INTRA-FAMILY LOANS

by C. Christine Borrett[*]

I. INTRODUCTION[1]

Parents are often motivated to assist their children in buying a home or starting a business. Typically, parents offer assistance in the form of a loan, particularly when the parents have limited means and cannot afford to make overly generous gifts. An intra-family loan can be a simple and effective estate planning tool for wealthy parents to transfer assets to their children without gift tax implications.[2] These loans can be made at interest rates lower than those available for commercial loans because children can borrow from parents and

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2. DELOITTE, THE ESSENTIAL TAX & WEALTH PLANNING GUIDE FOR 2004-2005: UPDATES AND TIPS TO STAY ON TOP 35 (2004), http://www.deloitte.com/dtt/cda/doc/content/T&WPGuide0405v3.pdf; *see* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION, 145-46 (14th ed. 2006).

grandparents with interest payable at the applicable federal rate (AFR).[3] If children can produce returns on the assets in excess of the AFR, then the loan transaction may accomplish significant estate planning objectives.

This Article covers loan basics for income and gift tax purposes with an emphasis on transactions common in the family context.[4] A discussion of interest-free loans, loans with insufficient interest, and imputed interest rules is also included.[5] Furthermore this Article considers a list of factors and case law for loans that were later deemed to be gifts.[6] In addition, income and gift tax consequences of debt forgiveness is addressed as many intra-family loans are later pardoned.[7] The discussion is concluded with a section on advanced techniques, including self-cancelling installment notes and *Graegin* loans.[8]

A. Basic Rules on the Taxation of Loans

Neither the Internal Revenue Code (Code) nor the Treasury Regulations has codified basic rules governing how loans are handled for tax purposes.[9] To the borrowers, a loan is not gross income.[10] In *Commissioner v. Glenshaw Glass Co.*, the Supreme Court defined income for tax purposes with the following three-part test: (1) an accession to wealth, (2) that is clearly realized, and (3) over which the taxpayer has complete dominion.[11] Because a borrower has the obligation to repay the loan, the borrower has no accession to wealth.[12] Additionally, the lender cannot deduct the loan amount.[13] The rationale for nondeductibility is that one asset—cash—has been converted into a different asset—a promise of repayment.[14] Deductions are not typically available when an outlay serves to create a new or different asset.[15] For the borrower, the amount paid to repay the loan is not deductible.[16] For the lender, repayment of the loan is not gross income.[17] In effect, the lender has no accession to wealth

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3. *See* IRC § 7872 (2006).
4. *See* discussion *infra* Parts I.A-II.E.
5. *See* discussion *infra* Parts I.A-II.C.
6. *See* discussion *infra* Part II.C.
7. *See* discussion *infra* Part II.D-E.
8. *See* discussion *infra* Part III.A-C.
9. *See* KLEIN ET AL., *supra* note 2, at 32-36. All references to the "Code" or to IRC are to the amended Internal Revenue Code of 1986. All references to "Treasury Regulations" are to the Treasury Regulations promulgated under the Code.
10. KLEIN ET AL, *supra* note 2, at 145.
11. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955); *see also* IRC § 61 (2006).
12. *Compare Glenshaw Glass Co.*, 348 U.S. at 431 *with* KLEIN ET AL., *supra* note 2, at 145.
13. KLEIN ET AL., *supra* note 2, at 145.
14. *Id.*
15. SAMUEL A. DONALDSON, FEDERAL INCOME TAXATION OF INDIVIDUALS: CASES, PROBLEMS & MATERIALS 111 (2d ed. 2007); *see Glenshaw Glass Co.*, 348 U.S. at 426; *see also* IRC § 61.
16. DONALDSON, *supra* note 15, at 111; *see* Comm'r v. Lincoln Sav. & Loan Assoc., 403 U.S. 345, 345 (1971).
17. *See* DONALDSON, *supra* note 15, at 111.

because a promise of repayment will be converted back to cash.[18] Any interest the borrower pays to the lender is included in the lender's gross income.[19] Interest paid represents compensation to the lender for the use of the lender's money or property as well as profit or an accession to wealth to the lender.[20] The Code may attribute interest income to lenders even if the lender fails to charge a minimum amount of interest under the imputed interest rules.[21] The borrower may not deduct interest paid to the lender.[22] The Code generally allows an income tax deduction to borrowers for all interest paid or accrued on indebtedness within the taxable year.[23] However, interest paid on a personal loan is generally *not* deductible.[24] One exception to the Code's bar on deducting interest paid on personal loans is the interest deduction to borrowers for qualified personal residence interest.[25] This important exception deals with the deductibility of qualified personal residence interest under § 163(h)(3) of the Code.[26] If the real estate secures a personal mortgage on a homestead, then the borrower generally deducts the interest paid on the mortgage.[27]

For borrowers who itemize deductions, the "qualified residence interest" paid on certain home mortgages, taken in connection with a primary residence or secondary residence, is deductible.[28] This deduction generally applies only to interest on mortgages to buy, build, or improve a primary or secondary residence or to home equity loans used for any purpose.[29] The extent to which the interest is deductible depends on several factors, including (i) how the loan proceeds are used; (ii) the amount of the loan or loans: (iii) the type of loan: and (iv) whether the loan was acquired prior to October 14, 1987.[30] For the deduction to be available, however, the taxpayer must secure the loan with the residence.[31] This issue may be relevant for parents who are not otherwise inclined to take a security interest on a loan for children in order to help them purchase a residence.[32]

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18. *See id.*; *see, e.g.*, Crane v. Comm'r, 153 F.2d 504, 505-06 (2d Cir. 1945), *aff'd*, 331 U.S. 1 (1947) (concluding that the basis of acquired property includes the amount funded with a nonrecourse loan).

19. DONALDSON, *supra* note 15, at 111; *see* IRC § 61(a)(4); Treas. Reg. § 1.61-7 (1966).

20. *See, e.g.*, IRC § 61(a)(4); Meyers v. Comm'r, 27 T.C.M. (CCH) 1535, 1540 (1968), *aff'd per curiam*, 453 F.2d 171 (3d Cir. 1970).

21. *See* DONALDSON, *supra* note 15, at 112.

22. *See id.*

23. *See* IRC § 163(a).

24. *Id.* § 163(h)(1).

25. *See id.* § 163(h)(3).

26. *See id.*

27. *See* § 163(h)(3)(B); Burris v. Comm'r, 81 T.C.M. (CCH) 1227, 1232 (2001).

28. *See id.* § 163(h)(3). However, interest with respect to a third residence is not deductible. *See id.* § 163(h)(4)(A).

29. *See* § 163(h)(3).

30. *See id.*

31. *See* § 163(h)(3)(B)-(C) (requiring the residence to secure the loan in case of a home acquisition loan and a home equity loan).

32. *See* § 163(h)(3)(B). A parent could still enjoy a deduction by taking out a home equity loan and giving the money to his child for the purchase of a residence. *See id.*

B. De Minimis Exceptions

There is a $10,000 de minimis exception for the reporting requirements or imputed interest income rules associated with gift loans.[33] Thus, loans below this amount will not trigger the reporting requirements or imputed interest income rules.[34]

Section 7872 of the Code also contains a limitation on interest accrual for purposes of the federal income tax in cases when the gift loan outstanding between individuals, or the aggregate of all the gifts loans outstanding between individuals, is less than $100,000.[35] Specifically, with a gift loan directly between individuals, the amount treated as retransferred at the close of any year from the borrower to the lender shall not exceed the borrower's net investment income for such year.[36] Taxpayers should take special note, however, that this provision does not apply to any loan "the interest arrangements of which have as of their principal purposes the avoidance of any Federal tax."[37] This subsection further states that if a borrower receives less than $1,000 of net investment income in a given year, then the borrower's net investment income shall be treated as zero.[38]

C. The Applicable Federal Rate (AFR)

The AFR is an interest rate used for various purposes under the Code and consistently appears in discussions of intra-family loans. The Internal Revenue Service (IRS) publishes the AFR on a monthly basis, with different rates issued for loans with terms of (i) less than three years (short-term); (ii) between three and nine years (mid-term); and (iii) more than nine years (long-term).[39]

Section 1274 of the Code applies the AFR to interest on promissory notes issued in consideration for certain sales of property, and § 7872 of the Code requires the imputation of interest on loans with a stated interest rate that is less than the AFR—"below-market loans."[40] AFRs are also provided based on the frequency with which interest compounds—annually, semi-annually, quarterly, or monthly.[41] The IRS updates its online index of AFR rulings on a monthly basis.[42]

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33. *See id*. § 7872(c)(2)(A). "In the case of any gift loan directly between individuals, this exception shall not apply to any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000." *Id*.

34. *See id*.

35. *See id*. § 7872(d)(1)(A).

36. *See id*. § 7872(d)(1).

37. *See* § 7872(d)(1)(B).

38. *See* § 7872(d)(1)(E)(2).

39. *See id*. § 1274(d)(1).

40. *See id*. §§ 1274(c)(1), 7872(a)(1) (discussing the treatment of "below-market interest" rate loans).

41. *See* Internal Revenue Service, Index of Applicable Federal Rates (AFR) Rulings, http://www.irs.gov/app/picklist/list/federalRates.html (lasted visited Apr. 5, 2009).

42. *See id*.

D. Basics of Promissory Notes

A promissory note is a contract or a written promise by which one party unconditionally agrees to repay a specific debt under specific terms.[43] The parties involved in this type of transaction are called the promisor or obligor and the promisee or obligee.[44] The promisor is the party who promises to repay the loan that the note secured.[45] The payment is generally made in stages, culminating on a pre-determined final payment date.[46] This type of loan is called a term promissory note.[47]

Certain types of promissory notes allow the promisee to obtain repayment upon demand.[48] This type of note is known as a demand promissory note.[49] A demand promissory note does not include a specific maturity date; instead, it is payable in full at any time upon the demand of the lender or within a reasonable time after the lender's demand.[50]

A "balloon note" is a long-term loan that requires the promisor to make a few small payments prior to making a large payment on the date of maturity because the principal is not amortized over the term of the loan but rather is paid in a lump sum at the end of the term.[51] Generally, balloon note interest rates can be kept low so that the promisor, or borrower, can take advantage of the additional capital garnered during the life of the loan.[52] Balloon notes are popular with business entities that have little initial capital and plan to use the low interest loan to help themselves grow.[53] Once the entity has been able to take advantage of the additional capital to expand their business, then they should be able to meet their payment obligations.

