Final Regulations Under Section 2053 Governing Estate Tax Deductions for Administration Expenses and Claims Against Estates

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1. Brief Summary of Major Changes in Final Regulations. Final regulations (effective for decedents dying after October 19, 2009) continue the general concept in the proposed regulations of allowing an estate tax deduction under §2053 for nonascertainable or contingent claims only when they are actually paid. Some of the major changes made in the final regulations include: (1) Exceptions are allowed for contingent claims against an estate to offset the value of other assets that comprise at least 10% of the gross estate and for the deduction of contingent claims totaling no more than $500,000 (although these exceptions may not be widely used); (2) Settlements do not have to be proven to be within the reasonable range of settlement outcomes to be recognized; (3) There is no affirmative duty for the executor to report when claimed expenses or claims are not actually paid; (4) Marital or charitable deductions do not have to be reduced on the return by contingent expenses or claims that may be paid out of amounts that would otherwise pass to a spouse or charity if a protective claim for refund is filed regarding that contingent expense or claim; (5) The rebuttable presumption that claims by family members, related entities or beneficiaries are not legitimate and bona fide has been deleted and a non-exclusive list of factors provided for determining whether a claim by such a person is bona fide; and (6) The concept of allowing only the *present value* of recurring noncontingent claims has been dropped, but a regulation project considering how present value concepts should be applied to §2053 administration expenses and claims is continuing. In addition, Notice 2009-84 issued in conjunction with the regulations clarifies that the IRS will review only evidence related to a §2053 expense or claim in considering a protective claim for refund under §2053 if the claim for refund "ripens" after the three-year period for assessment of additional estate taxes has run.

2. Case Law Regarding Deduction for Claims Against Estates (Now Governing Estates of Decedents Dying Before October 20, 2009). One possible debt deduction is for claims against the estate that are uncertain in amount at the date of death. There is a split among the circuit courts of appeal on this issue. Aghdami, Effect of Post-Mortem Facts On Claims Against the Estate, TR. & EST. 18 (May 2004); Loeb, Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims. The line of cases on the opposite side strictly follow the 1929 Supreme Court decision in Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929), and its general rule that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death. Cases in the Fifth, Ninth, Tenth, and Eleventh Circuits now agree in refusing to consider post-death events in valuing claims against the estate of uncertain value at the date of death.

   Observe that ignoring post-death events can also benefit the IRS in some circumstances. For example, one attorney reported having an estate audit over property worth $700,000 with known environmental problems and reported on the Form 706 an estimated value net of the clean up costs of $250,000. Within two years after the date of death, the estate had actually spent $2.5 million of clean up costs. The IRS objected to considering the actual expenditure.

   A practical problem is how to balance estate tax reporting with the defense of the actual litigation. The plaintiff suing the estate may depose the executor the day after the estate tax return is due and subpoena a copy of the return. If the claim against the estate is reported at a high value on the estate tax return (to support a large deduction), the plaintiff will use that as "Plaintiff's Exhibit 1" to argue that even the estate thinks the claim is valid and large. The best approach seems to report the claim against the estate on the Form 706 and list its value as "Undetermined."

3. Valuation of Disputed Claims Against Estate and Other Administration Expenses — Regulations Effective For Decedents Dying After October 19, 2009. The IRS issued proposed regulations in April 2007, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate, but there is an exception for estimated amounts that are ascertainable with reasonable certainty. A protective claim for refund can be filed before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved and paid. Final regulations were issued effective for decedents dying after October 19, 2009.

a General Rules Applicable to All of §2053, §20.2053-1.

(1) Applies to All of §2053. Regulation §20.2053-1 applies to all deductions under §2053, not just claims against the estate.

(2) Bona Fide Expenses and Claims; Claims by Family Members, Related Entities or Beneficiaries, §20.2053-1(b)(2). A deduction is allowed only for bona fide expenses and claims other than essentially donative transfers ("a mere cloak for a gift or bequest"). Treas. Reg. §20.2053-1(b)(2)(i).

