A Look at the Final Section 2053 Regulations

Introduction

As a general rule, expenses incurred in administering a decedent's estate, if not deducted for income tax purposes, and claims against a decedent's estate are deductible for estate tax purposes under Code Sec. 2053. That is, such expenses and claims reduce the amount subject to estate tax. (Under Code Sec. 2054, losses incurred during the settlement of estates arising from fires, storms, shipwrecks, or other casualties, or from theft, when such losses are not compensated for by insurance or otherwise, are also deductible.)

The Treasury Department has just issued final regulations under Code Sec. 2053 (reserving certain parts for later regulations) dealing with the estate tax deduction of claims against a decedent's estate and costs of administering the estate. (Although, in general, expenses of a decedent's estate may be deducted, alternatively, for income tax purposes, usually under Code Sec. 212, the conditions imposed by the new regulations for deducting the expenses for estate tax purposes were not expressly made to apply for income tax purposes.) Proposed regulations were issued in 2007. See, generally, Blattmachr & Zeydel, "Proposed Regs. on the Deduction for Administration Expenses and Claims," *Estate Planning*, October 2007, pg. 3.

The final regulations adopt the general thrust of the proposed regulations which is that expenses and claims are deductible only when and to the extent they are paid, although they make certain changes that will help avoid prolonged administration of estates in several cases. The final regulations retain the provision contained the proposed regulations that expenses and claims which are ascertainable in amount and which will be paid may be deducted before they are paid—essentially, meaning they may be deducted on the United States Estate (and Generation-Skipping Transfer) Tax Return (Form 706). A deduction may not be taken for a claim or expense (at least prior to its payment) based upon a "vague or uncertain estimate." The regulations further provide that a claim or expense that is contested or contingent is not ascertainable with reasonable certainty and, therefore, may not be deducted (again, at least prior to the time it is paid). The final regulations add provisions that permit up the $500,000 in value of claims, unpaid when the Form 706 is file, to be deducted on the return if they meet certain criteria. The final regulations also permit certain recurring payments to be deducted on the Form 706 even as to those payments that will extent beyond the period during which the IRS may assess additional tax and, unlike the proposed regulations, the deduction is not limited to the present value of payments.

It should be noted that while both the Code Sec. 2053 and its regulations deal with both claims against a decedent's estate and costs of administering the estate, some regulatory provisions apply only to claims and some only to expenses. For example, the $500,000 amount that may be deducted without being paid applies only to claims not to expenses. Although the regulations speak in terms of claims and expenses of an estate, their principles will apply in large measure to claims and expenses with respect to other property included in the gross estate (such as that in a revocable trust).

It is important to be familiar with and to follow the final regulations. If a claim or expenses is taken on a Form 706 which may not be deducted, the taxpayer might be charged with negligence or with intentionally disregarding a regulation either of which would subject the taxpayer to a non-deductible 20% penalty of the amount of tax underpaid under Code Sec. 6662. If it turns out that the deduction ultimately is allowed, presumably no penalty would be imposed. But it will be risky not to follow the regulations. In fact, in cases of doubt where the deduction is claimed on the Form 706, it may, perhaps, be best to disclose on the return the basis for taking it. That may prevent the imposition of the penalty under section 6662 and may prevent the return preparer from a penalty under Code Sec. 6694. Note, however, that the attaching Form 8275R to disclose that the taxpayer has taken a position contrary to a regulation will only "automatically" prevent the penalty under Code Sec. 6662 if it is a good faith challenge to the validity of a regulation (as opposed, for example, to a good faith construction of the regulation). *See* Reg. §§ 1.6662-3 and 1.6664-3.

Only Bona Fide Expenses and Claims Allowed

Reg. § 20.2053-1(b)(2) sets forth the general rule that an expense or claim is deductible only if "bona fide." After setting forth the bona fide condition, that regulation states that no deduction for an expense or claim is allowable under Code Sec. 2053 to the extent it is founded on a transfer "that is essentially donative in character (a mere cloak for a gift or bequest)" except for certain charitable pledges. (Enforceable charitable pledges are deductible under Code Sec. 2053 even if not founded upon consideration in money or money's worth.) It is uncertain whether the denial of the deduction for "cloaked gifts," apparently disguised as deductible claims and expenses, is an additional condition to the bona fide requirement. In any case, it may be prudent to consider taking a deduction for a claim or expense only if it is incurred and paid in good faith and certainly is not a cloak for a gift or bequest.

