

# **Deductibility of Litigation and Related Expenses in Estate and Trust Administration-Tax Considerations in Probate Litigation and Settlements - *Brief Musings concerning a very complex topic***

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*This is an extremely broad topic which cannot be adequately covered in a very limited time.*

## ***Why Should We Care?***

In arriving at an effective settlement, advisors to the litigating parties should understand all of the aspects relating to who and/or what property and/or which beneficiaries will bear the costs of litigation and whether the costs for tax purposes are deductible, non-deductible or capitalizable. These costs will benefit one or more of the litigating parties and may be a significant detriment to another. Understanding these costs from a tax perspective may actually assist in facilitating an equitable settlement . . . or prevent an inequitable one.

The starting point is the unfortunate reality that the tax rates for estate taxes and income taxes for trusts and estates are 40% or more. Economically,

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He is a founding director of the Center for Great Apes in Wauchula Florida. He has a fair amount of legal, accounting and governance experience as a director, officer and advisor of not for profit organizations. He has served on the Board of Directors of the Association of Graduates of the United States Air Force Academy and the Board of Governors of the Florida Institute of Certified Public Accountants. He is often Chairman or de facto Chairman of the FGCU Accounting and Tax Conference run by the FICPA which is a two day continuing education conference for CPAs held each fall. He taught business law and cost accounting as an adjunct professor at Florida Gulf Coast University for 6 years. He presently teaches Tax Law as an adjunct professor at Ave Maria Law School and helps plan the Annual Estate Planning Conference. He is fluent in Spanish. *Cierto, Imparando Spagnolo e molto facile.*

He does all of this to pay for his pencils, paper, brushes paints and canvas and hopes someday to be an artist able to support himself from his art alone. He loves Opera, Classical Music, Philosophy and Hard Core Jazz (Miles, Coltrane, Byrd, Monk et. al.)

therefore tax considerations should be considered as a significant deal point in any settlement discussion.

To further compound matters the relatively recent increase in the estate tax credit may push litigation costs in estates onto income tax returns rather than estate tax returns. The tax regimes are quite different and understanding the differences may be important in settlement discussions.

### **The Two Disparate Systems at a Glance**

#### **The Income Tax**

In standard income tax parlance it is axiomatic to paraphrase two important tax concepts that underlie a fair, though not complete discussion of the taxation of Probate Litigation and Settlements.

First – Accessions to wealth (increases) from whatever source derived are taxable, currently, absent a specific provision which excludes or defers the recognition of such accessions.

Second – Deductions (or credits) are a matter of legislative grace that are neither logical, consistent nor intended to be fair.

These two ... no, three axioms are further complicated by the fact that we are dealing with two different tax systems in probate litigation, one which is income tax based and the other which is excise tax based<sup>2</sup>.

#### **The Estate Tax - an Excise Tax**

The Excise tax system which comprises the gift, estate and generation skipping taxes is an entirely different regime. Likewise this system can be broken down into two compact axioms.

First – The right to transfer property from one person to another is taxable currently absent a specific provision which excludes or defers the tax. When taxed the measure of the tax is the fair market value of the property transferred which is loosely stated as that value at which a willing buyer and willing seller would agree to transfer the property neither of whom who

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<sup>2</sup> *And the third of our two axioms is rightly that **no one expects the Spanish Inquisition** . . . or in our case the administrative and judicial interpretations of the IRS and/or the Courts (be they Article II or Article III Courts) in efforts to avoid taxpayer victories in the protection of the public fisc.*

is under a compulsion to buy or sell and both having knowledge of all the facts.

Second - Deductions (or credits) are a matter of legislative grace that are neither logical, consistent nor intended to be fair<sup>3</sup>.

***The Starting Point - State law and the Probate, Trust and Fiduciary Accounting Statutes***

Whether we are dealing with estate taxes or income taxes, we need to determine whether an expenditure<sup>4</sup> of cash or property by the estate or trust to a beneficiary is treated for state law purposes as a distribution, a deductible item, non-deductible item, something else entirely, principal or income or partly both. For state law and federal law purposes we need to look to state law first. Primarily these answers are found under Chapter 738 of the Florida Statutes, The Principal and Income Act, Chapters 732 and 733 as they relate to the administration of Estates<sup>5</sup> and Chapter 736 as it relates to trust administration.

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<sup>3</sup> § 2053 Expenses, indebtedness, and taxes.

(a) General rule. For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—

(1) for funeral expenses,

(2) for administration expenses,

(3) for claims against the estate, and

(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate, as are allowable by the laws of the jurisdiction, whether within or without the United States under which the estate is being administered.

