



## **ABA SECTION OF TAXATION COMMENTS CONCERNING PROPOSED REGULATIONS RELATING TO DEDUCTIONS FOR CLAIMS AGAINST AN ESTATE UNDER SECTION 2053**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, the Comments should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Benjamin G. Carter of the Estate and Gift Taxes Committee (the “Committee”). Substantive contributions were made by Alan Jones, Lloyd Leva Plaine and Joseph Barry Schimmel. The Comments were reviewed by John F. Bergner, Chair of the Committee, Ronald D. Aucutt of the Section’s Committee on Government Submissions, and John P. Barrie, Council Director Nominee for the Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal estate tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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## EXECUTIVE SUMMARY

These Comments address proposed regulations (the “Proposed Regulations”) relating to the deductibility of claims against an estate under section 2053<sup>1</sup> as published on April 23, 2007.<sup>2</sup> We commend the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) for the extensive and well-considered Proposed Regulations addressing the deductibility of claims under section 2053. Despite credible arguments in favor of the date of death valuation approach for claims against an estate, we recognize that Treasury and the Service thoughtfully considered and rejected those arguments in favor of the view that the amount of a deduction for a claim against an estate be limited to the amount ultimately paid by the estate. Therefore, except in a few specific instances, we have limited these Comments to making the approach adopted by the Service in the Proposed Regulations clearer and more workable.

In an effort to assist Treasury and the Service in finalizing the Proposed Regulations, we submit the following Comments:

1. We recommend that the Regulations, when finalized, allow a decedent's estate to net the value of the various claims and counterclaims by and against a decedent's estate in the same or substantially related litigation matter on the initial Form 706 (using values as of the date of death or the alternate valuation date).
2. We recommend that the Regulations, when finalized, confirm that payments under a decedent's personal guarantee existing at the decedent's death would be deductible in the same manner as payments under any other claim against a decedent's estate.
3. We recommend that the Regulations, when finalized, encourage the Service to be liberal in granting extensions of time to pay estate tax when potential claims against an estate could cause liquidity problems that might impair the estate's ability to resolve the outstanding claims that ultimately will support an estate tax deduction.
4. We recommend that the Regulations, when finalized, clarify and confirm that an estate for which the residue passes in a manner that otherwise qualifies for the marital or charitable deduction would not have its marital or charitable deduction reduced with respect to the value of a contested or unmatured claim until the estate actually pays an amount in settlement of such claim.
5. We recommend that the Regulations, when finalized, omit the requirement under Proposed Regulation section 20.2053-1(b)(3) that an amount paid pursuant to a settlement of a claim be "within the range of reasonable outcomes under applicable state law."
6. We recommend the following clarifications and changes for the final Regulations to the "protective claim" process set forth in the Proposed Regulations:

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<sup>1</sup> All "section" references are to sections of the Internal Revenue Code of 1986, as amended (the "Code") and references to the “Regulations” are to the Treasury Regulations issued thereunder.

<sup>2</sup> REG-143316-03, 72 Fed. Reg. 20,080 (April 23, 2007).

