

**Keller v. U.S., 106 AFTR 2d 2010-XXXX (S.D. Tex. September 14, 2009) and 106 AFTR 2d 2010-XXXX (S.D. Tex. September 15, 2010)**

**Interest on Loan to Borrow Money From Partnership After Death to Pay Estate Taxes and Other Obligations Is Deductible For Estate Tax Purposes; Accounting and Legal Fees Deductible (Except Under Contingent Fee Agreement After Initial Favorable Decision); Executor/Trustee Fees Limited for Family Members Who Performed No Services; Maintenance Expense Deductions Allowed Through Final Settlement of Estate Tax Liability**

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## Synopsis

These are two opinions following up on the court's initial opinion on August 20, 2009. These opinions address various administration expenses. In the initial opinion, the court recognized that under applicable state law a partnership had been created and deemed funded even though no assets had been formally transferred to the partnership by the time of the decedent's death. Trusts created under a revocable trust (that were not part of the probate estate) paid about \$143 million as an estimate of the estate taxes, but the estate filed a claim for refund. The court's initial 2009 opinion concluded that the decedent had expressed the clear intent to fund the partnership with identified assets, and under Texas law that caused the assets to become partnership assets. The bona fide sale exception to §§2036 and 2038 applied and the taxpayer's valuation expert's value was accepted, representing a 47.5% discount (for the partnership consisting primarily of bonds and cash).

After realizing that the trusts created under the revocable trust did not actually own the assets, but that they were legally in the partnership, the trusts borrowed \$114 million from the partnership to pay estate taxes and other debts. The initial opinion held that the interest on the nine-year loan was deductible for estate tax purposes because the interest expense was actually and necessarily incurred in the administration of the estate. The IRS requested the court to amend or alter its holding regarding the interest deduction, but the court's September 14, 2010 opinion held that the interest was deductible, reasoning that there was economic substance to the loan and that the § 2053 (b) limitation on the time frame for deducting expenses paid from assets not subject to claims did not apply despite the fact the assets were paid from non-probate assets.

The September 15, 2010 opinion addressed the amounts of deductible administration expenses, and allowed deductions for various administration expenses, except for contingent accounting and legal fees paid pursuant to contingency fee arrangements entered into after the court's initial opinion (finding that those additional fees were not "necessary"), and except for executor fees paid to family members who performed no services that the court treated as disguised distributions to beneficiaries. Deductions for maintenance expenses (such as for lawn and tree services) were allowed pending the determination of the estate tax liability and final settlement of the estate.

## Court Analysis

- (1) Validity of Interest Deductions. The September 14 opinion addressed the validity of interest deductions on a deemed borrowing by the trusts created under the revocable trust. The IRS had requested the court to amend or alter its holding regarding the interest deductions. (The specific *amount* of interest deduction was addressed in the September 15 opinion.)

The IRS first argued that the loan lacked economic substance. Trusts funded under the revocable trust had paid \$148 million as estimated estate tax 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 (it "imposed liability on the makers in the event of default and applied interest at the applicable federal rate [and] millions of dollars of interest have been paid on the loan and reported as income to the Partnership" and 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."

Next, the IRS argued that part of the interest payments were time barred from being deducted because the interest payments were paid from “property not subject to claims,” reasoning that the revocable trust and the trusts that it funded [Trust A and Trust M] were not part of the probate estate. Section 2053(b) imposes a time limit on the deductibility of administration expenses paid from “property not subject to claims;” only expenses paid from such property before the expiration of the period of limitation for assessment of additional estate taxes can be deducted. (That limitation does not apply to expenses paid from property that is subject to claims.) 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 be paid from the revocable trust or residuary estate (which passed to the revocable trust), and therefore the revocable trust assets were subject to claims, and interest payments from the trusts created under the revocable trust could be deducted, even for interest payments made after the statute of limitations on additional assessments had run.

The remaining administration expense issues, discussed below, were addressed in the court’s second opinion dated September 15, 2010, which addressed the deductible amounts of accounting fees, legal fees, interest expenses, executor/trustee fees, and maintenance expenses.

- (2) Accounting and Legal Fees. The court allowed claimed accounting and legal fees, except for contingent fees pursuant to agreements entered into after the court’s initial decision on August 20, 2009. The court held that the accounting contingent fees for future work or as a “bonus” for work already performed was not a “necessary” expense. The attorneys argued that the legal contingent fee agreement “simply memorializes a previous understanding” and included a bonus for work already performed and covered yet to be performed work. However, the restated legal fee contingent agreement called for payment on an hourly rate in addition to the contingency fee. The court found that the legal contingency fee was “not necessary to the administration of the Estate; rather, it is an attempt by Plaintiffs to increase their deductions.”
- (3) Interest Amount. 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.
- (4) Executor/Trustee Fees. The executor/trustee fees paid to the accountant who performed all of the executor services were allowed, but executor fees of \$6.0 million to the decedent’s daughter and \$3.0 million to each of the two grandchildren — “a perfect split based upon their lineage” — were not allowed (the IRS argued that they were a “disguised distribution to heirs”). The executor/trustee fees were allowed even though some of the fees were paid as trustee fees. Under the regulations, trustee fees are deductible “to the extent that a trustee is in fact performing services with respect to property subject to claims which would normally be performed by an executor.” Treas. Reg. §20.2053-3(b)(3).
- (5) Maintenance Expenses. The IRS contested the deductibility of various maintenance expenses, including as an example over nine years of expenses for lawn and tree service on a lot that is the site of the decedent’s aunt’s homestead. The estate argued that the expenses were “necessary to preserve the property until a final distribution of the Estate can be effected.” The court agreed, reasoning that  

“[u]ntil the Estate [estate tax] liability is finally determined, the Executors are permitted to delay distributing the property of the Estate. *See* 31 U.S.C. § 3713. Therefore, the expenses incurred as a result of maintaining this property until the final settlement of the Estate is completed — and a distribution can be effected — are permissible deduction [sic] under Section 2053(a)(2).”

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