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Graegin Loans – Another Way to Reduce Estate Tax

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INTRODUCTION

Decedents' estates use so-called *Graegin* loans when an estate's sole major asset is an interest in a closely-held business. There are a variety of reasons why the executor may not want to sell the decedent's business interests—surviving family members may want to continue the business, or there may be a down market that temporarily reduces the value of those interests.

Unfortunately, the executor may need to look to those business interests to provide cash for estate expenses. Instead of selling the interests, the executor can either borrow money from the business or borrow money from a third party.

THE INTEREST DEDUCTION

The taxable estate is determined by deducting certain expenses, including administration expenses from the gross estate.[1] Necessary expenses in this context include those incurred for the collection and marshalling of assets, payment of debts, and distribution of property to beneficiaries. Nonessential expenses incurred for the individual benefit of heirs, legatees, or devisees are not deductible.

The personal representative may deduct loan interest if the personal representative actually and necessarily incurred interest expense in administering the estate.[2] A personal representative reasonably and necessarily incurs a loan when such loans prevent the forced sale of assets, especially at a reduced price such as an interest in a closely held business.[3] If the estate has enough liquid assets to pay estate taxes and other expenses, the forced sale of assets is not necessary.

In *Estate of Graegin*, the decedent's estate consisted primarily of non-probate assets. The assets at issue were assets held in the decedent's widow's trust, assets held in his own trust, and a $500,000 term life insurance policy payable to the decedent's son, a co-executor of the estate. Cecil Graegin's will stated that his residuary estate poured over to his trust, which was charged with payment of all claims and expenses of his estate.

The assets held in the decedent's trust consisted of a 97% interest of 5,130 shares of voting preferred stock of Graegin Industries, Inc., a closely held corporation. The shares were valued for estate tax purposes at $110 per share, an aggregate of $564,300.

After setting aside amounts to pay estimated administration expenses and Indiana inheritance taxes, the estate had approximately $20,000 in liquid assets available to pay federal estate taxes of $204,218. The estate executors elected to borrow $204,218 to pay the federal estate taxes, rather than sell the Graegin Industries stock. Graegin Corporation, a wholly owned subsidiary of Graegin Industries, agreed to loan the estate the needed $204,218, approval for which was obtained from the local probate court.

The loan consisted of an unsecured note at 15% per annum with a single balloon payment of principal and interest note at the end of the 15-year loan term. The term was set to coincide with the widow's life expectancy; it was expected that at her death, the assets in

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[1] §2053(a)(2). All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] Reg. §20.2053-3(a).

[3] *See*, *Estate of Thompson v.Commissioner*, T.C. Memo. 1998-325; *Estate of McKee v. Commissioner*, T.C. Memo. 1996-362; *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477; *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971); *Estate of Huntington v. Commissioner*, 36 B.T.A. 698, 726 (1937); Rev. Rul. 84-75.

her trust would be available to satisfy in part the note obligation. The note terms prohibited any prepayment of principal or interest. Graegin's son Paul held several related positions and acted in several related capacities in connection with the loan: he was co-executor of the decedent's estate and co-trustee of the decedent's trust; he was president of Graegin Industries and Graegin Corporation; and he was a member of the board of directors for both companies.

On its federal estate tax return, the estate deducted $459,491, the amount of the single interest payment due upon the note's maturity ($204,218 x 15% x 15 years), as an administration expense. The Internal Revenue Service disallowed that deduction.

The Tax Court held that the entire amount of interest on the note was deductible as an administration expense under §2053(a)(2). It discussed three issues in reaching its holding: whether the estate actually incurred the interest expense and could reasonably estimate such expense; whether the interest expense was a necessary estate expense; and whether the estate lacked liquidity and had to borrow money to prevent a forced sale of estate assets.

To deduct the interest expense, the estate had to show that the amount of the estimated interest expense was ascertainable with reasonable certainty and that it would be paid.[4] The Tax Court noted that it held in past cases that interest incurred for a loan to pay estate taxes was an allowable administration expense.[5] The court also noted that it previously held that projected interest payments are deductible for estate tax purposes as administration expenses.[6]

The court held that "the amount of interest on the note is not vague or uncertain but instead is capable of calculation ($204,218 x 15% x 15 years = $459,491). The court reasoned that the promissory note could not be prepaid, either as to principal or interest. The court also found credible Paul Graegin's testimony as to his intent to cause the loan to be timely repaid. The court concluded that the amount of interest on the note was ascertainable with reasonable certainty, and that it would be paid.[7]