The amortization repayment model is used to calculate how much is due on a promissory note at any given time.[54] Each amortization payment goes towards satisfying the principal balance and the interest balance.[55] The annual interest is first computed on the remaining balance of the note; then it is converted to a monthly interest charge by dividing the annual interest by twelve months.[56] This monthly interest is then subtracted from the payment, and the

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43. *See* BLACK'S LAW DICTIONARY 1249 (8th ed. 2004).
44. *See id*.
45. *See id*.
46. *See id*.
47. *See* DEPARTMENT OF TREASURY: INTERNAL REVENUE SERVICE, INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE MEMORANDUM FOR DISTRICT COUNSEL 7 (2000), http://www.irs.gov/pub/irs-wd/0040001.pdf (last visited Apr. 5, 2009).
48. *See id*.
49. *See id*.
50. *See id*.
51. *See* MONT. CODE ANN. § 32-5-102 (2007).
52. *See* David Pratt et al., *Estate Planning During Turbulent Times*, 82 FLA. B.J. 37, 37 (Dec. 2008).
53. *See id*.
54. *See* BLACK'S LAW DICTIONARY 93 (8th ed. 2004).
55. *See id*.
56. *See id*.

balance of the remaining payment is then deducted from the remaining outstanding balance.[57] Consequently, the larger balance in the early years of a note generates a higher portion of the monthly payment that is dedicated to the repayment of interest, whereas in later years a greater portion of each payment is credited against the principal.[58]

E. Factors to Consider with Intra-Family Loans

Intra-family loans are a versatile and flexible tool which, when used properly, can be instrumental in assisting a client in reaching his planning goals.[59] They are not, however, appropriate in every situation.

There are many potential advantages of an intra-family loan.[60] First, the maker can pay interest only for the term of the note.[61] Second, the AFR for a loan is lower than the rate in § 7520 of the Code, which is used for a grantor retained annuity trust (GRAT) with the same term.[62] Thus, it may be possible to effect a greater freeze of the grantor's estate than with a GRAT.[63] Third, the loan transfers growth in excess of the AFR free of gift or estate taxes.[64] Fourth, the lender does not have to survive the terms of the loan in order for the loan's objectives to be achieved.[65] Fifth, the loan does not have adverse generation-skipping transfer tax (GST) consequences and is appropriate for GST planning.[66] Finally, there is no risk of income tax at death.[67]

There are also many potential disadvantages of an intra-family loan.[68] First, there is possible loss of income tax deduction for interest expense if the borrower does not have sufficient investment income.[69] Second, adverse transfer tax consequences exist if the growth and income from the assets purchased with the loan proceeds do not exceed the AFR.[70] Third, an AFR loan requires the client to have sufficient liquidity to make the loan unless the

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57. *See id*.
58. *See id*.
59. *See* DELOITTE, *supra* note 3, at 35.
60. *See infra* text accompanying notes 62-68.
61. *See generally* Foley & Lardner LLP, *Attractive Estate Planning Techniques for a Low-Interest Rate and Depressed-Value Environment*, Dec. 3, 2008, http://www.foley.com/publications/pub_detail.aspx?pubid=5049 (last visited Apr. 5, 2009) (describing intra-family loans as promising estate planning techniques).
62. *See id*.
63. *See id*.
64. *See id*.
65. *See id*.
66. *See id*.
67. *See id*.
68. *See infra* Part II.C (discussing how to avoid treatment as a disguised gift).
69. *See infra* Part II.C.
70. *See infra* Part II.C.

property is seller-financed.[71] Finally, there is a possible gift if the borrower defaults.[72]

As previously stated, the terms of an intra-family loan can easily be customized to fit the client's particular circumstances.[73] If the loan uses a balloon note that provides for interest-only payments, then the borrower, who is typically the child, will receive the funds without the necessity of making large payments over the life of the loan.[74] This makes intra-family loans useful tools for lender-parents who want to assist their children with buying a starter home, launching a business, or encouraging other pursuits to help them become established adults.[75]

Another use for this type of loan is as "seed money" for an investment fund.[76] In sound economic times, the borrower can invest the loan proceeds for a rate of return larger than the interest rate on the loan.[77] When the loan matures, the principal is returned to the lender, who transferred an amount equal to the difference between the return on the investments less the amount of interest owed, free of gift tax consequences.[78] If, however, the market sours or the investments do not perform as well as anticipated, then adverse tax consequences can result if the growth and income from the assets are less than the AFR.[79]

The impending sunset of the legislation repealing the estate tax in 2010 has created a great deal of uncertainty for tax planning professionals with regard to the ultimate amount of the estate tax exemption for their very wealthy clients in the next few years.[80] As a result of this uncertainty, practitioners have discouraged clients from making taxable gifts in excess of the current $1 million gift-tax exclusion during their lifetimes.[81] Meanwhile, representatives from the Republican and Democratic parties have set forth policy recommendations indicating that a repeal of the estate tax is unlikely, and a compromise involving an estate tax exemption of at least $3.5 million is imminent.[82]

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71. *See infra* Part II.C.

72. *See infra* Part II.C.

73. *See* DELOITTE, *supra* note 3, at 35.

74. *See* Foley & Lardner LLP, *supra* note 62.

75. *See* Blank Rome LLP, *Historically Low Interest Rates Create Unique Gift and Estate Planning Opportunities*, Apr. 2008, http://www.blankrome.com/index.cfm?contentID=37&itemID=1527.

76. *See id*.

77. *See id*. ("The younger generation can use these loans to pay down higher-rate debt or make investments which they believe will yield a higher rate.").

78. *See id*.

79. Richard M. Goldstein & Derek P. Richman, *Estate Planning in a Low-Interest Rate Environment*, J. OF PRAC. EST. PLAN., at 44, 46, Dec. 2003-Jan. 2004, *available at* http://www.bilzin.com/news/pdfs/Goldstein1.pdf .

80. *See id*. at 43.

81. *See* Cole, Evans & Peterson, *They've Changed the Rules (For Filing Your Louisiana Tax Return)*, Apr. 2008, http://www.cepcpa.com/newsletters/apr2008.html.

82. *See* Conservation Tax Center, *Estate Tax Update*, 2007, http://www.conservationtaxcenter.org/plnlo/doc280127.asp (last visited Apr. 5, 2009).

An exceptionally wealthy client whose estate is likely to generate transfer tax liabilities, regardless of the outcome of the legislative process, may wish to consider the tax efficiency achieved by foregoing loans, GRATs, and other techniques in favor of making taxable gifts to children during their lifetime.[83] Although this may result in the payment of gift tax during a client's lifetime, it will result in the exclusion of these assets from a client's estate.[84] It may be more advantageous to incur a gift tax liability rather than structure a transaction as a loan for a client who is not motivated by the prospect of being paid back.[85] With a gift, a client retains no right of repayment; therefore, he can avoid an estate tax on amounts paid or payable under a note and on amounts used to satisfy gift tax liabilities, contingent on satisfaction of the three-year rule under § 2035(c) of the Code.[86]

F. Below-Market Loans Under Section 7872 of the Code

Section 7872 of the Code addresses the gift tax effects of "below-market" loans, and subsection (f)(1) defines "present value" with reference to the "applicable Federal rate."[87] Many years prior to the enactment of § 7872, gift loans between family members and other related parties were used to avoid taxes, as the donees were free to use the loan proceeds to invest and to retain the after-tax income.[88] Until the Supreme Court's decision in *Dickman v. Commissioner*, which held that interest-free loans do give rise to gift tax consequences, donors claimed that there were no gift tax consequences because of the lack of an applicable Code provision.[89]

Section 7872 of the Code subsequently closed the loophole by recharacterizing interest-free or below-market loans as an arm's length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at a statutory rate and in which the lender made a payment to the borrower—"imputed transfer."[90]

The lender's payment "to the borrower is treated as a gift, dividend, contribution to capital, payment of compensation or other payment depending on the substance of the transaction."[91] A demand loan is treated as a below-market loan if no interest is payable on the loan or if interest is payable at a rate

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83. *See* Bradford N. Dewan, *Low Interest Rates Provide Significant Opportunity in Estate Planning: Part I*, IV ALERT 1, 1-2, May 2004, http://www.sbllp.com/files/132_vol4_no2.pdf.

84. *See id*. (discussing the exclusion of assets may include the amount of the gift tax paid).

85. *See* Fiduciary Trust International, *Wealth Transfer Options*, Jan. 2009, http://www.fiduciarytrust.com/fiduciarytrust/jsp/content.jsp?url=/commentary/wealthTransferOptions.

86. *See* IRC § 2035(c) (2006). While gifts made within three years of a decedent's date of death are generally not included in the gross estate, gift tax paid with respect to a taxable gift made within three years of death is included under § 2035(c). *Id.*

87. *See id*. § 7872.

88. *See* Dean v. Comm'r, 35 T.C. 1083, 1090 (1961).

89. *See* Dickman v. Comm'r, 465 U.S. 330, 333 (1984).

90. *See* Treas. Reg. § 1.7872-15(a) (2003).

91. Roundtree Cotton Co. v. Comm'r, 113 T.C. 422, 427 (1999).

less than the AFR.[92] A term loan is treated as a below-market loan if the amount of the loan exceeds the present value of all payments due under the loan.[93] Section 7872(a) of the Code is applicable to gift and demand loans, and § 7872(b) is applicable to other below-market loans such as term loans.[94]

In the case of a below-market demand loan, the lender is treated as transferring to the borrower and the borrower is treated as retransferring from the lender, an amount equal to the foregone interest on an annual basis.[95] A demand loan that is issued at a market rate can become a below-market loan if the AFR later increases to a rate above that of the loan.[96] At that point, the loan is a below-market loan unless the lender calls the loan and demands a higher rate of interest equal to or greater than the current AFR.[97] The lender includes foregone interest in income, and the buyer can deduct this interest to the same extent as interest actually due on the loan from the borrower.[98] If no interest is charged, then the lender is deemed to have made a gift subject to all the rules associated with the federal gift tax.[99] Consequently, the short-term AFR is always applied to determine what constitutes "sufficient interest" such that § 7872 of the Code does not apply.[100]

In contrast, a term-gift loan is treated for income tax purposes as a demand loan.[101] For gift tax purposes, the amount of the gift is determined according to § 7872(b) because if the stated interest of a term loan at the time the loan is made is equal to or greater than the AFR, then the loan will never become a below-market loan.[102]

The case of *Frazee v. Commissioner* provides that the fair market value of a promissory note must be determined under the discount rate laid out under § 7872 of the Code, regardless of the subject of the loan.[103] In this case, the Tax Court addressed whether the fair market value of a promissory note for gift tax purposes, which a child issued to his parents in exchange for real property, must be determined by using a discount rate prescribed under § 7872

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92. *See* IRC § 7872(e)(1)(A).
93. *See id*. § 7872(e)(1)(B).
94. *See id*. § 7872(a), (b).
95. *See* § 7872(e)(2)(A)-(B).“Foregone interest” is defined:

> [W]ith respect to any period during which the loan is outstanding, the excess of-(A) the amount of interest which would have been payable on the loan for the period if interest accrued at the applicable Federal rate and were payable annually on the last day referred to in subsection (a)(2), over (B) any interest payable on the loan properly allocable to such period.

