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I. INTRODUCTION

The purpose of this presentation is to provide an overview of Code Sec. 6166, which governs the election to pay estate tax on business interests in installments, and Code Sec. 2053, which authorizes an estate tax deduction for administration expenses.

II. DEFERRAL OF ESTATE TAXES UNDER CODE SEC. 6166

Generally

Oftentimes, a decedent will have held closely held business interests at the time of his or her death and if his or her estate has insufficient funds, the executor may be forced to sell the business. This is of particular interests to those who have a family business. Code Sec. 6166 allows the executor to defer the federal estate tax attributable to the closely held business interests.

Specifically, Code Sec. 6166 provides that the federal estate tax attributable to closely held business interests which are included in the decedent's gross estate may be deferred and paid in installments provided that such interest equals at least 35% of the decedent's estate.[1] The executor can elect to pay the tax attributable to the closely held business interest in up to 10 annual installments, beginning no later than five years after the due date for payment.[2]

Notably, the maximum extension that can be granted is 14 years because the first installment payment is due at the end of the five-year period from the original due date and the subsequent installments will be due on that same date.[3] Payments can be spread over two to 10 annual payments, but for the first five years, payment of interest is required.[4]

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[1] Code Sec. 6166(a)(1) ("If the value of an interest in a closely held business...exceeds 35 percent of the adjusted gross estate [of the decedent], the executor may elect to pay part or all of the tax imposed by section 2001 in 2 or more (but not exceeding 10) equal installments.").

[2] Id.

[3] Treas. Reg. § 20.6166-1(e)(2); Code Sec. 6166(a)(3).

[4] Code Sec. 6166(f)(1).

Closely Held Business Interests

Interests in closely held businesses include interests in a proprietorship, partnership, or a corporation, all of which are carrying on a trade or business.[5] The inquiry often turns on whether the business is an active trade or business or a passive investment, although there is no requirement that all the assets of a partnership or corporation be utilized in carrying on the trade or business. Code Sec. 6166 therefore applies only with regard to an active trade or business, not to any mere management of investment assets, which is considered passive activity.[6]

In Revenue Ruling 2006-34, the IRS listed the following several non-exclusive factors used in determining whether a decedent's activities constitute an interest in a closely held business:[7]

1. Amount of time decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
2. Whether an office was maintained from which the activities of decedent, partnership, LLC, or corporation were conducted or coordinated, and whether decedent maintained regular business hours for that purpose;
3. Extent to which decedent was actively involved in finding new tenants and negotiating and executing leases;
4. Extent to which decedent provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
5. Extent to which decedent personally made, arranged for, performed, or supervised repairs and maintenance to the property, including without limitation painting, carpentry, and plumbing; and
6. Extent to which decedent handled tenant repair requests and complaints.[8]

Further, if the decedent owns stock in a corporation carrying on a trade or business, such stock may qualify as a closely held business interest if (a) 20% or more of the voting stock is

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[5] Code Sec. 6166(b)(1). Whether a business is a closely held business is determined by reference either to the total number of shareholders or owners, or to the percentage of the value of the business that is included in the decedent's gross estate, as discussed below. Attribution rules also apply in determining the number of shareholders or owners. Code Sec. 6166(b)(2).

[6] *See* Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (6/22/2006) (Discussing generally how an interest in an business can qualify as an interest in closely held business for purposes of Code Sec. 6166).

[7] Id.

[8] Id.

included in the decedent's gross estate or (b) there are 45 or fewer shareholders.[9] In meeting the 45-or-fewer-shareholder test, consideration should be given to shares held in trust and other types of co-ownership. Attribution rules are applicable to this test as well as to the 20% ownership test.[10]

Passive Assets

As stated above, only assets used in carrying on a trade or business are considered in determining the decedent's interest in the closely held business for purposes of the 35% test; passive investments or passive assets are excluded.[11] Thus, any portion of the value of the business that is attributable to passive investment assets is disregarded. A passive asset is defined as "any asset other than an asset used in carrying on a trade or business."[12]

Attribution Rules

Code Sec. 6166(b)(2)(C) attributes stock owned by corporations, partnerships, estates, and trusts to the shareholders, partners, or beneficiaries. In the case of trusts, this attribution is only to beneficiaries who have a present interest in the trust.[13] In addition, the Section treats all stock and all partnership interests held by the decedent or any family member as owned by the decedent. Such family members include the decedent's brothers and sisters, spouse, ancestors, and lineal descendants.[14]

Payment of Tax under the Election

If the executor makes an election under Code Sec. 6166, he or she may pay the federal estate tax attributable to the closely held business interest in up to 10 annual installments.[15] However, as mentioned above, this tax can be deferred in its entirety for up to five years after the normal due date

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[9] Code Sec. 6166(b)(1)(C). Note that the Economic Growth and Tax Relief Reconciliation Act of 2001 increased the maximum number of shareholders from 15 to 45 for estates of decedents dying after December 31, 2001. H.R.1836, Pub. L. No. 107-16, § 571.

