Tax Court Allows Interest Deduction for Interest on a Graegin-type Loan

By: Lisa M. Rico, Esq.

In Duncan v. Commissioner, T.C. Memo 2011-255, the Tax Court allowed an interest deduction for interest on a loan from an irrevocable trust, of which the decedent was the beneficiary, to a revocable trust established by decedent. The loan was used to pay a portion of the decedent’s estate’s federal estate tax.

Background

The decedent Vincent J. Duncan, Sr. (“Vincent Sr.”) was the primary beneficiary of a trust established upon the death of his father (the “Walter Trust”), which trust held a one-third interest in an oil and gas business. During Vincent Sr.’s lifetime, the Walter Trust was for his benefit and for the benefit of his spouse and descendants. In addition, Vincent Sr. was granted a power to appoint the trust’s remainder beneficiaries at his death. At the time of Vincent Sr.’s death, decedent’s son, Vincent J. Duncan, Jr. (“Vincent Jr.”) and Northern Trust Company (“NTC”), a wholly owned subsidiary of the Northern Trust Corporation, were the co-Trustees of the Walter Trust.

Vincent Sr. also had his own oil and gas business, the Club Oil & Gas, Ltd., LP (“Club LP”), a limited partnership. Initially, Vincent Sr. owned a 99% limited partner interest in Club LP and by Club Oil and Gas, Inc. (“Club Inc.”), an S corporation wholly owned by Vincent Sr. owned the 1% general partner interest. Prior to his death, Vincent Sr. reorganized the ownership structure of the oil and gas businesses, including the oil and gas business in the Walter Trust. The Walter Trust contributed its oil and gas business and approximately $2 million in cash to Club LP in exchange for a 56.6245% partnership interest. Club LP was thereafter converted into Club Oil & Gas Ltd. LLC (“Club LLC”). After the reorganization, the Walter Trust owned 56.6245% of Club LLC and the remainder of Club LLC was owned by Club Inc., which was wholly-owned by the Vincent J. Duncan 2001 Trust (the “2001 Trust”), a revocable trust which Vincent Sr. had established. The 2001 Trust was governed by Illinois law and Vincent Jr. and NTC were then serving as co-trustees.

Vincent Sr. died on January 14, 2006. Vincent, Jr. and Northern Trust, NA (NTNA), a wholly owned subsidiary of the Northern Trust Corporation, served as co-executors of his estate. At the time of Vincent Sr.’s death, the 2001 Trust owned 100
percent of Club Inc. and various entities that owned and operated a ski resort and the land near the ski resort. Vincent Sr.’s estate also included a number residences and vacant real estate lots.

Under the terms of the 2001 Trust, the Trustees were directed to pay out of the trust estate the estate's obligations and death taxes. After payment of the estate's expenses, the 2001 Trust was to be divided into six trusts, one for each of Vincent Sr.’s six children (collectively, the “2001 Subtrusts”). Each child (the “primary beneficiary”) and his or her spouse were the beneficiaries his or her subtrust. Each primary beneficiary was granted the power to appoint at his or her death any person or entity as the remainder beneficiary of his or her subtrust.

Vincent Sr. exercised the power of appointment granted to him in the Walter Trust by directing the principal of the Walter Trust be distributed pursuant to the terms of the 2001 Trust. The 2001 Trust directed the Walter Trust be divided into six trusts, one for each of Vincent Sr.’s six children (collectively, the “Walter Subtrusts”). The terms of the Walter Subtrusts were identical to the terms of the 2001 Subtrusts, except in the Walter Subtrusts each primary beneficiary has a limited power of appointment that allows for the distribution of the trust principal only to a descendant of Vincent Sr. or for a charitable purpose.

NTC estimated that the estate's federal estate tax liability would be $11.1 million. NTC also determined that the 2001 Trust needed to retain a cash reserve to satisfy the estate's other obligations. In order to raise the additional necessary funds, the co-executors sold the estate’s marketable securities for approximately $2 million, received a $3.2 million distribution from Club Inc. and decided to borrow money to pay the balance of the estate’s expenses. In October 2006, Vincent Jr. and NTC (as co-trustees of both the 2001 Trust and the Walter Trust) executed a secured promissory note reflecting a $6,475,515.97 loan from the Walter Trust to the 2001 Trust. The loan was a 15 year balloon note (chosen because of the volatility of the oil and gas businesses) with an interest at a rate of 6.7% per annum, compounded annually (Northern Trust Corporation's banking department's prevailing interest rate for a 15-year bullet loan). The note expressly prohibited the prepayment of interest and principal. At
the time the loan was made, the long-term applicable federal rate (“AFR”) was 5.02% and the prime rate of interest was 8.25%.