(b) **Other administration expenses.** Subject to the limitations in paragraph (1) of subsection (c), there shall be deducted in determining the taxable estate amounts representing expenses incurred in administering property not subject to claims which is included in the gross estate to the same extent such amounts would be allowable as a deduction under subsection (a) if such property were subject to claims, and such amounts are paid before the expiration of the period of limitation for assessment provided in section 6501.

<sup>4</sup> (loosely, a use of cash or property in the administration of the estate which is not a distribution)

<sup>5</sup> **Fla. Stat. §733.612** Transactions authorized for the personal representative; exceptions.—Except as otherwise provided by the will or court order, and subject to the priorities stated in s. 733.805, without court order, a personal representative, acting reasonably for the benefit of the interested persons, may properly:

(1) Retain assets owned by the decedent, pending distribution or liquidation, including those in which the personal representative is personally interested or that are otherwise improper for fiduciary investments.

(2) Perform or compromise, or, when proper, refuse to perform, the decedent's contracts. In performing the decedent's enforceable contracts to convey or lease real property, among other possible courses of action, the personal representative may:

(a) Convey the real property for cash payment of all sums remaining due or for the purchaser's note for the sum remaining due, secured by a mortgage on the property.

(b) Deliver a deed in escrow, with directions that the proceeds, when paid in accordance with the escrow agreement, be paid as provided in the escrow agreement.

(3) Receive assets from fiduciaries or other sources.

(4) Invest funds as provided in ss. 518.10-518.14, considering the amount to be invested, liquidity needs of the estate, and the time until distribution will be made.

(5) Acquire or dispose of an asset, excluding real property in this or another state, for cash or on credit and at public or private sale, and manage, develop, improve, exchange, partition, or change the character of an estate asset.

## ***Deductibility of Probate Expenses for Tax Purposes Generally under Estate tax principles***

In determining the deductibility of an expenditure associated with the administration of an estate for federal income tax purposes, Courts look

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- (6) Make ordinary or extraordinary repairs or alterations in buildings or other structures; demolish improvements; or erect new party walls or buildings.
  - (7) Enter into a lease, as lessor or lessee, for a term within, or extending beyond, the period of administration, with or without an option to renew.
  - (8) Enter into a lease or arrangement for exploration and removal of minerals or other natural resources or enter into a pooling or unitization agreement.
  - (9) Abandon property when it is valueless or so encumbered, or in a condition, that it is of no benefit to the estate.
  - (10) Vote, or refrain from voting, stocks or other securities in person or by general or limited proxy.
  - (11) Pay calls, assessments, and other sums chargeable or accruing against, or on account of, securities, unless barred by the provisions relating to claims.
  - (12) Hold property in the name of a nominee or in other form without disclosure of the interest of the estate, but the personal representative is liable for any act of the nominee in connection with the property so held.
  - (13) Insure the assets of the estate against damage or loss and insure against personal and fiduciary liability to third persons.
  - (14) Borrow money, with or without security, to be repaid from the estate assets or otherwise, other than real property, and advance money for the protection of the estate.
  - (15) Extend, renew, or in any manner modify any obligation owing to the estate. If the personal representative holds a mortgage, security interest, or other lien upon property of another person, he or she may accept a conveyance or transfer of encumbered assets from the owner in satisfaction of the indebtedness secured by its lien instead of foreclosure.
  - (16) Pay taxes, assessments, and other expenses incident to the administration of the estate.
  - (17) Sell or exercise stock subscription or conversion rights or consent, directly or through a committee or other agent, to the reorganization, consolidation, merger, dissolution, or liquidation of a corporation or other business enterprise.
  - (18) Allocate items of income or expense to either estate income or principal, as permitted or provided by law.
  - (19) Employ persons, including, but not limited to, attorneys, accountants, auditors, appraisers, investment advisers, and others, even if they are one and the same as the personal representative or are associated with the personal representative, to advise or assist the personal representative in the performance of administrative duties; act upon the recommendations of those employed persons without independent investigation; and, instead of acting personally, employ one or more agents to perform any act of administration, whether or not discretionary. Any fees and compensation paid to a person who is the same as, associated with, or employed by, the personal representative shall be taken into consideration in determining the personal representative's compensation.
  - (20) Prosecute or defend claims or proceedings in any jurisdiction for the protection of the estate and of the personal representative.
  - (21) Sell, mortgage, or lease any personal property of the estate or any interest in it for cash, credit, or for part cash or part credit, and with or without security for the unpaid balance.
  - (22) Continue any unincorporated business or venture in which the decedent was engaged at the time of death:
    - (a) In the same business form for a period of not more than 4 months from the date of appointment, if continuation is a reasonable means of preserving the value of the business, including good will.
    - (b) In the same business form for any additional period of time that may be approved by court order.
  - (23) Provide for exoneration of the personal representative from personal liability in any contract entered into on behalf of the estate.
  - (24) Satisfy and settle claims and distribute the estate as provided in this code.
  - (25) Enter into agreements with the proper officer or department head, commissioner, or agent of any department of the government of the United States, waiving the statute of limitations concerning the assessment and collection of any federal tax or any deficiency in a federal tax.
  - (26) Make partial distribution to the beneficiaries of any part of the estate not necessary to satisfy claims, expenses of administration, taxes, family allowance, exempt property, and an elective share, in accordance with the decedent's will or as authorized by operation of law.
  - (27) Execute any instruments necessary in the exercise of the personal representative's powers.