- We recommend that the Regulations, when finalized, offer guidance as to whether a "protective claim" would be filed in the same manner as any other claim for refund or whether the Service contemplates a different procedure.
  - We recommend that the Regulations, when finalized, offer guidance as to how soon the executor must notify the Commissioner following the removal of the contingency that prevented deduction of the claim before the refund claim would be barred.
  - We recommend that the Service add an additional Schedule on Form 706 for an executor to "file" protective claims on behalf of the estate.
7. We recommend that the Regulations, when finalized, omit the last sentence of Proposed Regulation section 20.2053-3(d)(3) that reads, "Expenses incurred merely for the purpose of unreasonably extending the time for payment, or incurred other than in good faith, are not deductible."
8. We recommend that the Regulations, when finalized, refine the terms of Proposed Regulation section 20.2053-4(b)(7) as follows:
- We recommend that the Regulations, when finalized, confirm that an estate is entitled to a deduction equal to the face amount of a decedent's interest-bearing debt obligation existing at the decedent's death, even if such principal amount may be paid in installments.
  - For non-contingent payments that could extend beyond the period for examination of the Form 706, we recommend that the Regulations, when finalized, provide that the estate may either (a) deduct a present value amount as provided in Proposed Regulation section 20.2053-4(b)(7)(i) or (b) elect not to deduct a present value amount and instead file a protective refund claim and later take a deduction for the amount paid (in the same manner as available for a contingent payment obligation).
  - With respect to the annuity described in Proposed Regulation section 20.2053-4(b)(7)(iii), we recommend that the Regulations, when finalized, require the estate (a) to transfer ownership of the purchased annuity to the creditor (or to a third party who will use the annuity to make payments to the creditor) or (b) to grant the creditor a security interest in the annuity.
9. We recommend that the Regulations, when finalized, permit an estate to deduct an amount irrevocably set aside for payment of a recurring payment obligation through an arrangement other than a commercial annuity.
10. We recommend that the Regulations, when finalized, omit the provisions of Proposed Regulation section 20.2053-4(b)(4) establishing a presumption against deductibility of claims by family members, related entities, or beneficiaries.

## COMMENTS

### I. Benefits of Date of Death Valuation of Claims Against Estate Already Addressed in Recent Court Decisions

Section 2053(a) authorizes an estate tax deduction for the following items as allowable by the laws of the jurisdiction under which the estate is being administered: (1) funeral expenses, (2) administration expenses, (3) claims against the estate, and (4) unpaid mortgages or indebtedness on or against property that is included in the value of the gross estate.

As noted in the preamble to the Proposed Regulations (“Preamble”), “[t]he amount an estate may deduct for claims against the estate has been a highly litigious issue.”<sup>3</sup> The Preamble correctly summarized the two general lines of cases developed by the courts on this issue – those following the Supreme Court's decision in *Ithaca Trust v. Commissioner* (deduction based on facts known at date of death)<sup>4</sup> and those adhering to the decision of the Eighth Circuit Court of Appeals in *Jacobs v. Commissioner* (deduction based on amount ultimately paid by the estate in satisfaction of the claim).<sup>5</sup> Although the Preamble did not address the recent trend in the Courts<sup>6</sup> of Appeal in favor of the *Ithaca Trust* approach,<sup>7</sup> it correctly assessed the wide disagreement among the courts as to the correct approach to this issue under the current state of the law:

Although numerous courts have addressed section 2053(a)(3), there is 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.<sup>8</sup>

The Proposed Regulations firmly adhere to the general principles of the *Jacobs* decision and its progeny – *i.e.*, that an estate may only receive a deduction for the amount actually paid in resolution of the claim and may not report an estimated amount on the Form 706 for unmatured or contested claims. Given the differing treatment for similarly situated taxpayers on this issue, we welcome the Service's attempt to create an approach that applies consistently to all taxpayers.

Although many may view the *Ithaca Trust* approach as preferable to the *Jacobs* approach, because the Proposed Regulations follow the *Jacobs* approach, our Comments generally will focus on recommendations to improve or clarify that approach in the Regulations.

### II. Impact of Proposed Regulations on Claims and Counterclaims in Same or Substantially Related Matter

We recommend that the Regulations, when finalized, address the impact of claims and counterclaims by and against an estate in the same or substantially related litigation matter.

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<sup>3</sup> 72 Fed. Reg. 20080 (2007).

<sup>4</sup> 279 U.S. 151 (1929).

<sup>5</sup> 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 U.S. 603 (1929).

<sup>6</sup> 72 Fed. Reg. 20080 (2007).

<sup>7</sup> *See O'Neal v. United States*, 258 F.3d 1265 (11th Cir. 2001); *Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001); *Estate of Smith v. Commissioner*, 198 F.3d 515 (5th Cir. 1999).

