SECTION 2053 FINAL REGULATIONS ON CLAIMS AGAINST THE ESTATE: YOU HAVE TO "PAY TO PLAY"

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As published in the May 2010 edition of The Will & The Way, a publication of the Estate Planning and Fiduciary Law Section of the North Carolina Bar Association

It is well-established that the executor must devote sufficient estate assets to meet the estate's liabilities. Amounts used to satisfy such liabilities do not flow to the decedent's beneficiaries. The Internal Revenue Code ("Code") contains several deductions from the gross estate that operate to lower the taxable estate. Code section 2053 and the corresponding Treasury Regulations govern the deductibility of certain estate expenses, claims, and unpaid mortgages. Section 2053(a)(3) specifically allows a deduction from the gross estate value of "such amounts . . . for claims against the estate." Over time the courts, the Department of the Treasury ("Treasury"), and practitioners have struggled with the extent to which the value of such claims should reflect only the facts as of the decedent's date of death or should consider post-death facts relating to the claims. Some Code sections expressly require a date of death valuation, but as Treasury has indicated repeatedly, nothing in section 2053(a) has ever required the valuation of a deductible claim as of the date of death. Accordingly, before Treasury's guidance in this area, determining the value of claims was especially difficult and based largely on the available information. Practitioners prepared estate tax returns based on a snapshot of the decedent's assets and liabilities as of the date of death, including all accruals and contingencies.

Issued on April 23, 2007, the proposed regulations under section 2053, 72 Fed. Reg. 20080, dramatically changed the reporting of claims against the estate on the decedent's estate tax return by denying a deduction for any liability not actually paid before filing the estate tax return. Practitioners submitted comments on the proposed regulations; thereafter, Treasury issued final regulations on Oct. 20, 2009, 74 Fed. Reg. 53652.

The final regulations fix some, but not all, the issues raised by the proposed regulations. In several respects the final regulations are helpful to estate tax return preparers, especially those dealing with smaller claims against the estate. However, some issues raised in the comments by organizations and practitioners remain unaddressed and will continue to challenge executors and return preparers until Treasury issues further guidance.

The Statute

Section 2053 was part of the Internal Revenue Code of 1954. The four categories of deductions in the original statute remain intact. Section 2053(a)(1) through (4) provides for deductibility of the following items: funeral expenses, administration expenses, claims against the estate, and mortgage or other indebtedness related to the decedent's interest in property included in the gross estate. The expenses and claims must be allowable by the domestic or foreign jurisdiction of the estate administration, too.

Subsection (b) allows the deduction for administration expenses incurred in administering property not subject to claims (i.e., non-probate property) to the same extent administration expenses relating to probate property would be deductible. The amounts must be paid before the expiration of the limitations period for assessments under section 6501, which, generally speaking, is three years after the due date of the estate tax return (including extensions).

Subsection (c) limits the deduction. For claims against the estate, unpaid mortgages, or any indebtedness when based on a promise or agreement, the deduction is limited “to the extent that they were contracted bona fide and for adequate and full consideration in money and money’s worth.” There is an exception to this limitation for certain charitable pledges. Section 2053(c) also disallows the deduction for other amounts, including, for example, income taxes on income received post-death, property taxes not accrued before death, transfer taxes, and claims by remainder beneficiaries relating to property includible in the estate under section 2044.

The Statute of Limitations

All claims against the estate must be within the statute of limitations under section 6501. Under section 6501, the estate tax must be assessed within three years after the return is filed, unless it is filed early, in which case the return is deemed filed on the last filing date prescribed by law. Furthermore, under subsection (e)(2), a six-year statute of limitations applies if the taxpayer omitted more than 25% of the gross estate stated in the return. The amount omitted does not include the amount of any item that is adequately disclosed on the estate tax return.

