Understanding the Allowable Interest Expense Deduction for Graegin Loans Within the Gift and Estate Tax Context

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Effective communication between the valuation analyst and estate counsel is important to identify all potential deductions from the gross estate to arrive at a final taxable estate value. This discussion summarizes the role of the valuation analyst in providing estate and gift tax services. This discussion reviews the regulations associated with certain estate deductions, including interest expense deductions for so-called Graegin loans. And, this discussion considers two recent court decisions regarding Graegin loan interest deductions.

Introduction

In collaborating with estate counsel and estate and gift tax return preparers, the valuation analyst should understand and communicate potential opportunities to reduce the overall tax levied against the estate. For example, certain administrative expenses are permitted as deductions from a decedent's gross estate when arriving at the final taxable estate value.

As documented in Regulation 20.2053, there are allowable deductions, within the law of jurisdiction (i.e., state law), for certain expenses related to the management of the estate. This discussion addresses the allowable administrative expense deductions, described in Regulation 20.2053-3, including interest expense deductions.

A so-called Graegin loan, as described by the U.S. Tax Court in *Estate of Cecil Graegin v. Commissioner*,[1] provides that administrative expenses incurred "in the collection of assets, payment of debts, and distribution of property to the persons entitled to it," are allowable deductions from the taxable estate. An example of such an expense is interest on a loan to avoid a forced sale of illiquid assets.

This discussion presents a review of a Graegin loan and explains why it was accepted by the Tax Court. This discussion also reviews two recent judicial decisions that are associated with the use of Graegin-type loans.

The Valuation Analyst and Estate and Gift Tax Returns

According to *PPC's Guide to Business Valuations*, the valuation analyst offers a number of services related to estate and gift taxation, including valuation of ownership interests in closely held businesses associated with the following:

1. Filing estate and gift tax returns
2. Tax dispute resolution
3. Estate planning[2]

Minimization of estate and gift taxes is one of the primary objectives for individuals who own closely held businesses. Valuation analysts collaborate with counsel and estate and gift tax return preparers in order to ensure an accurate and reliable indication of value for the subject taxable estate.

This statement does not infer that the valuation analyst is an advocate for his or her client. Rather, the analyst should thoroughly understand the applicable Internal Revenue Code, Regulations, and Revenue Rulings associated with each assignment.

The valuation analyst partners with counsel or the return preparers to ensure the final taxable estate value is accurate and appropriate.

Taxable Estate

Upon the death of an individual taxpayer, taxes are imposed on the total value of all property owned at the time of death, plus all taxable gifts provided during his or her lifetime less applicable deductions. Taxes are then levied against the estate regardless of the ultimate division of property among the estate's beneficiaries.

Generally, Internal Revenue Service Form 706 is filed by the executor of the subject estate within nine months of decedent's death.[3]

Gross Estate

As presented in PPC's *Guide to Business Valuations*, the estate executor is required to list all assets owned by the decedent at the time of death. The Form 706 supporting schedules include the following:

1. Real estate (Schedule A)
2. Stocks and bonds (Schedule B)
3. Mortgages, notes and cash (Schedule C)
4. Insurance on the decedent's life (Schedule D)
5. Jointly owned property (Schedule E)
6. Other miscellaneous property (Schedule F)
7. Transfers during the decedent's life (Schedule G)
8. Powers of appointment over trust assets (Schedule H)
9. Annuities (Schedule I)
10. Qualified conservation easement exclusions (Schedule U)[4]

Closely held business ownership interests are included in Schedule B. In valuing the above assets for estate and gift tax purposes, the standard of value is fair market value.

Within the scope of estate and gift tax valuation services, the analyst looks to have dialogue with counsel and return preparers. The analyst offers insight, based on the context of the valuation services provided, which may assist the client in honing his or her estate plan and strategy. While the analyst does not provide tax-planning advice, understanding some of the deductions that are allowable in arriving at the taxable estate may be an opportunity for the analyst to add value to the overall engagement.

