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Federal Tax Aspects of Will Contests

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FEDERAL TAX ASPECTS OF WILL CONTESTS

DAVID KEMP*

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I. INTRODUCTION

The will contest and the compromise agreements which often result have long been a part of the general practice of law. Attorneys are usually familiar with the local law, but often overlook the federal tax problems arising out of such contests. A thorough understanding of the tax law affecting all the parties involved can be invaluable to the attorney in the negotiations leading to the court decree or compromise. By anticipating the problems he will have an opportunity to shape the tax consequences in order to obtain the most favorable result for his client.

The importance of tax planning in will contests may become painfully apparent when a settlement is made without regard to the tax effects. For example, the claimant may find that he received property which con-

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stitutes taxable income when proper planning might have produced a more desirable result. The attorney will want to know when the amounts received by the claimant will be subject to income taxes, and how the nature of the claim will affect the tax result. Conflicts may arise over whether the estate will be entitled to a deduction as a result of the payment. In addition to income tax problems it is possible for the settlement to result in a taxable gift. There will also be important estate tax consequences, and the estate's charitable or marital deduction may be affected.

State law will be important in determining whether the claimant will have to share the estate tax burden. Some problems are unique to settlements after the termination of the estate. The statute of limitations on assessment and claims for refund should be considered along with the provisions relaxing such limitations. All parties to the contest will be concerned with the deduction of attorney's fees arising out of the dispute, and the executor of the estate may face unique tax problems with regard to his personal liability arising out of his actions in these contests. Also important is the role state law plays in the application of the provisions of the Internal Revenue Code: when is state law determinative of federal tax results?

A thorough understanding of the ultimate tax treatment of the settlement will enable the attorney to provide the most desirable result for his client. This article will discuss these various tax aspects of will contests, dealing first with the income tax problems and then with the estate tax problems. It will conclude with an analysis of the problems which accompany settlements that occur after the estate is closed, and the proper treatment of the deduction of attorney's fees.

II. Income Tax Considerations

A. *The Application of Section 102*

Section 102(a) of the Internal Revenue Code states the general rule that gross income does not include the value of property acquired by gift, bequest, or inheritance. Neither the Code nor the Regulations mention the application of section 102(a) to will contests or compromises. When the question of section 102(a)'s application to will settlements was presented to the Supreme Court in *Lyeth v. Hoey*[1] the Court apparently took a broad view of what constitutes a bequest or inheritance. There the Court held that property received by an heir under a compromise of his claim is not included in gross income, having been acquired by inheritance. In *Lyeth*, the heirs challenged the testamentary capacity of the decedent. The compromise resulted from the claimant's standing as an heir. The Court pointed out that state law provides the standing as an heir, or determines the validity of a will. However, in the interest of uniformity of application of the Code throughout all the states the Court held that

1. 305 U.S. 188 (1938).

it was a federal question whether the property the claimant received was acquired by gift, devise, bequest, or inheritance. In *Lyeth v. Hoey*, if the taxpayer had continued with the action and had won, the property he would then have received as a result of the laws of intestate succession would clearly have been acquired by inheritance. The Court held a settlement in compromise prior to final adjudication in the courts should not change the character of the property received when payment was based upon the claimant's status as an heir.

Just as payment to an heir in lieu of an inheritance in *Lyeth v. Hoey* was held to be exempt from taxation as property acquired in the devolution of a decedent's estate, the Board of Tax Appeals, in *Charlotte Keller*,[2] soon held that a claimant standing as a legatee received property which was not included in gross income. In the Keller case the taxpayer was not mentioned in the decedent's will, but was named as a residuary legatee in a prior will. Thus, the taxpayer was not an heir but instead based her claim upon the fact that she was a legatee under the earlier will. The court, extending the rule in *Lyeth v. Hoey*, reasoned that the property received by the claimant in the compromise was characterized by the basis of her claim of a legacy, which, if received under the probate of the earlier will, would have gone to her tax-free.

Lyeth v. Hoey was further extended in *United States v. Gavin*[3] where the claimant received over $206,000 as a compromise of her claim against the decedent's estate. The right to the share was based upon the claim of the taxpayer that she was the natural daughter and pretermitted heiress of the deceased. In contending that the amount received by the taxpayer was not exempt from income tax as property acquired by inheritance, the government argued that the facts did not warrant a finding that the amount paid the claimant was paid to her as an heir, and furthermore that some of the property she received did not come from the estate. The court, relying on *Lyeth v. Hoey*, held that even though the taxpayer was not an admitted heir and only claimed heirship, it was this status as a claimed heir which characterized the payment. It also held that the status was not altered because $100,000 of what the taxpayer received came from certain heirs out of their own funds and not from estate sources. Had the claimant successfully established her claim of heirship and had the other heirs paid her share in advance from their own funds, this sum would not have been taxable as income to her.

The attorney should realize when considering a contest or compromise that the *Lyeth v. Hoey* characterization of property received, according to the nature of the claim asserted, can also work against the claimant. For example, in *Tree v. United States*[4] the widow claimed a dower right in her deceased husband's share of a testamentary trust. Under local law

2. 41 B.T.A. 478 (1940).
3. 159 F.2d 613 (9th Cir. 1947).
4. 55 F. Supp. 483 (Ct. Cl. 1944), *cert. denied*, 324 U.S. 852 (1944).

the dower right in this case included one-third of the income from the husband's real estate. A settlement agreement between the widow and her deceased husband's brother, who succeeded to the trust share, gave her payments of certain sums outright, plus annual sums for life. Since the property received was characterized as dower and thus represented a share of income from the husband's property, it was taxable income to the widow.

By looking to see what the tax results would have been had the contest proceeded to judgment in favor of the claimant, the courts treat the compromise payment in the same way. Thus, if the claimant has more than one legal principle upon which his claim can be based, tax planning may play an important part in the determination of which status the taxpayer will assert when he presents his claim.

Section 102(b) provides that any income from an inheritance, or an inheritance of income from property, shall not be excluded from gross income. Thus, property received under a contest agreement as income from property will be wholly taxable to the claimant as a gift of income. It is interesting to note that a settlement which would qualify as tax-exempt inheritance under section 102(a) if collected in a lump sum may be converted in whole or in part to taxable income if the claimant accepts payment in the form of a series of distributions or an annuity. Even before the introduction of subchapter J into the Code in 1954, the courts readily held that such distributions consisted of an inheritance of income from property when they were in fact paid out of income earned by the estate's property.[5] The inheritance of income area is considered in greater detail in the discussion of the application of subchapter J in this Article.

An important consideration in determining the taxability of a settlement in a will contest will be the validity of the asserted claim. While *Lyeth v. Hoey* indicates that state law does not control in determining the nature of a settlement, the courts have often indicated that local law can be an important consideration in determining how the *Lyeth v. Hoey* rule should be applied to a particular case. In *Grossman v. Campbell*,[6] for example, when the validity of a 1949 will had been attacked in order to obtain a settlement on the basis of a later holographic will, the purported settlement was disregarded. The court questioned whether there was an actual dispute as to the validity of the 1949 will, out of which a good faith, valid, and bona fide settlement arose. The court pointed out that under Texas law the holographic will was invalid and a later codicil, properly executed, republished the first will. Thus, the attempt by an oral agreement to provide the decedent with only a life estate in certain property was disregarded by the court. Since the settlement was not bona fide, the property was included in the decedent's estate as property held at death

5. *E.g.*, Harte v. United States, 252 F.2d 259 (2d Cir. 1958); Pauline S. Nalle, 29 P-H TAX CT. MEM. 241 (1960).
6. 368 F.2d 206 (5th Cir. 1966).

rather than a mere life interest which the agreement purported to give him. In *Bailey v. Ratterre*[7] the court rejected the contention that property transferred as a result of an agreement was a transfer of a part of the estate in a manner so as to constitute an inheritance, pointing out that no step was taken to vacate the probate of the will. The court noted that there was no evidence that the estate was released from further claims and that the evidence pointed to nothing more than a mere arrangement between the parties. It was also shown that any rights the claimant had to contest the will had already expired. While the court did not elaborate upon this point, it seems to illustrate some concern with the right to contest under local law. This is an indication that the compromise of a will contest must be based upon more than a naked threat if the rule of *Lyeth v. Hoey* is to apply. A desire to avoid family friction may well prompt a settlement, but to recognize such a desire as a basis for a contest compromise could open the door to tax evasion.

In *Lyeth v. Hoey* there was concededly a valid compromise agreement, and the Supreme Court, as other courts in later cases, seemed to have placed emphasis upon the fact that the compromise agreement was made a part of the probate proceeding.[8] Other courts, however, have indicated that such incorporation is of itself not determinative and that each case must be decided upon its own facts.

It seems clear that, in order to obtain section 102(a) treatment of property received in settlement of a will contest, the claimant must have a valid claim under local law. *Lyeth v. Hoey* will not operate to protect the settlement from income taxation if state law does not provide the claimant with the proper status to contest. The courts will look for a bona fide compromise as opposed to what is actually a voluntary rearrangement of property between the parties. Moreover, the claim must not be one which, if successfully pressed, would result in taxable income to the claimant. If it is, then section 102(a) will not provide tax-free treatment.

B. *Disguised Claims for Compensation*

The importance of the true nature of a claim leading to a payment in compromise is illustrated in the many cases which deal with legacies, or promised legacies, which are actually disguised claims for compensation.[9] It is well established law that claims for legacies promised in return for personal services rendered will result in taxable income. If payment had been made prior to death and would have been taxable compensation, there is no reasonable way to interpret the *Lyeth v. Hoey* rule so that such income would be converted into a tax-free distribution. It seems

7. 144 F. Supp. 449 (N.D.N.Y. 1956), *aff'd*, 243 F.2d 454 (2d Cir. 1957).

8. *See, e.g.*, United States v. Gavin, 159 F.2d 613 (9th Cir. 1947); Dumont v. Commissioner, 150 F.2d 691 (3d Cir. 1945).

