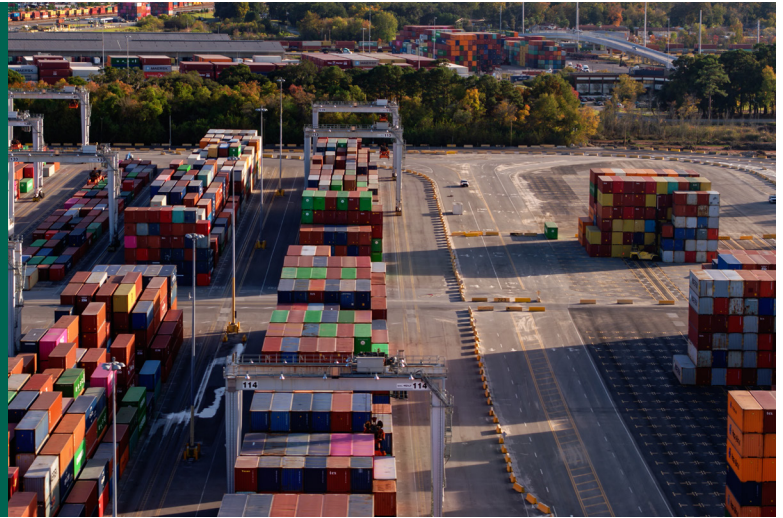




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THE GRAEGIN LOAN REMAINS A VIABLE OPTION FOR CERTAIN ILLIQUID ESTATES

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The Graegin loan was common in the 1980s and 1990s, when estate tax rates exceeded income tax rates by as much as 20 percentage points. This gap resulted in a large difference in the benefit of deducting an expense for the purpose of calculating the taxable estate versus deducting the same expense for the purpose of calculating the taxable income of the estate. The present value of that benefit was enhanced by the higher interest rate environment of the time. While the pecuniary benefit of the Graegin loan has been reduced by the convergence of tax rates and lower interest rates, the Graegin loan might still make sense for certain illiquid estates.

Introduction

In the mid-1990s, the annual gift tax exclusion was \$10,000, and the estate tax exclusion was \$600,000. Those low exclusions meant a lot of estate tax returns were being filed, and there were still estates from the era when the top federal marginal income tax rate was 28 percent or 31 percent, but the estate tax rate was 55 percent.

The difference in tax rates provided an incentive for estates to net everything the rules allowed against the gross value of the assets and have the administrative expenses of the estate reduce the 55 percent estate tax, rather than applying those deductions against the 28 percent or 31 percent federal income tax.

In that environment of relatively higher estate tax rates and relatively lower income tax rates, illiquid estates used a device known as the Graegin loan to provide the liquidity necessary to pay estate taxes.

Graegin Case Background

The Graegin loan takes its name from the result of *Estate of Graegin v. Commissioner*. The case involved the estate of Cecil Graegin, who died November 13, 1981. His estate held (among other assets) \$564,000 worth of illiquid stock in Graegin Industries, Inc. but had only \$20,000 of liquid assets after expenses and Indiana state inheritance taxes. The executors did not want to sell the shares of the family business, so the estate



asked Graegin Industries, Inc. for a loan in the amount of \$204,000 to provide the liquidity necessary to pay the estate taxes.

The term of the loan was 15 years, selected to match the life expectancy of Cecil Graegin's spouse, whose trust was expected to have the liquidity necessary to repay the loan at the time of her death. The loan called for a single payment of principal and interest at a rate of 15 percent per year, and prepayment was not allowed.

Although a 15 percent interest rate sounds high in the context of the last several decades' low interest rates, the prime rate exceeded 20 percent for much of 1981, and at the date of Graegin's death, it was still almost 17 percent.

THE USE OF A GRAEGIN LOAN AS A MECHANISM TO REDUCE ESTATE TAXES RELATIVE TO INCOME TAXES MAY BE LESS BENEFICIAL IN THE CURRENT TAX ENVIRONMENT.