[10] Code Sec. 6166(b)(2)(C).

[11] Code Sec. 6166(b)(9)(A).

[12] Code Sec. 6166(b)(9)(B)(i).

[13] Code Sec. 6166(b)(2)(C).

[14] Code Sec. 267(c)(4).

[15] Code Sec. 6166(a)(1).

for filing the federal estate tax return.[16] The amount of estate tax that can be deferred is based on the ratio between the estate tax value of the qualifying business interest and the adjusted gross estate.[17] In other words, the maximum amount of tax subject to installment payments must have the same ratio to the federal estate tax as the ratio of the value of the closely held business interest to the value of the adjusted gross estate. The adjusted gross estate is the gross estate, reduced by the amounts allowable as a deduction under Code Secs. 2053 or 2054.[18]

Payment of Interest under the Election

As stated above, interest must be paid for the initial five years of the deferral and thereafter, throughout the installment period.[19] The estate can now enjoy the benefit of a reduced interest rate, currently 2%.[20] However, interest on estate taxes deferred under Code Sec. 6166 is nondeductible for estate or income tax purposes under Code Sec. 2053.[21] Generally, Code Sec. 6601(a) requires that interest be paid if any amount is not paid "on or before the last date prescribed for payment" at the underpayment rate established under Code Sec. 6621(a)(2). Code Sec. 6621(a)(2) provides that the underpayment rate is the federal short-term rate plus three percentage points and it is determined the first month in each calendar quarter.[22] However, if time for payment of the estate tax is extended under Code Sec. 6166, then, in lieu of the annual rate provided by Code Sec. 6601(a), interest at a rate of 2% is imposed on the "2 percent portion" (as defined by Code Sec. 6601(j)(2)) of that amount,[23] and the interest rate imposed on deferred estate tax in excess of the 2% amount is 45% of the rate applicable to underpayments of tax provided by Code Sec. 6601(a) (i.e., 45% x 8% = 3.6%).[24]

The "2 percent portion" means the lesser of:

(1) The amount of the tentative tax determined under the estate tax rate schedule

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16 Code Sec. 6166(a)(3).

17 Code Sec. 6166(a)(2).

18 Code Sec. 6166(b)(6).

19 Code Secs. 6166(f)(1) and (f)(2).

20 Taxpayer Relief Act of 1997, Pub. L. No. 105-34 § 503(a).

21 Code Secs. 2053(c)(1)(D) and 163(k).

22 Code Sec. 6621(b)(1).

23 Code Sec. 6601(j)(1)(A).

24 Code Sec. 6601(j). *See also* Treas. Reg. § 20.6166-1(f).

if the amount on which such tax is to be computed were the sum of $1 million[25] (as increased for inflation[26]) and the applicable exclusion amount,[27] reduced by the applicable credit amount[28] of the unified credit[29] or

(2) The amount of the estate tax extended under Code Sec. 6166.[30]

Thus, interest at the rate of 2% is imposed on the amount of deferred estate tax attributable to the first $1 million (as adjusted for inflation) in value in excess of the amount exempted by the unified credit and any other exclusions.[31] For decedents dying in 2008 the estate tax attributable to the first $1,280,000 in excess of the amount exempted by the unified credit will bear interest at the rate of 2%.[32]

Further, to the extent the tax exceeds the "2 percent portion," the rate of interest will be that currently applied under Code Sec. 6621 (the federal short-term rate plus three percentage points).[33] Interest on the "2 percent portion" remains constant at 2% during the payment period. However, interest on the portion of the deferred estate tax exceeding the "2 percent portion" does not remain constant because the federal short-term rate changes every calendar quarter, meaning the rate of interest on the deferred estate tax that exceeds the "2 percent portion" will change to reflect the new Code Sec. 6621(a)(2) rate.[34]

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[25] Code Sec. 6601(j)(2)(A)(i).