9. *See*, Commercial Nat'l Bank v. United States, 196 F.2d 182 (4th Cir. 1952); *In re* Sages Estate, 122 F.2d 480 (3d Cir. 1941), *cert. denied*, 314 U.S. 699 (1941).

that the characterization requirements of this rule would clearly necessitate looking into the true nature of the claim, and this is exactly what the courts insist upon.[10] In *Cohen v. United States*[11] the taxpayer claimed that his brother promised to leave him certain stock. He received some stock in settlement of the claim, and he relied upon *Lyeth v. Hoey* and his status as a promised legatee in an attempt to enjoy the section 102(a) exclusion. The court held that mere payment in the nature of a testamentary disposition is not controlling and that the nature of the claim would determine the tax liability. The court found that the claimant's true status, which commanded the settlement, was as a party to a contract for services rather than as a claimed legatee.

A similar result was reached in the Tax Court when a claimant filed application to admit to probate an unsigned copy of a will alleged to be the decedent's last will and testament.[12] One provision in this will gave the claimant $5,000. He later filed a claim against the estate for compensation for personal services prior to the decedent's death. The court held that the payment which resulted was actually a settlement of the claim for services rather than the will suit. The court noted the manner in which the amount of cash to be paid was computed, reasoning that it was the service claim which commanded the compromise.

Since the amount received in a compromise agreement takes the same character as the claim compromised, the taxpayer will be deemed to have received taxable income when his claim is based upon compensation for services. He will not be permitted to twist the facts in order to obtain the benefit of the *Lyeth v. Hoey* rule.

C. *Promised Legacies*

While the treatment of a claim for compensation is well settled, there is still a question as to the treatment of one who claims under a promise of a legacy which was not made. The cases which have considered this point all seem to have decided that the claimant was actually receiving compensation. Only by inference have the courts provided any indication of the result when the promise actually was not a payment for services. The Tax Court has discussed this issue. In *Hugh Coyne*[13] the court was presented with the factual question of whether the property received as a result of a contest was a result of a compromise based upon a contract to make a bequest or a contract to pay for services. In holding that the contract for services would not be excluded from gross income the court seemed to hint that a compromise based upon a contract to make a bequest would be excluded. While the court did not specifically say so, it did imply that a contract to make a bequest would come within the exclusion

10. *See, e.g.*, Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959).
11. 241 F. Supp. 740 (E.D. Mich. 1965).
12. Wilbur D. Jones, 27 P-H TAX CT. MEM. 822-952 (1938).
13. 22 P-H TAX CT. MEM. 1229-1383 (1953).

provisions. Otherwise, there would have been no reason to decide the case by a determination of the facts if the result would have been the same regardless of the type contract involved. Even so, to stretch *Lyeth v. Hoey* to cover a claim of a mere promise which was not kept, without the benefit of standing as an heir or legatee, might require what a court would feel is an unreasonable extension of the general rule.

A somewhat related question involves a claim that asserts that the property had been given to the claimant before decedent's death. In *White v. Thomas*,[14] the taxpayer sued to recover a ranch which he claimed the decedent had given him before death. He received a cash settlement in return for a release of all claims on the ranch. The taxpayer cited *Lyeth v. Hoey* to show that what he received had the same character for tax purposes as the claim which was compromised, in this case a tax-free gift. The court agreed that his assertion was correct, in that what a claimant receives by compromise is a part of the very thing being claimed. If the taxpayer claiming the ranch as a gift had received a part of it, the land received would stand as a gift. Since he accepted money, however, he was considered as having sold the right which he claimed in the land. Since he had no cost in the claim, he thus had a zero basis and the amount he received was all gain taxable as income. This may at first seem a bit unfair, since had he received the land as a gift he would have been entitled to a section 1015 basis in the property which could be recovered without tax when he later sold the property. Here, however, he did not sell the land itself since he had neither title nor possession. The court seemed to grasp this bit of formalism to say that if he had received a distribution in kind of what he claimed, it would have been received tax-free, but instead he converted the claim into cash. In short, it seems he must actually receive a portion of what is claimed. Thus, it appears that where the claimant contends he is due a legacy of cash or a portion of the residuary estate, the requirement in *White v. Thomas* should be satisfied by a distribution of cash (or a distribution in kind from the residuary estate if such is the claim). Such a distribution would have the same characterization as the property claimed.

D. *The Role of State Law*

The relevance of state law in the determination of the claimant's status as an heir or legatee has been discussed previously. The significance of state law in determining the federal tax consequences of a particular transaction has not changed noticeably since *Lyeth v. Hoey*. However, the weight which is given to state court decisions, in determining what the state law is, has now greatly diminished. The new rule which was adopted by the Supreme Court in the case of *Commissioner v. Bosch*[15] states that the courts need only to give "proper regard" to a lower state court ruling,

14. 116 F.2d 147 (5th Cir. 1940), *cert. denied*, 313 U.S. 581 (1941).
15. 387 U.S. 456 (1966).

even when that ruling arises out of a genuine adversary proceeding. Prior to the *Bosch* case the "genuine adversary proceeding" test as set forth in sections 20.2053-1(b)(2) and 20.2056(e)-2(d)(2) of the Regulations was generally regarded as the law. The *Bosch* test does not ignore local law but permits the federal court to take its own look at the state law. The courts may decide that the state court decision should not control when it appears to be based upon a mistake of law, as in *Bosch*, or a mistake of fact, as in *Lakewood Plantation, Inc. v. United States*.[16] Thus, even when a claim is not compromised but is actually litigated, the state court decision adjudicating the property rights or characterizing the property interests of a claimant may not be determinative of his status as a claimant if the federal court finds that a mistake of law or fact prompted an incorrect result.[17]

E. *The Application of Subchapter J*

When the claimant receives property as an heir, legatee or devisee under the *Lyeth v. Hoey* rule, it would appear (for the purposes of subchapter J) that he would become a beneficiary as defined in section 643(c).[18] If this is so, the operation of the distribution net income (D.N.I.), the distribution deduction, and availability of section 642(h) carryovers should be recognized by the parties in negotiating the form of settlement. There is little case law which specifically states that a recipient, under the *Lyeth v. Hoey* rule, occupies from the date of decedent's death the same status as a beneficiary named in the will. There appears to be no reason why he should be placed in a different position from any other beneficiary, and the courts do this without comment. The idea that claimant's right to the property received under a compromise relates back to the date of death was expressed in *Hale v. Anglim*.[19] There the taxpayer was taxed on the income she received. This income arose from property, held by the estate, which she later obtained in a compromise agreement. The court pointed out that her right to the property did not arise at the time of settlement, but upon the death of the decedent.

F. *Distributable Net Income*

Distributable net income, or D.N.I., is defined in section 643(a) as the taxable income of a trust or estate, with certain modifications. It is used as a measuring rod to determine the amount and character of any income upon which the beneficiary is taxed. The operation of D.N.I.

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16. 272 F. Supp. 290 (D.S.C. 1967).

17. *See* Kendrick, *Binding Effect of State Court Judgment on Federal Tax Cases*, 21 S.W. L.J. 540 (1967) and Fried, *External Pressures on Internal Revenue: The Effect of State Court Adjudications in Tax Litigation*, 42 N.Y.U.L. Rev. 647 (1967).

18. *See generally*, Lewis, *Federal Income Taxation of Estate and Trusts*, 43 DENVER L.J. 183 (1960).

19. 140 F.2d 235 (9th Cir. 1944).

within the tier structure of section 662 can require the recipients of both current income and corpus to share in the payment of income taxes upon all or a portion of their distribution.[20] Section 662(a) provides for the inclusion in the gross income of the beneficiary of all amounts required to be distributed currently (first tier), and all other amounts properly paid, credited, or required to be distributed (second tier), subject to D.N.I. limitations. This may often be difficult for the beneficiary to understand since he claimed a portion of the corpus of the estate. When he receives property, other than money, he may feel he is being improperly forced to bear a portion of the tax which should fall upon those who received the income which was produced. This result would require the tracing of assets, which is one of the reasons for the adoption of the tier structure. If the claimant does not receive the property by a specific bequest, the distribution of the property will attract a ratable portion of the D.N.I. which is available for the second tier. In the absence of a specific bequest on which the beneficiary bases his claim the parties can sometimes minimize the effect of section 662 by careful planning.

The apparently inequitable allocation of income to distributions made from the corpus of the estate becomes even more pronounced when the claimant (or any other beneficiary) receives his share in a year when no other distribution is made. If all the legatees receive their share of property in the same year they will each bear a proportion of the income as provided by their respective positions in respect to the tier structure. For example, if there are four legatees who are to receive $200 each, all within the second tier, and the estate has income and D.N.I. of $100, each would include $25 in his gross income if all the distributions were made in the same year. If on the other hand, only one of the four was to receive his share in this year he would be forced to include $100 in his gross income since the D.N.I. for that year is allocated to him alone.

Since the year in which the claimant receives his distribution could well affect the amount which is received tax-free under section 102(a), this could become an important bargaining element. This might be especially so when the claimant is seeking income producing property which, if distributed to him one year, would reduce estate income which would be attributable to the distribution of the remaining property to the other beneficiaries in the following year. The claimant might be able to command a larger settlement in these circumstances. On the other hand, he might want to insist that the settlement agreement require that the executor also make other distributions within the same year so as to spread the impact of the D.N.I. The withholding of all distributions to the legatees until they can be paid in the same year will usually produce a more reasonable allocation of income among the recipients and could have the advantage of producing less overall tax in the year of receipt due to the

20. The exclusion provided by § 663(a)(1) is discussed later. All citations to sections in this article are to sections of the INT. REV. CODE of 1954 unless otherwise indicated.

splitting of income among a larger group of taxpayers. There appears to be room for a great deal of maneuvering in this area, and if the estate has a large amount of income the tax results can be significantly affected.

The tax treatment as illustrated above seems to have little justification when the interests of all the beneficiaries are considered as a whole, and the Code provides a separate share rule for trusts which will often alleviate the problem.[21] It is important to note, however, that the separate share rule is applicable only to trusts, and no provisions are available which will afford similar treatment to an estate.

