INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 15, 2004

Number: **200513028**
Release Date: 4/1/2005
Index (UIL) No.: 2053.05-00
CASE-MIS No.: TAM-145318-03, CC:PSI:4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Date of death:
Date of Conference:

LEGEND:

Decedent =
Child A =
Child B =
Accountant =
Partnership =
State =
Date 1 =
Date 2 =
Date 3 =
Year =
$h =
$i =
$j =
$k =
$l =
$m =
$n =
A% =
X% =

ISSUE:

Is the loan interest stated in a note executed for an advance from Partnership to the Estate deductible as an expense of administration under § 2053(a)?

CONCLUSION:

The loan interest stated in a note executed for an advance from Partnership to the Estate is not deductible as an expense of administration under § 2053(a).

FACTS:

Decedent and his spouse formed Partnership, a limited partnership, on Date 1. Decedent contributed 90% of his assets to Partnership in exchange for a 2% general partnership interest and a 97% limited partnership interest. His spouse contributed $h in cash in exchange for a 1% general partnership interest. Decedent transferred a 1% general partnership interest to Child A, Decedent's child. Subsequently, in Year, Decedent and his spouse were divorced. At that time, the partnership purchased her 1% general partnership interest. Partnership generated income each year.

Decedent died testate on Date 2, approximately 5-½ years after formation of Partnership. Under Paragraphs 1(d) and 2(b) of Decedent's will, the estate residue is to be distributed in equal shares to one trust for the benefit of Child A and another trust for the benefit of Decedent's child, Child B. Both trusts provide for distributions of income and principal, in the trustee's discretion, for support, maintenance and health of Child A or Child B, respectively. The trustee may also distribute to Child A or Child B, as the case may be, such additional amounts as the trustee deems appropriate. The trustee may also distribute income and principal from either trust, in his discretion, to Child A's descendants. On the death of Child A and Child B, respectively, the remaining corpus of the deceased child's trust is to be distributed pursuant to exercise of a testamentary general power of appointment granted to the child.

Under Paragraph 6 of Decedent's will, all estate taxes are to be paid from the residue of the estate ("the Estate"). Child A and Accountant were appointed as executors of the Estate. Accountant is also designated as the trustee of the trusts established for Child A and Child B.

The Estate residue consisted primarily of Decedent's 99% interest in Partnership. At Decedent's death, approximately 57.6% of the Partnership assets, or $n, consisted of publicly traded stocks, bonds and cash. These assets reflected accumulated income of the four prior years of $l. The remaining partnership assets consisted primarily of real property (17.5%) and personal notes (24.7%) that had been issued to the partnership on the sale of real property previously owned by the partnership.

On Date 3, Child A and Accountant, as executors, and Child A, as general partner, executed a promissory note describing the Estate as the borrower and Partnership as the lender. The note is described as an advancing line of credit pursuant to which funds, up to the designated principal amount, will be advanced to the borrower by the lender. Once the principal amount of the note is advanced, no further loan advances will be made. The principal amount of the note is $i and the annual interest is X%. The note is to mature 10 years from Date 3. Principal that is advanced and all accrued interest is to be paid in a lump sum on the maturity date. Prepayment of principal or interest is prohibited. The Estate's 99% Partnership interest was pledged as security pursuant to a separate security agreement (the "Security Agreement").

The Security Agreement acknowledges that Partnership has loaned funds to the Estate as evidenced by a promissory note dated Date 3, and that in order to secure the liability, the Estate grants Partnership a continuing security interest in the Estate's partnership interest in Partnership and all of the Estate's distributive share of partnership income, profits, etc., as well as the Estate's distributive share of Partnership assets upon dissolution. In the event of a default, Partnership has the right to receive the Estate's share of income and distributions from Partnership. The Estate is prohibited from selling, assigning or transferring its interest in Partnership without the written consent of Partnership.

On Date 3, the date the note was signed, the prime interest rate was one percent less than X%. The average interest rate for 15-year mortgage loans was three percent less than X%. Pursuant to the loan arrangement, Partnership advanced $j to the Estate. The advance was later increased to $m. Two checks were drawn on the Estate's account: one payable to the United States Treasury Department and another to the State treasurer. On the federal estate tax return filed for the Estate, the executors claimed a deduction under § 2053(a) for the $k in interest that is to be paid on the due date of the note.

LAW AND RATIONALE

Section 2053(a)(2) provides, in part, that the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for administration expenses.

Section 20.2053-1(b)(3) provides that an item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate.

Section 20.2053-3(a) provides that, "the amounts deductible from a decedent's gross estate as 'administration expenses' . . . are 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, payments of debts, and distribution of property." (Emphasis added.)

