Using the *Graegin* Loan Analysis for Intra Family Entities to Fund Estate Taxes

1. Estate Tax Illiquidity

One of the more complicated decisions is how to pay estate taxes, post mortem, when illiquidity exists because of family held businesses, including family limited partnerships. In those cases, outside of the family business entities, there are not sufficient assets to pay the estate taxes.

> Example*: Assume that John, a widower, has a house worth $1 million, limited partnership interests in a family limited partnership worth $3 million, and retirement plan assets worth $2m. Pursuant to his estate plan, the retirement plan assets go directly to his three children, without any obligation to pay estate taxes (to maximize the extension of time in which to defer income taxes and to take funds out of the IRA). In 2013, his projected estate tax, after including state inheritance taxes, is approximately $2 million. If the house is sold, his estate will acquire $1 million in liquidity to pay the taxes. His estate is still $1 million short to pay taxes. Assets from the partnership must be used, but how?*

Ideally, the estate would like to borrow from the family entity, and then deduct on the estate tax return the interest to be paid on the borrowing. If successful, the estate would deduct all future interest payments on the loan under Code section 2053 and the reasoning of the Tax Court in the *Graegin* decision. *Estate of Graegin v. C.I.R,* [1]discussed in JPTE article ______.

2. *Graegin*, Its Application and Its Possible Extension

An estate may deduct administration expenses allowable under the probate law of the jurisdiction where the estate is being administered,[2] and which are actually and necessarily incurred in administering a decedent's estate.[3]

Interest on funds borrowed to pay taxes or other debts of the estate while the estate is illiquid may be deductible as an administration expense under section 2053(a)(2).[4] If the amount of interest to be paid is ascertainable from the beginning, then the full amount of the interest to be paid is permitted as a deduction rather than the discounted

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[1] T.C. Memo 1988-477.

[2] Code sec.2053(a)(2).

[3] *Estate of Grant v. Commissioner,* 294 F.3d 352, 353 (2d Cir.2002), affg. T.C. Memo.1999-396; Treas. Reg. sec. 20.2053-3(a).

[4] *See, e.g., Estate of Todd v. Commissioner,* 57 T.C. 288, 1971 WL 2614 (1971) (9-month loan); *Estate of Thompson v. Commissioner,* T.C. Memo.1998-325 (series of five 1-year notes); *McKee v. Commissioner,* T.C. Memo.1996-362 (note with term of 85 days); *Estate of Graegin v. Commissioner,* T.C. Memo.1988-477 (loan with balloon payment in 15 years).

present value of the interest payments, thereby eliminating the need to file periodic claims for refund or encountering statute of limitations issues.

In order for the interest to be ascertainable, the loan must provide for a fixed rate as opposed to an adjustable rate of interest, and the loan must prohibit the prepayment of the amount borrowed unless all the interest that otherwise would have been due is also paid upon prepayment. *Graegin* and related cases require the following guidelines to be met in order to deduct interest incurred in borrowing funds to pay estate taxes:

- The loan must be actually and necessarily incurred in the administration of the decedent's estate -- the estate must be illiquid.
- The interest expense must be ascertainable with reasonable certainty and there must be assurances that it will be paid.
- The loan must be *bona fide* (related parties will be closely scrutinized).
- The lender must report the interest income.
- The authority to borrow to pay taxes must be allowable under local law.

All of these guidelines are necessarily met if the estate is illiquid and the funds to pay estate taxes are borrowed from a commercial lender. But borrowing from a family limited partnership, as would be the result in the example at the beginning of the article, is not the same as borrowing from a commercial lender. With a family limited partnership, the identity of the partners and the beneficiaries of the estate are often the same, or roughly the same, thereby calling into question the *bona fideness* of the loan, one of the required variables noted above.

3. Deducting Interest from Loans from Family Limited Partnerships?

In this regard, a negative ruling, TAM 200513028, initially created what seemed to be an insurmountable barrier in using *Graegin* with a family entity. In that TAM, the Service refused to extend the *Graegin* reasoning and allowability of future interest payments as estate tax deductions.

The Service refused to allow the deduction for future (post mortem) loan interest despite citing all the relevant authorities allowing such a deduction.[5] The Service was

[5] "In general, the courts and the IRS have concluded that interest expense incurred by an estate on funds borrowed by the estate can be a deductible administration expense provided the loan was reasonably and necessarily incurred in the administration of the estate. Rev. Rul. 84-75, 1984-1 C. B. 193 ("… because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D's estate."); Estate of Todd v. Commissioner, 57 T.C. 288 (1971)("the estate did not own any liquid assets at the time; and that if the estate liquidated some of its nonliquid assets, these would have had to have been sold at reduced prices."); Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, 35-36 ("We are convinced that the financial position of the estate at the time of the borrowing was insufficient to make the required tax payments and provide for the maintenance of Cane Mill [business property owned by the estate]"); McKee v. Commissioner, T.C. Memo. 1996-362 ("the executors

persuaded that the payment of interest did not change the economic consequences to the beneficiaries because the partners[6] and the beneficiaries of the estate were the same:

> "Further, we do not believe that the interest expense is deductible under § 2053 because: (1) it is questionable whether the Estate will actually make the payments in accordance with the terms of the arrangement; and (2) even if the Estate makes the payments in accordance with the terms of the arrangement, **the payments (whether characterized as interest or principal) will have no economic impact on the parties involved**" (emphasis added).