Family Member Claims and Expenses

The proposed regulations contained a rebuttable presumption that claims of family members, beneficiaries and related entities were not "legitimate and bona fide." The final regulations drop the presumption but provide a non-exclusive list of factors indicative of the bona fide nature of a claim or expense involving a family member, related entity or beneficiary of the decedent's estate. The first factor is that the transaction occurred in the ordinary course of business, was negotiated at arms' length and was free of donative intent. This is similar to Reg. § 25.2512-8 which provides, for gift tax purposes, that a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth and, therefore, will not be a gift. Developments under that regulation, therefore, may serve as guidance for construing this new provision in the Code Sec. 2053 regulation.

The second factor is that the nature of the claim is not related to an expectation or claim of inheritance. It may be difficult to apply this factor in practice. Perhaps, it covers a situation where an individual provides personal care for relative from whom the care provider expects or hope to receive an inheritance and then presents a bill for the services. But that is uncertain.

The third factor is whether any claim or expense based upon an agreement between the decedent, on the one side, and the family member, related entity or beneficiary, on the other side, was "substantiated with contemporary evidence." It may be that the regulations are indicating that a claim of a family member, related entity or beneficiary that is not founded upon an agreement but, perhaps, based upon *quantum meruit* would be indicative that it is not bona fide.

The fourth factor is that performance pursuant to the agreement with the decedent be substantiated. That is the claimant must prove that he or she performed pursuant to the agreement.

The fifth and final factor listed in the final regulations to determine if the claim of a family member, related entity of beneficiary is bona fide is whether the payment is reported by each party for Federal income tax and employment purposes in a manner consisted with the reported position of the claim or expense. For example, payment of a claim for pre-death services rendered to the decedent that is not reported as taxable income by the recipient would seem to indicate that the fifth factor has not been met.

Reg. § 20.2053-1(b)(iii) provides definitions of family members, related entities and beneficiaries. Family members "include" the decedent's spouse, grandparents and their descendants, including adopted descendants. Although the regulations use the term "include," it seems it must mean "consist of" rather than meaning the IRS could contend that others (such as a child-in-law) could be included in appropriate circumstances.

A related party is one in which the decedent had at or within three years of death any "beneficial ownership" although not a publicly traded entity or one in which the decedent and family members, "directly or indirectly," hold less than a 30% interest (whether voting or non-voting in stock, capital and/or profits). There is no explanation of "direct or indirect." It may be reminiscent of "direct or indirect" voting rights retained under Code Sec. 2036(b). But it might well mean something different. Indeed, it may develop that it is intended to encompass certain constructive ownership rules, such as under, among many other sections, Code Sec. 267, 318 or 4946. Moreover, "beneficial interest" is not defined. Hence, whether it is intended to encompass only interests that are capable of being valued actuarially or not also is unclear.

In any case, Example 3 of Reg. § 20.2053-1(b)(4) provides an illustration of a claim by a family member which is determined to be bona fide and, therefore, its payment deductible. It involves the rendering of pre-death accounting services to the decedent by his niece who is a CPA who charges others in the same manner she charged the decedent. There is no indication of whether the niece was a beneficiary of the decedent's estate. Nevertheless, under the facts of the case, it does not seem that the Example's outcome would have been any different had she been one. Indeed, the facts of the Example are so compelling to the conclusion that the niece's claim for her accounting services is bona fide that the Example is of little, if any, help in discerning the scope of the family rules.

Payments Pursuant to Court Order

Reg. § 20.2053-1(b)(3) sets for the rules about when payments pursuant to a court order may be used to establish that the payments are deductible under Code Sec. 2053. Expenditures for funeral expenses, administration expenses and claims against the estate, which are allowed by a court of competent jurisdiction (such as the probate court having jurisdiction over the decedent's estate) after review and then actually passing on the facts upon which deductibility depends (presumably, whether it is bona fide and, if based upon a promise or agreement, for full and adequate consideration in money or money's worth) and which are paid may be deducted under the section.

If the court does not make the allowance based upon the review of the merits of the expense or claim, its decree allowing the payment of the expense or claim does not serve as establishing the payment is deductible under Code Sec. 2053. However, the regulation provides a presumption that the court did pass on the review of the merits of the claim if there was a active and genuine contest. However, a court's decree that appears unreasonable will be used as evidence that there was no active or genuine contest although the estate may provide other evidence to establish it was a genuine contest. No example is provided to illustrate what constitutes a decree that is unreasonable. Perhaps, if a person put in a claim for rendering household services to the render for two months prior to death (e.g., cooking and cleaning), an allowance by the court of a claim of $100,000 would appear, on its face, as unreasonable.