first to State law<sup>6</sup> to determine whether the expenditure is an expense (as opposed to capital expenditure or other use) prior to determining whether a deduction is permissible under federal tax law<sup>7</sup>. Under this concept, an expense must be “necessary” under state law, *i.e.* for the benefit of the estate rather than for the benefit of the estate beneficiaries and that it be the result of a transfer of property<sup>8</sup>. By way of example (not related specifically to litigation expenses) selling expenses are generally deductible if they were reasonably incurred to preserve the assets of the estate or to make them productive. Whether the administration expenses are reasonably incurred to preserve the estate or make its assets productive is a question of fact. In order for a deduction to be permitted under federal tax law, a reasonably incurred administrative expense for estate tax purposes must be tested against the rules of IRC §2053 and the corresponding interpretive Treasury Regulations<sup>9</sup>.

### ***§2053(a) Expenses***

In the probate administration of an estate for estate tax purposes, we are looking primarily at deductibility under IRC §2053(a). I believe it is important to reproduce §2053(a) here to distinguish other provision permitting deductions other than those related strictly to probate administration. In reviewing this statute think about which categories litigation expenses might be associated with.

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<sup>6</sup> See Fidelity-Philadelphia Trust Co. v. US, 222 F.2d 379 (3d Cir. 1955) “laws” of the jurisdiction administering the estate refers to local judicial decisions if there is applicable statute. Citing §2053(a)(2). This should not be confused with the concept in the §7701 regulations which provides state law should be ignored in determining whether an entity or business relationship should be taxed as a partnership, corporation, sole proprietorship or trust.

<sup>7</sup> See *e.g.* Marcus v. DeWitt, 704 F.2d 1227, 1229–30 (11th Cir.1983). In order for an expense to be deductible under § 2053, it must qualify as an “administration expense” under both the applicable state law and the federal law as delineated in the Treasury regulations.

<sup>8</sup> Estate of Love v. Comm'r, 923 F.2d 335, 337–38 (4 th Cir.1991); Hibernia Bank v. United States, 581 F.2d 741, 744–46 (9 th Cir.1978).

<sup>9</sup> Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions." **Treas. Reg. §20.2053-3(a)**. **Treas. Reg. §20.2053-3(d)(2)** provides: "*Expenses for selling property of the estate are deductible if the sale is necessary in order to pay the decedent's debts, expenses of administration, or taxes, to preserve the estate, or to effect distribution.*" In order to be entitled to deduct administration expenses, an estate must satisfy a two-pronged requirement: (1) That the expenses in question are allowable under the applicable local law; (2) that, even if so allowable, the expenses meet the conditions of deductibility set forth in respondent's regulations. Estate of Posen v. Commissioner, 75 T.C. 355 (1980).

## § 2053 Expenses, indebtedness, and taxes.

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(2) **for administration expenses,**

(3) for claims against the estate, **and**

(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate, as are allowable by the laws of the jurisdiction, whether within or without the United States under which the estate is being administered.

### Examples

*Interest and other expenses incurred during an unduly prolonged administration at the request of beneficiaries because beneficiaries wanted illiquid assets to be converted into cash, rather than because estate needed cash held not deductible under § 2053(a)(2)<sup>10</sup>.*

*Selling expenses incurred by testamentary trust in disposing of decedent's collection of books pursuant to provisions of will not deductible under § 2053(a)(2)<sup>11</sup>;*

*In order to deduct unpaid commissions a personal representative must establish a “reasonable expectation” that the unpaid commissions will be paid<sup>12</sup>. (Note: similar treatment to attorney’s fees actual and estimated)*

***Non-probate Property Expenditures Deductible or Not? Consider that the expenses of the revocable trust associated with the estate may not be §2053(a) Expenses.***

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<sup>10</sup> **Hibernia Bank v. US**, 581 F2d 741, 747 (9th Cir. 1978)

<sup>11</sup> **Streeter's Est. v. CIR**, 491 F2d 375 (3d Cir. 1974); dictum in case indicated that deduction might have been allowed if testamentary provisions required executor to make sale and distribute proceeds to trust.

<sup>12</sup> See **Schildkraut's Est. v. CIR**, 24 TCM 1215 (1965).

