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This issue of the WKBK&Y newsletter addresses:

1. Treasury Finalizes Proposed Regulations under Section 2053
2. IRS Extends Current Suspension of Code Sec. 6707A Penalty Collection through the End of the Year
3. Proceeds from the Sale of Water Rights: Ordinary or Capital?

1. **Treasury Finalizes Proposed Regulations under Section 2053**

Background

In a move that is disturbing to many practitioners, the Treasury on October 20, 2009, finalized Prop. Treas. Reg. §20.2053-4, which generally requires actual payment of a debt by an estate to claim it as a deduction from the estate tax under IRC §2053. The finalization of the Proposed Regulation presents a number of conceptual and practical difficulties with estate tax and administration.

IRC §2053(a)(3) states, in relevant part, that, “[f]or purposes of [the federal estate tax], the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts . . . for claims against the estate . . . as are allowable by the law of the jurisdiction . . . under which the estate is being administered.”¹

While §2053(a)(3) is silent as whether and, to what extent, if any, post-death events should be considered for purposes of determining the validity or value of claims against an estate, former Regs. §20.2053-4 provided reasonable guidance on the issue: “The amounts that may be deducted as claims against a decedent’s estate are such only as represent personal obligations of the decedent existing at the time of his death, whether or not then matured”²

Over the years, two lines of case law have developed with respect to the analysis of whether and to what extent, if any, post-death events should be considered in determining the validity and/or value of claims under §2053. One line of cases, following *Jacobs v. Commissioner*,³ concludes that post-death events are relevant and only amounts actually paid are deductible. The other more widely accepted line⁴ follows the Supreme Court’s opinion in *Ithaca*

¹ I.R.C. §2053(a).

² Former Regs. §20.2053-4.

³ 34 F.2d 233 (8th Cir. 1929), cert. den’d 280 U.S. 603 (1929).

⁴ As adopted by the Fifth, Seventh, Ninth, Tenth and Eleventh Circuits.

Trust Co. v. U.S.,⁵ which held that post-death events are irrelevant and deductions under §2053 should be based on the value of the pertinent claims at the date of death, rather than being based on those amounts which actually happen to have been paid before the estate tax return (or a claim for refund with respect thereto) is filed.

Summary of Proposed Regulations

On April 23, 2007, the IRS issued proposed regulations amending the existing regulations under Treasury Reg. §20.2053-4.⁶ The Treasury explains that it amended former Regs. §20.2053-4 “to clarify that events occurring after a decedent’s death are to be considered when determining the amount deductible under all provisions of §2053; that deductions under §2053 are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims” and if a claim is “potential, unmatured or contested at the time that the return is filed,” the executor may not claim a deduction.⁷

The proposed regulations adopted a “bright line” test—if no payment is made, no deduction is allowed. Rather, the personal representative must wait until the eve of the expiration of the statute of limitations to make a protective refund, explaining the reasons delaying payment. The IRS will then act when notified that the contingency has been resolved and the claim has been paid. The estate must also notify the IRS and pay additional taxes or file a refund claim for overpaid taxes if, after the filing of the estate tax return, the estate receives a tax refund or other adjustment to a paid claim.⁸

The proposed regulation also established a rebuttable presumption that claims by a family member of a decedent, a related entity, or a beneficiary of the decedent’s estate or revocable trust are not legitimate and bona fide and, therefore, are not deductible.

On October 20, 2009, the Treasury finalized Proposed Regs. §20.2053-4 effective _____.

Problems with the Final Regulations

IRC §2001 imposes an estate tax on the net estate “transferred” by the decedent.⁹ The prevailing theory of the estate tax is that it is intended as a “snapshot” of all property owned and liabilities owed by a decedent on his date of death. Consistent with this characterization, the Supreme Court has determined that because the net value of the property transferred should be determined as nearly as possible to the date of death.¹⁰ It follows that this should encompass the valuation of both the assets and liabilities. In effect, the final regulations tax the property received, but ignore the claims, deductions, and burdens on the assets taxed.

