Headline: Borrowing To Pay Estate Tax

Deck: What to do when there's not enough bucks to take care of the financial damage

Byline: Louis S. Harrison

Byline Tag:

Estates with closely held businesses, family limited partnership, or commercial real estate (and occasionally, very expensive residential real estate) often run into issues of how to pay the estate tax within nine months of passing. And in those instances, insurance is not always available or purchased to provide the liquidity.

Then, the primary decisions are which of four methods—internal financing, third party financing, discretionarily allowed extension under Internal Revenue Code Section 6161, or mandatory extension under IRC Section 6166—the estate could or should use to pay estate taxes when readily available liquidity is insufficient within nine months of passing.

Here's a step-by-step look at the principles and decisions when choosing a source of payment for estate taxes.; and after this discussion, proposes heuristics as to whether third party financing or section 6166 (if available) should be used and under which circumstances.[1]

Subhed: Amount Needed?

With all new estate administration matters, the practitioner needs to make an initial determination as to whether an estate tax return will be required to be filed. The thinking is that no estate tax return is required for gross estates less than $3.5 million in 2009. But this heuristic is over-simplified. Rather, three variables complicate this rule of thumb:

(1) Congress is constantly fiddling with this threshold amount. [Insert Senate bills]

(2) The term "gross estate" is a tax term defined by the IRC that is not tied directly to probate matters and is much more expansive than most people think. Many assets that those unfamiliar with estate tax returns may think aren't subject to estate tax may actually be (for example,

[1] Heuristics, or rules of thumb, are interesting parts of an estate planning practice: as decisions become more complex, and in many matters, almost beyond the comprehension and attention by clients, planners often approach clients with the "desired" decision, for clients to consider. Hence, heuristics in our field play an important part in any complicated decision-making process that confronts clients in the estate administration front.

insurance, retained fiduciary appointments under IRC Section 2036, and joint interests). Clearly, it's critical to conduct a careful review of a client's financial portfolio.

(3) Lifetime taxable gifts, that is to say those using unified credit (also known as the "applicable credit amount"), reduce the threshold amount. For example, a gross estate of $10,000 still may require an estate tax return be filed if the client has made lifetime taxable gifts of $3.5 million or more.

The specific rule is that for estates of decedents who died during or after 2009, an estate tax return is required only if the gross estate plus adjusted taxable gifts exceeds the "applicable exclusion amount," because a credit of the "applicable credit amount" is allowed to the estate of every decedent against the tax imposed by IRC Section 2001. The applicable exclusion amounts and applicable credit amounts for 2009 and subsequent years are:

- in 2009, $3.5 million;
- in 2010, supposedly there will be no estate tax (don't hold your breath); then
- in 2011 and beyond, it's set to go back down to $1 million (but no one expects this to happen.)

Congressional bills currently being considered would freeze the $3.5 million amount for years 2010 and thereafter. [check]

Subhed: Deadlines

It's crucial that the practitioner ensure the estate tax return filing date is honored. From the moment one gets a file, ticklers should be placed in it. Without extension, the estate tax return must be filed and the tax paid within nine months after the date the decedent died.[2] The exact due date is the day of the ninth calendar month after death numerically corresponding to the day of the calendar month on which death occurred, modified by the following two exceptions:

(1) If there is no numerically corresponding day in the ninth month, the due date is the last day of the month. For example, say the decedent died on May 31. The ninth calendar month thereafter

[2] Internal Revenue Code Section 6075(a).

is February, which typically has only 28 days. The due date would be, therefore, the last day of February.[3]

(2) If the due date falls on a Saturday, Sunday or legal holiday, the next day that is not a Saturday, Sunday, or legal holiday is the due date.[4] For example, if the decedent died May 7, 2008, the return would be due Feb. 9, 2009.

Granting an extension for filing is now mandatory if it's applied for before the return due date. The request must be filed before the expiration of nine months after the date of death. The automatic extension now allowed for filing a return may not be more than six months.[5] The regulations do not allow the district director to grant an additional extension of time for filing the return beyond the six months (except for taxpayers who are abroad). From a practical standpoint, this means that in most circumstances both filing and payment will occur on the required date. Unlike an income tax return, for which extensions are quite common, an extension on the filing of an estate tax return should be treated as unusual. It's to be avoided unless there is a planning reason to extend. There still are penalties, .005 percent of the tax due per month, for the underpayment of the estate tax due as of the required payment date.

Extending the filing date does not extend the due date for tax payment.[6] The actual estate tax payment is due within nine months from death, except if an extension of time to pay is received. And granting that extension is discretionary under IRC Section 6161 or pursuant to an election to pay the estate tax in installments under IRC Section 6166.

