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Report No. 1467
September 26, 2022

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Re: Report No. 1467- Report on the Proposed Section 2053 Regulations Regarding Present-Value Concepts, Interest Expense, Substantiation Requirements, and Personal Guarantees

Dear Ms. Batchelder and Messrs. Rettig and Paul:

I am pleased to submit Report No. 1467 of the Tax Section of the New York State Bar Association discussing the proposed Section 2053 regulations regarding present-value concepts, interest expense, substantiation requirements, and personal guarantees.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist.

Respectfully Submitted,

Robert Cassanos
Chair

Enclosure

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Report No. 1467

New York State Bar Association Tax Section

REPORT ON THE PROPOSED SECTION 2053 REGULATIONS REGARDING PRESENT-VALUE CONCEPTS, INTEREST EXPENSE, SUBSTANTIATION REQUIREMENTS, AND PERSONAL GUARANTEES

September 26, 2022

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New York State Bar Association Tax Section

Report on the Proposed Section 2053 Regulations Regarding Present-Value Concepts, Interest Expense, Substantiation Requirements, and Personal Guarantees

This Report (the "Report")[1] provides comments on proposed regulations (the "Proposed Regulations")[2] issued by the Department of the Treasury ("Treasury") on June 28, 2022, which seek to amend regulations promulgated under Section 2053 of the Internal Revenue Code of 1986, as amended (the "Code").[3] Section 2053 permits the deduction from a decedent's gross estate, before calculating estate tax, of four categories of amounts that are allowable by the laws of the jurisdiction under which the estate is administered. The deductible amounts are: (i) funeral expenses; (ii) administration expenses; (iii) claims against the decedent's estate; and (iv) unpaid mortgages on, or indebtedness in respect of, property included in the decedent's estate (if the amount included was undiminished by the mortgage or indebtedness).[4]

In 2007, Treasury proposed regulations in connection with Section 2053(a)(3), relating to the amount deductible for claims against a decedent's estate (the "2007 Proposed Regulations").[5] Treasury stated in its preamble that there was "little or no consistency among the conclusions of . . . courts with regard to the extent (if any) to which post-death events are to be considered in valuing such claims," resulting in a situation where "similarly situated estates are being treated differently for Federal estate tax purposes, depending only upon the jurisdiction in which the executor resides."[6] Treasury proposed rules under which estates could only deduct amounts actually paid in settlement of claims, and that post-death events should be considered; if a claim was not yet resolved, a protective claim for refund could be filed.[7]

After receiving a number of comments, Treasury issued modified final regulations in 2009 (the "2009 Final Regulations").[8] Treasury noted in its 2009 preamble that "the Treasury Department and the [Internal Revenue Service (the "IRS" or the "Service")] plan to issue additional guidance, including additional proposed regulations, in order to respond to certain

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[1] The principal authors of this Report are Austin Bramwell, Alan S. Halperin and Carlyn S. McCaffrey. Substantial contributions were made by Robert Cassanos, Dana L. Mark and Michael D. Moritz. Helpful comments were received from Stephen B. Land, David Miller, Deborah L. Paul, Michael Schler and Philip Wagman. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Guidance Under Section 2053 Regarding Deduction for Interest Expense and Amounts Paid Under a Personal Guarantee, Certain Substantiation Requirements, and Applicability of Present Value Concepts, REG-130975-08, 87 Fed. Reg. 38331 (June 28, 2022).

[3] Unless otherwise indicated, all references in this Report to a "Section" shall refer to a particular section of the Code. The Code is also sometimes referred to in this Report as the "IRC."

[4] IRC § 2053(a).

[5] Guidance Under Section 2053 Regarding Post-Death Events, REG-143316-03, 72 Fed. Reg. 20080 (Apr. 23, 2007).

[6] *Id.* at 20080-81.

[7] *Id.* at 20081.

