Borrowing for Postmortem Liquidity, Part 1

By Lisa M. Rico

If an estate is comprised primarily of illiquid assets, such as a closely held business or real estate, the executor must find a way to fund the payment of estate administration expenses and the estate tax. One option for providing estate liquidity is for the estate to borrow the funds necessary to pay such amounts. Various sources and a number of methods can be used when borrowing money to pay the estate tax: intra-family loans, loans from related business entities, third-party loans, and "loans" from the IRS under §§ 6161 and 6166 of the Internal Revenue Code of 1986 (IRC), as amended. Part 1 of this article discusses first the non-IRS loan options, focusing on the deductibility of the interest, and then on "loans" from the IRS under IRC § 6161. Part 2 of this article, which will appear in the January/February 2011 issue, will analyze an estate's ability to defer taxes under IRC § 6166.

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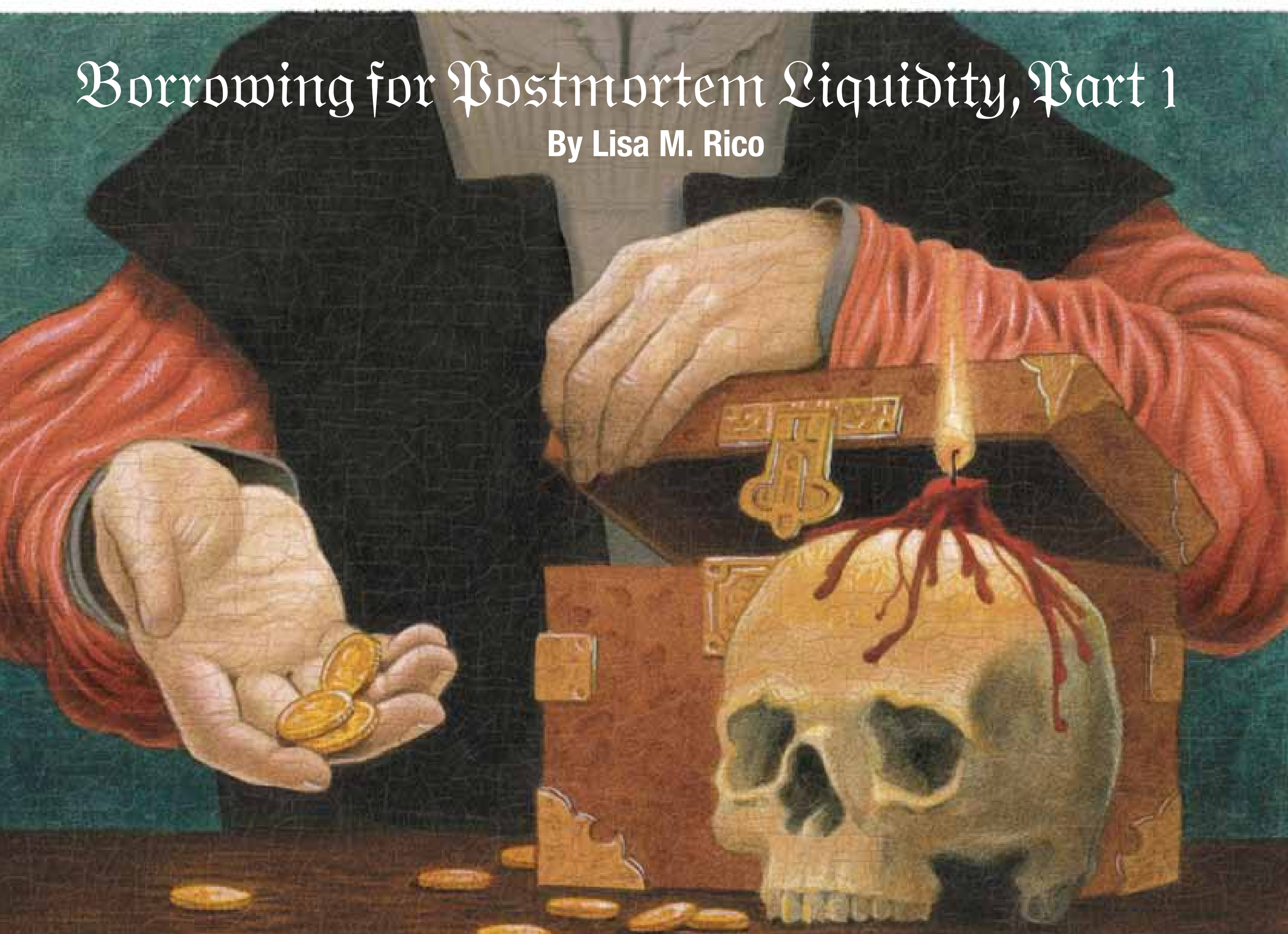
Deductibility of Interest on Non-IRS Loans

