

**Black, White, and Grae(gin): Borrowing to Pay Estate Taxes**

American Bar Association Real Property, Trust & Estate Law  
20th Annual Spring Symposia  
May 1, 2009

**Program Chair and Moderator:**

*Charles E. Hodges II, Esq.*<sup>1</sup>  
Chamberlain, Hrdlicka, White, Williams & Martin  
Atlanta, Georgia

**Panelists:**

*Paul S. Lee*  
Bernstein Global Wealth Management  
New York, NY

*Stephanie Loomis-Price, Esq.*  
Baker Botts, LLP  
Houston, Texas

*Janine A. Racanelli*  
JPMorgan Chase Bank  
New York, NY

**I. INTRODUCTION**

A “*Graegin* loan” is a popular option for estates that lack enough liquid assets to pay estate taxes and other expenses incurred during the administration of an estate. A *Graegin* loan is often utilized in estates of decedents whose major asset was an interest in a closely-held business. The decedent’s executor may not want to sell the decedent’s business interests, perhaps because of a down market or because the decedent’s family expects the business to continue to support the family. At the same time, the executor may have to look to the business assets to help provide the cash needed to pay for estate expenses. Instead of selling the business interests, the estate can borrow cash from the business in exchange for a promissory note. Alternatively, the estate can borrow funds from a third party.

There are several potential advantages to borrowing money to pay estate taxes and other expenses of administration. First, the estate may postpone payments via the loan structure, which frees up cash for use in business operations or for other purposes. Also, interest paid by an estate is potentially deductible against estate taxes under I.R.C. § 2053(a), which can significantly reduce the amount of estate taxes due. Although an estate may be able to defer

---

<sup>1</sup> All that is substantive and correct in this outline was drafted by Paul S. Lee or Stephanie Loomis-Price. All that is questionable or incorrect is mine.

payments of estate tax under I.R.C. § 6166, many estates may not qualify for the requirements under this section.

Although an estate may save significant estate taxes through the use of a *Graegin* loan, the estate should also be aware of potential income tax consequences to the lender resulting from interest payments on the loan. The economics and mathematics of *Graegin* loans are discussed in detail below.

## II. SECTION 2053: DEDUCTIBLE EXPENSES

**A. Generally.** Section 2053(a) of the Internal Revenue Code (“I.R.C.”) provides that, for estate tax purposes, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for: (1) funeral expenses, (2) administration expenses, (3) claims against the estate, and (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate. In order to be deductible, such amounts must be allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered. I.R.C. § 2053(a).

**B. Loan Interest Deduction.** The Code, Treasury Regulations, and case law impose several requirements for the deductibility of interest from loans used to pay estate taxes and other expenses. The deductibility of loan interest is governed by I.R.C. § 2053(a)(2) and the Treasury Regulations thereunder.

**1. Expense of Administration.** I.R.C. § 2053(a)(2) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for administration expenses. Treas. Reg. § 20.2053-3(a) provides that the amounts deductible from a decedent's gross estate as "administration expenses" are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the *collection of assets*, payment of debts, and distribution of property to persons entitled to it. Expenses that are not essential to the settlement of the estate but are incurred for the individual benefit of heirs, legatees, or devisees are not deductible. Treas. Reg. § 20.2053-3(a). Many of the cases discussed below consider whether loans are actually and necessarily incurred in the administration of the decedent's estate.

The courts and the IRS have generally concluded that a loan is reasonably and necessarily incurred when it prevents the forced sale of assets, particularly when such a sale would cause the estate to glean a reduced price for its assets, such as when the estate holds interests in closely held businesses. For example:

- 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. Comm’r*, 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. Comm'r*, 76 T.C.M. (CCH) 426 (1998) ("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 [business property owned by the estate]");
- *Estate of McKee v. Comm'r*, 72 T.C.M. (CCH) 324 (1996) ("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. Comm'r*, 56 T.C.M. (CCH) 387 (1988) ("[t]o avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability."); and
- *Estate of Huntington v. Comm'r*, 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").

Obviously, a forced sale of assets should not be necessary when an estate has sufficient liquid assets to pay the tax liability and other expenses. Courts have provided some additional guidelines regarding the determination of liquidity:

- The IRS tends to argue (particularly where there are questions about actual payment in full) that family limited partnerships do not provide sufficient illiquidity to qualify for *Graegin* treatment as partnerships can be in the IRS's words, a self-created liquidity crisis.<sup>2</sup>
- Some portion of the interest may be deemed non-deductible if liquidity subsequently will become available after death.<sup>3</sup>
- It is not necessary that the estate exhaust all sources of liquidity in the estate in order to qualify for the deduction.<sup>4</sup>
- The fact that the estate qualifies for estate tax deferral under Section 6166 of the Code will not affect the estate's ability to qualify a deduction on the interest paid.<sup>5</sup>
- *Graegin* loan can be used to satisfy deferred estate tax liability under Section 6166 of the Code.<sup>6</sup>

---

<sup>2</sup> I.R.S. Tech. Adv. Mem. 2005-13-028 (September 15, 2004).

<sup>3</sup> See *Estate of Gilman v. Comm'r*, 2004 WL 2985851 (U.S. Tax. Ct.).

<sup>4</sup> See *Estate of Thompson v. Comm'r*, 76 T.C.M. (CCH) 426 (1998); *Estate of Sturgis v. Comm'r*, 54 T.C.M. (CCH) 221 (1987).

<sup>5</sup> See *Estate of McKee v. Comm'r*, 72 T.C.M. (CCH) 324 (1996).

<sup>6</sup> I.R.S. Priv. Ltr. Rul. 2000-20-011 (September 30, 1999).

- In other pre-*Graegin* cases, interest has been found to be deductible where the loan was obtained to avoid a forced sale under a variety of circumstances, including thinly-traded public securities.<sup>7</sup>
- Term (length) of the loan may be required to have some relation to how long illiquidity is expected to persist.<sup>8</sup>

2. **Non-Tax Purpose.** The Service may challenge a loan for failure to have a purpose separate and apart from reducing tax liability. See *Lee v. Comm'r*, 155 F.3d 584 (2d Cir. 1998). The non-tax purpose may be important in *Graegin* loans from closely held corporations because a court will closely scrutinize a loan between related parties to determine whether or not it is bona fide. Courts have offered the following guidance regarding examination of non-tax purpose:

- Close scrutiny is applied when there is identity of interest between the lender and the borrower.<sup>9</sup>
- The loan must be for the benefit of the estate, not for the individual benefit of the beneficiaries.<sup>10</sup>

3. **Estimated Interest Payments.** A deduction may be allowable under I.R.C. § 2053 for *estimated* interest payments that have not yet accrued if, in addition to satisfying the other requirements I.R.C. § 2053(a) and the Treasury Regulations, the estimated amount is (i) Ascertainable with reasonable certainty, and (ii) Certain to be paid. Treas. Reg. § 20.2053-1(b)(3); *Estate of Bailly v. Comm'r*, 81 T.C. 246 (1983); *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988).

In determining whether the amount of interest can be determined with reasonable certainty, courts have offered the following guidelines:

- Fixed rate of interest and term will be respected by the IRS.<sup>11</sup>

<sup>7</sup> See *Hipp v. United States*, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971) (allowing deduction on loan obtained to pay federal and state death taxes where estate consisted mainly of thinly traded stock and loan was duly authorized by probate court to preserve the value of the estate); *Estate of Huntington v. Comm'r*, 36 B.T.A. 698, 726 (1937) (holding issuance of notes “avoided the necessity of sacrificing the assets of the estate by immediate or forced sale of the same...and the expenditures properly incident thereto were clearly made for the purposes of preserving and preventing waste of the estate”); I.R.S. Tech. Adv. Mem. 84-50-003 (August 17, 1984) (allowing approved deductions for interest incurred on a 34 year loan from the Federal Land Bank, if the District Director determines that it is necessary for the estate to borrow loan amount to pay taxes to avoid forced sale of assets).

