

Planning Ideas—The Graegin Note

What a difference a day makes. Twenty-four little hours.

As things stand today, if your wealthiest client dies on or before December 31 of this year, she escapes federal estate taxes. If she survives until January 1 of next year, she'll pay \$5.5 million in estate taxes on her \$10 million estate. If she's lucky, and Congress continues the 2009 rates into 2011, her estate tax bill will drop to only \$4.5 million.

Hopefully, you've already given thought to how those taxes might get paid without shorting heirs and/or liquidating valuable assets at fire-sale prices. But even if you have engaged in liquidity planning for this client, keep the *Graegin* note in your arsenal. Initially approved by the tax court in the 1988 case of *Estate of Graegin v. Commissioner, TC Memo 1988-477*, the *Graegin* note continues to be blessed by the courts and remains a cost-effective way of reducing the tax bite and providing estate liquidity.

How it Works

Example

Janine dies with a \$10 million estate in 2011. Assuming an estate tax rate of 45 percent, her estate owes \$4.5 million in estate taxes. To come up with the cash, the executor borrows \$1.493 million from a closely held company under a 15-year note, at 12 percent interest. The note requires a balloon payment of principal and interest at the end of the 15-year period. The accumulated interest payment due at the end of the 15 years would be \$6.681 million. Now, here's the key. Based on *Graegin*, the full amount of the interest is deductible on the estate tax return due nine months after death, even though the interest isn't actually payable until 15 years hence. When the interest is deducted, the estate is reduced to only \$3.319 million, which would result in a federal estate tax (at a 45 percent rate) of only \$1.493 million. **The estate tax is reduced from \$4.5 million to a little under \$1.5 million.**

Keep in mind that the interest paid to the company is taxable when received, and that the estate must remain open in order to eventually pay the principle and interest due on the balloon note. On the other hand, assuming Janine's heirs are the owners of the creditor company, they ultimately benefit not only from the estate tax savings, but also from the receipt of the interest on the note.

Consider making the *Graegin* note transaction even more attractive by creating an irrevocable life insurance trust (ILIT) and purchasing only enough insurance (which, if properly arranged, should be both income and estate tax free), so that when the death benefit is invested at a reasonable rate, it is sufficient to cover the note and interest when due 15 years after death.

Recent Developments

The *Graegin* note recently received approval in the case of *Estate of Murphy v. United States*, Case No. 07-CV-1013, W.D. Ark. El Dorado Division, Oct. 2, 2009. The case also involved a family limited partnership (FLP), which was used to generate valuation discounts and considerable estate tax savings. Significant to the court's approval of the interest deduction associated with the *Graegin* note was its conclusion that "[b]orrowing money to pay the estate tax of an illiquid estate is a 'necessarily incurred' administrative expense under section 2053" (citing *McKee v. Commissioner*, TC Memo 1996-362, and *Estate of Todd v. Commissioner*, 57 TC 288 (1971)).

The court rejected the IRS's argument that the up-front interest deduction should be denied on the grounds that the FLP was created solely for tax purposes and resulted in a "self-inflicted" liquidity need. According to the court, the FLP was created "in good faith and for legitimate and significant non-tax purposes." Furthermore, the court noted that the decedent retained sufficient assets (\$130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes.

Final regulations, T.D. 9468, 74 Fed. Reg. 53652 (Oct. 20, 2009, under IRC Section 2053, are now effective for the estates of decedents dying after October 19, 2009. The basic focus of the regulations is the extent to which post-death events may be considered in determining the deductible amount of a claim or expense. Consensus has it that the new regulations do not impact

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Bottom Line

Estate taxes are set to return with a vengeance next year. Clients will need every arrow in your quiver to meet the challenge. Don't overlook the *Graegin* note in your planning.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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