to handle the Estate without charge. In effect, if you provide any services to an Estate without payment, the Court regards any expected inheritance as compensation. Compare Revenue Ruling 66-167 (an Executor who inherits can serve on a gratuitous basis (thus able to choose an otherwise higher inheritance rather than diminish the Estate by receiving income) if he or she sends a written waiver to any principal beneficiary within six (6) months of being appointed); cf., George M. Breidert, 50 T.C. 844

(1968) (even if no written waiver is made within six (6) months, the intention of the Executor controls).

## MULTIPLE CLAIMS

In many cases, the plaintiffs' attorney represents multiple parties or alleges multiple claims. They may have slightly differing interests, even though there is no conflict of interest serious enough to prevent the representation. What may seem like no conflict of interest in the litigation may be a problem when it comes to allocations between the plaintiffs for tax purposes.

For example, suppose plaintiff number one files a will contest and claim for breach of contract for services. Plaintiff number two who lived out of town joins only in the will contest. The Executor and beneficiaries may choose a settlement amount because of the strength of the claim, yet the plaintiffs may choose to accept the amount only if the agreement assigns everything to the will contest claim. In such a situation, the Executor would have every reason to bargain in good faith to have the amount assigned to the claim so that the estate gets a corresponding deduction. But what if the estate did not need a claim deduction, such as where a transfer to the plaintiff would not be taxable, or the estate was not large enough to incur estate or inheritance taxes? Even if the claim for services was the strongest part of a case, everyone would permit assigning all amounts to settlement of the will contest.

A similar problem may arise when multiple parties have the same intentions yet different pleadings. For example, the decedent died in the year 2000 just after signing his new Will. Suppose plaintiff number one (a son) seeks to probate a will dated in 1998. Plaintiff number two (a former spouse) seeks to probate a will dated in 1997. You represent both. It so happens that the former spouse has the stronger case, yet because of her age and health (she has been on Medicaid for some time), she wants her son to get everything. If the Executor and beneficiaries choose a settlement amount because of the strength of the allegations by plaintiff number two, the Executor has no reason to care who ultimately gets the money. Yet Medicaid cares very much. You must work out a monetary amount to pay the State of Indiana so that plaintiff number two is not made ineligible for future Medicaid benefits.

## DIVORCE AGREEMENTS

Often disputes arise among family members because of prior divorces. The general rule is that payments of alimony, child support and property settlements are not treated as gifts for purposes of the transfer taxes, even though such transfers reduce a person's wealth. <u>See IRC Section 2516</u> for specific requirements, which are many and technical. Payments made for the support of adult children, however, are treated as gifts. <u>See Spruance v. Commr</u>., 60 T.C. 141 (1973), <u>aff'd.</u>, 505 F.2d 731 (3d Cir. 1974). Because gifts are by their very nature voluntary, there is no need to question whether adequate consideration was received if the transfer occurs because of a Court Order. <u>See Harris v. Commr.</u>, 340 U.S. 106 (1950) (holding that if a divorce decree is the basis for a payment obligation, there is no need for consideration as it only applies to a transfer founded on a promise or agreement).

Once such agreements or Court Orders are in place, sometimes an ex-spouse wishes to change the terms. Suppose that the husband must pay support now valued at $100,000.00. The ex-wife, however, now wants the husband to transfer $100,000.00 into a trust, income to ex-wife for life, remainder to their children. If they agree, the settlement will incur a gift tax. The value of ex-wife's interest in the trust is less than the value of support, say in this case $25,000, so she has made a $25,000 gift of a future interest to her children.

## ASSIGNMENTS AND RELEASES

It is not unusual for one who might inherit to assign his or her interest to another. Although the testator might very well exclude the beneficiary, the possible inheritance has a current value. See McAdams v. Bailey, 82 N.E. 1057 (Ind. 1907); Kuhn v. Kuhn, 385 N.E.2d 1196 (Ind.App. 1979). On a related note, the United States Supreme Court has taken the ignorance of state laws and testator's intentions to the extreme by ruling that assignments and disclaimers cannot affect a federal tax lien. See Drye v. U.S., 528 U.S. 49, 120 S.Ct. 474 (1999). But I leave this for another day.

