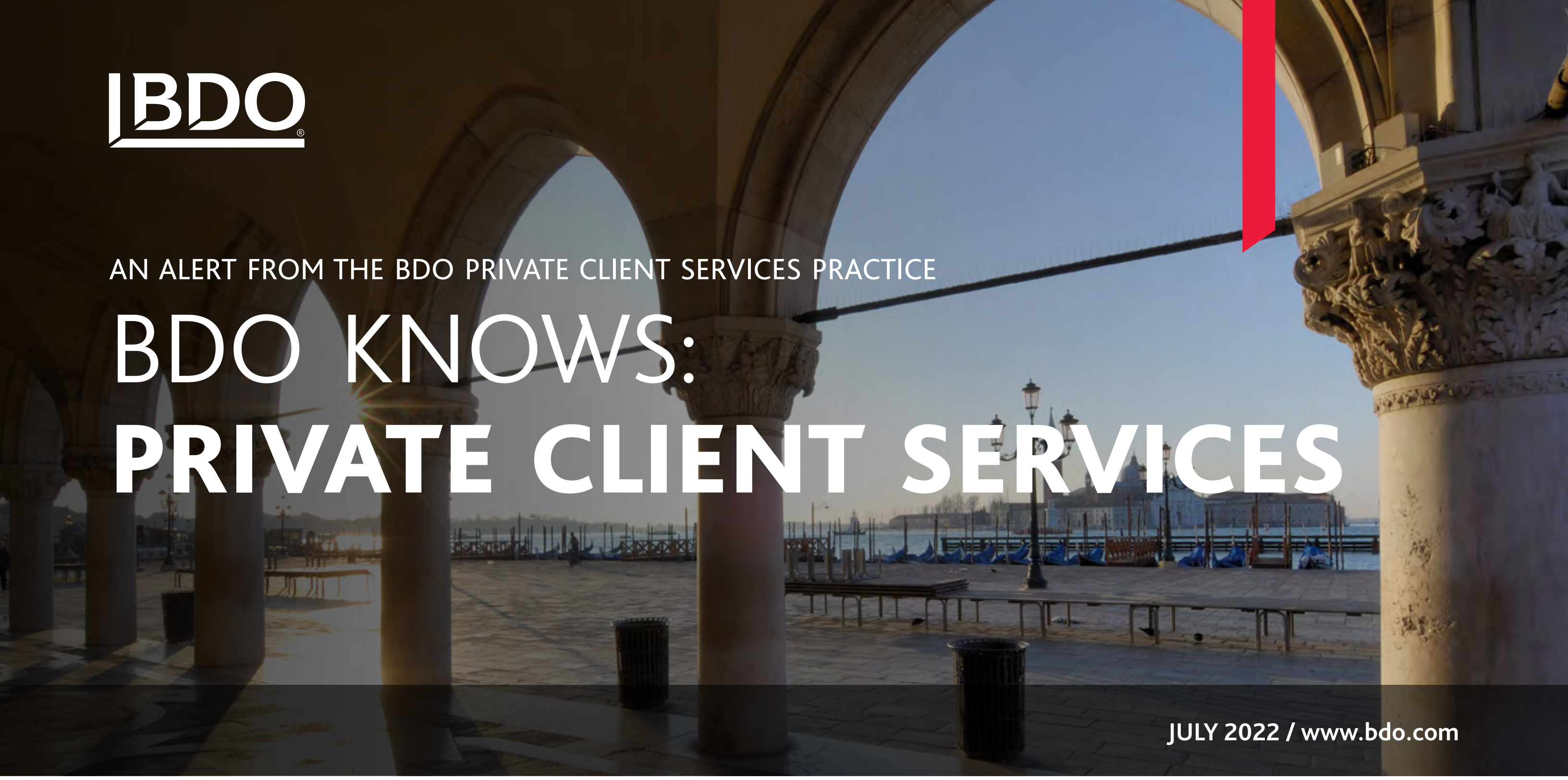

AN ALERT FROM THE BDO PRIVATE CLIENT SERVICES PRACTICE

BDO KNOWS: PRIVATE CLIENT SERVICES

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IRS ISSUES PROPOSED REGULATIONS ON PRESENT VALUE CONCEPTS AND ESTATE DEDUCTIONS

The IRS on June 24, 2022, issued proposed regulations under Internal Revenue Code Section 2053 that provide guidance in four areas:

- The use of present-value principles in determining certain deductible amounts on an estate tax return;
- An estate's ability to deduct interest expense accruing on certain tax and penalties owed by, and certain loan obligations incurred by, the estate;
- Substantiating the value of a deductible claim against the estate; and
- Deducting amounts paid by an estate under a decedent's personal guarantee.

These proposed regulations would apply to the estates of decedents dying on or after the date final regulations are published.