Case History

Treasury issued the proposed regulations because of the divergence in outcomes of section 2053(a)(3) cases across the federal circuit courts. According to the preamble, some circuits follow the seminal Supreme Court case **Ithaca Trust Co. v. United States**, 279 U.S. 151 (1929). Ithaca Trust was one of the early cases that examined how post-death events affect valuation. In that case, a decedent left his spouse an interest in property for her life with the ability to use principal as necessary, and then to charities. The first issue was whether the decedent’s provision for his spouse during her lifetime rendered the deductible value of the charitable gifts so uncertain so as to disallow the deduction.

Comfortable that the standard was “fixed in fact and capable of being stated in definite terms of money,” the court did not disallow the deduction. The second (and more important) issue was the effect of the surviving spouse’s death within the year allowed for filing the estate tax return. Was the deductible value to be determined by the event as it turned out (i.e., the widow’s death within six months) or by mortality tables showing the value of the life interest as of the decedent's date of death? The court recognized that it may seem absurd to use the mortality tables given that the facts were known; however, it pointed out that the estate settlement occurs as of the date of death. The court concluded that "the value of the thing to be taxed must be estimated as of the time when the act is done" – i.e., the deductible value should be determined using the mortality tables as of the date of death. Ithaca Trust has been cited repeatedly for the proposition that post-death events should not be considered in determining the section 2053 deduction.

Several courts have partially relied upon or distinguished Ithaca Trust. For example, in **O'Neal v. United States**, 253 F.3d 1265, (11th Cir. 2001), the Eleventh Circuit held that the value of the estate's section 2053 deduction for grandchildren's claims against the estate for transferee gift tax liability must be valued as of the date of death without regard to post-death events. Other circuits such as the Eighth **Circuit in Sachs v. Commissioner**, 856 F.2d 1158 (8th Cir. 1988), have held that the date of death valuation principle in Ithaca Trust does not apply universally. In that case the Commissioner wanted to disallow the estate's section 2053 deduction for income tax liability that was later forgiven as a result of the 1984 tax act. The Eighth Circuit agreed with the Commissioner that "when [the] claims disappear, the estate's 2053(a)(3) deduction disappears with them."

Finally, the Tax Court also has ruled on the deductibility of claims under section 2053. In Kyle v. Commissioner, 94 T.C. 829 (1990), the Tax Court addressed the enforceability of a claim against the decedent's estate. The court held that it was proper to consider post-death events in determining whether the claim was valid. It concluded that the claimant failed to show that the claim was valid and enforceable at the decedent's death, and therefore the estate's deduction was disallowed.

Given the divergence in the case law, Treasury decided to issue the proposed regulations under section 2053 to provide more certainty regarding the deductibility of claims against the estate and consideration of post-death events.

Treasury Regulations Before the 2007 Proposed Regulations

The Treasury Regulations in place before issuance of the 2007 proposed regulations described in little detail the following claims Treasury considered deductible: (1) the decedent's personal obligations, whether or not matured, and accrued interest as of death; (2) accrued interest as of the date of death even if alternate valuation is used; (3) enforceable claims; (4) claims based on a promise or agreement, contracted in good faith and for adequate consideration; and (5) tort or other legal liabilities.

2007 Proposed Regulations

In the preamble to the proposed regulations, Treasury stated that while numerous courts had addressed section 2053(a)(3), there was "little or no consistency among the conclusions of those courts with regard to the extent (if any) to which post-death events are to be considered in valuing such claims." According to Treasury, "similarly situated estates should be treated consistently by having section 2053(a)(3) construed and applied in the same way in all jurisdictions." At that time Treasury shared in the preamble its concerns about the date-of-death value approach, including (i) the inefficient use of resources; (ii) the requirement that substantive issues underlying the claims be retried in a tax controversy setting, which may be expensive and inappropriate; (iii) a deduction amount that differs from the amount actually paid in disputed claims; (iv) the possibility of contradictory positions taken by the taxpayer on the estate tax return and in court pleadings.

