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Estate Planning Issues With Intra-Family Loans and Notes

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Estate Planning Issues With Intra-Family Loans and Notes

*Stephen R. Akers and Philip J. Hayes**

Intra-family loans are quite prevalent, and can present significant estate planning opportunities. Loans among family members may seem simple, but they involve numerous complexities. The article addresses many of the complexities including estate, gift and income tax consequences of loans to both the lenders and borrowers in a wide variety of situations — from simple cash loans to sophisticated sale transactions.

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* Stephen R. Akers, Dallas, Texas; Philip J. Hayes, San Francisco, California. Copyright 2013 by Bessemer Trust Company, N.A. All rights reserved. Portions of this article, in particular Parts III-IV (the intricacies of § 7872), Part XI (income tax effects of installment sales under the §§ 483, 1274, and 7872 rules), and Part XIII (SCINs) are based on (and in large part taken verbatim from) outstanding articles by Philip J. Hayes. Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners,* 13 CALIF. TR. & EST. Q. 5 (Summer 2007) (permission granted for the use of portions of this article); Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness, Part 2: Intra-family Sales for Beginners,* 13 CALIF. TR. & EST. Q. 15 (Fall 2007) (permission granted for the use of portions of this article); Philip J. Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, ABA REAL PROP., PROB. & TR. L. SECTION (Spring 2007). The authors express their appreciation to Mickey R. Davis for his outstanding work in editing the article.

This summary is for general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This article is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

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I. Introduction

Wealthy families often run a "family bank" with advances to various family members as they have liquidity needs. Many of the uses of intra-family loans take advantage of the fact that the applicable federal rate ("AFR") is generally lower than the prevailing market interest rate in commercial transactions. (The AFR is based "on outstanding marketable obligations of the United States."[1] The short-term, mid-term, and long-term rates under § 1274 of the Internal Revenue Code[2] are determined based on the preceding two months' average market yield on marketable Treasury bonds with corresponding maturity.)[3] Examples of possible uses of intra-family loans and notes include the following:

1. Loans to children with significant net worth;
2. Loans to children without significant net worth;
3. Non-recourse loans to children or to trusts
4. Loans to a grantor trust;
5. Sales to children or a grantor trust for a note;
6. Loans between related trusts (e.g., from a bypass trust to a marital trust, from a marital trust to a GST exempt trust, such as transactions to freeze the growth of the marital trust and transfer appreciation to the tax-advantaged trust);
7. Loans to an estate;
8. Loans to trusts involving life insurance (including split dollar and financed premium plans);[4]
9. Home mortgages for family members;
10. Loans for consumption rather than for acquiring investment assets (these may be inefficient from an income tax perspec-

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[1] Treas. Reg. § 1.1274-4(b).

[2] References to a "Section " and to the "Code" in the text will be to sections of the Internal Revenue Code of 1986, as amended.

[3] *See* Michael D. Whitty, *Effects of Low Interest Rates on Investment-Driven Estate Planning Techniques,* 30 Est. Plan. 587, 588 (2003).

[4] The split dollar regulations provide that a premium financing arrangement will be governed by § 7872, unless it provides for the payment or accrual of interest at the AFR. Treas. Reg. § 1.7872-15(a)(1). Even if the loan provides for adequate interest, if the split dollar loan is "non-recourse" (e.g., a loan to a trust with no other assets than the life insurance policy), the loan will be treated as a below-market loan under § 7872 unless the parties attach statements to their annual income tax returns representing that a reasonable person would expect all payments under the loan to be made. Treas. Reg. § 1.7872-15(d)(2)(i)-(ii) ("Each party should . . . attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies."). Split dollar life insurance plans are outside the scope of this article and will not be addressed further.

tive because the interest payments will be personal interest that does not qualify for an interest deduction);

11. Loans as vehicles for gifts over time by forgiveness of payments in some years, including forgiveness of payments in 2012 as a method of utilizing $5.0 million gift exemption available in 2012;
12. Loan from a young family member to client for a note at a higher interest rate (to afford higher investment returns to those family members than they might otherwise receive) (In a different context, the Tax Court has acknowledged the reasonableness of paying an interest rate higher than the AFR);[5] and
13. Client borrowing from a trust to which the client had made a gift in case the client later needs liquidity (and the resulting interest may be deductible at the client's death if the note is still outstanding at that time).[6]

In addition to more traditional lending relationships, loan situations can arise inadvertently. For example, assume that a client pays a significant "endowment" for the client's parent to live in a retirement facility. The facility will refund a portion of the endowment when the occupant dies. The maximum refund is 90%. Payment of the "endowment" appears to represent a 10% gift and a 90% interest-free loan.

A. Advantages and Disadvantages of Loans and Notes

If the asset that the family member acquires with the loan proceeds has combined income and appreciation above the interest rate that is paid on the note, there will be a wealth transfer without gift tax implications. With the incredibly low current interest rates, there is significant opportunity for wealth transfer.

> **Example**: Assume a very simple example of a client loaning $1 million to a child in December 2013 with a 9-year balloon note bearing interest at 1.65% compounded annually (the AFR for mid-term notes in that month). Assume the child receives a

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[5] *See* Estate of Duncan v. Comm'r, 102 T.C.M. (CCH) 421 (2011). In *Duncan* the Court's reasoning is compelling:

> Interest rates are generally determined according to the debtor's rather than the creditor's characteristics. . . . The long-term applicable Federal rate is thus inappropriate because it is based on the yield on Government obligations. . . . It therefore reflects *the Government's* cost of borrowing, which is low because Government obligations are low-risk investments . . . . Using the long-term applicable Federal rate consequently would have been unfair to the Walter Trust.

Id. at 425(citations omitted) (emphasis in original).

[6] *See infra* Part I.B.

6% combined growth and income, annually (net of income taxes – the taxes would be borne by the client if the loan were made to a grantor trust).

Amount child owns at end of nine years (@6.0%, compounded annually):	$1,689,479
Amount owed by child at end of nine years (@1.65%, compounded annually):	$1,158,688
Net transfer to child (with no gift tax)	$ 530,791

There are a number of reasons why intra-family loans are popular. For example, with an intra-family loan, interest payments remain in the family rather than being paid to outside banks. Intra-family loans may be the only source of needed liquidity for family member members with poor credit histories. Moreover, borrowing from outside lenders may entail substantial closing costs and other expenses that can be avoided, or at least minimized, with intra-family loans.

If a client inquires about making a loan to children, one should not simply just knee-jerk into documenting the loan without considering whether gifts would be more appropriate.[7] Several circumstances suggesting that a gift may be preferable include (i) the lender does not need the funds to be returned; (ii) the lender does not need cash flow from the interest on the loan; (iii) how the loan will ever be repaid is not apparent; and/or (iv) the lender does not plan on collecting the loan.

Remember that the note receivable will be in the client's estate for estate tax purposes. In particular, make use of annual exclusion gifts, which allow asset transfers that are removed from the donor's estate and that do not use up any gift or estate exemption. The gift tax rate is applied to the net amount passing to the donee, whereas the estate tax rate is applied to the entire state, including the amount that will ultimately be paid in estate taxes. If the donor lives for three years, gift taxes paid are removed from the gross estate. If the client transfers a fractional interest or a minority interest in an asset owned by the client, the transfer may be valued with a fractionalization discount. On the other hand, if cash is loaned to the child, no fractionalization discounts are appropriate. In addition, gifts remove assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or

[7] See Benjamin N. Pruett, Loans Within the Family—Cautions and Consideration (Bessemer Trust, Washington, D.C.) (unpublished outline) (on file with author) for an excellent outline regarding the materials in this section.

"contemplation of death" recapture of gifts back into the state gross estate).

If the transfer is structured as a loan, the parent will recognize interest income (typically ordinary income) at least equal to the AFR, either as actual interest or as imputed interest, thus increasing the parent's income tax liability. Using loans to fund consumption needs of children is inefficient in that the interest is taxable income to the lender without any offsetting deduction to the borrower, thus generating net taxable income for the family. In addition, someone must keep track of the interest as it accrues to make sure that it is paid regularly or is reported as income. This can be particularly tedious for a demand loan or variable-rate term loan where the interest rate is changing periodically. There are additional complications for calculating the imputed interest for below-market loans (which means that loans should always bear interest at least equal to the AFR).

In the case of a loan, if interest is not paid annually, the original issue discount (OID) rules will probably require that a proportionate amount of the overall interest due on the note will have to be recognized each year by the seller, even if the seller is a cash basis taxpayer. Determining the precise amount of income that must be recognized each year can be complicated, particularly if some but not all interest payments are made. The amount of OID included in income each year is generally determined under a "constant yield method" as described in Treasury Regulation Section 1.1272-1(b)(1).[8] (The OID complications can be avoided if the loan is made to a grantor trust.)

If the borrower does not make payments as they are due, additional complications arise. The I.R.S. takes the position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.[9] While some cases have rejected this approach,[10] and while the lender can attempt to establish that there was no intention from the outset of forgiving the loan, if the lender ends up forgiving some or all of the note payments, questions can arise, possibly giving rise to past-due gift tax liability which could include interest and penalties.

Even if the loan is not treated as a gift from the outset, forgiven interest may be treated the same as forgone interest in a below-market loan, resulting in an imputed gift to the borrower and imputed interest

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[8] I.R.C. § 1272(b)(i). *See infra* Part V.B. regarding the OID implications of loans even if they provide for adequate interest.

[9] *See* Rev. Rul. 77-299, 1977-2 C.B. 343, 344.

[10] *See infra* Part I.C.

income to the lender. (However, if the forgiveness includes principal "in substantial part" as well as income, it may be possible for the lender to avoid having to recognize accrued interest as taxable income.)[11] If the parties agree to a loan modification, such as adding unpaid interest to the principal of the loan, the modification itself is treated as a new loan, subject to the AFRs in effect when the loan is made, thus further compounding the complexity of record keeping and reporting.

One of the advantages of making gifts to a grantor trust is that the grantor pays income taxes on the grantor trust income without being treated as making an additional gift. This allows the trust assets to grow faster (without having to pay taxes) and further reduces the grantor's estate for estate tax purposes. This same advantage is available if the loan is made to a grantor trust. In addition, making the loan to a grantor trust avoids having interest income taxed to the lender-grantor, and avoids having to deal with the complexity of the OID rules.

B. Loans vs. Equity

The I.R.S. may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the I.R.S.) if there appears to be an intention that the loan would never be repaid. (If the I.R.S. were to be successful in that argument, the note should not be treated as an asset in the lender's estate.) A similar issue arises with sales to grantor trust transactions in return for notes. The I.R.S. has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return.[12] Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering the application of § 2036 of the Code) rather than just receiving a debt instrument.

A transfer of property in an intra-family situation will be presumed to be a gift unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth."[13] In the context of a transfer in return for a promissory note, the gift presumption can be overcome by an affirmative showing of a bona fide loan with a "real expectation of repayment and intent to enforce the collection of indebt-

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[11] Prop. Treas. Reg. § 1.7872-11(a); *See infra* Part IX.B.

[12] *See infra* note 461 and discussion *infra* Part XII.H.

[13] Treas. Reg. § 25.2511-1(g)(1) ("The gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions . . . ."); Treas. Reg. § 25.2512-8; *see* Harwood v. Comm'r, 82 T.C. 239, 258 (1984), *aff'd,* 786 F.2d 1174 (9th Cir. 1986).

edness."[14] The bona fide loan issue has been addressed in various income tax cases, including cases involving bad debt deductions, and whether transfers constituted gross income even though they were made in return for promissory notes.[15] A recent case addresses the bona fide loan factors in the context of whether $400,000 transferred to an employee was taxable income or merely the proceeds of a loan from the employer.[16] The court applied seven factors in determining that there was not a bona fide loan: (1) existence of a note comporting with the substance of the transaction, (2) payment of reasonable interest, (3) fixed schedule of repayment, (4) adequate security, (5) repayment, (6) reasonable expectation of repayment in light of the economic realities, and (7) conduct of the parties indicating a debtor-creditor relationship.

The bona fide loan requirement has also been addressed in various gift tax cases. The issue was explored at length in *Miller v. Commissioner*,[17] a case in which the taxpayer made various transfers to her son in return for a non-interest-bearing unsecured demand note. The court stated that

> [t]he mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise will not be enforced is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth.[18]

The court concluded that the transfer was a gift and not a bona fide loan, on the basis of a rather detailed analysis of nine factors:

> The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment 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 the

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[14] Estate of Van Anda v. Comm'r, 12 T.C. 1158, 1162 (1949), *aff'd*, 192 F.2d 391 (2d Cir. 1951).

[15] *E.g.*, Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (no basis was established for assumption of debt that was not a bona fide indebtedness).

[16] Todd v. Comm'r, 101 T.C.M. (CCH) 1603 (2011), *aff'd*, 110 A.F.T.R.2d 2012-5606 (5th Cir. 2012) (unpublished opinion) (appellate decision emphasized post hoc note execution and that the loan was never repaid as supporting that the note was merely a formalized attempt to achieve a desired tax result despite a lack of substance).

[17] 71 T.C.M. (CCH) 1674 (1996), *aff'd*, 113 F.3d 1241 (9th Cir. 1997).