Allowable Deductions

An estate is allowed to deduct certain expenses from the gross estate in arriving at a taxable estate value. As presented in Regulation 20.2053-1(a), allowable estate deductions for expenses, indebtedness, and certain taxes include the following:

1. Funeral expenses
2. Administrative expenses
3. Claims against the estate (including certain taxes and charitable pledges)
4. Unpaid mortgages on, or any indebtedness related to, property held within the gross estate undiminished by the mortgage or indebtedness[5]

As described in Regulation 20.2053-3(a)-(d):

> The amounts deductible from a decedent's gross estate as "administrative 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 the persons entitled to it.[6]
>
> Administrative expenses include (1) executor's commissions; (2) attorney's fees; and (3) miscellaneous expenses.[7]

There are several specific deductions that are allowable as "miscellaneous expenses," such as court costs, surrogate fees, appraiser's fees, and court hire fees. However, the regulations also allow for the deduction of expenses necessarily incurred in preserving and distributing the estate, namely property storage and maintenance costs if the estate is unable to immediately distribute the estate's assets to the relevant beneficiaries.

Expenses for selling property of the estate are deductible if the sale is required in order to pay decedent's debts, cover expenses of administering the estate, and pay taxes associated with preserving the estate or effectuating property distribution.

Once the value of the gross estate is determined, the gross estate is reduced by the allowable deductions to arrive at the initial taxable estate.

One example of an allowable estate deduction is the deduction of interest from what is termed a Graegin loan. According to the *Estates, Gifts and Trusts Journal*, "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."[8]

As an alternative to selling the closely held business to cover applicable estate taxes, the estate executor has the ability, through a Graegin loan, to borrow cash directly from the closely held business in exchange for a promissory note. The Tax Court, as well as the Service, has considered that an estate loan is necessary and reasonable when it prevents the forced sale of assets, especially if the forced sales would result in the estate obtaining reduced prices for its assets.

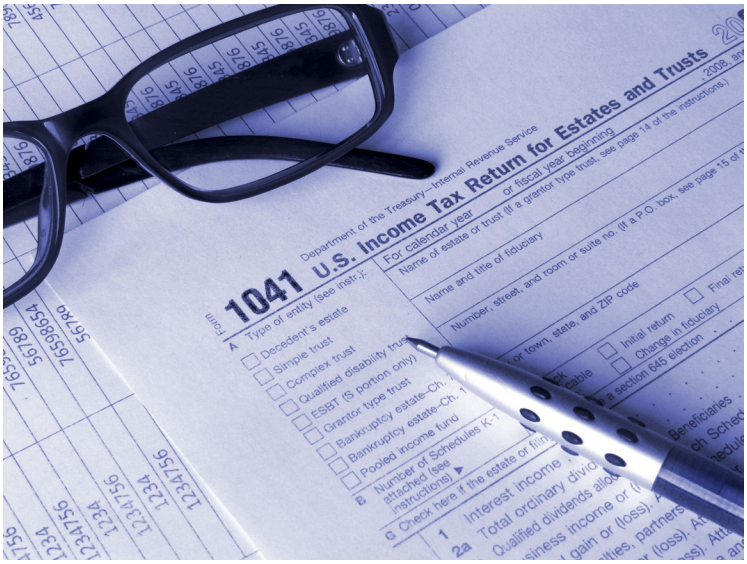
Simplified Example—Graegin Loan

Let's assume that an individual passes away in 2013 with a gross estate valued at $15 million. Assuming an estate tax rate of 40 percent, the estate would owe approximately $6.0 million in estate taxes.

Let's also assume that the majority of the value of the estate is a closely held business ownership interest, thereby making the estate relatively illiquid. In order to pay the $6.0 million in estate taxes as presented above, the executor of the estate decides to borrow from the closely held business (owned within the estate) half of the estate tax amount, or approximately $3.0 million.

The loan is structured as a 10-year note and incurs interest at an 8.0 percent annual rate. The note requires a balloon payment of principal and all interest at the end of the 10-year period. The accumulated interest due at the end of the 10-year period will be approximately $2.4 million (i.e., $3.0 million x 8.0 percent x 10 years = $2.4 million).

Based on the allowable deductions, and the Tax Court's *Graegin v. Commissioner* decision, the full amount of the interest on the loan (i.e., $2.4 million), is deductible from the gross estate in arriving at the taxable estate.



