Tax Treatment of Will Contest Recoveries

By Robert W. Wood[1]

I. INTRODUCTION

The tax treatment of the full panoply of litigation recoveries, whether received by way of settlement or pursuant to the payment of a judgment, has undergone increasing scrutiny both among litigators and tax professionals. To a far greater extent than in the past, parties to a lawsuit, both plaintiffs and defendants, are now increasingly cognizant of the tax rules that can spell radical swings in the success or failure of litigation. The income tax rules that apply to a payment can have an enormous impact on the litigation itself. The payment of a settlement or a judgment can be of radically different magnitude if it: (a) is fully deductible against ordinary income; (b) must be capitalized and amortized over a number of years; or (c) is nondeductible as a personal expense or as a fine or penalty. The same range of possibilities and consequent affects on the success of the recovery may exist in the case of the plaintiff's tax treatment. The plaintiff may receive a recovery: (a) totally tax-free; (b) as ordinary income; (c) as capital gain; (d) as wages; (e) as a recovery of capital or basis; or (f) as a combination of all of these items.

One particular niche which has garnered surprisingly little attention is the tax treatment of will contest recoveries. An estate's distribution of property to its beneficiaries generally does not result in taxable income to the beneficiaries. The same is true for settlement amounts paid to contesting beneficiaries of an estate.[2] The major exception to this rule applies to so-called "income in respect of a decedent," a topic addressed at the end of this article.

II. COMPENSATION v. INHERITANCE?

The primary line that is litigated concerning the tax aspects of will contests is between inheritance and the amorphous and overarching concept of gross income. It is axiomatic that gross income includes income derived from all sources.[3] Yet, where a litigant in a will contest receives money or property in compromise of a claim as an heir, the receipt is held to be exempt from tax, even though under state law the money or property might not be regarded as received by inheritance for other purposes.[4] Apparently it does not matter whether or not the plaintiff's asserted claim as an heir of the estate is well supported. If a settlement is reached, notwithstanding relatively shaky grounds of heirship, the recoveries are typically held nontaxable.[5]

Recently the Service ruled in Letter Ruling 200137031[6] that proceeds received in settlement of a woman's claim against her husband's estate are excludable from her gross income as an inheritance under section 102(a). The husband and wife contracted with an individual to manage their business for life. The manager agreed to a significant salary reduction in return for the couple's promise to make reciprocal wills conveying the business, after the couple's death, to the manager's wife. The couple agreed to pay the manager a lump sum on his involuntary termination.

After his wife died, the husband fired the manager, and paid for the release of the manager's causes of action. The husband then sold the business to a third party and the manager's wife filed suit against the husband. The manager's wife pleaded alternative causes of action, claiming that she had a cause of action for breach of contract and that she asserted her rights as a third party beneficiary of the contract between the couple and the manager. Before the suit was tried, the husband died. The executor and wife settled and the estate agreed to pay the manager's wife.

The Service noted that if the manager's wife had received the business under the husband's will in satisfaction of the promise, she would have received the property by inheritance. In the Service's view, the receipt of the settlement proceeds from the estate should be treated the same as if the will had been prepared as promised. Thus, the Service ruled that the proceeds received by the manager's wife in settlement of her claim against the husband's estate are excludable from her gross income under section 102(a) as a gift or inheritance.

Suppose a lawsuit makes claims for compensatory damages, as well as for amounts to recompense the plaintiff for having been overlooked as an heir? Here, the compensatory damages will have to be analyzed. In one case, a settlement amount was allocated between the claimants' interest as overlooked heirs of an estate and their interest in compensatory damages for lost income from a partnership.[7]

The most widely known case in this area involved the eldest son of J. Paul Getty. In *Getty v. Commissioner*,[8] J. Ronald Getty's $10 million lump-sum settlement of a lawsuit against competing beneficiaries of J. Paul Getty's will was held not to be taxable. The Ninth Circuit Court of Appeals found that the money was excludable from Getty's income under Section 102(a) of the Internal Revenue Code as property acquired by gift, bequest, devise or inheritance.

J. Ronald Getty had been the beneficiary of an irrevocable trust established in 1934 by J. Paul Getty and J. Paul Getty's mother to provide income to J. Paul for life, and then to his children or their descendants. The trust provided that on the death of J. Paul Getty, the income would be paid annually $9,000 to each of Ronald's three half brothers, $3,000 to Ronald, with the remainder payable equally to all the brothers except for Ronald. The trust was to terminate on

the death of J. Paul Getty's last surviving son, the corpus to be divided equally among all the grandchildren (including Ronald's children).