[26] Code Sec. 6601(j)(3). For estates of decedents dying in 2008, this number is $1,280,000. Rev. Proc. 2007-66, 2007-45. For estates of decedents dying in 2007, this number is $1,250,000. Rev. Proc. 2006-53, 2005-48 I.R.B. 996.

[27] For estates of decedents dying during 2006, 2007, or 2008, the applicable exclusion amount is $2 million. For estates of decedents dying in 2009 (before the repeal of the estate tax after 2009), the applicable exclusion amount will be $3.5 million. Code Sec. 2010(c).

[28] For 2006, 2007, and 2008, the applicable credit amount is $780,800 and thus, a credit of $780,800 exempts $2 million from tax. For 2009, the applicable credit amount will be $1,455,800 and thus, a credit of $1,455,800 exempts $3.5 million from tax.

[29] Code Sec. 6601(j)(2)(A)(ii).

[30] Code Sec. 6601(j)(2)(B).

[31] Rev. Proc. 99-42, 1999-2 C.B. 568.

[32] Rev. Proc. 2007-66, 2007-45 I.R.B. 970.

[33] Code Sec. 6601(j)(1)(B).

[34] Code Sec. 6601(j)(A) and (B); *See also* PLR 200529006 (07/22/2005).

If an election was made under Code Sec. 6166, the 2% interest rate applies from the date on which the estate tax was originally due.[35] If instead a protective election[36] is made, the 2% interest rate applies only to the amount of any deficiency from the due date of payment of federal estate tax and once the protective election is final, the 2% interest rate applies to the entire deferred tax subject to the limitations of Code Sec. 6601(j).

Payment of Deficiencies in Installments

If there is a deficiency in estate tax and the estate qualifies under Code Sec. 6166, the executor may elect to pay the deficiency in installments under Code Sec. 6166(h). However, the election is not available if the deficiency was due to negligence or intentional disregard of the rules or regulations, or due to fraud with intent to evade tax, in which case the executor will not be able to pay the deficiency in installments.[37] The election must be made within 60 days of notice and demand by the IRS for payment of the deficiency.[38] If the election is made, the deficiency is prorated to the installments that would have been due if an election had been timely made when the estate tax return was filed.[39]

How to Make the Section 6166 Election

The executor must check "Yes" on Line 3, Part 3 of a timely filed estate tax return, namely IRS Form 706, and attach a notice of election containing the following information:

1. Decedent's name and identification number;
2. Amount of tax to be paid in installments;
3. Date for payment of the first installment;
4. Number of annual installments, including the first installment;
5. Assets listed on the federal estate tax return that constitute the closely held business

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[35] Treas. Reg. § 20.6166-1(f).

[36] *See* Treas. Reg. § 20.6166-1(d). A protective election to defer tax can be made in circumstances in which there is uncertainty whether the estate will be eligible when the return is filed (i.e., there may be uncertainty as to the proper valuation of a closely held business interest for estate tax purposes). In other words, if the executor is unsure whether to use Code Sec. 6166, the executor may still file for an extension, even if he or she later decides not to use it. This is because the election for deferral under Code Sec. 6166 must be made on a timely filed estate tax return.

[37] Id.

[38] Code Sec. 6166(h)(2).

[39] Code Sec. 6166(e).

interest, identified by reference to both schedule and item numbers; and

6. Factual basis for the executor's conclusion that the estate qualifies for the election.[40]

However, once the election is made, the IRS may deny it on several grounds (e.g., not qualified as a closely held business interest or such qualification to continue payments is terminated). But the estate may still have a remedy under Code Sec. 7479 which provides that the executor may file a Tax Court petition for a declaratory judgment as to whether the election can be made or whether tax deferral can be continued.[41] However, all administrative remedies must first be exhausted.[42] Further, the action must be commenced within 90 days of receipt of a notice by an agent of the IRS, sent by registered or certified mail, that the election is not available or no longer available.

Acceleration

There are several circumstances that can result in acceleration of the deferred portion of the federal estate tax.[43] The executor must be aware of the possibility of acceleration and plan for sources of payment of the tax when it occurs. He or she is required to notify the IRS of all withdrawals and dispositions, as discussed below, within 30 days of becoming aware of them and to report each year on whether withdrawals, distributions, and the like have triggered acceleration.[44]

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[40] Treas. Reg. § 20.6166-1(b). Note that Part 3, Line 3 of Form 706 has a disclaimer providing that security may be required for estate tax deferred under Code Sec. 6166 and interest in the form of a surety bond or a Code Sec. 6324A lien. This is discussed below.