As a practical matter, payment should not occur much before the required payment date. There's no discount for paying early; it's simply, in effect, an interest-free loan to the government. At a six-percent earnings rate, the payment one month early of $1 million costs the estate $5,000 in lost income.

[3] Treasury Regulations Section 20.6075-1.

[4] *Ibid.*

[5] Treas. Regs. Section 20.6081-1(b).

[6] IRC Section 6151(a).

But it is advisable to be ready to make the payment and perhaps even to file and pay one day early, in case there are any mishaps. That way, the executor has a day to correct problems and still make the filing and payment on time.

Subhed: Extensions

IRC Section 6161(a)(2) authorizes the Secretary to extend "for reasonable cause" the time for payment of the federal estate tax (or any installment under IRC Section 6166) for a reasonable period not exceeding 10 years from the date the tax was due.

Specifically, the regulations provide that if there is "reasonable cause" the time period for filing may be extended up to 12 months.[7] If, in addition to "reasonable cause" there is a showing of "undue hardship," the time period for filing may be extended up to 10 years.[8] The instructions to the 706 provide, importantly, that even with a showing of "undue hardship" the extensions may be granted only "for 1 year at a time."[9]

Under Treasury Regulations Section 20.6161-1, reasonable cause is illustrated by four examples (to which I've added some commentary and notes on relevance):

Example (1)—An estate includes sufficient liquid assets to pay the estate tax when otherwise due, but these assets are located in several jurisdictions and not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence. (This situation is unlikely to arise; rare.)

Example (2)—An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (for example, annuities, copyright royalties, contingent fees or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms that would inflict loss upon the estate. (This is another situation that is unlikely to arise; rare.)

---

[7] Treas. Regs. Section 20.6161-1(a)(1).

[8] Treas. Regs. Section 20.6161-1(a)(2).

[9] Extensions for deficiency payments can also be extended for up to 4 years with a showing of undue hardship. Treas. Reg. §20.6161-2.

Example (3)—An estate includes a claim to substantial assets that cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due. (Another unlikely scenario; rarely occurs.)

Example (4)—An estate does not have sufficient funds (without borrowing at a rate of interest higher than what is generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash. (The phrase "without borrowing at a rate of interest higher than that generally available" seems to take most cases out of this example.)

As none of these examples are pertinent to modern economic situations facing an estate, the executor should develop another rationale as to why, as the 706 instructions put it: "it is impossible or impractical for the executor to pay the full amount of the estate by the estate tax return due date."

Strategies that should satisfy this standard include:

(1) pending will or trust contests;

(2) construction actions;

(3) illiquidity and inability to generate cash from illiquid assets; and

(4) litigation or indecision between two or more executors in determining which assets to use or how to pay the estate tax.

To get an extension beyond one year, an estate must show "undue hardship." The term "undue hardship" means more than an inconvenience to the estate.

According to the regulations, “A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate.” The negative implication is that a sale at less than fair market value (FMV), or on a non-public market should show undue hardship. In the current market, lack of marketability reasons is prevalent.

The regulations contain the two examples:

Example (1)—A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of IRC Section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its FMV, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.

Example (2)—The assets in the gross estate that must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.

If the request is granted, the estate tax due with it interest at the federal short-term rate plus 3%.[10] This rate on this interest, after the application of the deduction, is greater than that on T-bills and expensive in today's interest rate environment. The interest should be a deduction against the estate tax, unlike the Section 6166 interest rate, which is reduced to .45 of the required rate. The current highest marginal estate tax rate is 45 percent. As a result, a deduction reduces the 6161 rate to 55 percent of the required 6621 rate (unless a share of the residue qualifies for the charitable or marital deduction, in which case the 55 percent figure will be impacted by an interrelated computation.) For example, if the short term AFR is 1%, then the interest rate is 4%, but the real plan is only 55% times 4%, or effectively 2%.

An application under IRC Section 6161 should be made on Form 4768, the “Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping

[10] See Tech.Adv.Mem. 9241002 (July 23, 1992); Rev.Proc. 81-27, 1981-2 Cum.Bull. 548; Rev.Rul. 80-250, 1980-2 Cum.Bull. 278).

Transfer) Taxes." The form must be filed on, or before the due date for payment of tax.[11] The executor may be required to furnish a bond not exceeding double the amount of the tax due for the payment of the amount covered by the extension.[12]

As a practical matter, because the extension is discretionary, the request should be made early in the return preparation process, before the six-month mark. Most practitioners (for a variety of reasons unrelated necessarily to tax planning) wait until the last minute and file the form right before the nine-month mark, then hold their breath hoping for acceptance.