To address these concerns, Treasury proposed regulations with the underlying premise that the estate may deduct "only amounts actually paid in settlement of claims against the estate." In the event resolution of a contingent or contested claim could not be reached before expiration of the refund limitations period, according to Treasury, the estate could file a protective claim for refund to preserve the estate's right to claim the deduction.

Significantly, the proposed regulations clarified that post-death facts may be considered in determining the amount of the claim on the estate tax return based on the amount that is actually paid. Treasury further commented that section 2053(a) does not specifically direct that the value of a claim is determined based on date of death value.

In addition to the deduction limitation to claims "actually paid" and the consideration of post-death facts, the proposed regulations changed the then existing regulations in several respects, namely (1) including in the determination of the deductible amount final court decisions on the amount and enforceability of claims if in fact the court addressed facts upon which the deductibility depends; (2) supporting deductibility for bona fide negotiated settlements between adverse parties and consistent with local law; (3) allowing the estate to file a protective claim for refund if the amount of the liability is not ascertainable or paid before the expiration of the refund limitations period; (4) disallowing a deduction if insurance compensated for the expense or claim; (5) disallowing a deduction if at the time of filing the claim is "potential, unmatured, or contested"; (6) limiting deductibility to the decedent's portion if the claim is against multiple debtors; (7) scrutinizing family member and beneficiary claims; (8) requiring enforceability as of the filing of the return in order for the claim to be deductible; and (9) if the claim involves periodic payments made after the final determination of the estate tax liability, allowing the deduction only as the payments are made within the statute of limitations period (and thereafter, only if the estate has a protective claim for refund). As an alternative, the executor could buy a commercial annuity from an unrelated party to satisfy the continuing payments - and the deduction would be available for the cost of the annuity.

Practitioners, organizations, and other interested parties commented on the proposed regulations in the summer of 2007.

2009 Final Regulations

Treasury released the final regulations on Oct. 20, 2009, also the effective date. The preamble incorporates from the proposed regulations background discussion of the circuit split and Treasury's desire for consistency among the jurisdictions of executors. Amusingly to any reader, Treasury states what practitioners have known for years: "The amount an estate may deduct for claims against the estate has been a highly litigious issue."

The final regulations reflect Treasury's continued consideration of the practical consequences of the approaches relating to the valuation of claims. In general, the final regulations continue to allow consideration of post-death facts with respect to amounts actually paid. Treasury adopted the proposed regulations with revisions as outlined in the final regulations. The revisions reflected in the preamble to the final regulations are summarized below.

Comments Relating to Prop. Reg. § 20.2051-1.

With respect to the taxable estate of a decedent who is not a citizen or resident of the United States, the final regulations refer to regulations under section 2106, not 2051.

Comment Relating to the Standard for Deductibility

The basic standard under the proposed regulations was that a claim must have been "actually paid" in order for it to be deductible. Treasury received comments calling for the allowance of a deduction based not on what was actually paid but instead on what was reasonably known on the date of the decedent's death. Commentators cited various cases in support of this position and expressed their concerns about unduly prolonging the estate administration process on account of protective claim filings, the possible tax issues affecting litigation strategy in the substantive issues related to the contingent claims, and liquidity shortfalls. Treasury acknowledged the difficulty of this issue given the divergence in the case law and the problematic application of the alternatives, but it ultimately retained the position that deductibility based on amounts "actually paid" closely aligns with the legislative intent behind section 2053. Treasury also reiterated that its position optimally furthers the objective of "effective and fair administration of the tax laws." Even though Treasury's general position remained unchanged, it did include in the final regulations some exceptions, which are summarized herein.

Comment Relating to the Effect of a Court Decree in Prop. Reg. § 20.2053-1(b)(2)

The proposed regulations had made a change that in order to be deductible, a court had to "pass upon the facts upon which deductibility depends." Treasury revised this language to state that "the court reviewed the facts relating to the expenditures." With respect to settlements, the final regulations eliminated what was a separate requirement that a settlement be within a range of outcomes. Commentators felt that this requirement was unnecessary given the existing requirement that the settlement must resolve a bona fide issue involving a genuine contest between adverse parties who negotiate at arm's length. The final regulations also clarify that a deduction based on the settlement amount will not be denied if the estate establishes that the cost of defending the claim or contesting the expense, the litigation-related delays, or other significant factors will outweigh the expected results.

