

Proposed Regulations as to IRC Sec. 2053 Estate Tax Deductions

November 04, 2022

2022-11

A. Introduction

Proposed regulations (REG-130975-08) have been issued relating to certain aspects of deductions under IRC Sec. 2053. The major topics are (i) applying present-value principles to deductible amounts; (ii) extending a three-year safe harbor; (iii) interest accruing on unpaid tax and penalties; (iv) interest accruing on certain loan obligations of an estate; (v) substantiation requirements for valuations pursuant to Treas. Reg. §20.2053-4(b); and (vi) deductions for amounts paid pursuant to a decedent's personal guarantee. Each of the six topics will be discussed below. The discussion will quote from both the *"Supplementary Information"* section (the Preface) and the proposed regulations themselves (Prop. Reg.)

Useful comments have been filed by several organizations, including the American College of Trust and Estate Counsel (ACTEC), the Tax Section of the New York State Bar Association (NYSBA), the American Institute of CPAs (AICPA) and the Tax Section of the Florida Bar (FBTS). These comments will be mentioned later in this discussion. For the comments in full, see Tax Analysts Document Nos. 2022-31164 (ACTEC), 2022-31233 (NYSBA), 2022-31165 (AICPA), and 2022-31338 (FBTS). Except where indicated, footnotes will not be included. Our comments will be at the end of each topic.

B. Application of Present Value Principles; Grace Period

Under a heading *"Explanation of Provision,"* the Preface states:

The Treasury Department and the IRS propose to amend the regulations under section 2053 to incorporate present-value principles in determining the amount deductible under section 2053 for claims and expenses (excluding unpaid mortgages and indebtedness deductible under §20.2053-7). The Treasury Department and the IRS recognize, however, that estates often cannot pay every deductible claim and expense within a short time after the decedent's death and that sound tax administration should balance the benefit of more accurately determining the amounts not passing to the beneficiaries of an estate garnered from applying present-value principles with the administrative burden of applying those principles to deductible claims and expenses that occur during a reasonable period of administration of the estate. The Treasury Department and the IRS understand that a significant percentage of estates pay most, if not all, of their ordinary estate administration expenses during the three-year period following the decedent's date of death. This three-year period takes into account a reasonable time for administering and closing the estate. The Treasury Department and the IRS note that a reasonably short period of time between the decedent's death and the payment of a claim prevents the lack of a present-value discount from significantly distorting the value of the net (distributable) estate. Applying present-value principles in computing the deductible amount of those claims and expenses paid more than three years after the decedent's death strikes an appropriate balance between benefits and burdens.

Accordingly, the Treasury Department and the IRS propose to amend the regulations under section 2053 to require the discounting to present value of certain amounts paid or to be paid in settlement or satisfaction of certain claims and expenses in determining the amount deductible under section 2053. Specifically, the rule in these proposed regulations requires calculating the present value of the amount of a deductible claim or expense described in section 2053(a) and §20.2053-1(a) that is not paid or to be paid on or before the third anniversary of the decedent's date of death, which three-year period the proposed regulations define as the "grace period." The proposed regulations provide the general formula for calculating the present value of such amounts and state that the discount rate to be used in the calculation is the applicable Federal rate determined under section 1274(d) for the month in which the decedent's date of death occurs, compounded annually. The length of time from the decedent's death to the date of payment or expected date of payment will determine whether the Federal rate applicable to that amount is the Federal mid-term rate or the Federal long-term rate. The proposed regulations provide that any reasonable assumptions or methodology in regard to time period measurements may be used in calculating the present value. In addition, the proposed regulations require a supporting statement to be filed with the Form 706 showing any calculations of present value.

As noted, the 3-year period is referred to as the "grace period."

Prop. Reg. §20.2053-1(d)(6)(i)(B), captioned "*General Rule*," states:

The present value of each post-grace-period payment is calculated by discounting it from the payment date or expected date of payment to the decedent's date of death. The applicable discount rate is the applicable Federal rate determined under section 1274(d) for the month in which the decedent's death occurs, compounded annually. The length of time from the decedent's date of death to the date of payment or expected date of payment will determine whether the Federal rate applicable to that payment is the Federal mid-term rate or the Federal long-term rate.

Prop. Reg. §20.2053-1(d)(6)(ii), captioned "*Calculating present value of amounts paid or payable*," then provides that any post-grace period payment is determined as the

Amount of future payment $\times [1 \div (1 + i)]^t$

Where t is the amount of time (expressed in years and fractions of years) from the day after the decedent's date of death to the payment date or expected date of payment; and i is the applicable discount rate.

The NYSBA comments recommend the grace period be extended from three years to four years and three months. In making this recommendation, the submission states:

Section 2053 provides that the "value of the taxable estate" is "determined by deducting from the value of the gross estate such amounts . . . as are allowable by the laws of the jurisdiction under which the estate is being administered."

We understand the desire, as a matter of policy, for consistency of rules for valuing assets for purposes of determining the gross estate and the amount of deductions in arriving at the net taxable estate. We note that Treasury and the Service may have drafted this Proposed Regulation at least partly in response to so-called *Graegin* loans, which result in illiquid estates receiving full deductions, without any present-value discount, for the *future* interest of a loan, which is deemed a known and necessary expense of estate administration but which is not actually payable for many years. However, we question to what extent Section 2053 permits the amount of deductions to reflect present-value principles. The difference between the words "value" and "amounts . . . as are allowable" may be significant. In fact, this distinction between "value" and "amounts" as are allowable or allowed has been written into the country's tax laws for over a century, dating back to the inception of the Federal estate tax in 1916.

* * *

Congress did not define “such amounts” in Section 2053(a) to be anything other than the amounts “allowable by the laws of the jurisdiction” under which the estate is being administered. There is no reference to the “value” of the amounts in Section 2053(a). Nor is there any suggestion in the Code that these “amounts” be valued in the same manner as that used for incorporeal concepts such as reversions and remainders, which – without a defined calculation – would be left to debate as to quantification. Section 2053(a) specifically permits deductions of amounts allowable under local law of these very quantifiable categories of expenses. To the best of our knowledge, no jurisdiction in the United States limits amounts allowable as administration expenses to the present value, as of the date of the decedent’s death, of the amounts paid.