Id.
96. *See id*. § 7872(e)(1), (f)(2)(B).
97. *See* § 7872(e)(1)(A).
98. *See* § 7872(e)(2).
99. *See* K. GABRIEL HEISER, HOW TO PROTECT YOUR FAMILY'S ASSETS FROM DEVASTATING NURSING HOME COSTS: MEDICAL SECRETS 26, 56 (Boulder Elder Law, 3d ed. 2009) (2007).
100. *See* Treas. Reg. § 1.7872-15(g)(5) (2003).
101. *See* IRC § 7872(f)(3).
102. *Id.*
103. Frazee v. Comm'r, 98 T.C. 554, 582 (1992).

or the safe-harbor rate provided under § 483(e) of the Code.[104] The court determined that § 7872 applied in determining the gift tax treatment of below-market loans regardless of whether the transaction involved a sale of property or a cash loan.[105] The court noted that § 7872 was enacted specifically to address the gift tax treatment of below-market loans.[106] Thus, the court concluded that the application of § 7872 is not limited to cash loans; however, the term "loan" under § 7872 is broadly interpreted to include any extension of credit.[107]

Finally, practitioners are warned that although the AFR has long been the benchmark for an appropriate interest rate to charge in the context of intra-family loans, some commentators have expressed concern about one case implying that the AFR will not suffice to meet "market" conditions in every case.[108] If the loan in question is a demand loan, then the reader is advised to charge an interest rate slightly above the AFR to provide an extra measure of safety.

II. BASIC STRATEGIES

A. Loans Used to Leverage Assets and Freeze Values for Estate Planning Purposes

It is possible to use a sale financed by an intra-family loan to leverage assets and freeze values in the lender's estate. The presumption is that the fair market value of a note, secured or unsecured, is the unpaid principal plus accrued interest as of the date of the surviving spouse's death, unless shown to be otherwise.[109] Consequently, when children borrow and invest assets, these assets will grow free of estate tax, and the parents' promissory note will freeze the value of their estate.[110] As noted above, a GRAT can accomplish similar aims, but the rate in § 7520 is usually higher than the AFR.[111] Therefore, intra-family loans may be a better estate freezing tool than a GRAT.[112]

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104. *See id*. at 555.

105. *See id*. at 586.

106. *See id*. at 588.

107. *See id*.; *see also* I.R.S. Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (discussing the installment sale of assets to a grantor trust in return for a note with annual interest at the rate in § 7872 of the Code, with the balloon payment of the principal after 20 years); I.R.S. Priv. Ltr. Rul. 94-08-018 (Feb. 25, 1994) (discussing the gift tax treatment of the redemption of a mother's stock from a corporation in which her son was the remaining shareholder).

108. *See Smith v. United States*, No. 02-264, 2004 WL 1879212, *4-*7 (W.D. Pa. June 30, 2004) (describing how the Court disallowed the family limited partnership discount where, among other things, the purchase note called for interest payable at AFR).

109. *See* Treas. Reg. § 25.2512-4 (1958).

110. *See id*.

111. *See* Mark S. Poker, *Sales to Intentionally Defective Grantor Trusts*, SN070 ALI-ABA 197, 201-02 (2008).

112. *See supra* text accompanying notes 110-12.

Even though a surviving spouse is the only permissible beneficiary of a marital trust under § 2056(b)(1) of the Code, the IRS, in a private letter ruling, approved loans from a marital trust to the children of the decedent.[113] This occurs even though the interest on the loans would accrue and the loans would not be paid off until the death of the surviving spouse.[114] While the marital trust in the private letter ruling required payment of income to the surviving spouse at least quarterly, the trust also allowed the trustee to make discretionary principal distributions to the spouse.[115]

In the ruling request, the trustee proposed exercising its discretionary power to make annual principal distributions to the spouse equal to the amount of accrued interest for each year.[116] The IRS stated the following: (1) the proposed loan transaction was not a deemed distribution of the spouse's qualifying income interest for purposes of § 2519; (2) the spouse's income interest would remain intact as a result of the proposed transactions; and (3) the value of the promissory note plus accrued interest would be includable in the surviving spouse's estate at the time of her death under § 2044.[117] Likewise, a loan from a parent or a parent's trust to children would yield similar benefits.[118]

Many variations on this theme are possible. For example, to capture growth at the children's generation and freeze value in the parents' estates, consider having the children borrow funds from the parents to invest in assets likely to appreciate substantially in value.

B. Refinancing: Substituting Notes with Lower Interest Rates

It may be possible to refinance an intra-family loan without gift tax consequences.[119] As stated above, for gift tax purposes, § 25.2512-4 of the Treasury Regulations generally provides that the fair market value of a promissory note "is the amount of unpaid principal, plus accrued interest to the date of the gift."[120] The regulations contemplate a potential reduction in a note's value if it is uncollectible, as in the case of insolvency.[121] In contrast, the regulations do not require valuing a note at an amount higher than its face value.[122] Regulations contemplating gift tax consequences under § 7872 of the Code for below-market loans generally apply to the valuation of a note only at the time the loan is made.[123] A proposed regulation issued under § 7872 of the

113. *See* I.R.S. Priv. Ltr. Rul. 94-18-013 (May 6, 1994).
114. *See id*.
115. *See id*.
116. *See id*.
117. *See id*.
118. *See id*.
119. *See* Jonathan G. Blattmachr et al., *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 22, 22 (2008).
120. Treas. Reg. § 25.2512-4 (1958).
121. *See* Blattmachr et al., *supra* note 119, at 28.
122. *See id*.
123. *See id*.

Code provides, in the relevant part, that "the excess of the amount loaned over the present value of all payments which are required to be made under the terms of the loan agreement shall be treated as a gift from the lender to the borrower on the date the loan is made."[124] There is no indication that a gift is made if a promissory note is exchanged for a note at a new lower AFR.[125] The IRS has not issued any guidance on this topic specifically; however, this concept is generally consistent with the Treasury Regulations.[126] But, commentators have suggested that substituting a note may have discharge of indebtedness implications.[127]

C. How to Avoid Having a Loan Treated as a Disguised Gift

Section 2501(a) of the Code imposes a tax on the transfer of any property via gift by a U.S. citizen or resident.[128] Section 2512(b) of the Code defines a gift as a transfer of property for less than adequate and full consideration of the value of the property.[129] For purposes of § 2501(a) of the Code, Treasury Regulation § 25.2512-8 provides that a gift includes not only traditional donative transfers, but also "below market" sales, exchanges, or other transfers of property when the value of the property transferred exceeds the value of consideration received.[130] Sections 1274(d) and 7872 of the Code provide that there are gift tax consequences for intra-family loans only to the extent that the loan bears interest at a rate lower than the AFR.[131]

An exception to the above rule exists when the lender can demonstrate that the loan was bona fide, meaning that it was an arm's length transaction made without donative intent and in the ordinary course of business.[132] For the IRS to view an intra-family loan as a true arm's length transaction and not a gift, several formalities should be observed. The first rule is to put the loan in writing with a formal promissory note or other appropriate legal document.[133] The second rule is to charge a rate of interest at least equivalent to the AFR to avoid imputed interest income.[134] The third rule is to be sure that the borrower actually makes payments on the loan at the scheduled intervals and for an appropriate amount, even if the lender forgives some or all of the payments in the future.[135] This practice will create difficulty for the IRS if they try to

124. Prop. Treas. Reg. § 25.7872-1, 50 Fed. Reg. 33553-01 (Aug. 20, 1985).
125. Blattmachr et al., *supra* note 119, at 28.
126. *See id*. at 29.
127. *See id*. at 30.
128. IRC § 2501(a) (2006).
129. *Id.* § 2512(b).
130. *See* Treas. Reg. § 25.2512-8 (1992).
131. *See* IRC § 1274(d) (2006); IRC § 7872 (2006).
132. Treas. Reg. § 25.2512-8.
133. *See* Miller v. Comm'r, 71 T.C.M. (CCH) 1674, 1679 (1996). Sample promissory notes are included in Appendices A and B.
134. *See id*.
135. *See id*. at 1679-82.

categorize the transaction as a gift. The fourth rule is that if the borrower defaults on the loan, then the lender should attempt to collect on the debt so that the lender can show that the loan was bona fide when later writing off the bad debt.[136] This practice again avoids the IRS's categorization of the loan as a gift, with the stipulation that the lender may prefer to treat the debt forgiveness as a gift.[137]

The case of *Miller v. Commissioner* provides an illustration of the ways in which a lack of formality can lead to taxable gift treatment for an intra-family loan.[138] In *Miller*, the taxpayer lent her son Stephen $100,000 to assist in paying off a mortgage on his residence.[139] In return, Stephen signed a non-interest bearing unsecured note payable to his mother.[140] The note provided that full payment on the note was due upon demand or upon the passage of three years from the date of issuance.[141]

Stephen made no payments on the note other than one $15,000 payment made after the issuance of the note.[142] The taxpayer stated that she believed the note's due date was open and that she had no intention of demanding payment at any point in the future.[143] The taxpayer also never discussed with Stephen what consequences, if any, would occur if the note was not timely paid.[144] Instead, the taxpayer delivered a number of forgiveness letters to Stephen reducing the principal balance by a sum stated within each letter.[145] From 1982 to 1990, Stephen's mother delivered eight letters forgiving a total of $85,000 in debt, which was the remaining balance of the note after Stephen's initial $15,000 payment.[146]

About the same time as the taxpayer loaned $100,000 to Stephen, she loaned the same amount of money to her other son, Robert.[147] The terms of the loan to Robert were substantially similar to Stephen's note.[148] Robert failed to repay any of the loan, and the taxpayer issued a similar series of forgiveness letters relieving Robert of the responsibility to pay any of the principal.[149] Finally, in both cases, the taxpayer's gift tax returns, for the years she filed

136. *See id.* at 1679-81.
137. *See id*.
138. *See id*. at 1675.
139. *Id.* at 1675-76.
140. *Id.* at 1676.
141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.* at 1676-77.
147. *Id.* at 1677-78.
148. *Id.*
149. *Id.* at 1678.

them, were inconsistent in their reporting and treatment of the loans to the two sons.[150]

The court found that the taxpayer's testimony, as well as the testimony of her two sons, was self-serving, contradictory, and generally suspect.[151] The court also noted that monetary transfers between family members receive close inspection because, in such situations, there is a presumption of a gift.[152] A transfer does not overcome this presumption by reliance on a transferee's promise to repay; instead, the transferor must show that there was a bona fide expectation of the repayment and enforcement of the debt.[153] These expectations must exist at the time the transfer occurs.[154]

The court considered the following nine factors to determine whether an intra-family transfer was a loan or a gift:

> (1) There was a promissory note or other evidence of indebtedness, (2) charging of interest, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for payment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected that the transaction was a loan, and (9) the manner in which the transaction was reported for Federal tax purposes was consistent with its treatment as a loan.[155]

After analyzing these nine factors, the court determined that the taxpayer failed to rebut the presumption that the sums paid to her children were gifts and not loans.[156] This case serves as instruction to taxpayers and professionals on the pitfalls to be avoided when engaging in intra-family loans.[157]

D. Pardoning a Loan and Discharging the Debt

If a lender elects to discharge a debt gratuitously, then the IRS generally treats the lender as having made a gift to the borrower to the extent of the discharge.[158] Likewise, when a parent pardons a loan extended to his child, the

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150. *Id.* at 1678, 1679-80. The court's opinion noted that the taxpayer's certified professional accountants (CPAs), when preparing her gift tax returns, followed whatever characterization the taxpayer provided to them regarding the loans to her sons, and these CPAs did not independently determine whether those characterizations accurately reflected the nature of the underlying transactions. *Id.* at 1675. A CPA or attorney taking a similar course under today's regulations might have preparer penalty implications.