Vincent Sr.’s estate claimed the $10,653,826 interest owed by the 2001 Trust to the Walter Trust as an administration expense deduction under IRC §2053(a)(2) on the estate’s federal estate tax return. The Internal Revenue Service (the “IRS”) denied the deduction. The IRS contended that the estate was not entitled to deduct its interest expense because (i) the loan was not a bona fide debt, the loan was not actually and reasonably necessary to the administration of the estate, and (ii) the amount of the interest expense is not ascertainable with reasonable certainty.

**Bona Fide Loan**

In general, the courts have found interest on a loan to be deductible as an administration expense it must be a bona fide loan and it must meet the requirements under IRC § 2053(a)(2) and the regulations thereunder. A number of factors come into play when making the determination: Whether the loan is a bona fide loan. Does the estate have an unconditional obligation to repay the sums advanced to it? Does the loan have economic effect? Is the interest rate a reasonable interest rate? Whether a loan is deemed to be a “bona fide loan” turns on the intent of the estate at the time the distribution is made; that is, whether the estate and the “lender” actually anticipate repayment. This is essentially a factual determination, and the onus is on the estate to prove its intent. The courts have looked at various factors in determining intent, which may include the existence of promissory notes; collateral or interest payment provisions; reasonable expectation or enforceable obligation to repay the loan; whether and to what extent the “lender” is related to the estate; the treatment of such distributions in corporate records; any history of repayment of funds; and the estate’s use of the funds. See, e.g., *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, *Geftman v. Commissioner*, 154 F.3d 61 (3rd Cir., 1998), *Busch et al. v. Commissioner*, 728 F.2d 945 (7th Cir., 1984) and *Tollefsen v. Commissioner*, 431 F.2d 511 (2d Cir., 1970).

The Tax Court in *Duncan* first looked at whether the loan was a bona fide loan. The IRS argued that the loan was not bona fide based on factors from prior cases, *Estate of Rosen v. Commissioner*, T.C. Memo. 2006-115 and *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477. The Tax Court dismissed the factors in *Estate of
Rosen as irrelevant because they were used to decide whether a purported loan should be classified as equity rather than debt, which was not the situation in Duncan. Addressing the factors taken from Estate of Graegin, the Tax Court concluded that while the factors may provide helpful guidance (helpful to a court in analyzing all relevant facts and circumstances), they are not exclusive, and no single factor is determinative. The Tax Court determined that the questions that must be asked are (i) whether there was a genuine intention to create a debt with a reasonable expectation of repayment, and (ii) whether that intention fits the economic reality of creating a debtor-creditor relationship.

The IRS’s argument that the debt was not genuine was two-fold. First, the IRS argued that there was no objective indication that the Walter Trust intended to create a genuine debt and that the 2001 Trust intended to repay the loan. Second, the IRS contended that the loan had no economic consequence because the borrower and creditor trusts were identical, having the same trustees and beneficiaries.

The Tax Court dismissed the IRS’s arguments because the Trustees of the 2001 Trust, even though they were the same Trustees as the Walter Trust, were compelled under state law (Illinois) to treat the two trusts as two distinct trusts. The Trustees of the two trusts were prohibited under state law from commingling assets. Thus, Vincent Jr. and NTC could not simply ignore the 2001 Trust’s loan obligations because nonpayment of the loan would improperly impose a loss on the Walter Trust and thereby effectively shift assets to the 2001 Trust.

The Court further indicated there is no basis in Federal tax law for treating the 2001 Trust and the Walter Trust as a single trust. The only authorities that allow consolidation of multiple trusts are for income tax purposes under IRC § 643 in situations where trusts with the same or substantially the same grantor. Since this was an estate tax case, the Tax Court determined neither IRC § 643 nor its regulations were applicable to this case.

Section 2053(a)(2) Requirements

For an expense to be deductible as an administration expense it must meet the requirements under IRC § 2053(a)(2). Treas. Reg. §§ 20.2053-1(a)(1); 20.2053-1(a)(2)(ii); 20.2053-1(b)(3); 20.2053-3(a). An expense is deductible as an
administration expense under IRC § 2053(a)(2) if it is (1) “payable out of property subject to claims and which are allowable by the law of the jurisdiction, …, under which the estate is being administered;” (2) “ascertainable with reasonable certainty, and will be paid;” and (3) “actually and necessarily incurred in the administration of the decedent’s estate” (i.e., expenses incurred in the collection of the assets, payment of debts, and distribution of property to the persons entitled to it). Treas. Reg. §§ 20.2053-1(a)(1); 20.2053-1(a)(2)(ii); 20.2053-1(b)(3); 20.2053-3(a). The IRS argued that the interest expense in *Duncan* did not meet the requirements of (2) and (3), above.

