In recognition of an outstanding example of dedication, commitment and professionalism as a public official in the area of guardianship, Carleton F. Coleman is the 2017 recipient of the NCPJ Isabella Grant Award. Mr. Coleman presently serves as the Department of Human Services Public Guardian Manager for the entire State of Georgia. He began his career 19 years ago as an Adult Protective Services case manager, protecting vulnerable adults from abuse and neglect. Later, as an APS district manager, one of his top priorities was to insure those under guardianship and their family members were always treated with dignity and respect.

He has successfully managed numerous difficult and emotionally charged cases, some involving life and death decisions. He is recognized by many in Georgia for his genuine care and concern for those under guardianship, repeatedly going above and beyond the norm to provide the best possible service to vulnerable adults.

One of the many examples cited regarding Mr. Coleman’s efforts, was when he intervened in a guardianship after the protected person was arrested as a result of destructive conduct due out of jail or apprise the jail nurse of the mental condition or the needed medications. Because Mr. Coleman did not want the protected person to spend the night in jail without his medications, he posted the bond for the individual out of his own pocket. Mr. Coleman also relocated the individual to a better placement and worked to have the district attorney dismiss the criminal charges.

Mr. Coleman was selected as the manager when Georgia first established their Guardianship Program. Under his leadership, the processes and structures were developed to create a well functioning and successful program.

Mr. Coleman, his wife and two sons attended the NCPJ conference in Santa Fe, New Mexico to accept the award. It is an honor for NCPJ to recognize Mr. Coleman’s ongoing excellence, dedication, and professionalism with the Isabella Grant Award.

The Revised Uniform Fiduciary Access to Digital Assets Act: A Primer for Probate Judges

By Dr. Gerry W. Beyer
Governor Preston E. Smith Regents Professor of Law
Texas Tech University School of Law

A new type of motion is going to start hitting your bench with increased frequency—a request for an order allowing the personal representative to access a decedent’s or ward’s digital assets. What is this all about? What do I need to know? Should I grant or deny the motion? This article aims to answer these and other questions so that probate judges are well-informed about the cyberspace-estate administration interface.

What is a digital asset?
Digital assets are electronic records (think binary 1s and 0s) in which a person has a right or interest. Examples include e-mails, text messages, photos, digital music and video, word processing documents, social media accounts (e.g., Facebook, LinkedIn, Twitter), and gaming avatars.

(to be continued on page 2)
Why does a personal representative care about the digital assets of a decedent?

There are many reasons why a personal representative would want access to the decedent’s digital assets. (1) Many people forego paper statements for financial accounts such as bank accounts, retirement accounts, and brokerage accounts. The personal representative may seek access to the contents of the decedent’s e-mail messages to ascertain where these accounts are located and to gain the information necessary to complete the estate inventory, pay creditors, and distribute the funds appropriately. (2) Likewise, many people forego paper statements for utilities, credit cards, car loans, and home mortgages. The personal representative may need to give notice to and pay these creditors and thus needs access to e-mail messages to determine the names of the creditors and the amounts owed. (3) Some digital assets like domain names, customer lists, manuscripts, and compositions may have significant economic value. The personal representative needs access to these assets for both inventory and distribution purposes. (4) Some digital assets like family photos and videos do not have monetary value but they have great sentimental value and need to be transferred to the proper heirs or will beneficiaries.

What law governs a personal representative’s access to digital assets?

The Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA) either is or will soon take effect in 36 states including Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming. California enacted a portion of RUFADAA including the portion dealing with personal representatives of a decedent’s estate.

As of September 13, 2017, RUFADAA was pending in the District of Columbia, Georgia, Maine, Missouri, New Hampshire, New Jersey, Rhode Island, and West Virginia.

Delaware, Louisiana, Oklahoma, and Rhode Island have other governing statutes which are not covered in this article. There is no legislation, either enacted or pending, in Kentucky, Massachusetts, and Pennsylvania.

Does it matter when the decedent died?

No. RUFADAA applies to a personal representative acting for a decedent who died before, on, or after the effective date.

How is priority for access to a decedent’s digital assets determined?

Section 4 of RUFADAA provides the priority order. First priority is given to the decedent’s instructions using the custodian’s online tools. Examples include Google’s Inactive Account Manager and Facebook’s Legacy Contact. Second priority is given to the decedent’s instructions in the decedent’s will. If the decedent has not provided instructions through an online tool or will, then the service provider’s terms of service agreement (the “I agree” button) will govern the rights of the decedent’s personal representative.

Is there anything special about “access” that I need to know?

Yes! There is a major difference between two types of access. The first type is access to the contents of electronic communications which refers to the substance or meaning of the communication such as the actual subject line and text of e-mail messages.

The second type of access encompasses both the catalogue of electronic communications (e.g., the name of sender, the e-mail address of the sender, and the date and time of the message but not the subject line or the content) and other digital assets (e.g., photos, videos, material stored on the decedent’s computer, etc.).

Why is the personal representative bothering me for a court order?

RUFADAA §§ 7 & 8 provide procedures for the personal representative to seek access to digital assets directly from the custodian without the need for a court order. However, the custodian is authorized to ask for a court order before granting access. Many custodians ask for a court order as a matter of standard practice.

(to be continued page 3)
What must a court order granting access to contents of electronic communications contain?

You must make the following findings in your court order to grant the executor access to the contents of electronic communications:

- The decedent had the specific account with the custodian including the account’s number, username, address, or other unique subscriber or account identifier assigned by the custodian to identify the decedent’s account.
- The disclosure of the contents would not violate 18 U.S.C. § 2701 et seq., 47 U.S.C. § 221, or other applicable law.
- The decedent expressly consented in the decedent’s will to the disclosure of the contents.

May I issue a court order granting access to contents of electronic communications if the decedent died intestate or did not authorize access in the decedent’s will?

No. You may issue a court order granting access to contents only if the decedent had a will which expressly authorized the executor to have access to contents.

What must a court order granting access to the catalogue of electronic communications and other digital assets contain?

You must make the following findings in your court order to grant the executor of a will or the administrator of an intestate estate access to the catalogue of electronic communications and other digital assets:

- The decedent had the specific account with the custodian including the account’s number, username, address, or other unique subscriber or account identifier assigned by the custodian to identify the decedent’s account.
- The disclosure is reasonably necessary for the administration of the estate.

How long does the custodian have to comply with my court order?

The custodian should comply with the request not later than 60 days after your order under RUFADAA § 16. However, a custodian incurs no penalty for failing to disclose within sixty days of a proper request. If the custodian does not disclose, the personal representative may apply to your court for an order directing compliance. This order must state that compliance is not in violation of 18 U.S.C. § 2702. The decedent’s estate bears all the expenses of seeking and obtaining the court order such as attorney fees and court costs. If the custodian does not comply with the court order, you may be able to make an award against the custodian for non-compliance expenses or contempt of court.

 Might I need to deal with digital assets when a power of attorney or trust is involved?

Yes. A custodian has no right to ask for court findings as is the case when a personal representative of a decedent’s estate is involved. However, if the custodian does not comply with an agent or trustee’s valid request, the agent or trustee may seek a court order requiring the custodian to comply with the disclosure request.

Where can I get more information about RUFADAA?

RUFADAA has extensive Comments which are very helpful. You may access them on the website of the Uniform Law Commission at http://www.uniformlaws.org/.

*You may also access a comprehensive article on the planning for and administration of digital assets at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2166422.
Restoration of Rights in Adult Guardianship: Research and Recommendations

By Jenica Cassidy, Erica Wood, and Pamela B. Teaster

I. Introduction

An 86-year-old woman had a stroke, and her niece was appointed conservator to manage her financial affairs. Shortly thereafter, the woman moved to assisted living, where her condition improved significantly. She then wanted to go home and to manage her own affairs again, and so she petitioned for termination of the conservatorship. The niece opposed the petition.