Comments Relating to the Rule of Estimated Amounts in Prop. Reg. § 20.2053-1(b)(4)

Proposed regulation section 20.2053-1(b)(4) used the term "estimated amounts." The final regulations changed the term to "exception for certain ascertainable amounts." According to Treasury, this change was intended to reflect the substance of the rule more accurately. The final regulations also clarify that the deduction is allowed for certain ascertainable amounts to the extent the Service is "reasonably satisfied that the amount to be paid is ascertainable with reasonable certainty and will be paid." This standard is tighter than previous language regarding whether the amount "may reasonably be expected to be paid." Significantly, the final regulations confirm that the rules for deducting ascertainable amounts apply to both claims and administration expenses.

Treasury refused to change the language for prohibiting a deduction for "a vague or uncertain estimate" because it thought the standard was clear. Treasury then addressed comments recommending elimination of language disallowing the deduction taken in advance of payment if the payment is subsequently waived or left unpaid. Rejecting this recommendation, Treasury pointed out that the final regulations enable the estate to claim a deduction at the time of filing the estate tax return even though the amount ultimately allowable as a deduction will consider post-death events. According to Treasury, the "ability to deduct an ascertainable amount does not change the general rule that the amount of the deduction is to reflect post-death events." This then brings up the issue of whether or not the executor has a continuing duty to report amounts claimed as deductions on the estate tax return but later fully or partially unpaid, and whether such a duty would be enforceable after the expiration of the period of limitations on assessment. Treasury then confirmed that it did not intend for the proposed regulations to impose such a duty enforceable beyond the limitations period. Finally, the final regulations clarify the time period for consideration of post-death claims.

Comments Relating to Protective Claims

Treasury received comments on the increased estate administration costs and delay on account of the protective claim procedure. Generally speaking, a protective claim for refund can be filed within the limitations period for filing a refund claim under section 6511(a), that is, the later of three years after filing the return or two years after payment of tax. The protective claim filing effectively keeps open the limitations period to the extent of the amount of the refund claim. Treasury defended its position as necessary for the fair and equitable implementation of the regulations; however, to ease the administrative burden on taxpayers and the Service, Treasury included an exception. The exception applies to claims against the estate that do not exceed, in the aggregate,

$500,000. The entire amount of the claim must be at or below the $500,000 cap. The deduction on the estate tax return is allowed, but the amount of the deduction is still subject to adjustment to reflect post-death facts.

Issued concurrently with the final regulations, IRS Notice 2009-84 provides guidance on the protective claim for refund. The guidance announces the Service's decision to limit the review of a return, in some circumstances, when a timely-filed claim for refund of estate taxes based on a section 2053 deduction matures after expiration of the limitations period on assessment. The notice states that when the Service reviews an estate tax return with regard to a protective claim for refund, review will be limited to the "evidence relating to the deduction under section 2053 that was the subject of the protective claim." This notice was intended to provide some finality for the estate administration process based on the receipt of the estate tax closing letter (letter 626). The limitation on examination of Form 706 applies only if the timely-filed claim for refund ripens after expiration of the limitations period on assessments, but it does not apply if there is "evidence of fraud, malfeasance, collusion, concealment or misrepresentation of a material fact."

Commentators expressed much concern about the lack of guidance on protective claims for refunds. Treasury intends to publish further procedural guidance and may even incorporate the protective claim for refund on a revised IRS Form 706 to obviate the need for a separate filing. One commentator asked for the Service's lenience in granting extensions to pay estate tax under section 6161 if illiquidity results from the inability to deduct a claim that is part of the protective claim for refund. Section 6161 generally provides for extensions in 12-month periods up to 10 years. Treasury responded that such a provision would be beyond the scope of the regulations.