Consequently, when the $2.4 million in loan interest is deducted, the estate value is reduced to approximately $12.6 million (i.e., $15.0 million initial estate value less the $2.4 million Graegin loan interest deduction).

The result would be a federal estate tax, assuming an estate tax rate of 40 percent, of approximately $5.0 million ($5,040,000). The estate tax is reduced from approximately $6.0 million to $5.0 million through use of the Graegin loan.

While the subject estate may be able to reduce estate taxes through the use of a Graegin loan, there may be potential income tax consequences to the lender (i.e., the closely held business within the estate) as a result of loan interest payments.

Graegin v. Commissioner

While a Graegin loan is an available tax-planning strategy for estates that exhibit certain characteristics, the valuation analyst and counsel (or the estate tax return preparer) should fully understand the circumstances that resulted in the Tax Court's decision to allow the loan and subsequent interest deduction from the gross value of the estate.

In the *Graegin* opinion, the Tax Court noted the following:

1. The majority of the estate assets were illiquid. The bulk of the estate consisted of an ownership interest in a closely held business, Graegin Industries, Inc. (GII). This satisfies the initial requirement that the loan and corresponding interest expense was "actually and necessarily incurred."
2. An identity of interest among the executors and beneficiaries of the estate and the ownership interests in the closely held business did not preclude classification of the transaction as a loan.
3. The interest expense was ascertainable, with reasonable certainty of repayment.

Background

Decedent Cecil Graegin held an estate at the time of his death that primarily consisted of nonprobate assets, including a closely held corporation ownership interest in GII. According to Graegin's will, his residuary filtered into his trust. The trust was responsible for paying all claims and estate expenses.

Upon Graegin's death, the estate executor borrowed approximately $204,000 from a wholly owned subsidiary of GII, Graegin Corporation,

in order to satisfy the estimated estate taxes and avoid selling the ownership interests in GII. At the date of death, approximately 97.0 percent of the outstanding stock of GII was owned by Graegin or his son, Paul Graegin.

The loan was structured as a 15-year note, which corresponded to the life expectancy of Graegin's wife as upon her death, Mrs. Graegin's trust would be capable of satisfying the note. The rate of interest on the note was fixed at 15.0 percent per annum (the prime rate at the date of death), and a single balloon payment of both principal and interest was due upon maturity. Prepayment of both principal and interest was prohibited.

Paul Graegin was co-trustee of the decedent's trust, co-executor of the decedent's estate, and president of both GII and Graegin Corporation. Paul Graegin was also a member of the board of directors of each corporation.

In the estate tax return, the estate deducted the amount of the interest on the loan, or approximately $459,000 ($204,000 x 15 percent x 15 years = $459,000) as a deductible administration expense.

Interest Expense Actually and Necessarily Incurred (Illiquid Assets)

In order to meet the requirements of Regulation 20.2053-3(a), the amounts deductible from a decedent's gross estate categorized as administrative 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 the persons entitled to it."[9]

The estate of Graegin consisted mainly of a closely held corporation ownership interest. In the *Graegin* opinion, the Tax Court noted:

> Cecil's estate lacked liquidity. To avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability. 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. . . . We are thus satisfied that petitioner's interest expense was "actually and necessarily incurred," as required by section 20.2053-3(a), Estate Tax Regs.[10]

Identity of Interest Not Fatal

As argued before the Tax Court, the respondent contended that the loan made by the Graegin Corporation to the estate was not a "true" loan. Respondent based the argument on the fact that Paul Graegin controlled both the borrower (estate) and the lender (Graegin Corporation) in the transaction, and that the loan was unsecured. The Tax Court noted:

> Whether a particular transaction is to be properly characterized as a loan depends on the facts and circumstances. . . . The existence of a loan is determined by whether repayment was in fact contemplated by the borrower and lender.[11]
>
> While we agree with respondent that loans between a debtor and creditor having an identity of interest require close scrutiny, such identity of interest per se is not fatal in characterizing the transaction as a loan.[12]

The Tax Court supported its decision that the transaction was in fact a "true" loan by referencing (1) the testimony of Paul Graegin, which the court found to be credible; (2) the fact that an outside shareholder, Stephen Curtis (who held a small ownership interest in GII and was not related to the Graegin family), would presumably complain if the loan and related interest was not paid as agreed; and (3) the fact that the local Indiana court, having jurisdiction over the estate, approved the loan.[13]