The court also held that the estate "actually and necessarily incurred" the interest expense, a requirement found in Reg. §20.2053-3(a). In rejecting the IRS's argument that the borrowing by the estate from Graegin Corporation was not a true loan because Paul Graegin controlled both the borrower and lender of an unsecured note, the court stated that it needed to review the facts and circumstances of the subject transaction. It cited *Busch v. Commissioner*, 728 F. 2d 945 (7th Cir. 1984) in this regard. The court stated that the existence of a loan is determined by whether repayment was in fact contemplated by the borrower and lender, citing *Tollefsen v. Commissioner*, 431 F. 2d 511 (2d Cir. 1970), for this proposition. The court found Paul Graegin's testimony regarding his intent to repay the loan to be credible. It determined that the interest rate was reasonable, even though it was based on the prime rate of interest, a short-term obligation interest rate, while the loan in question was for a 15-year period.

The court was "disturbed" by the fact that the note consisted of one balloon payment but stated that this repayment term was not unreasonable given the decedent's postmortem asset arrangement. The court also noted that both the bank and the guardian ad litem for the minor heirs, even though they were not adverse parties, concurred in the decision to borrow from the Graegin Corporation and that the probate court approved the loan.

Although the court agreed with the IRS that Paul Graegin's relation to the borrower and lender required scrutiny of the transaction, it stated that "such identity of interest per se is not fatal in characterizing the transaction as a loan."[8] The court understood the potential of abuse but reiterated that it found Paul Graegin's testimony to be credible, and that there was a 3% outside shareholder of the corporation who could object to the transaction.

The court held that the estate lacked liquidity and would have to borrow money to satisfy its federal estate tax liability. It held that estate expenses incurred to prevent financial loss to an estate resulting from forced sales of its assets in order to pay estate taxes are deductible administration expenses, citing *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971) and *Estate of Huntington v. Commissioner*, 36 B.T.A. 698 (1937).

AFTER GRAEGIN: FACTORS IN DETERMINING THE VALIDITY OF THE LOAN

Although the *Graegin* court looked at several factors in upholding the interest expense deduction, courts have stated that such factors are not exclusive and thus no single factor is determinative of the is-

[4] Reg. §20.2053-1(b)(3).

[5] *Id.* at 391; *see also* Reg. §20.2053-3(a); *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971) (interest incurred for a loan to pay federal estate taxes and state inheritance taxes was an allowable administration expense).

[6] 56 T.C.M. (CCH) at 391, *citing Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977).

[7] *See also Estate of Bailly v. Commissioner*, 81 T.C. 246 (1983), supplemental opinion at 81 T.C. 949 (1983).

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

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sue.[9] The court uses these factors as objective criteria in analyzing all relevant facts and circumstances.[10] The ultimate issue is whether there was a ''genuine intention to create a debt with a reasonable expectation of repayment and whether that intention fits the economic reality of creating a debtor-creditor relationship.''[11]

In *Kahanic*, the Tax Court held the absence of a demand to repay a loan at the time the loan is made does not evidence any lack of intent to create a genuine debt.[12] It determined that the decedent's ex-wife-lender did not demand repayment of the loan because doing so would have exhausted the estate's funds. The estate would have been unable to challenge the IRS's deficiency determinations, thus potentially subjecting the executor to transferee liability. The court noted that the executor intended to repay the loan in full and received advice from accountants that the estate had enough assets to repay the principal and accrued interest.

The *Kahanic* case involved the difficulty in repaying a loan caused by the decrease in value and lack of availability of estate assets. The estate held two valuable non-liquid assets, the decedent's medical practice and unpaid compensation from that practice due him for the year before his death. The decedent's former business adviser advised the estate that selling the medical practice as a going concern would yield the most money. However, when the estate needed to pay its federal and Illinois tax liabilities, it had not been able to find a buyer for the medical practice.

Additionally, the executor learned that the decedent's former employees were considering a potential lawsuit related to any attempts to sell the medical practice as a going concern. Thus, with limited cash on hand and desiring to avoid a forced sale of the business, the estate made the decision that it needed to borrow money in order to timely pay its federal and Illinois estate taxes.

The court determined that if the estate liquidated the medical practice and sold its individual assets in a forced sale the result would be a financial loss. Seventy-six percent of the total business assets were accounts receivable. If the estate chose to sell the accounts receivable it likely would have been at a deep discount to reflect the present values of the receivables and possibility of un-collectability.

In addition, the business lacked the cash necessary to pay the decedent's unpaid compensation. The business had a limited amount of cash, which was insufficient to pay any winding-up expenses and an existing balance on a line of credit. The executor also had to evaluate the possibility of two medical malpractice lawsuits and a lawsuit brought by the decedent's former employees. The court weighed these facts and circumstances and determined that the estate ''actually and necessarily incurred'' the interest on the loan and could deduct such interest against the estate tax balance.