An estate encountering a lack of cash or other liquidity to pay its estate tax obligations may need to borrow funds sufficient to pay those taxes. The estate can borrow funds from a number of sources: family members; family controlled entities, including closely held businesses and insurance trusts established by the decedent; or a third party, such as a bank or other lending institution. One of the benefits of paying the estate tax with a loan is that interest on such a loan may be deductible as an administration expense of the estate if the interest meets the requirements of IRC § 2053(a)(2) and the Regulations thereunder. Such a deduction, of course, reduces the total amount of estate taxes paid. *Estate of Todd v. Commissioner,* 57 T.C. 288, 295 (1971), acq., 1973-2 C.B. 4. Interest may be deductible regardless of whether the loan is from a related party or a commercial bank, as long as the interest expense meets the requirements of IRC § 2053(a)(2) and the loan is a true loan. The estate has the burden of proving that these requirements are met. Id.



Under IRC § 2053(a)(2) and its Regulations, an expense is deductible as an administration expense if it is (1) "payable out of property subject to claims and which are allowable by the law of the jurisdiction, . . . under which the estate is being administered," (2) "ascertainable with reasonable certainty, and will be paid," and (3) "actually and necessarily incurred in the administration of the decedent's estate" (that is, expenses incurred in the collection of the assets, payment of debts, and distribution of property to the persons entitled to it). Treas. Reg. §§ 20.2053-1(a)(1), 20.2053-1(d)(4)(i) & 20.2053-1(b)(3). Any expenditure incurred that is "not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees" is not allowed as a deduction to the estate. *Hibernia Bank v. United States,* 581 F.2d 741, 745–47 (9th Cir. 1978).

The Tax Court has recognized that interest on a borrowing by an estate to pay estate taxes, which was necessary to prevent financial loss to the estate resulting from a forced sale of illiquid assets, is actually and necessarily incurred in the administration of an estate and allowable as a deduction under IRC § 2053(a)(2). *Estate of Todd,* 57 T.C. at 295. The interest, however, is deductible only to the extent that it has actually accrued. Rev. Rul. 84-75, 1984-1 C.B. 193. In Rev. Rul. 84-75, the IRS concluded that, if the terms of an estate's obligation allow repayment of the loan to be accelerated, the amount of the future interest that will be paid is indefinite because a premature repayment will stop the accrual of interest. As a result, the amount of interest is not ascertainable with reasonable certainty, and, in such a case, the interest becomes deductible only as it accrues. Rev. Proc. 81-27, 1981-2 C.B. 548, sets forth the procedure for recomputing the estate tax due as a result of a reduction in such tax by reason of the payment of interest on a borrowing as it accrues on the estate tax due. Id.

When the Tax Court has concluded that an estate's borrowing was not necessary to the administration of the estate, a deduction under IRC § 2053(a)(2) has not been allowed. *Hibernia,* 581 F.2d at 747. In *Estate of Lasarzig v. Commissioner,* 78 T.C.M. (CCH) 448 (1999), the Tax Court did not allow a deduction for interest on a loan used to pay a QTIP trust's share of estate tax liability, reasoning that the loan was not an administrative expense under IRC § 2053. In this case, the QTIP trust assets had been distributed to its beneficiaries, who in turn contributed the assets to their own family trusts. The family trusts obtained the loan to pay the estate tax obligations of the QTIP trust. The court found that the relationship between the family trusts and the estate was too remote. The assets of the QTIP trust were part of the gross estate, but, once they were distributed to the family trusts, those same assets no longer had any nexus to the estate.

Interest on an estate tax deficiency that is subsequently refunded is not deductible as an administration expense, because the interest has not actually been incurred.