Elsewhere, a mother was appointed as guardian of her 29-year-old daughter with intellectual disabilities. Three years later, the daughter had developed a network of assistance, including a supportive husband as well as help from her mother, close neighbors, a cousin, and a social worker who secured necessary supportive services. The daughter petitioned for termination of the guardianship, arguing that it was no longer necessary given her system of supported decision-making.

In such cases concerning termination of a guardianship order and restoration of rights, what should be the considerations for the court? What is the basis for restoration and what evidence is required? While the individuals above had supportive environments, other cases may be more ambiguous, requiring the judge to weigh a need for protection offered by continuing court intervention against the individual’s bid for self-determination and choice. What policies and practices should guide courts in restoration decisions?

In both instances profiled, the petitioner successfully navigated the legal process to terminate her guardianship and regain her rights. These are success stories. Are there others who share the same experience? What barriers did they have to overcome? How did they learn of their right to restoration?

In an effort to enhance self-determination of individuals subject to guardianship, the American Bar Association Commission on Law and Aging (ABA Commission) and research partners conducted a study to explore these questions and shine a light on the little-known process of restoration.

Although data on frequency of restoration is generally assumed to be permanent throughout the life of the individual or until the appointment of a different guardian. However, a guardianship may be modified or terminated in three scenarios: (1) the court finds that the person has regained the ability to make decisions and no longer meets the standard of an “incapacitated person;” (2) the court finds that the person has developed sufficient decision-making supports such that the guardianship is no longer necessary; or (3) additional evidence becomes available to show that the person does not meet the legal standard of an incapacitated person.

Current attention to the emergent concept of “supported decision-making” has brought restoration to the fore. Supported decision-making is a process in which people with disabilities are encouraged to understand choices and make decisions for themselves with the assistance of a support network. Supported decision-making is built on the belief that individuals under guardianship lose decision-making power, which thus reduces opportunities to make choices, take risks, and develop decision-making skills. Like the concept of restoration, the central focus of supported decision-making is to avoid the deprivation of rights imposed by guardianship in cases where the individual can make or express his or her own decisions, with or without support, and thus exercise autonomy and independence.

For courts, attention to restoration can weed out unnecessary cases from dockets, allowing for a stronger focus on problems requiring judicial intervention. For courts, attention to restoration can weed out unnecessary cases from dockets, allowing for a stronger focus on problems requiring judicial intervention; and can respond to legislative mandates to maximize self-determination and implement the least restrictive alternative. Courts play an essential role in making the process work, reviewing and evaluating cases for possible restoration, increasing awareness of the right to restoration, making the procedures more accessible, and tracking data to assess practice.

II. Empirical Research and Legal Research

The ABA Commission, in collaboration with Pamela B. Teaster, Ph.D., Director of the Virginia Tech Center for Gerontology, and Jenica Cassidy, Maryland elder law attorney, in 2015-2016 conducted empirical research on the frequency, circumstances and results of guardianship restoration proceedings. Funding was from the Greenwall Foundation, as well as supplementary support from the Borchard Foundation Center on Law and Aging.

(to be continued on page 6)
NCPJ Fall Conference in Ponte Vedra, Florida

In May, many of you attended our spring conference in picturesque Santa Fe, New Mexico and enjoyed an informative and intriguing program. The upcoming National College of Probate Judges Fall Conference will be held in sunny Ponte Vedra, Florida, from Wednesday, November 15, through Saturday, November 18, 2017. The beachfront resort hotel, Ponte Vedra Inn, will host the conference. The hotel is located at 200 Ponte Vedra Blvd., Ponte Vedra Beach, FL 32082.

Program: Executive Board Members Dianne Yamin and James Walther have developed an inspiring and thought provoking program. Topics will include Legislative Trends Affecting Probate Courts, Undue Influence and Diminished Capacity, and Bringing Fiduciary Guides to Your State. What is more, nationally renowned attorney, Dominic J. Campisi, will highlight important aspects of the 2016 Cognitive Aging Study. Please do not miss this opportunity to catch up on current trends in probate, guardianship, and elder law, visit with experts in varying disciplines, and fellowship with other judges and professionals.

Accommodations: The Ponte Vedra Inn is a year-round sporting paradise. Active travelers can choose from seaside golf, tennis, swimming, and cycling, while a luxurious spa, picturesque beaches and delightful dining options appeal to those in search of relaxation.

Cost of Hotel: The NCPJ has negotiated a guaranteed rate of $179.00 per night single or double (plus the sales and hotel occupancy taxes which total 10.5%). Please call the Central Reservations Office to make reservations at (800) 234-7842 and mention the NCPJ Conference.

Reservations for the hotel must be made no later than October 18, 2017. An online reservation page is available on the NCPJ website (www.ncpj.org) toward the bottom of the front landing page under “2017 Fall Conference.”

Registration: The conference registration fee will be $400.00 for members if received before September 15, 2017, and $450.00 after that date. The fee for retired judges is $300.00. The registration fee includes all conference materials, and the cost of the reception and banquet. The fee for spouses and guests will be $75.00, which includes the cost of the reception and banquet. In keeping with our policy to encourage the attendance of judges in the host state, non-member Florida probate judges who have not previously belonged to NCPJ will be granted a one year complimentary membership with their registration. The dress code for the conference is casual and the dress code for the reception and banquet is business casual.

Transportation: The hotel, Ponte Vedra Inn, is located approximately 30 miles southeast of Jacksonville International Airport, which is just north of Jacksonville, Florida. Transportation to and from the hotel is provided by East Coast Transportation for an additional charge of $93.00 each way which includes taxes and gratuity. To make reservations with East Coast Transportation you may contact them by phone and be sure to have your flight information ready (904) 525-8600. If you prefer a taxi, the cost is approximately $75.00 to $85.00 each way.

Activities: Ponte Vedra’s tourist resort area is best known for its association with golf, as it is home to the PGA Tour and The Players Championship. In addition to world class golf courses, Ponte Vedra boasts white, sandy beaches and abundant wildlife. A short walk will take you to Bird Island Park, a lovely sculpture garden where birders enjoy spotting wood ducks, ibis, blue heron, mocking birds, cardinals, and anhinga. For the adventurer, fishing charters and tours enable the sports enthusiast to enjoy time on the water and in the sun. For those members who enjoy history, Saint Augustine sits less than an hour’s drive down the coast of Florida from Ponte Vedra. Saint Augustine is the oldest, continuously occupied, European-established settlement within the continental United States, having been founded on September 8, 1565, by Spanish admiral Pedro Menendez de Aviles, Florida’s first governor. Since the late 19th century, Saint Augustine’s distinct historical character has made the city a major tourist attraction.

We hope you can join us for what is sure to be an informative and enjoyable gathering of probate judges and professionals from across the country. Mark your calendars now to join NCPJ this fall in Ponte Vedra, Florida. We look forward to seeing you there!
Restoration Rights in Adult Guardianships (continued from page 4)

The ABA study collected and analyzed statistics and cases from two state court systems—the Minnesota Judicial Branch and the Washington Administrative Office; and two state public guardianship systems—the Kentucky Guardianship Program and the Illinois Office of State Guardian. The objective of the court file research was to gather primary data and information on the frequency of guardianship restorations, the populations affected, and case characteristics when a restoration finding was made.

Each of the four participating sites conducted a search of their database for guardianship cases from August 2012 through August 2015. The sites reported 191 court cases and 84 public guardianship cases, for a total of 275 cases. The participating sites also provided 13 complete, redacted restoration case files for qualitative examination.

The project built upon legal research conducted by Jenica Cassidy in 2013-2014 for the ABA Commission. She collected a total of 104 restoration cases, primarily from state appellate courts, dating as far back as 1845. However, the analysis focused on the 57 cases dating from 1984 to the present. To supplement the case law analysis, the project included an analysis of restoration statutory provisions in each state as well as interviews and surveys of targeted judges and attorneys—including some NCPJ members as interviewees.