Comments Relating to the Effect on the Marital and Charitable Deductions

Sometimes a claim or expense is payable in whole or in part from a bequest that qualifies for the charitable or marital deduction. Commentators suggested that Treasury include a rule that if such a claim or expense is payable as described, then the charitable or marital deduction will not be reduced by the amount of the claim or expense until the amount is actually paid. Treasury decided to include this rule and pointed out that it is similar to rules under regulations for sections 2055 and 2056 that provide for the reduction of those shares by the amount of estate transmission expenses paid from such shares. Significantly, for purposes of the section 2055 estate tax charitable deduction, Treasury stated that a claim or expense that is the subject of a protective claim for refund under section 2053 will not make the charitable deduction contingent (and therefore non-deductible under section 2055).

Comments Relating to Reimbursements in Prop. Reg. §20.2053-1(b)(3)

Commentators were concerned about the proper procedure for an executor to determine that a claim or expense cannot be compensated for by insurance or otherwise reimbursed. Treasury shed light on this issue - now the executor can certify on Form 706 that no reimbursement is available if the executor “neither knows nor reasonably should have known” of the availability of such reimbursement. Moreover, if the cost of obtaining reimbursement outweighs the benefits, then the executor does not have to reduce the amount of the claim or expense by the amount of the potential reimbursement as long as the executor gives a reasonable explanation on Form 706. The executor must evaluate the economics of discovering whether or not a reimbursement is available and give such an explanation that the “burden of necessary collection efforts would outweigh the anticipated benefits from those efforts.”

Comments Relating to Deduction for Expenses of Administering Estate under Prop. Reg. § 20.2053-3

Treasury accepted commentators’ suggestion that duplicative language about the general rules be deleted from proposed regulation section 20.2053-3(b) and (c). Furthermore, Treasury eliminated language in proposed regulation section 20.2053-3(d)(3) that prohibited deductions for expenses incurred (i) to unreasonably extend time for payment or (ii) other than in good faith. Commentators said that prolonging litigation other than in good faith was unlikely to occur and would be difficult to prove in the negative. Treasury concluded that eliminating this language was appropriate, as expenses incurred as described above would not be “actually and necessarily incurred” in the estate administration and therefore would not be deductible anyway.

Comments Relating to Claims Against the Estate in Prop. Reg. § 20.2053-4(a)

The proposed regulations limited deductible claims against an estate to “legitimate” and “bona fide” claims. One commentator said this was redundant; Treasury agreed and removed the term “legitimate.” Another commentator wanted clarification that both the IRS and the executor would be bound to consider post-death events. Treasury disagreed, stating that the general principle already in section 20.2053-4(a)(2) binds estates and the Service, and therefore no change was considered necessary.

Comments Relating to Claims and Counterclaims

Commentators suggested allowing on the initial Form 706 the deduction for a claim against the estate if the gross estate value includes a claim in the “same or substantially-related matter or includes an asset integrally related or subject to the claim against the estate.” Treasury found this suggestion persuasive, especially as applied to situations where the claim or asset is a significant percentage of the gross estate. Therefore, to alleviate burdens on the estate, section 20.2053-4(b) of the final regulations allows the claim’s current value to be reported on Form 706 as described, but the related asset or claim of the estate must be at least 10 percent of the decedent’s gross estate. The claim’s value must be determined based on a “qualified appraisal” by a “qualified appraiser” within the meaning of section 170 and corresponding regulations. The value of each claim against the estate is subject to adjustment for post-death events. In addition, the deduction for each claim is limited to the value of the related asset or claim included in the gross estate. If the amount of the claim exceeds this limitation, then the excess may be a candidate for the protective claim for refund procedure.