⁵ 279 U.S. 151 (1929).

⁶ 72 F.R. 20080.

⁷ *Id.*

⁸ Proposed Reg. § 20.2053-4.

⁹ See *US v. Manufacturers Nat’l Bank of Detroit*, 363 U.S. at 194.

¹⁰ See *Estate of Smith*, 198 F.3d at 524; *Burnet v. Guggenheim* 288 U.S. 280, 285 (1933) (“Congress did not mean that the [estate] tax should be paid twice, or partly at one time and partly at another.”).

In *Propstra v. U.S.*,¹¹ the Ninth Circuit analyzed, in great detail, the 1954 amendment to IRC §2053(a), which changed the language authorizing a deduction for claims “allowed by the laws of the jurisdiction” to the current “allowable by the laws of the jurisdiction.” The *Propstra* court concluded “that enforceability was to be determined at date of death . . . [and] claims based on legally recognized and enforceable rights were deductible; claims that were unenforceable because they lacked legal foundation were not deductible, even if actually paid. Congress lent support to this . . . construction when . . . it replaced ‘allowed’ with ‘allowable.’”

*Estate of Smith v. Commissioner*¹² (the leading Fifth Circuit case on this issue) also follows the *Ithaca Trust* line of cases, holding that the claim must be valued as of the date of death and “must [be] appraised on information known or available up to (but not after) that date.” The Tenth and Eleventh Circuits likewise follow the *Ithaca Trust* line of cases and cite *Propstra* in refusing to consider post-death events for purposes of determining the amount of the §2053 deduction.

In *Kyle Estate v. Commissioner*,¹³ the Tax Court made a clear distinction between the issues of valuation and enforceability of a claim. In *Kyle*, the claim at issue was filed post-death against the decedent’s estate and, like the *Smith* case, was unresolved at the time of her death. The *Kyle* court determined that, in cases where the enforceability of a claim is an issue, post-death events are relevant for purposes of determining the validity or enforceability of the claim. Where validity and enforceability are not at issue and the matter is merely one of valuation, post-death events are not considered under these authorities.

The Eighth Circuit is the only circuit to hold that a deduction is allowed only for amounts actually paid.¹⁴

With respect to contingent claims, the final regulations’ post-return duties on executors are contained in or otherwise implied under §2053(a).¹⁵

In addition, statutory elections may not work under the final regulations. For example, to determine whether an estate qualifies for installment payments under IRC §6166, deductions allowable under §2053 must be considered. To the extent a claim remains open under these final regulations, certain estates could be precluded from utilizing these special relief provisions.

Other complexities created by the new final regulations relate to the use of formulas that establish values to be funded into marital and credit trusts, a common tool used in estate planning documents. Because there will be no ability to determine what can or should be funded into any marital trust or credit trust until resolution of the final amount of a claim, the final regulations will not work with certain formula clauses. Or at a minimum, the regulations will delay administration of trusts and estates that are subject to such formulas.

¹¹ 680 F.2d 1248 (9th Cir. 1982).

¹² 198 F.3d 515 (5th Cir. 1999).

¹³ 94 T.C. 829 (1990).

¹⁴ *Jacobs, supra* at footnote 3.

¹⁵ Compare, for example, the post return-filing obligations imposed under Code §§ 2013, 2031A, 2053(d), 2057 and 6166.

WKBKY Takeaway

The final regulations under IRC §2053 present a number of problems. They do not mesh well with the estate tax provisions of the Code or established estate planning practices. Furthermore, they directly conflict rulings from the Supreme Court and the Fifth, Seventh, Ninth, Tenth and Eleventh Circuit Courts of Appeal. Finally, implementation of the final regulations places additional burdens and uncertainties on fiduciaries, a result which is itself, contrary to Congressional intent. Notwithstanding the problems with the final regulations, they now carry the weight of a regulation and should be treated with due deference. As positions contrary to the final regulations may be supportable under *Ithaca Trust* and other authority, practitioners must now disclose such positions on the appropriate tax form (Form 8275-R) to avoid penalty exposure. Estates taking such positions will doubtlessly encounter much resistance from the IRS, and it will certainly be more difficult (if not impossible without judicial intervention) to get these deductions past audit.

