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Asset Rich, Cash Poor: Addressing Illiquidity with *Graegin* Loans, as Well as Sections 6166 and 6161

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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 §2053(a), which can significantly reduce the amount of estate taxes due. Although an estate may be able to defer payments of estate tax under §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.

SECTION 2053: DEDUCTIBLE EXPENSES

Generally

Section 2053(a) provides that, for estate tax purposes, the value of the taxable estate is 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) 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.[1]

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 §2053(a)(2) and the Treasury Regulations thereunder.

Expense of Administration

Section 2053(a)(2) provides that the value of the taxable estate is determined by deducting from the

[1] §2053(a).

ISSN 0886-3547

value of the gross estate such amounts for administration expenses. Regs. §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.[2] 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[3] (''because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D's estate'');
- *Todd Est. v. Comr.*[4] (''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'');
- *Thompson Est. v. Comr.*[5] (''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]'');
- *McKee Est. v. Comr.*[6] (''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'');
- *Graegin Est. v. Comr.*[7] (''to avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability''); and
- *Huntington Est. v. Comr.*[8] (''the issuance of the notes avoided the necessity of sacrificing the assets of the estate by immediate or forced sale'').

[2] Regs. §20.2053-3(a).

[3] 1984-1 C.B. 193.

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

[5] 76 T.C.M. 426 (1998).

[6] 72 T.C.M. 324 (1996).

[7] 56 T.C.M. 387 (1988).

[8] 36 B.T.A. 698, 726 (1937).

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.[9]
- Some portion of the interest may be deemed nondeductible if liquidity subsequently will become available after death.[10]
- It is not necessary that the estate exhaust all sources of liquidity in the estate in order to qualify for the deduction.[11]
- The fact that the estate qualifies for estate tax deferral under §6166 will not affect the estate's ability to qualify for a deduction on the interest paid.[12]
- *Graegin* loan can be used to satisfy deferred estate tax liability under §6166.[13]
- 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.[14]
- Term (length) of the loan may be required to have some relation to how long illiquidity is expected to persist.[15]

[9] TAM 200513028.

[10] *See Gilman Est. v. Comr.*, T.C. Memo 2004-286.

[11] *See Thompson Est. v. Comr.*, 76 T.C.M. 426 (1998); *Sturgis Est. v. Comr.*, 54 T.C.M. 221 (1987).

[12] *See McKee Est. v. Comr.*, 72 T.C.M. 324 (1996).

[13] PLR 200020011.

[14] *See Hipp v. U.S.*, 72-1 USTC ¶12,824 (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); *Huntington Est. v. Comr.*, 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''); TAM 8450003 (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).

[15] *See Graegin Est. v. Comr.*, 56 T.C.M. 387 (1988) (term was

ISSN 0886-3547

Non-Tax Purpose

The Service may challenge a loan for failure to have a purpose separate and apart from reducing tax liability.[16] 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.[17]
- The loan must be for the benefit of the estate, not for the individual benefit of the beneficiaries.[18]

Estimated Interest Payments

A deduction may be allowable under §2053 for *estimated* interest payments that have not yet accrued if, in addition to satisfying the other requirements of §2053(a) and the Treasury Regulations, the estimated amount is (i) ascertainable with reasonable certainty, and (ii) certain to be paid.[19]

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.[20]
- Prohibition on prepayment of principal and interest or a substantial prepayment penalty is recommended.[21]
- May provide that upon default all interest that would have been payable shall become due and payable.[22]

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.[23] This phrase has no reference to amounts allowable as a deduction under a law that imposes a state death tax.[24] 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.[25]

CASES UNDER §2053(a)(2)

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

Todd Est. v. Comr., 57 T.C. 288 (1971)

Facts

The estate borrowed $300K from Todd Cattle Co. on July 21, 1967 to pay estate taxes. The 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. The loan was required to be paid on or before April 15, 1968. The interest rate was 6.25% per annum. On 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 wanted to deduct the remainder ($23,013).

Issues and Holdings

The court concluded that the administration expense was actually incurred and subject to reasonable estimation because the amount of interest was already determined and paid. In reviewing whether the administration expense was necessary, the court looked at whether the loan was bona fide and whether the estate had liquidity. The court stated that ''petitioners have met this burden by presenting convincing, uncontroverted testimony.'' The independent co-executor of

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set at 15 years, which was the life *expectancy of the surviving spouse when liquid assets would become available*); *Gilman Est. v. Comr.*, T.C. Memo 2004-286 (interest deductions were disallowed after the time in which certain notes became due and payable to the estate).