<sup>8</sup> See *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988) (term was set at 15 years, which was the life expectancy of the surviving spouse when liquid assets would become available); *Estate of Gilman v. Comm'r*, 2004 WL 2985851 (U.S. Tax. Ct.) (interest deductions were disallowed after the time in which certain notes became due and payable to the estate).

<sup>9</sup> See *Estate of Graegin v. Comm'r*, 56 T.C.M. (CCH) 387 (1988); I.R.S. Tech. Adv. Mem. 2005-13-028 (September 15, 2004).

<sup>10</sup> See *Estate of Lasarzig v. Comm'r*, 78 T.C.M. (CCH) 448 (1999).

<sup>11</sup> IRS Litigation Memo TL-65 (March 14, 1989, released March 17, 1998) provides, “[w]here such interest is uncertain in amount due to fluctuations in rate or the possibility of accelerated repayment, however, it may not be

- Prohibition on prepayment of principal and interest or a substantial prepayment penalty is recommended.<sup>12</sup>
- May provide that upon default all interest that would have been payable shall become due and payable.<sup>13</sup>

4. **Allowable Amount.** Amounts are “allowable by the law of the jurisdiction” under which the estate is being administered if allowable by the laws governing the administration of decedents’ estates. Treas. Reg. § 20.2053-1(a)(1). This phrase has no reference to amounts allowable as a deduction under a law which imposes a State death tax. *Id.* The decision of a local court regarding the amount and allowability under local law of an expense of administration will ordinarily be accepted if the court makes its decision based on the facts upon which deductibility depends. Treas. Reg. § 20.2053-1(b)(2).

### III. **CASES UNDER I.R.C. § 2053(a)(2)**

The cases below discuss the application of I.R.C. § 2053(a)(2) to *Graegin*-type loans from third-party lenders and from closely-held businesses. As discussed below, the application of I.R.C. § 2053(a)(2) to loans between related parties is more closely scrutinized.

#### A. **Estate of Todd v. Comm’r, 57 T.C. 288 (1971).**

1. **Facts.** Estate borrowed \$300K from Todd Cattle Co. on July 21, 1967 to pay estate taxes. Executors believed it necessary to borrow because the estate did not own any liquid assets, and nonliquid assets would have to have been sold at “forced sale” prices. Details of the loan:

- Required to be paid on or before April 15, 1968.
- Interest rate at 6.25% per annum.
- March 31, 1969 – the loan was repaid through a transfer of interest in Todd Cattle Co.
- Part of the interest that accrued on the note was deducted by the estate on one of its fiduciary returns (\$8,913) and the estate now wants to deduct the remainder (\$23,013).

---

deducted until accrued or paid. If, in a balloon payment loan, the rate is fixed and the length of the loan is not subject to acceleration, the interest amount may be accrued and deducted on the estate tax return even though it will not be paid for a number of years. This was the situation in Estate of Graegin.”

<sup>12</sup> See I.R.S. Priv. Ltr. Rul. 1999-03-038 (October 2, 1998); I.R.S. Priv. Ltr. Rul. 1999-03-039 (September 30, 1999) (Facts similar to Pri. Ltr. Rul. 1999-03-038 but involving a 10 year note providing for annual interest with a balloon payment of principal at the end of the 10 year term); *Estate of Graegin v. Comm’r*, 56 T.C.M. (CCH) 387 (1988).

<sup>13</sup> See I.R.S. Priv. Ltr. Rul. 2004-49-031 (July 29, 2004).

2. **Issues and Holdings.**

- Was administration expense actually incurred and subject to reasonable estimation?
  - Yes, because the amount of interest was already determined and paid.
- Was the administration expense necessary?
  - Bona fide loan? Liquidity?
    - Ct said that “petitioners have met this burden by presenting convincing, uncontroverted testimony.”
      - Independent co-executor of the estate testified: he believed it necessary to borrow the money in order to pay the taxes;
      - That the estate did not own any liquid assets at the time; and
      - That if the estate liquidated some of its nonliquid assets, they would have to be sold at reduced prices.

B. **Estate of Sturgis v. Comm’r, 54 T.C.M. (CCH) 221 (1987).**

1. **Facts.** The decedent died holding a large amount of timberland. The estate lacked sufficient liquid assets to pay the estate taxes and other expenses, and the executor took out a private loan from Federal Land Bank in 1983 of approximately \$2.6 million to pay federal and state death taxes and interest. Three years later, the executor had paid only \$11,000 toward the principal on the loan, even though the estate held liquid assets with a market value of almost \$950,000. The executor claimed to hold the liquid assets as a cushion to cover contingencies, such as an increase in estate tax as a result of litigation in the Tax Court. Timber sales were made over the years, but the cash generated from the sales was not sufficient to cover both the loan payments and beneficiaries’ requirements.

2. **Issues and Holdings.**

- Was the administration expense necessary?
  - Liquidity?
    - Respondent argued that the debt could have been retired with estate assets and the estate was kept open much longer than necessary, rendering interest payments during the excess period unnecessary.
    - Tax Court disagreed, finding that ongoing litigation required the estate to remain open.
    - Tax Court noted Respondent had failed to consider state death taxes, contingencies, and the requirements of beneficiaries.

- Tax Court held that the interest expenses were necessary and thus deductible, saying that the executor had substantially understated the value of the assets and thus would need the reserve to pay the resulting additional estate taxes.

3. **Comments.** The Tax Court states, “Although respondent has suggested the executors could have sold more land or timber, and that no contingency reserve is appropriate, we are not prepared to second guess the judgments of a fiduciary not shown to have acted other than in the best interests of the estate. In fact, our decision on the first issue [regarding the value of timberland] has shown the fiduciaries to have been prudent indeed to have anticipated contingencies such as an increased estate tax liability.”

C. **Estate of Graegin v. Comm’r, 56 T.C.M. (CCH) 387 (1988).** Deduction allowed because estate was illiquid, there was credible testimony as to repayment, and payment could be accurately estimated.

1. **Facts.** In the *Graegin* case, the estate consisted primarily of nonprobate assets. Under the decedent’s will, his residuary poured over to his trust which was charged the payment of all claims and expenses of the estate. In order to pay estate taxes and avoid selling Graegin Industries’ stock, the executors borrowed approximately \$204,000 from Graegin Corporation, a wholly owned subsidiary of Graegin Industries, 97% of whose stock was owned by the decedent or the decedent’s son (who was also a co-executor of the estate). Details of the loan:

- Unsecured note.
- Interest rate of 15% fixed (not floating) per annum (prime rate as of that date).
- Principal and interest were due in a single payment in 15 years (based on life expectancy of decedent’s wife, because her trust would then partially satisfy the note).
- Prepayment of both principal and interest was prohibited.
- Paul Graegin (his son) was co-trustee of trust, co-executor of decedent’s estate, President of Graegin Industries and Graegin Corp., and member of Board of Directors of both companies.
- On the Federal estate return, petitioner deducted the amount of a single interest payment due upon maturity of the note.

## 2. Issues and Holdings.

- Was administration expense actually incurred and subject to reasonable estimation?
  - Yes. The Tax Court said that since the note prohibited prepayment of interest and principal, the amount of expense could be calculated.
- Was the administration expense necessary?
  - Bona fide loan?
    - The Tax Court looked at:
      - (1) credibility of witness - Paul Graegin's testimony regarding his intention to repay
      - (2) reasonableness of loan terms, and
        - interest rate was reasonable, even though it was based on the prime rate of interest which was a short term obligation interest rate even though the loan was for 15 years; and
        - The Tax Court was concerned that note required a single payment of principal and interest, but determined it was not unreasonable given the decedent's post-mortem asset arrangement
      - (3) approval of this arrangement by the probate court.
    - Even though loan was unsecured and the borrower and lender were both controlled by Paul Graegin, the Tax Court said there was some non-identity of interest because an unrelated shareholder had interest in Closely held business.
  - Liquidity?
    - Ct determined that the estate lacked liquidity and that the estate had to borrow money to avoid a forced sale of its assets.

