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Subject: Brett L. Bueltel, A. Kelly Walker & Jamie L. Seitz - When Terminable Interests Prevent the Marital Deduction in Estate Disputes

"As estate attorneys and advisors, one of our primary goals is to do what's in the best interests of the estate. We strive to minimize the amount of the estate subject to estate tax to maximize the value of property passed tax-free to the intended beneficiaries of the decedent. While individuals prepare their wills with the best of intentions, estate disputes often arise even in well-prepared estates.

The marital deduction is one of the most important tools that an estate can use. The deduction allows for the tax-free passing of assets to a surviving spouse by reducing the value of the estate for all assets that pass to the surviving spouse. But, the exact timing of when a surviving spouse has a nonterminable interest is complicated by settlement payments in estate disputes and court judgments.

Whenever an estate dispute occurs, estate attorneys and advisors need to consider all options before deciding on settlement or further litigation. A major deciding factor is whether the course of action will allow for or prevent the estate from using the marital deduction.

A common scenario faced by estate attorneys and advisors is when a surviving spouse has a terminable interest under a prenuptial agreement and decides to contest the validity of the agreement. Settling the dispute or proceeding with litigation is a major decision for the estate. If the estate decides to settle the dispute, the estate may be able to preserve the marital deduction by structuring the settlement payment as a statutory election. If the estate proceeds forward with litigation and is unsuccessful in court, any court award the estate pays to the surviving spouse would qualify for the marital deduction. An estate attorney or advisor must consider the effect of any course of action on the marital deduction."

We close the week with commentary by **Brett L. Bueltel, A. Kelly Walker** and **Jamie L. Seitz** that analyzes when terminable interests prevent the marital deduction in estate disputes.

Brett L. Bueltel and **Jamie L. Seitz** are both assistant professors of accounting at the University of Southern Indiana in Evansville, Ind., and **A. Kelly Walker** is a clinical assistant professor at Mississippi State University in Mississippi State, Miss. Thier commentary was originally published in *Trusts & Estates* in March 2018.

Here is their commentary:

EXECUTIVE SUMMARY:

As estate attorneys and advisors, one of our primary goals is to do what's in the best interests of the estate. We strive to minimize the amount of the estate subject to estate tax to maximize the value of property passed tax-free to the intended beneficiaries of the decedent. While individuals prepare their wills with the best of intentions, estate disputes often arise even in well-prepared estates.

The marital deduction is one of the most important tools that an estate can use. The deduction allows for the tax-free passing of assets to a surviving spouse by reducing the value of the estate for all assets that pass to the surviving spouse. But, the exact timing of when a surviving spouse has a nonterminable interest is complicated by settlement payments in estate disputes and court judgments. This commentary analyzes when terminable interests prevent the marital deduction and consider some strategies to allow for the marital deduction.

COMMENT:

Timing of Terminable Interests

The federal estate tax imposes a tax on the estate of every decedent who's a citizen or resident of the United States and whose estate value exceeds a certain dollar threshold.[i] The marital deduction in Internal Revenue Code Section 2056 allows for assets to pass from a decedent to a surviving spouse tax-free and avoid the estate tax except when the spouse has a "terminable interest."[ii]

IRC Section 2056 defines a terminable interest as any interest "[w]here, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail."[iii] Thus, a decedent must convey a complete interest to the surviving spouse to use the marital deduction.

To apply the marital deduction, a surviving spouse must have a nonterminable interest in the estate property. Knowing when a surviving spouse has a nonterminable interest in estate property isn't always clear. For instance, a prenuptial agreement allowing a surviving spouse to only receive a life estate in estate property is a terminable interest. But, any subsequent settlement payment or court judgment received from the estate would arguably be a nonterminable interest. The exact timing of a surviving spouse's interest in the estate is important in determining whether the estate can use the marital deduction.

The court in *Jackson v. U.S.* developed a legal doctrine to help determine when a nonterminable interest must be present for an estate to use the marital deduction.[iv] In *Jackson*, after the death of her husband, a surviving spouse received a widow's allowance under California law. The state court awarded the widow payments from the estate to satisfy the widow's allowance. The estate applied the marital deduction to the amount the estate paid to the surviving spouse as part of the widow's allowance. The Internal Revenue Service disputed the treatment of the widow's allowance, claiming that the payment was a terminable interest because the widow's allowance wasn't a vested right, and nothing accrued before payments were granted because the widow could only receive payments if certain conditions were met. Under California law, if a widow died or remarried, the widow's estate wouldn't be entitled to the widow's allowance. The state court disallowed the marital deduction, and the surviving spouse appealed.

On appeal, the case went before the U.S. Supreme Court on the issue of whether the estate's payments to the widow qualified for the marital deduction or if the widow's allowance was a terminable interest. The Court stated that the initial rights granted by the widow's allowance were terminable interests because to receive payments, the widow must not die or remarry. The Court also acknowledged that after a payment has been made to the widow as part of the widow's allowance, the widow has a completed interest in the payment, and neither of the contingencies (death or remarriage) would require the widow to forfeit the payment. Thus, after a completed payment, the widow arguably has a nonterminable interest in estate property.