[18] *Id.* at 1679.

transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan.[19]

Miller cites a number of cases in which those same factors have been noted to determine the existence of a bona fide loan in various contexts, and those nine factors have been listed in various subsequent cases.[20]

The risks of treating a note in a sale transaction as retained equity rather than debt were highlighted in *Karmazin v. Commissioner*,[21] in which the I.R.S. made a number of arguments to avoid respecting a sale of limited partnership units to a grantor trust, including §§ 2701 and 2702. In that case, the taxpayer created a limited partnership owning marketable securities. Taxpayer made a gift of 10% and sold 90% of the limited partnership interests to two family trusts. The sales agreements contained "defined value clauses." The sales to each of the trusts were made in exchange for secured promissory notes bearing interest equal to the AFR at the time of the sale, and providing for a balloon payment in 20 years. The I.R.S. sent a 75-page Agent's Determination Letter in which the entire transaction was disallowed. The I.R.S. agent determined the partnership to be a sham, with no substantial economic effect, and reclassified the note attributable to the sale as equity and not debt.[22] The result was a determination that a gift had been made of the entire undiscounted amount of assets subject to the sale.[23] The agent's argument included: (1) the partnership was a sham; (2) § 2703 applies to disregard the partnership; (3) the defined value adjustment clause is invalid; (4) the note is treated as equity and not debt because (i) the only assets owned by the trust are the limited partnership interests, (ii) the debt is non-recourse, (iii) commercial lenders would not enter this sale transaction without personal guaranties or a larger down payment, (iv) a nine-to-one debt equity ratio is too high, (v) insufficient partnership income exists to support the debt, and (vi) PLR 9535026 left open the question of whether the note was a valid debt; and (5) because the debt is re-characterized as equity, § 2701 of the Code applies[24] and § 2702 of the Code applies.[25] That case was ultimately settled (favorably to the taxpayer), but the wide ranging tax effects of having the note treated as equity rather than debt were highlighted.

[19] *Id.*

[20] *E.g.*, Estate of Lockett v. Comm'r, 103 T.C.M. (CCH) 1671 (2012).

[21] Karmazin v. Comm'r, No. 2127-03 (T.C. Oct. 15, 2003) (stipulated decision).

[22] *Id.*

[23] *Id.*

[24] Thus, the note is treated as a retention of non-periodic payments.

[25] Thus, rights to payments under the note do not constitute a qualified interest.

In *Dallas v. Commissioner*,[26] the I.R.S. agent made arguments under §§ 2701 and 2702 of the Code in the audit negotiations to disregard a sale to grantor trust transaction by treating the note as retained equity rather than debt, but the I.R.S. dropped that argument before trial and tried the case as a valuation dispute.

The bona fide loan issue has also arisen in various estate tax situations. For example, in *Estate of Maxwell v. Commissioner*,[27] a sale of property to the decedent's sons for a note secured by a mortgage, with a retained use of the property under a lease, triggered inclusion under § 2036. The court held that the sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent on the note.[28] The court observed that the rent payments effectively just cancelled the son's mortgage payments. The son never occupied the house or tried to sell it during the decedent's lifetime. The son never made any principal payments on the mortgage (the decedent forgave $20,000 per year, and forgave the remaining indebtedness at her death under her will). The court concluded that the alleged sale was not supported by adequate consideration even though the mortgage note was fully secured; the note was a "façade" and not a "bona fide instrument of indebtedness" because of the implied agreement (which the court characterized as an "understanding") that the son would not be asked to make payments.[29] The Second Circuit affirmed the Tax Court's conclusion that

> notwithstanding its form, the substance of the transaction calls for the conclusion that decedent made a transfer to her son and daughter-in-law with the understanding, at least implied, that she would continue to reside in her home until her death, that the transfer was not a bona fide sale for an adequate and full consideration in money or money's worth, and that the lease represented nothing more than an attempt to add color to the characterization of the transaction as a bona fide sale.

In *Estate of Musgrove v. United States*,[30] the decedent transferred $251,540 to his son less than a month before his death (at a time that he had a serious illness) in exchange for an interest-free, unsecured demand note, which by its terms was canceled upon the decedent's death. The court determined that the property transferred was included in the

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[26] 92 T.C.M (CCH) 313 (2006).
[27] 3 F.3d 591 (2d Cir. 1993).
[28] *Id*. at 594.
[29] *Id*. at 597.
[30] 33 Fed. Cl. 657 (1995).

decedent's estate under any of §§ 2033, 2035, or 2038.[31] The court reasoned that the promissory note did not constitute fair consideration where there was an implied agreement that the grantor would not make a demand on the obligation and the notes were not intended to be enforced.[32]

Assets of a family limited partnership (FLP) created by the decedent were included in the estate under § 2036 in *Estate of Rosen v. Commissioner*.[33] Part of the court's reasoning was that advances to the decedent from the partnership evidenced "retained enjoyment" of the assets transferred to the FLP even though the decedent gave an unsecured demand note for the advances.[34] The purported "loans" to the decedent were instead treated by the court as distributions from the FLP to the decedent. There was an extended discussion of actions required to establish bona fide loans.

Among the factors mentioned by the court are that the decedent never intended to repay the advances and the FLP never intended to enforce the note, the FLP never demanded repayment, there was no fixed maturity date or payment schedule, no interest (or principal) payments were made, the decedent had no ability to honor a demand for payment, repayment of the note depended solely on the FLP's success, transfers were made to meet the decedent's daily needs, and there was no collateral. The court also questioned the adequacy of interest on the note. The specific factors analyzed in detail by the court were summarized as follows:

> The relevant factors used to distinguish debt from equity include: (1) The name given to an instrument underlying the transfer of funds; (2) the presence or absence of a fixed maturity date and a schedule of payments; (3) the presence or absence of a fixed interest rate and actual interest payments; (4) the source of repayment; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between creditors and equity holders; (7) the security for repayment; (8) the transferee's ability to obtain financing from outside lending institutions; (9) the extent to which repayment was subordinated to the claims of outside creditors; (10) the extent to which transferred funds were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayment.[35]

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[31] *Id*. at 669.

[32] *Id*. at 664.

[33] 89 T.C.M. (RIA) 2006-115, 842 (2006).

[34] *Id*. at 862-63.

[35] *Id*. at 863. See Jonathan G. Blattmachr & Diana S.C. Zeydel, *Comparing GRATs and Installment Sales*, 41 U. Miami Heckerling Inst. On Est. Plan. ch. 2, ¶ 202.3

The nine factors listed above from the *Miller* cases were mentioned in *Estate of Holland v. Commissioner*,[36] to support the finding that the decedent's estate did not owe bona fide indebtedness that could be deducted under § 2053.[37] Various cases have mentioned one or more of these factors in analyzing the deductibility of a debt as a claim under § 2053(a)(3) of the Code[38] or of post-death interest paid on a loan as an administrative expense under § 2053(a)(2).[39]

One of the requirements for being able to deduct a debt as a claim or interest on a loan as an administrative expense under § 2053 is that the debt is bona fide in nature and not essentially donative in character.[40] A variety of factors applies in determining whether or not an obligation to certain family members or related entities is bona fide.[41] Factors that are indicative (but not necessarily determinative) of a bona fide claim or expense include, but are not limited to, (1) the transaction occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent; (2) the nature of the debt is not related to an expectation or claim of inheritance; (3) there is an agreement between the parties which is substantiated with contemporaneous evidence; (4) performance is pursuant to an agreement which can be

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(2007), for an excellent discussion of the impact of the *Rosen* case on potential estate inclusion.

36 73 T.C.M. (CCH) 3236 (1997).

37 *Id*. at 3237. Section 2053 allows a deduction for any indebtedness, but only "to the extent that [it was] contracted bona fide and for an adequate and full consideration in money or money's worth." I.R.C. § 2053(c)(1)(A).

38 *E.g.*, Estate of Labombarde v. Comm'r, 58 T.C. 745, 753 (1972), *aff'd*, 502 F.2d 1158 (1st Cir. 1973) (children's support payments to their mother were not a loan because there was no note evidencing the supposed debt and no interest was ever paid); Estate of Hicks v. Comm'r, 94 T.C.M. (CCH) 43 (2007) (loan from father to trust for daughter funded by proceeds of tort settlement, where loan arrangement was planned in part to keep from disqualifying the daughter for Medicaid assistance, was bona fide; court observed in particular that a note was executed, interest was paid every month on the loan, and the loan resulted in the creation of real interest income on which the father really paid income tax); Estate of Ribblesdale v. Comm'r, 23 T.C.M. (CCH) 1041 (1964) (wealthy son who was annoyed with constant requests from his mother for assistance made loans to mother for her support; "bona fides of a loan are primarily established by the intention of the parties that repayment will be made pursuant to the terms of the agreement;" factors mentioned by court were that the mother signed notes requiring repayment, her executor actually repaid the principal [but not the interest], and she had substantial assets for repaying the loans even though they were not secured.).

39 *E.g.*, Estate of Duncan v. Comm'r, 102 T.C.M. (CCH) 421, 426 (2011); Estate of Kahanic v. Comm'r, 103 T.C.M. (CCH) 1434 (2012); Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387 (1988).

40 Treas. Reg. § 20.2053-1(b)(2)(i).

41 *See* Treas. Reg. § 20.2053-1(b)(2)(iii) for a detailed description of the family members, related entities, and beneficiaries to whom such debts are given special scrutiny.

substantiated; and (5) all amounts paid are reported by each party for federal income and employment tax purposes.[42]

Based on the factors listed in the cases discussed above, the following is a brief 10-point checklist of "best practices" in structuring intra-family loans.

1. Have the borrower sign a promissory note.
2. Establish a fixed repayment schedule.
3. Charge interest at or above the minimum "safe harbor" rate.
4. Request collateral from the borrower.
5. Demand repayment.
6. Have records from both parties reflecting the debt.
7. Show evidence that payments have been made.
8. Make sure that the borrower has the wherewithal to repay the loan.
9. Do not establish any plan to forgive payments as they come due.
10. Refinance with caution.[43]

C. Upfront Gift If Intent to Forgive Loan?

Revenue Ruling 77-299[44] announced the I.R.S. position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.[45] However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness.[46]

The I.R.S. relied on the reasoning of *Deal v. Commissioner*,[47] for its conclusion in Revenue Ruling 77-299. In *Deal*, an individual transferred a remainder interest in unimproved non-income-producing property to children, and the children gave the individual noninterest-bearing, unsecured demand notes. The Tax Court held that the notes executed by the children were not intended as consideration for the transfer and, rather than a bona fide sale, the taxpayer made a gift of the remainder

[42] Treas. Reg. § 20.2053-1(b)(2)(ii).

[43] Philip J. Hayes, *Intra-Family Loans: Common Hazards and 10 Steps to Avoid Them*, BESSEMER TRUST PERSPECTIVES ON WEALTH MANAGEMENT, Issue IV at 3-4 (2011).

[44] Rev. Rul. 77-299, 1977-2 C.B. 343.

[45] *Id.*

[46] Rev. Rul. 81-264, 1981-2 C.B. 186.

[47] 29 T.C. 730 (1958).

interest to the children.[48] The I.R.S. has subsequently reiterated its position.[49]

The Tax Court reached a contrary result in several cases that were decided before the issuance of Revenue Ruling 77-299 (and the I.R.S. non-acquiesced to those cases in Revenue Ruling 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance.[50] The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable.

In *Haygood v. Commissioner*,[51] a mother deeded two properties, one to each of her two sons, and in return took vendor's lien notes from each of the sons for the full value of the property, payable $3000 per year. In accordance with her intention when she transferred the properties, the mother canceled the $3,000 annual payments as they became due. The I.R.S. cited the *Deal* case in support of its position that a gift was made at the outset without regard to the value of the notes received.[52] The Tax Court distinguished the *Deal* decision: (1) *Deal* involved the transfer of property to a trust and on the same date the daughters (rather than the trust) gave notes to the transferor; and (2) the daughters gave non-interest-bearing unsecured notes at the time of the transfer to the trust as compared to secured notes that were used in *Haygood*. The court in *Haygood* held that the amount of the gift that occurred at the time of the initial transfer was reduced by the full face amount of the secured notes even though the taxpayer had no intention of enforcing payment of the notes and the taxpayer in fact forgave $3,000 per year on the notes from each of the transferees.[53]

The Tax Court reached the same result 10 years later in *Estate of Kelley v. Commissioner*.[54] Parents transferred real estate to their three children in return for valid notes, secured by vendor's liens on the real properties. The parents extinguished the notes without payment as they became due. The I.R.S. argued that the notes "lacked economic sub-

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[48] *Id*. at 736.

[49] *See*, *e.g.* I.R.S. Field Service Advice 1999-837 (donor makes gift of full amount of loan initially if donor intends to forgive the loan as part of a prearranged plan); PLR 200603002 (Jan. 20, 2006) (transfer of life insurance policies to trust in return for note in the amount of the difference between the combined value of the policies and the amount sheltered by gift tax annual exclusions; several months later the donors canceled the note and forgave the debt; taxpayer did not request a ruling on this issue, but the I.R.S. stated that it viewed the donors as having made a gift at the outset in the amount of the note where there was a prearranged plan that it would be canceled).

[50] Estate of Maxwell v. Comm'r., 3 F.3d 591, 600 (2d Cir. 1993).

[51] 42 T.C. 936 (1964).

[52] *See* Minnie E. Deal v. Comm'r, 39 T.C. 730 (1958).

[53] *Haygood*, 42 T.C at 946.

[54] 63 T.C. 321 (1974).

stance and were a mere 'façade for the principal purpose of tax avoidance.'"[55] The court gave two answers to this argument. First, the notes and vendor's liens, without evidence showing they were a "façade," are prima facie what they purport to be. The parents reserved all rights given to them under the liens and notes until they actually forgave the notes and nothing in the record suggests that the notes were not collectible. Second, "since the notes and liens were enforceable, petitioners' gifts in 1954 were limited to the value of the transferred interests in excess of the face amount of the notes."[56]

The court in *Estate of Maxwell v. Commissioner*[57] distinguished *Haygood* and *Kelley* in a § 2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. The court reasoned that in *Haygood* and *Kelley*, the donor intended to forgive the note payments,[58] but under the facts of *Maxwell*, the court found that, at the time the note was executed, there was "an understanding" between the parties to the transaction that the note would be forgiven.[59] Other cases have criticized the approach taken in *Haygood* and *Kelley* (though in a different context), observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth.[60]

One commentator gives various reasons in concluding that taxpayer position is the more reasoned position on this issue.

> The IRS has not done well with this approach, and there are reasons for this. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona

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55 *Id*. at 324.

56 *Id*. at 325.

57 3 F.3d 591 (2d Cir. 1993).

58 *Id*. at 601; *See also* Haygood v. Comm'r, 42 T.C. 936, 946 (1964); *Kelley*, 63 T.C. at 325.

59 *Maxwell*, 3 F.3d at 595.