3. Comments. The court wrote that it was “disturbed by the fact that the note requires only a single payment of principal and interest,” but determined that such a repayment term was not unreasonable given the facts of the case. The court went on to say that it was “mindful of the potential for abuse presented by the facts in this case.” The court went on to say that “loans between a debtor and creditor having an identity of interest require close scrutiny” but “such identity of interest *per se* is not fatal in characterizing the transaction as a loan.” The court ultimately found the executor's testimony regarding his intention with respect to repayment of the note credible. The court found it also important that there was

an outside shareholder (3% owner) who would object if the loan was not repaid in a timely manner.

C. **Estate of Thompson v. Comm’r, 76 T.C.M. (CCH) 426 (1998).**

1. **Facts.** Decedent left will directing that all estate and inheritance taxes be paid from the residue of his estate, and that no claim would be made on any life insurance beneficiary for payment of any part of the taxes. One of the major assets of the estate was a Cane Mill, which was left in trust for the decedent’s four children. The estate also held some publicly traded stocks and cash. The decedent had created an irrevocable insurance trust (“Trust”) that was not part of the probate estate. Executor borrowed \$2M from the Trust, which was used to pay estate taxes and for ongoing maintenance and preservation of the Cane Mill (which was used for the production of merchantable timber and crops as a hunting preserve). Details of the loan:

- Annual interest rate of 5%
- Principal and interest payable 1 year from the date the note was executed (Nov. 17, 1992).
- New 1 year loans with differing interest rates were thereafter executed.
- Additional notes, representing the capitalization of interest due on the note, were also executed.
- On estate tax return, petitioner deducted interest on the Note. Petitioner then amended this return to increase the amount of deduction for the interest expense.

2. **Issues and Holdings.**

- Was the amount allowable under state law?
  - Ct looked at state law to determine whether this amount was deductible under state law and concluded it was deductible as long as the will gives such authority.
    - Under Georgia law, an executor has the power to borrow funds, provided the executor petitions the probate court and obtains approval; however, this power does not limit any powers under the decedent’s will.
    - The decedent’s will stated that the executor had the power to borrow money without court order, so the amount was allowable under local law.

- Was the interest expense necessary?
  - Bona fide loan?
    - Bona fide, given authority by the will.
    - Although the stock retained by the estate increased in value following the loan, the Court concluded the increase could not have been forecast at the time the loan was obtained, and therefore the loan was not for the benefit of the decedent's heirs.
  - Liquidity?
    - Ct said 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 until such time as the asset could be distributed to Decedent's heirs.
    - To prove such illiquidity, the individual responsible for the administration of decedent's estate testified credibly that a shortfall existed between estate tax liabilities and liquid assets available to pay them.
    - In addition to estate taxes, the estate had other obligations, including liability for property taxes, salaries of regular employees, and occasional laborers, all of which required retention of some liquidity.
    - In order to sustain a deduction, "section 2053 does not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary."

**D. McKee v. Comm'r, 72 T.C.M. (CCH) 324 (1996)**

**1. Facts.** The estate reported a taxable estate of \$12.4 million, which consisted mostly of stock in a closely held company. Both of the decedent's executors were officers of the company. The estate was entitled to make a section 6166 election, which would defer approximately 40% of the estate taxes, but the estate chose not to do so. If the estate had made a 6166 election, interest would have accrued on the unpaid liability at 11%. Instead, the estate borrowed \$5.5 million from the company on the due date for paying the estate taxes. Details on the loan from company:

- Annual interest rate of 11%
- Principal and interest payable 85 days from the date the note was executed
- Note was unsecured

- Executors did not seek approval from the probate court

Three months later, the executors borrowed that same amount from an outside lender and repaid the company. The loan from the outside lender bore a 9.69% interest rate, and the loan was secured by decedent's shares in the company. The company later redeemed shares from the estate, giving a note to the estate with a payment schedule and interest identical to the terms of the third party loan. Therefore, the interest received from the estate as a result of the redemption exactly offset the interest expense on the third party loan. The IRS disallowed a deduction for the interest expense on the loan, arguing, in part, that the estate could have deferred some of the tax under section 6166, and that the estate could have sold some of its shares to the corporation to generate cash to pay the estate tax.

## 2. Issues and Holdings.

- Was interest expense actually incurred and subject to reasonable estimation?
  - The court noted that the estate would have been obligated to incur interest expenses whether the executors made a section 6166 election or decided to borrow funds from a third party to pay all of the estate tax obligations.
  - The court concluded that it would not “second guess the business judgments of the executors” and observed that the executor’s decision not to make a section 6166 election was prudent, because, among other reasons, the estate benefited from increases in value to the Company stock and, consequently, the decedent’s estate was in a better situation to face contingencies such as an *increased* estate or gift tax liability. Also, a sale of the company stock would have been required if a 6166 election had been made, which would have given rise to a capital gain, and additional stock would have had to be sold to provide for payment of income taxes. A sale of the company stock could have jeopardized the estate’s subsequent ability to meet its obligations.
- Was the interest expense allowable under local law?
  - Under Tennessee law, the incorporation into a will of a statutory power authorizes an executor to borrow funds and provides a Tennessee court will credit the executor for interest necessarily and properly incurred.
  - The will incorporated the Tennessee statute allowing the executor to borrow funds, so the expense was allowable under local law.

## E. Estate of Lasarzig v. Comm’r, 78 T.C.M. (CCH) 448 (1999)

1. **Facts.** The decedent died with a gross estate consisting primarily of the decedent’s living trust and a QTIP trust created by the decedent’s spouse. The family trust paid its share of the estate taxes, but the QTIP trust was unable to pay its share. The QTIP trust had sold all its assets except for 3 parcels of realty. Of the three parcels that

had not been sold, one was chemically contaminated, which affected its marketability, and the other two parcels were under lease to a third party who developed the parcels into a shopping center. The shopping center was the most significant asset held by the QTIP trust and the only potential source of cash for the payment of the QTIP's portion of the estate liability. However, the properties were not sold because of a depressed real estate market. Instead, after the estate requested extensions of time to pay the tax, the QTIP trust distributed the shopping center properties to the QTIP beneficiaries. The QTIP beneficiaries subsequently transferred the shopping centers to their personal family trusts, which were separate from the decedent's living trust and the QTIP trust. After the estate had distributed all assets, the beneficiaries' personal family trusts borrowed the funds from a third party to pay the estate taxes due.

## 2. Issues and Holdings.

- Was the interest an expense of administration?
  - Respondent argued that because the tax burden was on the QTIP trust assets, but the QTIP beneficiaries chose to secure the loan rather than sell QTIP assets, the loan benefited the QTIP beneficiaries.
  - Respondent also argued that because the QTIP properties were not subject to probate, the interest was not an expense of administration.
  - The Tax Court agreed – because there were no more probate assets to administer at the time the personal family trusts obtained the third party loan, the interest could not be an expense of administration but was for the benefit of the beneficiaries.
  - The court observed that the prior cases that allowed the deduction of interest involved cases where the interest expense was incurred during the administration of the estate and before the resolution of the tax controversy.
- Was the interest expense allowable under local law?
  - Although the trustees pointed to California trust law allowing the trustees to borrow funds, the trustees' power to borrow was irrelevant to an estate having no assets and which required no further administration.

## F. Estate of Gilman v. Comm'r, 2004 WL 2985851 (U.S. Tax. Ct.)

1. **Facts.** The decedent's gross estate consisted primarily of stock in a holding company (GIC) for decedent's businesses and other assets. The co-executors of the estate were managers of an LLC (HG). The executors transferred the GIC stock and all of its assets to HG in exchange for \$143 million in promissory notes, which were scheduled to pay interest from 1999 to 2004, and to be fully paid in January 2004. The financial condition of HG began to decline in 2001, and HG was unable to pay the estate nearly \$23 million of interest in 2002. The estate made a 6166 election to pay the estate tax in 10 installments; however, during examination of the estate, the IRS informed the

executors that because the estate had transferred assets to HG, the estate's ability to continue to defer payments under I.R.C. § 6166 was doubtful. The executors decided to pay the estate taxes in full to avoid risk of acceleration under I.R.C. § 6166(g) and borrowed \$38 million in a private loan before the HG notes were scheduled for repayment. The private loan was payable over 10 years.