[8] *See* Guidance Under Section 2053 Regarding Post-Death Events, RD 9468, 74 Fed. Reg. 53652 (Oct. 20, 2009).

comments and emerging issues that the Treasury Department and the IRS believe merit further considerations."[9]

The current Proposed Regulations emerge from the backdrop of the 2007 Proposed Regulations and 2009 Final Regulations. Treasury has broken out the new Proposed Regulations into four categories: (1) incorporating present-value principles in determining the amount deductible under Section 2053 for claims and expenses (except unpaid mortgages and indebtedness deductible under Treas. Reg. § 20.2053-7)[10]; (2) addressing the deductibility of interest accruing on unpaid tax and penalties, and interest accruing on certain loan obligations incurred by an estate; (3) revising substantiation requirements for valuations of certain claims; and (4) addressing the deductibility of amounts paid pursuant to a decedent's personal guarantee. Our commentary is divided in the same manner.

While we support the efforts by Treasury and the Service to clarify and enhance the provisions of the Code, we address in this Report how certain approaches taken in the new Proposed Regulations might be improved or clarified further.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. We endorse, as a general policy matter, consistent rules for valuing assets for purposes of determining the gross estate, on the one hand, and the amount of deductions in arriving at the net taxable estate, on the other hand. However, the Code's plain language – providing for deductions of the "amounts" of claims and expenses "as are allowable by the laws of the jurisdiction under which the estate is being administered" – is arguably in tension with the blanket use of present-value concepts with respect to deductions (absent legislative change). If a present-value approach is adopted as a broad general principle, we recommend that the grace period should be extended from three years to four years and three months (which is the limitation of the estate tax assessment period on extension). As explained below, the proposed extension would allow most ordinary and necessary estate administration expenses to fall within the grace period; we believe that outcome was the intended result.

B. The Proposed Regulations address deductions for two categories of interest: (i) interest payable under IRC § 6601 on unpaid tax and (ii) interest expenses on certain

[9] *Id.* at 53653.

[10] The 2007 Proposed Regulations originally included one present-value principle. Specifically, the 2007 Proposed Regulations provided that, if a decedent was obligated to make recurring non-contingent payments on an enforceable and certain claim for which the payments would "continue for a period that will likely extend beyond the final determination of the estate tax liability," the taxpayer could deduct "the present value of the payments on the decedent's date of death as determined under § 20.2031-7(d)." *See* 2007 Prop. Reg. § 20.2053-4(b)(7)(i). In the preamble to the 2009 Final Regulations, Treasury noted that some commentators had suggested that it would be inequitable to include present-value adjustments only for non-contingent claims but not for contingent claims. The 2009 Final Regulations "eliminate[d] the disparate treatment by removing the present value limitation applicable only to noncontingent recurring payments." Treasury and the IRS "believe[d] that the issue of the appropriate use of present value in determining the amount of the deduction allowable under section 2053 merit[ed] further consideration," and thus Treas. Reg. § 20.2053-1(d)(6) was reserved to provide future guidance. *See* 2009 Final Regulations, 74 Fed. Reg. 53656-57.

loan obligations of an estate. The first category includes a presumption of an expense being "actually and necessarily incurred," subject to an exception for underpayment interest attributable to an executor's negligence, disregard of applicable rules or regulations, or fraud with intent to evade tax. We suggest that the exception not apply when the fiduciary acted reasonably and in good faith, as defined in Section 6664(c). As to the second category, we suggest that a standard of reasonable cause be included, in order to be consistent with the standard for determining whether an estate may obtain an extension of time to pay under Section 6161(a)(2) (which causes interest in the first category to be deductible *per se*). We appreciate Treasury's inclusion of a list of factors to consider in determining whether accrued interest is deductible; we comment on two of the factors below as well.

C. We agree with Treasury's proposed removal of the Section 170 rules (generally applicable for lifetime charitable contributions for income tax purposes) from the claim substantiation rules. Nevertheless, for purposes of consistency, we believe that it may be beneficial to use a definition from another provision of the Code, such as that included in the Regulations under Section 6501.