Claims by a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust must be "bona fide" to be deductible. The final regulations drop a rebuttable presumption in the proposed regulations that claims by such persons are not legitimate and bona fide. There is a definition of family members, including the decedent's spouse, grandparents, parents, siblings, lineal descendants, and spouses and lineal descendents of grandparents, parents and siblings. [Observe: Spouses of such lineal descendents are not included.] A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial interest at the date of death or in the preceding three years, other than a publicly-traded entity or a closely held entity in which the interests of the decedent and family members is less than 30% (whether voting or nonvoting).

The final regulations add a non-exclusive list of factors that may be considered in determining that such a claim is bona fide. Those factors include whether the claim is: (i) In the ordinary course of business; (ii) Not related to an expectation of inheritance; (iii) Founded on an agreement substantiated by contemporaneous evidence; (iv) Supported by actual performance of the agreement that can be substantiated; and (v) Supported by consistent reporting of such amounts for income and employment tax purposes. (There is an example for accounting services provided by a niece that are so clearly legitimate that the example gives little guidance of how the limitations would be applied in a more non-commercial setting. Treas. Reg. §§20.2053-1(b)(2)(ii-iii) & 20.2053-1(b)(4)Ex.3.)

(3) Court Decree, §20.2053-1(b)(3). The regulations restate the general discussion in the prior regulations regarding the effects of court decrees. The mere payment of funeral expenses, administration expenses, claims or mortgages is not, by itself, sufficient to assure the deductibility of the amount paid. While a court decree is not required to support a deduction (unless a court decree is required under applicable law), the regulation adds that a court decree may be relied on if: (a) the expenditures are otherwise deductible under §2053 and its regulations; (b) the court actually passed on the facts relating to the expenditures and actually passed on the merits of the claim (which is presumed if there is an active and genuine contest, but if the result appears unreasonable, that is "some evidence" that there

was not an active and genuine contest); and (c) the expenditures have been paid or will be paid by the estate. An example in the regulations clarifies that the court's decision must be consistent with local law. Treas. Reg. §20.2053-1(b)(4)Ex.1

If the court decree is based on consent of the parties, the consent must resolve "a bona fide issue in a genuine contest" [deleting the following parenthetical in the prior regulations — "(and not a mere cloak for a gift)"]. The regulation restates a similar provision in the prior regulation that "[c]onsent given by all parties having interests adverse to that of the claimant will be presumed to resolve a bona fide issue in a genuine contest." Treas. Reg. §20.2053-1(b)(3)(iii).

(4) Settlements, §20.2053-1(b)(3)(iv). A settlement may be relied on to support the deduction of an amount paid (or meeting the requirements for ascertainable expenses described below) if several requirements are met: (a) the settlement resolves a bona fide issue in an active and genuine contest; (b) the settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim; and (c) the underlying claim is not unenforceable. The final regulations drop a requirement in the proposed regulations that the settlement be within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement, (which might have led to substantial "second guessing" by IRS agents of the settlement decision). Despite dropping that requirement, the final regulations add that "a deduction will not be denied for a settlement amount paid by an estate if the estate can establish that the cost of defending or contesting the claim or expense, or the delay associated with litigating the claim or expense, would impose a higher burden on the estate than the payment of the amount paid to settle the claim or expense." Apparently, that sentence relates to showing the existence of arms' length negotiations; otherwise the regulation does not allow the IRS to address the substance of the settlement (but unenforceable claims may not be deducted despite any settlements).

Observe, if all family members agree with the validity of a claim by another family member, they may have difficulty establishing the arm's length requirement for settlements. That requirement does not exist for the court decree provision (even a court decree based on consent), so the parties may wish to go through a court proceeding rather than just relying on a settlement agreement.

