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Tax-deductible inheritance?

The terms of Warren Billhartz' 1978 divorce decree required him to leave half of his estate to the four children from his first marriage (one son, three daughters), divided equally. He remarried a year later. Most of Billhartz' assets were owned jointly with Marcia, his second wife, or were held in a living trust. Marcia and Ward, the son from the first marriage, were co-trustees of the trust.

Warren died in 2006, leaving a substantial estate. In accordance with the divorce decree, the trust obtained a lifetime annuity for the first wife, but he did not leave the children half of the estate. Ward received 16% of the balance of the trust, and each of the daughters 6%—in other words, the divorce decree requirement that the children be treated equally was ignored, and they received only 34% of the net trust assets.

The distribution to the children totaled \$14 million. The executor characterized that payment as a deductible claim against the estate under the divorce decree, and took a deduction for the full amount. IRS disallowed the entire deduction, creating a tax deficiency of \$6.6 million. The estate took the case to the Tax Court. However, after a series of negotiations, the estate and the IRS reached a settlement in which the Service agreed to allow 52.5% of the deduction. No rationale for that partial deduction is provided in the court opinion.

Next, it appears that the daughters were not aware that, under the terms of the divorce decree, they were entitled to the same share of their father's estate as their brother, and that the siblings should have had 50% of the estate. They first learned of the terms of the decree when the Tax Court litigation was filed. The sisters filed a state lawsuit alleging fraud. Curiously, the brother resigned his trusteeship and joined their lawsuit, alleging Marcia had concealed key documents from them.

With the possibility that additional payouts would be due to the children, the estate moved to void its settlement agreement with the IRS. Litigation with the children was settled with an additional distribution to each of the girls of \$1.45 million. Perhaps the estate hoped to apply the 52.5% deduction to the additional payouts.

The Tax Court refused to set aside the settlement, and entered a decision for the IRS. On appeal, the Seventh Circuit Court of Appeals agreed. The estate contended that the settlement was based upon a mistake of fact, that the distributions to the children had already been finalized. The Circuit Court notes that "mistake of fact" does not extend to a failure to anticipate future developments. The estate also alleged that counsel for the IRS had learned from one of the daughters that a lawsuit was being contemplated and should have relayed that information to the estate. The Court stated that the estate itself was in a better position to judge the future actions of the beneficiaries than was the IRS.

In a footnote the Court noted that no opinion was expressed on the appropriateness of the deduction for the bequests to the children. The fact that both sides agreed to a "split the baby" settlement figure of a 52.5% deduction suggests that neither were fully confident of the state of the law in this situation.

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