DISCOUNTING DEDUCTIONS RELATED TO CERTAIN EXPENSES AND CLAIMS TO BE PAID MORE THAN THREE YEARS AFTER THE DATE OF THE DECEDENT'S DEATH

The proposed regulations limit the deduction by an estate for funeral expenses, administration expenses and claims against the estate that are not paid, or expected to be paid, on or before the third anniversary of the decedent's date of death, to the present value of such deductible amount. The present value is determined using the applicable Federal rate (AFR) for the month in which the decedent's death occurs, compounded annually. Any reasonable assumptions and methodology are permitted when determining the time period to be used in calculating the present value of the deductible amount. In addition, any deduction is subject to adjustment to reflect post-death events that affect the amount of payment or any change in the expected or actual date of payment.

The proposed regulations also provide guidance for the computation of present value when multiple, recurring payments are anticipated and when the actual date of payment is unknown. Further, the proposed regulations provide that the present value calculation is computed before applying the limits in Treas. Reg. §20.2053-4(b)(2) and (c), which provide limitations for deducting litigated claims and claims not totaling more than $500,000.

Unpaid mortgage principal is excluded from this proposed rule.

BDO INSIGHTS

Most notably, these proposed regulations would eliminate the benefit of a Graegin loan. In Estate of *Graegin v. CIR*, T.C. Memo 1988-477, the Tax Court permitted an illiquid estate to deduct in full, without discounting for present value, the principal and interest on a 15-year note where the estate's executors entered into a loan transaction with a related entity to provide liquidity for the estate tax. The note prohibited prepayment and provided that principal and interest were due in a single balloon payment at the end of the loan term. If the proposed regulations are adopted, a similarly situated estate would now have to discount any deduction using the appropriate AFR.

INTEREST EXPENSE DEDUCTION

Section 2053 generally permits an estate to deduct interest expense due on any unpaid tax that is not Section 6166 interest. Section 6166 currently permits an executor to defer estate tax, including interest accruing on an installment or other payment, if the estate holds an interest in a closely held business that exceeds 35% of the adjusted value of the gross estate.

The proposed regulations 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 if otherwise permitted under the Section 2053 regulations. The proposed regulations provide that such interest is "actually and necessarily incurred in the administration of the estate," except in the case when such interest expense is attributable to an executor's negligence, fraud with the intent to evade tax, or careless, reckless, or intentional disregard of rules or regulations.

The proposed regulations also provide that interest expense on certain loan obligations of the estate are deductible as administration expenses provided:

- Such interest arises from an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of Federal tax law;
- The loan underlying the interest expense is bona fide in nature; and,
- The loan is "actually and necessarily incurred in the administration of the estate."

The proposed regulations provide a non-exclusive list of factors that may support finding that the loan is bona fide in nature, including that the terms of such loan are reasonable in nature and comparable to an arm's-length transaction, the loan proceeds are used to pay the estate's liabilities including the federal estate tax liability, and the only practical alternative to the loan would be the sale of estate assets at below-market prices or the forced liquidation of an active trade or business.

BDO INSIGHTS

These proposed regulations attempt to curb potential abuses that may arise in generating an interest expense deduction even if the estate does not lack liquidity to pay its federal estate tax liability, including the ability of a significant estate beneficiary to compel the loan.

SUBSTANTIATING CLAIMS AGAINST THE ESTATE

The proposed regulations amend the existing requirements for qualified appraisals to be obtained for certain deductible expenses related to litigated claims or claims in excess of $500,000. If adopted, the proposed regulations would require that a written appraisal be filed with Form 706, and the appraisal must consider post-death events occurring prior to the time a deduction is claimed, as well as those events reasonably anticipated to occur. The appraisal must be prepared by a qualified appraiser that is not related to the decedent, a beneficiary or any employee of an entity related to either the decedent or a beneficiary.

BDO INSIGHTS

These proposed regulations remove the requirement that the appraisal meet the same criteria as appraisals generated for charitable contributions and instead set forth appraisal standards that consider circumstances unique to estates, such as post-death events.

DEDUCTING AMOUNTS PAID UNDER A DECEDENT'S PERSONAL GUARANTEE

A claim against an estate based on a decedent's personal guarantee is deductible if the guarantee was bona fide and in exchange for adequate and full consideration. The proposed regulations set forth a bright line rule to determine whether a decedent's agreement to guarantee a bona fide debt of an entity, in which the decedent had control at the time of the guarantee, meets the requirements of a bona fide debt. Alternatively, the bona fide debt requirement may also be met if, at the time the guarantee is given, the decedent's maximum liability did not exceed the fair market value of the decedent's interest in the entity.

BDO INSIGHTS

These proposed regulations merely provide some certainty and a bright line safe harbor for substantiating that an amount paid (and claimed as a deduction) by an estate under a decedent's personal guarantee was a bona fide debt of the decedent.

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