In September 2016, the project convened a consensus-building Roundtable on Restoration of Rights that resulted in policy and practice recommendations. The Roundtable included 20 diverse, interdisciplinary participants, with Mary Joy Quinn representing NCPJ.

Notably, while the ABA study was underway, the Uniform Law Commission (ULC) was drafting revisions of the Uniform Guardianship and Protective Proceedings Act. In July 2017, the UCL approved a revised version of the Act, entitled the Uniform Guardianship, Conservatorship and Other Protective Arrangements Act (UGCOPAA), which, among many other key provisions, sets out the grounds for termination or modification of a guardianship or conservatorship order (Sec. 319 & Sec. 431), and provides for legal representation of the individual seeking restoration of rights.

III. Empirical Findings

The court file research of the 275 cases from the four participating sites in the ABA Commission study resulted in the following findings:

- **Who was restored?** The average individual was 40 years old at the time of the guardian appointment; the majority of individuals had estates under $50,000; the majority of individuals lived at home at the time of restoration; and the most prominent trigger for guardianship appointment was mental illness.

- **Who was the guardian?** Of the 191 cases from the court data, family members were serving as guardian of person and/or property in the majority of cases.

- **Who petitioned for restoration?** In 40% of cases, the guardian petitioned for restoration; in 38.8% of cases, the individual subject to guardianship was the petitioner; and in 4.7% of cases the court itself initiated the restoration.

- **Was there legal representation?** In 42.8% of cases, the individual had no legal counsel. The court appointed an attorney in 26.5% of cases and a guardian ad litem in 20% of cases.

- **Was the restoration contested?** The vast majority of cases (93.8%) were not contested.

- **What evidence was used to prove the restoration case?** The court relied on clinical evidence in 50.6% of cases, lay evidence in 50.1% of cases, and the individual’s own statements in 14.2% of cases. (Note that the survey asked for all evidence presented and accepted multiple counts).

- **Were there prior attempts at restoration?** In the vast majority of cases (87.6%), the current case was the first attempt at restoration.

- **What proportion of restoration requests were granted?** This study did not include cases in which a restoration petition was filed but not granted. However, the North Carolina Administrative Office of the Courts conducted an independent study and found that during the period of 2010–2015, 223 restoration petitions were filed and 74.2% were successful.

- **How long was the guardianship before restoration?** On average, the individual was subject to guardianship for 4.86 years before their rights were restored. Time periods ranged from less than one year to over 30 years.

- **What were the terms of the restoration order?** In about 80% of cases, the court restored all personal/health care rights, and in close to 70% of cases, the court restored all financial rights.

"In 40% of cases, the guardian petitioned for restoration; in 38.8% of cases, the individual subject to guardianship was the petitioner; and in 4.7% of cases the court itself initiated the restoration."
Restoration Rights in Adult Guardianships (continued from page 6)

- **What Were the Stated Reasons for Restoration?** In 15 cases, the survey responses provided the reasons cited by the court in granting the restoration petition, including that the individual was able to take care of him or herself, had the help of family members or others, was receiving assistance in a group home, had a representative payee, and was not considered “disabled” by the Social Security Administration.

Emerging from the court file research is a snapshot of a “successful restoration case” across states. In the typical case, the individual is about 40 years old, lives at home or in his or her family’s home, has an estate under $50,000, and has a mental illness or perhaps a dual diagnosis with other conditions. The guardian is most likely a family member. After a period of between two to five years, the guardianship is terminated and the individual’s rights are restored. Our research shows that for cases with these “typical” characteristics, the restoration process, while rare, can work.

However, what about cases in which no petition is filed because the individual or family is unaware of the procedure? Or cases in which the guardian, a family member, or service provider opposes the restoration and there is no attorney to represent the individual?

**IV. Discussion and Recommendations**

The project analyzed the legal research findings, the empirical case file research, and the Roundtable discussion and recommendations as a whole. These culminated in a list of discussion points and recommendations, a few of which are briefly discussed here:

A. **Court Review of Cases for Continuing Need for Guardianship.** Despite statutory court oversight requirements, in practice, guardianship monitoring remains uneven, and in some local courts, it is markedly weak or almost non-existent. Collected case law offers examples in which a scheduled court review resulted in restoration. In one case, a 76-year-old woman had a sudden change in medications, her condition deteriorated rapidly, and a guardian was appointed. At the six-month review hearing, the court granted a petition for restoration stating that her medications were modified and her condition improved.

The Roundtable discussion highlighted the importance of including in the guardian’s annual report a recommendation as to the need for continued guardianship or changes in the scope of the order. The Roundtable participants noted the importance of such a recommendation as an element in every report, as well as the need for guardian training in what such a recommendation means and how best to respond.

The new Uniform Act, UGCOPAA, includes in the guardian’s report “a recommendation as to the need for continued guardianship and any recommended change in the scope of the guardianship,” as well as a duty of the guardian to “immediately notify the court if the condition of the adult subject to guardianship has changed so that the adult is capable of exercising rights previously removed.”

While individuals seeking restoration face many barriers, the judicial system can promote access to court for a restoration hearing through a number of practices. Some twenty state statutes permit an informal request for restoration, such as a handwritten note to the judge. The Roundtable discussion favored such procedures, and the project case profiles showed that the practice of informal restoration requests does occur. For example, a man with a brain injury and subsequent surgery had a guardian appointed. Later, after his condition improved, he wrote a letter to court stating, “I’m doing just fine, whereas I can communicate decisions for myself and manage my own affairs.” The court interpreted this as a request for restoration.

Roundtable discussion also emphasized the important role of guardians ad litem and court visitors in spotting restoration cases and bringing them to the court’s attention. The project case files provide examples of such cases. One woman who had brain surgery spoke to the guardian ad litem about getting her rights back. The guardian ad litem included her statement in his report and helped initiate restoration. In another case, the guardian ad litem listed all of the individual’s accomplishments in his report to the court in support of a restoration request.

B. **Focus on Supports.** The Roundtable discussion drew attention to the idea that a restoration proceeding should assess not only the individual’s abilities, improved conditions and any continuing limitations, but also whether an individual has supports sufficient to make decisions, manage affairs, and protect him or herself without a guardian. Supports might include, for example, help from family members, less restrictive decision-making tools such as valid powers of attorney in which no exploitation is occurring, appropriate medications, community-based services, and money management or payee services.

Our case profiles showed many examples of supports that could contribute to a decision about restoration. In one case, an individual with autism and epilepsy had ongoing family support including one family member who would serve as agent under a power of attorney, as well as support from his employer, money management, and software technology. In some instances, courts have modified orders for a limited duration while planned supports are put in place to allow for a full restoration of rights. Thus, the question for judges is not so much “does the person lack capacity” as “does the person lack capacity, even with supports.”

C. **Kinds of Evidence and Evidentiary Standards.** The collected case law shows that courts generally rely on two primary kinds of evidence in restoration cases—clinical statements and in-court observation of the individual. Our court file research found significant use of clinical evidence in proving restoration cases. A total of 139 cases or 50.6% referenced clinical evidence: 28.4% included a clinical statement; 17.1% included a clinical test; and 5.1% indicated that there was in-court clinical testimony. Roundtable participants recognized that while clinical evidence frequently is useful, it should not be required. In-court testimony by the individual or by lay witnesses can offer crucial perspectives on day-to-day abilities, strengths, and limitations.

Some 34 jurisdictions do not statutorily provide an evidentiary standard, leaving wide discretion for courts and uncertainty for litigants. Roundtable participants generally endorsed the UGCOPAA approach requiring establishment of a prima facie case by the petitioner, upon which the burden shifts. Others said a restoration proceeding should be less adversarial and more of a court’s determination of the continuing need.