Courts have provided additional guidance regarding the determination of liquidity. First, it is not necessary that the estate exhaust all sources of liquidity in order to deduct interest.[13] Second, if the estate subsequently determines that it has enough liquid assets to satisfy the tax liability, some portion of the interest incurred may be deemed nondeductible.[14] Third, courts will consider the term of the loan and may require the term to have some relation to the time period of illiquidity for the entire interest amount to be deductible.[15]

In *Estate of Koons v. Commissioner,*[16] the Tax Court held that the estate could deduct interest for the Graegin Loan from the family entity because the loan was not necessary. In *Koons*, the decedent's revocable trust owned 46.9% of the voting stock and 51.5% of the non-voting stock of a company distributing PepsiCo products. The company sold these assets, transferring the remaining assets, owned by the children or owned by trusts for their benefit, to a limited liability company. The LLC offered to redeem such interests. The estate borrowed $10.75 Million from the LLC in exchange for a promissory note at 9.5% per annum, payable over 6 ½ years, but not to begin until 18 years after the date of the promissory note. The LLC had over $200 Million of ''highly liquid assets.'' Interest payments over the loan term approximated $71.4 Million. The Tax Court disallowed the interest deduction, reasoning that the revocable trust could have forced a distribution form the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution. The Tax Court rejected the taxpayer's argument that a cash distribution would leave the LLC with less cash to buy businesses (the purpose of the LLC was to invest in businesses), noting that the loan also depleted the LLC of cash. Finally, the Tax Court reasoned that the estate would be open 25 years, preventing proper and efficient settlement of the Estate.

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[9] *See Patrick v. Commissioner*, T.C. Memo. 1998-30, *aff'd.* without published opinion 181 F.3d 103 (6th Cir. 1999), *cited in Estate of Kahanic v. Commissioner*, T.C. Memo. 2012-81 at 41.

[10] *See also Duncan v. Commissioner*, T.C. Memo 2011-255.

[11] *Estate of Kahanic v. Commissioner*, T.C. Memo. 2012-81 at 41, *citing Litton Bus. Sys., Inc., v. Commissioner*, 61 T.C. 367, 377 (1973).

[12] *Estate of Kahanic* at 43.

[13] *Estate of Thompson v. Commissioner,* T.C. Memo. 1998-325; *Estate of Sturgis v. Commissioner,* T.C. Memo. 1987-415.

[14] *Estate of Gilman v. Commissioner*, T.C. Memo 2004-286 (2004).

[15] *Id.*

[16] T.C. Memo. 2013-94.

Advantages of the Graegin Loan

The advantage to structuring a *Graegin* loan is that the estate may deduct any interest on the loan in computing estate taxes. The estate may be able to defer estate tax payments provided the estate meets certain qualifications.[17] The estate may also include terms in the note that permit the estate to delay payments under the loan. This frees up cash to the estate for use in business operations or for other purposes. Whether or not the estate qualifies for estate tax deferral under §6166 will not affect its ability to qualify for a deduction on the interest paid in connection with the loan.[18]

An executor may elect to pay all or part of the estate tax due in two or more (but not exceeding 10) equal installments if the decedent was a citizen or resident of the United States when he died. The value of the interest in the closely held business must exceed 35% of the value of the decedent's gross estate.[19] In addition to an interest as a proprietor, a closely held businesses interest can be held as a partner in a partnership or a shareholder in a corporation that qualifies under §6166(b)(1). A partnership interest qualifies if 20% or more of the total capital interest in the partnership is included in the gross estate or the partnership has fewer than 45 partners carrying on a trade or business.[20] A shareholder interest qualifies if 20% or more of the value of the voting stock is included in determining the gross estate or the corporation had 45 or fewer shareholders.[21] Determining the decedent's interest in a close-held entity may consider ownership attribution rules such as spousal or family interest, and entity attribution by use of the ''look through'' rules.[22]

Any deferred amounts, including interest, penalties, and costs are subject to a special estate tax lien in favor of the U.S. government. Property subject to the lien include interests in real property, interests in other types of property to the extent such property is expected to survive the period of deferral, and other property designated by agreement. The estate tax lien is a lien upon the gross estate for 10 years from the decedent's date of death.[23]

The Service does not have to record the estate tax lien for it to be effective and enforceable. Nor does it have to keep a record of the release of the lien. *See* IRM 5.5.8 (Estate Tax Liens). Further discussion of estate tax liens is beyond the scope of this article.

[17] §6166.

[18] *Estate of McKee v. Commissioner*, T.C. Memo. 1996-362.

[19] §6166(a)(1).

[20] §6166(b)(1)(B).