J. Paul's mother apparently attempted to remedy the disparity, and J. Paul assured Ronald that the inequality would be eliminated. However, he died in 1976 without amending the terms of the trust. Ronald was named as one of the three executor's of the will and collected almost $4 million in fees. The will also awarded him 2,000 shares of Getty Oil stock (worth more than $300,000), plus a life interest in a home in Italy. The other brothers received nominal bequests, and none received any stock. The remainder of the estate went to the Getty Museum. At the time of J. Paul Getty's death, the assets of the trust were valued at $1.3 billion, which was distributed to the beneficiaries. Ronald received $3,000 from the trust.

Ronald filed suit in 1979 against the Getty Museum, seeking an amount equal to the amount he and his children would have received from the trust between the time of J. Paul Getty's death and the termination of the trust had he carried out his promise. In 1980, the trustees of the Museum entered into a settlement agreement under which Ronald would receive $10 million in exchange for dropping the suit. Ronald did not report the $10 million on his 1980 tax return.

When the IRS assessed a deficiency, Ronald argued that the money was excludable under Section 102(a) as property acquired by gift, bequest, devise or inheritance. The IRS, on the other hand, contended that Ronald's claim was for income from property and was consequently not excludable.[9] The IRS noted that Ronald had alleged that J. Paul promised to provide income to Ronald in his will equal to the income of the other children received from the trust. The Tax Court agreed with this approach, upholding the IRS' assessment of a deficiency.

The Ninth Circuit reversed, however, holding that the settlement money qualified for exclusion. The Ninth Circuit viewed Ronald's claim broadly, finding the complaint could be viewed as a claim for assets from J. Paul Getty's estate in an amount equal to the amount received by the other children. The Ninth Circuit indicated that the proceeds of the settlement did not need to be clearly classifiable as either property or income from property, and thus rejected a rigid approach based upon such classifications. Indeed, the Ninth Circuit stated that it was not necessary for Ronald to establish that J. Paul would have fulfilled his promise with a bequest of property. The fact that J. Paul Getty probably would have made a property bequest to satisfy the claims was sufficient to allow Ronald to exclude the $10 million from his gross income under Section 102(a).

In *Arthur Donn Vincent v. Commissioner*,[10] the Tax Court considered the appropriate tax treatment of a settlement received in connection with a disputed gift. Vincent's father and stepmother had received title to real property as joint tenants in 1968. In 1978, Vincent's father executed a grant deed purporting to deed the property to Vincent. The deed was signed by Vincent's father and notarized, and was recorded in 1980.

Vincent's father died in 1980, and shortly thereafter, Vincent's stepmother filed a complaint against Vincent to set aside the 1978 deed. Vincent filed a cross-complaint against his stepmother, alleging that he had acquired an undivided half-interest in the property pursuant to the 1978 deed. In 1983 this suit was settled, with Vincent's stepmother agreeing to pay Vincent $390,000. The settlement agreement stated that the 1978 deed was null and void, and specified that the payment to Vincent was in lieu of any inherited interest in the property. The agreement provided that Vincent's stepmother would pay all federal estate and gift taxes as well as California inheritance and gift taxes. As of the date of death of Vincent's father, the property in dispute was appraised at $1,275,000.

Although Vincent received the $390,000 in 1983, he did not include the amount in his 1983 income tax return. The IRS asserted a deficiency, arguing that the entire recovery was includable as ordinary income received as a nuisance settlement of an unrecognized claim to property. In Tax Court, Vincent argued that the amount was excludable under Section 102 as a payment in lieu of a gift or inheritance.

The Tax Court agreed with this notion, holding that the settlement represented property acquired by gift or inheritance. The court referred to the origin of the claims doctrine, noting that here the origin and character of the litigation arose out of a dispute as to the validity of a gratuitous transfer of property to Vincent from his father. Interestingly, the court in *Vincent* specifically referred to the language of the settlement agreement in reaching its conclusion. The court noted that the settlement agreement stated the payment was "in lieu and instead of any inherited interest." This suggests that language in the settlement agreement will be accorded some level of respect by the courts.

In *Huntington Estate v. Commissioner*,[11] a payment made in settlement of a suit brought by the stepsons of a decedent to enforce an alleged agreement between the decedent and her husband to execute reciprocal wills was held not to be a deductible claim against the estate. The estate was not able to deduct the payment because mere donative intent was not adequate consideration for purposes of the deduction. The fact that the agreement to make the wills was enforceable under applicable state law was irrelevant. The court held that the settlement was, in effect, a payment in the nature of an inheritance rather than a claim against the estate.[12] The problem of gift tax liability is well illustrated by Letter Ruling 9304015. There, a Rhode Island resident under a legal guardianship died without a will. He had executed a will in 1941, and then another one in 1982, amending that will in both 1984 and 1986. In 1986, the guardian petitioned the court for authorization to make annual $10,000 gifts to various family members. The ward's daughter objected on the grounds that she or her issue were the presumptive legatees and should inherit the bulk of the estate.