Comments Relating to Prop. Reg. § 20.2053-4(b)(4), Claims by Family Members, Related Entities, or Beneficiaries

Several Code provisions reflect Congress's heightened scrutiny of transactions and activities involving related parties such as family members and family owned or controlled entities. The proposed regulations contained a rebuttable presumption that claims by a decedent's family members, related entities, or beneficiaries were "not legitimate and bona fide." Commentators requested removal of this rebuttable presumption on account of its inconsistency with section 7491's burden of proof and the perceived unfairness. They believed that the proposed regulations and burden of proof provisions constituted an adequate deterrent to related parties' manipulation of claims. Although Treasury concluded that the rebuttable presumption did not conflict with section 7491, it nevertheless followed the commentators' recommendation and eliminated the presumption from the final regulations. Treasury preserved in the final regulations the general approach that any claim or expense deductible under section 2053 must be bona fide. It supplemented this provision with a nonexclusive list of factors that indicate the nature of a claim or expense involving a family member, related entity, or estate beneficiary.

Comments Relating to Payments in Prop. Reg. § 20.2053-4(b)(5)

One commentator wanted Treasury to remove the rule that disallowed the deduction if claims are unenforceable at or before the decedent's death (even if paid). Treasury did not remove this rule because of its belief that it was mandated by the statutory requirement that only amounts allowable under the laws of the jurisdiction of the estate administration may be deductible.

Comments Relating to Recurring Payments in Prop. Reg. § 20.2053-4(b)(7)

The proposed regulations allowed a deduction as estimated amounts certain "recurring, non-contingent obligations." Commentators said that prohibiting an estate from deducting the value of a contingent obligation was inefficient and inequitable because it forces the estate to stay open unless the estate buys a commercial annuity. Treasury acknowledged this, but Treasury's position in the final regulations is to allow a deduction for a non-contingent recurring payment as an ascertainable amount, but not to allow a deduction for a contingent recurring payment until paid. Treasury did mention that buying a commercial annuity to fund a contingent obligation should be considered substantially equivalent to a reasonably ascertainable (i.e., deductible) non-contingent obligation for purposes of section 2053.

This raised additional issues, including whether death or remarriage would be considered a contingency with respect to a decedent's obligation to make a recurring payment. Section 20.2053-4(d)(6)(i) of the final regulations clarify that obligations subject to death or remarriage would be treated as a non-contingent obligation.

Treasury received additional comments about the disparate treatment of non-contingent and contingent obligations. The former allows the deduction for the present value of the obligation, while the latter receives a dollar-for-dollar deduction as the obligations are paid. Commentators suggested that executors be allowed to choose whether to use (i) the present value of non-contingent recurring payments, or (ii) the amounts paid in the same manner as provided for a contingent obligation after filing a protective claim for refund. The final regulations remove the present value limitation applicable only to non-contingent recurring payments. Significantly, Treasury intends to examine further the use of present value in determining the amount of the section 2053 deduction. It has reserved final regulation section 20.2053-4(d)(6) for this future guidance.

Treasury also clarified that mortgage or other indebtedness on notes was not subject to the rules on recurring payments.

Finally, with respect to the commercial annuity provision, commentators asked whether the estate must transfer ownership of the purchased annuity to the creditor or to a third party who would use the annuity to make payments to the creditor. Another question presented was whether giving the creditor a security interest in the annuity would be adequate for the amount paid for the annuity to be deductible under section 2053. Commentators were concerned about the income tax consequences of the transfer, too. Treasury concluded that the purchase of the annuity and the "nonrefundable and generally significant costs" entailed in such purchase, would be sufficient to allow the deduction of the cost of the annuity under section 2053. Accordingly, the final regulations clarify that the estate is allowed to own the annuity.

What's Next

The section 2053 regulations have undergone quite an evolution. By answering many important questions and eliminating unworkable provisions from the proposed regulations, the final regulations undoubtedly will facilitate the estate administration process for executors. A handful of questions remain, however, so practitioners will look forward to additional Treasury guidance on Form 706 reporting, protective claim for refund procedures, and the use of present value in the context of the section 2053 deduction.

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