(5) Limit to Amounts Actually Paid (and Not Reimbursed), §20.2053-1(d)(1). A sentence is added to this regulation limiting all deductions under §2053 (including funeral expenses, executor commissions, attorney fees, administration expenses, and mortgages) to "the total amount actually paid." A corollary of this requirement is that no deduction is allowed if the amount "is or could be compensated for by insurance or otherwise." The final regulations add that an executor may certify on the return that the executor "neither knows nor reasonably should have known of any available reimbursement." §20.2053-1(d)(3). (Query, how can the executor certify on the return what he "reasonably should have known?") A potential reimbursement will not reduce the deduction if the executor provides a reasonable explanation of why the burden of collection efforts would outweigh the anticipated benefit. Observe: Being able to consider the "burden" of collections is considerably broader than just considering the "expenses" of collection.

(6) Ascertainable Amounts, §20.2053-1(d)(4). The regulation keeps the concept in the prior regulation that allows the deduction of estimated amounts that are ascertainable with reasonable certainty (as opposed to vague and uncertain estimates) and will be paid, even if the exact amount is unknown. The final regulation adds that executor commissions and attorney fees that meet the general requirements for deductibility (under Regulation §20.2053-3(b-c)) "are deemed to be ascertainable with reasonable certainty and may be deducted if such expenses will be paid." Treas. Reg. §20-2053-1(d)(4)(i).

If an amount cannot be ascertained with reasonable certainty, no deduction is allowed until the amount is paid. Treas. Reg. §20.2053-1(d)(4)(i). (There are several additional exceptions, described below, for uncertain claims against an estate.) Post-death events are taken into account in determining the amount that is "ascertainable with reasonable certainty and will be paid." Treas. Reg. §20.2053-1(d)(4)(ii).

If the tax preparer has any doubt whether an amount that is unpaid at the time of filing is "ascertainable with reasonable certainty," then the preparer should file a protective claim. If the IRS disallows the deduction, the protective claim will generate a deduction of the amount that is actually paid.

(7) No Affirmative Duty to Report. The proposed regulation added that the executor has the duty to notify the IRS if the payment is waived or left unpaid, and must pay the resulting additional estate tax (with interest). (Observe: that requirement was in the prior regulation dealing with executor commissions, §20.2053-3(b)(1).) The final regulation deletes the affirmative duty to report. The preamble to the final regulations noted that "[s]ome commentators questioned whether the proposed regulations would impose a duty on the executor to report amounts that were claimed as deductions on the estate tax return, but were subsequently not paid or not paid in full, and whether such a duty could be enforced after the period of limitations on assessment has expired." The preamble's response is that "[t]he Treasury Department and the IRS did not intend for the proposed regulations to impose a duty on the executor that could be enforced after the expiration of the period of limitations on assessment," and the final regulations eliminate the duty to report provision altogether. (Indeed, the final regulations eliminate the duty to report as to executor commissions that was in the prior regulation. Treas. Reg. §20-2053-3(b)(1).).

(8) Protective Claims for Refund, §20.2053-1(d)(5).

(a) Timing. The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax). (While there is an extended period of time to file the protective claim for refund, many planners recommend filing it at the same time as the Form 706, or very soon thereafter, to assure that the filing deadline is not later missed inadvertently.)

(b) Identification of Claims. The protective claim for refund must identify each claim or expense and describe the reasons and contingencies delaying actual payment of the claim. (Amounts do not have to be listed.)

(c) Consideration of Protective Refund Claim. The protective claim for refund is considered after the executor has notified the IRS "within a reasonable period that the contingency has been resolved." While no specific time period is specified beyond "reasonable period," the executor cannot delay raising the protective claim with the IRS indefinitely after the contingency has been resolved.

(d) Further Guidance. The preamble to the final regulations indicates that the IRS will issue further guidance on the process of using protective claims for refund. The preamble also indicates that the IRS is considering amending Form 706 to incorporate a protective claim for refund so that a separate form need not be filed.