151. *Id.* at 1679.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* at 1682.

157. *See id.*

158. IRC § 102(a) (2006).

result is likely to be treated as a gift.[159] If the debt forgiven is treated as a gift, then the child will not be required to recognize income from discharge of indebtedness.[160]

A parent, however, may find the concept of a gift to a delinquent borrower objectionable when the discharge of indebtedness was not anticipated or appreciated.[161] Under such circumstances, the borrower will recognize income to the extent of the discharged debt when the lender establishes that no gift was made to the borrower.[162] Although a loan is not initially income to the borrower, under § 61(a)(12) of the Code, a loan becomes gross income to the borrower if the lender discharges the borrower's indebtedness, to the extent that the discharge is not classified as a gift.[163] When a debt is discharged, the borrower essentially receives income equal to the amount of discharged indebtedness.[164] Likewise, § 166(d)(1)(B) of the Code gives a non-corporate taxpayer a short-term capital loss for a non-business bad debt.[165]

Section 108 of the Code provides exceptions to the general rule that a borrower recognizes income from the cancellation of indebtedness.[166] Under this section, income from a discharged debt is excluded from gross income if any of the following are satisfied: (i) the discharge occurs as a result of Title 11 bankruptcy proceedings or insolvency; (ii) the discharge is of qualified farm indebtedness; or (iii) the discharge is of qualified real property business indebtedness for any taxpayer other than a "C" corporation.[167]

There is also an exception for the discharge of mortgages on a debtor's main home under § 108(a)(1)(E).[168] This exclusion applies when taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure.[169]

Under § 108, certain tax attributes are lost to the extent of the discharged debt.[170] Specifically, any unused loss carryovers of the taxpayer are first reduced to the extent that the forgiven debt is excluded from income, then, under § 1017, any excess forgiven debt is applied toward the reduction of the taxpayer's basis of property.[171] Also, while taxpayers other than "C" corporations can elect to exclude income from the discharge of qualified real

159. *See Miller*, 71 T.C.M. (CCH) at 1682.
160. *See* IRC §§ 61(a)(12), 102(a), 108.
161. *See generally* Hunt v. Comm'r, 57 T.C.M (CCH) 919, 919 (1989) (showing an example of parents not making a gift).
162. *See* §§ 61(a)(12), 108(e).
163. *See* §§ 61(a)(12), 108(e).
164. *See* §§ 61(a)(12), 108(e).
165. *See id*. § 166(d)(1)(B).
166. *Id*. § 108.
167. § 108(a).
168. *See* § 108(a)(1)(E).
169. *See id*.
170. *See id*. § 108(b).
171. *See* § 108(b)(5).

property business debt, the excluded income is applied to reduce the basis of the taxpayer's business real property.[172]

Even if the taxpayer intends for the discharge of a debt to be a gift, there may be issues with whether that gift qualifies for the annual gift tax exclusion.[173] In *Stinson Estate v. United States*, the decedent sold farmland to a family-owned corporation in exchange for an installment note.[174] The decedent forgave $147,000 of the principal indebtedness.[175] The decedent did not report the debt forgiveness on gift tax returns because the decedent believed that the debt forgiveness qualified for annual exclusions.[176]

The court held that the discharge was a gift of a future interest that was ineligible for the annual exclusion because the shareholders did not have an unrestricted right to the immediate use or enjoyment of the property.[177] The beneficiaries could not individually realize the increase in value of the stock unless the corporation declared a dividend or was liquidated.[178] As a result, the increase in value of the stock resulting from the forgiveness of indebtedness was a gift of a future interest.[179]

E. Gift Tax Consequences of Personal Guarantees

A personal guarantee is an unsecured promise from an individual to make loan payments in the event of a borrower's default.[180] Particularly, commercial lenders frequently mandate personal guarantees in the context of loans for small and start-up businesses without an established line of credit.[181] While most company creditors are limited to recovering debts to the extent of company assets, personal guarantees allow lenders the assurances that lenders will be able to recover their losses from the guarantor's personal assets without initiating a lawsuit.[182] The guarantee is an interesting estate planning tool in that a parent may help a child acquire financing, which would otherwise be unavailable, with minimal tax consequences.[183]

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172. *See id*. § 108(c).
173. *See* Stinson Estate v. United States, 214 F.3d 846, 847 (7th Cir. 2000).
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.* at 848.
178. *See id*. at 849.
179. *See id*.
180. *See* Dima Berdiev, *The Personal Guarantee*, INC., July 1, 2006, http://www.inc.com/resources/finance/articles/20060701/dberdiev.html.
181. *See id*. at 180.
182. *See id*.
183. *See* Richard A. Campbell et al., *United States: Record Low Interest Rates Present Estate Planning Opportunities*, MONDAQ, May 21, 2008, http://www.mondaq.com/article.asp?articleid=60570.

There may be gift tax implications for gratuitous personal guarantees to the extent that the guarantee has any commercial value.[184] As a precautionary measure, a guarantee fee agreement may be needed to compensate a parent for guaranteeing a loan when necessary to avoid any gift implications.[185] On the other hand, the gift implications should be relatively minor because the value of the guarantee for gift tax purposes will be minimal.[186] In the event of default, the guarantor effectively steps into the shoes of the lender for income tax purposes because a guarantor generally has recourse against the borrower for amounts paid.[187] General principles of debt forgiveness should apply to the extent that the borrower defaults and the guarantor pardons the debt.[188]

III. ADVANCED STRATEGIES

A. Making a Loan to a Grantor Trust

Another effective estate planning tool involves a low interest loan to a grantor trust.[189] The concept is simple and provides benefits similar to those inherent in a GRAT or sale to a grantor trust.[190] In a loan to a grantor trust, a parent makes the loan in exchange for an installment note bearing interest at the AFR.[191] The note can be structured as a balloon note deferring principal payment as long as possible.[192] The trustee of the trust, which was established for the benefit of children, might make interest-only payments and invest principal for a rate of return higher than the AFR.[193] Because the trust is a grantor trust, the parent's loan to the trustee will not result in an income recognition event.[194] The transaction is effectively ignored for income tax purposes as long as the grantor is alive.[195]

Upon the parent's, that is the grantor's, death, the trust will not be a grantor trust.[196] However, pre-death accrued and unpaid interest will not be taxable income to the grantor or the grantor's estate.[197] Post-death interest is taxable to the grantor's estate.[198] There is a question regarding reporting

184. *See* Elaine Hightower Gagliardi, *Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 MONT. L. REV. 389, 402-03 (2003).
185. *See id*. at 403.
186. *See id*.
187. *See* Berdiev, *supra* note 180.
188. *See supra* Part II.D.
189. *See* Campbell et al., *supra* note 183.
190. *See id*.
191. *See id*.
192. T. Randolph Harris, *Basic Estate Planning: Separating Cash Flows from Capital*, 254 PLI/EST 369, 383 (1997).
193. *See id*.
194. *See id*.
195. *See id*.
196. *See id*. at 385.
197. *See id*. at 383.
198. *See id*. at 385.

requirements for capital gains if the grantor dies during the term of the note. Commentators have differing opinions as to whether gains are reportable on the grantor's final return or by the grantor's estate.[199]

As an added benefit, if the note is paid off during the lender's lifetime, then the trust can pay the note with appreciated assets without having to recognize gain on the appreciation.[200] Then, the appreciated assets are included in the grantor's gross estate for tax purposes and receive a step-up in basis at the death of the grantor.[201] While § 1014(e) of the Code prohibits a step-up in basis for appreciated property that the decedent acquired *by gift* within one year of death, in this hypothetical the appreciated property is acquired as a result of a loan repayment and the step-up should be allowed.[202]

B. Self-Canceling Installment Notes (SCINs)

Typically, when the holder of a promissory note dies, the outstanding amount due under the note is an asset for estate tax purposes.[203] If the obligation to pay the note is extinguished upon the death of the note's holder, then the outstanding unpaid amounts on the note are forgiven and not reportable as an asset of the decedent's estate.[204]

This death-terminating or self-canceling feature is typically found in the form of a self-canceling installment note (SCIN) issued in exchange for the sale of assets by a parent to a child on an installment basis.[205] A SCIN is an installment "note that by its terms is canceled at the death of the seller-creditor."[206] With a SCIN, the child issuing the note pays a premium in the form of an above-market sale price or an interest rate that is higher than the AFR as consideration for the death-terminating feature.[207]

The estate planning objectives of a SCIN are "(1) the exclusion of the unpaid balance of the note from the seller's estate and (2) the avoidance of any gift tax on the transfer."[208] Inherent in the sale aspect of the SCIN is an estate freeze to the extent that assets sold to children appreciate dramatically after

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199. *See id.*

200. *See id*. at 384.

201. *See id*. at 384-85.

202. *See* IRC § 1014(e) (2006).

203. *See* Julius H. Giarmarco, *Private Annuities and Self-Canceling Installment Notes*, PRODUCERSWEB, Aug. 15, 2008, http://www.producersweb.com/r/GMH/d/contentFocus/?adcID=4dd0eb8119d98c00c88fe9c433a97165.

204. *See* Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1980); Cain v. Comm'r, 37 T.C. 185, 187 (1961); G.C.M. 39503 (May 7, 1986).

205. *See* Lee G. Knight and Ray A. Knight, *Preserving the Family Legacy*, J. OF ACCT., Mar. 2002, http://www.journalofaccountancy.com/Issues/2002/Mar/PreservingTheFamilyLegacy.htm.

206. Giarmarco, *supra* note 203.

207. *See id*.; Knight & Knight, *supra* note 205.

208. Bay Financial Association, *The Self-Canceling Installment Note (SCN)*, BAY FINANCIAL NEWSLETTER, http://www.bfa-online.com/information.html (last visited Apr. 5, 2009); *see also* Giarmarco, *supra* note 203.

disposition outside the seller's estate.[209] A SCIN might also address potential cash flow concerns for retired parents that may have illiquid assets, such as undeveloped land or vacation homes.[210] A SCIN transforms an otherwise illiquid asset into an income-producing asset while keeping it in the family.[211]

A SCIN works best as an estate planning tool when the parent, as seller, has a shortened life expectancy and dies soon after the note is issued. If the parent, as seller, survives the term of the note, then estate planning objectives are thwarted because the payments from the child will exceed the value of the property sold.[212] This may result in a parent actually profiting from a transaction intended to benefit the child. Due to this risk and because the risk premium can be severe when the seller is of an advanced age, the SCIN has been a seldom-used tool in some law offices.

