FINAL IRC SECTION 2053 REGULATIONS

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Effective October 20, 2009, the Internal Revenue Service issued and finalized regulations determining the amount deductible from a deceased individual's gross estate for claims against the estate under Section 2053.[2] These regulations were first proposed in April of 2007.[3] The fundamental issue addressed by the proposed regulations, and now these final regulations, is whether post-death events can be taken into account in evaluating and deducting claims made against the estate. In short, claims have to be paid before they can be deducted, and protective claims for refund have to be filed to make sure refunds can be gotten once the claims are actually paid. The final regulations are 1/3rd longer than the proposed regulation, with the added text being much needed clarifications and amplification.

Snapshot Date of Death vs. Post-Death Developments. The primary debate over these regulations had been over the issue of whether claims should be treated like assets, which are valued as of the date of death. Assets are appraised. They may ultimately sell for more or less, but post-death events are not taken into account in their valuation (except for the alternative evaluation date). Many courts have followed that approach in dealing with claims.

In 1929, in the *Ithaca Trust* case[4], Justice Holmes, writing for the court, determined that the date of death was the appropriate point in time for evaluating claims against the estate. In that case, the decedent left a life interest to one person, and the remainder interest to a charity. The life interest owner's death was premature, and the issue was whether the life expectancy of the life tenant, as of the original decedent's death, should inform the value of the charitable remainder interest, or whether the untimely death should be taken into account. The court rejected the latter and adopted the former approach.

Since *Ithaca Trust* was decided, the Circuits have split on which approach to take. The Fifth Circuit, in the 1999 *Algerine Smith* case[5], the Ninth Circuit, in the 1971 *Propstra*[6] and 1983 *Van Horne*[7] cases, the Tenth Circuit in the 2001 *McMorris* case[8], and the Eleventh Circuit in the 1999 *O'Neal* case[9], have followed the *Ithaca Trust* approach.

Following the opposite approach and incorporating post-death events have been the Eighth Circuit decisions in the *Jacobs*[10] and in the *Sachs*[11] case, and also in a 44-year-old decision out of the Fifth Circuit in the *Shedd*[12]case. Another decision following this path is the *Cafaro*[13] case from the Tax Court out of Illinois (Seventh Circuit). But see the Tax Court's decision in the *May*[14] case, a 1947 decision out of Pennsylvania (Third Circuit) using a date-of-death approach.

The split among the Circuits was a problem, but it was not the whole problem. Going deeper reveals unevenness in the handling of Section 2053, especially where contingent and immature claims exist. Drill down into Tax Court and district court decisions and you will find that they stir the mix with a variety of different interpretations of the subsets of issues within the main categories laid out by Section 2053.

Based on that background of conflicting and confusing cases, Treasury and the Internal Revenue Service attempted to bring order and uniformity across the different Circuits. Rather than following the majority of the Circuits, instead Treasury opted to follow the minority view. And thus in the final regulations the fundamental rule that will be that claims may be deducted when they are actually paid.

Exceptions. There are some important exceptions prompted by Treasury's careful consideration of the comments to the proposed regulations. In the final rules, Treasury has attempted to deal with practical issues and difficulties. For example, while most claims are deductible when paid, the new rules contain an exception for claims against the estate that do not exceed $500,000 in the aggregate. As for those claims, the date-of-death snapshot rule applies, provided that the claims are valued by a qualified appraiser who produces a qualified appraisal of the claims.

Another major concern expressed by many commentators was the disconnect in situations where the estate might be in a lawsuit where there were claims and counterclaims. In the proposed regulations, claims against the estate would not be deductible until paid, but the claims by the estate by the other side would have to be valued at date of death and tax paid on them. In this regard, Treasury changed its mind. The final regulations provide that the current value of a claim against the estate with respect to which there is one or more substantially related claims or integrally related assets that are included in a decedent's gross estate may be deducted, provided that the related claim or asset constitutes at least 10% of the decedent's gross estate. Again, there must be a qualified appraisal performed by a qualified appraiser.

Protective Claims for Refund. An important and integral part of these regulations is the ability of the taxpayer to file a protective claim for refund to cover the claims that are pending but not paid by the time the 706 and tax are due.

Change in Dealing with Family Members. Also, Treasury appears to have taken to heart the criticism of its proposed rebuttable presumption that claims by, or settlements among, certain related individuals and entities are not legitimate and bona fide and, therefore, not deductible. Treasury has removed the presumption from the final regulations and, instead, has continued to include the generally applicable requirement that any claim or expense must be bona fide in nature. It has added a paragraph that provides a non-exclusive list of factors indicative of (but not necessarily determinative of) the bona fide nature of a claim or expense involving a family member, related entity or a beneficiary of the estate.

Clarification. Treasury has been careful in the final regulations to make clear that the regulations dealing with claims do not affect mortgages, which are the subject of existing regulations. It cross-references the existing regulations on mortgages and clears up perceived confusion on the latter. And language in the original regulations essentially saying "the executor may" has been removed so that the regulations can be applied to trustees and others who may be filing the estate tax return or dealing with issues of deductibility.

Court Orders. Executors can rely on court orders regarding the payment of amounts if the court addressed the merits of the claim, and, if the court did, the regulations presume an active and genuine contest, and the claim has been or *will be* paid. The final regulations removed the language in the proposed regulations which appeared to have given the Service the ability to second guess the court's decision[15]. Revised and helpful language related to consent decrees and settlements has been added. And the final regulations add language that clarifies the ability of an executor to take deductions that are otherwise permissible where the executor is in a state in which the obtaining of court orders is difficult or impossible.