[16] *See Lee v. Comr.*, 155 F.3d 584 (2d Cir. 1998).

[17] *See Graegin Est. v. Comr.*, 56 T.C.M. 387 (1988); TAM 200513028.

[18] *See Lasarzig Est. v. Comr.*, 78 T.C.M. 448 (1999).

[19] Regs. §20.2053-1(d)(4); *Bailly Est. v. Comr.*, 81 T.C. 246 (1983); *Graegin Est. v. Comr.*, 56 T.C.M. 387 (1988).

[20] IRS Litigation Memo TL-65 (Mar. 14, 1989, released Mar. 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 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*.

[21] *See* PLR 199903038; PLR 199952039 (facts similar to PLR 199903038 but involving a 10-year note providing for annual interest with a balloon payment of principal at the end of the 10-year term); *Graegin Est. v. Comr.*, 56 T.C.M. 387 (1988).

[22] *See* PLR 200449031.

[23] Regs. §20.2053-1(a)(1).

[24] *Id.*

[25] Regs. §20.2053-1(b)(3).

ISSN 0886-3547

the estate testified that he believed it necessary to borrow the money in order to pay the taxes, the estate did not own any liquid assets at the time, and, if the estate liquidated some of its nonliquid assets, they would have to be sold at reduced prices.

Sturgis Est. v. Comr., 54 T.C.M. 221 (1987)

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 the 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 the beneficiaries' requirements.

Issues and Holdings

At issue was whether the administration expense was necessary. The court examined the estate's liquidity. The 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. The Tax Court disagreed, finding that ongoing litigation required the estate to remain open. The Tax Court noted that the respondent had failed to consider state death taxes, contingencies, and the requirements of beneficiaries. The Tax Court held that the interest expenses were necessary and, thus, deductible, stating that the executor had substantially understated the value of the assets and, thus, would need the reserve to pay the resulting additional estate taxes. The Tax Court stated:

> 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.

Graegin Est. v. Comr., 56 T.C.M. 387 (1988)

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 with 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, Paul Graegin. The note was unsecured. The interest rate was 15% fixed (not floating) per annum (prime rate as of that date). The principal and interest were due in a single payment in 15 years (based on the life expectancy of the decedent's wife, because her trust would then partially satisfy the note). Prepayment of both principal and interest was prohibited. Paul Graegin was co-trustee of the trust, co-executor of the decedent's estate, president of Graegin Industries and Graegin Corp., and a member of the board of directors of both companies. On the federal estate return, the petitioner deducted the amount of a single interest payment due upon maturity of the note.

Issues and Holdings

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

Comments

The interest deduction was allowed because the estate was illiquid, there was credible testimony as to

ISSN 0886-3547

repayment, and payment could be accurately estimated. 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 stated 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.

Thompson Est. v. Comr., 76 T.C.M. 426 (1998)

Facts

The decedent left a 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. The executor borrowed $2 million 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 and as a hunting preserve). The note had an annual interest rate of 5%. Principal and interest were payable one year from the date the note was executed (Nov. 17, 1992). New one-year loans with differing interest rates were thereafter executed. Additional notes, representing the capitalization of interest due on the note, were also executed. On the estate tax return, the petitioner deducted interest on the note. The petitioner then amended this return to increase the amount of the deduction for the interest expense.

Issues and Holdings

The court looked at whether the amount was allowable under state law and concluded that the amount was deductible as long as the will gives appropriate authority for the amount. Under Georgia law, the court noted, 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 court concluded that the amount was allowable under local law. The court then looked at the necessity of the interest expense and whether the loan was bona fide. The court concluded that the loan was bona fide, given the authority in the will. Although the stock retained by the estate increased in value following the loan, the court indicated that 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. The court stated that the financial position of the estate at the time of the borrowing was insufficient to make the required tax payments and provide for the maintenance of the cane mill until such time as the asset could be distributed to the decedent's heirs. To prove such illiquidity, the individual responsible for the administration of the 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, the court stated, ''section 2053 does not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary.''