While Congress selected the words “amounts . . . allowable” in Section 2053 to describe deductions for expenses, it instead selected the word “value” in other Code provisions in connection with the determination of the taxable estate. Indeed, Section 2031, defining the gross estate, refers to the “value of the gross estate,” as do each of Sections 2033 through 2042 in describing how to calculate what is included in the gross estate. And other Code sections addressing deductions refer to the “value,” such as the marital deduction, for which a taxpayer may deduct “an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse.” This distinction may be intentional. Consequently, while Treasury seeks to provide “a more accurate measure of the amounts not passing to the heirs and legatees,” we believe this consideration should be balanced against the apparent intention of the drafters, as embodied in the statutory language.

Our Comments

We do not believe the NYSBA comments require a change to address any difference between “value” and “amount”.

C. Extending Three-Year Safe Harbor

The NYSBA comments state:

While we understand the benefit of bright-line cutoffs and the rationale for proposing a safe harbor, we believe that the proposed three-year period is too short. Treasury states in the Preamble that it and the IRS “understand that a significant percentage of estates pay most, if not all, of their ordinary expenses during the three-year period following the decedent’s date of death,” and therefore “[t]his three-year period takes into account a reasonable time for administering and closing the estate.” Based on our collective experience representing parties in estate administration, we believe that the three-year grace period is inadequate and impractical.

Estate administrations for decedents whose estates will have to file federal estate tax returns rarely conclude within three years of death, particularly if they are subject to audits by the IRS. The lengthy period of administration may be due to any number of reasons, including conflicts among heirs, estate litigation, inability to locate heirs, death of heirs, assessment of complex assets, and IRS audits. Further, it is common that executors cannot collect commissions until an estate administration is complete. In New York, for example, an executor is precluded from the payment of statutory commissions until final settlement of the estate. If the conclusion of an administration is more than three years after the decedent’s death, as is frequently the case, then these expenses will have to be discounted. Likewise, with administrations lasting longer than three years, legal fees and accounting fees will continue to accrue in a similar manner. Consequently, these lend further support to our belief that a three year grace period would be insufficient.

We believe the Proposed Regulation also could have the unintended effect of adversely affecting taxpayers who live in jurisdictions with slower court systems and favor those in speedier jurisdictions. For instance, it may be the case that certain types of tort or commercial disputes regularly take more than three years in certain jurisdictions across the country but take merely months in other jurisdictions. Similarly, it is our experience that speed and efficiency of administration proceedings vary drastically throughout the country (not to mention even within the

probate courts of a single state). We are also concerned that the three-year rule could create improper incentives, such as forum shopping in favor of speedier jurisdictions or premature settlement (in each case, to qualify for a full deduction).

We understand that any grace period will have an arbitrary cutoff. If, nonetheless, a grace period is adopted, we suggest that it should be four years and three months. This period is the length of time after a decedent's death until the expiration of the statutory period for assessment (on extension) by the Service, which generally cannot be extended. We believe this period would provide more time to adequately resolve the concerns addressed above and align the grace period with the assessment period.

The NYSBA report also suggests that the discount rate used not be the applicable federal rate under IRC Sec. 1274(d) because that rate would be higher than the amount the estate is likely to earn. It does not make a recommendation of a rate to be used.

The AICPA submission agrees with the NYSBA submission quoted above and comments:

We further note that the following types of estates generally have substantial administrative expenses after the defined Grace Period: estates that must be resolved in more than one jurisdiction (particularly foreign jurisdictions), estates subject to or embroiled in litigation, estates with closely held businesses meeting the requirements of section 6166 (which are statutorily permitted up to a 14-year deferral period for payment of estate tax), and estates experiencing liquidity hardships that permit such estate, under section 6161, an extension of time to pay for up to ten years. The administration for these complicated estates will exceed the applicable period of limitations on assessment prescribed in section 6501. Thus, the deduction for legitimate administrative expenses paid after the passing of the statute of limitations is, per se, the subject of a negotiated estimate. Subjecting such an estimate to further reduction under the net present value regime articulated in Prop. Reg. §20.2053-1(d)(6)(ii) and Prop. Reg. §20.2053-1(d)(6)(iv) is another form of an estimate.

Later it states:

Finally, the AICPA is concerned that the present value requirement might be construed to reduce a residuary marital or charitable deduction. As described above, the *Hubert* regulations, as a practical matter, require the reduction of the marital or charitable deduction for the amount of transmission expenses determined with respect to the estate. If transmission expenses are paid after the Grace Period, then the deductible amount of transmission expenses will, presumably, reduce the marital or charitable deduction. However, Treas. Reg. §20.2055-3 and Treas. Reg. §20.2056-4 require that the marital deduction be reduced by the amount paid – not the amount determined to be deductible under the Proposed Regulations. If the present value construction results in a reduced deduction on Form 706, Schedule J, it is not clear whether the actual amount of transmission expenses will nonetheless be required to calculate the marital or charitable residue, thus creating a phantom increase to the taxable estate equal to the difference between the actual amount paid for transmission expenses and their determined net present value under the Proposed Regulations. If the present value requirements as outlined are retained, the AICPA requests that the *Hubert* regulations and the Proposed Regulations be harmonized to prevent this outcome.

The AICPA also requests clarification regarding Example 6 of Prop. Reg. §20.2053-1(d)(7) and the exception of Prop. Reg. §20.2053-1(d)(6)(vii). The exception indicates that no mortgage or indebtedness deductible pursuant to Treas. Reg. §20.2053-7 is subject to discounting under the net present value regime introduced in the Proposed Regulation. Treas. Reg. §20.2053-7 applies if the value of property is wholly included in the estate and such property is encumbered by a mortgage or other indebtedness. It would appear then that Example 6 would apply only in those instances when the obligation is not collateralized or otherwise secured by specific property that is wholly included in the gross estate. If that is the proper interpretation of the exception, it would appear the exception would be easily invoked by securing the indebtedness with assets, the value of which must be included fully in the gross estate.