The interest expense on such loans must be a permitted expense under local probate law. It does not matter, however, that the interest expense is not deductible for state death tax purposes. In TAM 9106005 and TAM 9002001, the IRS determined that interest on a loan obtained to pay estate tax and the interest accruing on any unpaid balance of the state inheritance tax, when the estate did not have sufficient liquidity to pay the federal estate tax, were deductible under IRC § 2053(a)(2) to the extent allowable under local probate law. In addition, whether the interest expense is related to the payment of federal, state, or foreign estate taxes does not affect the determination of whether the expense is deductible under IRC § 2053(a)(2), so long as it is an allowable expense under local probate law. The IRS, in Rev. Rul. 81-256, 1981-2 C.B. 183, concluded that interest accrued by an estate incurred on the state death tax liability is deductible under IRC § 2053(a)(2) to the extent the expense was allowable under local probate law. Similarly, the IRS in Rev. Rul. 83-24, 1983-1 C.B. 229, concluded that interest paid to a foreign taxing authority as a result of a late payment of the foreign tax was deductible under IRC § 2053(a)(2) to the extent the expense was allowable under local probate law. But interest on an estate tax deficiency that is subsequently refunded is not deductible as an administration expense, because the interest has not actually been incurred. *Estate of O'Daniel v. United States,* 6 F.3d 321, 329 (5th Cir. 1993).

If the deduction for interest on a loan for the payment of estate tax or other administrative expense obtained to preserve an estate's investment or trade or business assets is not allowable under IRC § 2053(a)(2), then alternatively an income tax deduction under IRC § 163 may be available. IRC § 163 allows an income tax deduction for interest paid or accrued on indebtedness during the taxable year. IRC § 163(h) disallows the deduction for personal interest, however. IRC §§ 163(h)(2)(A) and (B) specifically provide that interest paid on indebtedness properly allocable to a trade or business or to property held for investment is not personal interest. Is interest on indebtedness incurred by an estate to preserve the estate's trade or business or investment assets properly allocable to a trade or business or to property held for investment? The IRS, in PLR 9449011, has taken the position that it is not. The IRS held that such interest is nondeductible personal interest under IRC § 163(h) and, therefore, not deductible under IRC § 163. The IRS reasoned that the interest could not be considered trade or business or investment interest under IRC § 163(h)(2)(A) or (B) because the interest is allocable to the payment of tax rather than to business or investment assets and, further, because the tax arises merely on the transfer of estate assets, which does not qualify as an investment or business activity.

Max Licht

True Loans

One inquiry about funding the payment of the estate tax with a loan is whether it is a true loan. A number of factors affect this determination: Does the estate have an unconditional obligation to repay the sums advanced to it? Does the loan have economic effect? Is the interest rate a reasonable one? Whether a distribution of funds is deemed to be a "true loan" turns on the intent of the estate at the time the distribution is made; that is, whether the estate and the "lender" actually anticipate repayment. This is essentially a factual determination, and the onus is on the estate to prove its intent. The court may look at various factors to determine intent, including the existence of promissory notes, collateral or interest payment provisions, a reasonable expectation or enforceable obligation to repay the loan, whether and to what extent the "lender" is related to the estate, the treatment of such distributions in corporate records, any history of repayment of funds, and the estate's use of the funds. See, e.g., *Geftman v. Commissioner,* 154 F.3d 61 (3d Cir. 1998); *Busch v. Commissioner,* 728 F.2d 945 (7th Cir. 1984); and *Tollefsen v. Commissioner,* 431 F.2d 511 (2d Cir. 1970).

"Graegin" Loans

As discussed above, interest may be deductible as it accrues. This deduction requires the estate to follow the procedures set forth in Rev. Proc. 81-27 and file supplemental Forms 706 as the interest expense accrues. The estate cannot receive a refund of estate taxes previously paid until after the final interest payment is made, if there is a subsequent reduction in the estate tax resulting from the allowance of the deduction of the interest expense under IRC § 2053(a)(2). One technique used to reduce the federal estate tax on the initial estate tax return filing, reducing the estate tax immediately, is for the estate to take out a loan, the terms of which do not allow prepayment and require interest payments for the entire term on acceleration. In *Graegin v. Commissioner,* 56 T.C.M. (CCH) 387 (1988), the Tax Court determined that a deduction by the estate for interest on a loan to the estate used to finance the estate's federal estate tax liability payment is deductible as an administrative expense under IRC § 2053(a)(2), even though the interest had not been paid at the time of filing the return. The loan was made by Graegin Corporation, a wholly owned subsidiary of Graegin Industries. Graegin Industries was a closely held business in which the decedent's revocable trust owned an approximately 96% interest in the voting preferred stock of the company. The decedent's son was president of both Graegin Corporation and Graegin Industries as well as a co-trustee of the decedent's revocable trust for the benefit of the decedent's wife. The terms of the note included interest at the prime rate payable in a balloon payment of principal and interest 15 years from the loan date; the term of the loan was based on the decedent's spouse's life expectancy. The court concluded that the estate lacked liquidity, the interest expense was "actually and necessarily incurred," the loan was genuine indebtedness, and the amount of the estimated interest expense both was ascertainable and would be paid. Therefore, interest on the note was deductible as an administration expense under IRC § 2053(a)(2).