D. In discussing the ability to deduct claims founded upon a decedent's guarantee, the Preamble describes that consideration must have been received *by the decedent*. However, the requirement that the *decedent* must have received consideration in connection with a guarantee (as opposed to a third party) is not included in the Proposed Regulations. We recommend that if the decedent's receipt of consideration was intended to be included, such requirement should be stated in the regulation itself. That being said, we question whether the Code requires that the decedent receive consideration, as opposed to a third party. More importantly, though, we believe that this issue of consideration received in connection with a guarantee is a *gift tax* concern, not an estate tax concern, given that the exchange takes place during the decedent's lifetime. We are also concerned that the Proposed Regulations could lead to unintended consequences if the amount of consideration is deemed "inadequate" by only a marginal amount. Additionally, we suggest that Treasury give further thought to whether a decedent's agreement to guarantee a debt of an entity will be treated as satisfying the consideration requirement if the decedent had control of the entity within the meaning of Section 2701(b)(2) but had no significant ownership interest in the entity.

II. APPLICABILITY OF PRESENT-VALUE PRINCIPLES TO AMOUNT DEDUCTIBLE UNDER SECTION 2053

A. Use of Valuation Concepts in Section 2053

Pursuant to IRC § 2001(a), the estate tax is imposed on a decedent's "taxable estate." The taxable estate is calculated by determining the "gross estate" as defined in Section 2031, and deducting from it certain categories of amounts identified in Sections 2053 through 2058. The value of the gross estate is defined as "the value at the time of [the decedent's] death of all property" included in the gross estate.[11]

[11] IRC § 2031(a).

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."[12] 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.[13] 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.[14]

In its preamble to the Proposed Regulations (the "Preamble"), Treasury suggests that "[t]axpayers, the IRS, and courts regularly employ present-value principles for valuation and for other income tax and transfer tax purposes"; in support of that assertion, it cites one Code provision and three regulations.[15] Section 1274(b), which Treasury cites, expressly provides that "the imputed principal amount of any debt instrument" includes the sum of the "present values of all payments due." Similarly, the regulations cited by Treasury address the concept of *valuation*. Specifically, Treasury was setting rules for how to value remainder interests in property transferred to a pooled income fund; and how to value annuities, interests for life or for a term of years, remainders, and reversions.[16]

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).[17] 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

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[12] IRC § 2053(a) (emphasis added).

[13] *See Estate of Graegin v. Comm'r*, T.C. Memo. 1988-477.

[14] *Compare* Rev. Act of 1916 § 202 (determining the value of the gross estate "by including the value . . . of all property") *with* § 203(a)(1) (determining value of net estate "by deducting from the value of the gross estate . . . [s]uch amounts . . . as are allowed by the laws of the jurisdiction . . . under which the estate is being administered.").

[15] *See* 87 Fed. Reg. 38332.

[16] *See* Treas. Reg. §§ 1.642(c)-6, 20.7520-1, and 25.2512-5.

[17] By comparison, in Code Section 1001(b), the "amount realized" from the sale or disposition of property includes the "sum of any money" as well as the "fair market value of the property" received. That section, however, is explicit in defining one term ("amount realized") to encompass the other term ("value") in the case of property received other than money. Section 1001(b) also does not relate such amounts to being allowed only if permitted by a local jurisdiction.

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."[18] 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,"[19] we believe this consideration should be balanced against the apparent intention of the drafters, as embodied in the statutory language.

B. Extending the Three-Year Safe Harbor

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."[20] 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.[21] 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.[22]

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[18] IRC § 2056(a).

[19] *See* 87 Fed. Reg. 38332.

[20] 87 Fed. Reg. 38333.

[21] *See* N.Y. Surr. Ct. Proc. Act. § 2307(1) (payment of executor commissions and compensation for legal services rendered is determined by the court "on the settlement of the account").

[22] In our experience, circumstances also arise when fiduciaries may be required to delay paying certain expenses until the final settlement of an estate. Therefore, we believe the Proposed Regulation could put

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.[23] 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.[24] We believe this period would provide more time to adequately resolve the concerns addressed above and align the grace period with the assessment period.

C. Applicable Discount Rate

Treasury suggests implementing a discount rate based on the applicable federal rate ("AFR") under Section 1274(d).[25] In our experience, though, executors often choose to hold sufficient cash to meet expenses and claims because they do not want the available assets to be subject to market fluctuations. Therefore, executors frequently keep cash on hand in standard bank accounts, money market accounts, short-term certificates of deposit and other cash equivalents (including short-term treasuries).