The FBTS objected to the 3-year grace period and said:

d. Given the complexity and contingencies of administering a taxable estate, the Treasury may consider applying the present-value principles only where the period of administration of an estate has been deemed to be unduly prolonged, similar to the test in Treasury Regulation section 1.641(b)-3(a), instead of imposing a one-size-fits-all three-year period that is not appropriate for many taxable estates.

e. Treasury should consider excepting from the grace-period deductions of estates that have elected to defer the payment of estate tax under section 6166 of the Code. The Service has expressly recognized in Rev. Rul. 76-23, 1976-1 CB 264, that the payment of estate taxes under section 6166 of the Code is not considered to unduly prolong estate administration:

* * *

f. Treasury should consider extending the three-year grace period to three years after the due date of the estate tax return, which is a more reasonable time for administering and closing a taxable estate that “strikes an appropriate balance between benefits and burdens” as deemed desirable by the preamble.

g. Treasury should consider allowing an estate to choose between deducting the present value of post-grace period deductions on the estate tax return or instead deducting the amounts paid in the same manner as provided for a contingent obligation (after filing an appropriate protective claim for refund).

h. Since many taxable estates have assets that require substantially more than three years to settle, we request in the alternative that the grace period be extended to five years.

Our Comments

The changes suggested by the NYSBA have merit. The AICPA comments concerning *Hubert* should be addressed. The FBTS comments regarding IRC Sec. 6166 should be accepted.

D. Interest Accruing on Unpaid Tax and Penalties

The preface states:

The proposed regulations also provide that non-section 6166 interest that accrues on or after the decedent’s date of death on any unpaid tax or penalties may be deductible to the extent permitted by §§20.2053-1 and 20.2053-3(a). The proposed regulations further provide that non-section 6166 interest on estate tax deferred under section 6161 or section 6163 is actually and necessarily incurred in the administration of the estate because the grant of the extension was based on a demonstrated need to defer payment. Finally, the proposed regulations provide that, in general, non-section 6166 interest accruing post-death on any unpaid tax or penalties in connection with an underpayment of tax or a deficiency is actually and necessarily incurred in the administration of the estate. However, the proposed regulations provide that, notwithstanding these rules, non-section 6166 interest accruing on unpaid tax and penalties on and after the decedent’s date of death, whether in connection with a deferral, underpayment, or deficiency, is not actually and necessarily incurred in the administration of the estate and is not deductible to the extent the interest expense is attributable to an executor’s negligence, disregard of applicable rules or regulations (including careless, reckless, or intentional disregard of rules or regulations) as defined in §1.6662-3(b)(2), or fraud with intent to evade tax. Interest expense is attributable to an executor’s negligence, disregard of applicable rules or regulations, or fraud with intent to evade tax to the extent that the underlying underpayment, deficiency, or penalty is attributable to such conduct by the executor. Similarly, even when the underlying underpayment, deficiency, or penalty is not attributable to such conduct by the executor, interest expense is attributable to an executor’s negligence, disregard of applicable rules or regulations, or fraud with intent to evade tax to the extent the subsequent accrual of interest is attributable to such conduct by the executor.

The rules in the proposed regulations pertaining to whether non-section 6166 interest satisfies the requirement in §20.2053-3(a) supplant the rule reflected in Rev. Rul. 79-252, 1979-2 C.B. 333, and in the second holding of Rev. Rul. 81-154, 1981-1 C.B. 470. (See §601.601(d)(2)(ii)(b).) Together, these two holdings create an implicit presumption that interest accruing on any unpaid portion of tax or penalties in all cases satisfies the requirements for a deductible administration expense, which is inconsistent with the requirement in §20.2053-3(a) that the expense be actually and necessarily incurred in the administration of the estate.

No comments were made by the organizations listed above.

Our Comments

We have none.

E. Interest Accruing on Loan Obligations

The preface states:

The same requirements that apply for deductible interest accruing on unpaid tax and penalties also apply for deductible interest accruing on loan obligations incurred by an estate. Interest accruing on a loan obligation incurred by an estate satisfies the “bona fide” requirement in §20.2053-1(b)(2) when both the interest expense and the loan underlying the interest expense are bona fide in nature and do not constitute a transfer that is essentially donative in character. Such interest satisfies the “actually and necessarily incurred” requirement in §20.2053-3(a) when the loan on which the interest expense accrues and its terms are necessary to the administration of the decedent’s estate and are essential to the proper settlement of the decedent’s estate.

Among the reasons an estate might enter into a loan arrangement is to facilitate the payment of the estate’s taxes and other liabilities or the administration of the estate. Some estates face genuine liquidity issues that make it necessary to find a means to satisfy their liabilities, and incurring a loan obligation on which interest accrues may be the only or best way to obtain the necessary liquid funds. However, if illiquidity has been created intentionally (whether in the estate planning, or by the estate with knowledge or reason to know of the estate tax liability) prior to the creation of the loan obligation to pay estate expenses and liabilities, the underlying loan may be bona fide in nature but most likely will not be found to be actually and necessarily incurred in the administration of the estate.

The issue of the deductibility of interest expense accruing on a loan obligation incurred by an estate has been litigated often, with varying results. See, e.g., *Estate of Black v. Commissioner*, 133 T.C. 340 (2009); *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477. In order to provide guidance on the deductibility of interest accruing on a loan obligation entered into by the decedent’s estate to facilitate the payment of the estate’s taxes and other liabilities or the administration of the estate, the Treasury Department and the IRS propose to amend the regulations under section 2053. The proposed regulations provide that interest expense is deductible only if: (i) the interest accrues pursuant to an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of Federal tax law; (ii) both the interest expense and the loan on which interest expense accrues satisfy the requirement of §20.2053-1(b)(2) that they are bona fide in nature; and (iii) the loan on which interest accrues and the loan’s terms are actually and necessarily incurred in the administration of the decedent’s estate and are essential to the proper settlement of the decedent’s estate (within the meaning of §20.2053-3(a)).