The regulations indicate that the court must pass on the claim. However, if there were a jury verdict, it likely would be accepted as evidence of an active or genuine contest over the claim. If applicable law allows an expense or claim to be paid without a court decree, its payment without a decree does not foreclose it from being deducted, although other factors (such as those involving claims by a family member and, if the claim is based upon a promise or agreement, one not founded upon consideration in money or money's worth) may foreclose its deductibility under Code Sec. 2053.

A local court consent decree permitting the payment or an expense or claim may be used to establish the payments deductibility under Code Sec. 2053 if the consent decree resolves a bona fide issue of in a genuine contest. Consent of all parties having interests adverse to the claimant raises a presumption under the regulations that the decree resolves a bona issue in a genuine contest.

Settlements

A settlement that resolves a bona fide issue in a genuine contest and is the result of arms' length negotiations by parties having adverse interests will respect to the claim or expense may establish its deductibility, if paid. Unlike the proposed regulations, the final regulations indicate that even if the settlement appears greater than the merits of the claim warrant, the amount agreed to be paid in the settlement may be deducted if the estate can establish that the cost of defending or contesting the claim or expense or the delay associated with it would impose a higher burden on the estate than the payment of the amount paid to settle the claim or expense.

Payment of Unenforceable Claims

The final regulations provide that an unenforceable claim, even if paid, cannot be deducted under Code Sec. 2053. That might be the case to the extent an attorney seeks a legal fee in excess of statutory limits permitted under applicable law. Nevertheless, where the enforceability of the claim is at issue, the payment of the claim may be allowed.

What is not discussed in the regulations is whether an affirmative defense (such as the running of the statute of limitations) must be considered in rendering the claim unenforceable.

Amount Deductible

The proposed regulations essentially limited a deduction for a claim or expense to what, in fact, is paid. This would have created practical problems for both the IRS and the estate. Often, the resolution of a claim will remain unresolved for years or its payment postponed for a considerable time. In addition, expenses, such as fees of attorneys and others, may be incurred in connection with resolving the claim or making its payment and the regulations permit such expenses to be deducted.

Reg. § 20.2053-1(d) continues the general rule in the proposed regulations that an expense or claim is deductible only if paid. The regulations specifically provide that post-death events will be considered. For example, assume a claim is bona fide, non-contingent and fixed in amount (and, if founded upon a promise or agreement, is based upon consideration in money or money's worth) and is paid. Such a claim should be deductible on the Form 706 when filed. However, if a portion of the payment is returned because, for example, the claimant realizes there was an overcharge, the amount deductible will be reduced accordingly and additional estate tax assessed (but only if the period, normally three years after the Form 706 is filed, to assess tax has not expired).

Additional Assessments

It seems relatively certain that an estate representative is not required to advise the IRS that a claim allowed should be reduced or eliminated on account of post-death events. For example, a final judgment against the decedent was rendered prior to death. The claim was properly presented to the estate for payment. The executor intends to pay it but only after determining all of the decedent's Federal tax liabilities (*e.g.*, for income and gift tax) because Federal claims generally are given priority in payment over other claims. The estate deducts the amount of the judgment as a claim against the estate on the Form 706 and the IRS does not challenge its deductibility. Prior to the payment of the judgment, it becomes unenforceable by lapse of time or, perhaps, legal counsel to the executor determines and successfully establishes that the court that rendered the judgment did not have subject matter jurisdiction over the claim against the decedent and was able to void it. Under *Badaracco v. Commissioner*, 464 US 386 (1984), the estate is under no duty voluntarily to file an amended return or pay the additional tax that is due.

Reimbursements

A deduction is not allowed to the extent a claim or expense is or could be compensated for by insurance or otherwise could be reimbursed. Reg. § 20.2053-1(d)(3) provides that an "executor *may* certify [on the Form 706] whether the executor neither knows nor reasonably should have known of any available reimbursement for a claim or expense." (Emphasis added.) It seems odd that to state that an "executor may certify whether the executor…reasonably should have known of any available reimbursement." Presumably, the executor may only certify as to what the executor, in fact, knows, not what the executor reasonably should know. Moreover, the regulations do not require the executor to advise the IRS of any refund.

Exceptions to the "Must Be Paid" Rule

The final regulations contain three exceptions to the requirement that an expense or claim may be deducted only to the extent it is paid. Under these exceptions, the claim or expense may be deducted on the Form 706 even though not paid by the time the return is filed.