[41] Code Sec. 7479(a).

[42] Code Sec. 7479(b)(2). A petitioner shall be deemed to have exhausted its administrative remedies with respect to a failure of the IRS to make a determination at the expiration of 180 days after the date on which the request for such determination was made if the petitioner has taken, in a timely manner, all reasonable steps to secure such determination. *See also* Rev. Proc. 2005-33, 2005-23 I.R.B. 1231 (5/20/2005) (Providing guidance as to what it means to exhaust administrative remedies).

[43] Code Sec. 6166(g).

[44] Treas. Reg. § 20.6166A-3(f)(1)(2).

Don't Forget About Security Requirements!

In addition to charging interest on the deferred payment of tax under Code Sec. 6166, the IRS may require security as a prerequisite to an extension under Code Sec. 6166.[45] Thus, in order for the executor to avoid, or be discharged from, liability[46] for the deferred estate tax, he or she may either provide a surety bond with respect to the deferred tax[47] or grant the IRS a lien on the affected business property in lieu of the bond.[48] A 2006 Chief Counsel Advice indicated that the IRS may seek either type of security for a Code Sec. 6166 election anytime prior to the full payment of the tax assessed; however there is no statutory period of limitations for obtaining such security.[49]

The IRS must determine, on a case-by-case basis, whether security is required.[50] Currently, the IRS is in the process of establishing standards to be applied on a case-by-case basis to identify estates making a Code Sec. 6166 election in which the IRS's interest in the deferred estate tax, and interest on the tax, is considered to be sufficiently at risk to justify the requirement of a bond or a Code Sec. 6324A special lien.[51] The IRS will consider the following non-exclusive factors to see

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[45] The Tax Court rejected the IRS's attempt to make a bond or lien mandatory in order to obtain approval for the extension under Code Sec. § 6166. Estate of Roski v. Comm'r, 128 T.C. 113 (April 12, 2007).

[46] Under Code Sec. 2002, the estate tax must be paid by the executor. In the event the executor pays any claims or makes distributions before payment of debts due to the IRS, including state taxes, the executor is personally liable for the payment of federal estate taxes.

[47] Code Sec. 6165, as cross-referenced in Code Secs. 6166(k)(1) and (2).

[48] Code Sec. 6324A.

[49] C.C.A. 200627023 (6/28/2006).

[50] *See* Code Sec. 6166(k)(1) (referencing Code Sec. 6165 for IRS's authority to require security). *See also* Notice 2007-90, 2007-46 I.R.B. 1003 (10/29/2007) and Estate of Roski, *supra.*

[51] *See* Notice 2007-90, 2007-46 I.R.B. 1003 (10/29/2007). This interim guidance represents a change of policy by the IRS in response to a Tax Court decision holding that the IRS abused its discretion by imposing bright line requirements of a bond or special lien for every Code Sec. 6166 election. *See also* Estate of Roski, *supra*. As further background, before 2002, the IRS had rarely invoked the bond or lien procedures and several estates defaulted on their deferred tax obligations when the closely held business deteriorated after the founder's death. In response, in 2002, the IRS adopted a bright line rule requiring every estate seeking deferral under Code Sec. 6166 to post bond or submit estate assets to a special lien in favor of the IRS. *See, generally*, J. Rikoon, et al., Trusts & Estates: The Journal of Wealth Management for Estate Planning Professionals, "How Big a Relief is Roski?," p. 24-27, Vol. 146, No. 8 (August 2007).

whether deferred installment payments under Code Sec. 6166 pose a sufficient credit risk to justify the imposition of bond or special lien: (i) duration and stability of the business; (ii) ability to pay the installments of tax and interest in a timely manner; and (iii) the business's history of compliance with federal tax payments and tax filing requirements.[52]

The IRS has no authority to require a bond or special lien in every case where an estate makes an election under Code Sec. 6166.[53] In Estate of Roski, the Tax Court held that the plain language of Code Secs. 6166 and 6165 indicate that the bond requirement is discretionary and thus not mandatory.[54] It also emphasized that the legislative purpose of Code Sec. 6166 was to avoid forcing the executor to sell an interest in a farm or other closely held business in order to pay estate taxes; thus, to allow the imposition of a mandatory bond would exacerbate the problem Congress was trying to alleviate in enacting Code Sec. 6166.[55] The issue then turns on when can the IRS require security under Code Sec. 6166. However, the Tax Court in Roski did not establish standards; it only implies that there should be such standards.[56] Similarly, the Tax Court does not require that the IRS be generous in waiving the bonding requirement, for example, which is unlikely to be the case in any event.