(e) Notice 2009-84: Entire Return Not Open to Offset Protective Refund Claim. The Supreme Court has held that the IRS can examine each item on a return to offset the amount of a refund claim, even after the period of limitations on assessment has run. Lewis v. Reynolds, 284 U.S. 281, 283 (1932). However, the IRS in Notice 2009-84 agreed that it would limit the review of protective claims for refund to preserve the ability to claim a deduction under §2053 "to the evidence relating to the deduction under section 2053," and not exercise its authority to examine each item on the return to offset a refund claim. This limitation does not apply if the IRS is considering a claim for refund not based on a protective claim regarding a deduction under §2053 in the same estate. Also, the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." (Accordingly, there may be an advantage in not having resolved the underlying lawsuit regarding the claim against the estate until after the period on additional assessments has run — to the extent that there may be items on other parts of the estate tax return that the IRS might question if it could.)

(f) Effect on Marital or Charitable Deduction. The possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. (This applies under the regulation only "to the extent that a protective claim for refund is filed." Presumably, the IRS anticipates that returns will not need to reduce the marital or charitable deduction even before the protective claim for refund has been filed.) However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

b. Executor Commissions and Attorney Fees, §20.2053-3(b-d). Executor commissions are deductible only if they are within the usually accepted standards and practice for estates of similar size and character. Any deviation from the usually accepted standards or range of amounts (permissible under applicable local law) must be justified to the Commissioner. If the decedent's will sets the amount of executor's commissions, they can be deducted to the

extent the amount does not exceed the amount allowable by local law or practice. Treas. Reg. §20.2053-3(b). Attorneys' fees may not be deducted if they exceed a reasonable amount considering the size and character of the estate, the law and practice in the jurisdiction, and the skill and expertise of the attorneys. A deduction for reasonable attorneys fees in contesting an asserted deficiency or in pursuing a claim for refund may be allowed even if not claimed on the return or in the claim for refund. Treas. Reg. §20.2053-3(c)(1-2). Expenses in defending against claims against an estate are deductible even if the estate does not prevail. Treas. Reg. §20.2053-3(d)(3).

c. Claims Against the Estate, §20.2053-4. The one short paragraph in the prior regulations has been expanded to pages of detailed provisions regarding the deductibility of claims against the estate.

(1) General Requirements. Deductible claims are limited to bona fide claims that —

(i) Represent personal obligations of the decedent existing at the time of the decedent's death;

(ii) Are enforceable against the decedent's estate (and not unenforceable when paid); and

(iii) Are actually paid by the estate in satisfaction of the claim or are ascertainable. Treas. Reg. §20.2053-4(a)(1).

Post-death events are considered. Treas. Reg. §20.2053-4(a)(2).

Executors must be very diligent and not pay unenforceable claims. Sometimes executors pay unenforceable claims — because it is the "right" thing to do or the executor may not realize the technical unenforceability. For example, maybe creditors did not follow the technical rules for presentment of claims. If the executor pays that claim, it is not deductible. As another example, if the statute of limitations has run on a note that a family member holds, the estate should not pay it.

(2) Potential and Unmatured Claims; Contested Claims, §20.2053-4(d)(1-2). No deduction may be taken on an estate tax return for a potential or unmatured claim or for a contested claim, but the estate can file a protective claim for refund, so that unmatured claims that later mature and are paid are deductible.

(3) Exceptions.

(a) Claims and Counterclaims in Related Matter, §20.2053-4(b). If the estate includes a claim or cause of action or other particular asset and there is a claim against the estate in the same matter or that is "integrally related to that asset," the claim may be deducted on the estate tax return if the claim meets the other requirements for deducting administration expenses other than the "reasonably ascertainable" requirement and if (i) the value of the claim is determined from a "qualified appraisal" by a "qualified appraiser" (using the rules under §170(f)(11)(E)) and (ii) the aggregate value of the related claims or assets included in the gross estate exceed 10 percent of the gross estate. The claim may be deducted only up to the value of the related claim or asset value. The value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(b)(3).