In general, the courts and the IRS have concluded that interest expense incurred by an estate on funds borrowed by the estate can be a deductible administration expense provided the loan was reasonably and necessarily incurred in the administration of the estate. Rev, Rul. 84-75, 1984-1 C. B. 193 ("… because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D's estate."); Estate of Todd v. Commissioner, 57 T.C. 288 (1971)("the estate did not own any liquid assets at the time; and that if the estate liquidated some of its nonliquid assets, these would have had to have been sold at reduced prices."); Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, 35-36 ("We are convinced that the financial position of the estate at the time of the borrowing was insufficient to make the required tax payments and provide for the maintenance of Cane Mill [business property owned by the estate]"); McKee v. Commissioner, T.C. Memo. 1996-362 ("the executors determined that it was preferable to preserve all of decedent's [closely-held] stock and to borrow funds… in order to better ensure the estate's ability to pay its obligations."); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477 ("[t]o avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability."); Estate of Huntington v. Commissioner, 36 B.T.A. 698, 726 (1937) ("[t]he issuance of the notes avoided the necessity of sacrificing the assets of the estate by immediate or forced sale"). See also, Hibernia Bank v. United States, 581 F.2d 741 (9th Cir. 1978).

A deduction may be allowable under § 2053 for estimated interest payments that have not yet accrued. However, before the administrative expense deduction may be allowed, in addition to satisfying other requirements § 2053(a) and the regulations, the estimated amount must be (i) ascertainable with reasonable certainty, and (ii) certain to be paid. Section 20.2053-1(b)(3); Estate of Bailly v. Commissioner, 81 T.C. 246 (1983); Estate of Graegin v. Commissioner, T.C. Memo 1988-477.

As noted above, the Estate claimed a deduction under § 2053(a)(2) for $k in interest that is due to be paid on the maturity date of the note, which is 10 years from Date 3. For the reasons discussed below, we do not believe the interest constitutes a deductible administration expense for purposes of § 2053.

First, we do not believe the transaction whereby the Estate purportedly borrowed $m from Partnership can properly be viewed as necessary to the administration of the estate. As the case law and revenue rulings noted above indicate, the interest deduction has been allowed where the loan was necessary to preserve the asset value of the estate; for example, where the estate is illiquid, cash is needed to pay the federal and/or state estate tax liability, and the loan supplies this cash while avoiding the need to sell a family business or otherwise dispose of estate property at distressed or reduced prices.

In this case, Partnership held substantial liquid assets totaling $n, or 57.6% of the partnership assets. On his death, the Estate succeeded to Decedent's 99% partnership interest. Child A, the co-executor of the Estate, was the remaining general partner. Further, the partnership was not engaged in any active business that would necessitate the retention of liquid assets. In addition, in view of the Estate's 99% ownership interest in the partnership and Child A's 1% interest, there was clearly no fiduciary restraint on Child A's ability to access the funds.

It may be argued that the Estate could not require the Partnership to distribute the funds, since the Estate possessed only a 99% "assignee" interest (as characterized by the Estate) and Child A, in her individual capacity, was the remaining general partner. However, the situation presented here is very different from the situations presented in Estate of Todd v. Commissioner, Estate of Graegin v. Commissioner and the other cases and revenue rulings cited above. In this case:

(i) the Estate owned 99% of the partnership,

(ii) Child A was the co-executor of the Estate and held the remaining 1% partnership interest as a general partner,

(iii) residuary trusts for Child A and Child B were to receive the Estate's 99% Partnership interest, and 99% of Partnership income was payable or would be credited to the trusts;

(iv) Child A and Child B are each to receive (for support, maintenance, health, and other amounts as appropriate) the income and principal paid to the partnership and then distributed by the partnership to the trusts; and

(v) Child A and Child B each hold a testamentary general power to appoint a respective half of 99% of Partnership along with any income and principal either retained by Partnership or paid by Partnership to the trusts but not distributed.

It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an "upfront" estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.) However, as indicated above, in order for the interest expense to be deductible under § 2053, the loan must be necessary for the administration of the estate. The interest deduction can not be the justification for an otherwise unnecessary loan. Thus, we do not believe the loan can properly be characterized as necessary to the administration of the estate.

Further, we do not believe that the interest expense is deductible under § 2053 because: (1) it is questionable whether the Estate will actually make the payments in accordance with the terms of the arrangement; and (2) even if the Estate makes the payments in accordance with the terms of the arrangement, the payments (whether characterized as interest or principal) will have no economic impact on the parties involved.

The deduction for administration expenses, such as interest, is limited to amounts actually paid. This requirement ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries. Further, transactions between family members are carefully scrutinized because the family relationship often makes it possible to shift tax incidence by surface changes of ownership without affecting the dominion and control over the subject of the transfer. Commissioner v. Culbertson, 337 U.S. 733 (1949); Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970).

In this case, other than generating an estate tax deduction, the "loan" transaction has no economic effect upon the parties. Specifically, the Estate's obligation to pay interest and principal will mature 10 years from Date 3. On this date, if the Estate has funds to pay the obligation then, absent the loan and interest "obligation," the beneficiaries (i.e., the trusts for Child A and Child B) would each be entitled to receive one-half of these funds. However, if the Estate uses these funds to pay the interest and principal, the Estate will simply transfer the funds to Partnership, in which it owns a 99% interest (and in which the Estate beneficiaries own a 100% interest). The Estate's payment will then be credited to the beneficiaries' partnership accounts or distributed to them by Partnership in virtually equal one-half shares.