4. If at First You Fail, Try Again

The *Graegin* concept related to loans from family owned entities has been tried in Federal District Court since that TAM, resulting in taxpayer victories in *Estate of Murphy*, 104 AFTR 2d 2009-7703 (DC Ark, 2009), and *Estate of Keller*, 104 AFTR 2d 2009-6015 (D.C. Tex 2009).

Recently, the Tax Court considered the situation in *Duncan v. Commr'r,* T.C. Memo 2011-255. In *Duncan*, prior to the decedent's death, the decedent's father had set up a trust for the benefit of the decedent and his family, referred to by the court as the "Walter Trust." The decedent exercised a power of appointment over the Walter Trust to set up trusts for the benefit of his children similar to what he set up for them under his estate plan.[7]

At decedent's death, the estate raised approximately $5.2 million of an estimated $11.1 million federal estate tax liability. To pay the balance, it borrowed about $6.4 million from the Walther Trust. The loan was for 15 years (set up in in 2006), at a 6.7 % interest rate. The Service found the loan structure to be a bit too familial and refused to allow a 2053 deduction for the interest to be paid. In reading the TAM, one would expect the Service to take that position, to refuse to allow a *Graegin* type structure for estate tax purposes for a loan from the Walter Trust.

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determined that it was preferable to preserve all of decedent's [closely-held] stock and to borrow funds… in order to better ensure the estate's ability to pay its obligations."); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477 ("[t]o avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability."); Estate of Huntington v. Commissioner, 36 B.T.A. 698, 726 (1937) ("[t]he issuance of the notes avoided the necessity of sacrificing the assets of the estate by immediate or forced sale"). See also, Hibernia Bank v. United States, 581 F.2d 741 (9th Cir. 1978)."

[6] Family members owned 99% of a FLP holding liquid assets.

[7] In both the Walter Trust and decedent's living trust, the decedent owned a non-controlling (a limited partnership) interest in an operating oil and gas partnership.

On the surface, the Service had a point. The opinion indicated that the estate claimed a $10.6 million dollar deduction[8] for money paid to, in essence, the beneficiaries of the estate.[9] Since the beneficiaries of the Walter trust were the same as the beneficiaries of the decedent's trusts, money was just being circulated from one to the other.

The court did not seem to be bothered by this closeness, by the 15 year payout period, or the interest rate. It allowed the estate to deduct the interest under 2053, concluding:

"We find that the loan was a bona fide debt, the interest expense was actually and necessarily incurred in the administration of the estate, and the amount of the interest was ascertainable with reasonable certainty."

The court concluded that the two trusts—borrower and lender-- were distinct trusts under Illinois law, and therefore could engage in business relations regardless of the similarity of the beneficiaries: "Illinois State law requires a trustee of two distinct trusts to maintain the trusts' individuality."

The court gave great deference to the terms negotiated by the parties and the reasonableness of the loan structure.[10] It rejected the argument that there were no negotiations, creating dicta that is important to this and other cases:

> "Formal negotiations would have amounted to nothing more than playacting, and to impose such a requirement on the co-trustees would be absurd. [The parties] made a good faith effort to select an interest rate that was fair to both trusts."

5. *Duncan* Lessons: Perhaps a Pyrrhic Victory

Among the takeaways, the court has certainly created an argument for a loan from a family limited partnership; but perhaps the partnership should be one created by one other than the decedent.

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[8] Strange that this was the amount of the deduction. At a 6.7 % interest rate, 15 years of interest on a $6.4 million dollar loan equals about 6.7 million of interest. If the interest were compounded annually, this would add about another $4 million to the deduction. One may argue that adding interest on to the principal of the loan on an annual basis was not commercially reasonable. That point was not discussed by the Tax Court Judge.

[9] Note, the Walter Trust flowed, via the power of appointment, to trusts for the benefit of the decedent's children, just like the trusts created for decedent's children under the estate plan. Hence, the interest was being paid to the decedent's children, in essence.

[10] The court further concluded that even though the parties were related, there was no reason to think they would simply ignore the loan rate and not pay the interest, a real problem if the tax structure is to be followed.

Certainly, the decedent can have no general partnership interest in the entity, or the court could merely conclude that the decedent, as general partner, could force the dissolution of the partnership or force the partnership to distribute assets to pay the estate tax.

And the end result is not as Win-Win as it may appear. True that the estate gets up an up front estate tax deduction, a good thing. But the estate must make interest payments each year, without a corresponding income tax deduction.

Think about the result in year 2012. The marginal federal estate tax rate is 35 %. For every dollar of interest payment, the estate saves 35 cents in estate taxes. But each dollar of interest could carry with it an income tax to the lender, a family entity, of 39 % or higher (as taxable income goes up, certain deductions are phased out). This would cost the family in the future 39 cents for each dollar, a net dollar loss. The net result is that planners must be careful with this strategy. In some cases, the strategy may be merely a deferral of the ultimate tax bite, versus a true tax savings plan.