The estate cannot receive a refund of estate taxes previously paid until after the final interest payment is made, if there is a subsequent reduction in the estate tax resulting from the allowance of the deduction of the interest expense under IRC § 2053(a)(2).

In similar cases, except that a commercial bank made the loan to the estate, the IRS in PLR 199952039 and PLR 199903038, both relying on *Graegin,* concluded that the interest is deductible on the estate tax return as an administration expense, provided the expense was necessarily incurred in the estate's administration and allowable under local law. In PLR 200020011, the IRS concluded that when an estate makes an election under IRC § 6166(a) to defer federal estate tax payments attributable to a closely held business's value and to pay such estate tax in installments, and the estate subsequently obtains a commercial loan to fully pay the tax deferred under IRC § 6166 to avoid a forced asset sale of the closely held business's assets, the commercial loan's interest may be deducted as an administration expense, as long as the terms do not allow prepayment and, in the event of a default, all interest payable through the term of the loan will be accelerated. In this case, the interest deducted as an administration expense, including any prospective payments, is an amount ascertainable with reasonable certainty and will be paid.

In TAM 200513028, however, the IRS determined that the interest on a loan similar to the one in *Graegin* from a related family limited partnership was not allowable as a deduction under IRC § 2053(a)(2). The IRS explained that, because the loan did not result in any economic benefit or detriment to the estate or the estate beneficiaries as obligors, the interest did not constitute a deductible administrative expense. The IRS focused on the facts that the family limited partnership had substantial liquid assets, the parties were the same on both sides of the transaction, and such parties' proportional interests in the family limited partnership and the estate were virtually identical.

Interest deductibility on *Graegin*-type loans was reviewed in several cases in 2009. In *Keller v. United States,* 104 A.F.T.R.2d (RIA) 6015 (S.D. Tex. 2009), an estate tax refund case, the District Court for the Southern District of Texas found that interest on a nine-year $114 million *Graegin* loan from a family limited partnership established by the decedent was an actual and necessary administration expense deductible by the estate because the decedent's estate lacked sufficient liquidity to pay its necessary taxes and obligations without forcing the sale of the estate's illiquid assets.

In the *Estate of Murphy v. United States,* 104 A.F.T.R.2d (RIA) 7703 (W.D. Ark. 2009), the District Court of the Western District of Arkansas, in an estate tax refund case, determined that the interest on an approximately $11 million, nine-year *Graegin* loan from a family limited partnership established by the decedent to the decedent's estate to pay federal and state estate taxes was properly deductible by an illiquid estate as a reasonable and necessary administrative expense. The loan, secured by a portion of the family limited partnership, had a fixed rate of interest and prohibited loan prepayment. The loan required payments of $500,000 annually and all accrued and unpaid interest as well as the outstanding balance at the end of the loan term. In rejecting the IRS's argument that the interest expense was not necessarily incurred because the estate could have raised the funds to pay the estate taxes by other means, such as by selling assets in the partnership and making a distribution to the estate, the court refused to second guess the executor's business judgment, even though the executors and the controlling owners of the partnership were the same individuals.

The Tax Court, in *Estate of Black v. Commissioner,* 133 T.C. No. 15 (2009), concluded that a family limited partnership's loan interest was not properly deductible as a reasonable and necessary administration expense by an illiquid estate as the loan was not necessary. In this case, after unsuccessfully attempting to obtain a commercial loan, the estate borrowed funds from a family limited partnership through a *Graegin* loan. The family limited partnership, Black Interests Limited Partnership ("Black LP"), was able to make the loan to the estate because Black LP received approximately $98 million in a secondary offering of a portion of the partnership's interest in Erie Indemnity Co. The promissory note's terms provided for 6% simple interest, all principal and interest due and payable no earlier than November 30, 2007, and prohibited prepayment. The court concluded that redeeming a portion of the estate's interest in the family limited partnership was the only way for the estate to timely repay the loan. The court concluded, therefore, that the loan was unnecessary because the estate was in the same position as it would have been had the family limited partnership redeemed a portion of the estate's interest in the family limited partnership to pay the estate tax. The only distinction between the loan scenario and the partial redemption scenario was that the loan gave rise to an immediate estate tax interest deduction.