<sup>8</sup> 72 Fed. Reg. 20080 – 81 (2007).

We believe that the Proposed Regulations could cause confusion and potential unfairness if a decedent both faces *claims from a third party* as of the decedent's death and possesses *claims against that same third party* in the same or substantially related matter. An estate must value its contested *claim against a third party* (as an asset of the estate) at the claim's fair market value on the date of the decedent's death (or the alternate valuation date, if applicable).<sup>9</sup> Even if the dispute has not been resolved by the due date for filing the estate's Form 706, the executor nevertheless must report a value for the claim as an asset of the estate and pay estate tax on that amount. In contrast, the Proposed Regulations prohibit an executor from taking a deduction for the value of the third party's contested or unmatured *claim against the estate* on the Form 706.<sup>10</sup> Instead, the estate must wait until resolution of the claim before it may then seek a refund from the Treasury for the overpayment of estate tax.<sup>11</sup>

Many modern lawsuits involve both claims and counterclaims. Therefore, under the approach of the Proposed Regulations, an estate could face the prospect of paying estate tax on the value of a claim on which it may never collect but without being able to offset the value of such claim with a deduction for a claim asserted against the estate in the same or substantially related litigation matter until the estate receives payment for such amount. Although the Proposed Regulations seek to avoid questions of "valuation" of claims and retrying those issues in the tax proceeding,<sup>12</sup> the taxpayer and the Service nevertheless will face that same dilemma when valuing an estate's claim against a third party as an asset.

Therefore, if a decedent faces claims from a third party as of the decedent's death and possesses claims against that same third party in the same or substantially related matter, we recommend that the Regulations, when finalized, allow the estate to net the value of the various claims against each other on the initial Form 706 (using values as of date of death or the alternate valuation date). This approach better reflects the realities of the assets subject to estate taxation. The executor must obtain an appraisal of the estate's claim against the third party in filing its Form 706. Usually, that same appraisal also can address the value of the claim by the third party against the estate, which ultimately will allow the executor to net the two values and more accurately determine the estate tax liability associated with the estate's participation in the relevant litigation.

By netting its claims, the estate would avoid the liquidity crisis that could befall it if it were forced to pay estate tax on its claim (with no guarantee of ultimate payment by the creditor) without any initial relief for the claims asserted against the estate.

### **III. Personal Guarantees**

We recommend that the Regulations, when finalized, clarify the deductibility of payments on a personal guarantee given by a decedent that remains in effect at the decedent's death.

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<sup>9</sup> I.R.C. § 2031(a).

<sup>10</sup> Prop. Reg. § 20.2053-4(b)(2), 72 Fed. Reg. 20084 (2007).

<sup>11</sup> Prop. Reg. § 20.2053-4(b)(1), 72 Fed. Reg. 20084 (2007).

<sup>12</sup> 82 Fed. Reg. 20081 (2007).

In Private Letter Ruling 9321004,<sup>13</sup> the Service allowed an estate to deduct payments made under a guarantee of a lease of the decedent's business. In the ruling, the Service noted that the guarantee was "bona fide and arms-length" but did not analyze the "adequate and full consideration" requirement under section 2053(c)(1)(A). If the Proposed Regulations had applied to the situation in this Ruling, we believe that the Service would have reached the same result and allowed the estate tax deduction.

Given the frequency of personal guarantees made by owners of closely-held businesses, we recommend that the Regulations, when finalized, confirm that payments under personal guarantees would be deductible in the same manner as payments under any other claim against an estate. With respect to claims by related entities, please see part X of these Comments.

#### **IV. Liquidity Issues**

By preventing an estate from claiming a deduction on its initial Form 706 for the value of a contested or unmatured claim against the estate, the Proposed Regulations could create considerable liquidity concerns for such an estate. Under the Proposed Regulations, the estate must pay the tax (assuming no deduction for the contested or unmatured claim) and then seek a refund once the estate pays an amount in settlement of the claim.

