

Family Transaction: Debt or Gift?

Take-Away: Creditor claims of a family member are highly suspect when they are paid from the deceased family member's estate at death.

Background: The federal estate tax works on the concept of a 'net transfer.' To achieve that 'net transfer, IRC 2053 allows deductions for claims against the decedent, so that portions of the decedent's gross estate that are not transferred to the decedent's beneficiaries are not subject to the federal estate tax, i.e., the portion of a decedent's gross estate that is used to pay the debt or claim is not part of the gross estate on which the federal estate tax is calculated. Sometimes a family member dies with a debt owed to another family member. Can that debt, if paid, be deducted from the debtor's gross estate, a 'net gross estate' for purposes of computing the debtor's federal estate liability? Maybe so, more likely not.

Regulations: In 2009 the IRS published Regulations that address IRC 2053 deductions for debts owed to the decedent's family members. In essence these Regulations bar the deduction for a claim "to the extent it is founded on a transfer that is essentially donative in character, i.e., it is a mere cloak for a gift or bequest." [IRC2053(c)(1)(A).] Consistent with this Regulation, federal courts regularly note that "a testator is more likely to be making a bequest...than repaying a *real* contractual obligation." Accordingly, these Regulations seek to restrict an IRC 2053 estate tax deduction by expanding the requirements for an intrafamily transaction, such as a contractual obligation or a loan, to be considered *bona fide*, and thus deductible from the decedent's gross estate.

The Regulations list five separate factors that suggest that such a transfer, via a claim made by a family member against the decedent's estate at death, is *bona fide*:

1. The transaction underlying the outstanding claim against the decedent's estate occurs in the ordinary course of business, is negotiated at arm's length, and is free of donative intent.
2. The claim is not related to an expectation of a claim of inheritance.

3. The claim originates pursuant to an agreement between the decedent and a family member.
4. Performance by the 'claimant' stems from an agreement between the decedent and the family member.
5. All amounts paid in satisfaction or settlement of a claim or expense are reported by each party for federal income and employment tax purposes in a manner that is consistent with the reported nature of the claim or expense. [Regulation 20.2053-1(b)(2)(ii).]

Moreover, these Regulations define 'family members' to include the spouse of the decedent and lineal descendants of the decedent's spouse," i.e., stepchildren. [Regulation 20.2053-1(b)(2)(ii)(A).]

This Regulation was recently used by a federal appeals court to deny a \$3.0 million payment that was paid by the decedent's estate to satisfy a claim against the estate established under a prenuptial agreement.

Estate of Spizzirri v. Commissioner, 136 F.4th 1336 (11th Circuit, 2025)

Facts: In 1997, Richard entered into a prenuptial agreement with Holly. Richard was then 64. Holly was 48. Richard was worth \$27 million, with an annual income of about \$750,000, while Holly was worth just over \$1.0 million, with no income but with 3 children from her prior marriage. Holly was going to be Richard's fourth wife. Their negotiated prenuptial agreement waived rights in the other's separate property. In addition, Richard agreed to provide Holly with up to \$5.5 million, less the value of her 12.5% interest in the gross sales proceeds of Richard's Aspen home. They both agreed to waive any claim for alimony from the other.

Amendment: During their 18-year marriage Richard and Holly periodically modified their prenuptial agreement. In the third modification in 2005 Richard agreed to 'make and keep in effect a Will that provided that on his death Holly would receive a \$9.0 million cash payment, which included \$6.0 million payable to Holly and \$3.0 million to Holly's adult

children. Under this third modification to the prenuptial agreement Holly accepted its provisions in lieu of any other rights which may be available to her as Richard's surviving spouse.

No Will Provision: While the amended prenuptial agreement required Richard to execute a Will to reflect the amended prenuptial agreement, he failed to do so. While Richard the executed 4 codicils to his 1979 Will after the third amendment to the prenuptial agreement, he never amended his Will to include the terms that he agreed to in the modified prenuptial agreement that benefited his stepchildren.

Probate Court: When Richard died in 2015, his stepchildren filed claims in the Colorado probate court seeking payment under the modified prenuptial agreement. The Personal Representative of Richard's estate handled their probate claim, which was eventually satisfied with cash payments, including the payment of penalties for the delayed payment to the stepchildren. Richard's estate filed Form 1099-MISC with the IRS reporting the payments to the stepchildren as taxable income.

Dispute: Richard's estate tax return deducted the \$3.0+ million payments to the stepchildren as valid claims against the estate based on the obligation that Richard assumed under the amended prenuptial agreement. The IRS denied the deductions and issued a Notice of Deficiency. Richard's estate challenged the Notice of Deficiency.

Tax Court: The U.S. Tax Court denied the \$3.0+ million payment as a deductible claim against the estate, relying on the *bona fide* requirement of the Regulations. Richard's estate appealed.

Appellate Court: This Court affirmed the Tax Court's denial of the claims against Richard's estate as deductible, relying on the 2009 Regulations that deal with the 'intrafamily' claims paid at the decedent's death. The Court supported its conclusion with the following observation:

Heightened Scrutiny: In this type of situation, such transactions are subject to “particular scrutiny”, even when they apparently are supported by monetary consideration.

Stepchildren were Family Members: Because Richard’s stepchildren were Holly’s ‘lineal descendants’ that required even higher ‘particular scrutiny’ to the estate’s payments to the stepchildren as “it applies to transactions between family members.”

Not Arm’s Length: The estate’s witness testified that Richard had agreed to make the payments to his stepchildren in the prenuptial amendment ‘to keep his wife happy and to show largesse to her children’ because he wanted to keep Holly married to him. This reason for the amended prenuptial agreement “was not a sign of ‘arm’s length transaction in the ordinary course of business that qualifies as a claim against the estate.”

Donative Intent: While Richard and Holly later became estranged, the Court did not find that fact relevant, since donative intent was determined at the time of the agreement, meaning when the prenuptial agreement was amended. To support this conclusion the Court also noted that Richard regularly gave money to his stepchildren before his death, thus reflecting of his donative intent toward them.

Related to an Expectation of an Inheritance: Richard’s payments to his stepchildren were related to Holly’s expectation or claim of inheritance. Because these payments to his stepchildren were contracted ‘in lieu of’ Holly’s rights as a surviving spouse, the stepchildren’s claims were ‘related to Holly’s expectation or claim of inheritance.’

Stepchildren Provided No Consideration: The stepchildren’s’ claims did not originate from any transaction between Richard and his stepchildren. The stepchildren were not required to perform anything under their mother’s prenuptial agreement, and thus the transaction lacked the characteristics of a bona fide transaction.

Conclusion: In recent years the IRS, along with Congress, seems to be stepping up its challenges to the deductibility of claims filed against a decedent’s estate, with many more conditions and limitations on the amount of the deduction. The *Spizzirri* decision is just

another example of how such claims against a decedent's estate are not well received in the Tax Court. Since intrafamily claims are going to attract 'heightened scrutiny' by the IRS and the Tax Court, time would be well spent becoming familiar with the factors that the IRS has identified in its Regulations for what will be viewed as a *bona fide* debt that can be deducted from the decedent's gross estate.

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