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Estate Legal Settlements: Rose-Colored Hindsight?

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Legal settlements are routinely deducted by businesses with little thought to value. In claims against decedents' estates, however, the need for valuation as of the date of death may be at odds with the amount later paid. Wood examines three recent cases that explore valuation and offers comments on planning in this area.

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Paying to settle legal disputes is never pleasant. Obviously, those payments are less painful if they generate tax deductions. In the income tax field, payments are made and deductions are claimed at the same time. But with estate taxes, estates must be valued. And legal claims frequently must be valued as of the decedent's date of death. The actual resolution of the pending litigation may occur much later.

This truism was on my mind as I read *Estate of Saunders*.[1] There, the Tax Court held that an estate could not deduct the value of a pending litigation claim for legal malpractice. The case involved a big deduction and raised interesting timing and valuation questions going far beyond the estate tax field.

In *Estate of Saunders*, the estate could not claim a $30 million deduction for malpractice litigation pending against the estate as of the date of death. There were varying expert reports assessing the litigation. The IRS and the Tax Court agreed that the value of the claim was simply too uncertain to be deducted based on estimates as of the date of death. Instead, one had to wait until the ultimate outcome of the case.

Claims Against the Estate

Legal claims against estates are common. Section 2053(a) allows various deductions to reach the taxable estate. Claims against the estate are merely one of them.[2] Before they were amended in 2009,[3] the regulations stated that "an item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid."[4] It was this inexact but somehow still ascertainable standard that was in question in *Estate of Saunders*.

Other taxpayers have run the gantlet of this provision, some quite successfully. For example, the taxpayer estate prevailed in *Estate of Smith*.[5] The estate sought a deduction for the appraised value of a claim on the date of death even though the claim was later settled for a lesser amount. The IRS maintained that the estate was limited to the settlement amount, and the Tax Court agreed. Yet, on appeal, the Fifth Circuit reversed and agreed with the taxpayer. Timing matters, of course. As *Estate of Smith* proves, the eventual settlement amount is not dispositive.

The Ninth Circuit's decision in *Propstra*[6] is to the same effect. The court held that a claim could be deducted using the date of death value even though it was settled after death for a smaller amount. Refining its view, however, the court considered post-death events as "relevant when computing the deduction to be taken for disputed or contingent claims."[7]

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[1]*Estate of Saunders v. Commissioner*, 136 T.C. No. 18 (Apr. 28, 2011), *Doc 2011-9140*, *2011 TNT 83-5*.

[2]Section 2053(a)(3).

[3]*See* T.D. 9468, *Doc 2009-22919*, *2009 TNT 199-9*.

[4]Reg. section 20.2053-1(b)(3).

[5]*Estate of Smith v. Commissioner*, 198 F.3d 515 (5th Cir. 1999), *Doc 1999-39280*, *1999 TNT 242-3*, *rev'g* 108 T.C. 412 (1997), *Doc 97-16418*, *97 TNT 108-24*.

[6]*Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982).

[7]*Id.* at 1253.

Against the background of these cases, much clearly depends on valuation and the valuation method. William Saunders was an attorney who died in 2003, and his wife, Gertrude Saunders, died a year later. More than 10 years before his death, Mr. Saunders had been sued for malpractice by a client, Harry Stonehill. Among other allegations, Stonehill claimed that Mr. Saunders had acted as a secret IRS informer against the interests of his own client.

The suit alleged legal malpractice, breach of confidence, breach of duty of loyalty, and fraudulent concealment. After pursuing the claims for 12 years, Stonehill died in 2002. The suit went on. Mr. Saunders died in 2003. The suit continued. In 2004, 74 days before Mrs. Saunders died, Stonehill's estate filed another suit for legal malpractice, breach of confidence, breach of the duty of loyalty, and fraudulent concealment.

The two lawsuits sought $90 million in compensatory damages and punitive damages. The protracted litigation continued. In 2007, a jury found that Mr. Saunders had breached his duties of confidentiality and loyalty but that neither of these breaches caused damages to Stonehill or to his estate.