Amount of Interest Ascertainable and Reasonable Certainty of Interest Repayment

As presented in Regulation 20.2053-1(b)(3), the amount of the estimated administrative expense being deducted must be ascertainable with reasonable certainty and must be likely to be paid. The respondent in *Graegin* asserted that the interest deduction should not be allowed because there was no reasonable certainty that the interest would actually be paid. The court opined:

> [T]he amount of interest on the note is not vague or uncertain, but instead is capable of calculation ($204,218 x 15 percent x 15 years = $459,491). The promissory note could not be prepaid, either as to principal or interest. As stated, we found credible Paul Graegin's testimony as to his intent to cause the loan to be timely repaid. Accordingly, we conclude that the amount of interest on the note is ascertainable with reasonable certainty, and that it will be paid.[14]

As presented above, the Tax Court's decision in *Graegin* was a direct result of the supporting facts and circumstances surrounding the estate loan and

requested interest deduction. In broaching Graegin loans, it is important that the decedent's estate and its advisers thoroughly understand the factors considered by the Tax Court in arriving at its opinion.

Recent Guidance from the Courts—Graegin Loans

Two recent judicial decisions relate the court's thought process in allowing the interest deduction in *Graegin*.

Black Estate v. Commissioner[15]

Beginning in 1988, Mr. and Mrs. Black began making gifts of stock in the family business, Erie Indemnity Company ("Erie"), to their children and grandchildren. Over time, Mr. Black became concerned that his children and grandchildren may sell the stock. And, in 1993, Mr. Black created a family limited partnership (FLP) in order to accomplish the following:

1. Protect his long-term investment strategy
2. Ensure the family's stock was in a single block of ownership

Upon Mr. and Mrs. Black's death, the executor of Mrs. Black's estate attempted to find liquidity to cover the estate taxes but was unsuccessful in borrowing funds from various banks and insurance companies. Erie completed a secondary offering whereby approximately one-third of the FLP's stock in Erie was sold for approximately $98 million.

Shortly thereafter, the FLP made a Graegin-type loan of approximately $71 million to the estate of Mrs. Black. The estate requested an estate tax deduction of approximately $20 million in current and future interest to be paid on the Graegin-type loan.

The Service argued that the interest on the loan from the FLP to the estate was not "necessarily incurred," thereby disallowing the $20 million interest deduction from the gross estate. The Tax Court reviewed the historical distributions from the FLP and concluded that it would not have been possible to repay the loan from distributions from the FLP, meaning it would ultimately be necessary for the estate to liquidate the underlying FLP assets (i.e., Erie stock) in order to service the loan.

The Tax Court opined that the FLP, in order to facilitate the Graegin-type loan, would likely make a distribution of the stock to the estate in partial redemption of its interests. The estate would ultimately return the stock back to the FLP in order to service the note.

This scenario would inevitably demonstrate that the loan was unnecessary as both parties (i.e., the FLP and Mrs. Black's estate) would have been in exactly the same position had the FLP initially liquidated the Erie stock in order to redeem a portion of the estate's FLP interest. That interest is the stock in Erie that would have ultimately been sold by the FLP in either scenario.

The Tax Court opinion stated that the reason for the transaction being structured as a Graegin-type loan was purely to obtain the $20 million interest deduction. As detailed in Regulation 20.2053-3(a):

> Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions.[16]

The Tax Court deemed that the Graegin-type loan and subsequent interest expense were not "necessarily incurred" and, therefore, the interest was not deductible on Mrs. Black's estate tax return. The Tax Court distinguished *Graegin*, and other similar cases, from the *Black* case in that the loan in *Graegin* was made in order to preserve the assets of the estate and avoid any liquidation of estate assets.

Murphy Estate v. U.S.[17]

Mr. Murphy, the decedent, became involved in his family's business early in his life. In 1997, Murphy transferred ownership interests in several entities to an FLP for the benefit of his children. Two of his four children also contributed assets to the FLP.