Probate expenses deductible under §2053(a) are not the only expenses deductible on Form 706.

**IRC §2053(b)** permits other reasonably necessary expense to be deducted even if they are not associated with probate administration<sup>13</sup>.

**§2053(b) Other administration expenses.** Subject to the limitations in paragraph (1) of subsection (c), *there shall be deducted in determining the taxable estate amounts representing expenses incurred in administering property not subject to claims which is included in the gross estate to the same extent such amounts would be allowable as a deduction under subsection (a) if such property were subject to claims, and such amounts are paid before the expiration of the period of limitation for assessment provided in section 6501.*

In permitting non-probate expenditures to be deducted from the gross estate to arrive at the taxable estate Congress was likely looking to those expenditures associated with nonprobate property included in the gross estate under §§ 2036–2038 (inter vivos transfers with retained life estate, power to control beneficial enjoyment, or reversionary interests), 2039 (annuities), 2040 (joint tenancy with right of survivorship), § 2041 (property subject to general power of appointment), and § 2042 (Life Insurance), *et. al.* §2053(b) is important given the fact that so much of the administration and payment of expenses in larger estates is required to be handled through a revocable trust instead of through probate administration itself.

Deductions are still limited to those related in some fashion to the decedent's death and properly incurred in settling the decedent's affairs or vesting title in those finally determined to be entitled to such property<sup>14</sup>.

For Example, one of the examples to Treas. Reg. § 20.2053-8(a) provides that where a decedent created a trust to pay the income to herself for life and to distribute the corpus to her children when she dies, a deduction is allowed for the trustee's termination commission and legal fees incurred by the trustee in connection with the termination<sup>15</sup>.

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<sup>13</sup> Prior to the adoption of §2053(b) non-probate expenses were not deductible from the Gross Estate,

<sup>14</sup> **Treas. Reg. § 20.2053-8(a).**

<sup>15</sup> **Treas. Reg. § 20.2053-8(a), Ex. 1.**

Another important example can be found in **Burrow Trust v. CIR**<sup>16</sup>. In that case, a revocable trust that terminated on the grantor's death and was included in the decedent's gross estate under § 2038. The Tax Court held that § 2053(b) required that expenses to be deductible “be of the same nature as administration expenses deductible under IRC§ 2053(a), *i.e., that the expenses must be incurred in winding up the affairs of the deceased*”<sup>17</sup>.

### **Trust Accountings**

Deductions for trust accountings, also not probate expenses where they are done by the trustee for the trustees own protection or local law or custom<sup>18</sup>. However, this deductibility may evaporate where the beneficiary requires the accounting<sup>19</sup>.

Query if the settlement agreement includes a demand from the beneficiaries for an accounting as opposed to a general requirement in the settlement agreement that an accounting as required under Florida law for the year will be provided to all parties will the accounting be deductible?

*No deduction permitted for trustee's expenses in an accounting as of date of death, even though accounting ordered by court, because decedent's wife requested accounting and therefore “the expenses were incurred on behalf of the wife”*<sup>20</sup>.

### ***Contesting the Validity of a Trust***

§2053(b) permits deductions for contesting the validity of a trust in certain circumstances. However, it is still important to understand who is bringing the claim, the nature of the claim and who is claiming the expenses as deductions. For example, in **Central Trust v. Welch**<sup>21</sup>, The trustee's expenses in defending the validity of a trust includible in the Gross Estate (§§2036, 2038) against the claim of a beneficiary were considered deductible because the expenses were considered related to the death of the decedent.

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<sup>16</sup> 39 TC 1080, 1088 (1963).

<sup>17</sup> Note that the §2053(a) deductibility standard is grafted into §2053(b), *i.e.* “Reasonably Necessary.” provided they are deducted within the §6501 limitation period.

<sup>18</sup> **Treas. Reg. § 20.2053-8(d), Ex. 4**

<sup>19</sup> **Id. Ex. 3**

<sup>20</sup> **Treas. Reg. § 20.2053-8(d) Ex. 3.**

<sup>21</sup> 304 F2d 923, 928 (6th Cir. 1962)

Because a revocable trust is revocable during the lifetime of an individual a beneficiary is unable to contest the trust during the lifetime of the decedent. Thus the occasion of death is the inflection point for the claim and hence the starting point for deductibility.

This deductibility outcome should be compared with the result in 20.2053-8(d), Example 3 as previously mentioned:

*The decedent predeceased his wife and the transferred property, less the value of the wife's outstanding life estate, was included in his gross estate under the provisions of section 2037 since his reversionary interest therein immediately before his death was in excess of 5 percent of the value of the property. At the wife's request, the court ordered the trustee to render an accounting of the trust property as of the date of the decedent's death. No deduction will be allowed the decedent's estate for any of the expenses incurred in connection with the trust accounting, since the expenses were incurred on behalf of the wife<sup>22</sup>.*

In Example 3, the inflection point for deductibility is not the death of the decedent. Further, it is the surviving spouse, not the trustee who is requesting the accounting. Probate or nonprobate expenses of beneficiaries are not deductible by the estate or a trust included in the gross estate.