Because the proceeds from the loan were used to pay federal estate tax, the executors deducted \$459,451, the total amount of interest that would be due when the loan matured 15 years later, from the gross estate as administrative expenses in the computation of the taxable estate. At a 70 percent estate tax rate, this deduction reduced the estate tax by almost \$322,000.

The Internal Revenue Service ("IRS") took umbrage with the deduction, presumably taking the position that rather than reducing the 70 percent estate tax today, the interest on the loan should reduce the 50 percent income tax that would be due when the loan matured in 15 years.

To put the two positions into perspective, the estate tax savings were realized immediately, such that the present value of the tax savings was \$322,000. The income tax savings, however, would be realized 15 years in the future. Assuming 15 percent was the correct discount rate at the time, that means the income tax savings had a present value of only \$28,000. Between the difference in the estate and income rates and the time value of

money, the estate's treatment created more than 10 times the tax benefit.

The dispute made its way to the U.S. Tax Court (the "Tax Court"). The Tax Court agreed with the estate in a 1988 memorandum opinion that the expected interest payment associated with the loan was an actual and necessary expense of the estate and therefore deductible for estate tax purposes as an administration expense.

Since that decision, the IRS issued a litigation guideline memorandum (LGM TL-65) that clarifies that the deductibility depends in part on whether the interest is certain to be paid, is commercially reasonable, and is reasonably estimable. This means that loans with variable rates, loans that do not feature a prohibition against prepayment, or loans whose rate of interest or term are deemed excessive are unlikely to meet the IRS criteria for deduction from the gross estate.

Further, the loan agreement itself must be bona fide, meaning it must have economic substance, and the proceeds from the loan must be necessary, which is presumably defined as necessary to pay the current expenses of the estate, including federal estate tax.

The Graegin Loan Today

The Graegin loan was more common when the difference between the estate tax rate and the highest marginal personal income tax rate was bigger. Today, the estate tax rate is 40 percent, and the top federal personal income tax rate is 37 percent, so the difference between the rates today (40 percent versus 37 percent) is smaller than the difference that existed at the time (70 percent versus 50 percent). Accordingly, the use of a Graegin loan as a mechanism to reduce estate taxes relative to income taxes may be less beneficial in the current tax environment.

The Graegin loan also was more beneficial when interest rates were high. The bank prime rate of 6.75 percent, as of February 2026, removes much of the power of present value discounting compared to the 15 percent rate at the time of the Graegin case.

Despite the reduction in its power as a funding mechanism over the past several decades, the Graegin loan continues to be an option in the toolbox of the estate planner or administrator. If interest rates continue to rise or if the estate tax rate becomes a larger premium



to the income tax rate, the Graegin loan likely will return to popularity as a source of liquidity for illiquid estates. The challenge is to create loans that meet the criteria outlined by the IRS for deductibility of the interest in the calculation of the taxable estate, which are:

1. Bona fide loan arrangement with economic substance
2. Loan necessarily incurred
3. Balloon payment loan
4. Fixed and reasonable rate of interest
5. Provision against prepayment



Conclusion

For valuation professionals, the funding mechanism for the estate tax is independent of the value of the underlying illiquid assets of the estate. This means that a Graegin loan typically will not affect an appraisal of the underlying business enterprise held by the estate. That said, the interest rate on the Graegin loan may be a subject of scrutiny, and valuation professionals are in a position to provide guidance on reasonable rates of interest for the loan. This guidance is likely to consider the expected ability of the estate to repay the loan, as well as interest rates on commercially available loans.

In addition, the necessity of the loan likely will be a subject of scrutiny, and valuation professionals are in a position to perform the iterative calculations necessary to determine the amount of the loan that covers the liquidity needs of the estate after the deduction of interest on the loan in calculating the taxable estate. Although not objectively complex, these calculations are an important step to establish the necessity of the loan.

Although valuation professionals may act more as supporting cast members when it comes to Graegin loans, the consulting role with regard to necessity and reasonableness can be a key difference between an estate tax return that is accepted as filed and one that winds up resulting in a trip to Tax Court.

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