## 2. Issues and Holdings.

- Was the interest expense necessary?
  - Liquidity?
    - Respondent argued that the estate created its own illiquidity by transferring GIC stock and assets to HG.
    - Tax Court disagreed, finding that both before and after the restructuring, the estate owned illiquid interests in closely held businesses.
    - Tax Court found that the executors could not have foreseen the decline in financial condition which contributed to HG's inability to pay interest on the promissory notes.
    - The Tax Court declined to consider the estate's 6166 election in deciding ability to pay because the executors acted on the advice of estate tax counsel to pay the estate tax in full.
- Was the amount allowable under the laws of the jurisdiction?
  - NY law allows interest expense to be deductible if necessary and if the estate lacks sufficient liquid assets.
  - Having determined the loan was necessary and the estate lacked sufficient liquid assets to pay the estate tax, the amount of interest was allowable under NY law.

3. Comments. The Tax Court allowed a deduction for interest incurred on the portion of the loan used to pay estate taxes but declined to allow a deduction for the portion of the loan used to pay certain other expenses because they were not expenses of administration. The Tax Court allowed an estate tax deduction on the loan until such point that the HG promissory notes became due. Once the notes became due, the Tax Court held that the estate had sufficient liquidity or access to liquidity, and as such, interest accrued after that point was not deductible under I.R.C. § 2053.

## G. Estate of Hughes, 133 Cal. App. 4th 121 (2005)

1. Facts. Mark Hughes died in 2000 with a gross estate of more than \$300 million. The federal estate tax return showed estate taxes of more than \$200 million. The sole beneficiary of the estate was a trust. The trust provided for specific bequests of Herbalife, Inc. stock to several beneficiaries (including the decedent's son Alex) with the residue to be payable to Alex. Most of the trust's investments were in limited liability

companies from which the trust had no power to compel cash distributions, and the trust's interests were subject to stringent restrictions on transfer. The estate sought to utilize a *Graegin* note, using related entities and an entity controlled by the tax attorney to the trust in question.

- Hughes Investment Partnership (HIP), and LLC controlled by the trust, loaned \$49,953,945 at 8.6% to Zacadia, a limited partnership controlled by the family of the trustees' tax attorney. No payments due until December 31, 2027
- HIP borrowed the same amount from Zacadia at 8.75% interest. Therefore, Zacadia would gain from the spread in interest rates
- Both loans zero coupon
- Aside from a \$10 million payment due September 9, 2005, no interim interest payments from HIP to Zacadia would be required for the loan
- Prepayment of the loan was prohibited
- The loan transactions were approved by the probate court in *Klein v. Hughes*, 2004 WL 838198 (Cal. App. 1st Dist. 2004) [unpublished opinion]

The following additional facts are taken from the opinion:

Due to the merger and sale of the Herbalife stock, the beneficiaries received no actual stock. Instead, the trustees made monetary distributions based on the \$19.50 share value, withholding a portion of the funds to account for the beneficiaries' shares of the estate taxes. Under the terms of Hughes' will and trust, each beneficiary is responsible for his or her pro rata share of estate taxes as provided in the Probate Code. The trustees petitioned the probate court for approval of a proposed estate tax proration. For the beneficiaries of specific bequests other than Alex, the trustees' calculation was based on the shares' market value rather than the \$19.50 value, to compensate for the fact that only the trust would enjoy the benefit of the estate tax deduction for administration expenses.

Respondent Suzan Hughes, Alex's mother and guardian, objected to the trustees' proposal, contending there was no reason to treat Alex's specific bequest differently. She also claimed it was inconsistent for the other beneficiaries to enjoy the capital gains benefits of the \$19.50 valuation but to pay estate taxes based on the lower market values.

\* \* \*

Appellants filed responses advocating the adoption of “Method E,” a proposal developed by the trustees’ accountants. This method used the \$19.50 share valuation and apportioned estate taxes “in the proportion that the value of the property received by each person interested in the estate bears to the total value of all property received by all persons interested in the estate,” as stated in Probate Code section 20111. Appellants contended this was the only method proposed by the trustees that conformed with the requirements of the Probate Code. It was also the method that resulted in the lowest estate tax burden on the specific bequests.

Suzan Hughes responded that the recommendations from all other parties failed to equitably adjust the estate tax proration to account for the *Graegin* transaction’s income tax consequences for Alex, as residuary beneficiary. Suzan claimed that under *Estate of Bixby*, supra, 140 Cal. App. 2d at p. 326, the trustees were authorized to charge the other beneficiaries with a portion of the present value of Alex’s future income tax liability on the interest income the trust would receive from Zacadia, to avoid the unjust enrichment of one class of beneficiaries at the expense of another class. She proposed the adoption of “Method E” with modifications to account for that future income tax liability.

\* \* \*

The probate court held a hearing at which all interested parties were afforded an opportunity to express their views on the proration issue. Toward the end of the hearing, the court announced it would adopt Suzan’s proposal, using “Method E” with modifications to charge the beneficiaries of the specific bequests for a portion of the present values of the costs of the *Graegin* transaction and the trust’s future income tax liability.

## 2. Issues and Holdings.

The appeals court reversed the lower court decision and stated that neither the California Probate Code nor *Bixby* contemplated consideration of future income tax consequences. The opinion states:

*Bixby* did not address estate tax proration, and establishes only the probate court’s equitable authority to make adjustments for immediate tax consequences in distributing the estate. A more cautious and predictable approach is suggested by the current state of the law — unless income tax consequences can be ascertained with reasonable certainty for purposes of equitable reallocation at the time of distribution, the beneficiaries of an estate are responsible for paying their own future taxes.

\* \* \*

Respondent contends that without the estimated income tax proration ordered by the court, Alex, like the remaindermen in *Bixby*, would suffer a diminishment of his inheritance so that appellants could profit at his expense. We disagree. There are several significant distinctions between *Bixby* and this case. First *Bixby* was not a proration case. The governing statute then, as now, provided for proration of estate taxes unless the testator directed otherwise. (Former Prob. Code §970, Stats. 1943, ch. 894, §1; Prob. Code §20110, subd.(b)(1).) The testator in *Bixby* provided for the payment of estate taxes from the residuary estate (*Bixby*, supra, 140 Cal. App. 2d at p. 330), whereas Hughes directed that estate taxes be a prorated as specified in the Probate Code.

Second, *Bixby* was concerned not with income taxes payable in the future, but with reallocating “an actual cash benefit in the form of tax savings.” (*Bixby*, supra, 140 Cal. App. 2d at p. 339.) Here, the actual cash benefit in the form of estate tax savings was appropriately allocated by the court’s proration of the estate taxes. The court did not make an adjustment based on taxes that would have been immediately payable under an alternate scenario, as did the *Bixby* court. It attempted instead to shift some of Alex’s future income tax burden to appellants, on the theory that those future taxes were one of the costs of the estate tax reduction accomplished by the *Graegin* transaction.

Third, in *Bixby* every dollar of income tax deduction was a lost dollar of estate tax deduction. Here, every dollar of interest taken as an estate tax deduction was not a dollar lost by Alex on his income taxes. The trade-off in this case is attenuated and highly uncertain. The interest deducted from the estate taxes is chargeable as income to Alex in future years, but as appellants point out Alex’s actual income tax consequences depend on future rates, the performance of trust investments, and the future tax strategies employed by the trust on Alex’s behalf. While Alex will presumably pay some amount in taxes over the 25 years before the trust receives its interest payment from *Zacadia*, this liability is at least partially offset by the fact that the trust immediately borrowed the principal amount back from *Zacadia* and has the use of those funds to generate further income, while the trust’s repayment of the bulk of the loan back is deferred for 25 years. This is hardly the sort of straightforward “unjust enrichment at the expense of the residuary beneficiar[y]” considered by the *Bixby* court. (*Bixby*, supra, 140 Cal. App. 2d at p. 338.)