To avoid litigation and to allow the gift program to go forward, a settlement was reached and approved by the court

under which a $750,000 trust was established for the daughter and her family. The family disclaimed any other interest. The IRS ruled that the settlement was a gratuitous transfer subject to the gift tax. According to the IRS, the family only had a tenuous right in the decedent's estate under the 1941 will. Of course, because the transfer was considered a gift subject to gift tax, the IRS also ruled that it did not constitute income to the recipients.

In *Nancy C. Roberts v. Commissioner*,[13] a woman caring for an aging man was promised a substantial sum upon his death. She sued for breach of contract, and after her death, her executors settled the suit for $50,000. The IRS determined that the settlement was taxable income to the now-deceased woman. The executor of her estate argued in Tax Court that the $50,000 was received as a bequest or inheritance. The Tax Court agreed, noting that the woman's primary claim against the estate was for breach of contract with respect to a will.

Finally, in *M. Bennett Marcus, et ux. v. Commissioner*,[14] the Tax Court held that part of the net proceeds from the sale of property received by a woman was received by her in lieu of an inheritance and in settlement of claims against her stepfather's estate. Accordingly, the Tax Court held this amount to be excludable from her gross income. There were somewhat complicated facts in the case, with the taxpayer entering into an agreement with her sisters in respect of some items. Ultimately, however, the Tax Court was able to point to the IRS since the IRS had actually admitted in its pleadings that the sisters had agreed to pay the taxpayer from the net proceeds as a substitute for a bequest of property. Thus, the language of the agreement between the sisters was given significant weight, even if it was not considered controlling.

III. WHEN WILL CONTEST RECOVERIES ARE TAXABLE

Although the general rule is that a compromise of a will contest will result in nontaxable recovery, there have been some circumstances in which this rule has not been applied. In *Edwards v. Commissioner*,[15] a widow compromised her claim against her husband's estate based upon a widow statute in exchange for a promise of monthly payments. The payments were from the income of an irrevocable *inter vivos* spendthrift trust which had been set up by her husband. The court held that the monthly payments were taxable to the widow because the primary responsibility for payments came from trust income.

In a similar case, *Harrison v. Commissioner*,[16] a widow settled her claim with a residuary legatee, an educational institution. The educational institution paid her $100,000 plus $21,000 in interest. Although the $100,000 was held nontaxable, the interest was held taxable either as distributions in lieu of income from the trust, or as interest.

Another interesting case litigating the line between taxable income and excludable will contest settlement proceeds is *Quigley v. Commissioner*.[17] In that case, the taxpayer threatened to contest the will, but dropped the threat upon reaching an agreement under which the taxpayer's brothers would pay an amount out of the annual net income of their trusts. Despite the income nature of the payment, the court held that the claim was based upon the taxpayer's right as an heir. The court did require that the taxpayer show the value of the right she surrendered in order to receive the settlement, in effect requiring a showing that she did not realize a taxable gain.

In *C. Anson Garrett v. Commissioner*,[18] the Tax Court considered a determination by the IRS that an individual had received income on a settlement with a trustee. The facts surrounding the creation of the trust are somewhat complicated. A family trust was established in which the taxpayer, Anson Garrett, had an interest. However, the taxpayer was indebted to his mother's estate (the mother had established the trust) in an amount in excess of his share of the estimated residuary estate. Consequently, the taxpayer requested that his share of the residuary estate be applied against this obligation, and that the trustee loan him funds necessary to pay the remainder of the obligation. The taxpayer and the bank/trustee reached an agreement which provided that the bank/trustee would be paid out of the taxpayer's interest in income from the trust. When one of the principal trust assets became worthless, the taxpayer sued the bank for mismanaging the trust's assets. Eventually, the taxpayer and various other family members settled with the bank. The bank agreed to pay the taxpayer and his children a cash lump sum, to release its interest in an insurance policy on the taxpayer's life, to dismiss its counterclaim against the taxpayer for the unpaid balance of the loan from the trust, and to pay all death or estate taxes relating to the taxpayer's mother.