G. *Distributions outside Subchapter J*

The problems in dealing with the tier structure will be avoided if the property being distributed is excluded from the operation of sections 661 and 662. For example, the Internal Revenue Service has ruled that a widow's dower interest is deemed to pass outside subchapter J.[22] Thus the basis upon which a widow's claim is founded should be carefully considered when the existence of D.N.I. would otherwise taint the distribution. Section 102(a) of the Code excludes from gross income the value of property acquired by gift, devise or inheritance, and section 663(a)(1) and the regulations thereunder offer a more specific interpretation of what constitutes a section 102(a) gift or bequest for the application of subchapter J. Section 663(a)(1) provides that property qualifying as a specific bequest or gift of money or property, paid in not more than three installments, shall pass outside the provisions of sections 661 and 662, and therefore pass without any allocation of D.N.I. Thus the beneficiary is not deemed to receive income on the distribution of the specific bequest in this situation. The section 663(a)(1) specific bequest exclusion assures tax free treatment to qualified property, and, in effect, reinstates tracing with respect to the identification of the property. Property which fails to qualify as a specific bequest will pass as a section 102(b) distribution to the extent of the D.N.I. allocated by the tier structure.

It is important to note that the language of section 663(a)(1) refers to property passing under the terms of the governing instrument. It becomes quickly apparent that a claimant who relies upon the laws of intestate succession will not be afforded the benefit of this section, since *Lyeth v. Hoey* says he is deemed to take by intestacy and not under the will.

The taxpayer who claims under a will must still meet the additional requirements of the Regulations in order to obtain the specific bequest benefits of section 663(a)(1). In addition to the requirement that the property be credited under the will, the Regulations in section 1.663(a)-1(b) provide that to constitute "specific property," the amount of money

21. INT. REV. CODE of 1954 § 663(c). If the rights of the beneficiaries are sufficiently identified and separate, then for purposes of the D.N.I. limitation, D.N.I. is computed separately for each share.

22. 1964-1 CUM. BULL. 77.

or identity of the specific property must be ascertainable under the terms of the testator's will as of the date of his death. The very fact that the property was acquired under a dispute or threat of a will contest would seem to indicate that the terms of the will were not sufficiently specific to qualify such property. It could be argued, however, that under *Lyeth v. Hoey* the compromise agreement after death either stands in the place of or becomes part of the will and relates back to the date of death. There is some support for this contention in other areas, which are discussed later in this article.

Section 1.1014(a)(2) of the Regulations states that, with relation to determining basis, all titles to property acquired by bequest, devise or inheritance relate back to the death of the decedent, even though the interest of the person taking title at the death of the decedent was legal, equitable, vested, contingent, general, specific, residual, conditional, executory or otherwise. The Treasury, in Revenue Ruling 55-122,[23] ruled that where charities contested the probated will as legatees under a prior will, the settlement agreement took the place of the will for the purpose of determining the charitable deduction allowed under the 1939 Code. However, since the settlement agreement merely provided for gifts of income to charity, it held that the charities were pecuniary legatees. Thus, any money received by them would not be allowed as a charitable deduction under what is now section 642(c), because it was not received in satisfaction of a claim for income. This ruling was revoked by Revenue Ruling 59-15,[24] which held that such a distribution would qualify as a charitable deduction. However, the revocation by the later ruling did not affect the Treasury's recognition of the relation back principle. Therefore, the compromise agreement would still be considered to take the place of the will, and the claimants would take as legatees.

Even if the agreement relates back to the will sufficiently to qualify under the date of death test, there is still another obstacle to avoid. Treasury Regulations, section 1.663(a)(1)(b), state that a bequest from the residuary estate cannot be considered a bequest of a sum of money or specific property within the meaning of section 663. Therefore, if the claim is one that would result in a share of the residue, if the claimant were to proceed to judgment, what is received in compromise will not be considered a specific bequest for the purposes of section 663(a)(1).

The claimant will not be able to benefit by the fact that the discussion of income did not enter into the negotiations. In the Tax Court case of *Eugene C. Delmar*,[25] the taxpayer argued that he claimed and negotiated for an inheritance which would be excluded from income. The court held that his lack of knowledge that the estate credited him with the receipt of his portion of the income for its tax purposes was no defense,

23. 1955-1 CUM. BULL. 390.
24. 1959-1 CUM. BULL. 164.
25. Eugene C. Delmar, 25 T.C. 1015 (1956).

and that whether he ever specifically claimed this amount had no bearing on the case. In this instance the estate took the income tax consequences into consideration in agreeing to the settlement, even though the agreement said nothing about the estate income. The failure of the claimant to consider the full impact of the tax law resulted in a settlement of an amount less than he might otherwise have accepted if the additional taxes had been anticipated.

H. *Annuity Payments*

Questions may still arise as to whether payments received in a compromise are to be treated as an inheritance, under section 102(a) and (b), when the claimant accepts annuity type payments. When the distribution of income is from the decedent's estate the question of whether it will be taxed to the estate or the claimant-beneficiary apparently will depend upon the rules of subchapter J. Prior to 1954, cases held that an annuity was received as an inheritance, and, if payable out of income or corpus, the payments were not taxable to the beneficiary nor deductible by the estate.[26] Now, subchapter J shifts the burden to the beneficiary in such situations.[27]

The tax consequences are not always so clear when a settlement is received from someone other than the estate. The case of *Lydia Hopkins*[28] illustrates some problems in this area. There the issue was whether the payments she received constituted an inheritance of income. In a compromise agreement the taxpayer transferred her claim to the other beneficiary in exchange for lifetime payments from a trust funded with assets which did not come from the estate. The court said that she acquired neither property from the estate nor income from property of the estate. In so holding they said that the fair market value of the rights relinquished by the taxpayer was equal to the present value of the annuity received; thus there was a fair exchange, and no income was to be received until her cost basis in the value of the rights relinquished was exhausted.

A similar question was presented in *Rosen v. United States*.[29] There the widow of the decedent exchanged her dower interest in the lands of the deceased (the interest having a fair market value of over $32,000 at the date of death) for an annuity of $375 per month for life. The court concluded that the amounts received each year were not taxable as ordinary income but as payment of an annuity, and that she should be taxed under the Code sections for computation of income tax on annuities. However, the case did not mention whether the payments involved came from a trust or were merely periodic payments received from the other beneficiaries.

26. Benfield v. United States, 27 F. Supp. 56 (Ct. Cl. 1939).

27. *See* Harte v. United States, 252 F.2d 259 (2d Cir. 1958); James F. Edwards, 37 T.C. 1107 (1962); Dartney Williams, 36 T.C. 195 (1961).

28. 13 T.C. 952 (1949).

29. 59-2 U.S. Tax Cas. ¶ 9587 (N.D. Ala. 1959).

Several cases have held that where the claimant accepts an annuity from the estate or trust in settlement of his claim, he does not thereby purchase an annuity which falls within the operation of section 72.[30] The cases which seem to give the claimant a basis in his claim and afford him the benefit of the exclusion ratio in section 72(b) seem to conflict with the last sentence of section 662(a)(1), which deals with annuity type payments. The Regulations in section 1.662(a)-2(c) in discussing this sentence point out that an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently within the first tier to the extent that there is income which is not paid, credited, or required to be distributed to other beneficiaries for the taxable year. It therefore appears that if the full amount of the annuity is paid out of income of a trust, section 662(a)(1) will override the annuity provision of section 72, and the payments received by the claimant will be fully taxed. This would enable the courts to avoid the conceptual problem presented by the *Hopkins* and *Rosen* assignment of a basis to claims, which makes available the use of section 72. (Recall that in non-annuity situations such as *White v. Thomas*, discussed earlier, the claimant was held to have no basis in his claim even though a section 1014 basis would have been applicable if he had received the property claimed instead of cash.) On the other hand, when dealing with divorce settlements the Service has ruled that there is no gain or loss to the wife upon receipt of property as consideration for the discharge of her dower rights, and her basis in the property is its fair market value.[31]

If the agreement does not provide for payments from a trust (therefore subchapter J has no application) it is still possible that *Hopkins* and *Rosen* may be applied. If, for example, the beneficiaries made the payments from their own assets, in the manner of a private annuity, it could then be argued the annuity provisions should apply, as demonstrated by *Hopkins* and *Rosen*. As yet, however, the law does not appear to be sufficiently developed in this area to afford a reasonable degree of certainty; thus, the claimant in such a situation must consider the possibility that litigation would result from his attempt to exclude these payments from income.

I. *The Estate's Distribution Deduction*

The status upon which the claim is based may affect the estate's distribution deduction in computing its income taxes.[32] The estate is entitled to deduct the amount (up to D.N.I. for the year) of income for the taxable year which is required to be distributed currently and other amounts properly paid, credited, or required to be distributed for the taxable year. Therefore, if the claimant qualifies as a beneficiary under section 643(c),

30. *E.g.*, Dartney Williams, 36 T.C. 195 (1961).
31. Rev. Rul. 67-221, 1967-2 CUM. BULL. 63.
32. INT. REV. CODE of 1954 § 661.

a distribution which includes a portion of the estate's D.N.I. for the year will provide the estate with a corresponding deduction. The special exclusion provisions, such as section 663(a)(1), discussed previously, will also be applied here to deny the estate a deduction for any portion of such distribution. This makes it important for not only the claimant but also the estate to pay close attention to the type of claim presented and the grounds upon which it is based. The availability of this deduction may provide additional leverage in the negotiation of a settlement and should not be overlooked.