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the fiduciary in a somewhat untenable situation of balancing fiduciary duties of effectively administering an estate, including a delay in paying off an expense, with the consideration that this delay could now result in a *smaller* deduction for the estate, leading to higher taxes and less left over to be distributed to the beneficiaries. Additionally, fiduciaries may be required to file protective claims for refunds in the event that a claim or expense is paid within the grace period, thus requiring added monitoring by the fiduciary, which would only further increase estate administration expenses and lessen the value of distributions to beneficiaries. Further, this process could add complications for fiduciaries in having to assess whether there is an obligation to file an amended return before the statutory period for assessment expires in the event that the fiduciary deducts an expense that he or she reasonably believes will be paid within the three-year grace period but which is in fact not paid.

[23] Of course it is also possible to discount *all* expenses, regardless of when they were paid. In that regard, we agree with the approach of the Proposed Regulations, which reflects that for administrative convenience, it would be beneficial *not* to have the discount apply to all such expenses.

[24] *See* IRC § 6075(a) (estate tax returns must be filed within 9 months of decedent's date of death); Treas. Reg. § 20.6081-1(b) (estates are allowed an automatic 6-month extension of time beyond the date prescribed in IRC § 6075(a) to file an estate tax return by meeting certain basic filing procedures); IRC § 6501(a) (requiring assessment of estate tax liability to be within three years of the filing date of the estate tax return (or due date, if later)); IRC § 6501(c)(4)(A) (preventing agreements for an extension of time for assessment of estate tax liability).

[25] *See* Prop. Reg. § 20.2053-1(d)(6)(i)(2)(B).

While the bank accounts in which executors hold cash to pay off expenses and claims might be interest-bearing, the interest rates on the account may not be as high as the AFR rates in place at the relevant time.[26]

While we know that there is no perfectly analogous rate, we believe the proposed use of the AFR rates would result, in certain cases, in a discount rate higher than the amount the estate is likely to earn, which is only exacerbated by the fact that the estate will be required to pay income tax on the income earned.[27] In other words, because a typical fact pattern is for an executor (as a matter of prudence) to keep a matched book of cash or cash equivalents to offset anticipated or accrued but unpaid expenses, discounting should be applied in a manner that would not unduly disadvantage the estate.

In the event Treasury determines to maintain the approach in the Proposed Regulations (a blanket use of discounting subject to a grace period), we request that the foregoing considerations be kept in mind.

D. Treatment of Claims Secured by Property Included in the Gross Estate

The Proposed Regulations would not limit the deduction for claims to the present value of the claims if the claims are secured by property included in the gross estate and, therefore, are deductible under Section 2053(a)(4) rather than Section 2053(a)(3). It is not clear why secured claims should be exempt from the present value requirement. Such an exemption would open a clear path for well-advised taxpayers to structure their loans in a manner intended to protect their debts from the present-value regime.

III. DEDUCTIBILITY OF INTEREST EXPENSE AS ADMINISTRATION EXPENSE

A. Applying a Reasonable Cause Standard to Fiduciaries

To be deductible under Section 2053(a)(2), an interest expense, like other administration expenses, must be actually and necessarily incurred in the administration of the decedent's estate and essential to its proper settlement.[28] Prop. Reg. § 25.2053-3(d)(2) clarifies that these requirements apply to both the underlying loan terms and the interest itself.

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[26] Of course the effect of this rule on any particular estate may depend to some degree on the cash equivalents in which the executor has chosen to invest.

[27] Suppose, for example, that an estate must pay an executor’s commission of $100X five years after the date of the decedent’s death. If the executor invests the $100X in a bank account with a 1% APY, after paying annual federal taxes on the interest at a 40.8% rate, the executor will have earned about $3X net of income taxes. If the $100X deduction is limited to its present value as of the date of the decedent’s death, discounted at a rate of 3%, the deduction will be reduced by about $13.7X. The reduction will cause an additional estate tax of about $5.5X, which is 83% more than the net income earned.

