ESTATE SETTLEMENT RECIPIENTS LOSE A CHUNK TO THE IRS

Two brothers brought suit against their step-siblings and the estate of their step-mother for a share of ownership of real properties that were devised to them by their step-mother, but which were transferred out of the step-mother's death in the months before her death. A settlement agreement was reached that provided for cash payments to the brothers. The attorney for the brothers received a contingency fee, and that was that. Well, until the IRS came a-knocking.

The estate had deducted the brothers' settlement payments as claims against the estate for federal estate tax purposes. On audit, this claim was denied, and thus additional estate taxes, penalties, and interest were imposed. By this time, the estate had already distributed all of its assets. The IRS came after the brothers for the amounts due, under Code Section 6901 transferee liability.

The brothers raised a number of well thought-out reasons why transferee liability did not apply. Unfortunately, the Tax Court rejected them all. These issues are instructive, and thus are summarized below:

a. The brothers asserted that they did not receive "property of a decedent," which is a requirement for transferee liability. They based this argument on their having sued their step-siblings, and that the settlement funds were thus paid by the step-siblings and not the decedent's estate. The court rejected this because the actual funds were paid to them from the estate and because the estate was a co-defendant. But the court went on to address what would be the case if the payments had in fact been paid by the step-siblings directly. The court noted that if the step-siblings received property from the estate, and then paid the brothers from their own funds, transferee liability would still apply since a "transferee of a transferee" is still liable.

b. The brothers argued that they were not "transferees" because they received their settlement proceeds not as beneficiaries but in exchange for a waiver of their right to sue to enforce the terms of the will. However, the court characterized the settlement proceeds as a substitute for the real property devised to them, which was thus received as transferees.

c. The brothers argued that the portion of the settlement that was paid to their attorney for his contingency fee was not property received by them for transferee liability purposes. The court rejected this, acknowledging that such fees were authorized and attributable to the brothers, and thus deemed received by them before the attorney was paid.

Note that Code Section 6901 does not independently create transferee liability. Instead, a transferee must first have liability for the estate taxes under applicable State law or state equity principles. In this case, as in most such settlement circumstances, this is not much of a hurdle to the IRS since under the law of most (if not all) States, a beneficiary will be liable for estate obligations to the extent of distributions received by the beneficiary.

While not addressed in the opinion, the brothers perhaps may be able to sue and collect from the other estate beneficiaries who received estate assets to the extent that a portion of the estate tax liability is apportioned to them under the applicable State law and their shares were not previously charged with their apportioned liability. Also, perhaps the fiduciaries of the estate may have some liability to the brothers for the penalties that were incurred attributable to estate issues.

The lesson from this case is that every plaintiff in estate litigation needs to determine what the federal estate tax exposure is of the plaintiff upon success or settlement. More particularly, counsel for such plaintiffs need to think about whether tax, penalties and interest will be apportioned to their clients. If yes, should this be varied by agreement? If yes, how can their clients monitor estate tax compliance and audit activity to protect their interests? If yes, should other parties be burdened with the penalties or interest? If yes, how can their clients be sure the other parties will pay their respective shares in case the IRS comes after only their clients for any deficiency?

We can't tell from the opinion whether the brothers knew of the risk of estate taxes being imposed on them by reason of the settlement, but I suspect the answer is no. This is doubly so as to the penalty portions of the liability.

Carl M. Upchurch, et al. v. Commissioner, TC Memo 2010-169

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