Examples. Treasury has added more examples. Most notable is the one dealing with a claim by a family member. It spotlights a claim by a niece who is a CPA performing accounting services for her uncle. If the charges are the normal types of charges incurred in the ordinary course of business, they are deductible. A list of factors relevant to the example is given to show how the factors in the regulations would be applied.

Reimbursements. The section on reimbursements has been expanded from a one-liner to an expansive paragraph explaining how the possibility of insurance coverage or other reimbursement works. The original language could have been read to say that no deduction would be available if any reimbursement "could" exist. The added language clarifies that a partial deduction still may be allowed if the executor can establish only partial coverage. And the new language clarified that the executor can show that the reimbursement is not collectible or otherwise worthy of pursuit.

Ascertainable Amounts. The regulations have re-titled the former section denominated “estimated amounts” to “ascertainable amounts,” adds an embedded example and expands the guidance on what is or is not ascertainable. It also removes the duty imposed on the executor to notify the Service if an amount is claimed but later not paid.

Protective Claim for Refund. The proposed regulations talked about filing a protective claim for refund where a deduction for a claim was not allowable, but provided no guidance on what a protective claim for refund should say or when it would be processed by the Service. The new language sheds some light on those issues.

Charitable and Marital Deductions. The final regulations add language addressing charitable and marital deductions. If they might be affected by the size of a claim, the claim is still valued and deducted (or not) under the other rules, and if there is no deduction, the estate gets the charitable or marital deduction in full. Once the claim is finally settled and paid, then an adjustment to the charitable and marital deductions will be made. And an example has been added to show how the rule works.

Executor Commissions and Attorney’s Fees. The section on commissions has been rewritten to cross-reference another regulation and to add language addressing compensation when the will sets a standard that is different from the state law default rule. The proposed regulation on attorney’s fees was modified to shorten it considerably, removing troublesome language about what would happen on audit, and discussing the filing of a protective claim for refund.

Expenses. Additional language has been added to modify some provisions of existing regulations that the proposed regulations had not addressed. And the proposed provisions related to costs of defending claims were carried forward, without the sentence, "Expenses incurred merely for the purposed of unreasonable extending the time for payment, or incurred other than in good faith, are not deductible." Several commentators had objected to that.

Other Provisions. A number of other provisions in the proposed regulations have been carried forward, some without significant change and some in ways that may not have broad impact. The reader is directed to the regulations themselves for further detail.

Criticism. The final regulations are already drawing severe criticism. In a commentary in Tax Notes Today written by Sam Young[16], Robin Klomparens and Douglas Youmans "provided a long list of what they see as flaws in the final regulations and even questioned their legality." The regulations "are contrary to express statutory language, they do not interplay well with the estate tax provisions of the Internal Revenue Code, and they are unreasonable, arbitrary and capricious." In the same article, Kenneth H. Ryesky, a former IRS attorney, now a professor at the Queens College of the City University of New York, said that the final regulations address some of the concerns expressed in comments and that "the IRS and the Treasury are to be thanked and applauded for the deliberation and effort behind the new regulations, and the dispatch with which this project was handled."

Ronald Aucutt, a partner with McGuire Woods of McLean, Virginia, probably has the best ultimate description of the new regulations. He is quoted in the Daily Tax Report[17] published by BNA, as saying, "this is an area where it is very difficult to achieve fundamental fairness." Situations may occur where the estate tax may be overpaid or underpaid. Mr. Aucutt said there was "no perfect solutions," but that the proposed rules were a good approach at "rough justice."

Conclusion. Without regard to whether the regulations will withstand any test, in the interim they certainly change how claims will have to be handled. At a minimum, the time for administration of estates will be extended until all of the protective claims for refund are determined. That factor may force changes in the handling of claims unrelated to the tax issues simply to avoid that prolonged window of time. The ultimate chapter on this area of the law certainly has not yet been written. Quoting a phrase often used by my estate tax professor in law school, "stay tuned."

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[2] T.D. 9468, 74 FR 53652

[3] IRS REG-143316-03, 72 FR 20080

[4] *Ithaca Trust v. Commissioner*, 27 US 151, 157 [7 AFTR 8856] (1929)

[5] *Algerine Smith v. Commissioner*, 198 F.3d 515, 84 AFTR 2d 99-7393 (1999)

[6] *Propstra v. United States*, 680 F.2d 1248, 50 AFTR 2d 82-6153, 82-2 USTC P 13475 (9th Cir. 1971)

[7] *Estate of Van Horne v. Commissioner*, 720 F.2d 1114, 53 AFTR 2d 84-1549, 83-2 USTC P 13548 (9th Cir. 1983)

[8] *Estate of McMorris v. Commissioner*, 243 F.3d 1254, 87 AFTR 2d 2001-1310 (10th Cir. 2001)

[9] *O'Neal v. United States*, 258 F.3d 1265, 88 AFTR 2d 2001-5248 (11th Cir. 2001)

[10] *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 US 603 (1929)

[11] *Estate of Sachs v. Commissioner*, 856 F.2d 1158, 62 A.F.T.R.2d 88-6000, 88-2 USTC P 13,781 (8th Cir. 1988)

[12] *Estate of Shedd v. Commissioner*, 320 F.2d 638, 12 AFTR 2d 6221 (9th Cir. 1963)

[13] *Estate of Cafaro v. Commissioner*, TC Memo 1989-348, PH TCM P 89348, 57 CCH TCM 1002

[14] *Estate of May v. Commissioner*, 8 TC 1099 (1947)

[15] For example, in the proposed regulations, Treasury used language such as "the [settlement] is within the reasonable range of outcomes under applicable state law governing the issues resolved by the [settlement]." That language has been removed.

[16] 2009 TNT 200-2

[17] October 19, 2009, issue