60 *E.g.*, Miller v. Comm'r, 71 T.C.M. (CCH) 1674 (1996); Estate of Musgrove v. United States, 33 Fed. Cl. 657, 664 (1995); Estate of Lockett v. Comm'r, 103 T.C.M. (CCH) 1671 (2012).

> fide debtor-creditor relationship at all, the entire loan may be recharacterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is considered to "really" own the property.
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> . . .
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> If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset.[61]

Other commentators agree that the Tax court analysis in *Haygood* and *Kelley* is the preferable approach.[62]

While the cases go both ways on this issue, taxpayers can clearly expect the I.R.S. to take the position that a loan is not bona fide and will not be recognized as an offset to the amount of the gift at the time of the initial transfer if the lender intends to forgive the note payments as they become due. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible in distinguishing debt from equity. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.

II. History and Context of Sections 7872 and 1274

A. Brief History

Once upon a time, life was good. Gas was 20 cents a gallon, Get Smart reruns ran daily, hard-core speed death-metal music had not been invented, personal interest was deductible, and even the most unsophisticated tax advisors knew enough to use interest-free loans to help clients drive large semi-trailers through gaping holes in the income and gift tax systems. During this tax utopia, taxpayers used interest-free loans in a variety of ways to exploit the failure of the I.R.S. to at first *assert*, then later *convince* the courts, that interest-free loans should be income- and/or gift- taxable transfers. This exploitation included interest-free loans: (i) by C corporations (usually closely-held) to shareholders (to avoid double taxation); (ii) by wealthy persons to family members in lower tax brackets to permit them to invest and receive returns taxed at lower rates; (iii) by employers to employees as a substitute for taxable com-

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[61] Kathryn G. Henkel, Estate Planning and Wealth Preservation ¶ 28.05[2][a] (1997).

[62] *E.g.*, Howard Zaritsky & Ronald D. Aucutt, Structuring Estate Freezes: Analysis With Forms § 12.03 (1997).

pensation (and payroll taxes); and (iv) by sellers using installment sales to convert interest income to capital gain. This tax Shangri-La lasted, for the most part, from 1913 to 1984.[63]

The I.R.S. was slow to catch on to the potential for tax avoidance, failing to strongly assert that interest-free loans should have tax consequences until 1960, when, in *Dean v. Commissioner*,[64] it made its first coherent argument. In *Dean*, the Commissioner argued that since an interest-free loan did not require an interest payment, the borrower received the free use of the principal as an economic benefit that should be included in gross income. At first the courts were not moved by the I.R.S.'s position.[65] Eventually, however, the United States Court of Claims adopted the theory, although that decision was reversed.[66] Finally, in 1984, the I.R.S. scored its breakthrough victory in this arena (albeit in the gift tax context), in *Dickman v. Commissioner*,[67] in which the U.S. Supreme Court held that the lender's right to receive interest is a "valuable property right,"[68] and that the transfer of such a right through an interest free loan is a taxable gift. *Dickman* quickly touched off comprehensive below-market loan reform. Later in 1984, Congress enacted Internal Revenue Code § 7872 to govern certain below-market loans. With § 7872, Congress created artificial transfers of deemed interest between the borrower and the lender, to ensure that income was recognized by each party.[69] Although *Dickman* concerned only gift tax, § 7872 went beyond mere codification of the *Dickman* holding, and beyond the intra-family context, to reach loans to shareholders, employees and a variety of other below-market loans, for *both* income tax and gift tax application. By enacting § 7872, Congress indicated that virtually all gifts involving the transfer of money or property would be valued using the currently applicable AFR,[70] thereby replacing the traditional fair-

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[63] *See* I.R.C. § 483 (in 1963 Congress enacted this section to address installment sale abuse).

[64] 35 T.C. 1083 (1961).

[65] Generally, in this era the Government was not concerned with benefits arising from the interest-free use of money. *See*, *e.g.*, Rev. Rul. 64-328, 1964-2 C.B. 11 (split dollar regime blessed).

[66] Hardee v. United States, 50 A.F.T.R. 2d 82-5252 (Cl. Ct. 1982), *rev'd*, 708 F.2d 661 (Fed. Cir. 1983).

[67] 41 T.C.M. (CCH) 620 (1980), *rev'd*, 690 F.2d 812, (11th Cir. 1982), *aff'd*, 465 U.S. 330 (1984).

[68] 465 U.S. at 336.

[69] At the time, the personal interest deduction made the statute essentially revenue neutral. The loss of the personal interest deduction through the enactment of I.R.C. § 163(h) under the 1986 Tax Act, however, caused income tax pain for the borrower when interest-free loans are compensatory.

[70] I.R.C. § 7872(f)(2)(B).

market-value method[71] of valuing below-market loans with a discounting method. Proposed Treasury Regulations interpreting § 7872 were issued in August 1985,[72] a portion of which were also adopted as temporary regulations.[73] Unfortunately, the statute was amended after the promulgation of the Proposed Regulations, leading to the confusing misalignment of the statute and the Proposed Regulations discussed below.

Section 7872 governs below-market loans in several circumstances, including loans between family members.[74] Section 7872 applies to any transaction that 1) is a bona-fide loan, 2) is below market, 3) falls within one of four categories of below-market loans, and 4) is not within any of several exceptions. The four categories are loans 1) from donor to a donee, 2) from an employer to an employee, 3) from a corporation to a shareholder, and 4) with interest arrangements made for tax avoidance purposes.[75] As we are concerned solely with intra-family transactions, in this article *we shall be concerned only with "gift loans."*[76]

Generally, § 7872 will not impute gift or income tax consequences to a loan providing "sufficient" stated interest, which means interest at a rate no lower than the appropriate AFR, based on the appropriate compounding period.[77] Any gift loan subject to § 7872 which bears interest below the AFR may have adverse tax consequences to the lender.[78] Section 7872 treats a bona fide below-market (i.e., below-AFR) gift loan as economically equivalent to a loan bearing interest at the AFR coupled with a payment by the lender to the borrower of funds to pay the imputed interest to the lender. This "forgone interest" is treated as retransferred by the borrower to the lender as interest. Thus, the forgone interest is treated as a gift by the lender to the borrower and then treated as income to the lender from the borrower. Although income

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71 As exemplified in *Blackburn v. Comm'r*, 20 T.C. 204 (1953).

72 All references to "Proposed Regulations" hereafter shall be to these proposed regulations issued in 1985 for I.R.C. § 7872, unless otherwise noted.

73 Prop. Treas. Reg. § 1.7872-1-14.

74 *See generally* I.R.C. § 7872. There is no I.R.C. provision, however, that specifically applies to intra-family loans.

75 I.R.C. § 7872(c)(1)(A)-(D).

76 I.R.C. § 7872(c)(1)(A). Although intra-family loans certainly occur in other contexts (employer-employee and corporation-stockholder), the majority of intra-family loans will be gift loans.

77 Prop. Treas. Reg. § 1.7872-3(c)(1).

78 Compare I.R.C. § 7872 with other categories of below-market loans, such as compensation related loans, which have adverse tax consequences for the *borrower* and the lender, in which case the amount of interest imputed constitutes wages to the employee.

and gift taxes are implicated, the amount of the gift and income do not always align.[79]

Section 7872 is complicated, therefore not well understood, and, in practice, often ignored. The problem is exacerbated in sales transactions, which implicate both the income and gift-tax safe harbor of § 7872 and the overlapping income tax (and gift tax?) safe harbors of §§ 483 and 1274 governing intra-family sales. Even if the correct safe harbor is used, the Code Section[80] may impute phantom income annually if the loan does not call for "qualified stated interest" (e.g., a loan that does not call for annual payment of interest will be subject to annual imputation of income under the OID rules even if the interest rate satisfies the applicable safe harbor).

B. The Gift Loan: One Type of Loan Under Section 7872

As a reminder, an important assumption of this article is that, unless indicated otherwise, we are discussing intra-family "gift loans" under § 7872(c)(1)(A) of the Code, as opposed to other loans also covered by § 7872, namely compensation related loans,[81] corporation-shareholder loans,[82] or tax-avoidance loans.[83] A below market loan is a "gift loan" if the forgoing of interest "is in the nature of a gift"[84] as defined under the gift tax.[85] The I.R.S. *assumes* that a transfer of money from one family member to another is a gift.[86] A loan can be a gift loan whether the lender is a natural person or an entity and whether, apart from the loan, the parties are related or unrelated,[87] or whether the loan is direct or indirect.[88]

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[79] I.R.C. § 7872. For example, under I.R.C. § 7872, in the case of term gift loans, the amount treated as transferred from the lender to the borrower, which is subject to gift tax, and the amount of imputed interest payable by the borrower to the lender, which is subject to income tax, are computed differently.

[80] Treas. Reg. § 1.1273-1(c).

[81] I.R.C. § 7872(c)(1)(B).

[82] I.R.C. § 7872(c)(1)(C).

[83] I.R.C. § 7872(c)(1)(D).

[84] I.R.C. § 7872(f)(3).

[85] Prop. Treas. Reg. § 1.7872-4(b)(1).

[86] *See* Harwood v. Comm'r, 82 T.C. 239, 258 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986), *cert. den.*, 479 U.S. 1007 (1986).

[87] Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 55.2.3, at 55-13 (3d ed. 2012); Prop. Treas. Reg. § 1.7872-4(b)(1)-(2).

[88] I.R.C. § 2511(a).

C. Avoiding Below-Market Gift Loan Status Under Section 7872

The level of many practitioners'[89] mastery of this area often begins and ends with one concern: keeping a loan from being characterized as below-market under § 7872 – and, therefore, in the context of this article, free from imputed taxable gift and taxable income consequences to the lender. The coping mechanism many have developed to blunt the awful truth about the complexity of § 7872 is a cursory knowledge of § 1274(d) of the Code, i.e., that "a 0-3 year note is subject to the short-term AFR, a 3-9 year note is subject to the mid-term AFR, and a 9+ year note is subject to the long-term AFR."[90] This level of mastery is not a springboard to intra-family loan bliss, so we will dig deeper and try to avoid confusion along the way.

A (bona fide) gift loan is "below market" if the lender does not charge at least the rate of interest required under § 7872.[91] The rate required under § 7872 is tied to the AFR, the lynchpin of the I.R.S. below-market loan scheme. The AFR, set forth in § 1274(d) of the Code, is published monthly by the I.R.S., usually around the 20th day of the preceding month,[92] based on the average yield for treasuries with the applicable remaining maturity periods for the one-month period ending on the 14th of the month. There are three federal rates, a short-term rate that is the AFR for obligations maturing three years or less from the issue date, a mid-term rate for the range three to nine years, and a long-term rate for obligations maturing more than nine years from issue.

The AFRs are based on annual, semiannual, quarterly, and monthly compounding of interest. The more often a loan is compounded, the more valuable it is to the lender; therefore, interest rates required by the statutes correspond to the length of the compounding period – the shorter the period, the lower the required rate. For example, 9% compounded annually is equivalent to 8.62% compounded daily. The appropriate AFR depends on the loan's terms. The shorter of the compounding period or the payment interval determines the appropri-

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[89] The authors include themselves in this group.

[90] *See* I.R.C. § 1274(d).

[91] *See* I.R.C. § 7872(e)(1)(A)-(B). Technically, a below market loan is a demand loan with an interest rate lower than the AFR or a term loan for which the amount loaned exceeds the present value of all payments due under the loan). *Id*. Because the present value of a term loan is determined using the AFR, a demand or term loan with an interest rate at least equal to the AFR is not a below market loan. *See* Prop. Treas. Reg. § 1.7872-3(c)(1).

[92] One way of locating the AFR for a particular month is to search for "AFR" on the I.R.S. website (*www.irs.gov*). In addition, planners can register on the IRS website to receive a monthly notification of the AFR from the IRS.

ate rate.[93] If interest payments or compoundings are at intervals other than those for which rates are published, the rate for the next longest interval for which rates are published may be used. For example, the monthly rate can be used for a note providing for daily compounding, and the quarterly rate can be used for bi-monthly interest payments.[94]

Those sections deal with valuing gifts from below market loans. Section 7872 seems to contemplate cash loans, and the objective method for valuing the gift element under § 7872 appears not to apply to loans of property other than cash.[95] However, the gift element of notes given in exchange for property is also determined under § 7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there *should* not be a deemed gift attributable to the note (although there is no assurance the IRS may not argue in the future that a market rate should be used).[96] Section 7872 is not limited to loans between individuals, and the concepts of § 7872 appear to apply to loans to or from trusts, although there is no explicit authority confirming that conclusion.[97]

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[93] Prop. Treas. Reg. § 1.7872-3(b)(1).

[94] *See* BITTKER & LOKKEN, *supra* note 87, ¶ 55.2.3, at 55-9. Alternatively, a rate precisely appropriate for the note's payment or compounding interval can be computed.

[95] *See* Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 21 (July 2008).

[96] *See* Frazee v. Commissioner, 98 T.C. 554, 588 (1992) ("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted."); Estate of True v. Comm'r, 82 T.C.M. (CCH) 27 (2001) ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). Private Letter Rulings 9535026 and 9408018 also used the AFR for notes in sale and redemption transactions, respectively. *See infra* Part XI.A.

[97] *See* Letter Ruling 9418013 (series of loans from QTIP trust would not be treated as a disposition of the spouse's qualifying income interest for life under § 2519 when the loans bore interest at the AFR). Section 7872 governs the effects of loans with below-market interest rates in a variety of contexts beyond just individuals, specifically including loans between employers and employees, corporation-shareholder loans, and loans to qualified continuing care facilities among others. I.R.C. § 7872(c)(1)(B-C, F). There are special exceptions that apply only to loans between individuals. I.R.C. § 7872(c)(2-3); *see infra* Part V.B.2. Having exceptions that apply only to individual loans confirms that the section applies beyond just loans between individuals. The application of the principles of § 7872 to trusts is important, for example to know that a loan or sale of assets from a

D. Demand Loans

A loan is a demand loan if it is "payable in full at any time on demand of the lender" or "within a reasonable time after the lender's demand."[98] As we will see, the rules of § 7872 are fairly straightforward in the context of term loans. Demand loans are different story.