[21] §6166(b)(1)(C).

[22] §6166(b)(2)(C).

[23] *See generally* §6324A, §6324(a)(1).

Carrying on a Trade or Business in Real Estate

The determination as to whether an interest qualifies as an interest in a closely held business is made immediately before the decedent's death in order to determine whether the estate qualifies for the extension.[24] For purposes of determining value, passive assets (assets not used in carrying on a trade or business) are excluded from the calculation.[25]

The use of property managers or third parties to conduct one's business in a real estate setting causes issues for meeting the ''carrying on trade or business'' definition. Even if some of the business activities are conducted by such agents, the business will still qualify under §6166 if such activities are not ''of such a nature that the activities of the decedent, partnership, LLC or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property.''[26]

Rev. Rul. 2006-34 provides useful guidance. The Internal Revenue Service recognizes that business owners often employ independent contractors such as property management companies to perform the business's day-to-day operations and activities. But if the business owner uses an unrelated property management company to perform most of the activities associated with the real estate interests, the IRS takes the position that an active trade or business does not exist.

Rev. Rul. 2006-34 employs several nonexclusive factors to determine whether the decedent's interest in real property is an interest in an asset in an active trade of business, none of which are dispositive to such issue. The first factor is the amount of time the decedent, decedent's agents, or employees (includes the partnership, limited liability company or corporation – and for all the listed factors) devote to the trade or business. The second factor is whether an office was maintained for the conduct or coordination of such activities and whether regular business hours were maintained for that purpose. The third factor is the extent that the decedent (or agents/employees and the entities listed above) are actively involved in finding new tenants or negotiating/executing new leases.

The fourth factor is the extent to which the decedent (or agents/employees and the entities listed above) provided landscaping, grounds care, or other services beyond the mere furnishing of the leased premises. The fifth factor is the extent to which the decedent (or agents/employees and the entities listed above) personally made, arranged for, performed, or

[24] §6166(b)(2)(A).

[25] §6166(b)(9)(B)(i).

[26] Rev. Rul. 2006-34.

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supervised repairs and maintenance to the property, including acts such as painting, carpentry, and plumbing. The final factor articulated in the revenue ruling is the extent to which the decedent (or agents/ employees and the entities listed above) handled tenant repair requests and complaints.

Purpose of the Graegin Loan

Courts will closely scrutinize loans between related parties to determine whether the loans are for a bona fide, non-tax purpose. This is especially true when there is an identity of interest between the lender and the borrower.[27] In addition, the loan must be for the benefit of the estate and not for any of the estate beneficiaries.[28]

It is important to consider all the after-tax savings or issues to all parties involved in the ''Graegin'' Loan transaction, especially when the loan is from a family member, a trust such as an ILIT for the benefit of family members, or a family owned entity. There may also be issues if the closely-held company files bankruptcy proceedings. This contravenes the purpose of ''Graegin'' loans, which is predicated upon not selling an illiquid asset. Additionally, a lender will have to pay income taxes on interest income.

Additionally, a lender will have to pay income taxes on interest income. A tax-exempt lender-entity would not be subject to income tax, however, thus enhancing the overall tax savings. Finally, there are also issues regarding investment objectives of intra-family lenders, who may choose to invest in less risky (in terms of bankruptcy) publicly traded securities.

[27] *Estate of Graegin*, above, at 387; TAM 200513028.
[28] *Estate of Graegin*, above, at 448.

Alternative Solutions to the Liquidity Problem

If an estate cannot qualify for tax deferral under §6166, it should consider applying for relief under §6161. For estate tax due and owing as determined on the estate's return, §6161(a) permits an extension of time up to one year for which to pay such estate tax due. The estate may obtain an extension for payment of any part of any installment (including any part of a deficiency prorated to any installment under such section) of ten years if it can establish reasonable cause.[29] For any deficient tax amounts, the maximum extension for which to pay the tax is four years if the estate can show reasonable cause.[30]

An estate may also request a distribution from the close-held business entity. The estate may also redeem some or all the decedent's interest in such entity. The IRS may challenge such distributions as taxable transactions, and such transactions may be included in a decedent's gross estate. Additionally, entity documents may contain certain restrictions on such distributions or redemptions.

CONCLUSION

Graegin loans are an available estate planning tool for decedents whose estate assets consist primarily of an ownership interest in a business, including real estate development, and can be used for two different purposes. They are available in the event the estate lacks liquidity for which to pay estate taxes and other estate administrative expenses. The loans allow a decedent's family or successors to continue the business. They also provide the estate and/or decedent's beneficiaries to sell any assets at fair market value rather than a distressed price.

[29] §6161(a)(2)(B).
[30] §6161(b).

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