Certain Ascertainable Amounts. Even if not yet paid, a claim or expense that otherwise is deductible (*e.g.*, if based on a promise or agreement is founded on full and adequate consideration in money or money's worth) may be deducted even before it is paid if the "amount to be paid is ascertainable with reasonable certainty and will be paid." Reg. § 20.2053-1(d)(4)(i). The example provided is one for executors' commissions and attorneys' fees not yet paid "are deemed to be ascertainable with reasonable certainty and may be deducted if such expenses are paid." That is similar to procedures followed by the IRS for years. Very often in audits of Forms 706, the attorney and/or executor will complete IRS Form 4421 on which the amount of executors' commissions and attorneys' fees are either stated as paid or estimated to be paid. In virtually all cases, the Service allows the sums so listed as deductions.

Although no example offer deals with a claim against the estate, it is certain that the "ascertainable with reasonable certainty" exception also applies to claims. An example may be where the decedent dies owning income tax to the IRS but its payment is not due until after the Form 706 is filed. Assuming the amount of income tax due is determinable with reasonable certainty and it is reasonably certain it may be paid, it may be deducted on the Form 706.

Claims Not in Excess of $500,000. Under Reg. § 20.2053-4(a)(1), only a claim against a decedent's estate that represents a "personal obligation of the decedent" may be deducted under that section. (It is appropriate to note that claims against property included in the gross estate but for which the decedent is not personally liable are dealt with under Reg. § 20.2053-7). Such personal claims are deductible if paid or meet the reasonably ascertainable rule mentioned above.

However, under Reg. § 20.2053-4(c)(1), the executor may deduction on the estate tax return the "current value" of one or more claims even though not paid by the time the Form 706 is filed provided such claims are otherwise deductible, if the value of the claim is determined by a "qualified appraisal" within the meaning of Code Sec. 170 (relating to income tax charitable deductions) made by a "qualified appraiser" within the meaning of that section. But the total amount so deducted does not exceed $500,0000 and the full value of the total claim or claims may not aggregate more than $500,000. It will be noted that this estate tax regulation "borrows" an income tax rule—there is nothing in the estate tax provisions that requires a qualified appraisal by a qualified appraiser.

Examples explain the "full value" limitation. Example 1 of Reg. § 20.2053-4(c)(3) provides that a $1 million claim may not be deducted, even in part, because it exceeds $500,000. Nonetheless, if a qualified appraiser determines in a qualified appraisal that the $1 million claim is worth $500,000 or less, it seems it may be deducted on the Form 706 under the $500,000 limit rule. Example 2 provides that if there are three $200,000 claims, the executor may deduct only two of them on the Form 706.

Offsetting Claims. The third exception is that if the gross estate includes claims against another and there is an unpaid claim against the estate arising from the "same or [a] substantially-related matter" or if there is an unpaid claim against the decedent's estate "integrally related" to a "particular asset" in the gross estate, the executor may deduct the "current value" of the claim on the Form 706 if six criteria are met. First, the claim must be otherwise deductible (e.g., if founded on a promise or agreement, is based upon full and adequate consideration in money or money's worth). Second, it must be a personal obligation of the decedent.

The third condition is that the claim is enforceable against the decedent's estate and is not unenforceable when paid.

Fourth, the value of the claim is determined in a qualified appraisal completed by a qualified appraiser under the rules set forth in Code Sec. 170.

Fifth, the value of the claim "is subject to adjustment for post-death events." This criteria also seems out of place. Presumably, the qualified appraiser would have taken into account events up to the date of filing of the return (or as close to that time as the appraiser reasonably could take into account). It seems this is not really a condition but a "warning" that the claim will be reduced to take into account post-*filing* events such as a payment of a smaller amount than the amount determined by the appraiser as the value of the claim.

Sixth, the aggregate value of the related claims of assets included in the gross estate exceeds ten percent of the gross estate.

<u>Certain Contingent Claims</u>

As a general rule, contingent claims may be deducted until paid. But some contingent claims may be deducted when they are essentially certain to be paid. For example, a decedent dies owning payments of $20,000 a year to her surviving husband or his estate for ten year. This likely would be deductible under the "reasonably ascertainable in amount" rule discussed above.

Even though the payments will not be made within the standard three year period to assess additional estate tax under Code Sec. 6501, the $200,000 in payments due may be deducted as they are ascertainable in amount and (presumably) will be paid. In fact, for such payments to a former spouse, the regulations permit the payments to be deducted even if they cease upon the first to occur of his death or his remarriage.