On his 1988 individual income tax return, the taxpayer did not allocate any portion of the net proceeds he claimed he received from the sale of his income interest in the trust for the settlement of his lawsuits against the bank. The IRS determined that the taxpayer received gross income in the form of settlement proceeds and forgiveness of indebtedness income (stemming from the loan from the trust). The taxpayer and the IRS argued about whether the taxpayer had realized gain in excess of his basis from the sale of his beneficial interest in the trust. The taxpayer also argued that any gain he may have realized was excludable under Section 102(a) as having been received in lieu of inheritance, or under Section 104(a)(2) on account of personal injury. He also argued that he did not receive any discharge of indebtedness income.

The Tax Court held that the taxpayer had to recognize gain on a relinquishment of his beneficial interest in the trust in the settlement with the bank. The Court also held that the taxpayer need not include in gross income as a transferee a share of the estate tax assumed by the bank in the settlement. However, the court rejected Garrett's attempt to exclude his gain under Section 102, concluding that he had received the amounts at issue in settlement of a contract claim against the bank rather than in lieu of inheritance. Likewise, the court found no support for Garrett's contention that he received

amounts on account of personal injury. Finally, the Tax Court sustained the IRS' determination that Garrett received discharge of indebtedness income upon the bank's release of his liability on the loan from the trust.[19]

Periodic Payments. Where annual installments are paid under a settlement arrangement, all or a portion of the annual installments are likely to be viewed as interest income.[20] However, this is not always the case. Indeed, periodic payments which result from the settlement of a will contest have occasionally been held nontaxable. In *Lydia Hopkins v. Commissioner*,[21] the taxpayer agreed not to contest her father's will in exchange for payments by the taxpayer's mother of $1,000 monthly during the mother's life and $2,000 monthly thereafter. Despite the periodic nature of the payments, the agreement was viewed as capital, creating an indebtedness of determinable value, so that the payments could be excluded from income. Of course, favorable results such as that obtained in *Lydia Hopkins* should not be counted on.

IV. COMPENSATION VS. WILL CONTEST RECOVERY

Occasionally, an amount received by a person in a will contest may be viewed as compensation income. For example, in one case a woman filed suit against the estate of her boyfriend for the value of "wifely" services she rendered to the decedent during his lifetime. The settlement amount she received was held to be in the nature of compensation, and therefore taxable, rather than in the nature of a recovery for a gift, bequest, devise or inheritance.[22] In *Mertz v. Hickey*,[23] the taxpayer and another legatee jointly contested a will, each receiving a settlement. After the settlement, the taxpayer received an additional amount from the other legatee (his co-plaintiff) representing his part of the legal fees. Although the settlement in the will contest was held nontaxable, the additional amount designed to compensate for attorney's fees was held to constitute taxable income.

V. INCOME IN RESPECT OF A DECEDENT

Certain amounts received upon the death of a decedent may be classified as income in respect of a decedent under Internal Revenue Code Section 691, and therefore taxable. The same can be said for amounts received by a litigant in a will contest, if they may be traced to items that would otherwise constitute income in respect of a decedent.

The term "income in respect of a decedent" generally refers to those amounts to which a decedent was entitled as gross income, but which were not properly includable in his taxable income for the tax year ending with the date of his death, or for a previous taxable year.[24] In other words, if a beneficiary receives a right to income from a decedent's estate, that income will be taxable to the recipient notwithstanding the ordinary rule that distributions from a decedent's estate are nontaxable.

The regulations under Section 691 of the Internal Revenue Code describe in detail what is meant by the term "income in respect of a decedent," and the situations to which it applies.[25]For example, if a widow acquires a right to receive renewal commissions on life insurance policies sold by the decedent, the commissions received by the widow would be includable in her gross income.[26] The character of gross income received as income in respect of a decedent is also generally determined by reference to the character the income would have had in the hands of the decedent had the decedent received the item and been taxable on it prior to his death.[27]

A particular concern may be raised with respect to installment obligations. The recipient of an installment obligation upon the death of the seller is generally taxed upon receipt of the installment payments in the same manner as the deceased seller would have been taxed.[28] In other words, the recipient of an installment obligation from a decedent will be required to examine the manner in which the installment obligation was taxed in the hands of the decedent in order to assess the tax consequences to the recipient.

ENDNOTES

1 Robert W. Wood practices law with Robert W. Wood, P.C., 477 Pacific Avenue, Suite 300, San Francisco, California 94113,(415) 834-1800 (telephone), (415) 834-1888 (facsimile), www.robertwwood.com (website). He is a Certified Specialist in Taxation, and is the author of 28 books, including ***Taxation of Damage Awards and Settlement Payments*** (2d Ed. © 1998, with 2001 Supplement), published by Tax Institute at 800/852-5515; e-mail info@taxinstitute.com).