\* \* \*

Indeed, it is far from clear that Alex's future income taxes may properly be viewed as a "cost" of the *Graegin* transaction that should equitably be spread among all beneficiaries. Alex would incur income tax liability on the returns from the trust's investments whether or not the *Graegin* transaction took place. That transaction was an enormously profitable form of investment for Alex, considering the estate and capital gains tax benefits he enjoyed without tying up a significant amount of trust capital. In addition to the tax savings for the trust, about 80 percent of the principal amount of the loan back from Zacadia will be available for other investments during the entire 25-year life of the loan. The other beneficiaries have no interest in those investments. Compared to Alex's gains and opportunities for future gain, the benefits of the *Graegin* transaction for the other beneficiaries might fairly be characterized as incidental.

**3. Comments.** The tax benefits from the *Graegin* transaction were very substantial. Absent any loan transaction, the trust owed \$212,460,485 in estate taxes, due immediately. However, by using Internal Revenue Code section 2053 to deduct the full amount of interest paid on a \$49 million loan, the trust could successfully reduce its estate taxes to \$45,931,555, for a savings of \$166,528,930 in estate taxes paid to the IRS. Subtracting the present value of profits Zacadia [the lender] would obtain from the interest rate spread (approximately \$3.6 million) and the present value of income tax HIP [a company owned by the trust] would have to pay on phantom income it would incur in the transaction (just over \$49 million), the trustees calculated the trust would gain a net savings of \$113,716,912 by entering the Zacadia transaction.

### **III. IRS GUIDANCE UNDER I.R.C. § 2053 (a)(2)**

#### **A. Revenue Ruling 84-75, 1984-21 I.R.B. 5.**

**1. Facts.** Decedent's estate consisted almost entirely of stock of a closely held corporation. No §6166 election was made. The estate had insufficient funds to pay the estate tax, and a forced sale would have been required to convert estate assets into sufficient cash. The estate borrowed funds to pay the tax obligation. On the federal estate tax return, the executor deducted the estimated total amount of future interest to be paid during the loan term.

- Principal of loan to be repaid over a period of 6 years
- 10% interest payable annually
- Loan could be fully repaid at any time at the executor's option, without penalty
- If the executor failed to timely make any payment, the remaining payments can be accelerated at the lender's option

## 2. Issues and Holdings.

- Was administration expense actually incurred and subject to reasonable estimation?
  - Held that because accelerated payment could be made at the executor's option or could be required upon failure to make a scheduled payment, the amount deducted that was estimated future interest expense is not yet deductible; it will only be deductible as it accrues.
- Was the administration expense necessary?
  - Liquidity?
    - "In this case, because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D's estate."

### **B. I.R.S. Priv. Ltr. Rul. 1999-03-038 (October 2, 1998)**

1. **Facts.** The estate consisted primarily of stock in a corporation described as "closely-held" but "publicly traded." The stock constituted no less than 80% of the value of the decedent's gross estate. The decedent's will incorporated certain powers enumerated in the Mississippi Code, which included power to borrow money. The executors of the estate proposed borrowing sufficient funds from a commercial bank to pay the federal and state estate taxes. The executors would petition the local probate court for approval to borrow the funds. The loan would provide for annual payments of interest and principal over a specified term, not exceeding seven years, at a fixed rate of interest. The note will prohibit prepayment. In the event of a default, the entire interest that would have been paid under the full term of the note will be accelerated and the total interest will be due and payable at the time of a default.

2. **Issues and Holdings.** The IRS allowed a deduction on Form 706 for the entire amount of post-death interest, provided the expense is necessarily incurred in the administration of the estate and is allowable under local law. The IRS refused to determine whether the expense is necessarily incurred in the administration of the estate, as that is a factual determination. The ruling was conditioned on the estate obtaining approval of the loan from the probate court.

### **C. I.R.S. P.L.R. 1999-03-039 (September 30, 1999)**

1. **Facts.** Decedent owned approximately 67% of a closely-held corporation. The value of the stock in decedent's gross estate was approximately 70% of the value of the gross estate. The executors proposed to borrow funds from a commercial bank for a term of 10 years with a fixed rate of interest, payable annually. The loan would provide for a balloon payment at maturity. The loan would prohibit prepayment.

2. **Issues and Holdings.** The IRS allowed a deduction on Form 706 for the entire amount of post-death interest, provided the expense is necessarily incurred in the administration of the estate and is allowable under local law. The IRS refused to determine whether the expense was necessarily incurred in the administration of the estate.

**D. I.R.S. P.L.R. 2000-20-011 (February 15, 2000)**

1. **Facts.** The decedent's gross estate included a closely-held business interest in a shopping center. The value of the shopping center as a percentage of the decedent's estate met the percentage requirements for purposes of the election under I.R.C. § 6166. The executor proposed to borrow funds to pay estate tax because estate experienced difficulty obtaining operational lines of credit because due to Federal tax lien resulting from I.R.C. § 6166 election. A loan was obtained to pay the estate taxes deferred under I.R.C. § 6166.

2. **Issues and Holdings.** Because the estate was unable to secure an operational line of credit for the shopping center, the loan was necessary for the preservation of a significant asset of the estate and was obtained to avoid a forced sale of assets.

3. **Comments.** A deduction was allowed for interest even though the IRS believed the loan incidentally benefited the beneficiary of the estate.

**E. I.R.S. Tech. Adv. Mem. 2005-13-028 (September 15, 2004).**

1. **Facts.** Decedent and spouse formed a limited partnership. Under Decedent's will, all estate taxes are to be paid from residue of the estate, which contained primarily decedent's 99% interest in the partnership. A promissory note was executed between estate as borrower and partnership as lender.

- Note advanced a line of credit pursuant to which funds, up to a designated principal amount, will be advanced to borrower by the lender
- Once the advance is made, no further advances were to be made
- Did not say principal amount of loan
- Did not say interest rate
- Note to mature in 10 years
- Principal that is advanced and all accrued interest is to be paid on a lump sum at the maturity date
- Prepayment of principal and interest is prohibited
- 99% partnership interest was pledged as security

- On date tax return filed for the estate, the executors claimed a deduction under §2053 for the interest that was to be paid on the due date of the note -- *i.e.*, early

## 2. **Issues and Holdings.**

- Was administration expense actually incurred and subject to reasonable estimation?
  - Ct not sure payments will be made.
  - even if made, payments will have no economic impact on the parties involved.
  - Because no financial impact besides tax effect, Ct said no deduction was allowed.
- Was the administration expense necessary?
  - Bona fide loan?
    - Identity of interest here – Estate owned 99% of the partnership.
    - Child was the co-executor of the estate and held the remaining 1% interest.
    - The same parties (closely related family members). stood on all side of the transactions.
  - Liquidity?
    - Here the partnership held substantial liquid assets.
    - Partnership was not engaged in any active business. that would necessitate the retention of liquid assets.
    - No restraint on fiduciary’s ability to access funds.

3. **Comments.** The TAM provides, “[i]n this case, Partnership held substantial liquid assets totaling \$n, or 57.6% of the partnership assets. On his death, the Estate succeeded to Decedent’s 99% partnership. Child A, the co-executor of the Estate, was the remaining general partner. Further, the partnership was not engaged in any active business that would necessitate the retention of liquid assets. In addition, in view of the Estate’s 99% ownership interest in the partnership and Child A’s 1% interest, there was clearly no fiduciary restraint on Child A’s ability to access the funds.” The TAM went on to provide, “[f]urther, 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 ... The present case presents a situation that is substantially similar to those presented in the [income tax] cases discussed above. The Estate and the partnership executed a document pursuant to which the partnership distributed funds to the Estate and the Estate executed a note under which the Estate became obligated to pay the partnership interest and principal on the maturity date. However, ninety-nine percent of the partnership was owned by the

Estate (to be transferred to trusts for the benefit of Child A and Child B) and the remaining one percent was owned by Child A, the co-executor of the Estate. Thus, the same parties owned and controlled both the borrower and the lender, and were essentially dealing with themselves and ‘sitting on both sides of the table.’ The circular flow of funds presented is readily apparent. The netting effect presented either obviates the need to actually pay the interest (and principal) when due, or if in fact funds are transferred in payment of interest, the payment will have no economic effect on the parties. After any such payment, the parties will be in the same economic position as they were before the payment.”