2. IRS Extends Current Suspension of Code Sec. 6707A Penalty Collection through the End of the Year

IRS Commissioner Douglas H. Shulman has extended until December 31, 2009, the suspension of Code Sec. 6707A penalty collection enforcement from those he identified as "taxpayers [who] have been caught in a penalty regime that the legislation did not intend." In an effort to prevent the use of tax shelters, the American Jobs Creation Act of 2004 (P.L. 108-357), drafted penalty provisions within Code Sec. 6707A that congressional leaders now agree were too broad. The suspension by Shulman, which has been in place since July 6, was scheduled to end on September. In a September 24 letter sent to Senate Finance Committee Chairman Max Baucus, D-Mont., as well as to other members of Congress, Shulman stated that the extension was being made to allow Congress the additional time needed to enact corrective legislation.

Many transactions now under IRS examination "involve tax benefits that are minor when compared to the statutory penalty amounts," Shulman originally stated in his July 6 letter. When the Code Sec. 6707A penalties were enacted in the American Jobs Creation Act of 2004 (2004 Jobs Act) (P.L. 108-357), the disproportionate consequences were not anticipated. However, many transactions now under IRS examination "involve tax benefits that are minor when compared to the statutory penalty amounts of \$100,000 (for individuals) and \$200,000 (for other taxpayers) per year," said Shulman in his July 6 letter to Congressman Lewis. SFC ranking member Charles E. Grassley, R-Iowa, stated that, when he advanced legislation to shut down tax shelters as part of the 2004 Jobs Act, he "did not intend to bankrupt small businesses that had no ill intent." Grassley's focus, on the other hand, had been "big corporations that were actively seeking to hide their participation in tax shelters."

Under Code Sec. 6707A, any taxpayer that fails to include information on a "reportable transaction" that is also a "listed transaction," is subject to a penalty of \$100,000 in the case of a natural person, and \$200,000 in any other case. According to lawmakers, some of the most egregious cases now in collection involve small business owners who purchased a benefit plan that, unknown to them, turned out to be a prohibited tax shelter. By failing to disclose this "tax shelter" on their returns, they were automatically subject to significant penalties on audit, despite the relatively small tax benefits that had been claimed.

The temporary suspension in July was in response to a request from the leaders of the House and Senate tax-writing committees. Members of the Ways and Means Committee intend to introduce bipartisan, bicameral legislation to modify the law and make the penalties more proportionate to the tax benefits. This legislative effort was the catalyst for the lawmakers' request that the IRS suspend collection actions against small businesses. The Small Business Tax Relief Bill of 2009 (Sen 1381), introduced by Grassley, contains provisions to amend the tax code to provide relief to small businesses. The relief would be applied retroactively to cover situations now in collection. No mark-up of the bill has yet been scheduled.

3. Proceeds from the Sale of Water Rights: Ordinary or Capital?

Introduction

With the supply of water in California progressively lagging behind the demand, the sale of water and water rights has become an increasingly essential aspect of many businesses' continued success. This is especially true for agricultural businesses. Historically, a landowner was entitled to draw as much water from water sources as the owner desired. The government later stepped in and in many instances purchased water rights from land owners either outright or per governmental powers, at which point the volume of water use became much more regulated.

A water transfer may occur in several forms, including the physical transfer of water from one location to another, the transfer of water rights, or by agreement of one with a superior right not to exercise that right.

Unfortunately, with the exception of short-term water transfers (less than one year), which likely result in ordinary income and permanent transfers of a complete interest, which likely result in capital gain treatment, there is little law dictating the tax implications of water transfers. As is the case in areas of tax law in which direct guidance is not available, indirect guidance is available by analogy to other established areas of tax law. In the case of water transfers, parallels can be made to multiple areas of tax law which all result in significantly different taxation. This article outlines the tax treatment of available water and analogous fact patterns as it relates to long-term, but incomplete transfer of water rights.