[28] Treas. Reg. § 20.2053-3(a). The Proposed Regulations state that expenses must be “actually and necessarily incurred” but that loans also “must be essential to the proper settlement of the decedent’s estate.” We assume for these purposes that these words (“actually and necessarily incurred” and “essential”) are intended to have the same general meaning. *See* Prop. Reg. § 20.2053-3(d)(1)(ii), (iii), (iv)(A), (B), (C), (d)(2), (d)(2)(iv); *see also* Treas. Reg. § 20.2053-3(a) (stating that expenses must be

The Proposed Regulations address deductions for two categories of interest: (i) interest payable under IRC § 6601 on unpaid tax and (ii) interest expenses on certain loan obligations of an estate. The first category includes a presumption that interest imposed by statute on an underpayment of tax is generally considered to be "actually and necessarily incurred,"[29] with an exception for underpayment interest that is attributable to an executor's negligence, disregard of applicable rules or regulations, or fraud with intent to evade tax. The terms "negligence," "disregard of applicable rules or regulations," and "fraud" apparently have the same meaning as those terms are used in Section 6662(b)(1) and Section 6663(a), which impose accuracy-related penalties in some cases on understatements of tax.[30] Indeed, the Proposed Regulations explicitly define "disregard" by reference to Treas. Reg. § 1.6662-3(b)(2).

In light of the apparent intent to import concepts from the Code's accuracy-related penalties into this first category of interest, we note that the exception to the general rule for negligence, disregard, or fraud with intent to evade tax may sweep more broadly than intended. Literally speaking, any underpayment of tax – such as underpayment resulting from a valuation position that turns out to be lower than the finally determined value – could be attributed to "disregard" of rules and regulations. To narrow the potential reach of the accuracy-related penalties, the Code provides an important exception to the accuracy-related penalties "if it is shown that there was reasonable cause [for the underpayment] and that the taxpayer acted in good faith."[31] Similarly, so that executors do not have to fear being penalized (in the form of denial of a deduction for underpayment interest) merely for choosing to compromise on a proposed deficiency amount, we suggest that that final regulations permit a deduction for underpayment interest if the executor acted in good faith and with reasonable cause.

As to the second category of interest addressed in the Proposed Regulations, while the proposal includes a list of factors to consider in determining deductibility, this Proposed Regulation does not include any standard of care with regard to fiduciaries. The first category, by contrast, implicitly incorporates a standard of reasonable cause. Under Section 6161(a)(2), after all, an extension of time to pay is available in the discretion of the Service on a showing of "reasonable cause"; if the estate obtains such an extension, Prop. Reg. § 20.2053-3(d)(1)(ii) then treats the underpayment interest as deductible *per se*. The same reasonable cause standard arguably should apply if the fiduciary incurs an interest expense in a manner other than by obtaining an extension of time to pay. We suggest that the test for the second category of interest expense deductions be made consistent with the first category. That is, we suggest that the final regulations provide that interest on a loan be considered to be deductible if the executor had "reasonable cause" to enter into the loan arrangement and agree to the interest provisions under that arrangement.

"actually and necessarily incurred" but then also identifying which expenditures are not "essential" to the proper settlement of estates).

[29] Prop. Reg. § 20.2053-3(d)(1)(ii).

[30] That said, the term "fraud with intent to evade tax" is not found in Section 6663; its analogue appears instead to be found in Section 6501(c)(1), relating to the statute of limitations for assessment. It would be helpful if the final regulations or the preamble thereto could provide cross-references defining the meaning of the relevant terms.

[31] IRC § 6664(c)(1).

B. Comments on Specific Factors

We generally agree with the Proposed Regulations' list of factors to be applied in determining when a loan and the ensuing interest expense are bona fide in nature, actually and necessarily incurred in the administration of the decedent's estate, and essential to the proper settlement of the estate. We note that here, too, Treasury and the Service appear to have been focusing at least in part on *Graegin* loans.[32] However, we would like to address two of the factors.

