Synopsis of

Estate of Koons, T.C. Memo. 2013-94

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No Interest Deduction Allowed for Graegin Loan from Family Entity Because Loan Was Not Necessary; LLC Owning Primarily Highly Liquid Assets Valued with 7.5% Marketability Discount Considering Binding Redemption Contract Resulting in Estate Owning Majority Interest

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Basic Facts

In *Estate of Koons v. Commissioner,* T.C. Memo. 2013-94, the decedent's revocable trust owned 46.9% of the voting stock (and 51.5% of the nonvoting stock) of a company distributing PepsiCo products. The company undertook steps to sell the PepsiCo assets, and the company's remaining assets were transferred to an LLC. As part of the sale transaction, the LLC offered to redeem interests owned by the decedent's children (or trusts for their benefit). Some of the children were unhappy with the structure of the sale and redemption, but all of the children accepted the offer by February 27, 2005. (One son sent a letter to his father saying the redemption "felt punitive" but the children acknowledged the "exit vehicle" and that they "would like to be gone." The letter made various other complaints, observations, and suggestions. The father responded in a letter a few days before he died: "I am going to study your letter of February 21st and if I wish to accept any of your suggestions I will let you know at an appropriate time.")

The LLC operating agreement was amended to limit, for 15 years, the annual amounts of discretionary distributions to 30% of the excess of "Distributable Cash" over income tax distributions.

The decedent died (supposedly very unexpectedly, though the case does not say that) within days of the children's acceptance of the redemption offers, on March 3, 2005. The redemptions were completed on April 30, 2005 following the decedent's death. Following the redemptions, the decedent's revocable trust owned 70.42% of the voting interest and 71.07% of the nonvoting interest of the LLC.

The estate had about $19 million of liquid assets and the decedent's estate tax return indicated that the estate owed about $21 million of estate tax and the decedent's revocable trust (which held the LLC interest) owed about $5 million of GST tax. (The IRS position was that those liabilities were $64 million and $20 million, respectively.) The estate borrowed $10.75 million from the LLC on February 28, 2006 in exchange for a promissory note. (The LLC had over $200 million of "highly liquid assets.") The note provided for interest at 9.5% per year with principal and interest due in equal installments to be paid over 6 ½ years, but the payments would not begin for over 18 years (they would be made between August 31, 2024 and February 28, 2031). The loan prohibited prepayment. Total interest payments to be made on the note were over $71.4 million. The LLC reported interest income annually with respect to the accrued interest on the loan.

Valuation Issue — Government's Appraisal Accepted, Allowing 7.5% Marketability Discount

The net asset value of the LLC was about $317.9 million. The valuation dispute was over the amount of marketability discount that should be allowed in valuing the estate interest in the LLC.

Neither expert allowed a control premium or discount. A control premium was not permitted, even though the revocable trust owned 70.4% voting control of the LLC after the redemptions, because the holder of that interest "could not have accrued private benefits" and could not "extract value above its pro-rata claim on company assets."

The taxpayer's expert was Mukesh Bajaj (who often testifies for the government in tax cases). The court observed, without details, that his expert rebuttal report admitted as testimony was different

from the report he prepared that was attached to the estate tax return. His report calculated the marketability discount based on his 2001 regression study of 88 companies, as described in Mukesh Bajaj, David J. Denis, Stephen P. Ferris & Atulya Sarin, *Firm Value and Marketability Discounts*, 27 J. CORP. L. 89 (2001). He calculated a marketability discount of 31.7%, after making adjustments for differences between the LLC and the 88 companies in the 2001 study. The court noted that his conclusion was based in large part on an assumption that the redemption of the children's interests would not occur.

The government's expert was Francis X. Burns (who also has served as the expert for the government in other tax valuation cases). He believed that it was reasonably foreseeable that the redemptions of the children's interests would occur, that the LLC would make cash distributions, and that the revocable trust's interest could force the LLC to distribute most of its assets. He thought the marketability discount should be between 5-10%, and that "7.5% would reflect a reasonable compromise between a seller and a buyer."