Subhed**: Section 6166**

The most important election to defer the payment of estate tax is pursuant to IRC Section 6166. This section allows the deferral and payment in installments of federal estate taxes relating to an interest in a closely held business. To qualify, a decedent must have an interest in a closely held business and be a citizen or resident of the United States, and the business interest must exceed 35 percent of the decedent's adjusted gross estate.[13]

The term "closely held business" includes an interest as a proprietor in a trade or business, an interest in a partnership carrying on a trade or business if 20 percent or more of the total capital interest is included in determining the gross estate of the decedent or the partnership has 15 or fewer partners, or stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock is included in determining the gross estate of the decedent or the corporation has 15 or fewer shareholders.[14]

The representative may request that the Section 6166 election be treated as a timely filed application for an extension under Section 6161. This rarely will be a concern, because in most instances the representative will know whether the estate qualifies under Section 6166. The one exception is when there are valuation disputes (about assets other than the closely held business, no doubt), or active versus passive concerns with the Service. Multiple operating partnerships are

---

[11] Treas.Regs. Section 20.6161-1(b).

[12] IRC Section 6165.

[13] IRC Section 6166(a)(1).

[14] IRC Section 6166(b)(1).

aggregated for purposes of determining the 35 percent qualification (and also the deferral amount that is available).

At least 20 percent of the capital interest in a partnership (or the partnership had no more than 45 partners) or 20 percent of the voting interest in a corporation (or the corporation had no more than 45 shareholders) must be includable in the gross estate.

If the decedent owned a business interest through a holding company, the holding company interests cannot count toward the deferral amount unless the executor makes an election under IRC Section 6166(b)(8). The election causes the 2 percent portion to be deemed to be zero (that is to say, in 2009, the first $598,500 of tax will be charged the higher quarterly interest rate instead of 2 percent), and causes the first installment of tax to be due on the filing date (that is to say, the five-year deferral of principal is not available).

If deferral is allowed under IRC Section 6166, then a certain amount of the estate tax can be paid in installments. That amount is the fraction of the estate tax equivalent to the ratio of the closely held business amount to the value of the gross estate, with certain adjustments.[15]

The first installment can be paid any time on or before five years and nine months after the date of the decedent's death.[16] Each succeeding installment is to be paid annually.[17]

Interest is payable under IRC Section 6601 both during the first five years from the date the estate tax should have been paid and during the installment period.[18]

Specifically, only interest on the unpaid balance is due on the first four anniversary dates after the due date. No payment is required on the filing date. The first tax payment (along with the interest payment) is due on the fifth anniversary of the due date of the return. Each year the estate must file an information return with the Service coordinating with the payment that year. (Note that this requirement may be substantially less onerous than those requirements that would be associated with a third party loan.)

---

[15] IRC Section 6166(a)(2). (Be careful though because there are unusual attribution rules that could apply in determining if the 20% applies. *See, e.g.*, PLR 200529006.

[16] IRC Sections 6166(a)(3), 6151(a).

[17] IRC Section 6166(a)(3).

[18] IRC Section 6166(f).

Principal payments (that is to say, those made in the fifth year and thereafter) are applied pro rata to the 2 percent and non-2 percent portions. That is to say the estate cannot pay down the higher-interest-rate portion more quickly than it pays down the 2 percent portion of principal.[19] How much tax can be deferred? Here's the formula for calculating it: It's (the estate of the tax value of closely held business interests divided by the adjusted gross estate) multiplied by the total federal estate tax. Here, the adjusted gross estate equals the (gross estate) minus (debts and expenses under IRC Sections 2053 and 2054.) For purposes of determining whether the closely held business amount exceeds 35 percent of the adjusted gross estate, the value of any interest in a closely held business does not include the value of the interest that is attributable to passive assets held by the business.[20]

The term "passive assets" means assets other than those used in carrying on a trade or business. Also, for a decedent's interest to qualify for the election, the proprietorship, partnership or corporation must be engaged in an active trade or business at the time of the decedent's death. If all of the decedent's real estate was owned through limited partnerships, the IRS may examine the partnership's level of activity to determine whether the decedent's partnership interest qualifies under 6166.[21] The activities of any partner, employee, or agent of the partnership will be considered the partnership's activities. [22]

A family limited partnership (FLP) with marketable investment assets is passive and will not qualify for a Section 6166 deferral.

