GRAEGIN LOANS:

A TOOL FOR DEFERRING AND REDUCING ESTATE TAX

BY JAMES A. TEWS & NATHAN G. PATTERSON, KOLEY JESSEN

As tax season gets underway, we are reminded of how important it is for tax-return preparers to consider strategies to cope with their clients' tax burdens. For estate tax-return preparers, one potential strategy is the use of a Graegin loan. A Graegin loan is a mechanism to finance payment of estate tax and administration expenses. Under the right circumstances, it can provide low liquidity estates with the ability to both defer and reduce estate tax liability.

When Graegin loans are used, it is in estates that contain illiquid assets of significant value, such as a significant holding in a closely held business. For these estates, low liquidity can make paying the estate tax difficult if the sale of the illiquid asset is not advisable (e.g., poor market timing or, in the case of a significant holding in a closely held business,

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an expectation for the business to remain owned and operated by the decedent's family). Rather than selling one or more illiquid assets under less than ideal circumstances to pay an estate tax, the executor may want to consider borrowing cash through a Graegin-style loan, which could be from the closely held business, a related entity, or a third party.

Graegin loans have two primary benefits for estates suffering from a lack of liquidity. First, using such a loan to finance estate tax liability can defer cash payments through the structure of the associated promissory note with the lender. Second, Graegin loans can be used to reduce estate tax liability through a deduction for the interest payments made over the term of the loan. These benefits can be especially important for estates that would not otherwise qualify for estate tax deferral under Internal Revenue Code (IRC) Section 6166.

For a loan to qualify for an interest deduction, it must be structured to comply with IRC Section 2053, related regulations, and case law. Section 2053 allows for the deduction of administration expenses from the value of the gross estate that are "actually and necessarily" incurred in the administration of the estate (i.e., the collection of assets, payments of debts, and distribution of property to beneficiaries).[1] The courts and the IRS will consider a loan to be "actually and necessarily" incurred if a majority of the estate assets are illiquid and borrowing is necessary to avoid a forced sale of those assets to pay estate tax.[2] In those situations, a deduction for the loan interest will be allowed.

Under a Graegin-style loan, the interest that has not yet been paid is also deductible. A deduction for the estimated interest will be allowed so long as the estimated interest is (1) ascertainable with reasonable certainty and (2) certain to be paid.[3] Promissory notes that meet this standard are typically structured with fixed interest rates, a prohibition against prepayment, and an immediate acceleration of all interest that would have been payable on the note upon default. A deduction for future loan interest can result in significant estate tax savings.

Calculating the deductible interest on a Graegin-style loan can be complex because the deduction is allowed only for the portion of estate tax attributable to one or more illiquid assets and, therefore, a circular computation is necessary. The following example is a simplified illustration of this calculation:

If an unmarried decedent dies in 2020, as a resident of a state that does not impose death taxes, with an estate valued at $21.58 million, the initially anticipated estate tax is approximately $4 million.[4] For simplicity, assume the estate consists entirely of an interest in a closely held business, valued at $21.58 million. Instead of liquidating a portion (or all) of this interest, the executor performs the necessary computation to determine the amount of cash to borrow from the closely held business in exchange for a 10-year, 5% interest promissory note with annualized payments of interest and a balloon payment of principal upon maturity. Under these circumstances, the estate should receive an interest deduction of approximately $1.667 million.[5] The estate is ultimately reduced by that amount, resulting in an estate tax savings of approximately $666,800.[6]

As illustrated above, a Graegin loan can be an effective tool to both defer and reduce estate tax owed in an estate with illiquid assets. However, care must be taken to properly structure such a loan to meet the technical requirements of IRC Section 2053. Lastly, as always, practitioners and clients should consider all circumstances surrounding the potential use of such a loan, as there are considerations (including income tax considerations) beyond estate tax deferral and savings. ◀

[1] *See* IRC Section 2053(a)(2); Treas. Reg. § 20.2053-3(a).
[2] *Estate of Graegin v. Comm'r,* 56 T.C.M. (CCH) 387 (1988); Rev. Rul. 84-75, 1984-1 C. B. 193.
[3] *Graegin,* 56 T.C.M. 387.
[4] ($21.58 million - $11.58 million) x 40% = $4 million.
[5] *See* Charles E. Hodges II, Esq., Paul S. Lee, Stephanie Loomis-Price, Esq., & Janine A. Racanelli, *Black, White, and Grae(gin): Borrowing to Pay Estate Taxes,* AMERICAN BAR ASSOCIATION REAL PROPERTY, TRUST & ESTATE LAW 20TH ANNUAL SPRING SYMPOSIA, 21-24 (2009) (discussing and providing guidance on the circular computation used to find the Graegin loan amount and IRC Section 2053 interest deduction).
[6] $1.667 million x 40% = $666,800.

James A. Tews is a shareholder in the estate, succession, and tax department at Koley Jessen. He works with families to develop comprehensive estate plans and to execute the directions outlined in those plans at the appropriate time. He also has significant experience in providing legal assistance to clients who are parenting or caring for a child with special needs.

Nathan G. Patterson is an associate in the estate, succession, and tax department at Koley Jessen. He provides services ranging from basic estate planning, business planning services, and tax strategies to wealth transfer techniques and high-net-worth estate planning. With an agriculture and business background, he also works with family businesses and agriculture clients on planning matters specific to their industry.