Bonds

Under Code Sec. 6165, if the IRS grants an extension of time for payment of any tax or tax deficiency, it may require the taxpayer or executor to furnish a bond for payment under the terms of the extension. The executor will be notified of the amount of bond required to be furnished, but it cannot exceed twice the amount for which payment is extended.[57] Additionally, while the IRS may require a bond under Code Sec. 6165 as a condition to granting an extension to pay estate tax under Code Sec. 6166, it may not also require a special lien under Code Sec. 6342A, as discussed in further detail below.

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[52] Id. *See also* C.C.A. 200747019 (11/23/2007) (Discussing the IRS's acceptance of stock as collateral for a Code Sec. 6324A lien) and C.C.A. 200803016 (1/18/2008) (Discussing whether the IRS should accept as collateral an interest in a LLC).

[53] *See* Estate of Roski, *supra*.

[54] Id.

[55] Id.

[56] Id.

[57] Code Sec. 6165.

Bond must be executed on the form prescribed by the IRS and with satisfactory surety.[58] Satisfactory surety is one that involves an approved surety company, or bonds or notes of the United States.[59] Other surety may be acceptable at the discretion of the IRS[60] and in most cases, the IRS can, at its discretion, permit the furnishing of a single bond where two bonds are required.[61]

Special Lien under Code Sec. 6324A

Code Sec. 6324A imposes a special lien that applies only to taxes deferred under Code Sec. 6166, and only to property, real or personal, included in the estate, which can be expected to survive the deferral period.[62] The property that the IRS may require to be designated as Code Sec. 6166 lien property may not exceed a value that is greater than the sum of the deferred amount of tax and the required interest amount. However, Treasury Regulation Section 301.6324A-1(b) permits a voluntary designation of property in excess of the required value to be included under the lien.

If the executor makes an election under Code Sec. 6324A[63] and files a lien agreement[64] signed by each person who has an interest in the property subject to the lien as collateral for payment of the deferred amount, a lien arises for the deferred amount.[65] This is a consensual lien against

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[58] Treas. Reg. § 301.7101-1(b)(1) ("[A] bond shall be considered executed with satisfactory surety if (i) [i]t is executed by a surety company holding a certificate of authority from the Secretary as an acceptable surety on Federal bonds, or (ii) [i]t is secured by bonds or notes of the United States as provided in 6 U.S.C. 15.").

[59] Id.

[60] Code Sec. 7101(a)(2); Treas. Reg. § 301.7101-1(b)(2).

[61] Code Sec. 7102; Treas. Reg. § 301.7102-1.

[62] Code Sec. 6324A ("[T]he term "section 6166 lien property" means interests in real and other property to the extent such interests can be expected to survive the deferral period and are designated in the agreement referred to in subsection (c).")

[63] Code Sec. 6324A(a); Treas. Reg. § 301.6324A-1(a).

[64] Treas. Reg. § 301.6324A-1(b). The lien agreement is a written agreement signed by each person who has an interest in the property designated in the agreement in which the signing person consents to the creation of a lien against such property and designates a responsible person as the agent for the beneficiaries of the estate and the signatories in dealings with the IRS on matters relating to Code Sec. 6166 or Code Sec. 6324A. Code Sec. §§ 6324A(c)(1) and (2). Additional conditions for the agreement may be found in Treas. Reg. § 301.6324A-1(b).

[65] Code Sec. 6324A(c); Treas. Reg. § 301.6324A-1(b).

"Section 6166 lien property."[66] This lien applies to any property and the regular estate tax lien under Code Sec. 6324 will not apply to that property for the same estate.[67]

This agreement is treated as the furnishing of a bond for the amount of the deferred estate tax.[68] Thus, the executor would be discharged from personal liability for the deferred estate tax once the special lien has been elected and the required agreement filed.