Finally, the proposed regulations include a nonexclusive list of factors to consider in determining whether interest expense payable pursuant to such a loan obligation of an estate satisfies the requirements of §§20.2053-1(b)(2) and 20.2053-3(a). In general, the factors suggest that interest accruing on a loan obligation may satisfy these requirements when the loan and its underlying terms are reasonable and comparable to an arms-length loan transaction and correspond to the estate’s ability to satisfy the loan, and the loan obligation is entered into by the executor

with a lender who is not a substantial beneficiary of the decedent's estate (or an entity controlled by such a beneficiary) at a time when there is no viable alternative to obtain the necessary liquid funds to satisfy estate liabilities. In addition to providing guidance on when interest accruing on a loan obligation may satisfy the requirements of §§20.2053-1(b)(2) and 20.2053-3(a), the list of factors may suggest when the opposite is true and interest accruing on a loan obligation does not satisfy these requirements. For instance, if, taken in their entirety, the facts and circumstances indicate that either the need for the loan or any of the loan terms are contrived to generate, or increase the amount of, a deduction for the interest expense, the interest is not deductible. Thus, if the lender is a primary beneficiary of the estate (or an entity controlled by such beneficiary) who may have liability for payment of the estate tax or whose share of the estate may bear the burden of estate taxes and other liabilities, the facts indicate the loan is not necessarily incurred in the administration of the estate and, therefore, indicate that any interest accruing on the loan is not necessarily incurred in the administration of the estate. Further, if the loan obligation carries an extended loan term with a single balloon payment that does not correspond with the estate's ability to satisfy the loan, the facts indicate that the interest accruing on the loan is not necessarily incurred in the administration of the estate.

Prop. Reg. §20.2053-3(d) deals with interest expense incurred in administering the estate and includes a paragraph (ii) captioned "*Non-section 6166 interest*" which provides:

As used in paragraph (d)(1) of this section, the phrase "non-section 6166 interest" means interest payable under section 6601 or under state or local law other than section 6166 interest. Non-section 6166 interest that accrues on or after the decedent's date of death on any unpaid tax or penalties may be deductible to the extent permitted by §20.2053-1 and this section. For purposes of paragraph (d)(1) of this section, penalties include any unpaid additions to tax, additional taxes, and penalties. When non-section 6166 interest accrues on unpaid estate tax deferred under section 6161 or section 6163, the interest expense is actually and necessarily incurred in the administration of the estate for purposes of paragraph (a) of this section because the extension was based on a demonstrated need to defer payment. When non-section 6166 interest accrues on and after the date of a decedent's death on any unpaid tax or penalties in connection with an underpayment of tax or a deficiency, the interest expense generally is actually and necessarily incurred in the administration of the estate for purposes of paragraph (a) of this section.

(iii) Exception. Notwithstanding paragraph (d)(1)(ii) of this section, non-section 6166 interest accruing on unpaid tax and penalties on and after the decedent's date of death, whether in connection with a deferral, underpayment, or deficiency, is not actually and necessarily incurred in the administration of the estate for purposes of paragraph (a) of this section and is not deductible to the extent the interest expense is attributable to an executor's negligence, disregard of applicable rules or regulations (including careless, reckless, or intentional disregard of rules or regulations) as defined in §1.6662-3(b)(2) of this chapter, or fraud with intent to evade tax. Interest expense is attributable to an executor's negligence, disregard of applicable rules or regulations, or fraud with intent to evade tax to the extent that the underlying deferral, underpayment, or deficiency, is attributable to such conduct by the executor. Similarly, even when the underlying deferral, underpayment, or deficiency is not attributable to such conduct by the executor, the interest expense is attributable to an executor's negligence, disregard of the rules or regulations, or fraud with intent to evade tax to the extent the subsequent accrual of interest is attributable to such conduct by the executor.

This is followed by three examples in paragraph (iv).

Prop. Reg. §20.2053-3(d)(2) is captioned "*Interest expense on certain loan obligations of the estate*" and states:

Interest on a loan entered into by the estate to facilitate the payment of the estate's tax and other liabilities or the administration of the estate may be deductible depending on all the facts and circumstances. To be a deductible administration expense, interest expense must arise from an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of Federal tax law. In addition, the interest expense and the loan to which interest expense relates must satisfy the requirement of §20.2053-1(b)(2) that they are bona fide in nature based on all the facts and circumstances. Further, both the loan to which the interest expense relates and the

loan terms must be actually and necessarily incurred in the administration of the decedent's estate and must be essential to the proper settlement of the decedent's estate. See paragraph (a) of this section. If the facts and circumstances establish that the interest expense arises from an instrument or contractual arrangement that constitutes indebtedness under general principles of Federal tax law, factors that collectively may support a finding that the interest expense also satisfies the additional requirements under §20.2053-1(b)(2) and paragraph (a) of this section include, but are not limited to, the following:

- (i) The interest rate on and the terms of the underlying loan (whether between related or unrelated parties), including any prepayment penalty, are reasonable given all the facts and circumstances and comparable to an arms-length loan transaction;
- (ii) The underlying loan is entered into by an executor of the decedent's estate acting in the capacity of executor or, if no executor is appointed and acting, the person accountable for satisfying the liabilities of the estate;
- (iii) The lender properly includes amounts of paid and/or accrued interest (including original issue discount as determined under sections 1271 through 1275 and the regulations in this part under those sections, such as original issue discount attributable to stated interest that is treated as part of the stated redemption price at maturity because it is not payable at least annually) in gross income for Federal income tax purposes, particularly if the lender is a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or trust (as defined in §20.2053-1(b)(2)(iii));
- (iv) The loan proceeds are used to satisfy estate liabilities that are essential to the proper settlement of the estate, including, but not limited to, the Federal estate tax liability;
- (v) The loan term and payment schedule correspond to the estate's anticipated ability to make the payments under, and to satisfy, the loan, and the loan term does not extend beyond what is reasonably necessary;
- (vi) The only practical alternatives to the loan are the sale of estate assets at prices that are significantly below-market, the forced liquidation of an entity that conducts an active trade or business, or some similar financially undesirable course of action;
- (vii) The underlying loan is entered into when the estate's liquid assets are insufficient to satisfy estate liabilities, the estate does not have control (within the meaning of section 2701(b)(2)) of an entity that has liquid assets sufficient to satisfy estate liabilities, the estate has no power to direct or compel an entity in which it has an interest to sell liquid assets to enable the estate to satisfy its liabilities, and the estate's assets are expected to generate sufficient cash flow or liquidity to make the payments required under the loan;
- (viii) The estate's illiquidity does not occur after the decedent's death as a result of the decedent's testamentary estate plan to create illiquidity; similarly, the illiquidity does not occur post-death as a deliberate result of the action or inaction of the executor who then had both knowledge or reason to know of the estate tax liability and a reasonable alternative to that action or inaction that could have avoided or mitigated the illiquidity;
- (ix) The lender is not a beneficiary of a substantial portion of the value of the estate, and is not an entity over which such a beneficiary has control (within the meaning of section 2701(b)(2)) or the right to compel or direct the making of the loan;
- (x) The lender or lenders are not beneficiaries of the estate whose individual share of liability under the loan is substantially similar to his or her share of the estate; and
- (xi) The decedent's estate has no right of recovery of estate tax against, or of contribution from, the person loaning the funds.

These items will be referred to as "the Factors."

The NYSBA report makes suggestions for improving the discussion of interest in the proposed regulations, including that the final regulations state interest on a loan be considered to be deductible if the executor has “reasonable cause” to enter into the loan arrangement and agree to the interest provisions under that arrangement.

The report also comments on the Factors and provides:

The first factor listed is whether the loan is both reasonable and “comparable to an arms’ length loan transaction.” As drafted, this factor would discourage an estate from obtaining low-interest loans, such as might be provided by a family member of the decedent or a trustee holding the proceeds of life insurance on the decedent’s life. We agree that intra-family transactions are and ought to be subject to heightened scrutiny. However, a factor suggesting that interest paid should be comparable to what a third party lender would demand would discourage estates from ever agreeing to pay below-market rates of interest. The ironic effect of this factor, if not qualified, would be to increase necessary administration expenses and reduce the amount of estate tax due. Treasury and the Service may wish to provide that deviation from arms’ length terms is generally acceptable if the interest rate is less than what would be agreed to between parties negotiating at arms’ length. An agreement by an estate to pay *above*-market interest to a related party, by contrast, still could be an adverse factor in determining whether the interest expense was necessarily incurred.

Second, the eighth factor listed would require courts and the Service to take into account whether the decedent planned during lifetime to create illiquidity at death. Although neither the Proposed Regulations nor the Preamble provides an example, it may be that this factor is aimed at abusive family limited partnership arrangements. We share the Treasury’s concern that the use of family limited partnerships, in extreme cases, can be abusive. That said, we have concerns with the proposal to take into account the decedent’s lifetime planning. There may be some risk that the proposal goes beyond Treasury’s regulatory authority. An executor, after all, must find a way to address liquidity shortages, whether or not those shortages are the result of deliberate or unwise planning by the decedent. If it turns out that an executor has no choice but to obtain a loan to satisfy the estate’s obligations, the interest paid by the estate may still be considered an “administration expense” within the meaning of Section 2053(a)(2), even if the decedent might have arranged his or her affairs differently. We therefore question whether it would be consistent with the Code for Treasury to deny a deduction for an actual and necessary expense of administration merely because the decedent might have planned to create more liquidity for his or her estate at death.

Ultimately, though, we believe this eighth factor may be unnecessary. There is no planning advantage from illiquidity *per se*. **Borrowing costs may be deductible in some cases, but they are still costs of administration that deplete the amounts passing to the beneficiaries of an estate.** Indeed, the Proposed Regulations, by allowing a deduction for interest paid to the Government as a result of a Section 6161 extension of time to pay, recognize that obtaining credit to remedy a liquidity shortage is not an abuse, even if it is the decedent’s own estate planning that causes the shortage. The abuse in question only arises if the decedent created a liquidity shortfall *and* the executor remedies the shortfall by borrowing, directly or indirectly, from the beneficiaries of the estate. It is the latter part of the arrangement – that is, the executor borrowing from the beneficiaries – that is potentially abusive. The Proposed Regulations already appropriately cite as a factor whether the lenders are also beneficiaries of the estate. We believe that this latter factor is sufficient to address the potential for abuse. The factor could be amplified by adding that the factor is especially relevant in cases where illiquidity results from the decedent’s testamentary plan.

The AICPA report makes the following recommendations as to interest expense:

- Treasury and IRS should provide a safe harbor to clarify that loans with legitimate non-tax purposes, bearing adequate interest, for a reasonable period of time, given the likely administration of the estate should be respected as bona fide debt regardless of the listed factors.

- Treasury and IRS should clarify Prop. Reg. §20.2053-3(d)(1)(iv)(C), Example 3 to point out, for purposes of the example, that the tax obligation (and related penalties and interest) was not a contested claim subject to Treas. Reg. §20.2053-4.
- Treasury and IRS should broaden the fourth factor regarding use of the loan proceeds to properly settle the estate to indicate that the funds may be used to satisfy estate liabilities, administrative expenses and other obligations imposed by the testamentary documents.
- If the fifth factor related to the loan term and payment schedule is not removed, the regulation should indicate how the burden of proof is to be met in order to satisfy this requirement.
- Treasury and IRS should consider eliminating the requirements in the sixth and seventh factors, which would require that borrowing occur only if there are no practical alternatives or if the estate does not have control of an entity with sufficient liquidity to satisfy the estate liabilities.
- Treasury and IRS should rethink or reformulate the eighth factor concerning intent to create illiquidity in the estate plan.
- Treasury and IRS should not treat the ninth and tenth factors as relevant and should withdraw these factors. These factors would limit borrowing from a lender who is an estate beneficiary or an entity over which the beneficiary has control.
- If it is decided not to withdraw the ninth and tenth factors, Treasury and IRS should clarify in the Proposed Regulations that interest on loans from a decedent's irrevocable life insurance trust would continue to be deductible.
- With respect to the eleventh factor on the right of recovery of estate tax, Treasury and IRS should limit the prohibition to the amount of right of contributions or the right of recovery and permit the executor to borrow funds from the parties in excess of these rights.
- Treasury and IRS should provide positive and negative examples to support the factors ultimately retained.

