

OBTAINING ESTATE TAX DEDUCTIONS VIA SETTLEMENT

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Oftentimes, parties in litigation will direct property to a spouse or charity in settlement, and seek a marital or charitable deduction. At times, such settlements are motivated by and structured around the estate tax deduction. However, litigants or their counsel oftentimes do not realize that the deductions cannot be created out of whole cloth – there must be a bona fide dispute regarding the entitlement of the spouse or charity to the payment. That is, there must be some reasonable legal basis that entitled the spouse or charity to the settlement payment. That is, if such a payment was not directed for under the dispositive documents (including prior dispositive documents involved in the dispute) or some other binding obligation, parties should expect IRS resistance to deductions for such payments that are “created” in the settlement process.

A recent case compares and contrasts the allowable and not allowable situations. In Estate of Palumbo (3/9/11, DC PA), a charitable trust was a remainder beneficiary under various versions of a prior Will. However, in the decedent’s last Will, the trust was inadvertently left out. In settlement of a dispute as to the rights of the charitable trust against the residuary beneficiary named in the last Will, the trust received over \$11 million. The estate sought a charitable deduction for the \$11+ million. The IRS disallowed it.

The District Court noted that there was a bona fide dispute. Further, even though the charitable trust was not mentioned in the last Will, it could not be said that it had no legal right to the residuary estate. Perhaps it didn’t, but there was a bona fide dispute based on the prior Will and the admission of the drafting attorney of a scrivener’s error. Thus, the settlement payment to the charity was deemed to qualify for a charitable deduction as a Code §2055 deduction.

This result was contrasted by the court with the disallowance of a charitable deduction in the case of Bach v. McGinnes, 333 F.2d 979 (3d Cir.1964). In that case, a decedent’s

surviving spouse did not like a dispositive plan of her decedent spouse that would only allow property to pass to charity only if certain named relatives predeceased her. To achieve a better result for the charity, after her spouse's death the surviving spouse threatened her use of her spousal elective share against the estate – if exercised, it would reduce the economic interests of some of the beneficiaries. Due to that threat, the beneficiaries and the charity reached an agreement that resulted in a current remainder distribution to the charity. A charitable deduction was sought for the transfer to the charity. The IRS objected, and no deduction was allowed either by the District Court or the Court of Appeals.

What distinguishes Palumbo from Bach? In Bach, there was no legal argument raised that if successful would have resulted in a charitable gift to the charity. Thus, there was no bona fide legal dispute over the charity's legal entitlement. Instead, the various parties arranged for the transfer to the charity because it otherwise best suited their economic interests, albeit some of them acting under the threat of a spousal elective share.

Estate of Antonio J. Palumbo, 107 AFTR 2d 2011-XXXX, (DC PA), 03/09/2011

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