For example, stock in a closely held corporation can be used as property which may be pledged in support of the election by the estate under Code Sec. 6166(k)(2) and Treasury Regulation Sections 20.6324A-1 and 301.6324A-1.[69] Under Code Sec. 6324A(c)(1)(A), the collateral offered to secure the lien may be an interest in "real and other property." Stock in a closely held corporation qualifies as "other property."[70]

The IRS may accept stock as collateral if the following requirements, as set forth in Code Sec. 6324A(b), are met: (i) the stock must be expected to survive the deferral period. Thus, the corporation must survive the deferral period and retain value and the IRS will have to first value the business and the estate will provide the IRS all relevant information, including appraisals, annual reports, and other relevant financial documents; (ii) the stock must be identified in the written agreement pursuant to Code Sec. 6324A(b)(1)(B); and (iii) the value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest. If these requirements are met, a special lien under Code Sec. 6324A exists and the IRS must accept the collateral.

In applying the first requirement above, namely whether the stock can be expected to survive the deferral period, the IRS may use any generally accepted business criteria.[71] Some factors to be used in making this determination are identified in Revenue Ruling 59-60, as listed below:

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[66] Code Sec. 6324A(b); Treas. Reg. § 20.6324A-1(b).

[67] Code Sec. 6324A(d)(4); Treas. Reg. §§ 20.6324A-1(a), 20.6324A-1(e).

[68] Code Sec. 2204(c).

[69] C.C.A. 200747019 (11/23/2007) ("Stock in closely held corp. meets requirements of IRC Sec(s). 6324A as property which may be pledged in support of election by estate under IRC Sec(s). 6166(k)(2) when corporation's stock is expected to survive March 31, 2008deferral period, stock is identified in IRC Sec(s). 6324A(b)(1)(B) written agreement, and value of stock as of agreement date is sufficient to pay deferred taxes plus required interest.").

[70] Id.

[71] Id.

1. Nature of the business and history of its enterprise from its inception;
2. General economic outlook and condition and outlook of industry;
3. Book value of stock and financial condition of business;
4. Earning capacity of the company;
5. Dividend-paying capacity;
6. Whether or not enterprise has goodwill or other intangible value;
7. Sales of stock and size of block of stock to be valued; or
8. Market price of stocks of corporations engaged in same or similar line of business having their stocks actively traded in free and open market, either on an exchange or over the counter.[72]

III. CODE SEC. 2053

Overview

The federal estate tax, as imposed by Code Sec. 2001, is computed on the basis of the decedent's taxable estate, which is defined by Code Sec. 2051 as the gross estate less deductions as provided by the Code, including those deductions set forth in Code Sec. 2053.

The deductions set forth in Code Sec. 2053 include funeral expenses,[73] administration expenses,[74] claims against the estate,[75] and unpaid mortgages or indebtedness in respect of property included in the decedent's gross estate.[76] Further, Code Sec. 2053(b) provides a deduction for administrative expenses incurred in administering property not subject to claims as if they were payable from probate property, but only if the amounts are paid before the expiration of the statute of limitations. Thus, a deduction of non-probate expenses are permitted only to the extent they were paid prior to the statute of limitations for assessment of the estate tax, which generally is 3 years from the due date of the estate tax return.[77]

[72] Rev. Rul. 59-60, 1959-1 CB 237.

[73] Code Sec. 2053(a)(1).

[74] Code Sec. 2053(a)(2).

[75] Code Sec. 2053(a)(3).

[76] Code Sec. 2053(a)(4).

[77] Code Sec. 6501(a).

Further, there are certain limitations on the deduction of claims and expenses.[78] Such limitations include the following:

1. Deductions for claims against the estate that are based on a promise or agreement are limited to the extent they were contracted for bona fide and for an adequate and full consideration in money or money's worth;[79]

2. Income taxes based on income received after the date of death or property taxes not accrued prior to the date of death are not deductible under Code Sec. 2053;[80]

3. Claims by remainder beneficiaries relating to property includible in the estate under Code Sec. 2044 are not deductible under Code Sec. 2053;[81]

4. Deductions may not be taken in excess of the value of property subject to claims, except to the extent that the amount was paid prior to the date prescribed for the filing of the estate tax return;[82]

   "Property subject to claims" means any property includible in the gross estate of the decedent that would (or the "avails," i.e., proceeds of sale, etc., of which would), under the applicable local law, bear the burden of the payment of those deductions in the final adjustment and settlement of the estate. The value of the property must, however, be reduced by the amount of any casualty, theft or similar loss sustained by the estate that is deducted for estate tax purposes and that is attributable to that property.[83]

Code Sec. 2053(a)(3) appears straightforward in allowing deductions for claims against the estate; however, Code Sec. 2053(c)(1)(A) limits the deduction for a claim against the estate to the extent it is a bona fide debt incurred for adequate and full consideration. The courts have struggled with this limitation, particularly with respect to which claims that were, at the time of the decedent's death, uncertain, contingent, or difficult to value. The primary issue that the courts face is whether and how to take into consideration post-death events in allowing a deduction for and in valuing a

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[78] Code Sec. 2053(c).