Bringing this into a litigation/settlement agreement context, if an accounting is going to be required or prudent consider whether placing a demand of a beneficiary into a settlement agreement for an accounting (non-deductible) versus the normal expenses incurred by the trustee to provide an accounting (deductible) changes the after tax amounts receivable by the beneficiaries.

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<sup>22</sup> **Treas. Reg. § 20.2053-8(d) Ex. 3.**

## ***The Deductibility of Litigation Expenses as Administrative Expenses for Estate Tax Purposes***

The starting point for the deductibility of litigation expenses for estate tax purposes is state law and for our purposes, Florida law specifically. The statute which controls an attorney's compensation in probate estates is Fla. Stat. §733.6171<sup>23</sup>, for trusts it is F.S. 736.1007<sup>24</sup>.

Taking the basic concepts from the prior paragraphs we can analogize the following: Litigation expenses should be deductible where the litigation expenses incurred facilitate: (i) the proper settlement of the estate; and (ii) the distribution of property to the persons entitled to it<sup>25</sup>. This should be true provided that the litigation expenses are reasonably necessary<sup>26</sup> to the administration of the estate. Stated in the negative, if the expenses are not reasonably necessary to the proper settlement of the estate or the distribution of property they will not be deductible (e.g. those incurred for the individual benefit of the heirs, legatees, or devisees<sup>27</sup>). Thus, an attorney's fee not meeting the foregoing two prong test is not deductible as an administration expense even if it is approved by a probate court as an expense payable or reimbursable by the estate<sup>28</sup>.

### ***Will/Trust Contests***

Although instituted by beneficiaries, primarily, courts most often treat litigation expenditures associated with will contests as necessary and proper to the settlement of the decedent's estate. Will constructions instituted by a fiduciary of the will or trust are handled in a similar fashion.

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<sup>23</sup> **Fla. Stat. §733.6171** Compensation of attorney for the personal representative.—

(1) Attorneys for personal representatives shall be entitled to reasonable compensation payable from the estate assets without court order.

<sup>24</sup> **Fla. Stat. §736.1007** Trustee's attorney's fees.—

(1) If the trustee of a revocable trust retains an attorney to render legal services in connection with the initial administration of the trust, the attorney is entitled to reasonable compensation for those legal services, payable from the assets of the trust without court order. The trustee and the attorney may agree to compensation that is determined in a manner or amount other than the manner or amount provided in this section. The agreement is not binding on a person who bears the impact of the compensation unless that person is a party to or otherwise consents to be bound by the agreement. The agreement may provide that the trustee is not individually liable for the attorney's fees and costs.

<sup>25</sup> **Pitner v. United States**, 388 F.2d 651 (5th Cir.1967).

<sup>26</sup> **Treas.Reg. §20.2053-3(d)(2)**. Note the difference between this "reasonably necessary" standard and the "ordinary and necessary" standard under §162.

<sup>27</sup> **Treas.Reg. §20.2053-3(a)**.

<sup>28</sup> **Treas. Reg. § 20.2053-3(c)(3)**.

### ***Examples***

*Payment to decedent's brother to settle will contest was deductible as administration expense because estate could not otherwise have been properly administered without expensive litigation*<sup>29</sup>.

*Attorney's fees incurred by estate beneficiaries of the estates of two brothers held deductible where proof of intent to execute mutual and joint wills found (expenses were reimbursed by the estate)*<sup>30</sup>.

*Attorney's fees and associated legal expenses of beneficiaries found deductible where executor instituted will construction action*<sup>31</sup>.

*Attorney's fees incurred by a person named as personal representative under will and ultimately denied appointment found to be deductible*<sup>32</sup>.

### ***Just what are Litigation Expenses Anyway?***

- (1) Attorney's fees;
- (2) Costs of litigation;
- (3) Appraisal Fees
- (4) Expert fees
- (5) Other

In considering litigation expenses associated with probate and non-probate expenditures, we still need to focus on whom is bringing/benefiting from the action brought and the source and nature of their claim.

### ***Examples***

*Attorney's fees incurred by the estate beneficiaries that resulted in the discovery of misappropriation of estate funds and malpractice on the part of the attorneys hired by the executrix, as well as fees incurred by the administrator pro tem in prosecuting the malpractice claim, were allowed as deductions under section 2053(a)(3)*<sup>33</sup>.

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<sup>29</sup> **Baldwin's Est. v. CIR**, 18 TCM 902 (1959).