McKee Est. v. Comr., 72 T.C.M. 324 (1996)

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 §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. The note had an annual interest rate of 11%. Principal and interest were payable 85 days from the date the note was executed. The note was unsecured. The 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 the 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 redemp-

ISSN 0886-3547

tion 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 §6166, and that the estate could have sold some of its shares to the corporation to generate cash to pay the estate tax.

Issues and Holdings

The court reviewed whether the interest expense was 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 §6166 election or decided to borrow funds from a third party to pay all of the estate tax obligations. The court stated that it would not ''second guess the business judgments of the executors'' and observed that the executor's decision not to make a §6166 election was prudent, because, among other reasons, the estate benefited from increases in the 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. The court also looked at whether the interest expense was allowable under local law. Under Tennessee law, the court noted, the incorporation into a will of a statutory power authorizes an executor to borrow funds and 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 court concluded that the expense was allowable under local law.

Lasarzig Est. v. Comr., 78 T.C.M. 448 (1999)

Facts

The decedent died with a gross estate consisting primarily of the decedent's living trust and a qualified terminable interest property (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 three 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 trust'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 trust beneficiaries. The QTIP trust 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.

Issues and Holdings

As to whether the interest was an expense of administration, the respondent argued that, because the tax burden was on the QTIP trust assets but the QTIP trust beneficiaries chose to secure the loan rather than sell QTIP trust assets, the loan benefited the QTIP trust beneficiaries. The respondent also argued that because the QTIP trust 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 allowing the deduction of interest involved situations where the interest expense was incurred during the administration of the estate and before the resolution of the tax controversy. The court also looked at whether the interest expense was allowable under local law. Although the trustees pointed to California trust law allowing trustees to borrow funds, the trustees' power to borrow was irrelevant to an estate having no assets and that required no further administration.

Gilman Est. v. Comr., T.C. Memo 2004-286

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 ex-

ISSN 0886-3547

ecutors that because the estate had transferred assets to HG, the estate's ability to continue to defer payments under §6166 was doubtful. The executors decided to pay the estate taxes in full to avoid risk of acceleration under §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.

Issues and Holdings

As to the necessity of the interest expense and liquidity, the respondent argued that the estate created its own illiquidity by transferring GIC stock and assets to HG. The Tax Court disagreed, finding that both before and after the restructuring, the estate owned illiquid interests in closely held businesses. The 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. The court also looked at whether the amount was allowable under the laws of the jurisdiction. The court observed that New York law allows interest expense to be deductible if necessary and if the estate lacks sufficient liquid assets. Having determined that the loan was necessary and the estate lacked sufficient liquid assets to pay the estate tax, the court concluded that the amount of interest was allowable under New York law.

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 §2053.

Klein v. Hughes, 133 Cal. App. 4th 121 (2005)

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 LLCs 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 an 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 were 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 were 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. On a previous appeal, the court had affirmed a probate court order that had approved the loan transactions.[26] 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.
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> * * *
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> Appellants filed responses advocating the adoption of ''Method E,'' a proposal developed by the trustees' accountants. This

[26] *Klein v. Hughes*, 2004 WL 838198 (Cal. App. 1st Dist. 2004) (unpublished opinion).

ISSN 0886-3547

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.

Issues and Holdings

The appeals court reversed the lower (probate) 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

ISSN 0886-3547

> 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.

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 §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 that the trust would gain a net savings of $113,716,912 by entering the Zacadia transaction.

Keller v. U.S., 2009-2 USTC ¶60,579 (S.D. Tex. 2009)

Facts

Prior to her death, Maude Williams began work to form a family partnership. Late in the almost two-year process, Mrs. Williams was diagnosed with cancer, but her physicians did not believe that her death was imminent. About 45 days after her cancer diagnosis, Mrs. Williams signed a partnership agreement and agreed to transfer certain assets to the newly created partnership. Mrs. Williams died unexpectedly six days later — before legal title to the pledged assets was transferred to the partnership. Mrs. William's executor and advisors put the funding of the partnership on hold, and estate taxes of approximately $148 million were paid. Shortly thereafter, one of Mrs. William's former advisors attended a seminar where the *Church v. U.S.*[27] case and its progeny were discussed. Upon learning of the *Church* case, the executor funded the partnership, took out a $114 million loan from the partnership with a *Graegin*-style note, and sought a refund from the Service, claiming, in essence, that equitable title to the assets had been transferred to the partnership, and, thus, what Mrs. Williams owned at her death was an interest in the partnership, not the underlying assets. Mrs. William's estate also asserted that interest paid and to be paid on the *Graegin*-style note was deductible for estate tax purposes.