A FLP with active rental real estate operations could be active. Most rulings on active versus passive focus on rental real estate. For rental real estate operations, the minimum activity level is a facts-and-circumstances test. Revenue Ruling 2006-34 (June 26, 2006) provides a "nonexclusive" list of factors that the IRS will examine to determine whether the entity's level of activity is sufficient for IRC Section 6166.

---

[19] IRC Section 6601(j)(4).

[20] IRC Section 6166(b)(9). Ponder whether capital reserves in a business can be justified as necessary for "net working capital" or future "capital expenditures."

[21] *See* Rev. Rul. 2006-34.

[22] *See Ibid.*

Activities of agents and employees will be considered. Modest activity by independent contractors will not automatically disqualify the business, especially if their services are of the type that the business itself could not provide, and if the work is carefully reviewed. The use of a third party management firm (in which the company had no ownership interest) weighs heavily against an active trade or business.

Many PLRs that were issued before Revenue Ruling 2006-34 also provide examples of what qualifies. The Internal Revenue Manual specifically cites PLRs 200518047 (May 6, 2005) and. 200521014 (May 27, 2005) as representing the current IRS view (presumably these two PLRs are still consistent with Rev. Rul. 2006-34 despite being issued earlier in time).

There are two primary reasons for an estate to elect deferral under Section 6166:

(1) The estate may not have the liquidity to pay the estate taxes nine months after date of death. Liquid assets outside of the business may be unavailable or insufficient. Further, the business may not have the capital and may not be capable of sustaining additional debt.

(2) Even if there are sufficient liquid assets to pay the tax at one time, economic considerations may militate in favor of deferral. From an economic perspective, a quantification of the benefits expected from the deferral must be carefully compared with the costs of the deferral, such as the interest paid during the installment payment period. Accordingly, an estate may desire to use Section 6166 for economic reasons if it can earn at a greater growth rate than the effective interest rate on the unpaid installment.

There is an *economic benefit* in electing Section 6166 deferral if the business itself appreciates on an after-tax rate greater than the effective interest rate. Then, even taking into account the interest paid, the family will be better off economically by deferring the payment of estate tax as opposed to paying it in a lump sum nine months after the date of death.

For example, assume an estate that owes $500,000 in estate taxes owns a company worth $1.7 million. The company, an S corporation, has available $500,000 in liquid assets from previously earned and taxed receipts. It reinvests the assets of the business in such a way that the overall value of the company, after consideration of any inherent capital gains tax, is growing at a rate of 10 percent. The estate elects Section 6166 deferral. Assume that the estate's first principal payment on the tax due is $50,000, with an additional $20,000 in interest ($500,000 multiplied by an average interest rate of four percent). As an S corporation, the company makes a dividend distribution, which can be done free of income tax to the estate, of $70,000 to cover the payment. Even if the business were a C corporation, IRC Section 303 could be used to allow after-tax distributions to the estate to pay the tax.

Should the company have distributed the $500,000 in a lump sum to the estate to avoid this $20,000 (and each future) interest charge? If so, the company would have lost the ability to realize the projected 10 percent per annum growth on that $500,000. Ignoring cumulative return on earnings, the cost to the company would have been the loss of $50,000 per annum. By electing the deferral, the company is benefiting by $50,000 minus the $20,000 effective interest cost, or $30,000 a year.

Interest is charged on the unpaid principal balance during the deferral period. The interest rate is 2 percent for the first $562,500 (for a decedent dying in 2007) or $576,000 (for a decedent dying in 2008), and $598,500 (for a decedent dying in 2009) of deferred estate taxes. The deferred estate taxes are the deferred tax attributable to the first $1.25 million (for a decedent dying in 2007), $1.28 million (for a decedent dying in 2008), or $1,330,000 (for a decedent dying in 2009) in value in excess of the useable applicable exclusion amount at death.[23]

The *lesser* of the following amounts is qualified for a 2 percent interest rate under IRC Section 6601(j):

• the amount of the tax that is extended under IRC Section 6166; or

• (the hypothetical tax on $1.25 million [for a decedent dying in 2007] or $1,280,000 [for a decedent dying in 2008], or $1,330,000 [for a decedent dying in 2009]) plus (the hypothetical tax on current applicable exclusion amount of $2 million [a figure that changes each year under the IRC]) minus ($780,800 current applicable credit amount). That equals $562,500 [for a decedent dying in 2007], $576,000 [for a decedent dying in 2008], and $598,500 (for a decedent dying in 2009)..

[23] IRC Section 6601(j).