The court agreed with the government's position that the children's signed redemption acceptance letters were enforceable and that they wanted to have their interests redeemed (the redemption agreements provided for redeeming their interests based on the full pro rata value of the LLC's assets). The majority members could eliminate the provision in the LLC operating agreement limiting discretionary distributions to 30% of the distributable cash in excess of income tax distributions. The taxpayer's expert believed that the LLC's board of managers would not distribute most of the LLC's assets because the decedent had expressed the desire that the LLC should invest in operating businesses after his death. The court observed, however, that a hypothetical buyer would consider that the LLC could be forced to distribute most of its assets by the 70.4% voting owner in spite of the decedent's expressed desire. A majority member who could force the LLC to distribute most of its assets would not sell its interest for less than the member's share of such a distribution (citing *Estate of Jones v. Commissioner*, 116 T.C. 121, 135 (2001)). The court also concluded that the government's appraiser appropriately considered potential liabilities of the company including the possibility of a particular lawsuit against the company (which was dismissed after the decedent's death based on the statute of limitations.)

A provision in the operating agreement requiring a 75% vote to transfer an interest in the LLC to persons who were not direct descendants was given little weight because a holder of the revocable trust's interest in the LLC could eventually force the LLC to distribute most of its assets to its members or control its investment decisions.

The court agreed with the government's expert's analysis of why the taxpayer-expert's regression analysis overstated the marketability discount. The reasons included that the 88 companies in the regression analysis derived their profits mainly from active business operations, the 88 company transactions involved ownership interests of less than 50.50%, and the taxpayer's expert overstated the relationship between block size and the valuation discount because regulatory restrictions were more responsible for the valuation discounts in the 88 companies than a large block size.

Graegin Loan Issue — Interest Deduction Disallowed

The court (Judge Morrison) disallowed the $71.4 million interest deduction for estate tax purposes on the $10.75 million note. The court reasoned that the revocable trust could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years "hinders the 'proper settlement' of the Estate."

Background Observations Regarding Graegin Loan Issue

1. *Estate of Graegin Approved Up-Front Deduction.* In Estate of Graegin v. Comm'r, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed 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 decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. ¶88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

2. *Key Advantage of Graegin Loans: Reducing Payment to IRS Nine Months After Date of Death; Income Tax Impact.* The same ultimate estate taxes would be paid whether the interest deduction is allowed at the outset, or as each interest payment is made. This phenomenon results because administrative expense deductions are not limited to the present value of payments made years after the date of death. **However, for estates facing a liquidity crunch, obtaining an up-front deduction and dramatically reducing the dollars that the estate must come up with to pay the IRS nine months after date of death is critical.**

   An offsetting tax cost is that the interest payments will be interest income to the recipient family member or family entity when they are paid. (Indeed, the OID rules will generally apply if the interest is not paid currently, and interest income will be recognized each year.) Even thought the income and estate tax rates may be essentially equal (for high bracket taxpayers, 43.4% income tax and "Medicare tax" vs. 40% estate tax), the key advantage of the Graegin loan is that the estate tax savings is realized nine months after the date of death.)

3. *Amounts Borrowed From Family Entities — Brief Overview.* Various cases over the last several years have addressed Graegin loans from partnerships in which the estate owned an interest. *Estate of Murphy v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009) (interest deduction allowed); *Keller v. U.S.,* 104 AFTR 2d 2009-6015 (2009) and 106 AFTR2d 2010-6309 (2010) ($114 million borrowed after death from FLP on a nine-year note; deduction allowed). The deduction for interest on amounts borrowed from the family partnership was denied in *Estate of Black v. Commissioner*, 133 T.C. 340 (2009). These cases (and others) are discussed below in more detail.

4. *Cases That Have Allowed Interest Deduction For Borrowing From Family Entity.* Several cases that have allowed interest deductions have emphasized not second guessing business judgments of the executor. An example is a case in which the loan was not from a family entity, but in which the court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors." *McKee v. Comm'r*, T.C. Memo. 1996-362. (The remaining cases discussed below have all involved borrowings from family members or a family entity.)

   In Estate of Thompson v. Comm'r, T.C. Memo 1998-325, the estate borrowed $2 million from an irrevocable life insurance trust. The court allowed an interest deduction on the loan, observing that regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary."