The obvious advantage of a *Graegin* loan for an illiquid estate is the immediate estate tax interest deduction. Caution must be used, however, when this technique is used to provide needed liquidity. If the IRS denies the estate tax deduction, the estate must continue to pay the interest. The interest is income to the lender, but the estate does not receive an offsetting estate tax interest deduction under IRC § 2053(a)(2). An additional risk is the IRS's recent position that a *Graegin* loan from a family limited partnership is evidence of retained enjoyment under IRC § 2036.

IRC § 6161

Under IRC § 6161(a)(1), the IRS can extend the time for the payment of the estate tax for a reasonable period not to exceed 12 months. IRC § 6161(a)(2) allows the IRS to extend the time for the payment of the estate tax for a reasonable period not to exceed 10 years from the date the estate tax is due under IRC § 6151(a), on a showing of reasonable cause by the executor. The Instructions for Form 4768 provide that the IRS can grant a discretionary extension for the payment of the estate tax or a deficiency for reasonable cause for one year at a time up to 10 years in the case of the payment of the estate tax and up to four years for the payment of a deficiency. In addition, the IRS determined in PLR 9314050 that IRC § 6161(a)(2) was available to defer payment of generation-skipping transfer (GST) taxes. On December 4, 2008, the IRS issued IRS Interim Guidance (SBSE-05-1208-062) for Processing Requests for Extension of Time to File, Pay Federal Estate Taxes, which sets forth the criteria for transfers of extension requests to Advisory, Insolvency and Quality Advisory staff and Campus Compliance Operations. The guidance issued under this Interim Guidance has been incorporated into the Internal Revenue Manual (IRM) at § 5.5.5 as of December 29, 2009. The criteria listed in IRM § 5.5.5 includes transfers of extension requests at certain liability thresholds, third requests for extensions, and all extension requests to pay annual installments that are deferred under IRC § 6166. IRM § 5.5.5 also includes guidance on evaluation of extension requests. For example, if a reasonable cause statement submitted by an executor provides details about why the estate is unable to determine its liability or its liquid assets, then it may be reasonable for the IRS to limit approval of the extension of time to pay the estate tax to six months, with the expectation that the estate will have identified its tax liability and liquid assets by the end of that six-month period. If further extension is needed, the executor may make an additional request using Form 4768. See IRM § 5.5.5.4. Any request for an extension to pay estate tax due that lacks a "reasonable cause statement" will be allowed only 15 calendar days to provide such a statement. Id. The IRS employee reviewing the request will make the request for additional information to the executor of the estate. Id. The IRS also can grant an extension, for reasonable cause, for any payment of part of any installment of tax deferred under IRC § 6166 (including any part of a deficiency prorated to an installment under IRC § 6166). IRM § 5.5.5.5. In the case of an extension for payment of installments under IRC § 6166, if such an extension would result in any payments being made *after* the 10-year limit noted above, then that extension can be no later than 12 months after the due date for the *last installment* under IRC § 6166. IRC § 6161(a)(2).

In addition to these reasons for the extension of time to pay, IRC § 6161(b)(2) provides that the IRS, for reasonable cause, can extend the time for the payment of a deficiency of the payment of the estate tax for a reasonable period not to exceed four years from the date payment of the deficiency was initially due. As a result, when there is a liquidity issue, the executor should request such an extension for a deficiency when filing the estate tax return.

No extension of time for the payment of estate tax will be granted "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." IRC § 6161(b)(3).