Usually, the AFR for a demand loan is the federal short term rate in effect for the period the amount imputed by § 7872 (referred to as "forgone interest") is being determined. This is because, by the nature of an arm's length demand loan, the lender is effectively protected against rate fluctuations. Section 7872 provides that interest on the hypothetical arm's length loan outstanding for any period during the calendar year is deemed paid annually on December 31.[99] Thus, with a loan outstanding from April 4 to November 12, the lender is deemed to require payment of interest on December 31.

For the semiannual period in which the loan is made, the short term AFR in effect on the day the loan is made is used. For each subsequent semiannual period (January-June and July-December), the short term AFR for the first month of that semiannual period (i.e., January or July) is used.[100] (However, "Example 5" in the regulations suggests that the lowest short term rate in the semiannual period [from and after the month in which the loan is made] may be used.)[101]

Where the principal amount of a demand loan is outstanding for a full calendar year, the Proposed Regulations provide that a "blended rate" shall compute the amount of sufficient interest for the year.[102]

GST non-exempt trust in return for an AFR note from a GST exempt trust will not cause a change in the inclusion ratio of the exempt trust.

98 I.R.C. § 7872(f)(5); Prop. Treas. Reg. § 1.7872-10(a)(1). What if a loan is payable at the earlier of a specified term or on demand? The statute and regulations do not address whether that is treated as a demand or term loan under §7872. The statute literally suggests that is a demand loan. Section 7872(f)(5) says that a demand loan "means any loan which is payable in full at any time on the demand of the lender," and § 7872(f)(6) says a term loan is any loan that is not a demand loan. The loan described is "payable in full on the demand of the lender"; therefore, the statute literally says it is a demand loan not a term loan. Indeed, the term may have no relationship to the economic reality; for example, what if it is a 15-year loan to lock in the benefit of the current low interest rates but the parties contemplate treating as a demand loan for which the rates will never have to fluctuate upward? A counterargument is that a loan with a fixed maturity but that can be called earlier sets a known outside limited on the term of the loan and arguably should be more akin to a term loan.

99 I.R.C. § 7872(a)(2).

100 Prop. Treas. Reg. § 1.7872-3(b)(3)(i)(A).

101 Prop. Treas. Reg. § 1.7872-3(b)(3)(i)(B), 1.7872-3(b)(3)(iii) ex.5(iii).

102 Prop. Treas. Reg. § 1.7872-13(a). The blended rate is available that effectively applies the January rate for the first half of the year and the July rate for the second half of the year. *Id.*

The blended rate is applied to the principal balance outstanding as of January 1, and reflects semiannual compounding. The blended rate is announced in the July AFR ruling each year (that is published approximately June 20 of each year.)[103] Accrued interest (not forgiven) is treated as a new loan and payments are applied to accrued interest first, then principal.

Since the AFR is recomputed monthly, a demand note might technically be below-market for any month during which it bears interest at a rate lower than that month's AFR. However, *forgone interest* (the *measure* of the gift once the loan fails the below-market *test*) is *computed* under the Proposed Regulations with rates determined once or twice a year.[104] Unfortunately, the Proposed Regulations on the *testing* procedures were issued before the most recent amendment to § 7872, which changed the statutory period for AFR adjustment from semi-annually to monthly.[105] Therefore, there is no definite method for *testing* demand loans.

One reputable authority infers the following procedure for testing whether a demand loan is below-market: A demand loan is not below-market for a particular semiannual period (January to June, or July to December) if it bears interest at a rate at least equal to the lesser of 1) a blended rate published annually by the I.R.S., or 2) the federal short-term rate for the first month of the semiannual period (January or July). For the semiannual period during which the loan is made, the loan is not below market if the rate equals or exceeds the Federal short-term rate for the month in which the loan is made, *even if this rate is lower than*

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[103] *See* Rev. Rul. 2013-15, 2013-28 I.R.B. 1, tbl.6 for the 2013 blended rate. The blended rates for the last five years have been as follows: 2009-0.82%; 2010-0.59%; 2011-0.40%; 2012-0.22%; 2013- 0.22%.

[104] Nomenclature alert: At the time the Proposed Regulations were drafted, the AFR was determined twice a year and was effective for the six-month period following the announcement. The Proposed Regulations refer to this as the "federal statutory rate." Soon after the Proposed Regulations were issued, the I.R.S. decided to determine the AFR monthly. What the Proposed Regulations refer to as the "alternate rate" is this monthly AFR; the "alternative rate" became the statutory rate under § 1274(d) through an amendment to the statute in 1985 (P.L. 99-121). Thus, what the Proposed Regulations refer to as the "alternate" rate is actually the federal statutory rate. However, the (former) federal statutory rate set forth in the Proposed Regulations is still used to determine *forgone interest* under the Proposed Regulations. Effectively, since the semiannual rate is no longer determined, the I.R.S. has adopted the January and July AFRs as substitutes for the former semiannual AFRs. And you wondered why it was so hard to understand the proposed regulations? Philip J. Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, ABA Real Prop., Prob. & Tr. L. Section 10-11 n.56 (Spring 2007), *available at* http://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/symposia/2007/hayes_final.authcheckdam.pdf.

[105] I.R.C. § 7872(f)(2)(A);

both the annual blended rate and the rate for the first month of the semiannual period.[106]

As outlined above, for a demand loan, no fixed rate can be certain to be sufficient under § 7872 for as long as the loan is outstanding; a loan that is above the market rate can quickly become below-market if interest rates rise and the note does not provide for periodic interest-rate adjustments. This problem may be solved by using a variable rate demand loan that calls for periodic revisions of the interest rate, which might be automatic.[107] Such a note may provide that 1) for each semiannual period (January to June, or July to December), the interest rate is the Federal short-term rate for the first month of the period (January or July), or 2) that the interest rate for a year is the blended rate for the year. Either determination provides, by definition, sufficient stated interest, and therefore will never be below-market.

The Proposed Regulations provide that variable rate demand loans will provide for sufficient interest if the rate fixed by the index used is no lower than the AFR for each semiannual period or the short term AFR in effect at the beginning of the payment period (or, if the agreement so provides, at the end) of the payment or compounding period, whichever is shorter.[108] This rule applies, for example, if interest on a demand loan is compounded monthly, with the rate for each month being the federal short-term rate for the month.

The simplest demand note would be one with a variable rate equal to the AFR in effect on the loan date with interest rate adjustments on the first day of each month. Alternatively, for simplicity, the final regulations could adopt a rule providing that there is sufficient interest when the variable rate changes at least in six-month intervals and, at the beginning of each interval, the rate is at least equal to the AFR in effect on that date.

> *Sample Language – Drafting Interest Rate for Demand Note*: [A]t an initial rate per annum equal to the Federal short-term rate, as published by the Internal Revenue Service pursuant to § 1274(d) of the Internal Revenue Code (hereafter the "Federal short-term rate"), in effect for the month first above written. The interest rate on the unpaid principal amount of this Promissory Note shall be adjusted as of January 1 and July 1 of each year to the Federal short-term rate in effect for such January and July, as the case may be.[109]

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106 *See* BITTKER & LOKKEN, *supra* note 87, ¶ 55.2.3, at 55-10.
107 Prop. Treas. Reg. § 1.7872-3(c)(2).
108 Prop. Treas. Reg. § 1.7872-3(e)(2)(i).
109 Hayes, *supra* note 104, at 52, Exhibit A.

Drafting Interest Rate for Demand Note, More Aggressive Approach Under Proposed Regulations Example 5: The interest rate . . . shall be adjusted as of January 1 and July 1 of each year to the Federal short term rate in effect for such January and July, as the case may be. During each semiannual period (Jan. 1 – June 30 and July 1 – Dec. 31; each a Period) the interest rate shall be adjusted to the lowest Federal short-term rate during the applicable Period. (By way of example only, if the lowest Federal short-term rate for January is 4.2%, February is 4.0% and the rest of the Period (March – June) is 4.4%, the rate charged for January shall be 4.2% and for February through June shall be 4.0%.)[110]

If the note provides that the interest rate will be the relevant AFR for each particular period, the appropriate AFR will have to be determined over relevant periods (as described below) to calculate the amount of interest due under the note. If the demand note does not call for interest to be paid at the ever-changing relevant short term AFR, such AFR will have to be determined in any event to determine the amount of imputed income and gift from the below-market loan.

Example: **Below-Market Demand Loan.** Your client, Adam, calls you to tell you that on February 1, 2011, he loaned $200,000 to his son, Chris, for the purchase of an investment property. There were no formal loan documents drafted for this loan. Adam tells you that he received full repayment from Chris on June 30, 2012 of $200,000. Adam also gave his son a $13,000 holiday gift on December 15, 2011. The AFRs were as follows: Jan 2011 – 0.43%; Feb 2011 – 0.51%; July 2011 - 0.37%; Jan 2012 – 0.19%; 2011 Blended 0.4%

1. What is the imputed interest for 2011 & 2012?

   Imputed Interest for 2011 = $728

   Jan 2011 ST AFR = 0.43% and July 2011 ST AFR = 0.37%

   [$200,000 x (0.43% x 5/12)] + [200,000 x (0.37% x 6/12)] = $728

   Imputed Interest for 2012 = $190

   Jan 2012 ST AFR = 0.19%

   $200,000 x (0.19% x 6/12) = $190

   Observe: Blended Rate Does Not Apply

The loan was not outstanding for all of 2011 or all of 2012. Therefore the blended rate for a calendar year does not apply for either 2011 or 2012.

[110] Hayes, *supra* note 104, at 53, Exhibit B.

2. How much does Adam show on his gift tax return as gifts to Chris 2011? 2012?
   Total reportable gift by Adam =
      2011 = $13,728 ($13,000 Cash gift + $728 Imputed Interest)
      2012 = $190 (Imputed Interest; assuming no other cash gifts)

E. Term Loans

A term loan is a loan that is not a demand loan.[111] Under the Proposed Regulations, a term loan is a loan made under an agreement that "specifies an ascertainable period of time for which the loan is to be outstanding."[112] A term loan is below-market if "the amount loaned exceeds the present value of all payments due under the loan."[113] The present value of the payments is determined as of the date of the loan using the AFR as the discount rate. The AFR is the Federal short-term (three years or less), mid-term (over three and up to nine years), or long-term (over nine years) rate, depending on the term of the loan, in effect on the date the loan is made.[114] The test is simplified in the Proposed Regulations, which provide that a loan is not below market if it bears "sufficient interest," which means interest computed "on the outstanding loan balance at a rate no lower than the applicable federal rate based on a compounding period appropriate for that loan."[115] Interest may be variable, so long as the rate is at or above the AFR at the time the loan is made and is based on an objective index.[116] As opposed to a demand gift loan, which may fall in and out of below-market status (if not properly drafted), a term loan need only qualify (for gift tax purposes) as a market loan at the time the loan is made (or when the $10,000 de minimis ceiling is exceeded). For sale transactions, the interest rate on the note can be the lowest AFR for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange."[117] For sale transactions the appropriate AFR is

[111] I.R.C. § 7872(f)(6).

[112] Prop. Treas. Reg. § 1.7872-10(a)(2). A period is considered ascertainable if it can be "determined actuarially." *Id.* For example, a loan payable only on the borrower's death is a term loan because the borrower's life expectancy is actuarially determinable. *Id.*

[113] Prop. Treas. Reg. § 1.7872-3(a)(2).

[114] I.R.C. § 7872(f)(10); *see* Prop. Treas. Reg. § 1.7872-8(b)(1).

[115] Prop. Treas. Reg. § 1.7872-3(c)(1).

[116] Prop. Treas. Reg. § 1.7872-3(e)(1).

[117] I.R.C. § 1274(d)(2)(B).

based not on the term of the note, but on its weighted average maturity.[118]

Structuring loans as term loans rather than demand loans is generally preferable. In light of the ability to use the AFR at the time of a term loan for its full term, rather than having to adjust the AFR every six months with a demand loan, using term loans has two distinct advantages. First, there is no complexity of repeatedly determining the appropriate AFR for any particular period. The AFR at the origination of the loan controls throughout the term of the loan for determining the income and gift tax effects of whether the below-market rules of §7872 apply. Second, during low interest rate environments, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

> ***Example: Below-Market Term Loan.*** Your client, Adam, calls you again to tell you that on March 1, 2011 he loaned his daughter, Stacey, $200,000 to purchase a new home. The loan has a stated rate of 2% payable annually. It also calls for a balloon repayment of the principal due in 10 Years. Stacey makes annual interest payments of $4,000 each year. The March 2011 AFR rates were as follows: Short-term = 0.54%; Mid-term = 2.44%; Long-term = 4.30%.
>
> 1. What is the total interest income reportable by Adam for 2011?
> 2. What is the 2011 & 2012 gift reportable by Adam?
>
>   **Step 1: Determine if this loan is a below-market loan (GIFT AMOUNT)**
>
>   *Calculate difference between PV of all loan payments and loan amount*
>
>   March 2011 Annual Long-Term Rate = 4.30%
>
>   Present value of all payment due under the loan:
>
>   PV of 10 annual $4,000 Interest payments and $200,000 balloon payment in 10 Years discounted using 4.3%
>
>   PV = $163,241 – Since the loan amount is greater, this is a below-market loan
>
>   Total Forgone Interest = $200,000 – 163,241 = **$36,759**
>
>   **Step 2: Calculate the forgone interest for each year (INCOME AMOUNT)**
>
>   March 2011 Annual Long-Term Rate = 4.30%

[118] I.R.C. § 1274(d)(2) (3-month provision); Treas. Reg. § 1.1274-4(c) (weighted average maturity description, referring to Treas. Reg. § 1.1273-1(e)(3)). *See infra* Part XI.A.