On the excess amount of estate tax, the interest charge is 45 percent multiplied by the federal short-term rate plus 3 percent.[24] At 4 percent for the first quarter of the extension, the interest rate would be 1.8 percent. The rate is subject to change each quarter thereafter.

Subhed: Avoid Acceleration

When paying estate taxes on the installment plan, IRC Section 6166(g) provides a boundary that needs to be considered: The extension of time for the payment of tax provided for under Section 6166 ceases to apply if any portion of an interest in a closely held business that qualifies under Section 6166 is distributed, sold, exchanged or otherwise disposed of and the aggregate of these dispositions and withdrawals equals or exceeds 50 percent of the estate tax value of the business interest.[25]

With each installment payment, the executor must file a report of all withdrawal and liquidation activity that has occurred.

There can be drastic and unexpected results when Section 6166(g) applies to a buy-out agreement requiring mandatory purchase of stock upon a deceased shareholder's death. For example, the typical buy-out agreement provides the purchase can be satisfied by a promissory note that can be paid in one or more installments. When the stock is exchanged for the promissory note, usually at the closing, there's a disposition of more than 50 percent of the value of the stock. The exceptions to Section 6166(g) do not apply (such as a distribution of the stock from the deceased shareholder to a beneficiary under the estate plan documents).[26] Instead, the

[24] IRC Section 6621(a)(2).

[25] IRC Section 6166(g)(1).The due dates for installments are accelerated if:

(a) The Estate has undistributed net income (i.e., DNI reduced by deductions, income taxes, and estate tax installments) for a taxable year ending on or after the first installment due date. Code § 6166(g)(2).

(b) 50% or more of the value of the entire entity is withdrawn (on a cumulative basis). In the partnership setting, at a minimum, this means that 50% of the commercial activities are sold and the proceeds distributed. If the underlying real estate in the partnership is sold, but the net proceeds are retained in the partnership, the acceleration provisions will not be triggered. Acceleration is triggered by the distribution/withdrawal of funds from the partnership (amounting to 50% of the estate tax value, on a cumulative basis). See, e.g., Rev. Rul. 89-4 (Jan. 9, 1989).

50% or more of the decedent's interest in the entity is distributed (unless the distribution is to the decedent's beneficiaries pursuant to his trust or Will), sold, exchanged, or disposed of (on a cumulative basis).

[26] IRC Section 6166(g)(1)(D). See Tech.Adv.Mem. 8506004 (Nov. 5, 1984).

acceleration clause is initiated and Section 6166 ceases to apply. The remaining estate tax is due. But because the deceased shareholder's estate has received only a promissory note and no cash, there may be insufficient cash to make that payment. The buy-out agreement has created a liquidity crisis.

For example, assume the two shareholders of a company enter into a cross-purchase agreement for the sale of each of their 50 percent interests in the company. The agreement provides that within six months of a shareholder's death, his estate must sell all of his interest to the surviving shareholder. The price is determined pursuant to a formula. Also, the amount to be paid in cash at closing is equal to the amount of available insurance proceeds on the deceased shareholder's life passing to the surviving shareholder or, if greater, 30 percent of the purchase price. The remaining amount can be represented by a promissory note payable in 10 equal installments. Each owns an insurance policy with a face value of $500,000 on the life of the other.

When the first shareholder dies, his stock interest is determined to be worth $2 million. Yet only $500,000 is available in insurance. Under the agreement, $600,000 is paid at closing (30 percent) and $1.4 million is paid by a promissory note. If the shareholder's taxable estate, other than the $2 million in stock, exceeds $2 million, the $2 million in stock is taxed at a marginal (federal and estate) rate of 50 percent and results in about $1 million due in additional tax. But only $600,000 in cash has been received. Although, the shareholder had intended that his estate pay the remaining $404,000 in installments under Section 6166, Section 6166(g) results in the deferral being unavailable. If the IRS declines to grant a discretionary extension of time to pay under Section 6161, the estate must find an additional $400,000 of liquidity within nine months of the shareholder's passing.

subhed: Form 706

Form 706 provides that the election to defer tax under IRC Section 6166 be made by checking the appropriate box in response to question 3 of part 3 and submitting with the return "the additional information described on page 9 of the instructions." But these instructions are not the model of clarity, as they're generally disorganized and the information needed is not made very clear. Also, the IRS prescribes no additional form.