If the estate used its available liquid funds to pay its estate tax liability, the estate would be forced to borrow funds to pay the amount required to settle the claim against it. Depending on the nature of the estate's remaining assets, a third party lender might refuse to loan the needed funds to the estate. Although the estate may prosecute its refund claim (assuming it filed a protective claim or the statute of limitations has not expired), that avenue necessarily will involve delays that could prejudice the estate's ability to settle the claim that will ultimately justify an estate tax deduction.

In short, we recommend that the Regulations (or the preamble thereto), when finalized, encourage the Service to be liberal in granting extensions of time to pay estate tax when contested and unmatured claims against an estate could cause liquidity problems that might impair the estate's ability to resolve the outstanding claims that ultimately will support an estate tax deduction.

#### **V. Effect on Marital and Charitable Deductions**

We recommend that the Regulations, when finalized, clarify the input on the marital or charitable deduction of an estate that directs its residue in a manner that qualifies for such a deduction but also faces contested or unmatured claims that would be paid out of the same residue.

It would appear that the estate in such a case could take a marital or charitable deduction on the initial Form 706 based on an assumption of no deduction for the contested or unmatured claims against the estate. In other words, the estate's marital or charitable deduction would not be reduced until the estate actually paid an amount in satisfaction of its contested or unmatured

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<sup>13</sup> PLR 9321004 (Feb. 16, 1993)

claim. We believe that such a result is correct and recommend that the Regulations, when finalized, explicitly confirm this view.

We do not believe that the Regulations, when finalized, should require the estate to reduce its marital or charitable deduction on the initial Form 706 because of the contested or unmatured claim, given that the estate may not report a deduction for such claims until ultimately paid. However, if the final Regulations did impose such a requirement, then the Regulations, when finalized, should clarify what happens if the estate later resolves the claim by not having to pay anything on it. We believe that the estate should be entitled to the marital or charitable deduction that was initially disallowed on the Form 706. The Regulations, when finalized, should clarify whether the estate must file a claim for refund (or protective claim) to preserve its right to later claim the marital or charitable deduction in this case.

## **VI. Section 2053(a)(3) Deduction Based on Amount Paid in Settlement of Claim**

Under the Proposed Regulations, a settlement will offer proof of the amount of the section 2053(a)(3) deduction for the settled claim if the settlement:

- (1) resolves a bona fide issue in an active and genuine contest,
- (2) is the product of arm's length negotiations by parties having adverse interests with respect to the claim, and
- (3) is within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement.<sup>14</sup>

The Proposed Regulations also state that an estate may not assert a deduction for an amount paid for an unenforceable claim.<sup>15</sup>

We agree that an amount paid in settlement of a claim must satisfy the first two elements described above in order for such amount to be deducted as a claim against the estate. However, we recommend that the Regulations, when finalized, omit the third element of Proposed Regulation section 20.2053-1(b)(3) (that the amount paid must be "within the range of reasonable outcomes under applicable state law"). These Comments analyze the rationale for this recommendation by reviewing the three characteristics of a settlement that qualifies as "within the range of reasonable outcomes" under the Proposed Regulations.

### **A. Compromise Between Position of Adverse Parties**

A settlement that qualifies as within the range of reasonable outcomes must reflect a "compromise between the positions...adverse parties."<sup>16</sup> This appears duplicative of the requirements that a deductible amount paid under a settlement agreement (1) must resolve a bona

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<sup>14</sup> Prop. Reg. § 20.2053-1(b)(3), 72 Fed. Reg. 20083 (2007).

<sup>15</sup> Prop. Reg. § 20.2053-1(b)(3), 72 Fed. Reg. 20083 (2007); Prop. Reg. § 20.2053-4(b)(5), 72 Fed. Reg. 20085 (2007).