[79] Code Sec. 2053(c)(1)(A).

[80] Code Sec. 2053(c)(1)(B).

[81] Code Sec. 2053(c)(1)(C).

[82] Code Sec. 2053(c)(2).

[83] Code Sec. 2053(c)(2); Treas. Reg. § 20.2053-1(c).

claim against the estate. Notably, Code Sec. 2031 defines the gross estate as including the value of all property of the decedent at the time of his or her death whereas Code Sec. 2053 contains no specific direction to value the deductions on the date of death. There is a wide divergence among the courts on this issue and the following is a delineation of the two approaches the courts take:

Date-of-Death Valuation Approach

Ithaca Trust Co. v. U.S.[84] The U.S. Supreme Court held that the estate tax charitable deduction for a charitable remainder interest was to be determined as of the date of death. Federal circuit courts that apply the Ithaca Trust date-of-death approach to claims against a decedent's estate under Code Sec. 2053(a)(3) generally hold that post-death events may not be considered when determining the amount deductible for that claim.[85]

Claims Actually Paid Approach

*Jacobs v. Comm'r***.**[86] There is a different line of cases following the 8th Circuit's approach which runs opposite to that set forth in Ithaca Trust. In Jacobs, the 8th Circuit considered, but rejected, the date-of-death valuation approach, reasoning that Congress intended for the claims to be deducted be actual claims, not theoretical ones.[87] Thus, courts that apply the *Jacobs* rule to claims against the estate restrict the amount deductible under Code Sec. 2053(a)(3) to amounts actually paid by the estate in satisfaction of the claim.[88]

New Proposed Regulations

On April 23, 2007, the Department of the Treasury published proposed regulations to Code Sec. 2053 which introduces a new approach to valuating deductions for claims and administration

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[84] 279 U.S. 151 (1929).

[85] *See, e.g.,* Propstra v. U.S., 680 F.2d 1248 (9th Cir., 1982); Smith v. Comm'r, 198 F.3d 515 (5th Cir., 1999); O'Neal v. U.S., 258 F.3d 1265 (11th Cir., 2001); Estate of McMorris v. Comm'r, 243 F.3d 1254 (10th Cir., 2001); Comm'r v. Strauss, 77 F.2d 401 (7th Cir., 1935).

[86] 34 F.2d 233 (8th Cir., 1929), *cert. denied*, 280 U.S. 603 (1929).

[87] Id. at 235.

[88] *See, e.g.,* Comm'r v. Shively's Estate, 276 F.2d 372 (2nd Cir., 1960); Comm'r v. State Street Trust Co., 128 F.2d 618 (1st Cir., 1942); Estate of Kyle v. Comm'r, 94 TC 829 (1990); Estate of Hagmann v. Comm'r, 60 TC 465 (1973), *aff'd per curiam*, 492 F.2d 796 (5th Cir., 1974); Nesselrodt Estate v. Comm'r, 51 TCM 1406 (1986).

expenses, for estate tax purposes.[89] In an attempt to settle the question of whether post-death events are to be considered in determining amounts deductible under Code Sec. 2053(c)(3), the proposed regulations appear to combine the Ithaca Trust and Jacobs approaches.[90] Generally, the proposed regulations provide that post-death facts will be considered in determining deductions from the gross estate under Code Sec. 2053 and such deductions will be allowed only for claims and expenses actually paid.

Specifically, the proposed regulations provide that a deduction for a claim against the estate will not be determined by valuing the claim as of the date of death. Rather, the deduction is limited to the amount that has already been paid in satisfaction of the claim at the time the deduction is being taken (i.e., at the time of the filing of the return or the audit of the return).[91]

However, there is an exception to the rule that claims are not deductible until paid is a claim in an amount that is "ascertainable with reasonable certainty and will be paid."[92] Thus, a deduction will not be allowed for a claim based on uncertain estimates. If the payment is later waived or remains unpaid, the taxpayer must notify the Commissioner and pay the resulting estate tax plus interest.