Suppose parents sign a divorce agreement requiring each to write a Will that benefits their children. Suppose each of the parents then remarry and the children are concerned that their inheritances will either be spent down or reduced too much by the second spouse's possible election against the Wills. If any of the children wish to accept a sum certain now, in exchange for a release of their future inheritance (or an assignment to another), what are the tax consequences?

It would seem that the answer is the same as a person who assigns (or sells) his possible inheritance to another. The taxpayer has converted what would otherwise have been an inheritance into a capital asset.

In Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757 (1941), the Supreme Court held that the amount received by a landlord in cancellation of a lease was ordinary income because "the payment was merely a substitute for the rent reserved in the lease." This is commonly referred to as the collapsed ordinary income principle. If this were the law on assignments of inheritances, there is an argument that any proceeds from any early receipt of an inheritance would be tax free; that is, an heir could substitute money now in exchange for what he would receive tax free in the future. But this line of thinking has not applied in the area of life estates and remainder interests.

In Blair v. Commissioner, 300 U.S. 5, 57 S.Ct. 330 (1937), the Supreme Court held that a gift of a life interest was a transfer of income producing property, not a transfer of income from property. This has led many courts to treat life estates and remainder interests as capital assets. See Bell's Estate v. Commr., 137 F.2d 454 (8th Cir. 1943); Quigley v. Commr., 143 F.2d 27 (7th Cir. 1944); Fry v. Commr., 31 T.C. 522 (1958). See also McAllister v. Commr., 157 F.2d 235 (2nd Cir. 1946) (allowing capital loss treatment). Given this line of cases, it is the undersigned's opinion that property received from the assignment of inheritances is capital gain, although there does not appear to be any case on point. (Note that IRC Section 1001(e) provides that a seller of a life estate or remainder interest acquired by a gift or inheritance or incident to a divorce has a zero basis unless all those with an interest in the entire property join in the sale.)

## QTIP ELECTIONS

Another common litigation problem is where an Executor makes a QTIP election, which the IRS accepts without question, and then the spouse receives less property, whether because of a dispute over the value of the assets, apportionment, or a change in the legal landscape of the case by subsequent litigation. Many of the federal cases involving contested QTIP issues arose where the first spouse died and his or her estate tax return stated a particular value of estate assets on the Form 706. Later the estate of the second spouse attempted to argue that the fair market value should be recalculated so as to lower the estate tax now due (with the IRS unable to collect tax from the first estate according to the recalculation). The IRS uses several doctrines to defeat such an inequitable result; namely, theories of estoppel, quasi-estoppel, and the duty of consistency to conclude that values as calculated in the first spouse's estate control in the second.

In Estate of Shefler v. IRS, 86 F.3d 1045, 1050 (11th Cir. 1996), the second spouse's estate sought to avoid the QTIP property from the first estate by arguing that the presence of stub income in the QTIP trust should have disqualified it from the outset. The Court did not reach any estoppel issues, but reviewed the marital deduction statutes and treated the couple as one economic entity. "Upon the death of the surviving spouse, the spouse's estate will be required to pay tax on all of the previously deducted [QTIP] marital assets." But such a broad holding, with its extreme simplicity, runs counter to the myriad of cases discussing the equitable theories. The Court's holding, if given such broad effect, would overrule all cases where the IRS lost on equitable grounds, such as Ford v. U. S., 149 Ct.Cl. 558, 276 F.2d 17 (1960).

The Courts have described the duty of consistency as follows:

1. the taxpayer (or a privity in interest) has made a representation or reported an item for tax purposes in one year;

2. the IRS has acquiesced in or relied on that fact for a subsequent year; and

3. the taxpayer desires to change the representation previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year. See, e.g., Kielmar v. U.S., 884 F.2d 959 (7th Cir. 1989).

When these requirements are met, the IRS may act as if the previous representations are true, even if it they are not, and the taxpayer may not assert to the contrary. See Estate of Letts v. IRS, 109 T.C. 15 (1997).