<sup>16</sup> Prop. Reg. § 20.2053-1(b)(3), 72 Fed. Reg. 20083 (2007).

fide issue in an active and genuine contest and (2) is the product of arm's length negotiations by parties with adverse interests with respect to the claim.

## **B. Assessment of Strengths and Weaknesses**

A settlement that qualifies as within the range of reasonable outcomes must "reflect the parties' assessment of the relative strengths of their respective positions."<sup>17</sup> As a preliminary matter, this general standard could require the Service (and potentially the Tax Court or District Court presiding over the estate tax litigation matter) to pass judgment on the legal strengths and weakness of a case in which it was not involved. We believe that such an evaluation contradicts the stated goal of the Proposed Regulations of not placing the Service or the court in the estate tax proceeding in a position of having to evaluate the legal merits of a claim adjudicated in another court proceeding.<sup>18</sup> This evaluation process would place the Service at the negotiating table when an estate attempts to settle a claim, even if the settlement reflects a resolution of a bona fide issue in an active and genuine contest and was reached through arm's length negotiations by parties with adverse interests in the claim, the Service and the court in the estate tax proceeding still would be required to evaluate whether the estate made a "good deal" in settling the claim.

Furthermore, this standard does not consider the cost to an estate of defending a claim in relation to the amount paid to settle it. For example, a third party could assert a claim against a decedent for damages of \$100,000. The executor of the decedent's estate may believe the estate would likely prevail if the claim were litigated to conclusion (perhaps even putting its odds of success at 75%). However, to achieve victory through the courts, the executor may incur legal fees and expenses of \$75,000 as well as value of the executor's time and (and potentially the beneficiaries of the estate). To avoid these burdens, the executor might agree to settle the claim for \$40,000. Under the language of the Proposed Regulations, such a settlement would not reflect "the parties' assessment of the relative strengths of their respective positions" but rather would reflect the practical realities of litigating a case to conclusion. We believe that such a result would contravene the purpose of the deduction for claims and indirectly discourage estates from resolving disputes through settlement rather than through the courts.

The Proposed Regulations also state that an executor may not deduct an amount paid for an unenforceable claim.<sup>19</sup> While enforceability is a reasonable element of a deductible claim and should discourage parties from attempting to disguise a donative transfer as a deductible claim. If enforceability of the claim is in doubt or if litigating the claim to a judicial decision would require more expense and hardship than the estate reasonably should be expected to incur, then the estate should still receive a deduction under section 2053 for a payment made in settlement of such a claim.

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<sup>17</sup> Prop. Reg. § 20.2053-1(b)(3), 72 Fed. Reg. 20083 (2007).

<sup>18</sup> 72 Fed. Reg. 20081 (2007).

<sup>19</sup> Prop. Reg. § 20.2053-1(b)(4), 72 Fed. Reg. 20083 (2007); Prop. Reg. § 20.2053-4(b)(5), 72 Fed. Reg. 20085 (2007).

### **C. Not Inconsistent with Local Law**

A settlement that qualifies as within the range of reasonable outcomes cannot be inconsistent with local law.<sup>20</sup> Standing alone, this obligation parallels the requirement under the current Regulations that a court decree by consent "will not be accepted if it is at variance with the law of the State."<sup>21</sup> However, the current Regulations include as an example to this point "an allowance made to an executor in excess of that prescribed by state law."<sup>22</sup> To the extent that this third element of the Proposed Regulations merely requires the Service (or the Court) to evaluate a rudimentary state law question (such as the calculation of an executor fee), then we do not view this as a departure from existing law.

However, in reading this third element of the Proposed Regulation in the context of the other requirements discussed above, we believe that this third element provides further incentive for the Service (and potentially the court hearing the estate tax proceeding) to evaluate the propriety of a settlement based on applicable state law. For the reasons discussed above with respect to the second element (that a settlement reflect an assessment of strengths and weaknesses), we recommend that the Regulations, when finalized, clarify that they do not intended to place the Service "at the negotiating table" when an executor seeks to resolve a claim against the decedent's estate.