The Court thus had to decide whether the surviving spouse's initial terminable interest before payment or the nonterminable interest after completed payment determined the marital deduction. The Court stated that, ". . . courts have held the date of death of the testator to be the correct point of time from which to judge the nature of a widow's allowance for the purpose of deciding terminability and deductibility."[v] The Court also stated, "there is no provision in the Code for deducting all terminable interests which become nonterminable at a later date . . . The examples cited in the legislative history make it clear that the determinative factor is not taxability to the surviving spouse but terminability as defined by the statute."[vi] Thus, the date of death became the point in time to determine if an interest is terminable or nonterminable, and the Court disallowed the marital deduction.

Applying the *Jackson* Doctrine

The *Jackson* doctrine states the surviving spouse's interest at the testator's date of death determines the marital deduction. But, the *Jackson* doctrine is more complicated when estate disputes result in settlement payments and court awards. In most instances, settlement payments and court awards are nonterminable interests because there are no conditions attached to them. If the interest at issue in settlement negotiations or litigation is a terminable interest, the subsequent change to a nonterminable interest can obfuscate the ability for an estate to use the marital deduction. We'll analyze a few common scenarios applying the *Jackson* doctrine to see how these scenarios potentially affect the marital deduction.

Example 1: Settlement payment with no prenuptial agreement. In this scenario, the testator dies leaving the surviving spouse part of the estate. The surviving spouse contests the will; subsequently receiving a settlement payment. The decedent's estate would like to use as much of the marital deduction as possible to limit any estate tax liability.

If the testator left the surviving spouse a nonterminable interest under the will, then the surviving spouse had a nonterminable interest in the estate at the testator's date of death. Thus, any subsequent settlement payment made by the estate to the surviving spouse would likely qualify for the marital deduction. In this case, the interest the surviving spouse received at the testator's date of death and the settlement payment are both nonterminable interests so the *Jackson* doctrine doesn't affect the outcome.

Example 2: Settlement payment with a prenuptial agreement. If a prenuptial agreement is present that grants a surviving spouse a life estate in estate property, the possibility of using the marital deduction becomes more complex. In this scenario, the testator and the surviving spouse enter into a prenuptial agreement granting the other a life estate in the estate property. On the death of the testator, the surviving spouse challenges the validity of the prenuptial agreement. The estate agrees to pay the surviving spouse a settlement payment, and the surviving spouse releases all claims against the estate.

According to the prenuptial agreement, the testator granted the surviving spouse a life estate in the estate property. The IRC considers a life estate to be a terminable interest.[vii] However, instead of obtaining a life estate in the estate property, the surviving spouse received a settlement payment from the estate. The settlement payment isn't a terminable interest because it isn't subject to any other conditions. Thus, the surviving spouse's interest in the estate has changed from a terminable interest into a nonterminable interest, and the *Jackson* doctrine will determine how the estate can treat the settlement payment. Looking at the date of death, the surviving spouse only had a terminable interest, a life estate. Thus the estate can't use the marital deduction even under the current version of the IRC.

While *Jackson* dealt with an older version of the IRC, *Carpenter* dealt with current version of Section 2056. In *Carpenter*, a surviving spouse had a life estate under the decedent's will.[viii] The surviving spouse and the estate entered into a settlement agreement in which the surviving spouse would receive a settlement payment. The Tax Court disallowed the marital deduction and reaffirmed the ruling in *Jackson* by holding that when a surviving spouse only has a life estate at the testator's date of death, any subsequent settlement payment won't qualify for the marital deduction. "[U]nder the *Carpenter* analysis, if a spouse does not have an enforceable right under state law to an interest qualifying for the martial deduction prior to the settlement agreement, the agreement cannot convey a perfected interest that qualifies for the [marital] deduction."[ix] Therefore, the interest doesn't qualify for the marital deduction because the surviving spouse didn't have a nonterminable interest prior to the settlement agreement.

Example 3: Settlement payment with a prenuptial agreement structured as a statutory election. Even though the scenario from Example 2 would prevent the marital deduction, another approach may allow an estate to take the marital deduction. In the scenario from Example 2, a prenuptial agreement grants a life estate to a surviving spouse who later contests the will and prenuptial agreement. The surviving spouse then receives a settlement payment to release all claims against the estate. If a surviving spouse elects to treat a settlement payment as a statutory election, the estate may be able to apply the marital deduction.

A statutory share election is a right granted by state law that allows a surviving spouse to elect to disregard the provisions of the will and receive a percentage of the estate determined by state law.[x] In most prenuptial agreements, each spouse waives the right to elect a statutory share. So, in most instances, spouses who enter into a prenuptial agreement won't be able to elect to receive a statutory share. However, if a surviving spouse challenges the validity of the prenuptial agreement and the will, an exception to the general rule exists.