J. *Section 642(h) Application*

Prior to 1954 any excess estate deductions in the year of termination were wasted since an estate is a taxable entity and the beneficiaries are not the taxpayers who incurred and paid the expenses. Section 642(h) provides a remedy for this situation in the year of termination of the estate. Under this provision the unused net operating loss carryovers, capital loss carryovers, and excess deductions in the last taxable year of the estate are allowed to the beneficiaries succeeding to the property. The Treasury Regulations in section 1.642(h)-3 define the phrase, "beneficiaries succeeding to the property of the estate," as those beneficiaries, upon termination of the estate, who bear the burden of any loss for which a carryover is allowed or of any excess of deductions over gross income for which a deduction is allowed under section 642(h). With reference to an intestate estate, it means the heirs and next of kin to whom the estate is distributed. In the case of a testate estate, it normally means the residuary beneficiaries and not specific legatees or devisees. Also excluded are recipients of dower and income beneficiaries. The application of *Lyeth v. Hoey* to the claim to determine the character of the settlement will probably also determine the eligibility of the taxpayer to the section 642(h) carryover. If he can otherwise qualify as a beneficiary as defined in the Regulations, there is no reason why the taxpayer should be denied the benefit of this section merely because he takes as a claimant.

K. *The Claimant's Basis in the Property Received*

Generally, the basis of property acquired by bequest, devise, or inheritance will be the fair market value at the date of the decedent's death, as provided by section 1014. The estate tax value of an asset is not binding for the purpose of computing basis, but there is a presumption that the estate tax value is correct, and convincing evidence will be required to prove that a different value is appropriate.[33] The Treasury Regulations in section 1.661(a)-2(f)(3) point out the effect of subchapter J upon the basis of the property received. To the extent that the value of property distributed in kind is included in the gross income through the operation

33. Rev. Rul. 54-97, 1954-1 CUM. BULL. 113.

of subchapter J, the basis to the beneficiary is the fair market value at the time of distribution. This income to the beneficiary as a result of D.N.I. will give him a basis in the property determined in part by section 1014 (fair market value at date of death) and in part by the fair market value at date of distribution. The Commissioner has supplied Revenue Ruling 64-314[34] to aid in the determination of basis adjustments required upon distribution of property in kind.

The application of the above basis provisions should be viewed in light of certain distributions which are likely to arise in the settlement of a will contest. In the case of *Sherman Ewing*[35] the decedent's will gave $300,000 in legacies to certain beneficiaries. The executor transferred both cash and securities in satisfaction of the legacy to the taxpayer. The taxpayer later sold some of the securities which had depreciated from the date of distribution value but were still worth more than their date of death value. The legacy here was general and not a specific bequest of property, and the court held that since the securities themselves were not acquired by inheritance or bequest, their basis to the taxpayer should be cost (here the fair market value on the date of distribution). The result is as if he received money from the estate which he used to purchase the stock.[36] While the *Ewing* case did not involve a will contest it could apply to a claim based upon a legacy.

Often the amount of the taxpayer's claim or the value of the ultimate settlement will determine the basis of the property received. For example, in *Wilson v. Tomlinson*[37] the basis of stock acquired by the taxpayer in a compromise settlement of her rights in her husband's estate, which she accepted in lieu of cash, was the value set up in the compromise agreement and not the lower value of the stock at the husband's death. Since the claimant had a right to receive cash, it was deemed to be an acquisition by purchase for the amount agreed upon.

The nature of the claim presented can obviously play an important part in determining the claimant's basis in the property. A distribution of a specific bequest will, of course, give the claimant a section 1014 date of death value. On the other hand, a claim for a dollar amount which is satisfied by a distribution in kind will give the claimant a cost basis in the property. Obviously, if there has been no significant appreciation or depreciation in the value of the property since the decedent's death, the question of basis will not be important. However, any time a distribution in kind is considered to satisfy a claim, this problem should be given some thought, especially if the claimant is considering a taxable disposition of the property in the foreseeable future.

34. 1964-2 CUM. BULL. 167.
35. 40 B.T.A. 912 (1939).
36 *See also* Rev. Rul. 67-74, 1967-1 CUM. BULL. 194.
37. 306 F.2d 103 (5th Cir. 1962).

L. *Other Income Tax Considerations Important to the Claimant and to the Estate*

As a general rule, the mere distribution of property by the estate does not result in the recognition of gain or loss. However, some transactions between the estate and the claimant may require recognition of gain to the estate. This will not affect the claimant directly, but when negotiating a compromise the executor must consider the total effect of the settlement. If the transaction agreed upon is one which will create additional taxes to be paid from the remaining estate assets, the executor must consider this as part of the cost of settlement, since it further reduces the amount which remains for distribution to the other beneficiaries. Thus, another element enters into the give and take at the negotiating table.

Perhaps the most common type of transaction which creates gain taxable to the estate is illustrated by *Kenan v. Commissioner*.[38] In *Kenan*, appreciated securities were transferred to the beneficiary of a trust in discharge of a right to receive a specific sum of money. The trust was held to have realized gain which, in this instance, was a capital gain. The recognition of this gain to the estate should be anticipated in cases such as *Ewing* and *Wilson* (discussed above) where the claimant is treated as "purchasing" the property and gets a section 1012 cost basis. This gain will also increase D.N.I. for the year, which will increase the amount of income attributable to any distributions to other beneficiaries, during the year, who receive their property through the operation of the general distribution rules of sections 661 and 662. The result is the same as if the estate had sold the appreciated property and used the cash to pay the claimant.

Another exception to the general rule of nonrecognition upon estate distributions may arise when section 1245 or 1250 property is distributed. The effect of D.N.I. upon the section 1245 or 1250 recapture and the resulting increase in D.N.I. is complex and beyond the scope of this article, but a thorough exploration of this problem has been provided by another author.[39]

The Service, in Revenue Ruling 55-117,[40] has ruled that the distribution to a beneficiary of a stated percentage of the corpus of a trust will not create a recognizable gain to the trustee. This type of distribution is not in satisfaction of an obligation for a definite amount, as in *Kenan*, but is actually a partial distribution of a share of the trust principal. If a will left a percentage of the net estate to each of several beneficiaries, an agreement among them providing for the distribution of particular assets to each is not a sale or exchange which requires recognition of gain on

38. 114 F.2d 217 (2d Cir. 1940).

39. *See* Freeland, *Estate Distributions in Kind*, 23 TAX L. REV. 59, 78-84 (1967).

40. 1955-1 CUM. BULL. 233.

appreciated property.[41] Therefore, it would seem that if the claimant is entitled to a share of the estate by intestacy or a percentage as a legatee, a distribution in settlement of his claim would not be a taxable transaction to the estate. Thus, if the distribution in compromise of the claim is one which would create an income tax burden on the estate, the claimant may have to adjust his demands to compensate for this additional slice out of the assets remaining for the other beneficiaries. It will probably not be a major issue, but it is certainly one worth consideration.

M. *Sale of Life Interest in Trust*

When the settlement agreement establishes a trust and the claimant receives a life interest in the income, the taxable income of the trust is passed through to him, as was pointed out in the previous discussion of subchapter J. However, there still exists the possibility that he will be able to convert what would ordinarily be ordinary income into capital gains. Three courts of appeal[42] have held that the sale of the life estate to the remainderman of the trust represents the sale of a capital asset. The courts have indicated that such a transaction is not a sale of a naked right to income but a life interest in trust property. There is a limit on how far the taxpayer can maneuver in this area, and it seems to be restricted to the sale of life estates in trust property. In *First National Bank v. Commissioner*,[43] for example, the taxpayer sold an annuity contract to a bank and the resulting gain was held to be ordinary income. The contract was with an insurance company, and the court refused to allow the taxpayer to convert ordinary income into capital gains in this situation. It appears that a life interest in property within the trust is a necessary element for this type of conversion.

A purchase of the life estate by the remainderman appears to allow the conversion of taxable income into a recovery of capital. In *Bell v. Harrison*[44] the court held that the remainderman, after such a purchase, was entitled to recover his cost over the life expectancy of the life beneficiary. The Commissioner's contention, that the merger of the life estate and the remainder required the remainderman to add the cost to the basis of the property he received, was rejected by the court. The Service, in Revenue Ruling 62-132,[45] has indicated that it will follow the *Bell v. Harrison* decision. The use of a trust with an income interest in the claimant has the advantage of preserving the principal for the remainderman and provides advantageous tax treatment to both parties if the remainder-

41. M. L. Long, 35 B.T.A. 95 (1936).

42. Allen v. First Nat'l Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946), *cert. denied*, 330 U.S. 828 (1947); McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert. denied*, 330 U.S. 826 (1947); Bell v. Commissioner, 137 F.2d 454 (8th Cir. 1943).

43. 309 F.2d 587 (8th Cir. 1962).

44. 212 F.2d 253 (7th Cir. 1954); *see also* Commissioner v. Fry, 283 F.2d 869 (6th Cir. 1960).

45. 1962-2 Cum. Bull. 73.

man accelerates his complete ownership by a purchase of the life estate. However, it might not be wise for the claimant to plan the sale of the life estate during the negotiations. If it is obviously a scheme for the avoidance of taxes the Commissioner is almost sure to attack it.

N. *Gift Tax Liability Can Arise out of a Will Contest*

The application of *Lyeth v. Hoey* to gift tax cases was originally rejected on the grounds that the tax involved in that case was an income tax.[46] Now, however, there is no question that *Lyeth* is to be considered when appropriate, regardless of the type of tax involved.[47] In general, the gift tax aspects of a will contest or compromise will depend upon the standing of the claimant under state law, just as *Lyeth v. Hoey* considered the right of the claimant to contest according to the law of his jurisdiction. The major concern in the gift tax area will center around the question of whether there was in fact a genuine dispute. The object is to prevent what is actually a gift from escaping taxation under the guise of a will contest. The Tax Court, in *Maud H. Farrell*,[48] illustrated the court's interest in the genuineness of the dispute which resulted in the compromise, pointing out that no taxable gift was made. The court focused upon the fact that the agreement, which settled the differences between a beneficiary under the will and a relative not mentioned in the will, was genuine and entered into at arm's length.