Another point made by the AICPA is as follows:

Finally, it should be clarified that interest paid under section 6161 outside the Grace Period should continue to be deducted in full and not subject to the present value regime. Section 6161 provides an estate tax deferral as an alternative to section 6166 for illiquid estates that are not comprised of closely held businesses. Though the interest incurred related to the section 6166 deferral is not deductible, it is calculated at a reduced, preferential interest rate. To provide equity with the section 6166 treatment, section 6161 interest should continue to be deductible in full.

The ACTEC report is troubled by the list of Factors, including item VI and the use of the word "significantly". Also, it states:

3. The Proposed Regulations could also be construed to penalize estate planning that involves the use of life insurance policies on a decedent's life that are owned by and payable to irrevocable life insurance trusts ("ILITs") to create a source of liquidity outside of one's taxable estate to help fund estate tax payment obligations through loans made by the ILIT's trustee to the estate's executor. An ILIT is commonly employed to create a source of liquidity outside of the decedent's taxable estate, with the trustee of the ILIT often lending the funds obtained through insurance proceeds to the executor to help fund the payment of estate taxes. We respectfully submit that the Proposed Regulations should be modified to expressly exonerate such pre-death funding arrangements (which can also be accomplished through business entities) from causing an estate's interest deductions to be denied.

We do, nevertheless, understand and appreciate the concerns that the Proposed Regulations express about a decedent's participation in estate planning transactions (particularly during the three-year period prior to the decedent's death) that produce illiquidity post-death where a significant non-tax purpose does not support the transactions (or where life insurance has not been used as a funding mechanism to create liquidity to help finance the payment of estate taxes). We believe that an appropriate balance can be struck through a focus on the estate's establishment of a significant non-tax purpose in the estate planning or other transactions that are undertaken within three years of the decedent's death that have the effect of producing illiquidity. (Transactions more than three years prior to death, in contrast, need not be subject to any such heightened scrutiny.) Those lifetime transactions within three years of the decedent's death that have produced illiquidity for which the estate is able to demonstrate a significant non-tax purpose should be conferred a presumption of validity for section 2053 deduction purposes, while those lifetime transactions within three years of death that produce illiquidity for which the estate is unable to demonstrate a significant non-tax purpose would not be conferred the benefit of such presumption. In addition, there should be an express and overriding "carve-out" that conclusively exonerates from such limitations on deductibility interest on loans that are made to the executor from an irrevocable life insurance trust (or through various other types of financing arrangements that could involve business entities) and are funded with proceeds of life insurance on the decedent's life.

The Florida Bar, after discussing its problems with the Factors, states:

An alternative to the eleven nonexclusive-factor approach would be to establish a rebuttable presumption denying an interest deduction for loans without a significant non-tax purpose.

Our Comments

The Preface discusses the allocation of interest payments in cases where the payments include both the original 3-year period and the period following the expiration of the 3-year period. See Prop. Reg. §20.2053-1(d)(7) for useful examples covering various cases.

In *Graegin* the Tax Court allowed the interest on a loan to pay estate taxes to be deducted in full even though the interest would not be paid until a balloon interest and principal payment due in 15 years, with no prepayment being permitted. Under the proposed regulations, only the present value of the interest due in the future would be allowed. On the other hand, the prohibition on prepayment, a feature of "*Graegin* loans," will no longer be needed, although a change in the expected or actual date of payment will make a claimed deduction subject to adjustment.

In items (vi), (ix) and (x), the words "significantly," "substantial" and "substantially" are used. The meanings of these words are uncertain. They should be stricken or described with precision.

The Preface discussion says nothing about the use of a revocable trust as the focal point for the administration of many estates. The discussion should be broadened to recognize this fact and say something about the subjects under discussion. For example, interest may be paid from a trust rather than an estate for certain loan obligations.

The discussion of the subject matter needs editing and "simplifying". For example, in the first quoted paragraph, the words "essential to the proper settlement of the decedent's estate" are used. "Essential to" could be replaced with "needed for" and the word "proper" could be omitted. "Essential" seems to suggest an absolute necessity which may not be the case. Also, in item (vi) the words "some similar financially undesirable course of action" are used.

This could be "softened" by substituting "other" for "similar financially."

We approve the AICPA recommendation concerning interest paid outside of the grace period. We also approve the Florida Bar alternative which would eliminate the Factors discussion.

F. Claims Against an Estate – Written Appraisal Document; Substantiation Requirements

Prop. Reg. §20.2053-4 relates to deductions for claims against an estate where the claim has not been paid prior to the estate tax return being filed. Prop. Reg. §20.2053-4(b)(1) provides:

(iv) The value of each such claim against the estate is supported by a written appraisal document to be filed with the Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, or successor form, and the written appraisal document —

(A) Adequately reflects post-death events that have occurred prior to the date on which a deduction is claimed on an estate's Form 706;

(B) Reports, considers, and appropriately weighs all relevant facts and elements of value as are known or are reasonably determinable at the time of the appraisal, including the underlying facts of the claim against the estate, potential litigating risks, and the current status of the claim and procedural history;

(C) Takes into account post-death events reasonably anticipated to occur;

(D) Identifies an expected date or dates of payment (for purposes of determining the applicability of the present value limitation in §20.2053-1(d)(6));

(E) Explains in detail the methods and analysis that support the appraisal's conclusions;

(F) Is prepared, signed under penalties of perjury, and dated by a person who is qualified by knowledge and experience to appraise the claim being valued and is not a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust (as those terms are defined in §20.2053-1(b)(2)(iii)), a family member of a beneficiary or a related entity as to a beneficiary (as those terms would be defined in §20.2053-1(b)(2)

(iii) if references therein to the decedent were replaced with a reference to such beneficiary, and without regard to the limitations in §20.2053-1(b)(2)(iii) based on the decedent's date of death), or an employee or other owner of any of them; and

(G) Includes a statement providing the basis for the person's qualifications to appraise the claim being valued;

This provision is repeated in Prop. Reg. §20.2053-4(c)(i)(iv).