“Actually and Necessarily Incurred in the Administration of the Decedent’s Estate”

The IRS argued that the loan was not actually and reasonably necessary because the loan was not necessary to prevent financial loss in that (1) the 2001 Trust could have instead sold illiquid interests in Club LLC to the Walter Trust at full fair market value and (2) the terms of the loan were unreasonable. The IRS also looked to the *Estate of Black v. Commissioner*, 133 T.C. 340 (2009), in which the Tax Court disallowed an interest deduction for a loan between the estate and family owned business that the estate substantially owned for support of its argument. The Tax Court differentiated *Black* from the situation in *Duncan* because it was clear that in *Black* the loan could not have been repaid without the partnership selling its assets attributable to the estate’s partnership interest, therefore, the Tax Court found the loan to be unnecessary. This was not the case in *Duncan* the 2001 Trust would be paying off the loan from income generated from Club LLC during the term of the loan.

The Tax Court also concluded that the 2001 Trust could not have sold any of its interest in Club LLC to the Walter Trust at fair market value. If other prospective purchasers could have insisted on a discount, the Trustees of the Walter Trust would have been required to do the same. Under state law, the Trustee could not have directed the Walter Trust to purchase the 2001 Trust's membership interests at an unreduced price because they would have improperly shifted the value of the discount from the Walter Trust to the 2001 Trust.

The Tax Court also rejected the IRS argument that the terms of the loan were unreasonable. The IRS argued that the loan should have carried a shorter term (because the 2001 Trust generated income necessary to pay off the loan in 3 years)
and a lower interest rate. The Trustees were not reasonably certain that the 2001 Trust would have enough money to fully pay the estate's federal estate tax and administration expenses within three years. To the contrary, Club Inc.'s accountant credibly testified that the volatility in the price of oil and gas made it difficult to predict future income from Club Inc. The Tax Court, therefore, concluded that although the estate may have generated enough cash to repay the loan after three years, they will not use the benefit of hindsight to second guess the Trustees judgment when they were acting in the best interest of the estate.

The IRS's argument that the interest was unreasonable also failed. The IRS's argued that the Trustees should have used the long-term AFR instead of the rate used and that the Trustees' selection of a higher interest rate has no economic consequence because the Walter Trust's interest income offsets the 2001 Trust's interest expense. In addition, the IRS argued that the loan's interest rate was not reasonable because there were no negotiations between the two trusts. Again, the Tax Court disagreed because the long-term AFR did not represent the 2001 Trust's cost of borrowing. The Tax Court explained that interest rates are generally determined according to the debtor's rather than the creditor's characteristics. The use of the long-term AFR was inappropriate because it is based on the Government's cost of borrowing and, therefore, would have been unfair to the Walter Trust.

The Court went on to reject the IRS's argument that a higher interest rate is economically inconsequential, which was argued based on the IRS's view that the Trusts should be treated as one trust. The Tax Court also disagreed with the IRS's argument that the interest rate was unreasonable because no negotiations had taken place. The Tax Court concluded that Vincent Jr. and NTC (the Trustees of both Trusts) made a good-faith effort to select an appropriate interest rate by asking the Northern Trust Corporation's banking department for the market rate of interest. Once more, the Tax Court concluded that there is no reason to second guess their judgment.

"Ascertainable with Reasonable Certainty, and Will be Paid"

Finally, the Tax Court looked at the issue of whether the interest was ascertainable with reasonable certainty, and will be paid. Interest is only deductible to the extent that it has actually accrued. Rev. Rul. 84-75, 1984-1 C.B. 193. However,
under Treas. Reg. § 20.2053-1(b)(3), if interest can be ascertained with reasonable
certainty and it will in fact be paid, even if the exact amount is not known, the estate
may take an immediate interest deduction. The IRS argued that because the Trustees
and the beneficiaries were the same on both sides of the loan there would be no
economic interest in enforcing the prepayment prohibition clause, the 2001 Trust could
choose to make an early repayment of the loan and the early repayment would reduce
the total amount of interest. Again, the Tax Court rejected the IRS’s argument that the
Trust should be treated as one trust, stating that the Walter Trust and the 2001 Trust
are distinct trusts to be administered separately. If interest rates rose the Walter Trust
would benefit from early repayment, in which case the Trustees would not direct an
early repayment because this would harm the 2001 Trust. If interest rates did not rise,
the Trustees would not allow prepayment because that would reduce the Walter Trust’s
interest income. Therefore, the Tax Court concluded the Trustees of neither Trust
could allow prepayment.

Accordingly, the Tax Court allowed the deduction for the interest expense as an
administration expenses. The Tax Court also addressed two additional issues, which
were not the focus of this summary: whether Vincent Sr.’s estate could decrease the
gross estate and whether certain administration expenses not taken on the originally
filed estate tax return may be deducted. The Tax Court held that the gross estate could
not be decreased and allowed some additional expenses and denied others.