Forgone Interest = Interest using AFR – Interest Payment Made
Annual Interest with AFR = ($200,000 x 4.30%) = $8,600
Annual Forgone Interest = $8,600 - $4,000 = $4,600
2011 Forgone Interest: $4,600 x 10/12 = 3,833
Answers:

1. What is the total interest income reportable by Adam for 2011?
   2011 Forgone Interest = $3,833
   Total interest reported in 2011 for this loan is $7,833 (Interest Paid $4,000 + Imputed Interest $3,833)
2. What is the 2011 & 2012 gift reportable by Adam?
   2011 Gift is total forgone interest = $36,759
   2012 Gift = None, because all forgone interest is reported as a gift in the year the loan is made

F. Exemptions From Section 7872

1. *$10,000 De Minimis Exception (Gift and Income Tax)*

A gift loan is exempt from § 7872 of the Code if it is made "directly between [individual] persons" and "the aggregate outstanding amount of the loans between [such individuals] does not exceed $10,000."[119] All loans between the lender and borrower are aggregated regardless of their character (market or below-market), the date made, or the rate of interest (if any).[120] This de minimis exemption does not apply to any gift loan "directly attributable to the purchase or carrying of income-producing assets," which are defined in the Proposed Regulations as 1) an asset of a type that generates ordinary income, or 2) a market discount bond issued prior to June 19, 1984.[121] This exception applies on a day-to-day basis for gift loans. Even if the aggregate amount of loans between the two individuals exceeds $10,000 for some days, there will be no imputed transfers for income or gift purposes (except as described below for term loans) on any days during which the aggregate standing amount of loans between the individuals does not exceed $10,000. For

[119] Prop. Treas. Reg. § 1.7872-8(b)(1). A loan to a custodian under the Uniform Transfers to Minors Act is deemed to be to a natural person, but a loan to a trust does NOT qualify, even though the beneficiaries are natural persons. Prop. Treas. Reg. § 1.7872-8(a)(2).

[120] *See* Prop. Treas. Reg. § 1.7872-8(a)(2)(ii). In determining the aggregate outstanding amount of loans between individuals, loans by a husband and wife to an individual borrower are treated as made by one person. STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., REP. ON REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 256 (Comm. Print 1984) [hereinafter REP. ON DEFICIT REDUCTION ACT].

[121] Prop. Treas. Reg. § 1.7872-8(b)(3)-(4).

gift term loans, § 7872 continues to apply for gift purposes even after the aggregate loss amount is reduced back to $10,000 or less.[122] (For non-gift loans, if the amount of loans between the individuals ever exceeds $10,000, the exception does not apply to outstanding loans between the individuals after that date even if the outstanding balance of the loans is later reduced below $10,000.)

For purposes of this exception (and all of § 7872), husband and wife are treated as one person.[123] Therefore a loan from daughter to father, from father to daughter, from mother to daughter and from daughter to mother will all be counted for purposes of determining if aggregate outstanding loans between daughter and either father or mother exceed $10,000.

2. *$100,000 Exception (Income Exception Only)*

The second exception applies if the aggregate outstanding amount of gift loans between individuals does not exceed $100,000. The imputed interest amount (i.e., the amount treated as retransferred from the borrower to the lender at the end of the year) for income tax purposes is limited to the borrower's net investment income for the year.[124] However, there is a de minimis rule: if the borrower has less than $1,000 of net investment income for the year, the net investment income for purposes of this exception is deemed to be zero (so there would be no imputed income from the loan during that year).[125]

This exception can be helpful for below market loans to borrowers who have little net investment income. However, the amount of forgone interest (the amount of interest that is below the interest that would have been incurred if the loan had used the AFR) will be treated as a taxable gift. (If the lender is not making other taxable gifts to the borrower during the year, the amount of the gift from the below-market loan may be covered by the gift tax annual exclusion.)

This exception applies on a day-to-day basis.[126] As with the $10,000 exception, husband and wife are treated as one person. The exception does not apply if a principal purpose of the transaction is to avoid "any Federal tax."[127] The limitation applies to both the borrower's interest

122 I.R.C. § 7872(f)(10).

123 I.R.C. § 7872(f)(7).

124 I.R.C. § 7872(d)(1)(A), (E). The amount of net investment income is determined under I.R.C. § 163(d)(3). If a borrower has more than one gift loan outstanding, the borrower's net investment income is allocated among the loans in proportion to the respective amounts that would be treated as retransferred by the borrower without regard to this exception. *See* I.R.C. § 7872(d)(1)(C).

125 I.R.C. § 7872(d)(1)(E)(ii).

126 I.R.C. § 7872(d).

127 I.R.C. § 7872(d)(1)(B).

deduction and the lender's interest income, except that it applies to the lender only if "the borrower notifies the lender, in a signed statement, of the amount of the borrower's net investment income properly allocable to the loan."[128]

3. *Sections 483 and 1274*

According to § 7872(f)(8) of the Code, § 7872 does not apply to any loan to which §§ 483 or 1274 (pertaining to loans in connection with sales or exchanges) apply. This exception is not nearly as straightforward as the clear language of the statute implies, and there is considerable room for interpretation (and confusion).[129]

G. Gift vs. Term Loans

In most settings, clients will be well advised to use a term loan instead of a demand loan. For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the state interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages.

First, there is no complexity of repeatedly determining the appropriate AFR for any particular period. The AFR at the origination of the loan controls throughout the term of the loan for determining the income and gift tax effects of whether the below-market rules of § 7872 apply. Second, during the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

III. Income Tax Consequences of Below-Market Gift Loans

If a below-market gift loan is made directly between individuals, and if the outstanding balance of all loans (of any kind) between them is not greater than $100,000, § 7872(d)(1) limits the amount of deemed interest paid by the borrower to the lender under § 7872 to the borrower's "net investment income" for the year (as defined under § 163(d)(4)).[130] Note that this limitation only applies for *income tax* purposes (thus, the lender is deemed to have made a gift of the full amount of the forgone interest regardless of the borrower's net investment income). The limi-

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[128] Prop. Treas. Reg. § 1.7872-11(g)(3).
[129] *See infra* Part XI.A.
[130] I.R.C. §§ 163(d)(4), 7872(d)(1)(E).

tation applies to both the borrower's interest deduction and the lender's interest income, except that it applies to the lender only if "the borrower notifies the lender, in a signed statement, of the amount of the borrower's net investment income properly allocable to the loan."[131]

A. Demand Loans

With a below-market demand loan, the amount of the "forgone interest" is deemed transferred from the lender to the borrower in the form of a gift, and then retransferred by the borrower to the lender as payment of interest on December 31 (or on the date the loan is repaid). The imputed interest income is in addition to any actual interest income received from the borrower. The amount of forgone interest for any calendar year (i.e., the amount of the additional payment/interest treated as a loan paid to lender) is the excess of (i) the amount of interest that would have been payable in that year if interest had accrued at the AFR, *over* (ii) any interest actually payable on the loan allocable to that year.[132]

To calculate the amount of forgone interest for a demand loan with a constant principal amount outstanding for an entire year, the forgone interest is equal to the sum of (1) The product of one-half of the January short-term rate based on semi-annual compounding times the principal amount of the loan; *and* (2) The product of one-half of the July short-term rate based on the semiannual compounding times the sum of the principal amount of the loan and the amount described in (1).[133] From this amount, the amount of interest actually paid during the calendar year, if any, is subtracted.

For easier computation, the I.R.S. also publishes a "blended annual rate" that is multiplied by the principal amount of the loan outstanding to arrive at the amount from which the actual interest paid, if any, is to be subtracted.[134] This blended annual rate is published annually in July in the Revenue Procedure that announces the applicable federal rates for that month. The excess amount over the interest actually paid is the forgone interest.

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[131] Prop. Treas. Reg. § 1.7872-11(g)(3).

[132] I.R.C. § 7872(e)(2)(A)-(B); Prop. Treas. Reg. §§ 1.7872-6, 25.7872-1.

[133] Rev. Rul. 86-17, 1986-1 C.B. 377.

[134] *Id.* Prop. Treas. Reg. § 1.7872-13(a). In the case of *term* gift loans, the taxpayer is to use the AFR based on annual compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the blended annual rate. Prop. Treas. Reg. § 1.7872-13(e)(1)(i). The blended rates for the last five years have been as follows: 2009 – 0.82%; 2010 – 0.59%; 2011 – 0.40%; 2012 – 0.22%; 2013 – 0.22%. *See* Rev. Rul. 2013-15, 2013-28 I.R.B. 1, tbl.6 for the 2013 blended rate.

If a portion of the loan principal is repaid or an additional amount is loaned during the calendar year, the calculation of the forgone interest is complicated. The amount of this interest is calculated by using the "exact method" or the "approximate method." The exact method is based upon a daily compounding of interest and calculates the interest as

> the principal amount multiplied by: (1 + I ÷ k)f -1 where:
> I = the Federal short-term rate expressed as a decimal[135]
> k = the number of accrual periods in a year; and
> f = a fraction consisting of the number of days in the period for which interest is being computed divided by the number of days in a complete accrual period.[136]

This amount should be computed separately for each month at the short-term rate for that month.[137] The exact method *must* be used in this situation (when the loan balance is not constant throughout the year) if either of the parties is not an individual or the aggregate of loans between them exceeds $250,000.

The approximate method is available to individual lenders and borrowers when the aggregate amount of loans between them is $250,000 or less. Under this method, interest is determined by calculating the interest for a semiannual period and then prorating that amount on a daily basis to determine the amount of interest for the portion of the semiannual period the loan was outstanding.[138] The amount imputed will always be slightly larger under the approximate method. The Proposed Regulations include examples contrasting the exact method and the approximate method.[139]

What if borrower-child pays as the spirit moves her? This situation presents a practical issue for most practitioners in administering a note. According to the Proposed Regulations

> [i]f a demand loan does not have a constant outstanding principal amount during a period, the amount of forgone interest shall be computed according to the principles [applying to loans outstanding less than the entire year], with each increase in the outstanding loan balance being treated as a new loan

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[135] Note, however, that for gift term loans, the amount of interest that would have been payable in that year if interest had accrued at the AFR is computed using the AFR based on *semi-annual* compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the Federal short-term rate. Prop. Reg. § 1.7872-13(e)(1)(ii).

[136] Bittker & Lokken, *supra* note 87, ¶ 55.3.2, at 55-41; *see* Prop. Treas. Reg. § 1.7872-13(b)-(d).

[137] Bittker & Lokken, *supra* note 87, ¶55.3.2, at 55-41.

[138] *See id.* at 55-42; Prop. Treas. Reg. § 1.7872-13(b)(1).

[139] Prop. Treas. Reg. § 1.7872-13(b)(3).

> and each decrease being treated as first a repayment of accrued but unpaid interest (if any), and then a repayment of principal.[140]

The Proposed Regulations contain examples calculating the imputed income from a loan with a fluctuating balance.[141]

B. Term Loans

Although § 7872(b) provides that a term loan with a below-market interest rate will be treated as having original issue discount (OID) at the time the loan is made,[142] the Proposed Regulations[143] provide that for *gift* term loans the forgone interest demand loan rules apply.[144] The OID rules rest on the premise that the present value of the borrower's promise to repay is less than the amount loaned; the OID rules are appropriate only if the borrower is assured the use of the lender's money for a fixed term.

Under the demand loan rules applied to term gift loans, as opposed to the OID scheme, forgone interest accrues on the full amount loaned, and none of the original principal is recharacterized as a non-loan payment.[145] Congress decided that demand loan rules should also determine the income tax consequences of gift term loans "because, in light of the familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as binding by the parties."[146] This regime relieves donors and donees of the burden of coping with the OID rules that apply to non-gift term loans.[147]

Each year, a lender must report the interest income imputed to him under § 7872 on his income tax return, attaching a statement containing five items. First, the statement must set forth that the interest income relates to an amount includible in his income by reason of § 7872. Second, the statement must provide the name, address and taxpayer identification number of each borrower. Third, it must specify the amount of imputed interest income attributable to each borrower. Fourth, it must

[140] Prop. Treas. Reg. § 1.7872-13(c).

[141] Prop. Treas. Reg. § 1.7872-13(d).

[142] I.R.C. § 7872(b)(2). The lender is treated as having transferred to the borrower the excess of the amount of the loan over the present value of the payments required to be made under the terms of the loan. I.R.C. § 7872(b)(1).

[143] Prop. Treas. Reg. § 1.7872-6(a).

[144] *Id.* (except for minor calculation adjustments as provided in Prop. Treas. Reg. § 1.7872-13(e)(1)).

[145] BITTKER & LOKKEN, *supra* note 87, ¶ 55.3.2, at 55-35.

[146] *Id.* (quoting REP. ON DEFICIT REDUCTION ACT, *supra* note 120, at 533).

[147] *Id.*

specify the mathematical assumptions used (*e.g.*, 360 day calendar year, the exact method or the approximate method for computing interest for a short period) for computing the amounts imputed under § 7872. Finally, it must include any other information required by the return or the instructions thereto.[148] The borrower must attach a similar statement to her income tax return for a taxable year in which the borrower claims a deduction for an amount of interest expense imputed under § 7872.

IV. Gift Tax Consequences of Below-Market Gift Loans

A. Demand Gift Loans

For a below-market demand gift loan, the amount of the gift is equal to the "forgone interest" treated as transferred from the lender to the borrower and retransferred from the borrower to the lender as payment of interest, calculated as provided in Part III.A, *supra.* The gift is deemed to be made on the last day of the calendar year for each year that the loan is outstanding, or the day the loan is repaid if it is repaid during the year.[149]

B. Term Gift Loans

For income tax purposes, below-market term and demand gift loans are, for the most part, treated the same. For gift tax purposes, however, demand gift loans and term gift loans are treated differently:[150] The amount of a deemed gift is calculated using a different methodology, and the gift is recognized at a different time than the income.[151]

For gift tax purposes, with a term gift loan, the OID rules apply[152] and the lender is treated as making a gift to the borrower in an amount equal to the excess of the principal amount of the loan over the present value of all payments that are required to be made under the terms of the loan. Present value is as determined under Treasury Regulation Section 1.7872-14 of the Proposed Regulations. The discount rate for the present value computation is the AFR in effect on the day the loan is made.

$$PV = \frac{FV}{(1+i)^n}$$

[148] *Id.*; Prop. Treas. Reg. § 1.7872-11(g).