<sup>30</sup> **Pitner v. United States**, 388 F.2d 651 (5th Cir.1967).

<sup>31</sup> **Dulles v. Johnson**, 273 F2d 362, 369-70 (2d Cir. 1959), cert. denied, 364 US 834 (1960).

<sup>32</sup> **Swayne's Est. v. CIR**, 43 TC 190, 200 (1964).

<sup>33</sup> **Estate of Glover v. Commissioner**, TCM 2002 -186,

*The attorney's fees and litigation expenses incurred as a result of the malpractice suit are deductible as administration expenses under § 2053<sup>34</sup>.*

*Litigation expense to establish estate's right to buy apartment at insider price will be deductible as essential to proper settlement of estate<sup>35</sup>.*

*Attorneys' fees incurred by decedent's widow in her litigation against his estate and paid by executor under settlement agreement between them are deductible. Payment was validly approved under Mass. law by Mass. probate court, and was "essential to the proper settlement of the estate." Main dispute between parties was whether widow or estate owned various assets; agreement was necessary to resolve dispute<sup>36</sup>*

*Court disallowed attorneys fees incurred by beneficiaries where as a result of the attorney's services, "the estate was in no way enlarged or protected...The purpose and effort of the appellee 'was not to recover the estate or to protect it from spoliation,' but to determine the amount that should be distributed to her<sup>37</sup>."*

*Legal fees incurred by beneficiaries of a trust in a proceeding brought by the trustee for instructions were nondeductible because trustee's expenses in proceeding not at issue; expenses related to the beneficiaries' needs not the administration of the trust<sup>38</sup>.*

### ***Alternative deductibility theory***

If litigation and the corresponding litigation settlement agreement concerns whether one beneficiary or another *is the owner of certain assets* as opposed to the proper distribution of the estate it may be possible to deduct the attorney's fees of the beneficiary under §2053(a)(3) as a claim as opposed to a §2053(a)(2) administration expenses.

### ***Estate Transmission Expenses and the Hubert<sup>39</sup> Regulations***

Litigation and Settlements often deal with amounts passing to a surviving spouse under §2056 or Charity under §2055. Deductibility of litigation expenses associated with such expenditures turns on whether the

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<sup>34</sup> **TAM 200532049**

<sup>35</sup> **Private Letter Ruling 8723011**, 3/03/1987

<sup>36</sup> **Estate Of Reilly v. Commissioner**, 76 TC 369

<sup>37</sup> **Mudge v. Mudge**, 155 Md. 1(1928)

<sup>38</sup> **Treas. Reg. § 20.2053-8(d) Ex. 2. See Heckscher's Est. v. CIR**, 63 TC 485 (1975).

<sup>39</sup> **Commissioner v. Hubert's Est.**, 520 US 93 (1997).

expenditures are properly treated as “Estate Management Expenses<sup>40</sup>” or “Estate Transmission Expenses<sup>41</sup>.” In short hand, Transmission expenses will decrease the value of property in arriving at the marital or charitable deduction (whether they are chargeable against income or principal), while Estate Management Expenses will not. Transmission expenses are really any expense other than a management expense<sup>42</sup>. The Regs use a “*but for*” test in determining what transmission expenses are<sup>43</sup>. As a result in any settlement agreement those entitled to the marital or charitable share will like management expenses but not transmission expenses. For our purposes the question is where do litigation expenses properly belong?

Under the *Hubert* Regs. it appears that legal fees associated with the settlement of litigation associated with determining amounts passing to charity or to the marital portion will reduce the value of the marital or charitable deduction.

Accordingly in settling litigation understanding the source of the claim and the purpose of the claim will assist in determining the appropriate dollar value a litigant can live with if they understand clearly the effect on the amounts they are to receive.

### ***Income Tax Concepts***

To understand litigation expenses under an income tax regime we should first consider the deductibility of expenses under Subtitle A of the Code, generally.

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<sup>40</sup> **Treas. Regs. §20.2056(b)-4(d)(1)(i)** Management expenses. Estate management expenses are expenses that are incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration. Examples of these expenses could include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

<sup>41</sup> **Treas. Regs. §20.2056(b)-4(d)(1)(ii)** Transmission expenses. Estate transmission expenses are expenses that would not have been incurred *but for* the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Estate transmission expenses include any administration expense that is not a management expense. Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

<sup>42</sup> **Id.**

<sup>43</sup> **Id.**

In shorthand, income tax deductions can be broken down into specific categories:

1. Ordinary and necessary trade or business expenses §162<sup>44</sup>
2. Specifically identified deductions:
  - a. Interest §163
  - b. Taxes §164
  - c. Casualty losses §165
  - d. Bad Debts §166
  - e. Depreciation (§§167/168)
  - f. Charitable Expenses (§170)
  - g. et. al.; and
3. Expenses incurred for the production of income - §212

As you can see the categories of deductible expenses is more broadly defined under the income tax rules. This is because the starting point for the determination of taxable income of a trust or estate begins with a determination of income and deductions as if you are preparing a return for an individual and then make appropriate adjustments to bring it on to the Form 1041.