A SCIN only makes sense as an estate planning tool when the seller's actual life expectancy is shorter than the life expectancy set forth in the IRS's tables.[213] Of course, the seller's life expectancy cannot be too short so as to preclude use of the tables.[214] For example, § 20.7520-3(b)(3) of the Treasury Regulations provides that actuarial tables cannot be used for a terminally ill person.[215] According to the regulation, "an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least 50 percent probability that the individual will die within 1 year" of the valuation date.[216]

A SCIN can be described as "a cross between a private annuity and an installment sale" with attractive incentives from both.[217] While a private annuity involves one party's transfer of property to another in exchange for periodic payments of a fixed amount for life, a SCIN operates similarly to a private annuity because one person sells to another, usually a parent selling to a child, on an installment basis.[218] "The [primary] advantage of a SCIN over [a simple installment sale] is that if the seller dies before the [expiration of the installment term], the unpaid balance of the [installments are] not included in [the seller's] estate."[219] The SCIN provides an advantage over a private annuity

209. *See* Bay Financial Association, *supra* note 208.
210. *See* Knight & Knight, *supra* note 205.
211. *See id*.
212. *See* Giarmarco, *supra* note 203; Knight & Knight, *supra* note 205; Bay Financial Association, *supra* note 208.
213. *See* Giarmarco, *supra* note 203.
214. *See id.*
215. *See* Treas. Reg. § 20.7520-3(b)(3) (1995).
216. *Id.*
217. Bay Financial Association, *supra* note 208.
218. *See* Giarmarco, *supra* note 203; Knight & Knight, *supra* note 205; Bay Financial Association, *supra* note 208.
219. Giarmarco, *supra* note 203.

because the installment sale involves a fixed term.[220] With a SCIN, the risk of continued annuity payments is abated as the installment term is finite.[221]

For income tax purposes, a SCIN is most often classified as an installment sale; however, it may also be treated as a private annuity.[222] Accordingly, it is possible to defer recognition of gain on the sale of a low-basis asset over the term of the note, which is not necessarily the case in the private annuity context.[223] If a taxpayer realizes income or gain from an installment sale, then income should be reported under the installment method as set forth under § 453.[224] The installment method generally requires "income recognized for any taxable year for a disposition [to be] that proportion of the payment received in that year . . . ."[225] The applicable fraction is based on the gross profit divided by the total sale price.[226] Thus, if a taxpayer sells property with a basis of $500,000 for $1 million resulting in a 50% profit, then 50% of the payment received that year is gross income.[227] Accordingly, the seller reports a portion of the gain at the time of receipt of each installment payment.[228] Interest is reportable according to the taxpayer's regular method of accounting.[229] With a SCIN, principal and interest payments should be made in level payments for the term of the note, which cannot be any longer than the seller's life expectancy under the IRS tables.[230]

While the outstanding balance of the note will not be included in the holder's estate, deferred gain on the installment obligation is reportable on the seller's estate income tax return.[231] Under § 691(a)(5), if an executor cancels an installment obligation, then any previously unreported gain from the installment sale will be recognized by the seller's estate.[232] This recognition event also occurs when payments due on an installment note are extinguished at the holder's death under a provision contained in the agreement.[233]

Because the obligation to repay the note terminates upon the death of the seller, the note is not included in the seller's gross estate.[234] Cancellation of the note may result in a gift with gift tax implications to the extent that the

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220. *See id*.; Knight & Knight, *supra* note 205; Bay Financial Association, *supra* note 208.

221. *See* Giarmarco, *supra* note 203; Knight & Knight, *supra* note 205; Bay Financial Association, *supra* note 208.

222. *See* IRC § 453(a), (d) (2006).

223. *See id*. § 453.

224. *See id*.

225. *Id.* § 453(c).

226. *See id*.

227. *See* § 453.

228. *See id*.

229. *See id*. § 446(a).

230. *See* § 453.

231. *See* John R. Price, *Recapitalization and Other Estate Freezes*, 159 PLI/EST 575, 631-32 (1985).

232. *See id*.

233. *See* Rev. Rul. 86-72, 1986-1 C.B. 253.

234. *See* Mary A. Mancini & Stefan Tucker, *Estate Planning for Real Owners*, 858 PLI/TAX 205, 280-81 (2009).

premium is insufficient consideration.[235] Case law on this feature generally suggests the following: (1) the cancellation provision must be bargained for as part of the consideration for the sale; (2) the purchase price must reflect this bargain either with a principal risk premium above-market sales price or an interest rate premium; and (3) the seller may not retain any control over the property being sold after the sale.[236]

To avoid retained control, the sales contract and note cannot place any restrictions on the buyer's use of the property, including restrictions with respect to subsequent sales.[237] This is important as the related-party resale rules under § 453(e) apply to SCINs and conventional installment sales.[238] Under § 453(e) of the Code, when the buyer is related to the seller, a buyer's subsequent sale of the property within two years of the original sale will trigger recognition of any of the original seller's remaining deferred gain, even if the note has not been fully repaid.[239] Furthermore, the property sold should not be used as collateral for the note so the seller has no right to reacquire the property in the event of default.[240]

The premium that should be used for a SCIN is somewhat difficult to calculate because it involves a mortality component based on the seller's life expectancy.[241] Generally, for installment sale notes, the interest rate must be at least the AFR with semiannual compounding.[242] Otherwise, the IRS may reapportion interest and principal for scheduled payments and impute interest income to the seller, even when the seller does not receive installment payments.[243]

Whether to reflect the risk premium as an increase in the sales price—principal risk premium—or as an increase in the interest rate—interest rate risk premium—depends on the relative tax situations of the buyer and seller. With a principal risk premium added to the sale price, each installment payment will reflect a higher portion of capital gain and less interest income.[244] The buyer's basis in the property will be higher; however, the buyer will pay less interest, which may be deductible if the interest is investment, trade, or business interest and not personal interest.[245]

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235. *See id.*

236. *See* Estate of Moss v. Comm'r, 74 T.C. 1239, 1246-47 (1980).

237. *See* Malcolm A. Moore, *Freezes Beyond Chapter 14: SCINS, Private Annuities, Installment Sales, and Other Methods*, C797 ALI-ABA 1, 24 (1993).

238. *See id*.

239. *See id*.

240. *See id*. at 7-8.

241. *See id*. at 16-22.

242. *See* T. Randolph Harris, *Freezing the Family Business: Estate Planning Techniques to Give the IRS the Cold Shoulder*, 276 PLI/EST 561, 569 (1999).

243. *See id*. at 570.

244. *See* Henry P. Lee & Andrew R. Lee, *Oops! I Almost Forgot the Income Tax Consequences! Cancel the Call to the Malpractice Carrier: Selective Income Tax Issues Resulting from Implementation of Gift and Estate Planning Techniques*, SD51 ALI-ABA 895, 908 (1999).

245. *See id*.

If the property is depreciable, and the buyer and seller are in similar tax brackets, then the principal risk premium may be advantageous to give the buyer a higher depreciable base.[246] If the property is not depreciable, then the buyer may prefer the interest rate premium, forfeiting a lower basis in exchange for deductible interest payments.[247] Finally, it may be possible to use a combination of both in a weighted combination risk premium.

Historically, the IRS has scrutinized SCINs.[248] The IRS has claimed that a sale between family members in exchange for a SCIN is not a bona fide transaction and that the remaining value of the SCIN should be included in the seller's estate for estate tax purposes.[249] Recently, the Sixth Circuit upheld the validity of a SCIN in *Estate of Costanza v. Commissioner*.[250] In this case, Mr. Costanza sold real estate and a restaurant to his son in exchange for a SCIN that was secured by a mortgage on the property.[251] Mr. Costanza planned to retire and move back to Italy.[252] Five months after the transaction, and after Mr. Costanza made only three payments on the note, he died unexpectedly during surgery.[253] Siding with the IRS, the Tax Court ruled that the conveyance was not a bona fide transaction for full and adequate consideration.[254] The son's inconsistency in making payments indicated that there was not a valid sale, and there was no evidence that either party intended to enforce the note.[255]

The appellate court conceded that a SCIN between the family members is presumed a gift and not a bona fide transaction but reversed the Tax Court's decision, noting that there was no evidence that anyone anticipated that Mr. Costanza would die so soon after the transaction.[256] The medical evidence suggested that at the time of the transaction, Mr. Costanza had a life expectancy of between 5 and 13.9 years and he had died unexpectedly.[257] The appellate court found that the SCIN was issued in a bona fide transaction.[258] However, the father's estate rebutted the presumption against the enforceability of an intra-family SCIN by showing that there existed a real expectation of repayment.[259] Although the appellate court remanded the case to the Tax Court to resolve the IRS's alternative argument—that the SCIN constituted a

246. *See id.*
247. *See id.*
248. *See* Estate of Costanza v. Comm'r, 320 F.3d 595, 596 (6th Cir. 2003).
249. *See id.*
250. *See id.*
251. *See id.*
252. *See id.*
253. *See id.*
254. *See id.*
255. *Id.* at 597.
256. *Id.* at 597-98.
257. *Id.* at 598.
258. *Id.*
259. *Id.*

bargain sale that subjected the estate to gift tax—commentators have suggested that *Costanza* validates the SCIN as an effective estate planning tool.[260]

C. Graegin *Loans: Intra-Family Loans in an Estate Administration Context*

Under certain circumstances, a deduction can be taken on an estate tax return for projected interest expense on a loan to provide funds to pay estate tax.[261] Section 2053 of the Code allows certain administration expenses to be deducted from the value of the gross estate.[262] Under the Treasury Regulations for § 2053, interest expense can be included as an administration expense.[263] Section 20.2053-3 of the Treasury Regulations provides that the amounts deductible as administration expenses "[a]re 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 . . . ."[264] Courts have held that "interest on a loan, obtained by an executor for an estate, is a deductible administration expense, provided the loan was reasonably and necessarily incurred in the administration of the estate."[265]

Section 20.2053-1(b)(3) of the Treasury Regulations provides that an item may be deducted on the estate tax return even though its exact amount is not known at the time, "provided it is ascertainable with reasonable certainty, and will be paid."[266] This regulation also states that no deduction may be taken upon the basis of a vague or uncertain estimate.[267]

Since 1937, the Tax Court and its predecessor court have held that the payment of interest on estate taxes or the payment of interest on money borrowed to pay estate taxes can be deductible as administration expenses, which are "actually and necessarily[] incurred" under § 20.2053-3(a) of the Treasury Regulations.[268] For example, the Tax Court has allowed interest expense deductions on executors' loans in the following situations: (1) to avoid the sale of closely held stock; (2) to pay estate taxes that could have been deferred under § 6166 of the Code; and (3) to avoid the sale of marketable securities to preserve liquidity in the estate.[269]

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260. *See* Shelton I. Banoff et al., *Appellate Court Upholds SCIN as Bona Fide Sale: Planning Opportunities Enhanced*, 98 J. TAX'N 292, 297 (2003).