The role of state law in the gift tax area is well illustrated in *Hardenbergh v. Commissioner*.[49] There the decedent died intestate leaving a widow, daughter and son as sole heirs at law. The widow and daughter had large estates of their own, and, to equalize the estates, the decedent arranged to prepare a will leaving the bulk of his estate to the son. He died before the will was executed, but the wife and daughter relinquished their rights to the estate which distributed the property according to the decedent's wish. The probate court recognized the renunciations. The court sustained the Commissioner's contention that the wife and daughter each made a gift of one-third the net estate. It reasoned that the general rule as to intestate succession is that title passes according to the rules of state law. Those who are entitled by law have no power to prevent vesting of title in themselves in this situation. The rule is different as to legatees or devisees under a will since they may accept or reject the testamentary gift. Thus, in *Hardenbergh*, the wife and daughter held title to the property by operation of law. The court pointed out that the agreement was not consistent with the state law and that the probate court's award would not have withstood a direct attack. Only the consent of the taxpayers enabled

46. Houseman v. Commissioner, 105 F.2d 973 (2d Cir. 1939), *cert. denied*, 309 U.S. 656 (1940).
47. *See* Vaughn, *Estate, Gift, and Inheritance Taxes and Compromise Settlements of Will Contests*, 17 BAYLOR L. REV. 66 (1965).
48. 23 P-H TAX CT. MEM. 280 (1954).
49. 198 F.2d 63 (8th Cir. 1952), *cert. denied*, 344 U.S. 836 (1952).

it to survive. Therefore, the source of the rights acquired by the son was not that of the probate decree (and thus an inheritance from the decedent) but the affirmative acts of the taxpayers in relinquishing the shares of the estate which state law had vested in them. In this case, a taxable gift resulted since the son had no legitimate claim to the entire estate under local law.

A gift may also arise from attempts to pass property from the estate down to the third generation in an attempt to avoid the inclusion of the property within the estate of the second generation. *Lyeth v. Hoey* permits property received in settlement of a claim to be received as a result of the claimant's standing as an heir, legatee or whatever basis he might have to contest. But, if the prior will or distribution is not actually challenged, and the agreement is nothing more than a voluntary rearrangement of property interests, the transfers may be considered to have been made among the beneficiaries rather than from the estate to the beneficiary who ultimately received the property. Thus, a valid claim under state law is of utmost importance in order to establish the application of *Lyeth v. Hoey* to the agreement.

If the compromise agreement results in the establishment of a trust, federal tax consequences might often depend upon who is the grantor. In addition to possible gift treatment, the determination of who is really the settlor may create future estate tax problems. For example, the court in *Commissioner v. Vease*[50] determined that the decedent had made a transfer of property into a trust (with a retained life income interest) rather than the decedent's father. The purported will challenge and settlement which created the trust from the father's estate was deemed to be without merit. Thus, the trust property was included in the decedent's estate since he and not his father was the settlor of the trust. *Lyeth v. Hoey* will not authorize a voluntary scheme which will allow property to bypass an heir's estate where local law affords the parties no legal standing to dispute the original plan of distribution (whether it be by will or intestacy).

III. ESTATE TAX CONSIDERATIONS

A. *The Nature of the Claim Determines the Section 2043 Deduction*

The estate and the claimant will be in direct conflict with respect to the treatment of the compromise payment as a deductible claim against the estate. The claimant will strive for recognition as an heir or legatee. As a result the payment would be a nondeductible gift, bequest, or inheritance for purposes of the estate tax computation. If the claim satisfies the section 2053(c) requirements, that the claim based upon a promise or agreement is bona fide and for an adequate and full consideration or money's worth, an estate deduction is available.[51]

50. 314 F.2d 79 (9th Cir. 1963); *see also* Bailey v. Ratterre, 243 F.2d 454 (2d Cir. 1957).
51. *See* Estate of Frederick C. Hodgdon, 21 P-H TAX CT. MEM. 791 (1952).

The treatment of the compromise by the probate court will often aid in the classification of the payments as either claims against the estate or legacies. In *Beecher v. United States*[52] the claim was based upon an agreement before death which grew out of a divorce settlement. The court discussed the probate court's decree and stressed the fact that it referred to the claimants as creditors, even though the decedent provided for payment of the obligation in his will. The deductions were allowed, and the court pointed out that even if the will had not provided for the payment, the claimants would have been able to recover from the estate for breach of contract.

Sometimes, when a compromise payment is made, it must be allocated between deductible and nondeductible claims. An example of such treatment is found in *Hull v. Continental Illinois National Bank and Trust Company*.[53] There the deceased, prior to her death, made claims against her brother's estate on two grounds: first, that the brother's will was null and void; and second, that he had defrauded her in connection with the settlement of her father's estate. The compromise payment, approved by the court, was paid in a lump sum without being allocated between the two claims. In the brother's estate tax proceedings, all the data on the settlement was presented to the Internal Revenue Service, which determined that $134,000 of the $250,000 settlement was attributable to the decedent's claim as a creditor, rather than as an heir taking by intestacy. This amount was allowed as a deduction for determining estate tax of the brother's estate. When the decedent died about two years later, this $134,000 was in her estate, and her representatives claimed that it should have been included in the brother's estate so that the decedent's estate would be entitled to a deduction for previously paid taxes. The court, holding against the taxpayer, said that the administrative determination of the Service was presumptively correct, absent clear evidence to the contrary.

It appears that some litigation might be avoided in this area if the parties to the compromise include in the settlement agreement a promise by the representatives of the estate not to claim the payments as a section 2053 deduction, when the claim is being settled on the basis of the claimant's assertion of his status as an heir or legatee. If, on the other hand, the settlement arises out of a claim which should entitle the estate to the deduction, the claimant should agree that the estate could claim the deduction and that he would not later assert that he received a tax-free gift, bequest, or inheritance.

B. *The Settlement May Affect the Charitable Deduction*

The effect the compromise may have upon the estate's charitable deduction should be considered during the negotiations. Perhaps the most common situation will be one in which a non-charitable claimant attacks

52. 280 F.2d 202 (3d Cir. 1960).
53. 177 F.2d 217 (7th Cir. 1949).

the decedent's will, as illustrated by *Sarge v. Commissioner*.[54] There the decedent left the bulk of his estate to charity. The guardian of the incompetent widow filed a caveat to the probate of the will. The resulting settlement agreement provided that 25 percent of what was to have gone to the charity would be distributed to the widow. The Commissioner required the charitable deduction to be reduced by this amount. The court pointed out that the failure to incorporate the agreement into the probate proceedings was immaterial. What the widow took in settlement of the contest she took by inheritance. The modification of the will which arose as a result of the compromise reduced the share of the charity's bequests and cut down proportionately the charitable deduction to which the estate was entitled.

The estate's deduction will be similarly reduced even if agreement is between the charity and the claimant rather than the estate and the claimant. In *Thompson's Estate v. Commissioner*[55] the residuary charitable legatees gave the claimants $325,000 to withdraw objections to the decedent's will. The court held that the charitable deduction was reduced by this amount and additional estate taxes were due. It clearly appears that the courts will treat the distribution as if it were made by the estate and will not allow the parties to rely upon a distribution to the charity to qualify for the full charitable deduction when a later distribution from the charity to a claimant reduces the amount which the charity ultimately receives from the decedent. This is clearly in line with Revenue Ruling 145,[56] which states that the test for determining the deductible charitable gifts for the estate will be calculated on the basis of what the charity actually receives. As indicated in this ruling, however, the rule operates both ways, and the charitable deduction may be increased in certain circumstances, often depending upon whether it is the charity or other beneficiaries contesting the will.

When the charity attacks the will offered for probate, the compromise might result in a larger charitable deduction. Whether the payments to the charity will be deductible by the estate may depend upon the charity's status as a claimant. If it is determined that the charity takes by bequest or inheritance, under *Lyeth v. Hoey* the estate is entitled to the deduction.

In *Robbins v. Commissioner*[57] the charitable deduction was denied when Amherst College received property under a compromise agreement. In this case, Amherst was a legatee of a remainder interest, in a very uncertain amount, under the decedent's will. The court did not allow the compromise agreement to stand in place of the will for purposes of the charitable deduction since the deduction would not have been allowed under the will as it was written. Since the college was not a legatee under

54. 122 F.2d 480 (3d Cir. 1941), *cert. denied*, 314 U.S. 699 (1941).
55. 123 F.2d 816 (2d Cir. 1941).
56. 1953-2 CUM. BULL. 273.
57. 111 F.2d 828 (1st Cir. 1940).

a prior will, it would have received nothing if the will offered for probate had been void. The court held that the college did not take by bequest or inheritance under the decedent's will but rather by purchase, and therefore no deduction was allowable to the estate for the payment to Amherst.

The estate successfully deducted a compromise payment to charity in *Dumont v. Commissioner*.[58] There the decedent executed two wills, one in 1938 and a second in 1939. Lafayette College was named the residuary beneficiary in both wills. The 1939 will was executed less than 30 days before decedent's death, and by operation of the state law the charitable bequest was rendered void. The college initiated a will contest which, if successful, would have permitted it to receive the bequest under the prior valid will. The property the college received in a settlement was held to be received by inheritance and not by purchase; therefore, the bequest was deductible for estate tax purposes as a charitable bequest. In reversing the Tax Court, the Third Circuit stated that the Tax Court had failed to consider that Lafayette college occupied the position of a legatee under a prior will and did not need to rely upon the probated will, under which its bequest would be void by operation of state law. Therefore the *Lyeth v. Hoey* rule applied, and the acquisition was by inheritance. The court distinguished *Robbins* because there Amherst College did not have the status to contest (as did the college in *Dumont*), since the right of Amherst as a legatee would have vanished had intestacy been established.