As a result of this decisive victory for the defendant, costs of $289,000 were awarded to the Saunders estate in the final judgment. The Stonehill estate appealed, but the litigation was ultimately resolved by a settlement agreement and mutual release. The Saunders estate paid $250,000 in attorney fees to the Stonehill estate's attorney and waived its right to the $289,000 costs awarded in the state court judgment. With that, the cases were concluded.

Rose-Colored Hindsight?

A federal estate tax return for Mr. Saunders's estate was filed in 2005. At that time, the malpractice litigation had been ongoing since 1990. In 2004 (after Mr. Saunders and Stonehill were both deceased but before the death of Mrs. Saunders), the Stonehill estate sued, too. The return claimed a $30 million deduction for the Stonehill estate malpractice claim. The estate tax return was examined, and a closing letter was issued in 2009. The closing letter stated that the value of the malpractice claim would be resolved in the estate of the surviving spouse, Mrs. Saunders.

A federal state tax return for Mrs. Saunders's estate was filed in 2006. It also claimed a $30 million deduction. Perhaps not surprisingly, the IRS was a little less pessimistic about the merits of the litigation than these returns reflected. The IRS allowed a $1 deduction for the malpractice claim and assessed a $14.4 million deficiency against Mrs. Saunders's estate. The estate went to Tax Court.

By this time, of course, the claims had actually been resolved. After the pro-defense jury verdict, Mrs. Saunders's estate was able to settle the case for far less money than had been anticipated by just about everyone but the IRS. Yet the Tax Court did not consider the subsequent settlement in resolving whether the value of the Stonehill claim was ''ascertainable with reasonable certainty'' as of the date of Mrs. Saunders's death in 2004.

Instead, the Tax Court focused on the various reports presented by the estate for use at trial. Without question, the reports reflected big numbers. However, they also showed significant variation. The court took their differences to be prima facie indications of the lack of reasonable certainty associated with valuing this massive legal claim. The suggested values ranged from:

- $30 million in a 2005 valuation ($90 million discounted to $30 million because of settlement possibility and the wide range of unknowns);
- $19.3 million in 2008 (using a decision tree analysis following through the various courses of action in the litigation);
- $25 million in a 2009 valuation (the first $30 million valuation discounted by $5 million in light of the time and expense involved in the litigation); and
- $22.5 million in 2010 (there was a 75 percent or better chance of obtaining a jury verdict in excess of $30 million such that the case had a risk-adjusted value of $22.5 million or more at the time it commenced).

Against these taxpayer reports were the IRS experts, whose views reflected that:

- the malpractice claim had no merit, at most having a 3 percent chance of prevailing and achieving a recovery; and
- the claim could be valued at $3.2 million.

These stark differences were taken by the Tax Court as manifest evidence that there simply was no reasonable certainty about valuing this claim. Besides, the Tax Court noted, none of the estate's experts had said (nor for that matter reasonably *could* say) that the $30 million claimed on the estate tax return — or even any specific lesser amount — would *actually* be paid. The latter is required by the regulations.

The Tax Court concluded that no amount for the Stonehill claim could be deducted as of Mrs. Saunders's death. Only the amount actually paid during the administration of the estate could be deducted in accordance with the then-prevailing regulations.[8]

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[8]*See* reg. section 20.2053-1(b)(3).

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Charity, Too?

We may think that only heirs and creditors make claims. Yet, any kind of litigation can become relevant for either income or estate tax purposes. Claims by charities are particularly interesting, raising fundamental questions of donative intent. In *Estate of Palumbo*,[9] the question was how to handle claims going to charity under the settlement of a will contest.

An indefatigable will writer, Antonio Palumbo had made numerous wills during his lifetime. He executed his last will and testament on July 6, 1999, and died in 2001. Many of his prior wills transferred the residuary to a charitable trust. In contrast, the 1999 will contained no residuary provision.