   In *Estate of Murphy v. U.S.*, 104 AFTR 2d 2009-7703 (W.D. Ark. October 2, 2009), the estate borrowed $11,040,000 from the Family Limited Partnership (FLP) on a nine-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The IRS argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred "because it was the result of an unnecessary estate-tax avoidance transfer" that drained decedent's estate of liquid assets. The court rejects this reasoning, because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes. (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejects this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. *McKee*, 72 T.C.M. at 333."

   In *Keller v. U.S.*, 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009), the decedent signed a partnership agreement and expressed the intent to fund the partnership with a specifically identified bond portfolio and cash, but the funding did not formally occur before her death. The decedent died unexpectedly, so the planner put the formal funding on hold for about a year until one of the planners heard about the <u>Church</u> case, which had recognized a partnership that similarly had not been formally funded at the decedent's death. In the meantime, the estate had paid the estate tax, not realizing that

the assets legally already belonged to the partnership. The estate then documented the payment as an advance from the partnership to the estate, and deducted the interest on the loan from the partnership. The initial case allowed the interest deduction because the "estate lacked sufficient liquid assets to pay its necessary taxes and obligations without forcing the sale of its illiquid properties." In a subsequent opinion (106 AFTR2d 2010-6309, Sept. 14, 2010), the district court again addressed the validity of interest deductions on the deemed borrowing by the estate from the partnership. The IRS argued that the loan lacked economic substance. The Family Trust had paid $148 million to the IRS in February 2001, so the IRS argued that no borrowing was necessary and that the loan "was a complete sham." The court found that the loan satisfied the economic substance test and that it was entered into to preserve the liquidity of the estate. "While it is true that Mrs. Williams' advisors, at first, did not believe the Partnership was established, and drew a check from Family Trust accounts to pay taxes, the trust [apparently the court meant the Partnership] *did* exist and there in fact *was* a liquidity problem for the Estate." In addition, the IRS argued that the interest payments should not be deductible because they were paid from "property not subject to claims" (because the Family Trust and the trusts that it funded [Trust A and Trust M] were not part of the probate estate) and that interest payments made after the statute of limitations for assessing additional taxes could not be deducted because of the limitation in § 2053(b). However, the court reasoned that § 2053(c)(2) defines "property subject to claims" as property includible in the gross estate that is burdened with the payment of the deducted expenses and it does not matter whether the property passes outside of probate. Under the decedent's will, administration expenses would to be paid from the Family Trust or residuary estate (which passed to the Family Trust), and therefore the Family Trust assets were subject to claims, and interest payments on the loan could be deducted in full, even after the statute of limitations on additional assessments had run. The court allowed a deduction for $52,018,200 of interest on the loan as requested by the Plaintiffs — calculated up to five days before the loan was due.

In *Beat v. United States*, 107 AFTR 2d 2011-1804 (D. Kan 2011), the estate owned largely illiquid farmland. The estate distributed the assets to the beneficiary subject to a refunding agreement, and the estate borrowed money from the beneficiary to pay estate taxes. The estate had not paid interest to the plaintiff; it was bankrupt and could not pay the interest. The court reasoned that even if the asset had not been distributed there would have had to be borrowing to pay the estate tax and that the borrowing was "necessary and beneficial to the Estate."

An interest deduction was allowed on a Graegin loan in *Estate of Duncan v. Comm'r*, T.C. Memo. 2011-255. In that case, the decedent had transferred a substantial part of his estate, including oil and gas businesses to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries. Following decedent's death in January 2006, the revocable trust borrowed about $6.5 million from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and

debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of one of the corporate co-trustee for a 15-year bullet loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate to over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

In *Duncan*, the estate claimed a deduction under § 2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan. The IRS denied any deduction for the interest (although at trial it was willing to allow a deduction for three years of interest). The court (Judge Kroupa) determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other. See generally Stephen Liss, *In* Estate of Duncan*, the Tax Court Returns to Traditional Graegin Loan Principles*, 116 J. TAX'N 193 (April 2012).