(b) Claims Totaling Not More Than $500,000, §20.2053-4(c). The estate may deduct any non-ascertainable claims (that meet the other general requirements for deductions under §2053) that have a combined value up to $500,000 (in addition to claims that can be deducted under the "counterclaim exception" described above). However, the "full value" of each such claim must be within the aggregate $500,000 limit for the estate. For example if there are three claims against the estate valued at $200,000 each, two of the claims could be deducted under this exception, but not the third claim because the full value of the third claim would not be covered by the $500,000 limit. Treas. Reg. §20.2053-4(c)(3)Ex. 2. As with the "counterclaim exception," there must be a qualified appraisal by a qualified appraiser of each such claim deducted under this exception, and the value of the claim is subject to adjustment for post-death events.

(c) Practical Effect of Exceptions. Notice 2009-84, issued in conjunction with the release of the final regulations to §2053, state that "[a]s a result of these exceptions, the Treasury Department and the Service anticipate that the number of protective refund claims filed to preserve a deduction under section 2053 will be significantly smaller that was anticipated by commentators to the proposed regulations." However, few estates may elect to use these two exceptions. Planners generally recommend not taking an estate tax deduction for non-ascertainable claims while litigation is still ongoing or threatened for fear the value placed on the estate tax return would be used in the underlying substantive litigation. This fear would be exacerbated if the return not only places a value on the claim but also is supported by a "qualified appraisal." Furthermore, it may be difficult to find "qualified appraisers" who have the expertise to value contingent claims in litigation. In the past, trial attorneys or judges with substantial experience in litigating claims have been used at trial to support the date of death estimated value of claims against an estate. In many situations, they would seem to have the best experience in evaluating such claims in litigation, but they probably do not meet the detailed requirements of a "qualified appraiser" under §170(f)(11)(E)(ii) (i.e., they probably do not have an appraisal designation from a recognized professional appraiser organization or regularly perform appraisals for which they receive compensation).

(4) Multiple Parties; Reimbursement, §20.2053-4(d)(3). If the claim is asserted against the estate and one or more other parties, only the portion "due from and paid by the estate" may be deducted. The deductible portion must be reduced by any reimbursement received from any other party or the amount the estate could collect from another party or insurer even if the estate declines or fails to attempt to collect. (Presumably, a failure to pursue reimbursement will not reduce the deduction if the burden of collecting from others "would outweigh the anticipated benefit from those efforts," but unfortunately, the regulation seems to mistakenly cross reference the wrong paragraph of Treas. Reg. §20.2053-1 (and not the paragraph dealing with reimbursements).)

(5) Unenforceable Claims, §20.2053-4(d)(4). Claims that are unenforceable prior to death or before they are actually paid are not deductible, even though the estate pays the claim.

(6) Claims Founded on a Promise, §20.2053-4(d)(5). The prior regulation says that claims founded on a promise or agreement or deductible only if the promise or agreement was "bona fide and in exchange for adequate and full consideration." The final regulation also requires that "the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to money value."

(7) Recurring Payments and Present Value Concepts, §20.2053-4(d)(6). The proposed regulations provided that only the date of death (or alternate valuation date) present value of recurring noncontingent obligations (such as an obligation under a divorce decree to make alimony payments) could be deducted under §2053. The present valuing concept does not apply for contingent payments after the contingency is resolved — the actual amount of those payments can be deducted in full without any present value limitation. To be consistent, the IRS dropped the present value limitation for recurring noncontingent obligations in the final regulations, and they can be deducted in full on the return. A claim subject to a contingency related to death or remarriage is still treated as a noncontingent claim for this purpose, although the death or remarriage contingency would be considered in determining the value of the claim using "factors set forth in the transfer tax regulations or otherwise provided by the IRS." Treas. Reg. §20.2053-4(d)(6)(i) & 20.2053-4(d)(7)Ex. 8. (Query, will the IRS supply remarriage factors? Example 8 suggests that it will.)

The preamble to the final regulations notes that the Treasury and IRS believe that the appropriate use of present value in determining §2053 deductions merits further consideration, and there is an ongoing project on the Treasury Priority Guidance Plan for that issue.