Discussion

A good starting place in evaluating whether the gain from a sale of water or water rights is ordinary or capital is the extent of the seller's continuing interest in the water after the sale.¹⁶ In *Vest*, the Court focused on whether a sale of water rights was effectively a sale or a lease, and that a sale is supported when all or a predetermined quantity is transferred in exchange for fixed consideration.¹⁷ In *Phuckett v. Comm.*, 355 F.2d 551 (1966) a 75-year transfer was found by the Court to be so similar to a lease as to result in ordinary income because the transfer could be terminated any year by the transferee, there was no substantial initial payment, and the transferor retained certain water rights which were paramount to the rights of the transferee and without limit.

¹⁶ *Vest v. Comm.*, 481 F.2d 238 (1978).

¹⁷ *Id.* at 243.

By contrast, the Court in *Day v. Commissioner*¹⁸ applied the same framework to find that the sale resulted in capital gains treatment where a lump sum payment was made for a complete transfer less a nominal entitlement and the fact that the underground water was not expected to be recharged.¹⁹ In *Rhodes v. US*, 464 F.2d 1307 (1972), the Court allowed capital gain treatment, reasoning that the extraction of clay deposits was essentially a transfer in fee simple, as opposed to a lease, because there was no limitation on the clay which could be extracted.²⁰

Contractual rights to water may exist, and the sale of such contractual rights creates an additional element in the analysis of taxation. Generally, the sale of partial contractual rights is more favorable to an argument of capital gain treatment because a specific and identifiable portion of a complete interest is being transferred.

For instance, in *Gladden v. Comr.*, 112 TC 209 (1999) the taxpayers received contractual water rights with a term of 50 years from the federal government. Such water rights could not be sold separately from the land. The taxpayers subsequently received payment in exchange for the relinquishment of their contractual water rights approximately nine years into the term of the contract. The Court held that the taxpayers' contractual water rights were capital assets, stating that "[t]he water rights, and particularly the decision in 1992 to relinquish the water rights, affected the partnership's farming activity and the investment risks associated with that farming activity--especially the financial risks associated with purchasing water on the open market."²¹

In determining whether an asset constituted a capital asset, *Gladden* cited *Commissioner v. Ferrer*, 304 F.2d 125 (1962). *Ferrer* dealt with a payment in exchange with an agreement to give up exclusive rights to a play. In allowing capital gains treatment the Court concluded "among other things, that where a taxpayer's 'bundle of rights' reflected 'something more than an opportunity, afforded by contract, to obtain periodic receipts of income,' and where they included 'equitable interests' similar to those of an owner of property, they were to be treated as capital assets."²² The *Ferrer* Court further commented that importance should be placed on the "passing of 'property' rights allegedly constituting 'capital assets'" and not to whom such rights are transferred.²³

Finally, to the extent that water rights are found to be property used in a taxpayer's trade or business, capital gain treatment will be available upon the sale of such water rights under section 1231.

WKBKY Takeaway

¹⁸ 54 TC 1417 (1970)

¹⁹ *Id.* at 1426.

²⁰ *Id.* at 1311.

²¹ *Id.* at 223.

²² *Gladden*, 112 TC 209 at 220-221.

²³ *Id.* at 131.

Water transfers are becoming increasingly important for many clients and the taxation of such transfers are nebulous and complex. A tax professional can add a great deal of value to a client's proposed water transfer by getting involved and structuring the deal to maximize the possibility of favorable tax treatment. WKBKY hopes that this general outline of these complexities will assist practitioners in giving clients preliminary guidance in this area of tax law.

We hope that you find these items of interest to you. If you need further information or would like to discuss a particular issue, feel free to call any one of the lawyers listed below. We will get you to the right person.

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