It is the basic policy of the marital deduction that property passing untaxed from a predeceasing spouse to a surviving spouse is included in the estate of the survivor. Letts, 109 T.C. 15 (1997), citing Shelfer, 86 F.3d 1045, 1048 (11th Cir. 1996). These doctrines, however, may not apply where certain factors are present:

1. Where the parties seeking a revaluation in the second spouse's estate had not taken part in the representations made on the first spouse's Form 706 return. See Hess et al. v. United States, 210 Ct.Cl. 483, 537 F.2d 457 (1976);

2. Where the IRS is given total disclosure of all relevant facts. Pennsylvania Company for Banking and Trusts v. United States, 51-2 U.S.T.C (E.D.Pa. 1951). E.g., did the second estate (or a privity) have access to knowledge that was particularly within their knowledge and not within the knowledge of the IRS? Lefever v. IRS, 100 F.3d 778 (10th Cir. 1996); did the taxpayer have more information than the IRS when the initial representations were made? Herrington v. IRS, 854 755 (5th Cir. 1988); did the IRS audit the estate tax

return? Estate of Letts v. IRS, 109 T.C. 15 (1997); did the first spouse's estate return include a copy of the Will? Letts, 109 T.C. 15 (1997).

3. Where the spouse or beneficiary of the second estate is not a fiduciary of the first estate. Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974); Letts, 109 T.C. 15 (1997); Cf., Cluck v. IRS, 105 T.C. 324 (1995) (husband and wife can have interests so closely aligned that one may be estopped by a prior representation of the other).

4. Where the issue is a mistake of law rather than a mistake of fact or a mixed question of law or fact. Eagon v. United States, 80 F.3d 13 (1st Cir. 1996); Ross v. IRS, 169 F.2d 483 (1st Cir. 1948); Lewis v. IRS, 18 F.3d 20, 26 (1st Cir. 1994) (citing Mertens section 60.05: "Where there is a mistake of law and no factual misrepresentations, the doctrine of consistency does not apply" and citing to Herrington and Mayfair Minerals: "the misstatement must be one on which the government . . . neither knew, nor ought to have known, the true nature of the transaction mischaracterized by the taxpayer").

Of course, what is an appropriate amount to pay in tax may not be the same question as what is an appropriate amount your client should inherit. Invariably there is an attorney representing the Executor who is probably getting sued. So these considerations play an important part in any litigation involving QTIP elections.

THE IMPORTANCE OF STATE COURT

As mentioned briefly, the United States Supreme Court recently ignored State law entirely in holding that a beneficiary cannot disclaim an inheritance to avoid his own federal tax lien. See Drye v. U.S., 528 U.S. 49, 120 S.Ct. 474 (1999). But that does not do away with the general rule that tax issues mostly involve an interpretation of State law. See Morgan v. Commissioner, 309 U.S. 78, 80-81 (1940) (language whether charitable transfers were to unascertainable beneficiaries determined entirely by State law). If the federal authorities wish to tax property interests, for example, it is State law that defines it, and federal authorities must respect such State law decisions. The United States Supreme Court has rejected any hint that there should be one rule of State law and a different rule on the same issue in the federal courts applying that State's law. *See, e.g., Fidelity Trust Co. v. Field*, 311 U.S. 169 (1940); *Nihiser v. Sendak*, 405 F.Supp. 482 (N.D.Ind. 1974), affirmed 431 U.S. 961, 97 S.Ct. 2914.

If the Supreme Court of Indiana spoke on a matter, the federal courts must respect that decision. As to any decisions of Indiana trial Courts or Courts of Appeals, in Commissioner v. Bosch the United States Supreme Court stated that the IRS must give "proper regard" to the state court rulings, and may disregard such decisions only if the federal court was convinced by other persuasive data that the State Supreme Court would decide otherwise. 387 U.S. 456, 87 S.Ct. 1776 (1967); accord, West v. A.T. & T. Co., 311 U.S. 223 (1940).

In Starkey v. U.S., 223 F.3d 694 ($7^{th}$ Cir. 2000), an Indiana attorney used the State Probate Court and the Court of Appeals to strike a significant victory over the IRS. Starkey's attorney drafted a Will that intended to leave his residuary in trust for a specific Church and College. The problem was that the beneficiary designation included words between the two beneficiaries, specifically "Lawndale Community Church, missionaries preaching the Gospel of Christ, and Milligan College." The Estate petitioned the Marion County Probate Court which construed the language to say that "missionaries" merely described the Church and the religious School, and after the Probate Court appointed a guardian ad litem who appealed, the Indiana Court of Appeals affirmed. The IRS argued that "missionaries" created a separate class of unascertainable beneficiaries, and thus denied any charitable deduction. The IRS won in the federal District Court, but the Seventh Circuit reversed completely and granted summary judgment to the Estate. The lesson here is that having the Indiana Courts contribute to your position may provide great benefits in later disputes over the tax implications.