[149] I.R.C. § 7872(a)(2); Prop. Treas. Reg. § 1.7872-6(b)(5).

[150] Prop. Treas. Reg. § 1.7872-7(a)(2).

[151] This also means that below market term loans are treated differently under the income tax and gift tax regimes.

[152] Prop. Treas. Reg. § 1.7872-7(a)(2).

The above calculates what present value (PV) would be needed to produce a certain future value (FV) if interest of i% accrues for n periods. The simplest present value example given in the Proposed Regulations is as follows:[153]

> *Example (1)*
> (i) On July 1, 1984, corporation A makes a $200,000 interest-free three-year term loan to shareholder B. The applicable federal rate is 10%, compounded semiannually.
> (ii) The present value of this payment is $149,243.08, determined as follows: $\$149{,}243.08 = \$200{,}000.00 \div (1 + (.10/2))^6$. The excess of the amount loaned over the present value of all payments on the loan ($200,000.00 - $149,243.08), or $50,756.92, is treated as a distribution of property (characterized according to § 301of the Code) paid to B on July 1, 1984.

The gift is treated as being made on the first day on which § 7872 applies to the term loan.[154] Thus, while with a below-market *demand loan* the lender makes a gift *each year* the loan is outstanding, with a below-market *term loan* the lender makes the total gift in the first year of the loan. This can make a significant difference if the lender plans on using her gift tax annual exclusion to shelter the gift to the borrower. While the imputed gift with respect to a demand loan may be less than the annual exclusion amount, the imputed gift with respect to a term loan in the first year of the loan could exceed that amount.

V. Timing of Recognition of Interest Income and Interest Deductions

A. Below-Market Gift Loans

For below-market gift loans, the § 7872 rules apply to determine how much "forgone interest" is treated as transferred to the lender each year, rather than applying the OID rules. The regulations under § 1274 of the Code—which addresses seller financed transactions—say that § 1274 does not apply to below-market loans.[155] For below-market loans, the forgone interest demand loan rules apply. (Although § 7872 says that a term loan with a below-market interest rate will be treated as having original issue discount ["OID"] at the time the loan is made, the proposed regulations say that for gift term loans the forgone interest

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[153] Prop. Treas. Reg. § 1.7872-14. Although the calculation is for a below-market loan to an employee, the concepts are the same for calculating the amount of a gift for a below-market intra-family gift loan. *Id.*

[154] I.R.C. § 7872(b)(1); Prop. Treas. Reg. §§ 1.7872-7(a) and 25.7872-1.

[155] Treas. Reg. § 1.1274-1(b)(3).

demand loan rules apply.)[156] Each year, a lender must report the interest income imputed to the lender under § 7872, with a statement explaining various details.[157] This regime relieves donors and donees of the burden of coping with the OID rules that apply to non-gift term loans.[158]

B. Loans With Adequate Interest

1. *Overview*

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under § 7872. Nevertheless, if interest accrues but is not actually payable, the OID rules will generally apply, which generally require ratable reporting of interest accruals, even for cash basis taxpayers[159] The OID rules of §§ 1271-1275 of the Code are extremely complex with many exceptions and technical details. Only a simplified overview of the most relevant provisions is included within the scope of this article.

An I.R.S. response from an I.R.S. Regional Coordinator to a practitioner comment observed that the OID rules will generally apply to loans with accrued interest, even if the loans bear interest at the AFR.[160]

That response interestingly points out that this issue may not receive rigorous scrutiny in audits of cash basis taxpayers. Practitioners may have planned numerous loans or notes in sale transactions in the past without advising that accrued interest must be recognized each year under the OID rules, and the issue may not have been raised in any audits.[161]

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156 Prop. Treas. Reg. § 1.7872-6(a).

157 Prop. Treas. Reg. § 1.7872-11(g).

158 Bittker & Lokken, *supra* note 87, ¶ 55.3.2, at 55-35; *See also* Rep. on Deficit Reduction Act, *supra* note 120, at 533.

159 I.R.C. §§ 1271-1275.

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> . . . the holder of a debt instrument that accrues interest at a fixed rate of interest [at or above the AFR], where such interest is not payable until maturity, must include in income portions of such interest under the OID provisions. See § 1.1272-1(f)3)(ii) of the proposed regulations. Therefore, in the above example, the cash basis shareholder must include the deferred interest in income currently. (We recognize that a cash basis taxpayer may be less likely to be scrutinized than an accrual basis taxpayer due to less restrictive accounting requirements. This problem pervades the Code and is not peculiar to § 7872).

I.R.S. Field Service Advice 087777 (June 24, 1991) (response of I.R.S. Regional Technical Coordinator to submission from practitioner requesting amendment or clarification of § 7872).

161 One commentator gives the following example:

> Example: Mom lends Junior $1,000,000. The note provides that interest at the AFR accrues during the term of the loan and a balloon payment of principal

If the loan/seller financed transaction is with a grantor trust, the lender/seller does not have to recognize interest income because he or she is treated as the owner of the trust income and assets for income tax purposes.[162]

2. *Exceptions*

There are exceptions for various types of financial instruments, including tax-exempt obligations, United States savings bonds, debts of not more than one year, and obligations issued before March 2, 1984.[163] There are a number of additional exceptions. For example, The OID rules do not apply to a loan if all outstanding loans between the lender and borrower do not exceed $10,000, if the loan is between natural persons, if the loan is not made in the course of a trade or business, and if a principal purpose of the loan is not the avoidance of any federal tax.[164] (For purposes of this exception, a husband and wife living together are treated as one person.)[165] Second, in the case of loans for acquiring personal use property, the OID rules restrict when the OID can be deducted by the obligor, but do not relieve the lender's recognition of OID income on an annual basis.[166] (For purposes of this exception, personal use property is all property other than trade or business property or property used for the production of income.)[167] A third exception applies to loans with "qualified stated interest."[168] Having "qualified stated interest" is not really an exception to the OID rules, but effectively avoids having OID under the operation of the rules. As a practical matter, interest that is accrued beyond the taxable year is probably not "qualified stated interest" that is subtracted in determining the amount of OID for that year because there must be specified strict pen-

> plus all accrued interest is due at the end of the term. If this arrangement is bona fide, it should successfully avoid the application of the gift tax. However, for income tax purposes, the interest which is accrued but not paid will constitute OID [citing I.R.C. § 1272(a)]. Assuming that no exception to the general rules applies, Mom will have to report interest income during the term of the loan, even though she is not getting paid. Junior will get to deduct the imputed interest paid, even if he is not actually paying it, if the interest is of a character that would otherwise be deductible by him.

HENKEL, *supra* note 61, ¶ 28.9.

162 I.R.C. § 671; *see* Rev. Rul. 85-13, 1985-1 C.B. 184.

163 I.R.C. § 1272(a)(2)(A)-(D).

164 I.R.C. § 1272(a)(2)(E)(ii).

165 I.R.C. § 1272(a)(2)(E)(iii).

166 I.R.C. § 1275(b)(2).

167 I.R.C. § 1275(b)(3).

168 Treas. Reg. § 1.1273-1(c).

alties for failing to pay the interest during a year (so strict that the interest in all likelihood will be paid each year).[169]

There is also a de minimis exception.[170] The OID is treated as zero if the total OID (i.e., the stated redemption price at maturity less the issue price, as discussed below) is less than ¼ of 1% of the stated redemption price at maturity multiplied by the number of complete years to maturity.[171]

There are various exceptions that apply for seller-financed sale transactions. If a note is given in consideration for the transfer of property (i.e., not a loan for cash), § 1274 of the Code applies to determine the "issue price," which is subtracted from the "stated redemption price at maturity" to determine the amount of OID.[172] There are a variety of exceptions under § 1274(c)(3), in which event there generally would be no OID.[173] These exceptions include sales of farms for $1 million or less by individuals or by small businesses, sales of principal residences, and sales involving total payments of $250,000 or less.[174] Finally, for certain seller-financed debt instruments that do not exceed $2 million, indexed from 1989 (the 2013 test amount is $3,905,900),[175] a cash-method seller who is not a dealer can agree with the buyer to treat the note as a "cash method debt instrument." In that event, the interest is taken into account by both buyer and seller under the cash receipts and disbursements method (i.e., as actually paid).[176]

Another exception applies in connection with § 483. In the limited situations in which § 483 applies, there is imputed interest under § 483 rather than OID under § 1274, and the taxpayer's accounting method (i.e., cash or accrual) controls the timing for reporting unstated interest; interest is not included or deducted until a payment is made or due.[177]

3. *Ratable Reporting and Determination of OID*

If the OID rules apply, the aggregate OID over the life of the loan is reported under a daily proration approach.[178] The OID is included in

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169 *See* discussion *infra* Part V.B.3.

170 Treas. Reg. § 1.1273-1(d).

171 I.R.C. § 1273(a)(3).

172 I.R.C. § 1273(a)(1).

173 I.R.C. § 1273(b)(4) (issue price is equal to the state redemption price at maturity so there would be no OID).

174 I.R.C. § 1274(c)(3); *see infra* Part V.B.3.

175 Rev. Rul. 2012-33, 2012-51 I.R.B. 710. The 2012 test amount is $3,813,800, Rev. Rul. 2011-27, 2011-48 I.R.B. 805.

176 I.R.C. § 1274A(c)(1).

177 *See infra* Part XI.B.

178 I.R.C. § 1272(a) ("[S]um of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument.").

income each year under the OID rules even for cash basis taxpayers. However, any "qualified stated interest" is included based on the taxpayer's normal method of accounting.[179] The amount of OID included in income each year is generally determined under the "constant yield method" as described in Treasury Regulation Section 1.1272-1(b)(1).[180]

The amount of original issue discount is the excess (if any) of the "stated redemption price at maturity" over the "issue price."[181] Each of these terms has very specific technical definitions.

The stated redemption price at maturity is the sum of all payments provided for by the debt instrument except for qualified stated interest payments.[182] (Qualified stated interest is excluded from the OID calculation because it is reported separately based on the taxpayers' accounting methods.) To the extent that stated interest exceeds qualified stated interest (discussed immediately below), the excess is included in the stated redemption price at maturity.[183]

Qualified stated interest is interest stated in the debt instrument that meets various significant restrictions, including that the note calls for interest at a fixed rate payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the instrument.[184] The Treasury Regulations clarify that the "unconditionally" requirement means that there must be reasonable legal remedies to compel timely payment of the interest or conditions are imposed that make the likelihood of late payment (other than a late payment within a reasonable grace period) of nonpayment a remote contingency.[185] Remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. According to a Senate Finance Committee Report, interest will be considered payable unconditionally only if the failure to pay the interest will result in consequences to the borrower that are typical in normal commercial lending transactions.[186] Thus, in general, interest will be considered payable unconditionally only if the failure to timely pay interest results in acceleration of all amounts under the debt obligation or similar consequences.[187] Revenue Ruling 95-70, 1995-2 C.B. 124 states that if the debt instrument's terms do not provide the holder with the right to com-

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[179] Treas. Reg. § 1.1272-1(a)(1).
[180] I.R.C. § 1272(a).
[181] I.R.C. § 1273(a)(1).
[182] Treas. Reg. § 1.1273-1(b).
[183] Treas. Reg. § 1.1273-1(c)(4).
[184] I.R.C. § 1273(a)(2).
[185] Treas. Reg. § 1.1273-1(c)(1)(iii).
[186] *See generally* REP. ON DEFICIT REDUCTION ACT, *supra* note 120, at 121 n.40.
[187] REP. ON DEFICIT REDUCTION ACT, *supra* note 120, at 121 n.40.

pel payment, they must provide for a penalty that is large enough to ensure that, at the time the debt instrument is issued, it is reasonably certain that the issuer will make interest payments when due.

> **Example**: Parent loans $100,000 cash to Child for a 4-year note that pays stated interest of 1% for the first two years and 6% for the last two years. Assuming there are sufficient restrictions to assure that the interest will be paid currently, the "qualified stated interest" is the 1% amount that is paid throughout the life of the loan. The stated redemption price at maturity includes the full amount of interest payments over the four years less the 1% payments that constitute qualified stated interest. As a result, the stated redemption price at maturity exceeds the issue price (which equals the amount of the cash loan, as discussed below), and the excess amount is OID. A note that has stated interest that does not constitute qualified stated interest will generally have the effect of creating or increasing OID.

Section 1273 describes the definition of "issue price" for various types of debt instruments, including notes received for cash loans. (There are separate special rules under § 1274 that apply to seller-financed transactions, as discussed below.) For cash loans, the "issue price" is the amount loaned.[188]

> **Example**: Parent loans $1,000,000 cash to Child in return for a 4-year note with stated interest equal to the mid-term AFR on the date of the cash loan. However, the interest is not paid annually (or if the note does call for annual interest payments, there are not sufficient penalties and restrictions on non-payment of interest for the interest to constitute qualified stated interest). Because the interest is not qualified payment interest, the full amount of interest payments under the note will constitute OID, calculated as follows:
>
> > Stated redemption price at maturity: $1,000,000 + all interest payments required
> >
> > *Less Issue price: $1,000,000*
> >
> > OID is the amount of aggregate interest payments required under the note.

Section 1274 generally applies to debt instruments given in a sale or exchange for property that is not regularly traded on an established market (other than for cash, services, or the right to use property). It applies special rules for determining the issue price. The general con-

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[188] I.R.C. § 1273(b)(2); Treas. Reg. § 1.1273-2(a)(1).

cept of § 1274 of the Code is that all payments due on seller financed sales or exchanges of property are discounted at a minimum interest rate (the relevant AFR) to compute an imputed principal amount. The issue price is the lesser of the stated principal amount or this imputed principal amount. (If the note has stated interest equal to the AFR, the imputed principal amount will generally be the same as the stated principal amount.)[189] The difference between the total payments due under the note (excluding qualified stated interest) and this issue price is the OID that is taxable as ordinary income to the holder of the debt instrument over his holding period.