The first factor listed is whether the loan is both reasonable and "comparable to an arms' length loan transaction."[33] 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.[34] 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.[35] 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.[36] 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

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[32] The Preamble cites *Graegin* in connection with the statement that "[t]he issue of the deductibility of interest expense accruing on a loan obligation by an estate has been litigated often, with varying results." *See* 87 Fed. Reg. 38335.

[33] Prop. Reg. § 20.2053-3(d)(2)(i).

[34] Indeed, in litigation, the Service has argued that interest expense should be considered unnecessary when the rate of interest paid to a related party was market-based, rather than one-sided in favor of the estate. *See Estate of Duncan v. Comm'r*, TC Memo 2011-255 (rejecting the Service's argument that the estate should have agreed to pay interest only at the low applicable federal rate, rather than a market-based rate).

[35] Prop. Reg. § 20.2053-3(d)(2)(viii).

[36] For suggestions addressing valuation abuses, *see generally* NYSBA Report No. 1358, Joint Report on Proposed Regulations under Section 2704 of the Code (Nov. 21, 2016).

the decedent might have arranged his or her affairs differently.[37] 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.[38]

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.[39] 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.

IV. SUBSTANTIATION REQUIREMENTS FOR VALUATIONS PERFORMED PURSUANT TO TREAS. REG. § 20.2053-4(b) AND (c)

The substantiation rules included in Treas. Reg. § 20.2053-4(b) and (c) are a product of the 2009 Final Regulations. In the preamble to the 2009 Final Regulations, Treasury stated that, although it would keep its proposed rule that only amounts *actually paid* by an estate in satisfaction of a claim would be deductible, there would be two exceptions where claims could be deducted even before payment: claims that in the aggregate were less than $500,000, and claims where the value of the gross estate includes a claim in the same or substantially-related matter or includes an asset integrally related or subject to the claim against the estate.[40] In relation to this second exception, Treasury added, without specific commentary, that to receive the benefit of a deduction before paying a claim, the values of these excepted claims would need to be determined by a "qualified appraisal" performed by a "qualified appraiser" as defined by

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[37] Whether deliberate planning created an artificial liquidity shortage may pertain more to whether a loan is bona fide than whether it was necessary in the administration of an estate. In particular, it may be an indication that the decedent anticipated that the estate would effectively borrow from the same persons who are beneficiaries of the decedent's estate, in a circulation of cash that artificially generates additional interest expense deductions. Nevertheless, the Preamble states that where the decedent planned for a liquidity shortage, the loan may still be bona fide. *See* 87 Fed. Reg. 38335.

[38] Note also that tax may be deferred under Section 6161 upon a showing of reasonable cause, which does not take into account the decedent's planning.

[39] Prop. Reg. § 20.2053-3(d)(2)(x). We suggest that the factor be clarified to provide that the identify of lenders and beneficiaries is considered even if the beneficiaries are only indirectly the lenders (such as through an entity or a trust).

[40] *See* 2009 Final Regulations, 74 Fed. Reg. 53653-54, 53656.

Section 170 and the corresponding regulations.[41] The final regulations added this substantiation requirement for both exceptions under subsections (b) and (c) of Treas. Reg. § 20.2053-4.

We agree with Treasury's decision to move the substantiation rules here away from the charitable contribution rules. That being said, we take this opportunity to note that it may be beneficial for Treasury to adopt a more singular approach to appraisal guidelines in general, given differing standards among the Regulations.[42] Until that time occurs, though, we believe it may be beneficial to mirror more closely the appraisal rules in the Proposed Regulations on those in Treas. Reg. § 301.6501(c)-1(f)(3). That subsection specifically considers what information must be included in an appraisal when the appraisal is submitted in connection with a gift tax return in lieu of an "adequate disclosure." Based on our collective experience, the appraisal guidelines under that subsection are widely used, given that appraisals are very commonly included with gift tax returns.

Next, recent caselaw has highlighted that in the context of deductions for charitable contributions, the Service and courts have required a very strict compliance with substantiation rules.[43] The draft substantiation rules here do not include any standard for compliance. Especially in light of the fact that the substantiation requirements in the Proposed Regulations are rather general, we suggest that the Proposed Regulations include a standard of substantial compliance so as to avoid litigating over-technical issues about the appraisals.