If a commercial annuity is purchased from an unrelated dealer to satisfy a recurring obligation on an enforceable and certain claim (whether or not contingent), the estate can deduct the sum of (a) the amount paid for the commercial annuity, (b) any amount actually paid prior to the purchase of the commercial annuity, and (c) any additional amount in excess of the annuity amount necessary to satisfy the recurring obligation. Treas. Reg. §20.2053-4(d)(6)(iii).

(8) Interest on Claims, §20.2053-4(e). The interest accrued up to the date of death and actually paid on a claim is deductible as a claim. (The date of death amount applies even if the estate elects the alternate valuation date for purposes of valuing assets.)

"Post-death accrued interest may be deductible in appropriate circumstances either as an estate tax administration expense under section 2053 or as an income tax deduction."

d. Taxes, §20.2053-6, 20.2053-9, 20.2053-10. The regulations are updated to refer to the deductibility of state estate taxes for decedents dying after 2004 under §2058. The regulations also add a provision clarifying that a deduction for taxes is allowed for any post-death adjustments increasing a tax [such as gift or income tax] and allowing a

protective claim for refund to keep the statue of limitations open to make such a claim. Treas. Reg. §20.2053-6(g). Similarly, any refund subsequently determined and paid after the date of death will reduce the deduction "upon examination by the Commissioner." (The final regulations omit an affirmative duty to report the refund to the IRS that appeared in an example in the proposed regulations. Treas. Reg. §20.2053-6(g)Ex.2.)

e. Practical Considerations for Completion of Form 706 and Form 843. On the Form 706, the nature of the claim against the estate (and counterclaims) should be described. Give the IRS examiner an idea of how big the claim is or could be. Many attorneys list "Value Undetermined" in the value column on form 706 rather than zero. Putting zeros on the estate tax return might conceivably be argued as an admission against interest.

An example Form 843 proposed by Ann Burns suggests the following example description: "This protective claim for refund is filed pursuant to Treas. Reg. §20.2053. The decedent is a defendant in a suit by John Smith and Mary Jones for breach of contract. Decedent has filed a counterclaim based in fraud. The amount claimed against the decedent is $xxxx. The amount of the counterclaim is $xxxx. Cross motions for summary judgment have been filed and a decision of the court is pending." Cathy Hughes suggests also adding a reference to the related item number on Schedule K of the Form 706.

The problem is even worse if the estate owns a claim against another party. The executor will have to take a position on the estate tax return as to the value of the asset. Even if the executor lists the value as "uncertain" on the estate tax return, the issue will be addressed in the audit, and it is more likely that the attorney defending the claim will be able to discover the negotiated value than in the case of a claim against the estate, for which a deduction can just be delayed until after the underlying claim is resolved.

If a claim owned by the estate that is in litigation has a significant value, the estate should be able to obtain an extension of time to pay under §6161. Treas. Reg. §20.6161-1(a)(1)Ex.(3). Estate tax extensions are granted for 12 month intervals for up to 10 years. Subsequent extensions are generally more difficult to obtain than the initial extension because the IRS wants to make sure that executors move promptly to pay their taxes, but if an asset is tied up on litigation, as a practical matter the IRS will likely just ask for a status update. *See* Internal Revenue Manual §§ 5.5,5.2, 5.5.5.3.

f. New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans. The proposed regulations do not seem to impact Graegin loans at all. While Regulation §20.2053-1(d)(1) limits §2053 deductions to amounts actually paid, Regulation §20.2053-1(d)(4) allows the deduction of estimated amounts that are ascertainable with reasonable certainty. The prior and final regulations both allow a deduction of estimated amounts of administration expenses that may be ascertained with reasonable certainty and will be paid. Prior Reg. §20.2053-1(b)(3); Final Reg. §20.2053-1(d)(4).

The Treasury Priority Guidance Plan for 2009 includes a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project. The final regulations confirm that the project is continuing and reserves §20.2053-1(d)(6) for further guidance on this issue.

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