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ESTATE LITIGANTS BEWARE AS YOU CAN BE HELD RESPONSIBLE FOR AN ESTATE TAX LIABILITY

Marc Soss' practice focuses on estate planning; asset protection, elder law, and probate and trust administration and litigation in Southwest Florida. Marc is a frequent contributor to LISI and has published articles and been quoted in the Florida Bar, Rhode Island Bar, North Carolina Bar, Association of the United States Navy, Lawyers USA, Military.Com, Forbes.Com, and CNN Business. Marc also serves as an officer in the United States Naval Reserve.

In *Carl M. Upchurch et al*, (T.C. Memo. 2010-169), on audit the IRS disallowed a deduction for certain debts of the estate of Judith Upchurch ("Judith's estate"), and determined that the debts claimed by family members were not an obligation of Judith's estate but a family disagreement. The IRS then sought to collect the additional federal estate tax from two of the beneficiaries as transferees (i) under equity principles long recognized in Illinois and (ii) at law under the Illinois Uniform Fraudulent Transfer Act (IUFTA). The family members argued that (i) they did not receive "property of a decedent," which is a requirement for transferee liability, and (ii) they were not "transferees" as they received their settlement proceeds in exchange for a waiver of their right to sue to enforce the terms of the will. The Tax Court disagreed and concluded that (i) the claimant family members were liable as transferees under IRC Section 6901(a) and under Illinois equity principles, and (ii) characterized the settlement proceeds as a substitute for the real property devised to them.

BACKGROUND:

Tasker Upchurch, who had two sons, Bruce and Carl, passed away in 1994 followed by his spouse, Judith Upchurch, who had three children, Rodney, Ronald and Robin, on August 20, 2000. Judith's Last Will and Testament ("Will") dated June 7, 1999, bequeathed specific items of personal property to the five children (Carl, Bruce, Rodney, Ronald, and Robin), and her grandchildren. Article III directed that 80 percent of her cash and investments be equally divided among her three natural-born children, Rodney, Ronald, and Robin, and the remaining 20 percent be divided among her 11 grandchildren. Article IV of the will directed that the interest in her home be divided equally among the five children. Her three natural-born children were to be the recipients of the residue of her estate.

Prior to her death, Judith subdivided the property on which her residence was located into two parcels. Judith subsequently conveyed the vacant lot to her son, Ronald, and his Wife, and the lot on which her home resided to her daughter, Robin. As a result, on Judith's death, there was no real property to be divided equally among the five children per Article IV of her will.

Bruce and Carl then commenced litigation against Judith's three children and her estate in Illinois Circuit Court seeking (i) to impose a constructive trust on the real property in favor of the estate and its devisees, or, in the alternative, (ii) to obtain a declaratory judgment that both quitclaim deeds were invalid. In November 2001, the parties entered into a settlement agreement which required Bruce and Carl to file a $53,500 claim against Judith's estate, and Judith's estate to pay the claim. The payments were made directly to their attorney who retained a one-third contingency fee. The estate then distributed all of its other assets before receiving a final determination of the estate's tax liability from the IRS.

The IRS audited the estate tax return and disallowed the settlement payments to Bruce and Carl as debts of the estate. The IRS classified the settlement payments as a "family disagreement," not an obligation of the Estate, and assessed a $46,758.12 deficiency, plus interest, against them. The IRS then, under Illinois equity principles, assessed the estate tax liability against Bruce and Carl individually. Bruce and Carl then commenced an action in the Tax Court contesting their liability.

TAX ISSUES:

Whether Bruce and Carl are transferees of property of Judith's estate?

IRC Section 6901(a) provides a procedure through which the IRS may collect unpaid taxes owed by the transferor of the assets from a transferee if an independent basis exists under applicable state law or equity principles for holding the transferee liable for the transferor's debts. In order to assess the unpaid tax the IRS bears the burden of proving that "(1) the alleged transferee received property of the transferor; (2) the transfer was made without consideration or for less than adequate consideration; (3) the transfer was made during or after the period for which the tax liability of the transferor accrued; (4) that the transferor was insolvent prior to or because of the transfer of property or that the transfer of property was one of a series of distributions of property that resulted in the insolvency of the transferor; (5) that all reasonable efforts to collect from the transferor were made and that further collection efforts would be futile; and (6) the value of the transferred property" (which determines the limit of the transferee's liability). IRC Section 6901(h) further provides that the term "transferee" includes "donee, heir, legatee, devisee, and distribute."

Bruce and Carl argued to the Tax Court that the individual defendants (their siblings) in the estate litigation, not Judith's estate, should be considered the transferors of the property they received. Their position was that if their lawsuit had resulted in a judgment, the individual defendants, not Judith's estate, would have been liable for and would have paid the damages. In contrast, the IRS argued that Bruce and Carl named Judith's estate as a defendant in the proceeding and were liable under Illinois law as the transfer to them constituted "fraud in law" since they occurred without adequate consideration and rendered the estate insolvent.

Whether the attorney's fees paid by Bruce and Carl to enforce their claims on Judith's estate should be included in the total amounts for which they are liable?

The parties agree that if Bruce and Carl are liable as transferees, they are each individually liable only for the value of the property transferred to each of them. Bruce and Carl argued that the value of the property transferred to them was equal to the amounts each actually received net of their attorney's fees. The IRS, in reliance on *Commissioner v. Banks*, 543 U.S. 426, 430 (2005), argued that Bruce and Carl were transferred the full amount of the settlement payments and their gross income should not be reduced by the contingent fee paid to their legal counsel. The property procured by their legal counsel was attributable to them even though the legal fee did not pass directly into Bruce or Carl's hands.

CONCLUSION:

In reaching its ruling, the Tax Court determined that Bruce and Carl were transferees of Judith's estate property as the settlement payment was a substitute for the real property that was devised to them under the terms of Judith's Last Will and Testament but were not available for distribution to them upon her death. Thus, Bruce and Carl are transferees of property from Judith's estate within the meaning of IRC Section 6901(a). The court further determined that the total settlement amount obtained by their legal counsel was attributable to them since they controlled the litigation process in order to enforce their legal rights under the terms of Judith's Last Will and Testament.

The case emphasizes the need, in estate litigation proceedings, to factor a party's federal estate tax exposure upon success or settlement. Counsel must consider whether tax, penalties and interest will be apportioned to their client upon success.

CITATIONS:

Carl M. Upchurch, et al. v. Commissioner, TC Memo 2010-169
Commissioner v. Banks, 543 U.S. 426, 430 (2005)
Commissioner v. Stern, 357 U.S. 39 (1958)
Estate of Taracido v. Commissioner, 72 T.C. 1014, 1023 (1979)
Freeman v. Commissioner, 33 T.C. 323, 327 (1959)
IRC Section 6901(a)
IRC Section 6901(h)