### **D. Conclusion**

For all of the foregoing reasons, we recommend that the Regulations, when finalized, omit the requirement from Proposed Regulation section 20.2053-1(b)(3) that a deductible settlement must be "within the range of reasonable outcomes under applicable state law governing the issues resolved by settlement."

## **VII. Protective Claims**

Under the Proposed Regulations, an estate may file a "protective claim" to preserve a refund claim for a deduction that was not ascertainable at the time of examination of the return or if it is not then clear that the amount will be paid.<sup>23</sup> Given the general approach taken under the Proposed Regulations as to when an estate may claim a deduction under section 2053, the option of filing a protective claim seems to be an appropriate and reasonable means of preserving the estate's rights to assert deductions under section 2053. In finalizing the Regulations, however, we believe that the procedure and structure of the protective claim process would benefit from a more detailed discussion.

### **A. Clarify Procedure for Filing Protective Claim**

The Proposed Regulations state that, if necessary, "a protective claim may be filed before the expiration of the period of limitations for claims for refund in order to preserve the estate's

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<sup>20</sup> Prop. Reg. § 20.2053-1(b)(4), 72 Fed. Reg. 20083 (2007).

<sup>21</sup> Reg. § 20.2053-1(b)(2).

<sup>22</sup> Reg. § 20.2053-1(b)(2).

<sup>23</sup> Prop. Reg. § 20.2053-1(b)(4), 72 Fed. Reg. 20083 (2007).

right to claim a refund if the amount of a liability was or will not be paid before the expiration of the period of limitations for claims for refund."<sup>24</sup> The Regulations, when finalized, also should provide guidance as to whether a "protective claim" would be filed in the same manner as any other claim for refund or whether a different procedure is contemplated.

### **B. Clarify Timeframe for Resolving Protective Claim**

The Proposed Regulations also state that "[a]ction on the protective claims will proceed after the executor has notified the Commissioner that the contingency has been resolved."<sup>25</sup> The Regulations, when finalized, should offer guidance as to how soon the executor must notify the Commissioner following the removal of the contingency for the claim against the estate before the refund claim would be barred.

### **C. Include Protective Claim Schedule on Form 706**

We recommend that the Service include an additional Schedule on Form 706 for an executor to "file" protective claims on behalf of the estate.

Under the Proposed Regulations, the time between filing the protective claim and payment in satisfaction of that claim could be several years. The Service might not even review the protective claim until the estate contacts the Service many years after the claim was filed (well beyond the time for filing a protective claim). If the protective claim contained any technical deficiencies, it likely would be too late for the estate to resolve them.

If, on the other hand, the Form 706 included a Schedule on which the executor could assert protective claims, an estate could rely on the standard statute of limitations. If the Service does not assess a deficiency within that statutory period or object to the form of the protective claim during that time, then the estate will be assured that, once the claim is paid, it can resolve its refund claim without a concern that the protective claim was technically deficient.

## **VIII. Expenses Incurred in Defending Estate Against Claims**

The Proposed Regulations appropriately include specific authorization for deducting expenses incurred in defending a claim against an estate, even if the claim is not ultimately successful.<sup>26</sup> We question the necessity, however, of providing an exclusion for expenses incurred "merely for the purpose of unreasonably extending the time for payment or other than in good faith."<sup>27</sup>

Under the Proposed Regulations, the estate may not take a deduction for the amount of a claim against the estate until the time of actual payment of the claim by the estate. While we acknowledge the theoretical possibility of an estate deliberately incurring additional legal fees and expenses that delay the ultimate payment of the settlement (with the belief that those fees

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<sup>24</sup> Prop. Reg. § 20.2053-1(b)(4), 72 Fed. Reg. 20083 (2007).

<sup>25</sup> Prop. Reg. § 20.2053-1(b)(4), 72 Fed. Reg. 20083 (2007).

