TAX COURT CASE UPDATE

Citation:

Estate of Gertrude H. Saunders, et al. v. Commissioner, No. 12-70323 (9th Circuit), March 12, 2014.

Overview:

The Court of Appeals for the Ninth Circuit, affirming the Tax Court, has held that, in determining a decedent's federal taxable estate for estate tax purposes, the estate could not claim a $30 million deduction for malpractice litigation pending against it as of the date of death. The value of the claim was too uncertain to be deducted based on estimates as of the date of death. A deduction was allowed, however, for the amount paid in settlement of the claim.

The Facts:

William Saunders was an attorney who at one time represented Harry Stonehill. In 1990, extensive litigation commenced involving Mr. Stonehill, and an IRS document suggested that Saunders had acted as a secret IRS informer against Mr. Stonehill's interests. Mr. Stonehill died in 2002, and Saunders died in 2003. In 2004, 74 days before Mr. Saunders' wife Gertrude died, the Stonehill estate filed formal complaints alleging that Mr. Saunders had committed legal malpractice, breach of confidence, breach of duty of loyalty, and fraudulent concealment against Mr. Stonehill. The complaints requested over $90 million in compensatory damages, plus additional punitive damages. Years of litigation ensued.

In 2007, a jury trial found that Mr. Saunders had breached his fiduciary duty of confidentiality and his duty of undivided loyalty to Mr. Stonehill, but also found that neither breach was a legal cause of injury or damage to Mr. Stonehill or to his estate. Costs of $289,000 were awarded to the Saunders estate in the final judgment. The Stonehill estate appealed the judgment, but the litigation was ultimately resolved by a settlement agreement and mutual release. Mr. Saunders' estate paid $250,000 in attorney's fees to the Stonehill estate's attorney and waived its right to the $289,000 costs awarded in the state court judgment.

A return for William Saunders' estate was filed in 2005, and a $30 million deduction was claimed for the Stonehill estate malpractice claim. The estate tax return was examined, and in 2009, a closing document was issued stating that the value of the malpractice claim would be resolved in the estate of the surviving spouse, Gertrude Saunders. A return for her estate was filed in 2006, also claiming a $30 million deduction for the Stonehill estate malpractice claim. The IRS allowed a $1 deduction for the malpractice claim and assessed a $14.4 million deficiency against Mrs. Saunders' estate.

The dispute wound up in Tax Court, which held that the value of the Stonehill claim was not ascertainable with reasonable certainty as of the date of Mrs. Saunders' death in 2004. In reaching this result, the court focused on the various reports presented by the estate for use at trial. These were prima facie indications of the lack of reasonable certainty. The suggested values of the claim were $30 million in a 2005 valuation ($90 million discounted to $30 million

because of settlement possibility and the wide range of unknowns), $25 million in a 2009 valuation (the first $30 million valuation discounted by $5 million in light of the time and expense involved in the litigation), $19.3 million in 2008 (using a "decision tree" analysis following through the various courses of action in the litigation), and $22.5 million in 2010 (there was a 75 percent or better chance of obtaining a jury verdict in excess of $30 million such that the case had a risk-adjusted value of $22.5 million or more at the time it commenced). The Tax Court said none of the estate's experts opined, nor could they reasonably opine, that the $30 million claimed on the estate tax return or any specific lesser amount would be paid, as required by the regulations. The stark differences between their reports and those of the IRS's experts (one said the malpractice claim had no merit, and at most a 3 percent chance of recovery if pursued fully, and the other said it could be valued at $3.2 million) merely reinforced the uncertainties inherent in the process.

The Tax Court concluded that the Stonehill claim was not deductible as of the date of death of Gertrude Saunders, and that the amount actually paid during the administration of the estate could be deducted in accordance with prior Regulation Section 20.2053-1(b)(3).

Discussion:

The Ninth Circuit said that it applied the regulations at issue in the case several times. In so doing, it classified claims as either "certain and enforceable," on the one hand, or "disputed or contingent," on the other. This distinction governs whether courts may consider post-death events, such as the settlement in this case, when determining the permissible deduction for claims against an estate. Under Ninth Circuit case law, *Propstra* makes it clear that courts may "consider post-death events when valuing a disputed or contingent claim against an estate."

The Ninth Circuit says its distinction between certain and enforceable claims and disputed or contingent claims flows naturally from the text of the regulations. When a certain and enforceable claim is pending against an estate at the date of the decedent's death, it follows that the estimated date-of-death value of such a claim is "ascertainable with reasonable certainty." When, however, a claim is disputed or contingent, its estimated date-of-death value is far less likely to be reasonably ascertainable. In such circumstances, estates must petition the Tax Court or file a claim for a refund once the claim's value later becomes certain.

The estate argued that the Stonehill claim was "certain and enforceable" at the date of Gertrude Saunders' death. As such, it asserted that the claim's estimated date-of-death value was ascertainable with reasonable certainty as a matter of law.

The Ninth Circuit noted that the Tax Court did not expressly classify the Stonehill claim as either "certain and enforceable" or "disputed or contingent." While the Tax Court did not follow the *Propstra*-dichotomy, that did not matter. The Tax Court properly considered post-death events in computing the allowable deduction.

The Stonehill claim was not contingent, but it was disputed at the date-of-death. As such, the Tax Court properly considered its post-death settlement value in computing the allowable deduction. Even so, the estate asserted that the Tax Court should have assigned it a date-of-death value, notwithstanding the substantial disparities in expert valuations, and the post-mortem settlement of the claim. But the Ninth Circuit found the estate's arguments unpersuasive.

Conclusion:

The estate failed to show that the claim’s estimated value was ascertainable with reasonable certainty. As such, the IRS properly disallowed the estate's $30 million deduction. The value of the Stonehill claim became certain when it settled after Gertrude Saunders' death. Thus, the Tax Court properly allowed a deduction in the amount of the claim's settlement value.