Item (F) requires that the document referred to be "signed under penalties of perjury." This is a new requirement.

The NYSBA submission includes significant matters relating to the substantiation requirements. First, it suggested that the standard used should be substantially the same as what is contained in Treas. Reg. §301.6501(c)-1(f)(3) which deals with information to be included in an appraisal submitted with a gift tax return in lieu of an "adequate disclosure." Second, a standard of substantial compliance should be used to avoid "litigating over-technical issues about the appraisals."

The ACTEC report states:

The Proposed Regulations would remove the requirement that the written appraisal document comply with the rules for a "qualified appraisal," because, as the Preamble states, those rules were adopted to address charitable contributions and are not all appropriate under section 2053. 87 Fed. Reg. at 38335 (June 28, 2022). The qualified appraisal rules, however, do not require that the appraisal be signed under penalties of perjury, and no other provision of the Code or Treasury regulations includes such a requirement. See §1.170A-17(a)(3). Furthermore, the Proposed Regulations provide that a written appraisal document may not be prepared by a related party, which makes it less likely that the

person signing the written appraisal document will have firsthand knowledge of the underlying facts, further making a “penalties of perjury” requirement inappropriate. ACTEC therefore recommends that this requirement be deleted.

ACTEC welcomes the removal of the “qualified appraisal” references from the section 2053 context and believes that that removal should also encourage reexamination of whether an “appraisal” as such should be required at all. The use of the term “appraisal document” implies that it must be formally prepared by someone who is an “appraiser” by profession. Unlike the value of a nonmarketable asset, a claim against the estate will often be grounded mainly in legal considerations and arguments. ACTEC believes, for example, that often an attorney overseeing the estate administration will be eminently, if not uniquely, qualified to weigh such legal considerations and arguments and estimate the likely amount and timing of the payment of such claims. ACTEC therefore recommends that §20.2053-4(b)(1)(iv) and (c)(1)(iv) of the final regulations omit the use of the word “appraisal” (unless it is used only as an example of several options). The use of the word “statement” in Prop. Treas. Reg. §20.2053-1(d)(6)(iv) would be a good model. It may still be appropriate to require that the person preparing the statement is not a family member of the decedent, a beneficiary or family member of a beneficiary, or an employee or similarly related person, as in Prop. Treas. Reg. §20.2053-4(b)(1)(iv)(F) and (c)(1)(iv)(F).

Our Comments

In general, we agree with the positions taken in the statements quoted above from the organizations referred to, including rejection of the position that a written appraisal should be made under a threat of perjury.

G. Claims Based upon Promise, Including Guarantee

Claims based upon a promise are covered by Prop. Reg. §20.2053(d)(5) which provides:

i) In general. To be deductible, a claim founded on a promise must represent a personal obligation of the decedent existing at the time of the decedent’s death, and the claim must be enforceable against the decedent’s estate. In addition, except with regard to pledges or subscriptions (see §20.2053-5), the deduction for a claim founded upon a promise or agreement is limited to the extent that the promise or agreement was bona fide and in exchange for adequate and full consideration in money or money’s worth; that is, the promise or agreement must have been bargained for at arm’s length and the price must have been an adequate and full equivalent reducible to money value.

(ii) Decedent’s promise to guarantee a debt. A deduction for a claim founded upon a decedent’s agreement to guarantee a debt of another is a claim founded on a promise and is subject to the limitation in paragraph (d)(5)(i) of this section. For purposes of section 2053, a decedent’s agreement to guarantee a debt of an entity in which the decedent had an interest at the time the guarantee was given satisfies the requirement that the agreement be in exchange for adequate and full consideration in money or money’s worth if, at the time the guarantee was given, the decedent had control (within the meaning of section 2701(b)(2)) of the entity. Alternatively, this requirement is satisfied to the extent the maximum liability of the decedent under the guarantee did not exceed, at the time the guarantee was given, the fair market value of the decedent’s interest in the entity. The bona fide nature of the decedent’s agreement to guarantee a debt of a family member, a related entity, or a beneficiary (as defined in §20.2053-1(b)(2)(iii)) is determined in accordance with §20.2053-1(b)(2)(ii). For a claim otherwise deductible under this paragraph (d)(5)(ii), the estate’s right of contribution or reimbursement will reduce the amount deductible in accordance with §20.2053-1(d)(3).

Payments made pursuant to the decedent’s guarantee of a debt are deductible only to the extent that the debt for which the guarantee is given has not been taken into account in computing the value of the gross estate under §20.2053-7 or otherwise.

A new Example 10 deals with a guarantee and states:

On Date 1, D entered into a guarantee agreement with Bank (C) to secure financing for a closely-held business (LLC) in which D had a controlling interest. LLC was solvent at the time LLC executed a promissory note in the amount of \$100x in favor of C. Prior to D's death, LLC became insolvent and stopped making payments on the note. After D's death, C filed a claim against D's estate for payment of the remaining balance due under the note and E paid the full amount due. Although E had a right of contribution against LLC for primary payment of the indebtedness, LLC was insolvent and no part of the debt was collectible at the time E deducted the payment. D's estate may deduct the amount paid to C in satisfaction of D's liability under the guarantee agreement. The guarantee agreement is considered to have been contracted for an adequate and full consideration in money or money's worth. The result would be the same if D did not have control of LLC as long as the fair market value of D's interest in the LLC on Date 1 was at least \$100x.