More likely, if the Estate (or the Estate beneficiaries) does not have the funds necessary to pay the indebtedness and interest, Partnership will distribute the funds needed, if available, which funds will immediately be paid back to Partnership in satisfaction of the loan. Indeed, Partnership may simply cancel the note and avoid the necessity of the circular transfer of funds.

Regardless of the mechanism ultimately selected to satisfy the note on the maturity date, it is clear that the payment of the interest and principal to Partnership, of which the Estate owns a 99% interest and the Estate and Estate beneficiaries own a 100% interest, will not result in any economic detriment or benefit to the Estate or the

Estate beneficiaries as obligors, or the Partnership as obligee. Since the parties have virtually identical interests in the Estate and the partnership**,** there is no change in the relative net worth of these parties as a result of the loan transaction. Rather, other than the favorable tax treatment resulting from the transaction, it is difficult to see what benefit will be derived from this circular transfer of funds.

Thus, from an economic standpoint, the “loan” transaction has no financial impact aside from the estate tax effect if the “interest” is allowed as a deduction. Under these circumstances, we do not believe the interest constitutes a deductible administration expense under § 2053.

We believe this position is amply supported by numerous income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances. For example, in Knetsch v. United States, 364 U.S. 361 (1960), the Court considered a “loan transaction” in which the taxpayer purchased an annuity with a long-term note (and a small amount of cash). In a series of circular transfers, the taxpayer paid the interest due on the note each year in advance and then immediately borrowed against the annuity contract in an amount that covered most of the taxpayer’s cash outlay for “interest.” The annual loans negated any possibility that the arrangement would ever generate any net cash value from which the annuity would be paid. In reality, the annuity transaction had no economic value for the taxpayer other than to provide an income tax deduction for his interest payments. The Court concluded that an income tax deduction was not allowable for the taxpayer’s “interest” payment, as follows:

> When we examine ‘what was done’ here, we see that . . . [i]n form, [the taxpayer] had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000 . . . This . . . was a fiction, because each year Knetsch’s annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000. Knetsch’s transaction with the insurance company did “not appreciably affect his beneficial interest except to reduce his tax . . .” For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly “lent” back was in reality only the rebate of a substantial part of the so-called “interest” payments.

Knetsch v. United States, 364 U.S. at 366.

The courts have applied similar reasoning in numerous cases to disallow the deduction of purported expenses. See, American Electric Power Company, Inc. v. United States, 326 F.3d 737 (6th Cir. 2003) (“[Taxpayer] did nothing more than show a deductible expense on paper, without actually suffering any of the ordinary economic consequences of paying the money. . . because circular netting transactions obviated the obligations to ever actually repay the underlying [loans].”); ACM Holdings, Inc. v.

Internal Revenue Service, 301 F.3d 96 (3d Cir. 2002) ("The main question . . . is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way."); Lee v. Commissioner, 155 F.3d 584 (2d Cir. 1998) ("[N]ot only must the underlying transaction have economic substance, but the debt must be real as well"); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), (deduction denied for interest charges in loan arrangements "that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences").

In Geftman v. Commissioner, 154 F.3d 61 (3d Cir. 1998), a case in which the Third Circuit rejected the IRS' characterization of a transaction between a trust and an estate as a loan, the court noted:

> [W]here "the same persons occupy both sides of the bargaining table," the form of a transaction "does not necessarily correspond to the intrinsic economic nature of the transaction, for the parties may mold it at their will" in order "to create whatever appearance would be of. . . benefit to them despite the economic reality of the transaction." Accordingly, where the same individuals control both the transferor and the transferee, the transaction must be scrutinized according to "an objective test of economic reality" to determine its true economic nature.

Geftman v. Commissioner, 154 F.3d at 75. [Emphasis supplied.]

The present case presents a situation that is substantially similar to those presented in the cases discussed above. The Estate and the partnership executed a document pursuant to which the partnership distributed funds to the Estate and the Estate executed a note under which the Estate became obligated to pay the partnership interest and principal on the maturity date. However, ninety-nine percent of the partnership was owned by the Estate (to be transferred to trusts for the benefit of Child A and Child B) and the remaining one percent was owned by Child A, the co-executor of the Estate. Thus, the same parties owned and controlled both the borrower and the lender, and were essentially dealing with themselves and "sitting on both sides of the table." The circular flow of funds presented is readily apparent. The netting effect presented either obviates the need to actually pay the interest (and principal) when due, or if in fact funds are transferred in payment of interest, the payment will have no economic effect on the parties. After any such payment, the parties will be in the same economic position as they were before the payment.

Consequently, for the reasons discussed above, a deduction is not allowed under § 2053(a)(2) for the claimed interest amount in this case.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.