V. DEDUCTIBILITY OF AMOUNTS PAID PURSUANT TO DECEDENT'S PERSONAL GUARANTEE

The Proposed Regulations add a new subparagraph dealing with a decedent's guarantees and add a new sentence at the beginning of the existing Section 20.2053-4(d)(5) in connection with personal obligations and enforceability.

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[41] *Id.* at 53656.

[42] For example, under Treas. Reg. § 20.2031-3(a), in connection with the valuation of business interests, the Regulations require a "fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will." The details required for such an appraisal, however, are not mentioned. Meanwhile, under Treas. Reg. § 20.2031-6(d), in connection with the valuation of household and personal effects, where "expert appraisers are employed," the Regulations in this case state that "care should be taken to see that [the expert appraisers] are reputable and of recognized competency to appraise the particular class of property involved," and further provide details as to "books in sets by standard authors," paintings, rugs, and silverware, with such detail that silverware weights must be "given in troy ounces." Further, the Proposed Regulations provide a very general definition of who is an adequate appraiser (anyone who is "qualified by knowledge and experience to appraise the claim being valued"), while the rules under Section 170 include detailed requirements for education and experience, the type of coursework that must be satisfied to be an appraiser, and who *does not* meet the standards to be a "qualified appraiser." *See* Prop. Reg. § 20.2053-4(b)(1)(iv)(F), (c)(1)(iv)(F); Treas. Reg. § 1.170A-17(b).

[43] *See*, *e.g.*, *Albrecht v. Commissioner*, T.C. Memo. 2022-53 (May 25, 2022) (denying charitable contribution deduction, despite a "good faith attempt by petitioner to substantially comply with the Code" to substantiate the contribution, because "[s]ubstantial compliance, unfortunately for petitioner, does not satisfy the strict requirements of section 170(f)(8)(B).").

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."[44] 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."[45] 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.[46]

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.[47]

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

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[44] Prop. Reg. § 20.2053-4(d)(5)(i).

[45] 87 Fed. Reg. 38336.

[46] *See* IRC § 2512(b) ("Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year."). There is also a larger consideration of what is deemed "adequate," which could lead to an unintended (yet consequential) cliff effect. For example, if a child pays a parent $X to guarantee an obligation, the obligation may be deducted for estate tax purposes under these Proposed Regulations only if $X is deemed "adequate." But what is the effect if $X was one dollar less than what Treasury deems adequate? We believe it may be valuable for Treasury and the Service to address this concept in a separate guidance initiative.

[47] *See Comm'r v. Bryn Mawr Trust Co.*, 87 F.2d 607 (3d Cir. 1936); *see also Carney v. Benz,* 90 F.2d 747 (1st Cir. 1937); *Estate of Scofield v. Comm'r*, T.C. Memo 1980-470 ("A guarantor's obligation has been held to have been contracted for adequate and full consideration in money or money's worth when there has been a loan of money to a third party as a result of the guaranty and the guaranty thereby became binding").

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).[48] 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.[49]

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.

VI. CONCLUSION

We support the efforts of Treasury and the Service to provide further guidance under the Code by means of amending the Regulations. However, we respectfully suggest that consideration be given to modifying the Proposed Regulations to reflect recommendations set forth in this Report.

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[48] *See* Prop. Reg. § 20.2053-4(d)(5)(ii).

[49] The Proposed Regulations specifically consider whether the decedent had control of an entity within the meaning of Section 2701. *See* Prop. Reg. § 20.2053-4(d)(5)(ii), (d)(7)(iii)(J). Yet, there is uncertainty under Section 2701 as to whether a member of an LLC (or a shareholder of a corporation), which, in turn, is a general partner of a limited partnership has "control" over the limited partnership for purposes of Section 2701. In our prior report regarding the Section 2704 Proposed Regulations, we highlight the need for clarity as to the meaning of "control" for purposes of Section 2701. *See* NYSBA Report No. 1358, at 28-30.