The charities were unhappy. Eventually, a court found that the omission was "due to a scrivener's error on the part of Palumbo's attorney." With no residuary provision, it was unclear who should get what. In particular, the generous "residuary to charity" provision was gone.

A negotiation ensued among Palumbo's son (a beneficiary under the will) and the trustees of the charitable trust enunciated in the prior wills. Ultimately, the Pennsylvania Court of Common Pleas determined that the son would receive $5.6 million and specified real property. The balance of $11.7 million was transferred to the charitable trust to resolve the dispute.

On its Form 706, the estate reported the charitable trust payment as a section 2055 charitable deduction. That seemed to make sense. However, the IRS denied the deduction because it was a settlement payment and not a charitable contribution provided for in the will.

When one considers history, this decedent had arguably shown his intent (via multiple prior wills) to transfer the estate residue to a charitable trust. Even so, the IRS said that section 2055(a)(3) permits a charitable deduction only if charitable purpose and benefit tests are met. In the IRS's view, the statute had to be strictly interpreted.

The estate fought for its deduction and went to district court. The court recognized that there was substantial uncertainty about how this large residuary — in excess of $16 million — was to be distributed. The court saw it as an obvious scrivener's error, noting that the Pennsylvania state court had made an exception from its normal evidentiary rule about collateral evidence or documents.

Given the nature of this error, the Pennsylvania state court had called for an examination of the previous wills to determine the decedent's intent. There was also a more practical consideration. These negotiations about resolving the claims were clearly at arm's length and between unrelated parties. The settlement between the son and the charitable trust was therefore a reliable representation of their respective legal interests.

The district court found that the decedent clearly had a donative intent. The charitable trust unquestionably had grounds under Pennsylvania law to assert its claim to a portion of the estate. As a result, the district court held that the estate could deduct the charitable contribution.[10]

Pals or Palimony?

As further evidence that all manner of claims can be made against estates and that valuation and timing are universal factors, consider palimony. *Estate of Shapiro*[11] involved the curious case of an estate tax return that claimed a settlement payment for palimony. Bernard Shapiro, the decedent, cohabited with Cora Jane Chenchark for more than 20 years. Shapiro paid all their living expenses and granted her a weekly allowance.

When Chenchark learned Shapiro had been unfaithful, she sued him for palimony. Shapiro died shortly thereafter, and his estate filed its Form 706 in May 2001. In September 2001, a jury trial concluded in the estate's favor, finding that there was neither an express nor implied contract between Shapiro and Chenchark.

Chenchark appealed, and the estate settled her case on appeal for approximately $1 million. The estate then filed an amended Form 706 in 2003. It valued the palimony claim at $8 million on Shapiro's date of death. In 2006, the estate filed suit in federal district court, valuing the claim at $5 million. The court held for the IRS, concluding that there was insufficient consideration to support a contract claim deductible under section 2053.

The estate appealed to the Ninth Circuit, which held that the district court was wrong to conclude as a matter of law that love, support, and homemaking services were insufficient consideration to support a state contract claim. The appeals court expounded on the classic palimony cases, including *Marvin v. Marvin*.[12] According to the Ninth Circuit, the district court had completely failed to address the adequacy of consideration, forcing the appellate court to remand.

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[9]2011 U.S. Dist. LEXIS 23602 (W.D. Pa. 2011), *Doc 2011-5061*, *2011 TNT 48-9*.

[10]For further discussion, see Bridget J. Crawford, "*Palumbo* and the Estate Tax Charitable Deduction," *Tax Notes*, Apr. 25, 2011, p. 423, *Doc 2011-6509*, or *2011 TNT 82-12*.

[11]*Estate of Shapiro v. United States*, 634 F.3d 1055 (9th Cir. 2011), *Doc 2011-3741*, *2011 TNT 36-12*.

[12]18 Cal.3d 660 (1976).