<sup>26</sup> Prop. Reg. § 20.2053-3(d)(3), 72 Fed. Reg. 20084 (2007).

<sup>27</sup> Prop. Reg. § 20.2053-3(d)(3), 72 Fed. Reg. 20084 (2007).

would be deductible), such a scenario is unlikely. However, in an estate tax audit, this provision could open up the estate to questions over its legal strategy or even the cost of legal representation in defending an estate against a claim. We believe that such decisions carry significant independent significance, well beyond their deductibility on the Form 706.

Therefore, we recommend that the Regulations, when finalized, omit the limitation in Proposed Regulation section 20.2053-3(d)(3) that bars a deduction for expenses incurred "merely for the purpose of unreasonably extending the time for payment or other than in good faith."

## **IX. Recurring Obligations**

Proposed Regulation section 20.2053-4(b)(7) addresses the deductibility of an obligation to make recurring payments on an enforceable and certain claim that will extend beyond the period for final determination of the estate tax liability. For payments that are not subject to a contingency ("non-contingent payments"), an estate may deduct an estimated amount for those payments on the basis of the present value of the payments as of the date of the decedent's death (measured through the valuation rules of section 7520).<sup>28</sup> For those recurring payments that are subject to a contingency ("contingent payments"), the Proposed Regulations limit the deduction to the amount ultimately paid.<sup>29</sup> If the recurring payments are made prior to the period for determination of the estate tax liability, it appears that the estate may deduct the amounts paid, regardless of whether they were "contingent" or "non-contingent" at the time the obligation was incurred.

### **A. Stated Principal Amount Payable with Interest**

As a preliminary matter, we believe that the Regulations, when finalized, should clarify that the provisions of Proposed Regulation section 20.2053-4(b)(7) do not apply to debts of a decedent on which the decedent was obligated to pay a fixed principal amount, which bears interest and has a stated due date for payment of the principal balance and unpaid interest. For example, assume that during the decedent's life, the decedent borrowed \$1,000,000 from a third party, which the decedent agreed to repay pursuant a promissory note that had a ten (10) year term and interest stated at the applicable federal rate or some other negotiated interest rate. If the principal balance on the note is \$870,000 at the decedent's death we believe that the decedent's estate should receive a deduction under section 2053 equal to \$870,000. Further, we believe that such result should obtain regardless of whether the note is secured.

### **B. Non-Contingent Payment Obligation**

By contrast, if the decedent's obligation is to pay a third party a stated dollar amount each year for a fixed number of years (or some other fixed timeframe), then we generally approve of the approach under Proposed Regulation section 20.2053-4(b)(7)(i) that the deduction should equal the present value of the payment obligation, subject to the suggestions described below. However, the Regulations, when finalized, should provide that the estate may either (1) deduct a discounted present value amount as provided in Proposed Regulation section 20.2053-4(b)(7)(i)

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<sup>28</sup> Prop. Reg. § 20.2053-4(b)(7)(i), 72 Fed. Reg. 20085 (2007).

<sup>29</sup> Prop. Reg. § 20.2053-4(b)(7)(ii), 72 Fed. Reg. 20085 (2007).

or (2) elect not to deduct a discounted present value amount and instead file a protective claim for refund and later take a deduction for the amount paid (in the same manner as available for a contingent payment obligation).

### **C. Modify Annuity Purchase Provisions**

Proposed Regulation section 20.2053-4(b)(7)(iii) authorizes an estate to purchase a commercial annuity (for contingent or non-contingent payments) and receive a section 2053 deduction equal to the amount paid for the annuity plus any payments made on the claim following decedent's death. However, the Proposed Regulations do not discuss whether (1) the annuity must be transferred to the creditor to satisfy the obligation, (2) the annuity can be used as security to satisfy the obligation (*e.g.*, by granting the creditor a security interest in the annuity), or (3) the annuity need be purchased and held by the estate with the "intent" (as may possibly be expressed in the annuity application) that it be used to satisfy the obligation. To clarify these points we recommend that the Regulations, when finalized, require the estate to either (1) transfer ownership of the annuity to the creditor or to a third party (which third party will then make payments from the annuity to the creditor) or (2) grant the creditor a security interest in the annuity.