261. *See* Treas. Reg. § 20.2053-1 (1972).

262. *See id*.

263. *See id*.

264. *Id.* § 20.2053-3 (1965).

265. Rev. Rul. 84-75, 1984-1 C.B. 193.

266. Treas. Reg. § 20.2053-1(b)(3).

267. *Id*.

268. *Id.* § 20.2053-3(a).

269. *See* Estate of Todd v. Comm'r, 57 T.C. 288, 288 (1971), *acq. in result*, 1973-2 C.B. 4 (discussing the sale of non-liquid assets); McKee v. Comm'r, 72 T.C.M. (CCH) 324, 332 (1996) (discussing the deferral of taxes); Estate of Thompson v. Comm'r, 76 T.C.M. (CCH) 426, 433 (1998) (discussing the market securities and liquidity).

Interest paid to the IRS on a federal estate tax deficiency can be deducted as an administration expense.[270] If there is litigation with the IRS over the estate tax return, then interest on an estate tax deficiency is deductible for the period of time it takes to conclude the litigation and determine the final amount of estate tax due.[271]

Under § 6166 of the Code, if the value of the decedent's interest in a closely held business "exceeds 35 percent of the adjusted gross estate, [then] the executor may elect to pay part or all of the [estate tax] in 2 or more (but not exceeding 10) equal installments."[272] Under § 6166(a)(3), if the estate qualifies and the executor makes an election under § 6166, then the first installment payment can be deferred for five years.[273]

Prior to the Taxpayer Relief Act of 1997, the law allowed the taxpayer to deduct interest paid to the IRS on a deferral under § 6166 as an administration expense.[274] The Taxpayer Relief Act of 1997 provided that interest paid to the IRS on estate tax deferred under § 6166 is not deductible for estate tax purposes.[275] Instead, a lower interest rate is used for interest paid to the IRS on a deferral under § 6166.[276] This rule applies to decedents dying after December 31, 1997.[277]

When a taxpayer deducted interest on a deferral under § 6166 of the Code, an important issue was the timing of the deduction.[278] Although interest cannot be deducted on a deferred payment of estate tax under § 6166 for persons dying after 1997, the cases discussing timing of the deduction under prior law provide background information to take an up-front interest expense deduction on amounts borrowed from a bank or a family-owned entity when the loan proceeds are used to pay estate tax.[279]

Initially, the IRS allowed an up-front interest deduction on the deferral of estate tax under § 6166.[280] However, in 1980, the IRS ruled that an up-front deduction for the projected interest expense on a deferred payment under § 6166 of the Code should not be allowed.[281] The IRS reasoned that it is impossible to accurately estimate the projected interest expense since the estate could accelerate the payment of the deferred tax and the interest rate on the

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270. *See* Estate of Buchholtz v. Comm'r, 70 T.C. 814, 815-16 (1978); Rev. Rul. 79-252, 1979-2 C.B. 333.

271. *See* Estate of O'Neal v. Comm'r, 258 F.3d 1265, 1269-70 (11th Cir. 2001).

272. IRC § 6166(a)(1) (2006).

273. *See id.* § 6166(a)(3).

274. *See* Treas. Reg. § 20.2053-3(a) (1965).

275. *See* IRC § 2053(c)(1)(D) (2006).

276. *See* Rev. Rul. 98-15, 1998-1 C.B. 374.

277. *See id.*; IRC § 2053(c)(1)(D).

278. *See* Rev. Rul. 98-15, 1998-1 C.B. 374.

279. *See* discussion *infra* notes 287-365 and accompanying text.

280. *See* Rev. Rul. 78-125, 1978-1 C.B. 292 (revoking Rev. Rul. 75-239, 1975-1 C.B. 304).

281. *See* Rev. Rul. 80-250, 1980-2 C.B. 278.

deferred amount fluctuates.[282] Courts agreed with the IRS and refused to allow an up-front deduction of estimated interest expense.[283]

In 1981, the IRS set forth a procedure for deducting interest on estate tax installments under § 6166.[284] The interest expense deduction was allowed only if the interest was actually paid.[285] Under Revenue Procedure 81-27, the estate would file a "supplemental Form 706" claiming an additional interest expense deduction when the annual installments were due.[286]

In various cases and rulings, the IRS has allowed an estate to deduct interest expense on loans when the loan proceeds were used to pay estate tax.[287] Sometimes the loan was obtained from a bank, and, in other cases, the decedent and his family members' closely held entity obtained the loan.[288] In other situations, the IRS has allowed an estate to take an up-front deduction on the estate tax return for all of the interest expense projected to be incurred over the life of the loan.[289]

A threshold question regarding the ability to take an interest expense deduction is whether the executor has the power to borrow money under applicable state law.[290] Courts in several cases have raised this issue.[291] This should not be an issue if the will gives the executors the authority to borrow funds when necessary for the payment of federal estate and state inheritance taxes and the authority to pledge assets to secure such loans.[292]

There have also been cases when loans were used to avoid a forced sale of assets.[293] In all cases and rulings when the executor was allowed to deduct interest, whether all up-front or as it was paid, a key factor was the IRS's acceptance of the executor's determination that borrowing was necessary in order to avoid the forced sale of illiquid assets.[294] The following cases illustrate situations in which the IRS accepted the executor's determination that a loan was necessary to avoid a forced sale of assets.[295]

In *Estate of Todd v. Commissioner*, the decedent, a Texas resident, died on April 27, 1966, leaving behind an estate that consisted mainly of all liquidated

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282. *See id*.

283. *See* Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306, 1310 (1987); Estate of Spillar v. Comm'r, 50 T.C.M. (CCH) 1285, 1288-89 (1985).

284. *See* Rev. Proc. 81-27, 1981-2 C.B. 547.

285. *See id.*

286. *Id.*

287. *See* Axtell v. United States, 860 F. Supp. 795, 799 (1994).

288. *See* Estate of Thompson v. Comm'r, 76 T.C.M. (CCH) 426, 428 (1998); Estate of McKee v. Comm'r, 72 T.C.M. (CCH) 324, 324 (1996); Estate of Sturgis v. Comm'r, 54 T.C.M. (CCH) 221, 230 (1987).

289. *See Estate of Thompson*, 76 T.C.M. (CCH) at 429; *Estate of Sturgis*, 54 T.C.M. (CCH) at 230.

290. *See Estate of Thompson*, 76 T.C.M. (CCH) at 432.

291. *See id*.

292. *See id*.

293. *See* Estate of Bahr v. Comm'r, 68 T.C. 74, 78 (1977).

294. *See* Rev. Rul. 84-75, 1984-1 C.B. 193.

295. *See* discussion *infra* notes 296-340 and accompanying text.

assets.[296] Without a loan, the executor would have been forced to sell assets on unfavorable terms.[297] A related corporation, Todd Cattle Company, created the loan.[298] The decedent's estate tax return was filed on July 26, 1967.[299] On July 21, 1967, prior to filing the estate tax return, the estate borrowed $300,000 from Todd Cattle Company.[300] On March 31, 1969, the estate repaid the note by transferring the estate's undivided one-half interest in various mineral interests to Todd Cattle Company.[301] The estate deducted part of the interest, which had accrued on the promissory note, on one of its fiduciary income tax returns, and the estate sought to deduct the balance of the interest expense as an administrative expense on the estate tax return.[302]

The Tax Court observed that the executors had the power under the Texas Probate Code to borrow funds when necessary to pay estate tax.[303] The Tax Court held that the "interest expense which was incurred, paid, and not previously deducted" on the fiduciary income tax return was deductible as an administrative expense on the estate tax return.[304] This case did not involve a deduction for projected interest payments.[305]

In *Estate of Sturgis v. Commissioner*, a large part of the estate was real estate with the "highest and best use" as timberland.[306] The executors obtained a hardship deferral under § 6161 of the Code for payment of a portion of the estate tax.[307] The estate tax return was filed in March of 1982.[308] One year later, in March of 1983, the estate borrowed approximately $2.6 million to pay estate taxes.[309] The estate and the IRS were involved in litigation regarding the value of the timberland.[310]

In 1986, three years after the loan was made, the estate "held liquid assets with a market value of $944,448.19."[311] The executors held the liquid assets as a cushion for future payments on the loan, "for administration expenses, and to cover contingencies, such as an increase in the estate tax as a result of the instant litigation" with the IRS regarding the value of the timberland.[312]

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296. *See* Estate of Todd v. Comm'r, 57 T.C. 288, 289 (1972), *acq. in result* 1973-2 C.B. 4.
297. *See id*.
298. *See id*.
299. *See id*.
300. *See id*. at 292.
301. *See id*.
302. *See id*. at 289.
303. *See id*. at 295.
304. *Id*. at 289.
305. *See id*.
306. Estate of Sturgis v. Comm'r, 54 T.C.M. (CCH) 221, 222 (1987).
307. *Id*. at 230.
308. *Id*. at 221.
309. *Id*. at 230.
310. *Id*. at 221.
311. *Id.*
312. *Id.*

During the course of the estate's administration, the IRS allowed the estate to deduct $510,032 in interest paid to the bank.[313] In 1986, the estate paid the bank another $333,127.95 in interest, and the IRS challenged the deduction for $322,823.07 of that amount.[314] The IRS argued that the estate had failed to prove that the amount of the loan was necessary for the administration of the estate.[315] The IRS also argued that the debt could have retired with the estate assets and that the estate was kept open longer than necessary, making the interest payments during the excess period unnecessary.[316]

The Tax Court held that the loan was not unnecessary, either when it was made or because the estate administration was prolonged.[317] The Tax Court explained that the litigation with the IRS required the estate to remain open and that the loan was reasonable when it was made.[318] Although the IRS suggested that the "executors could have sold more land or timber, and that no contingency reserve is appropriate," the Tax Court said it was not prepared to "second guess the judgments of a fiduciary not shown to have acted other than in the best interests of the estate."[319] The Tax Court added that the litigation regarding the value of the timberland showed that the executors were prudent in anticipating contingencies such as an increase in estate tax liability.[320] In *Estate of Sturgis*, the executors were not claiming an up-front deduction for projected interest expense over the life of the loan.[321]

In *Estate of McKee v. Commissioner*, the estate's main asset was stock in a closely held corporation.[322] The executors borrowed money from the company for eighty-five days and then took out a commercial loan to repay the company.[323] The IRS sought to disallow the deduction for the interest expense on the loan.[324] The IRS argued that the estate could have deferred some of the tax liability under § 6166 of the Code and that the estate could have sold some of its shares in order to raise funds to pay the estate tax liability.[325]