2. See *Chait v. Commissioner*, T.C. Memo. 1983-272, T.C.M. (P-H) ¶83272, 46 T.C.M. (CCH) 169 (1983).

3. See *Eisner v. Macomber*, 252 U.S. 189 (1920).

4. See *Lyeth v. Hoey*, 305 U.S. 188, 38_2 U.S.T.C. ¶9602, 21 A.F.T.R. 986 (1938). See also *Rhodes v. Commissioner*, T.C.M. (P-H) ¶44301, 3 T.C.M. (CCH) 963 (1944).

5. See *U.S. v. Gavin,* 159 F.2d 613, 47_1 U.S.T.C. ¶9157, 35 A.F.T.R. 829 (9th Cir. 1947). But see several earlier decisions in the contrary, including *Sterling v. Commissioner*, 93 F.2d 304, 37_2 U.S.T.C. ¶9589, 20 A.F.T.R. 549 (2d Cir. 1937), *cert. denied,* 303 U.S. 663 (1938); and *Kearney v. Commissioner,* 31 B.T.A. 935 (1934).

6.Tax Analysts Doc. No. 2001-23731, 2001 TNT 180-20.

7. See *Parker v. U.S.*, 573 F.2d 42, 78-1 U.S.T.C. ¶9248, 41 A.F.T.R. 2d 78-888 (Ct. Cl. 1978), *cert. denied*, 439 U.S. 1046 (1978).

8. 913 F.2d 1486, 90-2 U.S. Tax Cas. (CCH) ¶50502, 66 A.F.T.R.2d (P-H) ¶90-5517 (9th Cir. 1990).

9. See I.R.C. §102(b)(2).

10.T.C. Memo. P 92021, T.C. Memo. 1992-21, 63 T.C.M. (CCH) 1776 (1992).

11.100 T.C. 313 (1993), *aff'd.* 16 F.3d 462 (1st Cir. 1994).

12. For discussion, see "Reciprocal Will Not Bargained For—No Claim Against Estate," *J. of Tax'n* (May 1994), p. 292.

13.T.C. Memo 1995-171, T.C.M. (RIA) ¶95171, 69 T.C.M. (CCH) 2409, 95 T.N.T. 72-10 (1995).

14.T.C. Memo 1996-190, T.C.M. (RIA) ¶96190, 71 T.C.M. (CCH) 2823 (1996)

15.37 T.C. 1107 (1962), *acq.*, 1963-1 C.B. 4.

16.119 F.2d 963, 41-1 U.S.T.C. ¶9449, 27 A.F.T.R. 247 (7th Cir. 1941).

17.143 F.2d 27, 44-2 U.S.T.C. ¶9352, 32 A.F.T.R. 908 (7th Cir. 1944).

18.T.C. Memo. 1994-70, T.C.M. (RIA) ¶94070, 67 T.C.M. (CCH) 2214 (1994).

19.For a situation involving the applicability of gift taxes to a settlement transfer, see Ltr. Rul. 9304015.

20.See *Tree v. U.S.*, 55 F.Supp. 438, 44-2 U.S.T.C. ¶9364, 32 A.F.T.R. 842 (Ct. Cl. 1944), *cert. denied*, 324 U.S. 852 (1945).

21.13 T.C. 952 (1949), *nonacq. and acq.*, 1950-1 C.B. 317.

22.See *Green v. Commissioner*, 54 T.C.M. 764, 1987 P-H TC Memo 87,503 (1987), *aff'd per curiam*, 846 F.2d 870, 88-1 U.S.T.C. ¶9349, 61 A.F.T.R. 2d 88-1193 (2d Cir. 1988), *cert. den.*, 109 S. Ct. 131 (1988).

23.162 F.2d 403, 47_2 U.S.T.C. ¶9304, 35 A.F.T.R. 1482 (2d Cir. 1947).

24.See I.R.C. §691.

25.See Reg. §1.691(a)-1.

26.See Reg. §1.691(a)-2(b), Example (2).

27.See Reg. §1.691(a)-3(a).

28.See Reg. §1.691(a)-5.

WRITE FOR THE *CALIFORNIA TAX LAWYER*

GET PUBLISHED

The *California Tax Lawyer* is seeking high quality technical articles for publication in future issues. Authors are encouraged to submit articles of current interest to California tax practitioners on both state and federal tax matters.

Featured articles may be of any length, although the typical article is under 12,000 words. Longer articles my be published if space permits.

California practitioners are also encouraged to submit shorter articles on current developments in ferderal and California tax law affecting their fields of practice.

For more information concerning the submission of articles for publication in the *California Tax Lawyer*, please refer to the Publication Guidelines on pages 42 and 43 or call Steven D. Blanc, Articles Editor, at (310) 281-3292