### **D. Allow for Other Irrevocable Means of Setting Aside Payment of Funds**

We also recommend that the Regulations, when finalized, authorize an immediate deduction for amounts irrevocably set aside for payment of a recurring obligation in ways other than through a commercial annuity. For example, an estate could transfer funds to an escrow agent or perhaps to the trustee of an irrevocable trust that, in turn, must make the payments to the creditor. We believe that as long as the funds are irrevocably set aside by the estate and remain outside of the estate's control, then the amount paid to the intermediary should be treated in the same manner as a commercial annuity. Given the costs and expenses frequently associated with commercial annuities, estates likely would benefit from alternative (and less costly) means of funding these recurring obligations.

## **X. Special Provisions for Claims by Family Members, Related Entities, or Beneficiaries**

We appreciate the concern that family members not take advantage of the deductibility of claims against an estate as a tool to make tax-free donative transfers out of the estate to the family member. For that reason, we understand the logic of the inclusion of Proposed Regulation section 20.2053-4(b)(4). However, for the reasons discussed below, we respectfully recommend that the Regulations, when finalized, omit the provisions of Proposed Regulation section 20.2053-4(b)(4).

### **A. Existing Provisions Adequately Address Issue**

Both the current Regulations and other provisions of the Proposed Regulations adequately protect against the manipulation of claims as a tool to make transfer-tax-free donative transfers. Consider the following examples from the Proposed Regulations:

- *Court Decree by Consent* – A court decree by consent will support a deduction for a claim only if the consent was a bona fide recognition of the validity of the claim.<sup>30</sup>
- *Settlement of Claim* – A settlement will support a deduction for the claim only if, among other points, the settlement resolves a bona fide issue in an active and genuine contest and is the product of arm's length negotiations by parties with adverse interests with respect to the claim.<sup>31</sup>

In fact, the current Regulations explicitly state that consent to payment of a claim cannot be a cloak for a gift.<sup>32</sup> These provisions adequately protect against taxpayers attempting to disguise donative transfers in the form of deductible claims.

### **B. Inconsistent with Burden of Proof Statute**

Proposed Regulation section 20.2053-4(b)(4) implies that the payment of a claim to a "related party" is less likely to be the product of arm's length bona fide negotiations than the payment of a claim to an unrelated party. The Proposed Regulations acknowledge that a related party claim may be deductible, if the estate overcomes the presumption of invalidity by producing certain factual proof to bolster the claim's validity.

We believe that this presumption against deductibility of a related party settlement is inconsistent with the burden of proof provisions of section 7491. Under section 7491, the Service bears the burden of proof on a factual issue provided that:

- the taxpayer introduces credible evidence with respect to the factual issue,

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<sup>30</sup>Prop. Reg. § 20.2053-1(b)(2)(ii), 72 Fed. Reg. 20082 (2007).

<sup>31</sup>Prop. Reg. § 20.2053-1(b)(3), 72 Fed. Reg. 20083 (2007).

<sup>32</sup>Prop. Reg. § 20.2053-1(b)(2), 72 Fed. Reg. 20082 (2007).

- the taxpayer has compiled with all applicable requirements to substantiate the item, and
- the taxpayer has maintained all required records and has cooperated with reasonable requests by the Service for witnesses, information, documents, meetings and interviews.

Because the terms of Proposed Regulation section 20.2053-4(b)(4) extend significantly beyond requiring the taxpayer to introduce "credible evidence" on the legitimacy of the settlement, we believe that the burden-shifting contemplated by Proposed Regulation section 20.2053-4(b)(4) is inconsistent with the terms of section 7491 and, therefore, should be deleted.