The court held that the estate "met its burden of proving that the loans were necessary costs of administering the estate."[326] The court said that the estate incurred interest expenses whether the executors made an election under § 6166 of the Code or whether the executors borrowed funds from a third

313. *Id.*
314. *Id.*
315. *Id.*
316. *Id.* at 231.
317. *Id.*
318. *Id.*
319. *Id.*
320. *See id.* at 221.
321. *See id.*
322. Estate of Mckee v. Comm'r, 72 T.C.M. (CCH) 324, 324-25 (1996).
323. *Id.* at 324, 326-27.
324. *See id.* at 324.
325. *Id.* at 324; *see* IRC § 6166 (2006).
326. *Estate of McKee*, 72 T.C.M. (CCH) at 333.

party.[327] The court stated that it was not prepared "to second guess the business judgments of the executors, for the executors have not been shown to have acted other than in the best interest of the estate."[328] The court added that it believed that "the estate benefited from increases in value to the Company stock and, consequently, decedent's estate was in a better situation to face contingencies such as an increased estate tax liability."[329] The court allowed the estate to deduct the interest expense it had paid.[330] The timing of the interest expense deduction was not at issue in this case.[331] The executors were not claiming an up-front deduction for projected interest expense over the life of the loan.[332]

In *Estate of Thompson v. Commissioner*, the estate held a significant amount of farm and timberland, along with $1,335,344 of publicly held securities, cash worth $67,632, and life insurance of $400,740.[333] In addition, there was also an irrevocable life insurance trust that received $2 million of life insurance proceeds.[334] The decedent's will provided for all estate taxes to be paid from the residuary estate and further specified that no claim was to be made against any life insurance beneficiary for payment of any of the estate tax.[335]

The estate had insufficient liquid assets to pay all of the estate taxes.[336] Thus, the estate borrowed $2 million from the irrevocable life insurance trust.[337] The court said "the regulations under section 2053 do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary."[338] The court held that the interest was deductible.[339] The structure of the note and the timing of the deduction was not at issue in the decision.[340]

The cases discussed above involved a loan to obtain funds to pay the estate tax liability but did not involve an up-front deduction for projected interest expense over the life of the loan.[341] A *Graegin* loan, which refers to a loan patterned after a 1988 Tax Court case, involves a projected interest loan.[342] In *Estate of Graegin*, the Tax Court allowed a deduction on an estate

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327. *Id.* at 330.
328. *Id.* at 333.
329. *Id.*
330. *See id.* at 324.
331. *See id.*
332. *See id.*
333. Estate of Thompson v. Comm'r, 76 T.C.M. (CCH) 426, 427 (1998).
334. *Id.*
335. *Id.*
336. *See id.*
337. *Id.* at 429.
338. *Id.*
339. *Id.* at 432.
340. *See id.* at 433.
341. *See* discussion *supra* notes 296-340 and accompanying text.
342. *See generally* Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387, 390-91 (1988) (defining a *Graegin* loan).

tax return for interest expense projected to be paid on a fifteen-year loan obtained in order to provide funds to pay the estate tax liability.[343]

Graegin loans have a potential for a significant economic benefit associated with taking an up-front interest expense deduction on the estate tax return.[344] The projected interest expense over the life of the loan yields an immediate estate tax savings.[345] The annual interest payment on the loan is taxable interest income to the family-owned entity.[346] Thus, the *Graegin* loan gives a permanent savings calculated by the difference between the 45% maximum estate tax rate and the 35% highest marginal income tax rate.[347] The other benefit of a *Graegin* loan is the timing difference between the up-front interest deduction versus the income tax on the annual interest payments.[348]

For an estate to take an up-front deduction on the estate tax return for interest payments to be made in the future, the following factors must be present.[349] First, a loan is necessary.[350] The executors determine the loan is necessary in order to avoid having a forced sale of estate assets.[351] Second, the amount of the loan is necessary.[352] After setting aside a reasonable amount of funds to be reserved for other needs of the estate, the amount of the loan should not exceed the amount of the estate tax liability that cannot be paid using available funds of the estate.[353] Finally, the note must bear a fixed rate of interest and must prohibit prepayment.[354]

In Revenue Ruling 84-75, the decedent's estate consisted almost entirely of the stock of a closely held corporation.[355] No election to extend the time for payment of the estate tax was made under § 6166 of the Code.[356] The estate did not have enough funds to pay the estate tax, and a forced sale of assets would have been required to convert assets to cash.[357] The executor borrowed funds to pay the estate tax.[358] The loan provided for principal and interest payments to be made over a period of six years.[359] The executor could repay

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343. *Id.* at 391.
344. *See id*.
345. *See id*.
346. *See id*.
347. IRC §§ 1(a), 2001 (setting forth income tax rates for married individuals filing joint returns and setting forth estate tax rates).
348. *See Estate of Graegin*, 56 T.C.M. (CCH) at 391
349. *See* discussion *infra* notes 350-54 and accompanying text.
350. I.R.S. Tech. Adv. Mem. 85-50-005 (Aug. 17, 1984).
351. *Id.*
352. Treas. Reg. § 20.2053-3 (1965); *see also Estate of Graegin*, 56 T.C.M. (CCH) at 391.
353. Treas. Reg. § 20.2053-3; *see also Estate of Graegin*, 56 T.C.M. (CCH) at 390.
354. *See* Estate of Mckee v. Comm'r, 72 T.C.M. (CCH) 324, 324 (1996); *see also Estate of Graegin*, 56 T.C.M. (CCH) at 391.
355. Rev. Rul. 84-75, 1984-1 C.B. 193.
356. *Id.*
357. *Id.*
358. *Id.*
359. *Id.*

the loan at any time without penalty; however, if the executor missed a payment, then the lender could accelerate the remainder.[360]

On the estate tax return, the executor deducted the total estimated amount of future interest expense to be paid during the six year loan term.[361] The IRS ruled that "because accelerated payment could be made at the executor's option or could be required [by the lender] upon [the executor's] failure to make a timely scheduled payment," the estimated future interest expense was not allowable as a deductible administrative expense.[362] Instead, the future interest expense would become deductible only as it accrued.[363] In this ruling, the IRS referenced Revenue Procedure 81-27, which explains "the procedure for claiming interest deductions in situations where the estate tax liability has not been fully paid when the interest accrues."[364] In Revenue Ruling 84-75, the IRS also stated that "where a deduction is sought for interest that has accrued after the federal estate tax liability has been paid, a refund of tax may be requested by filing a claim for refund on Form 843."[365]

In Technical Advice Memoranda 84-50-003, the estate's assets consisted primarily of assets used in a farming operation.[366] These assets comprised more than 90% of the gross estate.[367] Although this percentage of business assets would have met the percentage requirements of § 6166 of the Code for a deferred payment of estate taxes, an election under § 6166 was not made.[368] Instead, the estate borrowed $380,000 from the Federal Land Bank at a variable interest rate.[369] The estate needed to make equal annual payments on the note for thirty-four years, and the payments would adjust to reflect the changes in the interest rate.[370] In the event of any default in payment, any unpaid principal and accrued interest would become immediately due.[371]

The IRS ruled that interest on a long-term loan obtained to pay federal estate tax is a deductible administration expense if obtaining the loan is necessary to prevent a forced sale of the decedent's assets at a reduced price.[372] However, the IRS also ruled that a current deduction is not allowed for estimated future interest payments on a note with an acceleration clause because the amount of future interest is too indefinite.[373] A deduction for interest payments and a refund claim for a reduced estate tax liability are only

360. *Id.*
361. *Id.*
362. *Id.*
363. *Id.*
364. *Id.*
365. *Id.*
366. I.R.S. Tech. Adv. Mem. 85-50-005 (Aug. 17, 1984).
367. *Id.*
368. *Id.*
369. *Id.*
370. *Id.*
371. *Id.*
372. *Id.*
373. *Id.*

allowed in the year that the interest is paid.[374] The estate could perfect its claim by filing a Form 843 for each year's interest after the payments are made.[375]

In *Estate of Graegin*, the Tax Court allowed an up-front deduction of all interest expenses projected to be paid on a fifteen year loan.[376] In this case, a significant asset of the decedent's estate was preferred stock in a closely held family corporation.[377] After the executors set aside amounts to pay estimated administration expenses and inheritance taxes, approximately $20,000 in liquid assets remained to pay $204,218 in estate tax liability.[378]

The executors borrowed money from Graegin Corporation, a wholly owned subsidiary of Graegin Industries, to avoid having to sell the decedent's stock in Graegin Industries.[379] The unsecured note had a fixed 15% interest rate for the entire fifteen-year term, and "[p]repayment of both principal and interest was prohibited."[380] All interest and principal was due in a single balloon payment at the end of the fifteen year term, which coincided with the surviving spouse's fifteen year life expectancy.[381] The executors used the life expectancy of the surviving spouse because upon the death of the surviving spouse, a trust for her benefit would terminate, and liquid funds in that trust could be used to pay the note.[382]

The Tax Court found that the estate lacked liquidity, and the executors had to borrow money to pay the estate tax to avoid a forced sale of the estate's assets.[383] Thus, the court was satisfied that the interest expense was "actually and necessarily[] incurred" as required by § 20.2053-3(a) of the Treasury Regulations.[384]

The IRS argued that the loan from Graegin Corporation was not a true loan because repayment of the loan was uncertain.[385] The IRS stated that repayment was uncertain because the decedent's son, who was a co-executor, controlled the borrower and the lender, and the loan was unsecured.[386]

The IRS also argued that, because there were no corporate minutes approving a loan to the estate, the court should infer the loan was not negotiated in good faith.[387] However, according to the court, "closely-held corporations

374. *Id.*
375. *Id.*
376. Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387, 391 (1988).
377. *Id.* at 389.
378. *Id.*
379. *Id.*
380. *Id.*
381. *Id.*
382. *Id.*
383. *Id.* at 390.
384. *Id.*; Treas. Reg. § 20.2053-3(a) (1965).
385. *Estate of Graegin*, 56 T.C.M. (CCH) at 390.
386. *Id.*
387. *Id.*

often act informally with decisions being made by action rather than being recorded in corporate minutes."[388]

The Tax Court also observed that it depends on the transaction's particular facts and circumstances to see whether it may be classified as a loan and that a loan's existence is determined if, in fact, the borrower and lender contemplated repayment.[389] The court acknowledged that loans between related parties require close scrutiny, but such a relationship between the borrower and the lender is not fatal in characterizing the transaction as a loan.[390]

The court found that the "interest rate was reasonable, even though it was based on the prime rate of interest (a short term interest rate) whereas the loan in question was for a 15 year period."[391] The court was concerned with the note's single payment of principal and interest, but it concluded that the repayment term was reasonable given the decedent's post-mortem asset arrangement.[392]

The IRS also argued no interest deduction should be allowed because "there [was] no reasonable certainty that the interest [would] be paid."[393] Section 20.2053-1(b)(3) of the Treasury Regulations "requires both that the amount of the estimated expense be ascertainable with reasonable certainty and that it will be paid."[394] The Tax Court found the amount of interest on the note in *Estate of Graegin* was not vague or uncertain but instead was capable of calculation—$204,218 x 15% x 15 years = $459,491.[395] Also, as to principal or interest, the note could not be prepaid.[396] Thus, the amount of the estimated interest expense could be determined with reasonable certainty.[397]

Regarding the question of whether the interest would actually be paid, the court stated that it was "mindful of the potential for abuse presented by the facts in this case" but added that the son's testimony was credible regarding his intention to repay the note.[398] The court also observed that the outside shareholder would complain if the loan were not paid on time.[399] In *Estate of Graegin*, one of the shareholders was a trust, which benefited a person not related to the Graegin family.[400]

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388. *Id.* at 390 n.10*; see* Levenson & Klein, Inc. v. Comm'r, 67 T.C. 694, 713-14 (1977).
389. *Estate of Graegin*, 56 T.C.M. (CCH) at 390.
390. *Id.*
391. *Id.* at 391.
392. *Id.*
393. *Id.*
394. *Id.*; Treas. Reg. § 20.2053-1(b)(3) (1972).
395. *Estate of Graegin*, 56 T.C.M. (CCH) at 391.
396. *Id.*
397. *Id.*
398. *Id.* at 390.
399. *Id.* at 390-91.
400. *Id.* at 389.