In a more recent case, *Bach v. McGinnes*,[59] the court denied the application of the *Lyeth v. Hoey* rationale by holding that the will, as modified by the compromise settlement, did not convert an otherwise nondeductible contingent charitable bequest into property received by the charity as an inheritance, deductible under section 2055(a)(2). In this case the decedent died testate, leaving the residue of the estate in trust to his wife for life, the remainder to others, and if the remaindermen failed to survive the wife, the remainder was to go to charity. The wife wanted to be sure the charity received some money and elected against the will, which under Pennsylvania law gave her one half of the estate. The remaindermen and the charity agreed to a settlement, and the remaining half was distributed between them. The district court rejected the estate's claim for a charitable deduction on two grounds. First, the charitable bequest in the will did not meet the requirements of the Regulations, section 20.2055-2, since at the date of death it was only a contingent bequest, and the possibility that it would not become effective was not so remote as to be negligible. Second, under Pennsylvania law the widow's election against the will was equivalent to her death, so that her election accelerated the remainder interest in the remaindermen, which would deprive the charity of the legacy. The court said the charity actually received the property from the other remaindermen and not the testator.

58. 150 F.2d 691 (3d Cir. 1945).
59. 333 F.2d 979 (3d Cir. 1964).

The appellate court affirmed this decision, indicating that under the will as written the charitable bequest did not qualify for the deduction and that this failure to qualify is controlling when property is ultimately distributed. Presumably the remaindermen would be entitled to a charitable deduction.

When the charity is to receive property from the residuary estate, it will be important that the executor be able to support any contention that claims and expenses were in fact paid out of income. Otherwise, these distributions may likely be deducted from the gross estate before determining the residue available for charitable purposes.[60]

C. *Disclaimers*

Section 20.2055-2(c) of the Regulations indicates that the deduction for charitable contributions includes any interest which becomes part of a contribution as a result of a disclaimer by a beneficiary. To effect such an increased deduction, the disclaimer must be made within 15 months after the decedent's death or within an extension of time allowed for filing the estate tax return. If a beneficiary disclaims his interest, which results in the property passing into the residuary going to charity, the charitable deduction will include this amount. If, on the other hand, the property passes to charity not through the will but as a result of a contractual agreement with the beneficiary, the estate will get no charitable deduction for this portion.[61]

If a disclaimer is too late, the effect is a gift to the charity by the beneficiary rather than the estate.[62] However, the mere fact that the agreement includes a beneficiary's renunciation of his claim to some property does not automatically create a disclaimer.[63]

If the amount received by the charity under the settlement of a will contest would have been received under the will had the contest continued and the asserted claim been successful, the amount received under the settlement is received as an inheritance and gives rise to a charitable deduction. On the other hand, if no valid gift to the charity is made by the will, the amount received through the settlement will not provide the charitable deduction.

D. *The Marital Deduction and the Will Contest*

The will contest and settlement can alter the amount which would otherwise qualify for the marital deduction in much the same manner as it alters the charitable deduction. Section 20.2056(e)-2(d) of the Regulations specifically states that when the surviving spouse assigns or sur-

60. Estate of Luehrmann v. Commissioner, 287 F.2d 10 (8th Cir. 1961).
61. Rev. Rul. 55-759, 1955-2 CUM. BULL. 607.
62. *See* Drexler, *Problem In Gift Tax Returns*, N.Y.U. Twenty-third Annual Institute on Federal Taxation 1169 (1965).
63. Estate of Mary E. Morris, Jr., 35 P-H TAX CT. MEM. 1095 (1966).

renders a property interest in settlement of a controversy involving the decedent's will, the interest so assigned or surrendered is not considered as having passed from the decedent to his surviving spouse. Therefore, it will not qualify for the marital deduction. Conversely, the Regulations also provide that if, as a result of the controversy, 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 the spouse only if the assignment or surrender was a bona fide recognition of enforceable rights of the spouse in the decedent's estate. If the assignment was pursuant to a decision of a local court upon the merits in an adversary proceeding, the Regulations state that the required bona fide recognition will be presumed. However, this rule of the applicability of local law appears to have been somewhat altered by the recent decision in the *Bosch* case, discussed previously. The *Bosch* rule, which states that federal courts shall give "proper regard" to local law, does not provide the presumption which the Regulations here indicate. At any rate, the Regulations go on to indicate that if the assignment or surrender was pursuant to a consent decree, or pursuant to an agreement not to contest or probate the will, it will not necessarily be accepted as a bona fide evaluation of this right of the spouse. Since *Bosch*, this is a more accurate statement of the law with respect to will contests than the adversary proceeding test. The courts will consider the merits of the claim asserted, giving the proper regard to the local law, in evaluating the rights of the spouse out of which the settlement arose.

Section 20.2056(e)-2(c) of the Regulations indicates that the property received by a surviving spouse who renounces the will and takes dower can qualify for the marital deduction. The Service, in Revenue Ruling 66-139,[64] states that the settlement payment made by the executor of the decedent's estate to the surviving spouse, in compromise of a claim made by her for an absolute dower interest under state law, following arms length negotiations, qualifies for the marital deduction. The spouse had signed an antenuptial agreement in which she renounced present and future rights in the decedent's estate. Relying upon this agreement, which the spouse claimed was invalid, the executor denied the dower claim. Following the rationale of *Lyeth v. Hoey*, the amount paid to the surviving spouse pursuant to this bona fide compromise agreement qualified for the marital deduction to the extent the interest which would have passed to her as a result of the completed exercise of her rights would have been deductible.

The requirement that the compromise payment be in bona fide recognition of an enforceable right of the surviving spouse is also illustrated in *Estate of Morris Menkus*.[65] There the decedent established five inter vivos trusts with the bulk of his assets. He retained a life interest in three of

64. 1966-1 CUM. BULL. 225.
65. 31 P-H TAX CT. MEM. 619 (1962).

these trusts which was sufficient to include them in his taxable estate. He left his wife nothing, and his probate estate was very small. The surviving spouse filed a caveat against the probate of the decedent's will, and the dispute was settled by the payment to her of $6,000. This amount was actually in excess of the probate estate. The court pointed out that the most the spouse would have received under state law, if the will attack had been successful, was about $1,500 due to the small probate estate and the lack of any interest passing to her in the trusts. The estate was unsuccessful in its attempt to qualify the $6,000 settlement for the marital deduction since at least part of it was for something other than her claim as an heir. Part of the payment, for example, was probably to get her to agree to join in a joint return for the decedent's last income tax return. The court held that the petitioner failed to prove what part, if any, of the payment to the widow was a bona fide recognition of her claim as an heir, which was necessary to qualify as an interest passing from the decedent for the purpose of the marital deduction.

When facing a similar situation, the parties to the dispute should consider an allocation of the payment among the claims asserted, and such allocation should be included in the compromise agreement. This incorporation of the allocation within the agreement will, without more, probably not be sufficient to sustain the taxpayer's burden of proof. It will, however, offer some evidence in support of the deduction.

An interesting application of the will contest as a tax-saving device is illustrated in the case of *Isaac Harter, Jr.*[66] There, the decedent willed her entire estate to her son. The decedent's husband elected against the will to share in her estate by intestacy pursuant to state law. On the same day the husband received his intestate share he gave it to the son's three children. The gift tax on this transfer was less than the amount of estate tax saved by obtaining the marital deduction for the estate. The Commissioner, in disallowing the marital deduction, said the gift to the children made the husband's election a nullity. In holding for the estate and allowing the marital deduction, the court found that the proper election was in fact made and that the ultimate disposition was actually different from that provided in the will. The court made no decision as to the result if the husband had given the property to his son (so that the ultimate disposition was the same as the will directed) rather than to his grandchildren. Therefore, in spite of the Commissioner's acquiescence in this decision, it may not be advisable for the surviving spouse to immediately transfer the property, received as a result of the election, to beneficiaries named in the will.[67] Of course, the transaction will be doomed from the beginning if there existed a contractual agreement with the surviving spouse to transfer the property to others. In this situation the spouse's

66. 39 T.C. 511 (1962).
67. 1963-2 CUM. BULL. 4.

interest in the property would be regarded as a terminable interest which would not qualify for the marital deduction.

E. *Payment of Estate Tax*

Section 2002 of the Internal Revenue Code provides that the estate tax shall be paid by the executor. Beyond this, the manner in which the tax burden is distributed is left to local law; therefore, the effect of the payment of the tax upon the beneficiaries will vary in different jurisdictions. There will often arise a question as to the effect of a contest or compromise upon the payment of both the federal estate tax and state inheritance taxes. A detailed discussion of the varying application of the local law in each state is beyond the scope of this article. However, a few examples should be mentioned in order to point out the widely differing results in various jurisdictions.

Local law may provide that death costs are to be paid out of the residuary estate, unless the decedent expresses a different intent. Other states have adopted acts which apportion the tax among the various items which contribute to the tax. The terms of the apportionment act or other applicable local law must be examined to determine the distribution of the tax load when there has been a compromise under which the assets are not distributed according to the will. The solution may depend upon whether the state law regards the property as passing to the takers under the will and then to the claimants, or as passing directly to the takers under the compromise.

In *Pulliam v. Thrash*[68] a North Carolina court held that an inheritance tax was properly assessed against the three devisees named in the will even though the property was divided among four people as a result of a compromise agreement. On the other hand, a Maryland court in *Hart v. Mercantile Trust Co.*[69] applied the state inheritance tax as though the will had given the property initially to those who took under the compromise agreement. These cases indicate the lack of conformity in local law with respect to the apportionment of certain taxes upon the compromise of a will contest. The parties to a dispute must consult the law in their own jurisdiction to determine the net result of any proposed settlement.

IV. COMPROMISE AFTER DISTRIBUTION OF ASSETS

A. *Special Statute of Limitations Considerations*

Obviously, consideration of the statutes of limitations is not restricted to circumstances involving a compromise after the distribution of estate assets. However, the compromise after distribution is more likely to be

68. 245 N.C. 636, 97 S.E.2d 253 (1957); *see also* Hasting v. Unander, 224 Ore. 165, 355 P.2d 738 (1960).
69. 180 Md. 218, 23 A.2d 682 (1941).

affected by the statute of limitations than the compromise before distribution simply because it is more likely to occur near the end or after the period of limitations has run.