Reasonable Cause

Treas. Reg. § 20.6161-1(a)(1) provides that the district director or the director of a service center can grant an extension for the payment of the estate tax if an examination of all facts and circumstances shows an application for extension is based on reasonable cause. The Regulation provides examples of reasonable cause:

- An estate includes liquid assets sufficient to pay the estate tax due; however, there is a delay in marshalling the liquid assets, as they are located in several jurisdictions and are not immediately subject to the control of the executor. Treas. Reg. § 20.6161-1(a)(1), ex. 1.
- A substantial part of an estate includes assets consisting of the rights to receive payments in the future (such as annuities, copyright royalties, accounts receivable, or contingent fees), and such assets do not provide sufficient present cash to pay the estate tax when due. In addition, the estate cannot borrow against these assets without inflicting a loss on the estate. Treas. Reg. § 20.6161-1(a)(1), ex. 2.
- A substantial asset of an estate cannot be collected without litigation; therefore, the size of the gross estate is unascertainable at the time the estate tax is due. Treas. Reg. § 20.6161-1(a)(1), ex. 3.
- After a reasonable effort made by the executor to liquidate assets in the estate into cash, except for an interest in a closely held business to which IRC § 6166 applies, an estate does not have sufficient assets to pay the entire estate tax due, to provide a reasonable allowance during the remaining administration period for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable without borrowing funds at a higher rate of interest than is generally available. Treas. Reg. § 20.6161-1(a)(1), ex. 4.

Payment of Interest

If the IRS grants an extension to pay estate tax under IRC § 6161, the estate must pay interest on the estate tax owed during the extension period at the underpayment rate established under IRC § 6621. Treas. Reg. § 20.6161-1(c)(2); IRC § 6601. In a Chief Counsel Advice Memorandum, IRS CCA 200836027, the IRS determined that interest on the estate tax accruing during the extension period is nondeductible, personal interest under IRC § 163(h)(2) for income tax purposes. Interest paid by the estate during the extension period, however, is deductible on the estate tax return as an administrative expense under IRC § 2053(a)(2) at such time as the interest accrues if the expense is an allowable expense under the laws of the jurisdiction in which the estate is being administered. *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977); Rev. Rul. 80-250, 1980-2 C.B. 278. See also Rev. Rul. 78-125, 1978-1 C.B. 292, in which the IRS acquiesced to the *Bahr* decision. When the interest accrues and becomes deductible, the estate tax is recomputed and any refund due to the estate will be paid when the entire estate tax liability is paid. Rev. Rul. 80-250, 1980-2 C.B. 278. Rev. Proc. 81-27 sets forth the procedure for recomputing the estate tax due as a result of a reduction in the estate tax by reason of the payment of interest on the estate tax due. The IRS ruled in TAM 9241002 that the procedure set forth in Rev. Proc. 81-27 is available to recompute the estate tax for interest payments under an IRC § 6161 extension.

Period of Limitations and Security

The running of the period of limitations for the collection of estate tax is suspended during the extension of the period of time granted for the payment of estate tax under IRC §§ 6161(a)(2) and 6161(b)(2). IRC §§ 6161(d)(1) and 6503(d). Under IRC § 6165, if an extension of time to pay estate tax is granted, the IRS can require an estate to provide a bond for the amount to which the extension applies. The amount of the bond may not exceed double the amount of tax or deficiency so extended. See also Treas. Reg. § 20.6165-1(a).

Application for Extension

An application for an extension of time to pay the estate tax must be in writing and include the following:

- the period of extension requested,
- a declaration that the application is made under the penalties of perjury, and
- a statement of reasonable cause, if applicable.

The request for an extension to pay the estate tax should be made on a Form 4768 and filed with the Internal Revenue office where the estate tax return must be filed on or before the due date for the payment of the return. Treas. Reg. § 20.6161-1(b). Any additional applications for an extension of time to pay the estate tax must be filed before the expiration of the prior extension. The Regulations provide that the IRS should notify the estate of the grant, denial, or conditional grant of an extension within 30 days of its receipt of the application for extension. If the IRS denies the extension, Treas. Reg. § 20.6161-1(b) provides a procedure to appeal the IRS decision.

Conclusion

A number of methods are available to an illiquid estate to borrow funds to pay its estate tax and administration expenses, including IRC § 6166, which will be discussed in detail in Part 2 of this article. Before making a decision about which method should be used by the estate, the estate's executor should analyze each option available, because each option can have different tax or business consequences. For example, in certain instances a commercial loan may not be available because a lender and the estate cannot agree on terms for the loan. On the other hand, a *Graegin*-type loan may not make economic sense, particularly in a case in which the loan is from a closely held business, a portion of which is owned by unrelated parties. ■