Prop. Reg. § 20.2053-3 provides the following rules with respect to administration expenses:

Executor's Commissions. Commissions may be deducted on the estate tax return in an amount that has been actually paid or in an amount that may reasonably be expected to be paid.[93]

Attorney's Fees. Fees may be deducted in such amount as actually paid or in such an amount that at the time of filing of the return may reasonably be expected to paid.[94] A deduction may be allowed even if the fees have not been awarded by a court or have not been paid if the Commissioner is reasonably satisfied that the amount claimed will be paid and does not exceed a reasonable amount for services rendered.[95]

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[89] *See* Prop. Treas. Reg. §§ 20.2053-1(b), 20.2053-3(b), 20.2053-3(c)(1), and 20.2053-3(d)(3).

[90] *See* REG-143316-03, 72 Fed. Reg. 20080 (42307).

[91] Prop. Reg. § 20.2053-1(b).

[92] Prop. Reg. § 20.2053-1(b)(4).

[93] Prop. Reg. § 20.2053-3(b).

[94] Prop. Reg. § 20.2053-3(c).

[95] Id.

Expenses Incurred in Defending Against Claims Against the Estate. These expenses will be allowed as deductions even if the estate is not ultimately victorious.[96] Such expenses include costs of litigation, arbitration, and mediation and costs associated with reaching a settlement of the issues.[97]

Prop. Reg. § 20.2053-4 provides the following rules with respect to claims against the estate:

Bona Fide Claims. Claims against a decedent's estate must be bona fide claims representing personal obligations of the decedent which existed at the time of the decedent's death, which are enforceable against the decedent's estate at the time of the payments, and which are actually paid by the estate in settlement of the claim.[98]

Unmatured or Contested Claims. No deduction will be available for any potential or unmatured claims or to the extent the estate contests the decedent's liability.[99] Thus, the executor has the option of filing a protective claim for refund to preserve the estate's right to claim a refund once the claim is matured or resolved and paid. If this protective claim is not filed and a claim later matures or ripens, the executor may still file a claim for a refund assuming the statute of limitations for assessing the tax has not expired.

Claims against Multiple Parties. If the decedent or the decedent's estate is one of several parties against whom a claim is asserted, the estate may deduct only the portion of the claim payable by th estate minus any amount to be received by another party or insurance or by other reimbursement.[100] Thus, the estate will ultimately receive a deduction only for the portion of the liability actually paid by the estate.

Claims by Family Members or Related Entities. There is a presumption that all claims by family members or related entities are not legitimate and bona fide and therefore, are not deductible.[101] The estate has the burden of rebutting this presumption with evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons.[102]

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[96] Prop. Reg. § 20.2053-3(d).

[97] Id.

[98] Prop. Reg. § 20.2053-4 (a)(1).

[99] Prop. Reg. §§ 20.2053-4(b)(1) and (2).

[100] Prop. Reg. § 20.2053-4(b)(3).

[101] Prop. Reg. § 20.2053-4(b)(4).

[102] Id.

Unenforceable Claims. Claims that are unenforceable prior to, or at the decedent's death, are not deductible even if they are actually paid.[103] Claims that become unenforceable during the estate administration will not be deductible to the extent they are paid after they become unenforceable.[104]

Claims Founded on a Promise. Claims based on a promise or agreement are limited to the extent that the promise or agreement was bona fide and in exchange for adequate and full consideration.[105]

Recurring Payments. If the decedent is obligated to make recurring payments on an enforceable claim that is not subject to a contingency and if the payments will continue for a period beyond the final determination of the estate tax liability, the obligation may be deducted as an estimation in an amount equal to the present value of the payments.[106] If, however, the obligation is subject to a contingency, the estate's deduction is limited to the amount actually paid by the estate in satisfaction of the claim.[107]

Interest. Interest on deductible claims is itself deductible as a claim under Code Sec. 2053 only to the extent of the amount of interest accrued as of the date of the decedent's death and actually paid.[108] However, as discussed above, interest on payments deferred under Code Sec. 6166 is not deductible.[109]

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[103] Prop. Reg. § 20.2053-4(b)(5).

[104] Id.

[105] Prop. Reg. § 20.2053-4(b)(6).

[106] Prop. Reg. § 20.2053-4(b)(7)(i).

[107] Prop. Reg. § 20.2053-4(b)(7)(ii).

[108] Prop. Reg. § 20.2053-4(c).

[109] Code Secs. 2053(c)(1)(D) and 163(k).