Issues and Holdings

The district court reviewed whether the interest expense was necessary. The court held that the estate lacked sufficient liquid assets to pay its taxes and obligations (in the absence of a forced sale of its illiquid assets); therefore, the interest was necessarily incurred in the administration of the estate and deductible under §2053. Thus, the district court agreed with the executor that the interest deduction claimed was proper.

Murphy Est. v. U.S., 2009-2 USTC ¶60,583 (W.D. Ark. 2009)

Facts

Mr. Murphy transferred interests in three entities (a publicly traded oil company, a timberland/farmland company, and a bank) into a partnership. Mr. Murphy's contributions to the partnership totaled approximately $90 million. Two of his four children also contributed to the partnership. Mr. Murphy chose to create the partnership in order to centralize management of assets owned by him and by two of his children, as well as to prevent dissipation of those family assets. (Two of his four children had sold or pledged family assets in prior years.) At Mr. Murphy's death, his estate borrowed funds in order to pay estate administration expenses (specifically estate taxes). In the first loan, the estate borrowed $11 million from the part-

[27] 2000-1 USTC ¶60,369 (W.D. Tex. 2000), *aff'd per curiam*, 268 F.3d 1063 (5th Cir. 2001).

ISSN 0886-3547

nership with terms similar those found in the *Graegin* case and sought a deduction of $3.1 million for the interest related to that loan. In addition, the estate borrowed $14 million from a trust with a non-*Graegin*-style note and sought a deduction only for the interest paid to date.

Issues and Holdings

The district court held that the interest on the *Graegin*-style note was actually and necessarily incurred. Without a great deal of discussion, the district court held that the interest paid and to be paid on the *Graegin*-style note was fixed and ascertainable, and the interest paid to date on the non-*Graegin*-style note was also fixed and ascertainable. The district court agreed with the executor and held that all interest deductions claimed were proper.

Comments

The Service filed a notice of appeal in this case, but withdrew its appeal before its brief was due.

Black Est. v. Comr., 133 T.C. 340 (2009)

Facts

Throughout their lives, Mr. and Mrs. Black made gifts of stock in the family company to their children and grandchildren. When Mr. Black became concerned that his offspring might sell the stock, the family created a limited partnership to protect Mr. Black's buy and hold investment philosophy. Upon Mr. Black's death, the estate sought liquidity to pay estate taxes. The executor tried (unsuccessfully) to borrow funds from various banks and an insurance company. Eventually, the company in which the partnership owned stock completed a secondary offering, and about one-third of the partnership's stock in the company was sold for approximately $98 million. The partnership later made a *Graegin*-style loan of $71 million to Mr. Black's estate. The estate sought an estate tax deduction for $20.3 million in interest paid and to be paid on the *Graegin*-style note.

Issues and Holdings

In addition to arguing that §2036 applied to the assets transferred by Mr. Black to the partnership during his lifetime, the Service argued that the interest on the loan from the partnership was not ''necessarily incurred'' and, therefore, was not deductible on the estate tax return. With respect to §2036, the Service argued that Mr. Black's failure to retain sufficient assets outside of the partnership to pay transfer tax liabilities was evidence of an implied agreement to retain rights to the assets contributed to the partnership. The Service's conclusion was based on the assumption that the method of satisfying the need for the estate's liquidity did not matter — the mere need for liquidity evidenced the applicability of §2036. In its opinion, the Tax Court held that the exception to §2036 applied in light of Mr. Black's desire to protect his buy-and-hold investment philosophy. Analysis of whether borrowing from the partnership was evidence of an implied agreement such that §2036 would apply was not necessary, because the exception to §2036 was applicable. With respect to the *Graegin*-style loan, the court held that the loan and resulting interest expense was not necessarily incurred and, therefore, the interest was not deductible.

IRS GUIDANCE UNDER §2053(a)(2)

Rev. Rul. 84-75, 1984-1 C.B. 193

Facts

The 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. The loan required principal to be repaid over a period of six years with 10% interest payable annually. The 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 could be accelerated at the lender's option.