Even though the payments are contingent upon his not remarrying or dying, the value of the payments may be deducted. However, in determining the value of the payments, the probability of death or remarriage must be factored in. The Treasury Department issues life expectancy tables which would be used to determine the probability of the husband's death. Although they are not readily available, the regulations state that the IRS will supply the probability of remarriage factor. Of course if the surviving spouse dies or remarries, the amount deductible will be limited to what was paid, although if the time to assess additional estate tax has expired, the IRS would be unable to assess additional tax.

Present Values

As mentioned earlier, these recurring claims (such as those due over a term of years to a former spouse) may be deducted without having to "present value" the payments due. However, the preamble to the final regulations states that the regulations will be amended in the future to deal with present valuation matters.

Claims for Refund

Even though the final regulations are more "generous" in allowing claims and expenses to be deducted on the Form 706 even though not paid by that time, there will be many claims and expenses that will not be allowed because they have not yet been paid or, possibly, because there is some entitled to reimbursement (from insurance or otherwise). Reg. § 20.2053-1(d)(5) deals with protective claims for refund with respect to such claims and expenses.

The regulation recites that a claim may be filed before the expiration of the time prescribed by Code Sec. 6511 for the filing of a claim for refund. Normally, this is three years after the return is filed or, if later, two years after tax has been paid (although the claim cannot exceed in that case the amount of tax paid within that two year period).

The regulation states that, although the protective claim need not state a particular dollar amount or even demand an immediate refund, each outstanding claim or expense must be set forth and must describe the reasons and contingencies delaying the actual payment of the claim or expense.

The regulation states that the action will be taken by the IRS about the claim within a reasonable time after the contingency has been resolved and the amount deductible is established.

The preamble to the final regulations indicates that the IRS will revise Form 706 so a claim for refund can be made right on a special schedule on that return rather than forcing the estate to file a Form 843, which is the

IRS claim for refund form. As a general rule, it seems likely an estate would list all claims and expenses not otherwise deductible on the Form 706 on such schedule.

The IRS issued Notice 2009-84 in connection with the issuance of the final regulations. Essentially, the Notice states that the IRS will not, as a general rule, raise other issues to foreclose a claim for refund with respect to claims and expenses. In other words, the IRS will not attempt to prevent a refund for a claim or expense otherwise deductible under Code Sec. 2053 by contending, for example, that property included in the gross estate was undervalued.

Impact on the Marital or Charitable Deduction

Fortunately, the final regulations provide some relief with respect to unpaid claims and their impact on the marital or charitable deduction interests in the estate. Reg. § 20.2053-1(d)(5) provides that the marital deduction of charitable deduction need not be reduced with respect to any unpaid claim with respect to which a protective claim for refund is filed.

It is uncertain whether the IRS would contend that any other claim that is unpaid and, therefore, may not be deducted on the Form 706 (*e.g.*, a contingent one) must be taken into account to determine the estate tax marital or charitable deduction when such expense or claim, if paid, would be paid from property that otherwise would qualify for such a deduction but no claim for refund is filed with respect to it. It may be appropriate to compare *Ahmanson Foundation v. U.S.,* 674 F2d 761 (9^{th} Cir. 1981) (a discount in the value of the assets that would be available to satisfy a residuary charitable devise had to be taken into account for purposes of determining the estate tax charitable deduction) with *Chenoweth v. Comm'r,* 88 T.C. 1577 (estate was entitled to show that a 51% majority block of stock passing to the surviving spouse is entitled to an additional value because of the control element).

Conclusions

The final regulations, while retaining the general rule that expenses or claims may be deducted under Code Sec. 2053 only if paid, contains three exceptions to that general rule. That will reduce that number of estates that must be "kept open" to resolve the deductibility of claims and expenses that cannot be deducted on Form 706 and are not allowed in audit. But the administration of some estates will be postponed. It will behoove estates to be prepared to file protective claims of refund to insure the lowest possible tax is paid. In some cases, such as where the only amounts not allowed relate to expenses (as opposed to claims), it may be appropriate not to file a claim for estate tax refund but to deduct those expense for income tax purposes. The new regulations apply to individual dying after October 19, 2009. It is, unfortunately, unclear whether the new regulations apply to assets not in the decedent's probate estate such as QTIP trust created by decedent's spouse which is included in the decedent's gross estate under Code Sec. 2044. Section 2053(b) has a special rule for expenses incurred in administering property not subject to claims but that does not answer the question.

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