A notice of election should contain:

(1) the decedent's name and Social Security number;
(2) calculation of the maximum amount that can be paid in installments;
(3) the amount of tax that is to be paid in installments;
(4) the date selected for payment of the first installment;
(5) the number of annual installments, including the first installment, in which the tax is to be paid;
(6) the properties shown on the estate tax return that constitute the closely held business interest (identified by schedule and item number); and
(7) the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments (spreadsheets are recommended).[27]
(8) The practitioner should also indicate whether the notice is a protective or final election.[28]

Subhed: Third Party Financing

An estate may deduct administration expenses that are allowable under the probate law of the jurisdiction where the estate is being administered,[29] and that are actually and necessarily incurred in administering a decedent's estate.[30]

Interest on funds borrowed to pay taxes or other debts of the estate while the estate is illiquid (for example, if the estate assets cannot be immediately liquidated) may be deductible as an administration expense under Section 2053(a)(2).[31] Specifically, in *Estate of Todd v. Commissioner*, [32] the Tax Court held that interest incurred for a loan to pay federal estate taxes and state inheritance taxes was an allowable administration expense.

[27] Treas.Regs. Section 20.6166-1(b).

[28] Treas. Regs. Section 20.6166-1(d).

[29] IRC Section 2053(a)(2).

[30] *Estate of Grant v. Comm'r*, 294 F.3d 352, 353 (2d Cir.2002), affg. T.C. Memo.1999-396; Treas. Regs. Section 20.2053-3(a).

[31] *See, for example, Estate of Todd v. Comm'r,* 57 T.C. 288, 1971 WL 2614 (1971) (nine-month loan); *Estate of Thompson v. Comm'r,* T.C. Memo.1998-325 (series of five 1-year notes); *McKee v. Comm'r,* T.C. Memo.1996-362 (note with term of 85 days); *Estate of Graegin v. Comm'r,* T.C. Memo.1988-477 (loan with balloon payment in 15 years).

[32] 57 T.C. 288 (1971)

More interestingly, projected interest payments may be deductible for estate tax purposes as administration expenses.[33] If the amount of interest to be paid is ascertainable from the beginning, the full amount of the interest to be paid may be permitted as a deduction rather than the discounted present value of the interest payments, thereby eliminating the need to file periodic claims for refund or encountering statute of limitations issues.

For the interest to be ascertainable, the loan must provide for a fixed rather than 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. The most cited case for this proposition is *Estate of Graegin v. C.I.R*.[34] There, the lender was the decedent's closely held operating company—the actual cause of the estate's liquidity problem. The decedent's son was both a co-executor of the decedent's estate and the president of the closely held company involved. The court analyzed the long-term loan from the decedent's closely held corporation—15 years—to determine if the interest was really going to be paid for the full 15 years and whether this was really a loan.

The court said, " "While we agree with respondent that loans between a debtor and creditor having an identity of interest require close scrutiny, such identity of interest per se is not fatal in characterizing the transaction as a loan. We are mindful of the potential for abuse presented by the facts in this case; however, we found Paul Graegin's testimony regarding his intention with respect to the repayment of the note credible."

With regard to the identity of the lender being the closely held corporation, the court indicated that there were enough checks and balances on repayment to make the loan credible.[35]

The court concluded that the interest rate was ascertainable because it was a fixed rate loan. Treasury Regs. Section 20.2053-1(b)(3) requires both that the amount of the estimated

[33] Estate of Bahr v. Commissioner, 68 T.C. 74 (1977).

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

[35] Specifically, the court said: "In addition, presumably the outside shareholder (Stephen Curtis) would complain if the loan is not timely paid. We believe the interest rate was reasonable, even though it was based on the prime rate of interest (a short term obligation interest rate) whereas the loan in question was for a 15-year period. While we are disturbed by the fact that the note requires only a single payment of principal and interest, such a repayment term is not unreasonable given the decedent's post-mortem asset arrangement. Finally, we note that both the Bank and the guardian ad litem for the minor heirs, even though they were not adverse parties, concurred in the decision to borrow from Graegin Corporation and that the local court having jurisdiction over the decedent's estate approved the borrowing. Thus, all matters considered, we believe the loan from Graegin Corporation was a genuine indebtedness."

expense be ascertainable with reasonable certainty and that it be paid. Onn both points in *GraeginGragein*, the court was satisfied.[36]

In a somewhat similar case, *Klein v. Hughes,*[37] the IRS allowed a deduction for interest on a loan to pay estate taxes in the amount of $50 million. The lender was a limited liability company (LLC) created by the decedent's tax attorney. The lender was to borrow the funds from the decedent's company (a holding company for fractional interests in a number of LLCs from which the decedent could not compel distributions) and loan those funds at a higher rate to the decedent's trust. The lending LLC received a closing fee and was to earn fees based on the spread on the loan.