**V. Conclusion**

Due process protections and the foundations of liberty require that individuals subject to guardianship have access to the restoration of their rights in appropriate circumstances. This study has brought to life the possibility that guardianship is not automatically an end but can be “a way station and not a final destination.” Probate judges can play an important part in translating this goal into workable practices.

“This article is based on the Report by the ABA Commission, with the Virginia Tech Center for Gerontology and Jenica Cassidy, Restoration of Rights in Adult Guardianship: Research & Recommendations, posted on the ABA Commission’s website at: https://www.americanbar.org/content/dam/aba/administrative/law_aging/restoration%20report.authcheckdam.pdf
Income and Transfer Tax Issues That Arise When Settling Disputes—

What Every Fiduciary Should Know

By: Mickey Davis, Melissa Willms, and Arielle Prangner

I. Introduction

Every aspect of estate and trust administration has one or more transfer tax (gift, estate, and generation-skipping transfer tax) and fiduciary or personal income tax ramifications, even if those ramifications are that certain of these taxes do not apply. Litigation and other dispute resolution measures in estate and trust administration are no different. Virtually every action taken, from the filing of the complaint to the settling of a lawsuit or other dispute, has some potential implication for both transfer and income tax purposes.

Dealing competently with the tax ramifications is the responsibility of the fiduciary, and it is often treated as a non-delegable responsibility, so neither the fiduciary nor the fiduciary’s lawyer (or, for that matter, the non-fiduciary who is a plaintiff or defendant serving his or her own interests) can successfully avoid the responsibility by claiming to have delegated it to a third party, such as an accountant. Therefore, it is important for any party to actual or threatened litigation to consider the transfer and income tax consequences of any matter or issue that arises in any stage of the controversy.

A. Federal Transfer Taxes. The federal estate tax has changed significantly since 2001. However, the American Taxpayer Relief Act of 2012, Pub. L. 112-240, 126 Stat. 2313 (2013), made permanent changes to the transfer tax system. Of course, these changes are only “permanent” until additional changes are made. The recently unveiled House Republican tax bill proposes that the estate, gift, and generation-skipping transfer (“GST”) tax exemptions be doubled after December 31, 2017, and proposes a repeal of the estate and GST taxes after December 31, 2023.

As the law stands now, the executor of a decedent’s estate is required to pay federal estate tax if the decedent died owning property worth more than the amount of his or her estate tax applicable exclusion amount. Any estate tax due nine months after death. See IRS § 2001. Living individuals who make taxable gifts (i.e., gifts other than the direct payment of tuition and medical expenses for others, to the extent that the value of the gifts exceed the applicable annual exclusion amount), must report those gifts annually, and pay any resulting gift tax if the aggregate lifetime total of those gifts exceeds the individual’s available gift tax applicable exclusion amount. See IRC § 2501. In addition, if an individual makes a taxable gift during lifetime, or transfers property at death, in a manner that vests property in persons that occupy the generation of the transferor’s grandchildren, without subjecting that property to gift or estate tax in the children’s generation (or makes a transfer to an unrelated person more than 37½ years the transferor’s junior), a GST tax must be paid when the property passes to the transferee, to the extent that the aggregate value of that property exceeds the transferor’s available GST tax exemption. See IRC § 2601. Since 2011, the amount of the gift, estate and GST tax exemptions available to an individual are the same ($5.49 million in 2017, and $5.6 million in 2018).

B. Federal Trust and Estate Income Taxation. For federal income tax purposes, trusts and estates are treated as though they were entities, and must pay tax on their undistributed taxable income. For this purpose, trusts and estates use tax rules applicable to individuals, with certain modifications. IRC § 641. The most important difference is that trusts and estates are entitled to deduct the amount of income that they distribute (or are required to distribute) in any year to their beneficiaries. IRC §§ 651, 661. The beneficiaries must report a corresponding amount of the distributions as taxable income. IRC §§ 652, 662.

II. Federalism and the Interplay Between Federal Tax Law and State Law

A. Overview. In general, despite the fervent wish of litigants and their counsel, private parties cannot simply agree as between themselves what the tax consequences of resolving their dispute will be. The shifting of valuable property rights as a result of litigation, or in compromising bona fide disputes between adverse parties, will have tax consequences to the parties that are largely dependent upon the nature of the underlying claim. See Lyeth v. Hoey, 305 U.S. 188 (1938). Thus, for example, as discussed in more detail below, amounts received in settlement of a will contest are generally treated as amounts received in the nature of an inheritance, and as a result, are not subject to income tax. Id.

If a dispute is resolved by means of a settlement agreement instead of a final judgment, the IRS will generally respect the outcome so long as the settlement agreement resolves a bona fide dispute and the participants are bona fide claimants. Conversely, if there is no actual dispute, a settlement agreement that is a voluntary rearrangement of property interests may not be recognized by the IRS. Reed’s Est. v. Comm’r, 171 F.2d 685 (8th Cir. 1948); Centrex Trust Co. of St. Louis v. U.S., 676 F. Supp. 928 (E.D. Mo. 1988); Comm’r v. Vease, 314 F.2d 79 (9th Cir. 1963). In most cases, a shift of property rights between parties as the result of a bona fide settlement of a dispute rights does not give rise to the imposition of gift tax. Treas. Reg. § 25.2512-8. See also PLR 8902045 (bona fide settlement does not result in gift tax under Section 2501 of the Internal Revenue Code (“Code”)). Thus, the tax effect of a settlement of the property rights at issue depends on the existence of a bona fide dispute, the transfers involved, and the existence of an enforceable right as between the settling parties. See Ahmanson Found. v. U.S., 674 F.2d 761 (9th Cir. 1981); PLRs 201606002, 8902045.

B. Getting the IRS to Respect the Result. Is the IRS bound by a state court adjudication of property rights when the United States was not a party to the state court action? To resolve any doubt, the taxpayer could seek a private letter ruling asking the IRS to approve the tax consequences of the action. See Rev. Proc. 2016-1, 2016-1 IRB 1. Such a ruling would bind the IRS. However, seeking a private letter ruling is not the only way to bind the IRS. The U.S. Supreme Court expressly addressed the issue of the effect of state court decisions in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). In reaching its decision, the Court reiterated its longstanding holding that property rights are determined by state law. Id. at 467. The Court also held that when federal estate tax liability as it related to a settlement was contingent on the character of a property interest held and transferred by a decedent under state law, the IRS is not “conclusively bound” by a state court ruling as to a property interest. The Court formulated a new test which essentially provided that: (i) when a state law property right has been

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(to be continued on page 9)
III. INCOME TAX CONSIDERATIONS ARISING FROM SETTLEMENTS

A. Taxation of Will Contest Settlements

1. General Rule. An Inheritance is Not Taxable. Under the general rule of Code Section 102, "gross income does not include the value of property acquired by gift, devise, or inheritance." IRC § 102(a). Similarly, the portion of an estate received by an heir in compromise of a will contest against the decedent's will is generally exempt from federal income tax. See Lyeth v. Hoey, 305 U.S. 188 (1938); Quigly v. Comm'r, 143 F.2d 27 (7th Cir. 1944). Pursuant to the Supreme Court's reasoning in Lyeth, as a general proposition, amounts received by beneficiaries which constitute an inheritance, or a payment or settlement in lieu of or in the nature of an inheritance, are income tax free to the recipient. See id. at 196. The general rule, however, is subject to a number of exceptions which must be kept in mind when characterizing trust and estate distributions.

2. Exception: Distributable Net Income. Broadly speaking, income earned by a trust or estate in any year is taxed to the trust or estate to the extent that the income is retained, but is taxed to the beneficiaries to the extent that it is distributed to them. The Code sets forth a detailed method to determine which trust or estate distributions carry income out to the beneficiaries. Thus, the structure of the payments or distribution from a trust or estate may subject the beneficiary to income tax. For example, the payment of an amount from the residuary of an estate will typically carry out income that has been earned by the estate in the year of payment (i.e., distributable net income) while the payment of a specific sum will not. See IRC § 663(a)(1). Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's distributable net income, commonly referred to as DNI.

Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the lesser of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate does not generally recognize gain or loss as a result of making a distribution to a beneficiary. However, this general rule is also subject to some important exceptions. One notable exception is that a distribution of assets to fund a bequest of "a specific dollar amount," including a pecuniary bequest or a formula bequest may cause the estate or trust to recognize gain. For example, an agreement requiring an executor to distribute $400,000 worth of property, if funded with assets worth $400,000 at the time of distribution, but worth only $380,000 at the date of death, will cause the estate to recognize a $20,000 gain.

Distributions to creditors that satisfy a pecuniary obligation of the estate are also recognition events for the estate. The fair market value of the property is treated as being received by the estate as a result of the distribution; therefore, the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, for example, if the estate agrees to pay a debt of $10,000 pursuant to a settlement agreement, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

3. Exception: Bequest of Income. Code Section 102's general rule that an inheritance is not taxable also does not apply to bequests of income. If the bequest or inheritance is the right to receive income, the amounts are taxable to the beneficiary. See IRC § 102(b). In resolving a disputed fiduciary matter, whether through judgment or through settlement, an issue may arise as to

(To be continued on page 10)
whether a payment will be characterized as a bequest of income when the basis of the original claim at issue was a claim to income. When the judgment or settlement payment is in lieu of an income interest, the courts have generally held that the settlement amount is includable in gross income under Code Section 102(b). See Getty v. Comm’r, 91 TC 160, 176 (1988), rev’d. 913 F.2d 1486 (9th Cir. 1990).

4. Exception: Bequest for Services Rendered. Bequests made to compensate for services rendered to the decedent are not excluded from income. See Cotnam v. Comm’r, 263 F.2d 119 (5th Cir. 1959); see also Wolder v. Comm’r, 493 F.2d 608 (2d Cir. 1974), (payment to lawyer in the form of bequest was method that parties chose to compensate lawyer for his legal services and was subject to taxation); Davies v. Comm’r., 23 TC 524 (1954); Est. of Braddock v. U.S., 434 F.2d 631 (9th Cir. 1970); Rev. Rul. 67-375, 1967-2 CB 60) (distribution of property under will in satisfaction of written agreement under which taxpayers were required to perform services for testator is compensation for services includible in gross income in year of receipt). In line with case law holdings, IRS Publication 525 states that "[i]f you receive cash or other property as a bequest for services you performed while the decedent was alive, the value is taxable compensation." IRS Pub 525, p. 32 (Jan. 13, 2016).

B. Deduction of Payments by Estate

1. General Rule. As a general rule, the payment of a bequest to a beneficiary is not deductible by the estate, unless the bequest qualifies for the estate tax marital or charitable deduction. Therefore, characterizing a claim as taking the form of an inheritance, while preserving favorable income tax treatment for the beneficiary under Code Section 102, will often yield no income tax benefit to the estate.

2. Exception: Payments to Employees. Code Section 102(c) provides that the exclusion from income for bequests does not apply to any amount transferred by or for an employer to or for the benefit of an employee. In the context of settling claims against an estate from an employee or former employee, those claims may be deductible by the estate for income tax purposes under Code Sections 162 or 212.

3. Exception: Administration Expenses. Litigation expenses are commonly deducted as expenses of administration under Code Section 2053(a)(2) if they are actually and necessarily incurred in the proper administration and settlement of a decedent’s estate and are allowable under applicable state law. Expenses of administration are not generally deductible when incurred for the individual benefit of heirs, legatees, or devisees. See Est. of Dutcher v. Comm’r, 34 TC 918 (1960); Est. of Landers v. Comm’r, 38 TC 828 (1962); Est. of Baldwin v. Comm’r, 59 TC 654 (1973). A deduction not taken on an estate tax return is generally available as an income tax deduction. See IRC § 642(g).

4. Exception: Charitable Deductions. For federal income tax purposes, distributions from a trust or an estate to charity are not considered distributions to beneficiaries for purposes of computing the trust or estate’s distribution deduction. Treas. Reg. § 1.663(a)-2. See also U.S. Trust Co. v. Comm’r, 803 F.2d 1363 (5th Cir. 1986); Mott v. Comm’r, 462 F.2d 512 (Cl. Ct. 1972); Rev. Rul. 68-667; Rev. Rul. 2003-123. Rather, distributions to charities are deductible only if they meet the requirements of Code Section 642(c). Under Code Section 642(c)(1), a trust or estate is allowed a deduction in computing its taxable income for any amount of gross income, without limitation, that under the terms of the governing instrument is, during the tax year, paid for a charitable purpose. Because a charitable deduction is available only if the source of the contribution is gross income, tracing the contribution is required to determine whether the source of the bequest to the charity is the gross income of the trust or estate. See Van Buren v. Comm’r, 89 TC 1101, 1109 (1987).

A charitable income tax deduction is permitted to an estate (but not a trust unless the trust was irrevocable on or before October 9, 1969) not only for amounts of gross income paid for a charitable purpose, but also for amounts that the estate permanently sets aside for a charitable purpose. IRC § 642(c)(2). Treasury Regulations require that in order to obtain this deduction, the estate must prove that the possibility that the amount set aside for the charitable beneficiaries would go to noncharitable beneficiaries is so remote as to be negligible. Treas. Reg. § 1.642(c)-2(d). In the context of a will contest, the IRS argues that an estate cannot permanently set aside funds as a matter of law when there is a pending will contest or active litigation, the result of which might distribute the estate’s funds to noncharitable beneficiaries. See Est. of Wright v. US, 677 F.2d 53 (9th Cir. 1982) (income from estate cannot be permanently set aside during pendency of will contest); Est. of Belmont v. Comm’r, 144 TC 84 (2015) (brother’s "serious [legal] claim based on alleged events that predated" taxable year-end demonstrated that prolonged legal controversy which might deplete permanently set-aside funds was not so remote as to be negligible). C. Non-Pro Rata Distributions. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries (meaning unauthorized under the terms of the governing instrument or local law), the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 CB 159. For example, suppose an estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm was worth $110,000. At the date of distribution, each is worth $120,000. If the executor gives the stock to A and the farm to B and if the will or local law fails to authorize non-pro rata distributions, the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" her interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. See PLR 9429012. To avoid this result, local law or the governing instrument must expressly authorize non-pro rata distributions. See PLRs 9422052, 9523029 (no gain recognized).

D. Income Tax Basis in Property Received under Settlement

1. General Rule. Most practitioners describing the impact of death upon basis use a kind of short-hand by saying that assets get a "step-up" in basis at death. In inflationary times, this oversimplification is often accurate. However, it is important to remember that the basis of an asset may be stepped up or down, and therefore, it is more appropriate to say that a basis adjustment occurs,
whereby the assets receive a new cost basis at the date of death. In community property states, both halves of the community property receive a basis adjustment as of the death of either spouse. IRC § 1014(b)(6).

Other than for persons dying in 2010, when a special set of laws applies, the original cost basis in the hands of the decedent is simply irrelevant. Stated generally, a decedent’s estate receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. IRC § 1014. In most cases, the basis is the date-of-death value of the property. However, for estates that qualify, if the alternate valuation date has been validly elected, the value on that date fixes the cost basis of the estate’s assets. IRC § 1014(a)(3).

The adjustment to the basis of a decedent’s assets occurs regardless of whether the estate is large enough to be subject to federal estate tax. Original basis is simply ignored and federal estate tax values are substituted. However, it is important to remember that the basis adjustment rule is subject to some important exceptions.