“When considering a Graegin loan as a possible solution for estate illiquidity attributable to FLP interests, well-advised clients and their well-informed advisors should be able to plan around the facts in this TAM. Out of concern for the Strangi II holding over the scope of Code Section 2036(a)(2), cautious advisors are now recommending that clients who previously established FLPs as part of a lifetime giving program divest their ownership in any retained GP units by either selling them or giving them away. A transfer by the client during life of the proscribed GP units to someone other than the named executor – such as a trust with an independent trustee – might ensure that the identity-of-interests issue raised in the TAM discussed above could be avoided.” Perspective, JPMorgan Private Bank, Graegin loans: alternative estate tax funding strategies (Spring 2006).

#### **IV. ECONOMICS AND MATHEMATICS OF GRAEGIN LOANS**

##### **A. Determining How Much Loan is Allowable**

1. The principal amount of a *Graegin* loan allowable is based upon the estate taxes payable on the asset that is causing illiquidity or that should not otherwise be sold in a forced sale to pay estate taxes.

2. Keep in mind that the deduction can not be any larger than the value of the illiquid asset (otherwise the estate would be entitled to an estate tax refund). Because the deduction is immediate and is determined by the accumulated interest on the loan (rather than a present value of the interest payments), it is possible to have more interest payable than the value of the illiquid asset causing the need for the *Graegin* loan.

2. The complicating issue is that the amount of estate taxes ultimately payable on the illiquid asset is determined by the deduction under Section 2053 of the Code, which in turn is determined by the accumulated interest on the loan needed to pay the estate taxes on the illiquid asset. In other words, determining the amount of the deduction requires a circular computation.

3. When the proposed *Graegin* loan is going to be structured as interest-only, payable annually, with a balloon payment of the principal at the end of the term, there are

two ways of approximating the appropriate loan amount. The first is through (groan) algebra. The second is with brute force through the use of an Excel spreadsheet.

4. The algebraic formula in determining the Graegin loan amount and, thus, the deduction under Section 2053, is as follows:

| <b>Legend</b> |  |
|---------------|--|
| <i>Symbol</i> | <i>Description</i>   |
| V             | Value of the Illiquid Asset                                |
| D             | Deduction under Section 2053 ( <i>Graegin</i> Loan Amount) |
| T             | Taxable Estate Attributable to the Illiquid Asset          |
| E             | Estate Tax Due, Attributable to the Illiquid Asset         |
| R             | Rate of Annualized Interest                                |
| Y             | Years of the Loan  |

The basic computation of determining the Taxable Estate Attributable to the Illiquid Asset (T) is the Value of the Illiquid Asset (V) less the deduction under Section 2053 (D):

$$\mathbf{T = V - D}$$

Estate Tax Due, Attributable to the Illiquid Asset (E) is (assuming a flat 45% total state and Federal estate tax rate):

$$E = (45\%) (T)$$

The Deduction under Section 2053 (D) is the cumulative interest payable on the loan to pay the Estate Taxes Due Attributable to the Illiquid Asset (E), as such:

$$D = (R) (Y) (E)$$

$$\mathbf{D = (R) (Y) (45\%) (T)}$$

As such, when placed in the basic computation of the Taxable Estate (T), the result is, as follows:

$$T = V - D$$

$$\mathbf{T = V - (R) (Y) (45\%) (T)}$$

In this formula and in real life, we will know the Value of the Illiquid Asset for estate tax purposes (V) and we will know the Rate of Annualized Interest on the loan (R) and the number of Years of the Loan (Y). As such, we can solve for the resulting Taxable Estate Attributable to the Illiquid Asset (T) and consequently also solve for the Deduction under Section 2053 and *Graegin* loan amount (D).

**Example 1 (Low Interest Rate):** Assume an illiquid asset that is worth \$10 Million, and the rate on the proposed loan is 4% for 10 years, interest only annually with a balloon note:

$$\begin{aligned}
 & \mathbf{T = V - (R) (Y) (45\%) (T)} \\
 T &= \$10,000,000 - 4\% (10 \text{ years}) (45\%) (T) \\
 & T = \$10,000,000 - .18 (T) \\
 & 1.18 (T) = \$10,000,000 \\
 & T = \$10,000,000 \div 1.18 \\
 & T = \$8,474,576 \text{ (Taxable Estate)}
 \end{aligned}$$

As such, with a \$10 Million illiquid asset (V), the deduction/*Graegin* loan amount must be:

$$\begin{aligned}
 & \mathbf{T = V - D} \\
 \$8,474,576 &= \$10,000,000 - D \\
 D &= \$10,000,000 - \$8,474,576 \\
 & \underline{D = \$1,525,424}
 \end{aligned}$$

**Example 2 (Average Interest Rate):** Assume an illiquid asset that is worth \$10 Million, and the rate on the proposed loan is 8% for 10 years, interest only annually with a balloon note:

$$\begin{aligned}
 & \mathbf{T = V - (R) (Y) (45\%) (T)} \\
 T &= \$10,000,000 - 8\% (10 \text{ years}) (45\%) (T) \\
 & T = \$10,000,000 - .36 (T) \\
 & 1.36 (T) = \$10,000,000 \\
 & T = \$10,000,000 \div 1.36 \\
 & T = \$7,352,941 \text{ (Taxable Estate)}
 \end{aligned}$$

As such, with a \$10 Million illiquid asset (V), the deduction/*Graegin* loan amount must be:

$$\begin{aligned}
 & \mathbf{T = V - D} \\
 \$7,352,941 &= \$10,000,000 - D \\
 D &= \$10,000,000 - \$7,352,941 \\
 & \underline{D = \$2,647,059}
 \end{aligned}$$

**Example 3 (High Interest Rate):** Assume an illiquid asset that is worth \$10 Million, and the rate on the proposed loan is 12% for 10 years, interest only annually with a balloon note:

$$\begin{aligned}
 & \mathbf{T = V - (R) (Y) (45\%) (T)} \\
 T &= \$10,000,000 - 12\% (10 \text{ years}) (45\%) (T) \\
 & T = \$10,000,000 - .54 (T) \\
 & 1.54 (T) = \$10,000,000 \\
 & T = \$10,000,000 \div 1.54 \\
 & T = \$6,493,506 \text{ (Taxable Estate)}
 \end{aligned}$$

As such, with a \$10 Million illiquid asset (V), the deduction/*Graegin* loan amount must be:

$$\begin{aligned} T &= V - D \\ \$6,493,506 &= \$10,000,000 - D \\ D &= \$10,000,000 - \$6,493,506 \\ D &= \underline{\$3,506,494} \end{aligned}$$

5. For the brute force method on the same examples above, see Appendix A (Brute Force Method of Determining *Graegin* Loan Deduction Amount). This method should be used if algebra makes you sick to your stomach, causes uncontrollable facial tics, the loan terms provide for interest being payable on any accrued and unpaid interest, or the loan terms provide for amortized interest and principal payments.

## **B. The Net Amounts to Debtor Estate and Lender**

1. The *Hughes* cases mentioned above points out that *Graegin* loans are not simply about getting an upfront deduction, saving the estate up to 45% in transfer taxes. It is critical to take into account all of the after-tax (specifically including income taxes) savings to all parties involved, especially when the loan is from a family member, a trust (like an irrevocable life insurance trust) for the benefit of family members, or a family-owned entity.

2. The IRS takes the position that, from an income tax standpoint, the interest payable on a *Graegin*-type loan is “personal interest” and as such is not deductible pursuant to Section 163(h) of the Code,<sup>14</sup> despite the fact that the Code section provides that “indebtedness . . . properly allocable to the conduct of a trade or business,” is not treated as nondeductible personal interest.<sup>15</sup>

3. If the loan is an intra-family loan, *Graegin* and its progeny point out that exact identity of beneficial interest between the estate (as the debtor) and the affiliated lender may jeopardize the deduction of the interest under Section 2053 of the Code. If there is not exact identity of beneficial interest (whether individually or by share of beneficial interest in the estate or through the lender), as the *Hughes* cases point out, there are a number of potential fiduciary litigation issues that can result.