The note called for a balloon payment of interest and principal payable 25 years in the future with prepayments prohibited. It was estimated that the estate would incur $309 million expense by the time the loan was due. The IRS and the appropriate court allowed the deduction of the entire interest expense without requiring a present value calculation.

In another case, *Estate of Gilman,*[38] the estate's representatives, in a post-death restructuring of the decedent's $611 million estate, managed to disqualify the estate for 6166 installment payments and create a degree of illiquidity in the form of promissory notes payable from several of the decedent's businesses. The court's reasoning in allowing the deduction of $38 million in interest to pay estate taxes was similar to that in *Graegin* and *Klein,* that a deduction is permitted if the loan is bona fide and necessary to pay legitimately incurred obligations of the estate.

Graegin and related cases require certain guidelines to be met in order to deduct interest incurred in borrowing funds to pay estate taxes:

---

[36] Here the court found:

"Here, the amount of interest on the note is not vague or uncertain but instead is capable of calculation ($204,218 x 15% x 15 years = $459,491). The promissory note couldcold not be prepaid, either as to principal or interest. As stated, we found credible Paul Graegin's testimony as to his intent to cause the loan to be timely repaid. Accordingly, we conclude that the amount of interest on the note is ascertainable with reasonable certainty, and that it will be paid. "

[37] 2004 WL 838198 (Cal. App. 1 Dist. 2004) – (Unreported case).

[38] TCM 2004-286

• The loan must be actually and necessarily incurred in the administration of the decedent's estate, *i.e.*, 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 these guidelines are necessarily met if the estate is illiquid and the funds to pay estate taxes are borrowed from a commercial lender. All can be met even with a FLP. But the IRS will not necessarily allow the accelerated interest deduction for estate tax purposes in the FLP setting.

For example: assume that John, a widower, dies in 2008 having a house worth $1 million, limited partnership interests in an FLP worth $3 million, and retirement plan assets worth $2 million. 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.) His projected estate tax, after including state inheritance taxes, is about $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?

How then would the estate tax be paid if the partnership assets are needed for this purpose? One possibility is a partial distribution to the partners, with the partners contributing assets to the estate (either as loans or "reverse" advancements) to pay the estate tax. An alterative would be, if the estate is a partner, a pro rata distribution to all the partners to allow the estate liquidity to pay the estate taxes. Both these options increase the ability of the IRS to assert Section 2036 (a) (1). For example, the Service could argue that the partnership was intended from inception to be available to pay estate taxes, and therefore evidenced an implied retention.

Another solution: the partnership could loan money to the estate for this purpose. This approach has less of a Section 2036 taint. Also, if this route is taken, the question is whether the estate gets to deduct all future interest payments on the loan because of the *Graegin* decision.

Subhed: FLPs

How close to the edge is this approach, including the Section 2036 argument? Well, it does require a tough countenance and a clear understanding that it could increase audit scrutiny.

The interest deduction and FLP valuation discount issues have a lot of common elements—and the IRS approach to each is very similar. Generally, the IRS denies the *Graegin*-like deduction in cases when the liquidity is the result of an asset or assets held by the estate that have no valid business purpose or economic reality and are nothing more than wrappers to enable the estate to qualify for various valuation discounts. Given the number of cases in the last five years that apply Section 2036 to invalidate discounts in family partnerships without economic substance, the IRS scrutiny on this element will be substantial.

If the partnership consists of readily marketable assets, then for the loan to be sustainable, it must at a minimum have a justifiable and sustainable business purpose. Also, the ability of the family to control the partnership will be a devastating fact. The Service's strongest argument is that the loan arrangement with a family partnership does not change the economic interests of the partners—and therefore must be disregarded.

In this regard, a negative ruling, Technical Advice Memorandum 200513028, addresses the bad fact partnership cases the IRS will look for in terms of liquidity and economic reality:

• Family members owned 99 percent of a FLP holding liquid assets.

• The executor had the ability to liquidate the internal assets of the FLP.

• Over half of the internal assets of the FLP consisted of readily marketable securities.

• There was no demonstrable economic purpose to the partnership.

• The family (but not the estate) could control the distribution from the partnership.

The Service refused to allow the deduction for interest despite citing all the relevant authorities allowing such a deduction.[39] The court was persuaded that the payment of interest did not change the economic consequences to the beneficiaries because the partners and the beneficiaries of the estate were the same: "Further, we do not believe that the interest expense is deductible under section 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."

Subhed: *Graegin* or 6166?