There are several exceptions in determining the "issue price" for debt instruments given for sales or exchanges of property where § 1274 does not apply and in those situations, there will be no OID—the issue price of the debt instrument is its stated redemption price at maturity.[190] These exceptions include sales of farms for $1 million or less by individuals or by small businesses, sales of principal residences, and sales involving total payments of $250,000 or less.[191]

If the debt instrument has adequate stated interest, the issue price is the stated principal amount under the note (including all payments due under the note other than stated interest). There will be adequate stated interest if the debt instrument has a single stated interest rate, paid or compounded at least annually, that is equal to or greater than the test rate under § 1274(d).[192] The test rate is generally the lowest of the AFRs for the 3-month period ending with the month in which there is a binding contract of sale.[193] However, there are several exceptions in which the test rate is different than the AFR. For sale-leaseback transactions, the test rate is 110% of the AFR.[194] For "qualified debt instruments" under § 1274A(b) (notes under $2.8 million, indexed since 1989 —- $5,339,300 in 2012, for the sale or exchange of property other than new § 38 property), the test rate is no greater than 9%, compounded semiannually.[195]

> **Example**: Parent sells property worth $1.0 million to Child in February 2012 in return for a 4-year note. The note bears interest at 1.12% (the mid-term AFR for February 2012), with all

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189 I.R.C. § 1274(a)(1).

190 I.R.C. § 1273(b)(4); Prop. Treas. Reg. 1.1273-2(e).

191 I.R.C. § 1274(c)(3). *See* Harrison McCawley, *Time Value of Money: OID and Imputed Interest*, 535 TAX MGMT. PORT. ¶ III.C.2 (2012), for a detailed discussion of these exceptions.

192 *See* Treas. Reg. §§ 1.1274-2(c)(1), 1274-2(d).

193 I.R.C. § 1274(d)(2).

194 I.R.C. § 1274(e).

195 I.R.C. § 1274A(a).

interest and principal being due at the end of 4 years (i.e., $1,045,558). The note has adequate interest. The issue price is the stated principal amount of the note, or $1,000,000. The OID calculation is as follows:

Stated redemption price at maturity	$1,045,558
Less issue price (stated principal amount)	$1,000,000
OID	$ 45,558

If the debt instrument does not have adequate stated interest, its issue price is the sum of the present values of all payments, including interest, due under the instrument, using a discount rate equal to the relevant test rate under § 1274(d) (as described immediately above).[196] The sum of such present values is the imputed principal amount of the note.[197]

If the loan/seller financed transaction is with a grantor trust, the lender/seller does not have to recognize interest income because he or she is treated as the owner of the trust income and assets for income tax purposes.[198]

VI. Deduction Of Interest Paid under Loans

Under both § 7872 and the OID rules of § 1274 of the Code, the interest element that is recognized as interest or OID taxable income in a particular year by the lender may be deducted in that same year by the borrower if the interest is of a type that is deductible under the Code.[199] In general, interest that is not explicitly deductible under specified provisions in § 163 (including, among other things, investment interest and qualified residence interest) is treated as personal interest that is not deductible.[200]

A. Investment Interest

A noncorporate taxpayer may deduct "investment interest" to the extent of "net investment income" for the taxable year.[201] An unlimited

196 I.R.C. § 1274(b).

197 Treas. Reg. § 1.1274-2(c)(1).

198 I.R.C. § 671; *see* Rev. Rul. 85-13, 1985-1 C.B. 184.

199 *E.g.*, Treas. Reg. § 1.1273(g)(2)(ii) (referring to interest deduction under § 163); Prop. Treas. Reg. § 1.7872-11(g)(3) (limitation for deemed interest by the borrow to the borrower's net investment income under exception for loans not exceeding $100,000 also applies for determining the borrower's interest deduction under § 163); Prop. Treas. Reg. § 1.7872-11(g)(2) (statement required by borrower who is deducting deemed transfer under § 7872 as an interest deduction).

200 I.R.C. § 163(h).

201 I.R.C. § 163(d)(1).

carryforward is allowed for investment interest so that it can be deducted in a succeeding taxable year to the extent the taxpayer has investment income in that succeeding year.[202] (If the taxpayer never has such an excess, the carryover dies with the taxpayer.) Both "investment interest" and "net investment income" relate to interest expense or income related to "property held for investment," which is generally property that "produces income" in the form of interest, dividends, annuities, or royalties or is "of a type" that produces such income.[203] For example, stock is held for investment even if dividends are not received in a year because stock is a type of property that produces dividend income.[204] In addition, "property held for investment" includes an interest in a trade or business if the business is not a passive activity for purposes of § 469 (such as working interests in oil and gas properties) and if the taxpayer does not materially participate in the business.[205]

"Investment interest" is interest expense that generally is deductible (*e.g.,* an expense that is not required to be capitalized) that is "properly allocable to property held for investment" other than qualified residence interest or interest expense included in computing income or loss from a passive activity subject to § 469.[206] "In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures."[207] Specific rules for tracing debt proceeds to specific expenditures are described in that temporary regulation.[208]

"Net investment income" is the excess of investment income over investment expense.[209] Investment income generally is gross income from property held for investment and generally includes net gain on dispositions of such property.[210] Investment expenses that must be deducted in determining net investment income include all deductions "(other than for interest) which are directly connected with the production of investment income."[211] Gross income or expenses of a passive activity are not included in the calculation of net investment income. Net capital gain and qualified dividend income are included in invest-

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202 I.R.C. § 163(d)(2).

203 I.R.C. §§ 163(d)(5)(A)(i), 469(e)(1).

204 Rev. Rul. 93-68, 1993-2 C.B. 72.

205 I.R.C. § 163(d)(5)(A)(ii).

206 I.R.C. § 163(d)(3)(A)-(B).

207 Treas. Reg. § 1.163-8T(a)(3).

208 *See*, *e.g.*, Armacost v. Comm'r, 75 T.C.M. (CCH) 2177 (1998).

209 I.R.C. § 163(d)(4)(A).

210 I.R.C. § 163(d)(4)(B).

211 I.R.C. § 163(d)(4)(C).

ment income only to the extent the taxpayer so elects.[212] (Making this election causes such net capital gain or qualified dividend income to be treated as ordinary income,[213] but making the election is often advantageous because the effect is that the net capital gain or qualified dividend ordinary income can be offset by the investment interest deduction. A taxpayer may choose not to make the election if the taxpayer anticipates having ordinary investment income in excess of investment expense in an upcoming year, so that the investment interest expense offsets what would otherwise be recognized as ordinary income in the near future.)

B. Original Issue Discount

Section 163(e) provides that the issuer of a debt instrument (i.e., the borrower who gives a note) may deduct the daily portions of OID during the taxable year as determined under § 1272(a) to the extent the deduction is not disallowed by some other Code provision (for example, if the proceeds of the debt instrument were used to acquire personal use property.) As with all of the OID rules, the provisions of § 163(e) are quite complex.

C. Qualified Residence Interest

Parents are increasingly making loans to children to finance their acquisition of personal residences, or even second homes. In December 2013, the AFR for mid-term loans (3-9 years) was 1.65% and the AFR for long-term loans (over 9 years) was 3.32%.[214] These incredibly low rates are significantly lower than rates that the children can get from commercial lenders for home mortgage loans. More significantly, as lenders have adopted much stricter down payment and qualification standards for home mortgage loans, loans from parents may be the only alternative for the child to be able to acquire a residence desired by the child (and that the child's parents want the child to be able to purchase).

Interest on loans secured by personal residences (or second homes) may be deducted only if the loan meets various requirements so that the interest is "qualified personal interest."[215] The main requirement is that the loan must be secured by the personal residence. Even though the parent may be willing to make an unsecured loan, the loan should be documented with a legally binding mortgage in order for the child to be able to deduct the interest on the loan as qualified residence interest.

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212 I.R.C. § 163(d)(4)(B).

213 I.R.C. § 1(h).

214 Rev. Rul. 2013-26, 2013-50 I.R.B. 628.

215 I.R.C. § 163(h)(3).

There are a number of other requirements for the loan to qualify so that interest on the loan is treated as qualified interest. First, the borrower must be legally liable for the loan; there must be a true debtor-creditor relationship. Second, as noted above, the mortgage must be secured by the borrower's principal residence (as described in § 121) or a second home in which the borrower has an ownership interest.[216] Debt is secured by a qualified residence only if (1) the residence is specific security for the loan, (2) the residence can be foreclosed on in the event of default, and (3) the security interest is recorded or otherwise perfected under state law, whether or not the deed is recorded.[217] While the debt must be secured by the residence, the loan can still qualify even if the security interest is ineffective or the enforceability of the security interest is restricted under any applicable state or local homestead or other debtor protection law.[218] The debt can be secured by other assets in addition to the residence without violating the security requirement.[219] (Observe that a non-tax advantage of having the loan secured by the residence is that if the residence is awarded to the borrower's spouse in a divorce action, the residence continues to serve as collateral for the outstanding loan.) A qualified residence includes a house, condominium, mobile home, boat, house trailer, or other property that under all the facts and circumstances can be considered a residence.[220] A residence currently under construction can be treated as a qualified residence for a period of up to 24 months if it becomes a qualified residence when it is ready for occupancy.[221] If the residence is rented during the year, it is treated as a qualified residence only if the taxpayer uses it for personal purposes for a number of days that exceeds the greater of (i) 14 days, or (ii) 10% of the number of days the unit was rented at a fair rental rate.[222] If a second residence is not rented or held out for rent during the year, it qualifies as a qualified residence even if the taxpayer does not use the residence personally during the year.[223]

In addition to the foregoing requirements regarding a legally binding note and mortgage, the loan must constitute acquisition indebtedness (i.e., debt incurred in acquiring, constructing, or substantially

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216 I.R.C. § 163(h)(4)(A)(i); Treas. Reg. § 1.163-1(b) (taxpayer must be legal or equitable owner of the property).

217 Temp. Treas. Reg. § 1.163-10T(o)(1).

218 I.R.C. § 163(h)(4)(C); Temp. Treas. Reg. § 1.163-10T(o)(2).

219 *See* Ellington v. Comm'r,102 T.C.M. (CCH) 158 (2011).

220 Temp. Treas. Reg. § 1.163-10T(p)(3)(ii).

221 Temp. Treas. Reg. § 1.163-10T(p)(5).

222 I.R.C. §§ 163(h)(4)(A)(i)(II), 280A(d)(1); Temp. Treas. Reg. § 1.163-10T(p)(3)(iii).

223 I.R.C. § 163(h)(4)(A)(iii).

improving the residence,[224] or a refinancing of acquisition indebtedness, or home equity indebtedness.[225] For acquisition indebtedness, the aggregate amount treated as acquisition indebtedness does not exceed $1.0 million ($500,000 for a married individual filing a separate return).[226] (The $1 million acquisition indebtedness limit is a "per residence" limitation, not a "per taxpayer" limitation where the residence is owned jointly by two individuals.)[227] For home equity indebtedness, the aggregate amount treated as home equity indebtedness does not exceed the fair market value of the residence reduced by acquisition indebtedness, and does not exceed $100,000 ($50,000 for a married individual filing a separate return).[228]

The combined acquisition indebtedness and home equity indebtedness that can qualify is up to $1,100,000, or $550,000 for married individuals filing separate returns.[229] A taxpayer who borrows more than $1 million to purchase a principal residence may deduct the interest on up to $1.1 million of the loan: $1 million as acquisition indebtedness and $100,000 as home equity indebtedness.[230] If the debt secured by the residence exceeds the $1.1 million amount, there must be an allocation of interest that is attributable to the amount of debt that qualifies. Various allocation methods are provided in temporary regulations (that were issued before the $1.1 million limit was imposed under OBRA in 1987), and in an I.R.S. Notice and Publication.[231] The I.R.S. has confirmed that, based on the legislative history of § 163(h), until further regulations are issued, taxpayers may use any reasonable method in allocating debt in excess of the acquisition and home equity debt limitation, including the exact and simplified methods in the temporary regulations, the method in Publication 936, or a reasonable approximation of these methods.[232] For a residence held by an estate or trust, the interest can be a qualified interest if the residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.[233]

If qualified residential interest is paid to an individual (such as a parent), the name, address, and TIN of the person to whom the interest

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[224] I.R.C. § 163(h)(3)(B)(i).
[225] I.R.C. § 163(h)(3)(A)-(C).
[226] I.R.C. § 163(h)(3)(B)(ii).
[227] I.R.S. Chief Couns. Mem. 200911007 (Nov. 24, 2008).
[228] I.R.C. § 163(h)(3)(C).
[229] I.R.C. § 163(h)(3)(B)(ii).
[230] Rev. Rul. 2010-25, 2010-44 I.R.B. 571.
[231] Temp. Treas. Reg. § 1.163-10T(d)-(e); I.R.S. Notice 88-74, 1988-27 I.R.B. 27 ; I.R.S. Publication 936.
[232] I.R.S. Chief Couns. Mem. 201201017 (Nov. 1, 2011).
[233] I.R.C. § 163(h)(4)(D).

is paid must be disclosed on Form 1040, Schedule A, and a $50 penalty can be assed for the failure to do so.[234]

VII. Refinancing Notes at Lower Current AFR

There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under § 7872 include a section entitled "Treatment of Renegotiations," but the section merely reserves the subject for later guidance, which has never been issued.[235] One commentator concludes that refinancings at lower AFRS should be possible without gift consequences:

> Although there is no case, ruling, or Code section that explicitly provides that promissory notes may be restated without gift tax effects, economic analysis of the transaction and Regulations strongly support the conclusion that it is possible to do so without a taxable gift being deemed to occur.[236]

If the borrower can prepay the note with a penalty at any time, and if prevailing interest rates decline, the borrower would likely pay off the original note and borrow the amount on a new note at current rates. That happens daily with thousands of homeowners refinancing their mortgages as interest rates have declined. The borrower could either (i) pay off the original loan (with the higher interest rate) and borrow again at the lower rate, or (ii) give a new note (at the current AFR) in substitution for the original note (with the higher interest rate). This phenomenon is supported by the prices at which marketable callable notes are traded. For callable bonds, the bond prices do not increase proportionally as interest rate decrease (because investors know that the issuer may likely call (i.e., prepay) the bonds that bear higher than current market rates).[237] While it is possible that the I.R.S. might argue that a gift results by re-characterizing the transaction as merely having the lender accept a lower AFR note in place of a higher AFR note, there is no case law or rulings addressing the issue. One commentator reasons that, logically, there should be no gift tax consequences:

> Many of the promissory notes used in the intrafamilial context are term (rather than demand) notes that provide that the bor-

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[234] *Id.*

[235] Prop. Treas. Reg. § 1.7872-11(e).