---

<sup>14</sup> I.R.S. Priv. Ltr. Rul. 94-49-011 (September 4, 1994)(The estate had procured a loan to pay Federal estate taxes, and the asserted reason for making the loan and not selling such assets was that prices were depressed. The IRS held, “[a]lthough the assets of the Estate consist of business and investment assets, interest on estate taxes cannot be considered trade or business or investment interest under section 163(h)(2)(A) or (B). The interest is allocable to the payment of the tax; not to business or investment assets. Furthermore, the tax arises merely on transfer of the estate assets, which does not qualify as an investment or business activity.”

<sup>15</sup> I.R.C. § 163(h)(2)(A); Kasner, *Is Interest Paid by an Estate on a Loan to Pay Estate Taxes Deductible?*, 66 TAX NOTES 98 (Jan. 2, 1995); Practical Drafting 4023-4024 (R. Covey ed. April 1995) (specifically commenting on this ruling, “[s]ince the estate assets not sold to pay estate taxes were primarily investment assets, the interest on the loan to avoid their sale would seem to be properly allocable to this property”).

4. For intra-family loans, essentially the potential tax savings can be summarized as the arbitrage between the interest (which is subject to income taxes at ordinary rates) received by the lender and the transfer tax savings under Section 2053 of the Code. See Appendix B, Calculation of Potential Tax Savings Arising from 5 Year *Graegin* Loan. As one can see, without taking into account the time value of the deferred income tax liabilities, the total tax savings can be significantly less than the transfer tax savings.

5. Finally, from an investment standpoint, it is important to note that all of the tax savings often assume that both the estate and the intra-family lender are invested in the same manner, but that is virtually never the case. *Graegin* loans are predicated upon not selling an asset when it is illiquid, quite often a closely-held company. Well, what would happen if the closely-held company went bankrupt? An intra-family lender, who has liquidity, would, in all likelihood, otherwise be investing the assets in publicly-traded securities, which has less of a chance to go bankrupt but which may not have the same return potential as the interest on the loan. Suffice it to say, fiduciaries should consider all of the variables.

6. For an example of how all of the variables (interest rate charged on the loan, investment risk, tax rates, etc.) please see the handout “*Graegin* Loan Wealth Forecasting Analysis.”

## V. LIQUIDITY ALTERNATIVES

### A. I.R.C. § 6161.

Consider applying for § 6161 relief in extreme circumstances (for instance, where §6166 does not apply) to allow the Estate renewable one-year extensions of time in which to pay the estate tax. Section 6161 is quoted as follows:

#### **SEC. 6161. EXTENSION OF TIME FOR PAYING TAX.**

##### (a) Amount Determined By Taxpayer on Return.—

(1) GENERAL RULE.—The Secretary, except as otherwise provided in this title, may extend the time for payment of the amount of the tax shown, or required to be shown, on any return or declaration required under authority of this title (or any installment thereof), for a reasonable period not to exceed 6 months (12 months in the case of estate tax) from the date fixed for payment thereof. Such extension may exceed 6 months in the case of a taxpayer who is abroad.

(2) ESTATE TAX.—The Secretary may, for reasonable cause, extend the time for payment of –

(A) any part of the amount determined by the executor as the tax imposed by chapter 11, or

(B) any part of any installment under section 6166 (including any part of a deficiency prorated to any installment under such section), for a reasonable period not in excess of 10 years from the date prescribed by section 6151(a) for payment of the tax (or, in the case of an amount referred to in subparagraph (B), if later, not beyond the date which is 12 months after the due date for the last installment).

(b) Amount Determined as Deficiency.—

(1) INCOME, GIFT, AND CERTAIN OTHER TAXES.—Under regulations prescribed by the Secretary, the Secretary may extend the time for the payment of the amount determined as a deficiency of a tax imposed by chapter 1, 12, 41, 42, 43, or 44 for a period not to exceed 18 months from the date fixed for the payment of the deficiency, and in exceptional cases, for a further period not to exceed 12 months. An extension under this paragraph may be granted only where it is shown to the satisfaction of the Secretary that payment of a deficiency upon the date fixed for the payment thereof will result in undue hardship to the taxpayer in the case of a tax imposed by chapter 1, 41, 42, 43, or 44, or to the donor in the case of a tax imposed by chapter 12.

(2) ESTATE TAX.—Under regulations prescribed by the Secretary, the Secretary may, for reasonable cause, extend the time for the payment of any deficiency of a tax imposed by chapter 11 for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency.

(3) NO EXTENSION FOR CERTAIN DEFICIENCIES.—No extension shall be granted under this subsection for any deficiency if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

(c) CLAIMS IN CASES UNDER TITLE 11 OF THE UNITED STATES CODE OR IN RECEIVERSHIP PROCEEDINGS.—Extensions of time for payment of any portion of a claim for tax under chapter 1 or chapter 12, allowed in cases under title 11 of the United States Code or in receivership proceedings, which is unpaid, may be had in the same manner and subject to the same provisions and

limitations as provided in subsection (b) in respect of a deficiency in such tax.

**B. I.R.C. § 6166.**

Consider applying for § 6166 relief where the Estate's liquidity crisis results at least in part from the estate's ownership interests in closely held entities. The general rule of § 6166 is quoted as follows:

**SEC. 6166. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS**

(a) 5-Year Deferral; 10-Year Installment Payment.—

(1) IN GENERAL.—If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in 2 or more (but not exceeding 10) equal installments.

(2) LIMITATION.—The maximum amount of tax which may be paid in installments under this subsection shall be an amount which bears the same ratio to the tax imposed by section 2001 (reduced by the credits against such tax) as—

- (A) the closely held business amount, bears to
- (B) the amount of the adjusted gross estate.

(3) DATE FOR PAYMENT OF INSTALLMENTS.—If an election is made under paragraph (1), the first installment shall be paid on or before the date selected by the executor which is not more than 5 years after the date prescribed by section 6151(a) for payment of the tax, and each succeeding installment shall be paid on or before the date which is 1 year after the date prescribed by this paragraph for payment of the preceding installment.

**C. Transacting with Closely Held Entities**

You might also consider other methods of obtaining liquidity, in addition to debt. To the extent that the decedent owned an interest in a closely held entity, you might consider instead obtaining liquidity by requesting that the entity make a distribution or requesting that the entity redeem some or all of the estate's interest in the entity. Each of these options is discussed briefly below. (For ease of discussion, it is assumed in the following discussion that the closely held entity is a partnership.)

**1. Requesting a Distribution from a Closely Held Entity:**

In order to minimize avenues of IRS attack, make sure that any distributions made by the partnership are proportionate to the percentage interests held by the partners in the partnership. In cases under IRS scrutiny where non-pro rata distributions have been made (typically to the parent/decedent partner), the IRS typically has argued that the partner receiving non-pro rata distributions retained rights to the assets contributed to the partnership such that § 2036 applies. The IRS has pursued this argument even when distributions were made pro rata, and even where distributions (pro rata or otherwise) were made post-death. Consequently, requesting a distribution from a closely held entity in order to pay estate taxes is not risk free.

**2. Requesting a Redemption by a Closely Held Entity:**

When seeking to transfer a partnership interest by way of redemption by the partnership, be sure to review the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Any redemption should be documented, to be executed by partnership management and the transferring partner or his personal representative. Consider having other partners consent, given that a redemption may affect them economically. Finally, be sure that the books and records of the partnership reflect a decrease in the transferring partner's interest and a corresponding proportionate increase to all remaining partners' interests. While taking these steps in the course of a redemption may help avoid IRS attack, beware that redemptions can be complicated and engaging in a redemption may cause increased legal fees during audit given the additional discussion often necessary to explain the transaction to the examining agent.