2. Exception: Income in Respect of a Decedent. The Code does not provide a specific definition of “income in respect of a decedent,” commonly referred to as IRD. Essentially, IRD consists of income earned by a decedent before death, but not recognized until after death. It may be included in the gross income of the decedent’s estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the items of income. An estate is not entitled to an adjusted tax basis on IRD assets includible in a decedent’s estate. IRC § 1014(c). Likewise, a beneficiary (by will or agreement) is generally not entitled to an adjusted tax basis on IRD assets to be received by the beneficiary. Id.

The fact that an asset representing the right to IRD passes to a beneficiary as a result of the settlement of a dispute as opposed to passing pursuant to a will or by inheritance does not change the character of the asset or the underlying tax treatment to the recipient. Thus, a person who receives a right to IRD as part of a judgment or in settlement of disputed claims must generally pay income tax on the income associated with the receipt. See, e.g., Rev. Rul. 55-463, 1955-2 CB 277.

3. Exception: No New Basis for Re-inherited Deathbed Transfers to Decedent. Code Section 1014(e) provides an exception for appreciated property given to a decedent within one year of death, which then passes from the decedent back to the donor or the donor’s spouse as a result of the decedent’s death. This rule is presumably designed to prevent avaricious taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis. In the litigation context, passing these assets back directly or indirectly to the original donor as a result of a judgment or settlement would presumably deny him or her of a basis adjustment. IRC § 1014(e).

4. Considerations in Settlement of Trust Funding Claims. The impact of basis in the context of settlements of trust claims illustrates the importance of how the claim is couched. Suppose that a trust was to have been funded prior to the decedent’s death, and the claim at issue is the failure of the executor or trustee to fund that trust, or to properly segregate trust assets. Suppose that the fiduciary has commingled trust and personal funds, and has now passed away. The following examples illustrate just two of the ways that the claim may be asserted, resulting in vastly different tax consequences.

(a) Debt Approach. If the claim is couched as a direct claim for damages against the decedent (when, for example, the decedent had been an executor of an estate prior to death and failed to fund a trust or otherwise distribute estate property), the commingled property would be included in the decedent’s gross estate. This analysis uses the remedy of requiring the estate of the deceased executor to pay money to remedy the breach of trust as mandated by Section 1001(b)(3) of the Uniform Trust Code. See also Restatement Of Trusts 2d § 202 (1959); Est. of Bailey v. Com’r, 741 F.2d 801 (5th Cir. 1984). The amount of the damage claim would be claimed as a deduction by the estate of the deceased executor under Code Section 2053, which would effectively remove the value of the assets from the decedent’s estate. In other words, including the assets but offsetting their value by a corresponding deduction would effectively be a wash. Having the wrongfully withheld assets treated as owned by the decedent permits a second basis adjustment for the assets. But, if the claim is for a pecuniary amount, and is satisfied with property that has appreciated subsequent to the decedent’s date of death, the estate will recognize gain on funding, (measured, however, only by the difference in value from the decedent’s death to the date of funding). Treas. Reg. § 1.661(a)-(2)(f)(1); Rev. Rul. 74-178, 1974-1 CB 196.

If the amount of the debt owed includes accrued interest, that interest, when paid, will constitute ordinary income to the claimant. Rev. Rul. 73-322, 1973-2 CB 44. Payment of this interest is treated for income tax purposes not as a distribution of DNI, but as an interest expense to the estate and interest income to the beneficiary. Id. Under Code Section 163(h), interest is nondeductible “personal interest” unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. The effect of this characterization would be to cause the recipient to report taxable interest income, with no offsetting interest deduction for the payor-estate.

(b) Constructive Trust Approach. If instead, the claim seeks to impose a constructive trust over the commingled asset, the assets traceable to the trust should be excludable from the decedent’s estate as belonging to the (constructive) trust. As a result, the assets would be treated as having passed from the estate of the original transferor. Basis therefore will depend upon the fair market value at the date of the prior decedent’s death. IRC § 1014. Since the constructive trust assets are not included in the estate of the deceased fiduciary, no basis adjustment applies. Stansbury v. U.S., 543 F. Supp. 154 (N.D. Ill. 1982), aff’d 735 F.2d 1367 (7th Cir. 1984).

E. Sale of an Expected Inheritance. In Revenue Ruling 70-60, a daughter sold a partial interest in her expected inheritance from her father, who was living at the time of sale and had made no will. The IRS held that “the entire amount received by the [daughter] for the relinquishment of her right to inherit the interest from her father” was includible under Code Section 61(a) in her gross income in the year of sale. Rev. Rul. 70-60, 1970-1 CB 11. It is notable that IRS Publication 525 provides that the seller of an interest in an expected inheritance from a living person is required to report the entire amount received in gross income in the year of sale. IRS Pub. 525, p. 32 (Jan. 13, 2016).

F. Sale of a Remainder Interest in a Trust. One settlement technique used in controversies between the income and remainder beneficiaries of a trust involves a “sale” of the interest of one set of beneficiaries to the other. One effect of the sale is to merge the

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(2)(B). to a partnership in which the insured is a partner, or to a corpora-
value, and seek to tax the beneficiary on any proceeds received in
ment attributable to the insurance policy
transferred to a party other than the insured is a
transferee." IRC § 101(a)(2); see also Tennessee Foundry & Mach.
and the premiums and other amounts subsequently paid by the
amount equal to the sum of the actual value of such consideration
important exception to the foregoing rule must be considered
assets to be divided upon the settlement of an estate dispute, an
party with tax
are income
severances occurring on or after August 24, 2004, and before Au-
trustee, is authorized by an applicable state statute or the governing
funding of the separate trusts resulting from the sever-
trust into multiple trusts." G. Trust Severances. One tool in resolving disputes among trust
beneficiaries or among beneficiaries and trustees includes severing a
interest in that trust in exchange for an interest in the
new trust. For trust severances occurring on or after August 2, 2007, Treasury Regulations provide that the
severance of a trust (including without limitation a
qualified severance of a trust) through a generation-skipping
transfer tax purposes under Treasury Regulation Sections 26.2642-6 or 26.2654-1(b) is not an exchange of
property for other property differing materially either
in kind or in extent if (i) an applicable state statute or the
governing instrument authorizes or directs the
trustee to sever the trust; and (ii) any non-pro rata
funding of the separate trusts resulting from the
severance, whether mandatory or in the discretion of the
trustee, is authorized by an applicable state statute or the
governing instrument. Treas. Reg. § 1.1001-1(h). The Regulation authorizes
(but does not require) taxpayers to apply its provisions to trust
severances occurring on or after August 24, 2004, and before August

H. Life Insurance. Generally speaking, life insurance proceeds
are income-tax free to the beneficiary of the policy. IRC § 101(a)
(1). The acquisition of a policy of life insurance by one party to a
dispute on the life of another will normally provide the acquiring
party with tax-free income upon the death of the insured. Id.

However, when an existing policy of insurance is among the
assets to be divided upon the settlement of an estate dispute, an
important exception to the foregoing rule must be considered—the
transfer-for-value rule. Code Section 101(a)(2) provides, "[t]he
case of a transfer for a valuable consideration, by assignment or
otherwise, of a life insurance contract or any interest therein, the
amount excluded from gross income . . . shall not exceed an
amount equal to the sum of the actual value of such consideration
and the premiums and other amounts subsequently paid by the
transferee." IRC § 101(a)(2); see also Tennessee Foundry & Mach.
Co. v. Comm'r, 399 F.2d 156 (6th Cir. 1968) (death proceeds
subject to income tax when beneficiary/employer received life
insurance policy purchased with funds embezzled by employee and
received in settlement of beneficiary/employer's claims of embezzle-
ment). Under this provision, the IRS might take the position that
insurance transferred to a party other than the insured is a
"transfer for a valuable consideration" (i.e., the value of the settle-
ment attributable to the insurance policy—presumably its then cash value), and seek to tax the beneficiary on any proceeds received in
excess of the policy's basis upon the insured's death.