The NYSBA report states:

A. Decedent's Promise to Guarantee a Debt

The Proposed Regulations state, in relevant part, that "the deduction for a claim founded upon a promise or agreement is limited to the extent that the promise or agreement was bona fide and in exchange for adequate and full consideration in money or money's worth." The Preamble describes that this consideration must be received by the decedent, stating that "the decedent must have received a benefit reducible to money value in exchange for the decedent's guarantee." As a preliminary matter, we do not believe that the Proposed Regulation, as drafted, actually adopts the same standard. If such is the desired effect, we suggest including the standard in the regulation itself that the decedent must have received the consideration.

That being said, we believe the issue Treasury and the Service may be trying to address is actually one that already is treated in the gift tax context. Specifically, deductibility in the Proposed Regulation is assessed in connection with whether there is "adequate" consideration. If, however, a guarantee is made during the decedent's lifetime and there is inadequate consideration, then the guarantee may have been donative and therefore be treated as a taxable gift at the time of the guarantee.

We believe that Section 2053(c)(1) does not require that the consideration furnished for a promise be passed to the decedent. Courts consistently have held that a bona fide business contract entered into with a third party to guarantee the debt of another should be treated as entered into for adequate and full consideration in money or money's worth, even if the consideration for the contract had not passed to the decedent. In fact, in 1936, the Third Circuit struck down a regulation promulgated under Section 303(a)(1) of the Revenue Act of 1926 (a provision similar to Section 2053(c)(1)) – which had required that a pledge, in order to be deductible, had to be made for adequate and full consideration received by the decedent – holding that such was not required by the Revenue Act.

Additionally, if it is determined that consideration must have passed to the decedent, we suggest that further thought be given to the provision in the Proposed Regulations that a decedent's agreement to guarantee a debt of an entity will be treated as satisfying the consideration requirement if the decedent had an interest in and control of the entity within the meaning of Section 2701(b)(2). While we appreciate the logic of treating the consideration requirement as having been satisfied to the extent that the motive for a guarantee is to preserve the decedent's interest in the entity or to enable the entity to make investments that will inure to the economic advantage of the decedent, we do not believe that those motives would necessarily exist simply because the decedent controlled an entity, if the decedent's interest in the entity was not significant. For example, consider a limited partnership in which the decedent was the 1% general partner and a trust for the decedent's children was a 99% limited partner. The decedent would be treated as controlling the partnership within the meaning of Section 2701(b)(2) and having an interest in it. In that case, a guarantee of the partnership's debt by the decedent would more likely be motivated by a desire to benefit his children rather than a desire to advance his own economic interests.

B. The Additional Sentence at the Beginning of Treas. Reg. §20.2053-4(d)(5)

The proposed regulations add the following sentence to the beginning of new subparagraph (i): "To be deductible, a claim founded on a promise must represent a personal obligation of the decedent existing at the time of the decedent's death, and the claim must be enforceable against the decedent's estate." We are uncertain about the purpose of the addition of this sentence. A similar sentence already appears in Treas. Reg. §20.2053-4(a)(1), which applies to all claims against the estate, not just claims founded on a promise. The only difference between the two sentences is the addition, in the Proposed Regulations, of a requirement that the claim must be enforceable against the decedent's estate. It is unclear whether the requirement of enforceability is a different requirement than the promise having to be "a personal obligation of the decedent existing at the time of the decedent's death." If it is, we suggest that there should be clarification for how it is different and why it should not also be a requirement for the deductibility of all claims.

The ACTEC comments contain a lengthy discussion of guarantees and suggestions for modifications including case law that consideration for a loan guarantee need not be paid to the decedent and the circumstances under which the loan should be recognized.

The comments of the FBTS contain the following criticism of the position taken in the proposed regulations that consideration must flow from the decedent:

Proposed Regulation section 20.2053-4(d)(5)(ii) is a proposed bright-line rule limiting deductions of claims based on the decedent's personal guarantee of a debt of a closely held business. Treasury should consider expanding deductions on personal guarantees by minority interest holders. The bright-line rule in the Proposed Regulations appears to be unduly restrictive to deceased minority interest holders who had personally guaranteed debts of entities in which such debt may be greater than the value of the decedent's interest. Treasury should consider expanding the rule allowing deductions in instances where a legitimate business reason existed for making the personal guarantee. Treasury should consider, for example, allowing deductions based on guarantees by minority owners of start-up companies, guaranteed debts incurred during economic hardship, and debts related to long-term investments.

Our Comments

The uniform criticism of the limitation on guarantees made in the submissions quoted should be recognized. Specifically, the final regulations should allow a deduction where, in the words of the FBTS, a "legitimate [significant] business reason existed for making the personal guarantee." A determination should be made whether the word "legitimate" or "significant" should be used. See page 12.

H. Conclusion

In the Introduction, six topics were mentioned concerning the proposed regulations. The comments made by ACTEC, NYSBA, AICPA and FBTS uniformly criticize four of those topics in significant ways. Work remains by the IRS to respond. In doing so, a more "neutral" position as between the IRS and decedents' estates should be taken.

* * *

Practical Drafting® is published by Carter Ledyard & Milburn LLP. It is intended to provide information and guidance with respect to specific topics of interest to trust and estate lawyers and other professionals practicing in the field. It is not intended to provide individualized legal or other professional advice, and should not be used as a substitute therefor. Neither the authors, the editorial staff nor the publisher of **Practical Drafting®** assumes any liability for the accuracy of its contents.

The statements in this issue cannot be used by any taxpayer to avoid tax penalties. The previous sentence is inserted pursuant to U.S. Treasury Regulations governing tax practice.

Practical Drafting® may not be reproduced without the express permission of the publisher. For questions regarding subscriptions, please contact us at practicaldrafting@clm.com.

related professionals

Jerome J. Caulfield / Partner

D 212 238-8809

caulfield@clm.com