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## Fiduciary Update

### Estate Tax Deduction for Claims and Expenses: Final Section 2053 Regulations

Almost two years after introducing proposed regulations, the IRS issued final regulations under Code §2053, which are applicable for decedents dying after October 19, 2009. The IRS introduced these regulations to correct a perceived lack of consistency among jurisdictions in the allowance of deductions for claims and expenses where the amount was unknown.

The principal change made by the regulations is the extent to which post-death events are taken into account in determining the deductible amount. The general rules regarding what expenses and claims are deductible have not changed. Generally, administration expenses must be necessarily incurred in preserving and distributing the estate, and expenses for selling property are deductible if the sale is necessary to pay debts, expenses or taxes, to preserve the estate or to effect distribution. The new regulations add the requirement that deductions are generally limited to amounts actually paid in satisfaction of claims and expenses. Thus, subject to certain exceptions, an estate may not claim a deduction for a claim or expense on a federal estate tax return until the claim or expense is actually paid. If a claim or expense is paid after the return is filed, a supplemental return must be filed to claim a refund. If the claim or expense is not paid within the limitation period, the executor may file a protective claim for refund to preserve the estate's right to deduct the claim or expense.

The new regulations deny a deduction if the claim or expense paid is or could be compensated by insurance or otherwise reimbursed. The executor may certify that he or she neither knows nor reasonably should know of any available reimbursements. If there is only a potential reimbursement, a claim or expense paid will still be deductible if the executor provides an explanation of his reasonable determination that the burden or expense for collection would outweigh the expected benefits. Reg. § 20.2053-1(d)(3). In addition, an executor may not deduct a claim if the estate is contesting liability for the claim. Nevertheless, expenses incurred in defending a claim are deductible even if the estate does not prevail. Reg. § 20.2053-3(d)(3). Finally, the regulations provide that any claim or expense paid must be bona fide, and sets forth guidance for when expenses or claims involving family members or related parties are bona fide. Reg. § 20.2053-1(b)(2).

There are three important exceptions to the "actually paid" requirement under the new regulations: claims or expenses whose amount is reasonably ascertainable, claims included in the gross estate subject to counter claims, and claims or expenses of less than \$500,000.

**Exception for ascertainable amounts**

A deduction is allowed for an unpaid claim or expense if the amount is ascertainable with reasonable certainty and will be paid. Reg. § 20.2053-1(d)(4). A contested or contingent claim or expense cannot be ascertained with reasonable certainty. For example, if state law provides for an executor's fee of 2.5% of the estate, the executor may deduct the 2.5% fee, even if not yet paid, if the amount will be paid since the amount is ascertainable. Reg. § 20.2053-1(d)(7), Ex. 1. In contrast, if the decedent is sued for tort and the estate tax return is due before final judgment or settlement, the potential tort claim may not be deducted on the return as the amount is not ascertainable. Reg. § 20.2053-1(d)(7), Ex. 2.

**Exception for claims and counter-claims in related matter**

If a decedent has an unpaid claim includable in the estate under Code §2033, and there is a related counter-claim against the decedent or a claim against the estate is integrally related to an estate asset, the executor may deduct the current value of that claim against the decedent/estate even though payment has not been made if: (1) the claim satisfies the general requirements for deduction; (2) the claim represents a personal obligation of the decedent; (c) the claim is enforceable against the decedent's estate; (4) the value of the claim is determined from a "qualified appraisal" by a "qualified appraiser"; (5) the value of the claim is subject to adjustment for post-death events; and (6) the related claim/asset included in the gross estate exceeds 10% of the gross estate. Reg. § 20.2053 4(b).

**Exception for claims totaling not more than \$500,000**

The current value of one or more claims against the estate may be deducted even though payment has not been made on the claim(s) if: (1) each claim satisfies the general requirements for deduction; (2) each claim represents a personal obligation of the decedent; (3) each claim is enforceable against the decedent's estate; (4) the value of the claim(s) are determined from a "qualified appraisal" by a "qualified appraiser"; and (5) the total amount deducted by the estate does not exceed \$500,000. Reg. § 20.2053 4(c).

**Effect of a court order/consent order/settlement on amount of deduction**

In addition to adding the requirement that a deductible claim or expense must actually be paid, the new regulations also address (or clarify) the amount deductible for an expense or claim that is paid pursuant to a court order, consent decree or settlement.

If a claim or expense is paid pursuant to a court order, the amount paid is the amount deductible if the court actually passes on the facts upon which deductibility depends (i.e., on the merits). Reg. § 20.2053-1(b)(3)(i). If an estate pays an expense or claim under a consent decree, the amount paid is deductible to the extent the consent decree resolves a bona fide issue in a genuine contest. If the parties providing consent have adverse interests to that of the claimant, the regulations presume that the consent order resolves a bona fide issue in a genuine contest. Reg. § 20.2053-1(b)(3)(iii). An expense or claim paid pursuant to a settlement agreement is the amount deductible if the settlement resolves a bona fide issue in a genuine contest and is the result of arms' length negotiations by parties having adverse interests with respect to the claim or expense. Reg. § 20.2053-1(b)(3)(iv). A

deduction will also be allowed for the settlement amount if the estate can establish that the cost or delay associated with litigating the claim or expense would impose a higher burden on the estate than the payment of the amount to settle.

The deductible amount paid pursuant to a court order, a consent order or a settlement must still meet the deductibility requirements under the regulations. For example, where state law provides for an executor's fee not in excess of 3% of the value of the probate estate but a consent decree is entered allowing the executor's commission in the amount of 5%, even if the executor pays the 5% fee, only 3% is deductible because the consent amount is in excess of the applicable limits under local law. Reg. § 20.2053-1(b)(4), Ex 1.

### **Claims for refunds and protective claims for refunds**

If a claim or expense is not paid and is not ascertainable and therefore is not deducted or is disallowed, but is subsequently paid or becomes ascertainable, relief may be sought by filing a claim for refund. To preserve an estate's right to a claim for refund for amounts becoming deductible after the expiration of the period of limitations for claiming a refund, a protective claim for refund may be filed. Reg. § 20.2053-1(d)(5). The IRS issued Notice 2009-84 to provide guidance on how to file protective claims for refunds.

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