It should be noted that the foregoing provisions do not apply
in the case of a transfer to the insured, to a partner of the insured,
to a partnership in which the insured is a partner, or to a corpora-
tion in which the insured is a shareholder or officer. IRC § 101(a)
(2)(B).

IV. Gift Tax Considerations Arising From Settlements

A. Generally. Code Section 2501 imposes a tax on property
transferred by gift. In addition, Code Section 2512(b) provides that
where a transfer of property is made for less than adequate and full
consideration, the amount in excess of the consideration will be
treated as a gift. Generally, a transfer of property by an individual in
compromise and settlement of a trust or estate dispute is a transfer
for full and adequate consideration in money or money's worth.
Thus, it is not a gift for federal gift tax purposes. See Lampert v.
Comm'r, TC Memo 56-226 (1956); see also Righter v. U.S., 258 F.
Supp. 763 (8th Cir. 1966), rev'd and remanded on other grounds
400 F.2d 344 (8th Cir. 1968).

B. Unintended Gifts. The effect of a settlement on estate or gift
taxation of the property at issue often depends on the existence of
a bona fide dispute, the transfers involved, and the existence of an
enforceable right as between the settling parties. See Ahmanson
Found. v. U.S., 674 F.2d 761 (9th Cir. 1981). As noted previously,
where there is no adequate consideration for the settlement agree-
ment, gift tax consequences may arise. See Nelson v.

A transfer of property will be regarded as occurring
"in the ordinary course of business" and thus will
be considered to have been made "for an adequate
and full consideration" in money or money's worth" only if it satisfies the three elements specified in Treas-
ury Regulation Section 25.2512-8. To meet this stand-
ard, the transfer must have been bona fide, transacted
at arm's length, and free of donative intent. In applying
this regulation to settlements of family disputes, the
courts have identified several subsidiary factors that
may also be relevant. For example, they have considered: (i)
whether a genuine controversy existed between the parties; whether
the parties were represented by and acted upon the advice of counsel;
(ii) whether the parties engaged in adversarial negotiations; (iii)
whether the value of the property involved was substantial; (iv)
whether the settlement was motivated by the parties' desire to
avoid the uncertainty and expense of litigation; and (v) whether the
settlement was finalized under judicial supervision and incorporated
in a judicial decree. See, e.g., Est. of Natkanski, TC Memo 1992-380

The IRS has issued a number of favorable private letter rulings
in which no gift tax exposure has been found in a wide variety of
contexts. Such rulings should not be construed, however, as an
indication that the IRS will not seek to impose gift tax where war-
ranted.

C. Use of Surviving Spouse's Applicable Exclusion Amount. In
a settlement involving a surviving spouse, the overall tax effect of the
settlement may be improved by having other parties agree to forgo
claims so that property passes to the surviving spouse in a manner
that qualifies for the unlimited estate tax marital deduction. It may
be easier to obtain the agreement of others to forgo claims if the
surviving spouse is willing to make donative transfers to those per-
sons, perhaps utilizing his or her own federal gift tax applicable
exclusion amount. While the marital deduction may be disallowed if
the IRS determines that the surviving spouse purchased an interest
from the other claimants, properly structured, such a technique
effectively allows the use of both the decedent's estate tax exclu-
sion and the surviving spouse's gift tax applicable exclusion amount
(which might include all or part of the deceased spouse's unused
exclusion amount if a "portability" election was made for the dece-
dent's estate under Code Section 2010(c)). Using the spouse's
applicable exclusion amount would permit property to pass to per-
sons other than the spouse or charity without paying any current
transfer tax.

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Naturally, the surviving spouse must feel comfortable that the loss of his or her gift tax applicable exclusion amount (and effectively, a corresponding amount of estate tax applicable exclusion amount at his or her death), will not result in an undue hardship on the spouse’s intended beneficiaries. With current tax laws and the anticipation of continued inflation adjustments to the estate and gift tax exclusions, younger spouses may be willing to bet that future increases will be sufficient to avoid estate taxes for heirs, even after the current use of some or all of the gift tax applicable exclusion amount.

V. Estate Tax Considerations Arising from Settlements

A. Deduction of Debts. One of the most significant estate tax questions arising from the administration of claims against estates involves the allowance of the estate tax deduction under Code Section 2053 for claims against a decedent’s estate. An estate tax deductible claim must be timely asserted so that it is valid under state law and must be payable from property included in the estate tax base. IRC §§ 2053(a), 2053(b); Treas. Reg. § 20.2053-1(a)(1). Therefore, pursuant to the general rule, claims that are paid and could have been barred under state law but were not, are not deductible. Rev. Rul. 60-247, 1960-2 CB 272; In re Est. of Hagmann, 492 F.2d 796 (5th Cir. 1974).

In Estate of Thompson v. Commissioner, 730 F.2d 1071 (7th Cir. 1983), however, the Seventh Circuit held that the claim of a creditor under a settlement agreement with the decedent’s estate was an enforceable, deductible claim even though the creditor failed to file the claim before the expiration of the claims period under state law. Similarly, in Greene v. United States, 447 F. Supp. 885 (N.D. Ill. 1978), the United States District Court allowed a deduction for a claim filed after the claims period had expired, stating that the enforceability of the claim arose at the decedent’s death, not at the time of filing. The court, however, refused to allow a deduction for loans to the decedent when the statute of limitations had run on the collection of such loans prior to the decedent’s death. In contrast, the Tax Court has held that if a claim is enforceable against more than one entity and not filed against an estate, it is not deductible. Est. of Courtney v. Comm’r, 62 TC 317 (1974). An enforceable claim that is not formally filed with the court within the claims period but is presented to a representative within the claims period and paid pursuant to an agreement with the beneficiaries of the estate is deductible for estate tax purposes. Rev. Rul. 75-24, 1975-1 CB 306.

In addition, claims that have been timely filed or asserted but not finally determined or paid at the time the estate tax return must be filed create deductibility issues. When the full extent of the liability has not been legally determined, the IRS takes the position that only the part finally determined is allowable and that the estate must pay tax and claim a refund when a final determination is made. Est. of Sachs v. Comm’r, 856 F.2d 1158 (8th Cir. 1988); Greene v. U.S., 447 F. Supp. 885 (N.D. Ill. 1978); Russell v. U.S., 260 F. Supp. 493 (N.D. Ill. 1966); Est. of Cafaro v. Comm’r, TC Memo 1989-348 (1989). This issue becomes important when a dispute is ongoing. If a significant claim is filed but the final adjudication is still pending when the return is due, the fiduciary must take care to dock the limitations period during which a claim for refund of estate tax can be made. This limitations period is generally the later of three years from the date the estate tax return is filed or, for amounts later paid, two years from the date of payment. IRC § 6511.

Considerable litigation occurred regarding the deductibility of contingent claims and the use of hindsight in establishing the amount of claims reported for decedent’s dying prior to October 20, 2009. However, Treasury Regulations were issued effective October 20, 2009 which address the effect of post-death events on the deductibility of claims against an estate and provide other rules relating to the deductibility of claims. See Treas. Reg. §§ 20.2053-1(b)(2), 20.2053-1(b)(3), 20.2053-1(d), 20.2053-4. Under those regulations, deductible claims are limited to bona fide claims that are enforceable against the decedent’s estate and meet other requirements set out in the regulations. Treas. Reg. §§ 20.2053-1(d)(1), 20.2053-4(a)(1)(i). In addition, the deduction is limited to the amount actually paid to satisfy the claim. Treas. Reg. § 20.2053-1(d)(3).

Generally, no deduction can be taken for a claim that is merely potential or has not matured. Treas. Reg. § 20.2053-1(d)(1). However, a deduction can be taken prior to payment if the amount of the claim is ascertainable with reasonable certainty and the claim will be paid. Treas. Reg. § 20.2053-1(d)(4). A claim is not ascertainable with reasonable certainty if it is contested or contingent.