**APPENDIX A: BRUTE FORCE METHOD OF DETERMINING GRAEGIN LOAN DEDUCTION AMOUNT**

| Example 1: Low Interest Rate |                          |                |                   |                     |
|------------------------------|--------------------------|----------------|-------------------|---------------------|
| Term                         | 10                       |                |                   |                     |
| Rate                         | 4%                       |                |                   |                     |
| Value of Illiquid Asset      | Resulting 2053 Deduction | Taxable Estate | Estate Tax at 45% | Cumulative Interest |
| 10,000,000                   | 0                        | 10,000,000     | 4,500,000         | 1,800,000           |
| 10,000,000                   | 1,800,000                | 8,200,000      | 3,690,000         | 1,476,000           |
| 10,000,000                   | 1,476,000                | 8,524,000      | 3,835,800         | 1,534,320           |
| 10,000,000                   | 1,534,320                | 8,465,680      | 3,809,556         | 1,523,822           |
| 10,000,000                   | 1,523,822                | 8,476,178      | 3,814,280         | 1,525,712           |
| 10,000,000                   | 1,525,712                | 8,474,288      | 3,813,430         | 1,525,372           |
| 10,000,000                   | 1,525,372                | 8,474,628      | 3,813,583         | 1,525,433           |
| 10,000,000                   | 1,525,433                | 8,474,567      | 3,813,555         | 1,525,422           |
| 10,000,000                   | 1,525,422                | 8,474,578      | 3,813,560         | 1,525,424           |
| 10,000,000                   | 1,525,424                | 8,474,576      | 3,813,559         | 1,525,424           |

| Example 2: Average Interest Rate |                          |                |                   |                     |
|----------------------------------|--------------------------|----------------|-------------------|---------------------|
| Term                             | 10                       |                |                   |                     |
| Rate                             | 8%                       |                |                   |                     |
| Value of Illiquid Asset          | Resulting 2053 Deduction | Taxable Estate | Estate Tax at 45% | Cumulative Interest |
| 10,000,000                       | 0                        | 10,000,000     | 4,500,000         | 3,600,000           |
| 10,000,000                       | 3,600,000                | 6,400,000      | 2,880,000         | 2,304,000           |
| 10,000,000                       | 2,304,000                | 7,696,000      | 3,463,200         | 2,770,560           |
| 10,000,000                       | 2,770,560                | 7,229,440      | 3,253,248         | 2,602,598           |
| 10,000,000                       | 2,602,598                | 7,397,402      | 3,328,831         | 2,663,065           |
| 10,000,000                       | 2,663,065                | 7,336,935      | 3,301,621         | 2,641,297           |
| 10,000,000                       | 2,641,297                | 7,358,703      | 3,311,416         | 2,649,133           |
| 10,000,000                       | 2,649,133                | 7,350,867      | 3,307,890         | 2,646,312           |
| 10,000,000                       | 2,646,312                | 7,353,688      | 3,309,160         | 2,647,328           |
| 10,000,000                       | 2,647,328                | 7,352,672      | 3,308,703         | 2,646,962           |
| 10,000,000                       | 2,646,962                | 7,353,038      | 3,308,867         | 2,647,094           |
| 10,000,000                       | 2,647,094                | 7,352,906      | 3,308,808         | 2,647,046           |
| 10,000,000                       | 2,647,046                | 7,352,954      | 3,308,829         | 2,647,063           |
| 10,000,000                       | 2,647,063                | 7,352,937      | 3,308,821         | 2,647,057           |
| 10,000,000                       | 2,647,057                | 7,352,943      | 3,308,824         | 2,647,059           |
| 10,000,000                       | 2,647,059                | 7,352,941      | 3,308,823         | 2,647,059           |

| Example 3: High Interest Rate |                          |                |                   |                     |
|-------------------------------|--------------------------|----------------|-------------------|---------------------|
| Term                          | 10                       |                |                   |                     |
| Rate                          | 12%                      |                |                   |                     |
| Value of Illiquid Asset       | Resulting 2053 Deduction | Taxable Estate | Estate Tax at 45% | Cumulative Interest |
| 10,000,000                    | 0                        | 10,000,000     | 4,500,000         | 5,400,000           |
| 10,000,000                    | 5,400,000                | 4,600,000      | 2,070,000         | 2,484,000           |
| 10,000,000                    | 2,484,000                | 7,516,000      | 3,382,200         | 4,058,640           |
| 10,000,000                    | 4,058,640                | 5,941,360      | 2,673,612         | 3,208,334           |
| 10,000,000                    | 3,208,334                | 6,791,666      | 3,056,250         | 3,667,499           |
| 10,000,000                    | 3,667,499                | 6,332,501      | 2,849,625         | 3,419,550           |
| 10,000,000                    | 3,419,550                | 6,580,450      | 2,961,202         | 3,553,443           |
| 10,000,000                    | 3,553,443                | 6,446,557      | 2,900,951         | 3,481,141           |
| 10,000,000                    | 3,481,141                | 6,518,859      | 2,933,487         | 3,520,184           |
| 10,000,000                    | 3,520,184                | 6,479,816      | 2,915,917         | 3,499,101           |
| 10,000,000                    | 3,499,101                | 6,500,899      | 2,925,405         | 3,510,486           |
| 10,000,000                    | 3,510,486                | 6,489,514      | 2,920,281         | 3,504,338           |
| 10,000,000                    | 3,504,338                | 6,495,662      | 2,923,048         | 3,507,658           |
| 10,000,000                    | 3,507,658                | 6,492,342      | 2,921,554         | 3,505,865           |
| 10,000,000                    | 3,505,865                | 6,494,135      | 2,922,361         | 3,506,833           |
| 10,000,000                    | 3,506,833                | 6,493,167      | 2,921,925         | 3,506,310           |
| 10,000,000                    | 3,506,310                | 6,493,690      | 2,922,160         | 3,506,592           |
| 10,000,000                    | 3,506,592                | 6,493,408      | 2,922,033         | 3,506,440           |
| 10,000,000                    | 3,506,440                | 6,493,560      | 2,922,102         | 3,506,522           |
| 10,000,000                    | 3,506,522                | 6,493,478      | 2,922,065         | 3,506,478           |
| 10,000,000                    | 3,506,478                | 6,493,522      | 2,922,085         | 3,506,502           |
| 10,000,000                    | 3,506,502                | 6,493,498      | 2,922,074         | 3,506,489           |
| 10,000,000                    | 3,506,489                | 6,493,511      | 2,922,080         | 3,506,496           |
| 10,000,000                    | 3,506,496                | 6,493,504      | 2,922,077         | 3,506,492           |
| 10,000,000                    | 3,506,492                | 6,493,508      | 2,922,079         | 3,506,494           |
| 10,000,000                    | 3,506,494                | 6,493,506      | 2,922,078         | 3,506,493           |

**APPENDIX B: CALCULATION OF POTENTIAL TAX SAVINGS ARISING FROM 5 YEAR GRAEGIN LOAN**

| Year                                    | Loan Amount | Interest Rate on the Loan | Loan Interest due to LLC | Federal Tax Rate                           | Total Federal Tax on Interest |
|---|-------------|---------------------------|--------------------------|--|-------------------------------|
|   | (1)         | (2)                       | (3) = (1) x (2)          | (4)  | (5) = (3) x (4)               |
| 2009                                    | 10,000,000  | 8.0%                      | 800,000                  | 35.0%                                      | 280,000                       |
| 2010                                    |             | 8.0%                      | 800,000                  | 35.0%                                      | 280,000                       |
| 2011                                    |             | 8.0%                      | 800,000                  | 39.6%                                      | 316,800                       |
| 2012                                    |             | 8.0%                      | 800,000                  | 39.6%                                      | 316,800                       |
| 2013                                    |             | 8.0%                      | 800,000                  | 39.6%                                      | 316,800                       |
|   |             |                           |                          |  |                               |
| Total Reduction of Estate Tax Liability |             |                           | 1,800,000                | (6) = Total of (3) x 45.0% Estate Tax Rate |                               |
| Total Federal Tax on Interest to LLC    |             |                           | 1,510,400                | (7) = Total of (5)                         |                               |
| Total Tax Savings                       |             |                           | <b>289,600</b>           | (8) = (6) - (7)                            |                               |