In our discussion we are looking primarily at litigation deductions under §162 and §212. Note that trusts are most often not engaged in a trade or business unless operating business assets are part of the trust estate. As such §162 is typically not the source of authority for deductibility for expenditures associated with an estate or trust. Instead, trusts are most often engaged in activities associated with the production of income. Accordingly, IRC §212<sup>45</sup> and the interpretive regulations will be our primary starting point for deductibility of litigation expenses. Treas. Reg.

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<sup>44</sup> The statutory words '*ordinary and necessary expenses*' mean those which are an integral part of a business. **Commissioner v. Doyle**, 321 F.2d 635 (7th Cir. 1956). **Reg. § 20.2053-3(a)** uses a relaxed meaning given the word "necessary" in § 162(a). The question is whether for income tax purposes a stricter standard exists for deductibility.

<sup>45</sup> Section 212 of the Code provides that in case of an individual, there shall be allowed as a deduction all the *ordinary and necessary expenses paid or incurred during the taxable year* – (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.

§1.212-1(d) requires expenses to be both ordinary<sup>46</sup> and necessary<sup>47</sup> (as opposed to extraordinary and/or unnecessary) to the production of income. This means that expenditures to be “*deductible must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.*”

Litigation expenses are specifically granted deductibility in an estate settlement context in §1.212-1(i)<sup>48</sup>. The regulation provides that “ordinary and necessary” litigation expenses are deductible<sup>49</sup> provided they are (i) incurred in connection with the performance of the fiduciary’s duties of administration; and (ii) reasonable. One further limitation is that the deductions may not have been taken on the estate tax return (in most cases)<sup>50</sup>.

Not all litigation expenses are deductible however. Even though Treas. Regs. §1.212-1(i) provides that “*litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business*<sup>51</sup>,” expenditures required to be capitalized under §263 are not deductible<sup>52</sup>. For example,

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<sup>46</sup> The principal function of the term 'ordinary' is to clarify the distinction between those expenses that are currently deductible and those that are in the nature of capital expenditures. Commissioner v. Tellier, 383 U.S. 687 (1966), 1966-1 C.B. 32. In Tellier, the Supreme Court of the United States held that legal expenses incurred by a securities dealer in the unsuccessful defense of a prosecution for fraud arising from his business activities were deductible as ordinary and necessary business expenses under section 162(a) of the Code. In reaching this decision the Supreme Court relied on the ‘origin of the claim’ doctrine in United States v. Gilmore, cited below.

<sup>47</sup> An expense will be considered necessary if the expenditure is appropriate and helpful to developing and maintaining taxpayer's business. Welch v. Helvering, 290 U.S. 111 (1933). It is sufficient if there are also reasonably evident business ends to be served, and an intention to serve them appears from the record. Manischewitz Co. v. Commissioner, 10 T.C. 1139 (1948). Normally, a taxpayer will not incur a business expenditure unless it is required or justified by the needs of the business.

<sup>48</sup> **Treas. Reg. §1.212-1(i)** Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

<sup>49</sup> An expenditure is not deductible under section 212 if it is a personal expense under IRC §262, United States v. Gilmore, 372 U.S. 39 (1963), 1963-1 C.B. 355, or a capital expenditure under IRC §263, Woodward v. Commissioner, 397, U.S. 572 (1970), 1970-1 C.B. 56, United States v. Hilton Hotels Corp., 397 U.S. 500 (1970), 1970-2 C.B. 59. If the expenses are paid to perfect or acquire title to property, then they are never deductible under section 212. See section 1.212-1(k) of the regulations.

<sup>50</sup> *see* IRC §642 (g).

<sup>51</sup> **Treas. Regs. §1.212-1(i)**.

<sup>52</sup> **Treas. Regs §§ 1.263(a)-1** Capital expenditures: in general.

litigation expenses paid or incurred in defending or perfecting title to property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property, and are not deductible expenses<sup>53</sup>. Further, attorney's fees paid in a suit to quiet title to lands are not deductible<sup>54</sup>; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allowable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible<sup>55</sup>.

In determining the deductibility of litigation expenses, generally, courts look to the “so called” *Origin of the Claim Doctrine*, adopted by the US Supreme Court in *US. v. Gilmore*<sup>56</sup>. The doctrine provides that “*the origin and character of the claim with respect to which an expense is incurred, rather than its potential consequence upon the fortunes of the taxpayer is the controlling basic test of whether an expense was “business” or “personal” and hence whether it is deductible or not*<sup>57</sup>.” This means that courts do not look at the primary purpose of the deduction. Rather, courts will look at how and in what context the expenditure came to be incurred. As a result if the “origin” of the deduction is a non-deductible activity or objective, no deduction is permitted<sup>58</sup>.