As noted above and consistent with the earlier Revenue Ruling, if a claim is initially not deductible because it has not been paid and cannot be determined with reasonable certainty, the executor can subsequently file a timely refund claim when the claim is actually paid. Treas. Reg. § 20.2053-1(d)(4)(ii). If necessary, the executor can file a protective refund claim if the time for filing a refund claim would otherwise expire. Treas. Reg. §§ 20.2053-1(d)(4)(ii), 20.2053-1(d)(5)(i); see also Treas. Reg. § 20.2053-1(d)(7), Ex. 2.

The IRS has established a few exceptions to the foregoing rules for administrative convenience. Under one exception, claims can be deducted when the return is filed to the extent the full value of the claims in the aggregate does not exceed $500,000. See Treas. Reg. § 20.2053-4(c)(1). Importantly, the value of the claims must be determined by a qualified appraiser under the rules that apply in determining the value of a charitable contribution for income tax purposes. Treas. Reg. § 20.2053-4(c)(1)(iv). The amount of the deduction is subject to adjustment for post-death events. Treas. Reg. §§ 20.2053-4(b)(3), 20.2053-4(c)(2). In addition, the estate can preserve its right to a greater deduction if the claims are not resolved until after the expiration of the period for filing refund claims by filing a protective claim. Id.

B. Marital and Charitable Deductions. The availability of the unlimited federal estate tax marital and charitable deductions means that payments made to a surviving spouse or to charity pursuant to a settlement agreement can have a significant impact on the amount of estate taxes ultimately paid. IRC §§ 2055, 2056. The availability of marital or charitable deductions depends not only on the amount but also on the form and substance of the agreement.

I. The Marital Deduction. The marital deduction should be considered whenever there is a settlement agreement involving a surviving spouse. For this purpose, “spouse” may include persons other than those ceremonially married in the jurisdiction in which the decedent died. For example, persons who are married under the common law may be recognized as married for federal tax purposes, even if they later move to a jurisdiction that does not recognize common law marriage. See Rev. Rul. 58-66, 1958-1 CB 60 (couple married under common law and filing income tax returns as married-filing-jointly will continue to be treated as married, even after moving to a jurisdiction that doesn’t recognize common-law marriages). Additionally, the term “spouse” includes same sex spouses pursuant to the U.S. Supreme Court’s holding in Obergefell v. Hodges, which stated that the Fourteenth Amendment of the U.S. Constitution requires states to license marriages between two people of the same sex, and to recognize all marriages between two people of the same sex when their marriage was lawfully licensed.

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Income and Transfer Tax Considerations (continued from page 13) and performed out-of-state. 135 S. Ct. 2584 (2015).

Code Section 2056 requires that in order to qualify for the marital deduction, property must have passed from the decedent to the surviving spouse, and that it must not pass in a manner such that it is characterized as a non-deductible terminable interest. IRC § 2056.

The principal issue in the context of an estate involved in actual or threatened litigation involves the passing requirement. The Treasury Regulations provide that 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. Treas. Reg. § 20.2056(c)-2(d)(2) (emphasis added). Payment made to a surviving spouse pursuant to a settlement agreement will be afforded the same treatment as one made pursuant to a judicial decree. See, e.g., Est. of Barrett v. Commissioner, 22 TC 606, at 610 (1954).

A potential pitfall arises in an estate that is large enough to be exposed to the federal estate tax if the surviving spouse agrees to reduce his or her outright ownership interest in property to some form of terminable interest (i.e., an interest in property that terminates at the time of the spouse’s death, with the property then passing to someone else). In those situations, the terminable interest the spouse retains may not qualify for the estate tax marital deduction. See Est. of Tebb v. Comm’r, 27 TC 671 (1957); see also U.S. Trust Co. v. Comm’r, 321 F.2d 908 (2d Cir. 1963). Accordingly, if payment of the estate tax is a consideration, it is important that a fiduciary consider the structure of an interest passing to the surviving spouse to ensure that it is an interest that qualifies for the marital deduction under Code Section 2056.

2. The Estate Tax Charitable Deduction. The rules involving the estate tax charitable deductions in the family settlement context are typically less complex than those involving the marital deduction. Nevertheless, important issues arise that may impact the amount, timing and availability of the charitable deduction.

Code Section 2055 permits an unlimited estate tax deduction for qualifying bequests made to charities. Amounts passing as "split interests" involving both charitable and non-charitable beneficiaries (for example, life estate to child, remainder to charity, or trust paying all income to child for life, remainder to charity) generally do not qualify for an estate tax charitable deduction unless the split interest meets specific requirements. IRC § 2055(e)(2). Specifically, in the case of a charitable remainder interest, no deduction is allowed unless the interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust (as described in Code Section 664) or a pooled income fund (as described in Code Section 642(c)(5)). IRC § 2055(e)(2)(A). In the case of any other split interest, it must be in the form of a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly). IRC § 2055(e)(2)(B). Amounts passing to charities pursuant to settlement agreements are generally deductible so long as the settlement arises from a bona fide dispute. See Rev. Rul. 145, 1953-2 CB 273; Rev. Rul. 89-31, 1989-1 CB 277.

The IRS has stated that it will scrutinize a settlement of will contests to be sure that the litigation was not collusive or instituted merely to obtain the charitable deduction. However, if in settlement of a bona fide will contest, a charity receives an outright accelerated payment in lieu of an otherwise non-deductible split interest, the IRS will allow an estate tax deduction for the amount paid to the charity. Rev. Rul. 89-31, 1989-1 CB 277; cf. TAM 8945004 (valid charitable lead annuity trust converted to a single fixed-sum payment to charity received no estate tax charitable deduction where facts indicated that threatened will contest was not bona fide).

C. Tax Apportionment Issues. When drafting a will, the draftsman must pay special attention to the apportionment of estate and inheritance taxes to ensure that the intended net after-tax benefit comports with the client’s wishes. Likewise, in advising clients about the tax impact of a proposed settlement, the apportionment of estate and inheritance taxes should be carefully thought through, and the “net” numbers examined. It is often important to remind clients about the tax impact of settling the case (and of not settling the case) so that they enter any dispute with a realistic expectation of the net after-tax amount that might reasonably be expected at the conclusion of the dispute. To the extent that the settlement is structured with a view toward minimizing or eliminating transfer taxes, more funds will be left on the table to be divided among the parties. Even in those circumstances, however (and perhaps especially in those circumstances), thought should be given to who will bear the tax risk if the IRS is successful in re-characterizing some component of the transaction, and as a result, taxes are owed. In this setting, the parties may wish to negotiate an indemnity for taxes ultimately assessed, and provide notice and an opportunity to participate in the tax dispute for the party who may ultimately be charged with the tax.

VI. Conclusion

Disputes involving trusts and estates can be impacted by every aspect of income and transfer taxation. Clients involved in these disputes are well served by involving their tax advisors at an early stage in the proceedings. Taking into consideration tax principles applicable to settlements, judgments, and other dispute-resolution measures can have a dramatic impact upon the value of a settlement, and can avoid an unintended shift in tax benefits and burdens among the parties. It is hoped that the foregoing material will be useful in understanding and applying general tax principles involved in resolving disputes and in understanding the estate, income, gift, and GST tax principles that may arise when will contests, trust disputes, and disputes involving a breach of fiduciary duties are resolved by settlement, judgment, or other means.

*This article has been excerpted from Wills and Davis, Knowing the Ropes and Binding the IRS: Income and Transfer Tax Issues of Settlements and Modifications Every Fiduciary Should Know, Duke University 39th Annual Estate Planning Conference, 2017. References herein to “Section(s)” or to “Code” are to the Internal Revenue Code of 1986, as amended.