The IRS has stated that the waiver of statutory rights in a prenuptial agreement that's later challenged doesn't preclude a surviving spouse from exercising his statutory election rights. In Revenue Ruling 66-139, the IRS concluded that an estate can take the marital deduction in recognition of the surviving spouse's elective share even when a prenuptial agreement is present.

In the revenue ruling, a couple entered into a prenuptial agreement in which they each renounced all rights in the other's property. When the testator passed, the surviving spouse challenged the prenuptial agreement and tried to claim her statutory election rights under state law. The surviving spouse and estate settled before the dispute went to trial, and the surviving spouse received a settlement payment. The IRS allowed the marital deduction for the elective share based on the good faith nature of the settlement even without a formal finding of invalidity of the prenuptial agreement.[xi] Even though there's been some negative treatment of the revenue ruling, the IRS continues to cite it favorably.[xii] Thus, if a surviving spouse challenges a prenuptial agreement, the surviving spouse can elect to receive a statutory share in the form of a settlement payment.

If the surviving spouse is allowed to elect to take the statutory election, the *Jackson* doctrine likely allows for the estate to use the marital deduction. Without the statutory election, the rights under the prenuptial agreement only allow for a terminable interest, and the subsequent settlement payment would be a nonterminable interest. Because the *Jackson* doctrine requires the interest at the date of death to be controlling, the surviving spouse would only have a terminable interest at the date of death preventing the marital deduction. A statutory election right, however, exists at the date of death of the testator. When the settlement payment is structured as a statutory election, the surviving spouse's right at the testator's date of death would be a nonterminable interest. Thus, if the settlement payment is structured as a statutory election, the estate will likely be able to employ the marital deduction.

Example 4: Court award. Instead of settling, the estate and surviving spouse may decide to proceed forward with litigation. If a surviving spouse has a terminable interest in the estate, contests the validity of the will and prenuptial agreement and then receives a court award, the result will be different from a settlement payment.

The *Jackson* doctrine seems to prevent the marital deduction in this situation. If a surviving spouse had a terminable interest at the date of death of the decedent, any subsequent court award even if nonterminable wouldn't qualify for the marital deduction. Treasury Regulation Section 20.2056, however, explicitly allows for the tax-free passing of a court award resulting from a dispute over a will:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a *bona fide recognition of enforceable rights* of the surviving spouse in the decedent's estate. Such a bona fide recognition *will be presumed* where the assignment or surrender was pursuant to a

> decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. . .[xiii]

Even though the surviving spouse only had a terminable interest at the testator's date of death, this regulation explicitly allows for the marital deduction to apply to the court award paid by the estate to the surviving spouse. Thus, the estate can use the marital deduction in this scenario.

A Major Decision

Whenever an estate dispute occurs, estate attorneys and advisors need to consider all options before deciding on settlement or further litigation. A major deciding factor is whether the course of action will allow for or prevent the estate from using the marital deduction.

A common scenario faced by estate attorneys and advisors is when a surviving spouse has a terminable interest under a prenuptial agreement and decides to contest the validity of the agreement. Settling the dispute or proceeding with litigation is a major decision for the estate. If the estate decides to settle the dispute, the estate may be able to preserve the marital deduction by structuring the settlement payment as a statutory election. If the estate proceeds forward with litigation and is unsuccessful in court, any court award the estate pays to the surviving spouse would qualify for the marital deduction. An estate attorney or advisor must consider the effect of any course of action on the marital deduction.

HOPE THIS HELPS YOU HELPS OTHERS MAKE A *POSITIVE* DIFFERENCE!

Brett L. Bueltel

A. Kelly Walker

Jamie L. Seitz

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[i] Internal Revenue Code Section 2001.

[ii] IRC Section 2056(b).

[iii] *Ibid.*

[iv] *Jackson v. United States*, 376 U.S. 503 (1964).

[v] *Ibid*., at 508.

[vi] *Ibid*., at 509-510.

[vii] IRC Section 2056(b).

[viii] *Estate of Carpenter v. C.I.R.*, 52 F.3d 1266 (1995).

[ix] *See* Julie K. Kwon, "*Tax Aspects of Settlements*," SN045 ALI-ABA 325 (2008).

[x] *See generally* Angela M. Vallario, "The Elective Share Has No Friends: Creditors Trump Spouse In The Battle Over The Revocable Trust," 45 *Cap. U. L. Rev.* 333 (2017). (Every state has a statutory elective share except Georgia.)

[xi] Revenue Ruling 66-139.

[xii] *See* Brett L. Bueltel, et al., “Using the Marital Deduction in Settlements,” 157 *Tax Notes* 667, 668 (2017) (“…it is worth noting that the IRS continues to view Rev. Rul. 66-139 as an authority”).

[xiii] Treasury Regulation Section 20.2056(2) (emphasis added).