For income tax purposes, the use of section 1311 for making adjustments in closed years will be rather limited when adjustments are required by the compromise. The circumstances of adjustment defined in section 1312(5) will provide for the proper adjustments between the estate or trust and the beneficiaries, heirs, and legatees. However, no provision seems to be available to reopen closed years when the adjustment is between two beneficiaries since the claimant and the beneficiary will not fall within any of the groups of related taxpayers in section 1313(c). Therefore, the beneficiary will normally have to rely upon other means of adjustment, such as the claim of right doctrine which is discussed later in this article.

B. *Statute of Limitations on Assessments*

The parties to the compromise should also be aware of the statute of limitations with respect to assessments and filing claims for refunds. This could be especially important if the compromise will result in an increase or reduction of either the marital or charitable deductions. The basic provision of limitations on assessments, found in section 6501, provides for assessment within three years after the return is filed, or from the last day allowed for filing if an early return is filed. This three-year period is extended to six years if the taxpayer omits from the gross estate items which exceed 25 percent of the gross estate stated on the return. This possibility of newly discovered assets extending the normal three year period of limitations will probably not be encountered too often, but the persons upon whom state law places the burden of the additional taxes should be aware of the consequences. Section 6501(c)(4) provides for an agreement to extend the period for assessment, but it specifically excludes estate taxes from its coverage. The running of the statute of limitations will be suspended by section 6503 if a 90-day letter is mailed during the period in which the Secretary is prohibited from making an assessment, and for 60 days thereafter. Therefore, a timely mailing of a 90-day letter will give the Commissioner additional time to assess a deficiency. Thus, if the compromise results in a reduction of estate deductions, the parties must be prepared to pay an additional assessment within the statutory period.

Section 2016 provides an important exception to the section 6501 period of limitations on assessment. If the executor or any other person recovers any state or foreign death taxes which were claimed as credits under sections 2011 or 2014, he must notify the Commissioner. Any federal estate tax found to be due as a result of the refund is payable by the person or persons receiving it upon notice and demand, even though

the refund is received after expiration of the period of limitations set forth in section 6501.

C. *Statute of Limitations on Claims for Refund*

If, on the other hand, the compromise would result in a reduction of estate taxes due to an increase in the marital or charitable deduction, the limitations on the period for filing a claim for refunds will be important if the estate tax has already been paid. In general, section 6511 requires a claim for refund to be filed within three years from the date the return was filed or two years from the time the tax is paid, whichever is later. If the claim for refund is disallowed, section 6532(a) requires that suit be filed within two years of the date of the disallowance. The Supreme Court, in *Flora v. United States*,[70] held that full payment of the tax assessed is a jurisdictional prerequisite to a suit for refund. This decision appears to place the taxpayer in a difficult position if the tax has not yet been fully paid, because of an election to pay a part of the tax over a ten-year period, as provided by sections 6161 or 6166. If the taxpayer waits ten years, until the tax is paid, it will be too late to file a claim for refund under section 6511. If he files a timely claim for refund, which the Commissioner denies, the two-year period for filing a suit for refund provided by section 6532(a) will expire before the total tax is paid, since *Flora* requires full payment as a prerequisite to jurisdiction. It appears that the taxpayer in this situation is faced with the possibility of losing a refund to which he is righfully entitled if he is not able to pay the full amount of tax originally due. There seems to be no statutory provision which permits him to ignore the *Flora* rule and sue before full payment is made. It may be possible for the taxpayer to file a timely protective claim for refund and request the Internal Revenue Service to postpone action upon it until the tax has been paid, since the two-year period of section 6532(a) begins when the claim is disallowed. Postponement of the disallowance would enable the taxpayer to pay during the extended period available. Section 6532(a)(2) provides for a written extension of the two-year period for filing suit, and in this situation the Secretary should agree. Since the Code itself contemplates the payment of estate taxes over a period of years, this alone might justify an exception to the *Flora* rule if the Commissioner refuses to extend the time for filing suit. However, there is not yet any authority for such an exception.

D. *The Tax Effect in General*

The parties cannot be certain how the status of the claim and the terms of the compromise will affect the tax consequences of a compromise agreement when the payment is made by the distributees, rather than the estate. Will the principle of *Lyeth v. Hoey* be as applicable to a com-

70. 362 U.S. 145 (1960).

promise after the distribution of assets by the estate as it would be prior to such distribution? If a settlement would have been considered a section 102(b) bequest or gift of income if distributed by the estate, perhaps the same characterization should attach to the settlement after distribution. If the claimant receives a payment from a beneficiary which the agreement characterizes as part principal and part income there is justification for taxing him on that basis. However, the taxpayers must remember that many times the courts have expressed a willingness to look beyond the wording of an agreement, ignoring the formalism, in order to determine what really occurred in the transaction and tax the parties accordingly. For example, if the compromise is actually a scheme to disguise an assignment of income the agreement might properly be ignored.

Even if the agreement calls for the payment of a lump sum, without any attempt to characterize the property transferred, the proper tax treatment is not always clear. If the estate is terminated there can be no current D.N.I. to create taxable income upon receipt. But what regard should be given to previous D.N.I. which may have been allocated to the property upon its initial distribution from the estate to the beneficiary now giving up the property? An example of this problem might be illustrated as follows: beneficiary *A* received property from the estate worth $100 at a time when $50 of D.N.I. was allocated to the distribution. *A* would pay a tax on $50 of income. Suppose now, claimant *C* appears and asserts a claim to the property, and this claim is successfully litigated in court. What tax effect would the transfer of the property have on *A* and *C*? Should *C* be permitted to claim the entire $100 value of the property received as a tax exempt bequest since it was received in a lump sum award and there was no D.N.I. present at the time? Clearly, he would have had $50 of taxable income if he had received the property from the estate if it had been originally distributed to him instead of *A*. Beneficiary *A* would have paid the tax on $50 upon receipt of the property which he no longer has, thus he should be entitled to an adjustment. If after an adjustment for *A*, claimant *C* is permitted to receive the property tax free the $50 of D.N.I. allocable to the property would escape taxation. On the other hand, it might be argued that the first error, which resulted from the improper distribution to *A*, does not justify a second erroneous application of the statute in an attempt to rectify the original mistake.

Would it be an unreasonable extension of *Lyeth v. Hoey* to deem the receipt of the property to relate back to the will, or if the decedent died intestate back to the date of death or original distribution from the estate? If this idea was applied to the above example we could reasonably maintain that the D.N.I. which followed the property to beneficiary *A* would be allocated to the claimant as if he had received the property by distribution from the estate. Thus, there would be no income escaping taxation, and if accompanied by a proper adjustment to *A* for the taxes he had paid, the parties would be placed in essentially the same position

they would have been had the proper distribution been made in the first place. Some support for the relation back principle in general is illustrated in *Emanuelson v. United States*.[71] There, a dispute between charitable and non-charitable legatees was settled in 1950. The compromise gave the charities a portion of the estate and its income for the years 1949 and 1950. The Commissioner denied the estate a charitable deduction for the 1949 income which went to the charity under the 1950 agreement. He asserted that this income could not qualify under the statute as "paid or permanently set aside" for charitable purposes "during the tax year."[72] The government said that the charitable disposition must have been operative at the time the income occurred and the "paid or permanently set aside" feature must have been currently applicable. The court allowed the deduction for the 1949 income, holding that the compromise agreement relates back to the time of probate of the will. To treat it otherwise would ignore the principle that the compromise agreement takes the place of the will.

Even the relation back idea would not always provide a satisfactory adjustment in all situations. For example, the compromise might result in a distribution of property which would have altered the amount of the marital or charitable deductions allowable for estate tax purposes had the conflict been settled before the statute of limitations on assessment or claim for refund of estate taxes had run. There is no authority available which would authorize the reopening of the closed years in this situation. However, the relation back principle could still be useful in reallocating the burden of the payment of the taxes among the beneficiaries, conforming with the redistribution of the property as a result of the compromise.

E. *Adjustment for Original Distributees*

The beneficiaries giving up the property will usually be entitled to some income tax relief as a result of the compromise. The Regulations for subchapter J, when discussing the operation of the second tier distributions, use the word "properly" distributed to a beneficiary, without any mention of the result when a distribution is improperly made. (Such as when the executor distributes to one beneficiary more than his share of the estate.) It appears that such a distribution would be outside subchapter J and would not be included in the second tier computation of the beneficiaries' taxes. The fact that such distribution was improper may not be known until the claim is asserted. In these cases, it appears that the beneficiaries giving up the property may use the "claim of right doctrine" to obtain an adjustment in the year of payment.[73] The adjustment would provide a deduction to offset the income he was required to include in the

71. 159 F. Supp. 34 (D. Conn. 1958).
72. INT. REV. CODE OF 1939 § 162(a), now found in § 642(c) of the 1954 CODE.
73. Martin R. Bowen, 34 T.C. 222 (1960), *aff'd per curiam*, 295 F.2d 816 (2d Cir. 1961).

earlier year. If the beneficiary meets the statutory requirements of section 1341, the alternative relief provisions of that statutory claim of right section are available.[74] Since the claim of right allows the adjustment in the year of repayment, the beneficiary may want to go back and file amended returns, if the year of erroneous inclusion of income is not closed by the statute of limitations. If the beneficiary must rely upon the claim of right doctrine for relief because the statute of limitations prevents an amended return, the deduction allowable in the year of payment could be lost if the beneficiary had no income in the year of repayment against which the deduction would apply.[75]

F. *Section 642(h) Deductions*

If the recovery of the claimant relates back to provide him a portion of any section 642(h) deductions which were allowed to the beneficiary in the year the estate was terminated, the tax adjustments may not be balanced. If the claimant is allowed the benefit of his share of the section 642(h) excess deductions, the Commissioner should be able to go back and assert a deficiency against the original beneficiary who claimed the deductions, if the tax year involved is still open. As a result of the two adjustments, both the claimant and the original recipient of the property are placed in approximately the same position as they would have been had the proper distribution been made in the first place. If the statute of limitations has closed the year, it appears doubtful that the tax benefit doctrine within section 111 should be available to the Commissioner. The reallocation of the excess deductions in a will compromise does not fit within the definition of a recovery of bad debts, prior taxes, or delinquency amounts. Section 1.111-(a), of the Regulations, applies the tax benefit rules of this section to all "losses, expenditures, and accruals" which were deducted in earlier years. Whether an extension of the section 111 language would apply to tax the original beneficiary on the benefit he received by claiming a deduction to which he is not entitled is not clear. At least one case, *Streckfus Steamers, Inc.*,[76] held that the tax benefit doctrine of section 111 applied only to recovery of a deduction properly allowed. While this case did not involve a will contest, it may indicate that a section 642(h) deduction which was improperly taken would not enable the Commissioner to later include the tax benefit received in the beneficiary's income. If this is the case, the relation back principle would seem to permit a double section 642(h) deduction when the settlement occurs after the statute of limitations for assessment has run on the original beneficiary's year of deduction. This is certainly not the result which the relation back idea is designed to provide. It might be suggested, how-

74. *See also* Berarducci, *Repayment of Claim of Right Income By an Estate Under Section 1341*, 69 DICK. L. REV. 56 (1964).
75. Phillips v. Commissioner, 262 F.2d 668 (9th Cir. 1959).
76. 19 T.C. 1 (1952).

ever, that with a tax structure as complex as ours it would be almost impossible to eliminate every loophole or inequity.