Issues and Holdings

The IRS looked at whether the administration expense was actually incurred and subject to reasonable estimation. The IRS ruled 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 was not yet deductible; it would only be deductible as it accrued. The IRS also reviewed whether the administration expense was necessary and whether the estate was liquid, stating: ''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.''

PLR 199903038

Facts

The estate consisted primarily of stock in a corporation described as ''closely held'' but ''publicly

ISSN 0886-3547

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 the 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 planned to 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 would prohibit prepayment. In the event of a default, the entire interest that would have been paid under the full term of the note was to be accelerated and the total interest would be due and payable at the time of a default.

Issues and Holdings

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

PLR 199952039

Facts

The decedent owned approximately 67% of a closely held corporation. The value of the stock in the 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.

Issues and Holdings

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

PLR 200020011

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 §6166. The executor proposed to borrow funds to pay the estate tax because the estate experienced difficulty obtaining operational lines of credit due to a federal tax lien resulting from the §6166 election. A loan was obtained to pay the estate taxes deferred under §6166.

Issues and Holdings

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

Comments

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

TAM 200513028

Facts

The decedent and the decedent's spouse formed a limited partnership. Under the decedent's will, all estate taxes were to be paid from the 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. The note advanced a line of credit pursuant to which funds, up to a designated principal amount, would be advanced to the borrower by the lender. Once the advance was made, no further advances were to be made. The TAM did not state the principal amount of loan or the interest rate. The note was to mature in 10 years. The principal that was advanced and all accrued interest was to be paid in a lump sum at the maturity date. Prepayment of principal and interest was prohibited. A 99% partnership interest was pledged as security. On the date the tax return was 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.

Issues and Holdings

In analyzing whether the administration expense was actually incurred and subject to reasonable estimation, the National Office noted that there was uncertainty as to whether the payments would be made and, even if they were made, the payments would have no economic impact on the parties involved. Because there was no financial impact besides the tax effect, the National Office advised that no deduction was allowed. In analyzing whether the administration expense necessary, the National Office looked at whether the loan was bona fide, noting the identity of

ISSN 0886-3547

interest: (1) the estate owned 99% of the partnership; (2) a child was the co-executor of the estate and held the remaining 1% interest; and (3) the same parties (closely related family members) stood on all sides of the transactions. As to liquidity, the National Office observed that the partnership held substantial liquid assets, the partnership was not engaged in any active business that would necessitate the retention of liquid assets, and there was no restraint on the fiduciary's ability to access funds.

Comments

The TAM provides:

> In 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:

> Further, we do not believe that the interest expense is deductible under §2053 because: (1) it is questionable whether the Estate will actually make the payments in accordance with the terms of the arrangement; and (2) even if the Estate makes the payments in accordance with the terms of the arrangement, the payments (whether characterized as interest or principal) will have no economic impact on the parties involved . . . 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.

It is important to note:[28]

> 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.

ECONOMICS OF *GRAEGIN* LOANS

The Net Amounts to Debtor Estate and Lender

The *Hughes* cases discussed above point 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.

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 §163(h),[29] despite the fact that the Code section provides that ''interest paid or accrued

[28] Perspective, JPMorgan Private Bank, ''Graegin Loans: Alternative Estate Tax Funding Strategies'' (Spring 2006).

[29] PLR 9449011 (the estate had procured a loan to pay federal estate taxes, and the asserted reason for making the loan and not

ISSN 0886-3547

on indebtedness properly allocable to the conduct of a trade or business'' is not treated as nondeductible personal interest.[30]

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 §2053. 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.

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 §2053.

Finally, from an investment standpoint, it is important to note that the tax savings cited 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 have a smaller 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.

LIQUIDITY ALTERNATIVES

Section 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 reads in part 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,

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selling such assets was that prices were depressed; the IRS ruled, ''[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.'').

[30] §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. Apr. 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'').

ISSN 0886-3547

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.

Section 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. Section 6166 reads in part 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.

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.)

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 in accordance with the partnership agreement — likely 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.

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 re-

ISSN 0886-3547

view the partnership agreement to ensure that the partnership is not prohibited from redeeming the interest from the interest holder. Any redemption should be documented and executed by partnership management and the transferring partner or his or her 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.

ISSN 0886-3547