Funding Estate Taxes: Is the Interplay of *Graegin* and Family Limited Partnerships a Toxic Concoction?

Estate Tax Illiquidity Concerns with a Family Limited Partnership

One of the more complicated decisions is how to pay estate taxes, post mortem, when a family limited partnership has been set up with a substantial portion of the decedent's assets. In many cases, outside of the family limited partnership, 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). 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?*

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. Or, if the estate is a partner, a *pro rata* distribution to all the partners, including the estate, to allow the estate liquidity to pay the estate taxes, would be an alternative. Both of these options increase the ability of the Service to assert 2036 (a) (1); e.g., the Service would 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 has less of a section 2036 taint. In addition, if this is done, the question is whether the estate gets to deduct all future interest payments on the loan under Code section 2053 and the reasoning of the Tax Court in the *Graegin* decision.

Graegin, It's 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,[1] and which are actually and necessarily incurred in administering a decedent's estate.[2]

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)

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

[2] *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).

(2).[3] Specifically, in Estate *of Todd v. Commissioner*, [4] the Tax Court held that interest incurred for a loan to pay Federal estate taxes and State inheritance taxes was an allowable administration expense.

More importantly, even projected interest payments are deductible for estate tax purposes as administration expenses.[5] 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 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. The most cited case for this proposition is *Estate of Graegin v. C.I.R*.[6] 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 noted:

> "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:

> " 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

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[3] *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).

[4] 57 T.C. 288 (1971).

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

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

> obligation interest rate) whereas the loan in question was for a 15-year period … Thus, all matters considered, we believe the loan from Graegin Corporation was a genuine indebtedness."

In a somewhat similar case, Klein v. Hughes, [7] the IRS allowed a deduction for interest on a loan to pay estate taxes in the amount of $50 million. The lender was an 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 note called for a balloon payment of interest and principal payable 25 years in the future with prepayments prohibited. The IRS and the appropriate court allowed the deduction of the entire interest amount to be paid without requiring a present value calculation. [8]

The General Principles of *Graegin* and Its Progeny

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. In looking at the example at the beginning of the article, all of these variables can be met even with a family limited partnership. But in the family limited partnership, there is one additional fact that could operate to negate the accelerated interest deduction. The identity of the partners and the beneficiaries of the estate are often the same, thereby calling into question the bona fideness of the loan.

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[7] 2004 WL 838198 (Cal. App. 1 Dist. 2004) – (Unreported case).

[8] In another case, Estate of Gilman, TCM 2004-286, 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, formerly discrete, 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,* a deduction is permitted if the loan is bona fide and necessary to pay legitimately incurred obligations of the estate. In addition, the decision found the estate to be illiquid in spite of the fact that the decedent's estate was able to provide cash bequests of approximately $30 million to individual beneficiaries.

Deducting Interest from Loans from Family Limited Partnerships?

How close to the edge, including on the section 2036 argument, is this approach? The practitioner should expect substantial scrutiny. For example, 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. In addition, 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, TAM 200513028, parallels the bad fact estate tax partnership cases. In that TAM, the Service refused to extend the *Graegin* reasoning and allowability of future interest payments as estate tax deductions. Among the bad facts:

- Family members owned 99% 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 future (post mortem) loan interest despite citing all the relevant authorities allowing such a deduction.[9] The Service 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:

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[9] "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 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)."

> "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).

Conclusion

Whether to incur a loan and attempt to deduct all future interest payments requires a financial analysis by an estate, 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 ala the *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 (e.g., that the loan was unnecessary).

If the loan is a noncommercial one, from a family limited partnership, this could bolster the Service's attempt to disregard the partnership under section 2036 though the author believes this argument 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 argue that the loan was unnecessary -- that distributions to the partners could have been made instead -- and disallow the interest payments as estate tax deductions. In that event, the practitioner should expect an interesting and protracted dispute with the Service, with the victor still being anyone's guess. But if one guesses wrong, the estate is left with an interest only loan, with no prepayment possible, and the creation of phantom income (and related income tax) each year. This, the author believes, is a gambit requiring fortitude.