The Commissioner will also not be able to rely upon section 6501(e)(1) to extend the statute of limitations on assessment from three to six years, since this section operates only when there has been an omission from gross income, and deductions may be overstated in any amount without incurring the extension provided by the statute. This area of the law is not yet well developed with respect to will contests. Section 642(h) was not added to the Code until 1954, and there are no cases which deal with the adjustment of taxes in this situation.

V. Executor's and Transferee's Liability

The executor should be aware of the extent of his personal liability for the payment of taxes, especially if the compromise is one which will result in additional taxes to the estate.[77] Section 6901(a)(1)(B) refers to 31 U.S.C., section 192 for the determination of the fiduciaries' liability. Under section 192, an executor who pays the decedent's other debts before he satisfies the debts due the United States from such person or estate shall become answerable in his own person to the extent of such payments for the debts due the United States, or for the amount which remains unpaid. Section 20.2002-1 of the Regulations, which discusses 31 U.S.C., section 192, indicates that the word "debt" includes a beneficiary's distributive share of the estate. If the executor is not certain that he will retain enough property after a distribution to pay the taxes due, he should protect himself by requiring the distributees to furnish a bond with surety. This liability applies only if the fiduciary has personal knowledge of the unpaid tax liability or possesses such knowledge as would put a reasonable man on inquiry.[78] The executor in a will compromise would certainly be put on notice of the possible tax consequences to the estate which would arise as a result of the compromise.

The discharge of the executor by the probate court does not terminate his liability. If he is subjected to personal liability as a result of a distribution, he may compel reimbursement from the distributees. The executor may wish to take advantage of section 6501(d) to shorten the assessment and collection period. The effect of the request for prompt assessment, as provided by this section, is to require the assessment of any tax or proceeding in court without assessment, to be begun within eighteen months from the date the request is received. This will not operate to give the Commissioner more than the normal three-year period for assessment. It is important to note, however, that in the case of the liability of a fiduciary, section 6901(c)(4) provides that the period of limitation extends for one year after the liability arises, or after the ex-

77. *See* Cohen, *Transferee Liability Under The Internal Revenue Code*, 10 Tax Coun. Q. 247 (1966).

78. Rev. Rul. 66-43, 1966-1 Cum. Bull. 291.

piration of the period for the collection of the tax, whichever is the later. Thus the executor's liability could extend beyond the period of limitations on assessment against the estate.

Section 6901 also deals with the claimant's liability as a transferee. In the case of a transferee, assessment must be made within one year after expiration of the period of limitation for assessment against the transferor. If the estate's inability to pay the taxes due arises out of the personal representative's failure to observe the proper priority of payment, the Commissioner has the election to go against the fiduciary under 31 U.S.C., section 192, or against the beneficiary under section 6901, or he may invoke both remedies if necessary to collect the tax.

If the contest and compromise arise after the section 2204 discharge of the executor, he is protected from further claims which may arise as a result of the settlement. However, the claimant and other beneficiaries will not be relieved of liability, and the Commissioner can still assess a deficiency against them within the statutory period.

VI. Treatment of Attorneys' Fees Arising out of the Contest

A. *The Claimant—Beneficiaries*

The nature of the claim upon which the compromise is based will probably be the most important factor in determining the availability of a section 212 deduction for attorney's fees. Generally, if the property received in compromise is characterized as income, a deduction will be allowed for the expenses incurred for the production or collection of income. On the other hand, expenses incurred in obtaining a section 102(a) tax-exempt bequest or inheritance will not be deductible. It would seem to make no difference whether the dispute involved an outside claimant or was merely a disagreement among beneficiaries named in the will. The Commissioner will certainly contend such expenses were incurred in defending or perfecting one's title to property and thus are not allowable as a deduction. If the expenses arise out of an attempt to acquire an inheritance under the laws of intestate succession, they are considered capital in nature and are not deductible.[79] The same results should follow from attempts to acquire property as a legatee under a prior will or as the dower interest of a surviving spouse.

It is not always easy to decide when a court will determine an expense as one which is to perfect title to property (and not deductible) or an expense of conservation of property held for income (thus deductible). The cases are decided upon factual questions, and no clear distinction can be drawn beyond the fact situations in each case.[80] If the claimant incurs

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79. Bliss v. United States, 373 F.2d 936 (Ct. Cl. 1967).

80. *See generally* E. W. Brown, Jr., 19 T.C. 87 (1952), *aff'd*, 215 F.2d 697 (5th Cir. 1954); Garrett v. Crenshaw, 196 F.2d 185 (4th Cir. 1952); Frederich Rowe, 24 T.C. 382 (1955).

expenses in obtaining title to income-producing property, the expenses are still capital in nature and are not deductible as cost incurred for the production of income, nor for the conservation of income-producing property, since he did not have prior title to the property.[81]

When the claimant is entitled to a deduction for expenses incurred, often he will not be able to obtain full benefit of the deduction. In *Walter F. O'Brien*,[82] the taxpayer filed a claim for recovery of salary. He received $16,000 and paid his attorney one half. He was required to treat the entire $16,000 as back pay and used section 1301 to spread back the income. The court denied his attempt to spread back the attorney's fees and held that they must be deducted in full in the year they were paid. The court agreed with the equity of the taxpayer's position but pointed out there is no provision for spreading back the related expenses. The court also denied his claim that he should only include $8,000 in income since this is what he actually received. In holding that the full amount was includable, the court stressed the state law which appeared to give the attorney no claim on the judgement. Thus, with income of less than $8,000 in the year of recovery, the excess deduction above the available income was lost. This case did not involve a will contest, but it clearly illustrates the type of problem which might arise.

In *Cotnam v. Commissioner*,[83] the court relied upon local law to exclude the attorney's fee from the claimant's income. There a contingent fee arrangement, under Alabama law, gave the attorney a right to the fee in the manner of an assignment of a portion of the claim. With regard to this portion of the recovery, the attorney had the same rights as the client, and the taxpayer could not have gotten this amount. Thus the attorney's portion of the recovery (his contingent fee) was not included in the claimant's income. This application solves the bunching of deductions problem which was present in the *O'Brien* case.

The Tax Court has not followed the Fifth Circuit in *Cotnam* and distinguishes the case on its facts. It continues to follow *O'Brien* in requiring the entire recovery to be included in income.[84] In *Walter Petersen*,[85] another contingent fee case, the Tax Court distinguished *Cotnam* on the basis of local law and held that the attorney's fees were not a reduction of the amount received by the taxpayer. In *Petersen*, even though the Nebraska attorney has a lien upon the money in the hands of an adverse party, such provisions differed from Alabama law in that they do not provide the attorney with the same power over suit and judgments as his client has. It seems that the Tax Court needs only a small variance from the Alabama law to distinguish *Cotnam*.

81. James W. Hofstead, 31 P-H TAX CT. MEM. 1405 (1962).
82. 38 T.C. 707 (1962).
83. 263 F.2d 119 (5th Cir. 1959).
84. T. Michael Smith, 36 P-H TAX CT. MEM. 1116 (1967).
85. 38 T.C. 137 (1962).

B. *The Estate's Expenses*

Administrative expenses allowable under state law will constitute an estate deduction under section 2053. This statutory reliance upon state law makes it easier for the estate to deduct attorney's fees, especially when the expenses are approved by the local probate court. In *Sussman v. United States*,[86] for example, the daughter contested her father's will and, in compromise, received one-half the residue of the estate. The agreement also provided that her attorney's fees were to be paid by the estate. The probate court allowed the payment as an administrative expense. The court held that since the state law was not clearly contrary to the probate court's holding, the deduction should be allowed.

Section 20.2053-3(c)(3) of the Regulations indicates that the attorney's fees incurred by beneficiaries, incident to litigation as to their respective interests, do not constitute proper deductions, inasmuch as these expenses are incurred on behalf of the beneficiaries personally. The holding in the *Sussman* case seems directly contrary to this regulation, but the fact that the probate court approved the payment seems sufficient to make the expense deductible. It seems, therefore, that it would be wise to seek the court's approval of the compromise agreement and expenses paid by the estate thereunder. As costs of administration under local law, such expenses are clearly deductible.[87]

VII. CONCLUSION

The application of *Lyeth v. Hoey* will characterize a claim and compromise settlement. This characterization, and the relation back principle, are determinative factors in ascertaining the resulting tax consequences. Both the claimant and the estate must consider the entire range of tax considerations in order to negotiate most effectively, and the application of state law in the federal courts should be considered. The ultimate application of the federal tax laws to the compromise may not be clearly predictable in each individual instance, but the general rules which have been established should provide the parties an adequate framework within which to operate.

86. 236 F. Supp. 507 (E.D.N.Y. 1962).

87. *See* Estate of Minnie S. Pridemore, 30 P-H TAX CT. MEM. 59 (1961).