The court concluded that the amount of interest on the note was ascertainable with reasonable certainty and that the interest would be paid.[401] Therefore, the entire amount of projected interest expense on the note was deductible as an administration expense under § 2053 of the Code.[402]

In Private Letter Ruling 1999-03-038, the decedent owned more than 20% of the stock in a closely held corporation.[403] The value of the decedent's stock was 80% of the value of his gross estate.[404] The executors proposed to borrow funds from a bank to pay the estate tax.[405] The seven-year loan would provide for annual payments of both principal and interest at a fixed rate.[406] No prepayment would be allowed, and all interest would be due if there were a default on the loan.[407] The IRS ruled that a deduction could be claimed on the estate tax return for the entire amount of the after-death interest expense, provided that the expense was necessarily incurred in the estate's administration.[408] The IRS said that it is a factual determination whether the interest expense was necessarily incurred during the estate's administration and would not rule on that issue.[409]

Private Letter Ruling 1999-52-039 reached the same conclusion in a similar situation involving a ten-year note that provided for annual interest payments with a balloon principal payment due at the end of the term.[410] In this letter ruling, the loan agreement also provided "that in the event of a default, in addition to the payment of principal, all interest which would have been otherwise paid under the terms of the Agreement and the Note, had default not occurred, [would] become due and payable at the time of the default."[411]

In Private Letter Ruling 2000-20-011, the IRS allowed a current deduction for projected interest payments after the loan documents were amended to prohibit prepayment as well as require that all interest be due upon default.[412]

The IRS's position in the above private letter rulings is that all the interest owed for the entire term of the loan would have to be paid upon default of the note.[413] This would likely raise the issue of usury in some states, including Texas.[414] To avoid this problem of usury, it would be better to structure the

401. *Id.* at 391.
402. *Id.*
403. I.R.S. Priv. Ltr. Rul. 1999-03-038 (Jan. 22, 1999).
404. *Id.*
405. *Id.*
406. *Id.*
407. *Id.*
408. *Id.*
409. *Id.*
410. I.R.S. Priv. Ltr. Rul. 1999-52-039 (Dec. 29, 1999).
411. *Id.*
412. I.R.S. Priv. Ltr. Rul. 2000-20-011 (May 19, 2000).
413. *See* discussion *supra* notes 403-12 and accompanying text.
414. Steve R. Akers, *Postmortem Planning Considerations for the Family Business Owners: A Review of Income, Gift, and Estate Tax Planning Issues*, SP023 ALI-ABA 1203, 1307 (2008).

note so that the lender does not have the right to accelerate the note in the event of a default.[415] If there is a default, then the terms of the note would continue to apply and interest would continue to accumulate until the end of the term.[416] Also, the lender might receive other rights under the note and security agreement; therefore, in the event of a default, the lender would have the right to receive any distributions the borrower would receive from interest in an entity that pledged to secure the note.[417]

In *Estate of Lasarzig v. Commissioner*, the Tax Court ruled in favor of the IRS and refused to allow the estate to deduct the present value of interest payments on a twenty-year note.[418] The Tax Court also refused to delay entry of the case's decision for up to twenty years to permit the payment and deduction of the interest.[419] In this case, the most valuable assets in the estate had already been distributed to the beneficiaries.[420] The trust for the beneficiaries had borrowed the money to pay the estate tax, and no assets remained in the estate to be administered.[421] The terms of the loan provided that the beneficiaries could prepay after three years and that the loan could be accelerated after ten years.[422]

In *Estate of Seltzer v. Commissioner*, a settlement was reached and a decision was entered prior to trial.[423] This Tax Court case involved a loan from a partnership.[424]

Seltzer Family Properties, Limited, was a Texas limited partnership created in December of 1994.[425] The primary assets of the partnership included stocks, bonds, and commercial real estate.[426] Mr. Seltzer died on December 7, 1996.[427] At the time of his death, Mr. Seltzer owned a 100% interest in the Seltzer Management Trust and a 97.5% limited partner interest.[428] The Seltzer Management Trust itself owned a 2% general partner interest.[429] The main asset of Mr. Seltzer's estate was the interest in the limited partnership.[430] The estate had no substantial liquidity.[431] The co-executors

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415. *Id.*
416. *Id.*
417. Estate of Lasarzig v. Comm'r, 78 T.C.M. (CCH) 448, 449 (1999).
418. *Id.* at 453.
419. *Id.*
420. *Id.* at 448.
421. *Id.* at 451.
422. Akers, *supra* note 414, at 1303.
423. *See* Steve Akers, *Postmortem Planning Considerations: A Review of Income, Gift & Estate Tax Planning Issues* (Ctr. Am. & Int'l Law), May 25, 2007 IV, D, 2, pg 86 (on file with author).
424. *See id*.
425. *See id*.
426. *See id*.
427. *See id*.
428. *See id*.
429. *See id.*
430. *See id*.
431. *See id*.

borrowed money from the partnership to pay federal estate taxes, State of Texas inheritance taxes, and administration expenses.[432]

On September 8, 1997, the co-executors borrowed $4 million from the partnership.[433] The estate's interest secured the loan in the partnership.[434] Under the terms of the note, unpaid principal and accrued unpaid interest would be due and payable on December 31, 2014, which was the date of the partnership's termination.[435] The terms of the note provided that the note could not be prepaid.[436]

On March 4, 1998, the co-executors borrowed an additional $1 million from the partnership.[437] The estate's interest in the partnership secured this loan.[438] All unpaid principal and accrued unpaid interest on the second note was once again due and payable on December 31, 2014.[439] As with the first note, the second note could not be prepaid.[440] The executors claimed a deduction for the projected interest expense on both notes.[441]

The IRS said that the partnership should be disregarded and that the underlying assets of the partnership should be included in the estate at their fair market value.[442] The IRS also claimed that the projected interest expense did not qualify as an administrative expense under § 2053 of the Code.[443] The IRS stated that "any illiquidity of the estate is directly attributable to decedent's transfer of substantially all of his assets to the purported partnership for purposes of creating specious insolvency of the estate and to justify the estate's incurrence of debt, and the creation of an interest deduction for the estate."[444]

As stated above, prior to trial, the estate and the IRS reached a settlement in which the estate agreed to pay an additional $3 million in estate tax.[445] It is understood that as part of the settlement with the IRS, at least part of the projected interest expense was allowed as a deduction.[446]

In Private Letter Ruling 2004-49-031, a decedent's gross estate included stock in a closely held corporation and separate closely held business interests.[447] The decedent's estate also included the value of a marital trust that the decedent's spouse, who predeceased the decedent, created for the

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432. *See id*.
433. *See id*.
434. *See id*.
435. *See id*.
436. *See id*.
437. *See id*.
438. *See id*.
439. *See id*.
440. *See id*.
441. *See id*.
442. *See id*.
443. *See id*.
444. *See id*.
445. *See id*.
446. *See id*.
447. I.R.S. Priv. Ltr. Rul. 2004-49-031 (July 29, 2004).

decedent.[448] The executors of the decedent's estate and the trustees of the marital trust determined that it would not be a prudent exercise of their fiduciary duties to sell the stock in the closely held corporation and its assets.[449] The executors planned to liquidate a substantial portion of the estate's non-closely held business assets, and the proceeds from those sales would be used to partially pay the estate tax liability.[450] The executors determined that it would be in the corporation's best interest to obtain a commercial loan to pay the remainder of the estate tax liability.[451]

The closely held corporation issued separate notes—redemption notes—to the estate and to the marital trust in exchange for shares of the corporation's stock.[452] This was a redemption under § 303 of the Code.[453] Certain mortgages would secure the estate's and martial trust's redemption notes, and the commercial loan would be paid with the repayment of the redemption notes.[454]

The loan agreement between (1) the bank and (2) the estate and the marital trust provided that any part of the outstanding principal of the loan could be prepaid without penalty, unless the borrower had irrevocably waived its right to such prepayment in writing.[455] The taxpayers in Private Letter Ruling 2004-49-031 indicated that the estate and the marital trust intended to irrevocably waive their right of prepayment if the loan was necessary for the administration of the estate.[456] Also, the estate and the marital trust represented that the corporation's stock would not be sold while the loan was outstanding.[457]

The IRS concluded that the interest attributable to the loan obtained to pay the estate's federal and state estate tax liability was deductible as an administration expense under § 2053 of the Code, if the loan was necessary for the administration of the estate.[458]

IV. CONCLUSION

Tax professionals should not neglect the intangible factors that will help determine whether an intra-family loan is an appropriate tool for a given situation. Ideally, the purpose of the loan is to assist the borrower in attaining some worthwhile goal or achievement, thus constituting a productive use of capital rather than merely enabling a child to continue to rely on his or her

448. *Id.*
449. *Id.*
450. *Id.*
451. *Id.*
452. *Id.*
453. *Id.*
454. *Id.*
455. *Id.*
456. *Id.*
457. *Id.*
458. *Id.*

parents for support. The borrower's ability and willingness to repay the loan, including any past difficulties with debt or creditworthiness, should also be considered. If the borrower defaults on the loan, then the lender may be deemed to have made a taxable gift to the borrower. To the extent that the default is not treated as a gift, the borrower may have to recognize income from the discharge of indebtedness. Part II discusses the adverse tax consequences that may result from the borrower's default.[459] In the end, the tension and strained family relationships that can result from a poorly considered intra-family financial dispute should concern the planner as much as any negative tax consequences.

459. *See* discussion *supra* Part II.C-D.