Whether to incur a loan and attempt to deduct all future interest payments requires a financial analysis, and needs to be decided on a case-by-case basis. But in those estates that are illiquid and in which third party financing is desired, interest payments can be structured to be deductible a la *Graegin* and related decisions.

If the loan is a commercial loan, at a fixed and reasonable rate of interest, the IRS can only attempt to establish that the alleged illiquidity is illusory, that is to say that the loan was unnecessary.

If the loan is a noncommercial one, from an FLP, this could bolster the Service's attempt to disregard the partnership under Section 2036, though I believe the IRS' argument here to be fallacious. More concerning, if the underlying partnership is demonstrated not to have economic substance or if the estate can force liquidation of the assets in the partnership, the Service could

[39] "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," citing 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 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)."

argue that the loan was unnecessary—that distributions to the partners could have been made instead—and disallow the interest payments.

So how does one go about deciding which a client choose, a *Graegin*-type loan or a Section 6166 payment plan? The variables in this analysis are complex and, from a practical standpoint, make a side-by-side comparison difficult. The economic analysis can focus on cash flow and determine which approach will generate more cash flow for the estate (or lose less, as the case may be).

But, before we even get to the cash flow concerns, we need to acknowledge that others factors make it pragmatically hard to determine which route to select. For example, with Section 6166, the estate can pay off the estate tax obligation earlier, if the liquidity emerges or for other investment reasons. But with the *Graegin* loan, there is in essence no prepayment possibility and the interest must be paid through the term.

Conversely, with *Graegin*, the interest rate is fixed, whereas under Section 6166, the interest rate is variable and could increase or decrease based on economic conditions. For example, in a hyperinflation environment, the election of Section 6166 would prove horrible, far worse than having done a *Graegin* loan.[40]

With a *Graegin* loan, there is a third party overseer, with loan covenants and guarantees that are more onerous than the conditions imposed by the government with Section 6166.

Section 6166 requires annual filings; *Graegin* requires annual compliance with the financing requirements of the third party.

Section 6166 is subject to the government arguing that it does not apply, and certainly could be a trigger for an audit. *Graegin* is subject to the IRS disallowing the up-front interest deduction under the argument that the estate did not need to incur the loan for liquidity purposes.

And these are just a few of the practical nuances of selecting one of the techniques versus the other.

From a cash-flow standpoint, the way to compare *Graegin* versus 6166 is to look at each strategy's cash-flow requirement. In this regard, if the *Graegin* loan is determined to be five years, then the 6166 payments should be run out five years, and a side-by-side comparison made.

[40] Ponder, however, that the *Graegin* loan, with third party financing, will be at an interest rate that is supposed to take into account forward rates, and interest rate increases (or decreases during the term). Therefore, in most situations, the *Graegin* loan and the 6166 interest rate should be essentially equivalent in terms of economic risk.

In our example, let's say the *Graegin* loan is for five years, at a 6 percent interest rate. The 6166 rate is first at 2.7 percent, and thereafter assumed to be 3.15 percent for the remainder of the loan. On the surface, the 6166 immediately shows less cash flow is required to pay the interest: 3.15 percent for example, versus 6 percent. On the other hand, the total *Graegin* loan interest is immediately deducted for federal estate tax purposes, meaning less federal (and state) estate tax paid up front.[41]

So, which is better? Using the assumptions in chart _____, assume either the estate elects 6166 or obtains a *Graegin* type loan for $8,500,000. *Graegin* saves federal estate taxes of $989,224 (the difference between the federal tax due of $15,660,142 in the 6166 scenario versus $14,670,918 in the *Graegin* scenario). There is an additional state tax differential of $300,000 for a total differential as $1.3 million. With *Graegin*, five years of interest at about $510,000 per year, was deducted from the gross estate.

But the *Graegin* analysis requires interest to be paid equal to about $2.5 million, while the 6166 requires interest to be about $300,000 per year, or $1.5 million total, for a difference of $1 million.

Graegin probably incurs an additional $50,000 of expense, after taking into account the estate tax deduction.

So, *Graegin* saves about $300,000 in total taxes.

Conclusion

Liquidity planning for estate taxes in our current economic environment is one of the most important aspects of estate planning. However, the topic is not enjoyed by clients, and often not viewed with much urgency or priority by clients.

Liquidity planning left unaddressed by clients during life – thereby creating illiquidity issues post mortem -- pose important and challenging concerns for   practitioner. Much value added can be obtained in estate administration by considering the tax payment and liquidity concerns immediately after a client passes away, and focusing on the solutions available to the estate.

[41] Note that for income tax purposes, the interest payments are not deductible under either scenario.