Another interesting opportunity presents itself if you consider the extent of Estate of McNicholas v. State, 580 N.E.2d 978 (Ind.App. 1991). This case holds that Indiana inheritance taxes are paid under the Will probated by the Court, notwithstanding any settlement agreement signed by the beneficiaries. Only a Judgment or Verdict can change this result. It is an open question whether the federal government will abide by this standard.

Consider a simple example: A Will signed in 1999 benefits only the surviving spouse, so that all estate assets will pass to her tax free. Another Will signed in 2001 benefits only the children of the marriage. If the 1999 Will is admitted to probate (even though it was not the most recent), and the children contest the Will, any settlement between the parties will result in all of the tax returns showing no tax due, no matter who gets what property. Conversely, if the 2001 Will is admitted to probate, and the surviving spouse contests the Will, any settlement between the parties will result in the tax returns showing taxes due as if the children received all of the Estate property, even if the surviving spouse receives a sizeable settlement amount.

Recent tax experts have been discussing the use of intentionally defective grantor trusts. The grantor can get property out of his or her Estate, with the added bonus of paying any future trust income taxes so that his or her Estate is reduced even more and the beneficiaries receive larger amounts. What about an intentionally defective Will? Is it ethical for an attorney to have the client sign a Will that leaves an Estate to a non-spouse, and then a few days later have the client sign a defective Will (that the Court would later admit to probate) leaving an Estate to a spouse in a tax free manner? The children can contest the Will, and settle by getting the entire Estate tax free. The taxing authorities wouldn't know enough to complain. Form 706s and Form IH-6s that show a Will giving everything to a spouse tax free are routinely rubber stamped prior to any contested litigation being resolved.

## PROPOSED SETTLEMENT LANGUAGE

No matter how the federal or state laws might handle the tax issues, it is important that any settlement agreement address them, even if it means shifting an unknown amount of tax from one party to the other. Listed below are some paragraphs to consider, even if all of the parties believe that the proceeds will not be taxed:

> 1. The [Defendants, Estate or Trust, etc.] shall pay all consideration in this Settlement Agreement free from all liens, encumbrances, and federal and state taxes of any kind (whether involving income, fiduciary, estate, inheritance, gift, generation skipping, capital gains, sales, property, FICA or any other federal or state or local taxes of any kind).
>
> 2. The [Defendants, Estate or Trust, etc.] agree to pay all taxes concerning the decedent, whether involving income, fiduciary, estate, inheritance, gift, generation skipping,

capital gains, sales, property, FICA or any other federal or state or local taxes of any kind, and to indemnify the Plaintiffs concerning any further contribution.

3. Other than providing information to the Internal Revenue Service as requested in an audit, the Plaintiffs shall not take any action that would adversely effect any and all tax obligations of the Defendants, any corporations named herein, the estate, or any trusts named herein.

4. The Defendants agree to permit the Plaintiffs any and all access to correspondence and communications by and between the Estate and any other person with the Internal Revenue Service concerning any audit of the federal estate tax return (Form 706) or Indiana inheritance tax return.

5. The parties agree to sign all reasonable documents in the decedent's Estate, Trusts and involving any corporations identified herein which are reasonably calculated to minimize any tax consequences to the presenting party so long as such documents do not compromise the signing party's tax position.

6. The Plaintiffs' attorney fees and expenses are $________, which amount may be used by the Defendants as proper deductions on any estate, inheritance, and fiduciary tax returns.

## CONCLUSION

Giving money away is usually a simple and kind gesture. The government has made it complicated, especially when a disgruntled beneficiary picks a fight. Ending the litigation with a settlement agreement may be only the beginning. Because tax laws drive many of the options facing those who transfer wealth, attorneys face complex and unknown challenges. Good luck.

Curtis E. Shirley
151 N. Delaware St., Suite 1700
Indianapolis, IN 46204
317.685.6512
curtis@shirleylaw.net