A deduction was also allowed in *Estate of Kahanic v. Comm'r.* T.C. Memo. 2012-81. This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053. The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate

taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short-term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial. One of the IRS's arguments was that the estate could have sold its illiquid assets in time to pay the taxes. The court again disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

5. *TAM and Cases That Have Not Allowed Interest Deduction For Borrowing From Family Entity.* Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a FLP to pay estate taxes. In that situation, the decedent created a FLP with 90% of his assets, and died 5 ½ years later. The estate borrowed funds from the FLP to pay federal and state estate taxes under a 10-year note with principal and all interest payable on maturity, with a prohibition against any prepayments. The stated interest rate was 1% over the prime rate and 3% more than the 15-year mortgage rate on the date of the note. The estate's 99% interest in the FLP was pledged as security for the note. The ruling gave various reasons for denying a deduction for the interest expenses. (The IRS did not refer to the creation of the FLP as a self-imposed illiquidity as one of the reasons.) First, the IRS reasoned that the loan was not necessary to the administration of the estate because one of the decedent's sons who was a co-executor of the estate was the remaining general partner of the FLP, the FLP was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to access the funds. The IRS rejected the notion that the estate could not require a distribution from the partnership since the estate possessed only a 99% assignee interest:

> "It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an 'upfront' estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.)"

Second, the IRS reasoned in TAM 200513028 that the interest may not be repaid, and even if it is, the repayment has no economic impact on the parties. The limitation of the deduction for amounts actually paid "ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries." In this case the interest payments have no economic effect on the beneficiaries. If the estate has any funds for making payments, the estate would make the payments to the FLP to pay the interest, which would proportionately increase the value of the beneficiaries' interests in the FLP. More likely, the FLP will distribute assets to the estate, which will then repay those assets back to the FLP in payment of the loan. "Since the parties have virtually identical interests in the Estate and the partnership, there is no change in the relative net worth of these parties as a result of the loan transaction. Rather, other than the

favorable tax treatment resulting from the transaction, it is difficult to see what benefit will be derived from this circular transfer of funds." The IRS attempted to further support this argument by analogizing to income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances involving circular transfers for making payments on purported loan transactions.

The court rejected an interest deduction for amounts loaned from an FLP to the estate in *Estate of Black v. Comm'r*, 133 T.C. 340 (2009). *See generally* Liss, Estate of Black*: When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?*, 112 J. TAX'N (June 2010). An FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock. In this case, the company stock that was owned by the FLP was in fact sold by the FLP. That seems to be the key distinguishing factor from the prior cases that have allowed interest deductions for Graegin loans. John Porter (the attorney representing the estate and was also the taxpayer's attorney arguing *Koons*) points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

In *Estate of Stick v. Comm'r*, T.C. Memo. 2010-192, the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the

estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

6. *IRS Approach Going Forward.* IRS officials have stated informally that the IRS is continuing to look for vehicles to contest Graegin loans, particularly in situations involving FLPs. Part of the IRS's concern is that a deduction will be allowed but the interest in fact will not have to be paid over the entire term of the note.

   The §2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plans for 2009-2013 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

7. *Summary Regarding Koons.* The reasoning in *Koons* is similar to the analysis in *Black*. In both, the court reasoned that the family entity could have simply made a distribution to the estate, that the estate had no ability to repay the loan apart from eventual distributions from the family entity, and that the loan merely deferred the eventual distribution from the entity to repay the loan. A distinction is that in *Black*, a purported reason for the loan was to avoid a forced sale of a favored asset, but the family entity sold the favored asset anyway in order to have the cash to loan to the estate. By analogy, the estate argued in *Koons* that the LLC could not make a distribution to the estate because the LLC purpose was to invest in businesses, but the loan reduced the LLC's cash that was available to invest in businesses. In *Duncan*, a case in which the interest deduction was allowed, the loan kept the estate from having to sell illiquid assets (i.e. oil and gas interests).

   In any event, the extreme nature of the loan in *Koons* (a 25-year loan with no payments for 18 years, generating $71.4 million of interest on a $10.4 million loan) no doubt highlighted the issue for IRS scrutiny and possibly trigger a harsh "smell test" concern with the judge. The old adage "pigs get fat and hogs get slaughtered" comes to mind.