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To the Ninth Circuit, the district court had suggested that the services provided by Chenchark had no value whatsoever. That would mean no estate tax deduction could have been proper. The Ninth Circuit disagreed. It concluded that the value of Chenchark's claim at Shapiro's death was a factual question. For that reason, the Ninth Circuit remanded.

Interestingly, most of the focus in *Estate of Shapiro* is on the nature and strength of palimony claims. The timing nuances presented on these facts appear not to have been of great interest. Even the sole dissenter on the Ninth Circuit panel (Senior Circuit Judge A. Wallace Tashima) said that he thought federal tax law — not state palimony law — should decide the question.

Moreover, Tashima even went so far as to imply that this case appeared to be like one in which a bequest was being re-characterized as a deductible claim. One purpose of the law, he noted, was to prevent the depletion of the decedent's estate by recharacterizing what should be bequests into allowable deductions. There was a letter in evidence, the dissent noted, suggesting that although Chenchark had no legitimate legal claim, "it would be a nice gesture" to put money in trust for her lifetime support.[13]

Final Thoughts

It may be a mistake to attempt to extract universal principles from this group of cases. Still, there do seem to be some common themes. For example, good appraisals are obviously important. This is so for estate tax valuation purposes.

It can also be relevant in other contexts. Indeed, consider liquidations of corporations, distributions from trusts or partnerships, and the filing of S corporation elections. All those situations involve valuation and timing niceties, and the stakes can be high. In any context in which the value of an extant and unresolved legal claim has relevance, document it well.

However, consider carefully whether you want to document it with multiple appraisals. It seems obvious that if there are tax advantages associated with an appraisal of a legal claim, the IRS may disagree. In some situations, such as income tax charitable contributions or estate tax will contests, valuation disputes seem almost certain.

Yet, you would generally not want a brace of appraisals emanating from your own camp unless they are all quite consistent. One of the problems in *Estate of Saunders* was the $19.3 million to $30 million swings between the multiple appraisals. Multiple appraisals may sometimes be a good idea and seem particularly understandable in a case such as *Estate of Saunders*. Mr. Saunders died in 2002; Mr. Stonehill died in 2003; another lawsuit (this time by Mr. Stonehill's estate) was filed in 2004; and Mrs. Saunders died in 2004.

These were all valuation signposts. The estate tax return for Mr. Saunders's estate was filed in 2005; the estate tax return for Mrs. Saunders's estate was filed in 2006; the jury returned a verdict in 2007; and the case was settled in 2007.

Multiple appraisals were not the only problem, of course. Still, that there were so many and that they involved significant percentage swings fueled the argument that this was simply too speculative to be reasonably certain.

Litigation is uncertain by its very nature. As most annual letters from lawyers to auditors for financial statement purposes reveal, litigation involves risks. Most letters to audit firms from lawyers handling legal disputes say that one cannot determine the likely outcome of the suit.

The lawyer writing that letter does not want to be sued. He also does not want to be embarrassed. Saying that the chances of a recovery or a loss are either certain or negligible could be awkward if a few months later something precipitous occurs to propel the case one direction or the other. Yet, when there is a critical date — whether it be the date of death, the date of liquidation, an S corporation election, or what have you — value will matter.

On the income tax side, the IRS dislikes the open transaction doctrine. It is generally invoked with installment sales when the total purchase price is subject to contingencies. In the same way, if a legal claim cannot be valued, one must wait to see the result to determine the gain formula.

The IRS likes this kind of wait-and-see notion much better on the estate tax side. A cynic might seek to explain this discrepancy by the obvious and disparate tax incentives. But at a minimum, it should mean that thoroughness and presentation in valuation materials matter.

The sole appraisal of a multimillion-dollar lawsuit should not be a half-page letter from the lawyer handling it, saying that the case is currently worth nothing. Going out into the world adorned with that appraisal will be cold or worse. Always try to think how those documents will appear to the IRS or to a court, even if you firmly hope that there will never be a need to review them.

[13]*Estate of Shapiro*, 634 F.3d at 1063.

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