Murphy created the FLP to (1) centralize the management of the family assets and (2) prevent dissemination of the family assets. Two children who did not contribute assets to the FLP had sold or pledged the family assets in prior years.

Upon Murphy's death, the estate constructed two loans in order to pay the related estate taxes. The first loan was a Graegin-type loan whereby the estate borrowed approximately $11 million from the FLP on terms that were similar to the terms in *Greagin*, with the executor seeking to deduct approximately $3 million of interest from the gross estate. Additionally, the estate borrowed approximately $14 million from a related trust as a non-Graegin-type loan.

The Service argued that the interest deduction should be denied on the grounds that the interest deduction was not actually and necessarily incurred, and the FLP was created solely for tax purposes, resulting in "self-inflicted" illiquidity of the estate assets.

The Tax Court disagreed, and concluded that the Graegin-type loan and corresponding interest deduction were appropriate due to the facts that (1) the FLP was created in good faith for legitimate and significant nontax purposes and (2) the interest paid and to be payable on the Graegin-type loan was fixed and ascertainable.

Conclusion

In working with counsel and return preparers, the valuation analyst should be aware of certain administrative deductions that are available in determining the taxable estate, such as interest deductions from so-called Graegin loans.

A Graegin loan is a common alternative for estates that lack enough liquid assets to pay estate taxes and other expenses incurred during the administration of an estate. Current and future interest charged on a Graegin loan is an allowable deduction from the gross estate, as described in Regulation 20.2053.

As with many valuation-related engagements, the determining factor in legitimizing a Graegin loan lies in the story. As explained by the Tax Court in Graegin, and documented in two recent decisions, in considering a Graegin loan, counsel and return preparers should consider the following:

1. Determine and fully document the estate's need for liquidity or the illiquid nature of the assets owned by the estate.
2. Provide ample detail as to the structure of the loan, to ensure that the interest paid on the Graegin loan is both ascertainable (i.e., not vague or uncertain, calculable) and likely to be repaid.
3. Determine that the Graegin loan terms are reasonable and appropriate.
4. Understand that nontax reasons for creating a "self-inflicted liquidity need" (e.g., the formation of an FLP) should be well-documented and supported.
5. Be aware of the fact that while an "identity of interest" between the borrower (estate) and lender (closely held business) does not preclude the loan, there should be reasonable support in defending an "identity of interest," such as:
   a. gaining approval for the loan from the local jurisdiction and/or independent third parties (i.e., banks, brokerage firms, etc.);
   b. noting any independent, unrelated ownership interests in the estate assets that will provide a "nonidentity of interest," thereby further supporting the validity of the loan; and
   c. compelling testimony, if needed, of the executor/co-executor and individuals holding controlling ownership interests in the estate and the underlying assets (i.e., the closely held business).

"A Graegin loan is a common alternative for estates that lack enough liquid assets to pay estate taxes and other expenses incurred during the administration of an estate."

Notes:

1. Estate of Cecil Graegin v. Commissioner, T.C. Memo 1988-477 (Sept. 28, 1988).
2. Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, James H. Hitchner, Stanton L. Meltzer, Mark W. Wells, and Eric G. Lipnicky, *PPC's Guide to Business Valuations*, 22nd ed. (Fort Worth, TX: Thomson Reuters/PPC, 2012): 10-2.
3. Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.
4. Fishman, et al. *PPC's Guide to Business Valuation.*
5. Regulation 20.2053-1(a).
6. Regulation 20.2053-3(a)-(d).
7. Ibid.
8. Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, "Asset Rich, Cash Poor: Addressing Illiquidity with *Graegin* Loans, as Well as Sections 6166 and 6161," *Tax Management Estates, Gifts and Trusts Journal,* 36 EGTJ 214 (2011): 1.
9. Regulation 20.2053-3(a).
10. Estate of Cecil Graegin v. Commissioner, T.C. Memo 1988-477 (Sept. 28, 1988).
11. Ibid.
12. Ibid.
13. Ibid.
14. Ibid.
15. Estate of Samuel P. Black, Jr. v. Commissioner, T.C. No. 15, 133 T.C. 340, (2009).
16 Regulation 20.2053-3(a).
17. Estate of Murphy v. United States, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct 2, 2009).

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