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(a) General rule for capital expenditures. Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for—

(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

<sup>53</sup> **Treas. Regs. §1.212- (k)** Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

<sup>54</sup> **Treas. Regs. §1.263(2)-(2)(c)** provides that an example of a capital expenditure is the cost of defending or perfecting title to property.

<sup>55</sup> **Treas. Regs. §1.212- (k)** .

<sup>56</sup> 372 U.S. 39 (1963).

<sup>57</sup> **Id.**

<sup>58</sup> This standard seems narrower than §2053

## *Example*

*Attorney fees paid by executrix in defense of a will contest deductible under section 212 because the parties agreed that the executrix would have received no executrix fees if the will had been declared invalid in the will contest*<sup>59</sup>.

## *Inclusion of IRD and Deductibility of DRD*

There is an additional area of potential litigation expense deductions that must be considered. While we have discussed deductions associated with estate and trust administration we need to consider transitional income and expenses associated with Income in Respect of a Decedent (“IRD”)<sup>60</sup> and deductions related thereto (“DRD”)<sup>61</sup>.

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<sup>59</sup> **Estate of Leaf v. Commissioner**, T.C. Memo. 1964-249.

<sup>60</sup> **IRC §691(a)(1)** The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

**691(a)(2)** Income in case of sale, etc.

If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term “transfer” includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

**691(a)(3)** Character of income determined by reference to decedent.

The right, described in paragraph (1), to receive an amount shall be treated, in the hands of the estate of the decedent or any person who acquired such right by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent, as if it had been acquired by the estate or such person in the transaction in which the right to receive the income was originally derived and the amount includible in gross income under paragraph (1) or(2) shall be considered in the hands of the estate or such person to have the character which it would have had in the hands of the decedent if the decedent had lived and received such amount.

<sup>61</sup> **IRC §691(b)** Allowance of deductions and credit.

The amount of any deduction specified in section 162 , 163,164 , 212, or611 (relating to deductions for expenses, interest, taxes, and depletion) or credit specified in section 27 (relating to foreign tax credit), in respect of a decedent which is not properly allowable to the decedent in respect of the taxable period in which falls the date of his death, or a prior period, shall be allowed:

(1)Expenses, interest, and taxes.

In the case of a deduction specified in section 162 , 163,164 , or 212 and a credit specified in section 27, in the taxable year when paid—

(A) to the estate of the decedent; except that

In the case of litigation expenses that are considered DRD we need to look first to the Origin of the Claim doctrine as applied to the decedent's activities which would rightly be accrued but not paid during the decedent's lifetime and related to income accrued but not collected during the decedent's lifetime<sup>62</sup>. If the decedent is married then there is still a chance to take litigation expenses on the decedent's final income tax return and potentially one additional joint return with the surviving spouse. If not, IRD and associated DRD should pass through to the Estate income tax return.

### ***Election to take Administrative Expenses of Form 1041***

To complicate matters further it is possible to elect to take expenses on the Form 1041 instead of the Form 706<sup>63</sup>. However, it should be noted that the election to take deductions on the Form 1041 does not apply to IRD.

§643(g) and corresponding regulations attempt to prevent double deductions and are for the most part successful. They do so in part by requiring an election to be filed with the 1041 indicating the waiving by the fiduciary of the right to take the §2053 expenses. The election to waive should be filed in duplicate with the first estate/trust income tax return.

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(B) if the estate of the decedent is not liable to discharge the obligation to which the deduction or credit relates, to the person who, by reason of the death of the decedent or by bequest, devise, or inheritance acquires, subject to such obligation, from the decedent an interest in property of the decedent.

<sup>62</sup> *See generally* the cites to IRC §§691(a) and 691(b) above.

<sup>63</sup> **Treas. Reg § 1.642(g)-1.** Disallowance of double deductions; in general. Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

***Conclusion -Taking Litigation Expenses into Account in arriving at a Settlement***

From the foregoing discussion we can see that taxes are an important consideration in any settlement agreement and deductions for litigation expenses is not as easy as it might appear:

1. We may need to map out the “origin of the claim” to determine deductibility.
2. We need to identify whether the expense benefits the administration of the decedent’s estate or the beneficiaries.
3. There may be a different standard for estate deductions under §2053 and income tax deductions under §212.
4. We need to determine if the litigation expenses must be capitalized.
5. We need to consider whether the *Hubert* Regulations are involved and the cash effects on the settlement.
6. And of course other factors.

If you are unsure, ask a tax professional.