[236] *See* Blattmachr, Madden, & Crawford, *supra* note 95, at 26. Other commentators have agreed, for example, concluding that "there is no gift consequence when such a loan is refinanced at a lower AFR." Robert Schweihs, *The AFR and the Value of Debt,* Willamette Mngt. Associates Insights 12, 17 (Summer 2012)(discussing how to value notes).

[237] *See* Blattmachr, Madden, & Crawford, *supra* note 95, at 27.

> rower may, at the borrower's option, prepay all or any portion of the principal of the promissory note at any time with premium or penalty of any kind. Whether or not this right to prepay is restricted, if the borrower has the funds available, it seems that the borrower, without negative gift or income tax consequences, may repay the lender in advance of the maturity date, thereby decreasing the amount of total interest that would accrue on the borrower's debt (and, as a result, the total payment the lender expected to receive under the note in *the* absence of repayment).[238]

Commentators have provided cogent analysis of regulations suggesting that there should be no gift tax consequences to substituting a lower AFR note for a high rate note.[239] Specifically, they note that Proposed Regulation Section 25.7872-1 provides a rule for valuing a term loan note, and it seems to contemplate addressing the value of the note *just at the time the loan is made.*[240] According to its heading, that proposed regulation applies only to "Certain Below-Market Loans," which would not include loans having stated interest equal to the AFR (or higher). In any event, there is no proposed regulation addressing the valuation of notes for gift tax purposes after they have been issued. In addition, § 7872(h) of the Code (now § 7872(i)) may authorize gift tax regulations regarding the valuation of intra-family notes that bear interest at the AFR in light of § 7872, but none have been promulgated. The gift tax regulation that generally applies for valuing notes says that the value is "the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value."[241] A *lower* value may be established by satisfactory evidence "that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible . . . and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."[242] Proposed Regulations under § 7872 regarding the *estate tax* value of notes says that the value is the lesser of

> a) the unpaid stated principal, plus accrued interest, or b) the sum of the present value of all payment due under the note (including accrual interest), using the applicable Federal rate

[238] *Id*. at 26-27.

[239] *Id.* at 27-29.

[240] Prop. Treas. Reg. § 25.7872-1 ("[S]hall be treated as a gift from the lender to the borrower on the date the loan is made.").

[241] Treas. Reg. § 25.2512-4.

[242] *Id*.

for loans of a term equal to the remaining term of the loan in effect at the date of death.[243]

Thus, the only applicable gift tax regulation, and the proposed estate tax regulation, both indicate that the value of a note as of the relevant date will not be greater than the amount of unpaid principal plus accrued interest. As a result, "a family note issued at the AFR which is higher than the current AFR has an FMV for gift tax purposes *not greater* than its face amount."[244] Therefore, there should be no gift if a lower AFR note is substituted for a pre-existing note with a higher interest rate. The "old" note has a value presumed to equal its face amount and the new note has a gift tax value under § 7872 equal to its face amount (as long as the interest rate is at least equal to the AFR). Therefore, the exchanged notes have equal values for gift tax purposes, and no gift results from the exchange.

A possible concern is that consistent refinancing of the note may be a factor in determining that the loan transaction does not result in bona fide debt, but should be treated as an equity transfer.[245] In light of the lack of any case law or direct discussion of refinancings at lower AFRs in regulations or in any rulings, most planners suggest caution in this area, and not merely refinancing notes every time the AFR decreases.[246] If the planner is concerned about the treatment of a refinancing (perhaps because there have been refinancing in the past), consider having the borrower borrow money from a bank to repay the loan and several months later approaching the original lender about the possibility of borrowing money under a new note (at the lower AFR) to be able to pay off the bank. Repeated refinancings every time the AFR goes down would seem to fall clearly under the "Pigs get fat and hogs get slaughtered" proverb. Lenders in arm's length transactions are not willing to simply reduce interest rates on existing debt, at least not without getting something in return.

Some planners advise renegotiating the terms of notes not only to adopt the lower, more current AFR, but also to compensate the lender in some way for accepting the lower rate, "perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral."[247] Another possibility is to change the interest rate to a

243 Prop. Treas. Reg. § 20.7872-1.

244 Blattmachr, Madden, & Crawford, *supra* note 95, at 28-29.

245 *See* discussion *supra* Part I.B.

246 *E.g.*, Benjamin Feder, *The Promissory Note Problem,* 142 TR. & EST., Jan. 2003 at 10.

247 Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners,* 13 CALIF. TR. & EST. Q. 5, 7 (Summer 2007). While the lender is permitted to use his or her normal method of accounting in reporting the interest if the note

rate that is higher than the minimum required rate, but lower than the interest rate stated in the original loan. The rationale for this suggestion is that borrowers in the commercial context will not continue paying higher interest rates if they can refinance a debt at a significantly lower interest rate without a prepayment penalty. Refinancing, however, may incur some closing costs, but those costs may be minimal compared to the interest savings over the remaining term of the note. If the borrower refinances the note, the original lender will then lend the funds to some other borrower, but at the current lower interest rate. A refinancing at a lower rate, but not quite down to market rates, may result in a win/win for both the borrower and lender.[248]

VIII. Discounting Notes For Gift and Estate Tax Purposes

A. Valuation of Notes in General

The gift and estate tax regulations for valuing notes generally (discussed below) provide that notes can be valued at less than face value plus accrued interest if the donor or estate demonstrates by "satisfactory evidence" that the value is lower. The I.R.S. has conceded in Technical Advice Memoranda that notes need not necessarily be valued at their face amounts. Technical Advice Memorandum 8229001 identified eight specific considerations for valuing mortgages and promissory notes:[249] (1) Presence or lack of protective covenants (the more onerous the restrictions on the borrower, the lower the risk for the lender and the lower the required discount); (2) the nature of the default provisions and the default risk (the default risk is lower [and the discount is lower] if the borrower has better coverage for making payments, evidenced by factors such as interest coverage ratios, fixed-charge coverage ratios, and debt-equity ratios; the more stringent the default provisions under the note, the lower the risk to the lender [and the discount is lower]); (3) the financial strength of the issuer (the key financial ratios mentioned above and current economic conditions, including financial strength of any parties giving guarantees are important, strong financials indicate

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contains an adequate rate of interest that is payable at least annually, *see* Treas. Reg. 1.1272-1(a), this rule does not apply if it is established that there was no intent to enforce the note according to its terms, *see* Treas. Reg. 1.1273-1(c). Thus, if the note requires that an adequate rate of interest be paid annually, the lender is permitted to use the normal method of accounting in reporting the interest rather than the OID rules. But if in fact interest is not paid in accordance with the note's terms, the I.R.S. may be able to invoke the OID rules.

[248] Pruett, *supra* note 7.

[249] The impact of these factors, as summarized in the text, are addressed in Carsten Hoffmann, *The Evolution of Note Valuations,* 100 Tax Notes 1143, 1144-45 (Sept. 1, 2003).

lower risk and lower discounts); (4) the value of the security (the higher the value of the security, the lower the risk for the lender and the lower the discount); (5) the interest rate and term of the note (the analysis goes beyond just determining if the interest rate on the note equals the current market rate, an increase in market interest rates during the term of the note will decrease the value of the note, the longer the term of the note, the more exposed the holder is to interest rate increases and the greater the discount on the note [or the higher the required interest rate to offset this risk]); (6) comparable market yields (the yields from various types of financial instruments may be considered, the most comparable debt instrument is used and adjustments are made for specific risk differences from the comparable instrument, there may be few comparables for private transaction notes); (7) payment history (if payments are current and are made timely, especially if there is a lengthy history of timely payments, the risk for the lender is lower [and the discount is lower]); and (8) the size of the note (there are conflicting impacts, on one hand the borrower may have more ability to repay smaller notes, on the other hand small notes are note as likely to be from larger companies with excellent financials and the universe of potential buyers of small notes is very limited; smaller notes may call for higher discounts).

Technical Advice Memorandum 9240003[250] valued a note for estate tax purposes. The note from the decedent's nephew had a face amount of $215,000 and was cancelled in the decedent's will. The TAM concluded that the note was worth significantly less than face value because of its uncollectability (and also determined that the cancellation did not result in taxable income to the nephew because the cancellation was in the nature of a gift). Upon a showing of appropriate circumstances, it is clear that notes can be discounted for gift and estate tax purposes.[251]

Cases in various contexts have addressed factors that should be considered in valuing notes. Courts have applied substantial discounts to notes in a variety of estate tax cases.[252] For gift tax purposes, if gifts

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[250] TAM 9240003 (Oct. 2, 1992).

[251] *Id.* See Hoffmann, *supra* note 249, at1144-45 for general discussions of the valuation of promissory notes; M. Read Moore & D. Alan Hungate, *Valuation Discounts for Private Debt in Estate Administration*, 25 EST. PLAN. 195 (June 1998).

[252] Estate of Smith v. Comm'r, 923 F. Supp. 896 (S.D. Miss. 1996) (note from Fortune 500 company; 6% interest, annual principal payments of about 10% of face amount of note at date of death, court accepted estate appraiser's methodology which determined value of payments on discounted cash flow basis, starting with discount rate of 10.09% but adjusted to 16% rate to account for specific risk factors, and also applied 20% lack of marketability discount factor); Scher v. United States, 39 A.F.T.R 2d 77-1580 (D. N.J. 1976) (corporate notes were valued at face value at date of death although corporation may have been insolvent at that time; notes were not worthless merely because corporation was insolvent because corporation at that time had good credit reputation, was paying notes when presented, and potential lenders would not have checked the

are made of notes themselves, the I.R.S. has an incentive to reduce the amount of discount-to-face of the gift tax value of the notes. On the other hand, if assets are transferred in return for notes, the I.R.S. has an incentive to increase the discount-to-face of the notes and to treat the excess value transferred over the value of the notes as gifts. Discounts have been allowed in gift tax cases.[253] Note valuations can arise in a

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corporation's actual financial status); Estate of Hoffman v. Comm'r, 81 T.C.M. (CCH) 1588 (2001) (unsecured 7.61% promissory notes with balloon payment of all principal and interest 18 years after the date of death; I.R.S. and estate appraiser both used discounted cash flow approach to value the notes; difference was appropriate fair market value discount rate; court adopted I.R.S .appraiser's approach of using a 12.5% discount rate after considering interest rates associated with various debt instruments [the prime rate was 6% and Treasury yields ranged from 3 to 6%] and that borrower had enough assets to pay off notes at maturity, and that the 12.5% discount rate incorporated the nonmarketable nature of the notes); Estate of Luton v. Comm'r, 68 T.C.M. (CCH) 1044 (1994) (court valued decedent's 41.9% interest in a liquidating trust, the primary asset of which was an unsecured 10% promissory note payable over about 11 years from a company in good financial condition [having Roy Disney as one of its principal shareholders]; court rejected estate's argument for discounts due to comparison of bond yields of similar grade and for lack of control [because decedent could sue to compel trustee to sell the note its retention was impudent under state law]; court allowed 10% discount in valuing 41.9% interest in liquidating trust for lack of marketability); Estate of Friedberg v. Comm'r, 63 T.C.M. (CCH) 3080 (1992) (corporation redeemed shares of Rule 144 restricted stock from estate for a down payment and 5-year note bearing interest at the short-term rate under § 6621(b); I.R.S. willing to allow only 1% discount on note; court allowed 32% discount from face considering the rate of interest, payment schedule, financial covenants, reporting requirements, restriction that payments could not exceed 15% of the corporation's cash flow in any year, noteholder's possible remedies, corporation financial condition, yields on comparable securities, and nature of the secondary market for private notes); Estate of Berkman v. Comm'r, 38 T.C.M. (CCH) 183 (1979) (gift and estate tax valuation; unsecured 6% notes from family members had 20-year term, with balloon principal payment at end of 20-year term, borrowers made timely interest payments and were good credit risks; I.R.S. disallowed any discount from face; court allowed discount-to-face for estate tax purposes of 50-60% of various notes focusing on low rate of interest because prime rate was 9.75% at death and long term of notes; discount for gift tax purposes was lower [15%-25%] because prime rate was only 7% at the date of the gift); Sam Broadhead Trust v. Comm'r, 31 T.C.M. (CCH) 975 (1972) (no discount from face plus accrued interest because estate offered no evidence of lower value).

[253] Estate of Reynolds v. Comm'r, 55 T.C. 172 (1970) (units in voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years, interest-free except that 4% interest rate applied to late payments, $30,000 of payments were made on each of two of the notes and $27,000 of payments were made on the third note; court agreed with I.R.S. that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts; factors included interest-free nature of the note (until a payment default), large note amounts, ability of children to repay, fact of default on payments and that no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes); Estate of Berkman v. Comm'r, 38 T.C.M. (CCH) 183 (1979) (gift and estate tax valuation; unsecured 6% notes from family mem-

wide variety of contexts for income tax purposes, and various income tax cases have allowed substantial discounts.[254]

A recurring situation is of a taxpayer who makes a transfer in return for a note, claiming that the note equals the value of the asset transferred so that there is no gift. At the taxpayer's death, the estate takes the position that a discount-to-face should be applied in valuing the note for estate tax purposes. There can certainly be situations where interest rate changes or changes in the borrower's ability to repay may justify valuation differences, but the estate should expect the I.R.S. agent to be wary that the I.R.S. is being whipsawed in such situations. Indeed, the I.R.S. Estate Tax Examiner's Handbook advises agents that reporting a note from a related party at less than its face amount raises strong evidence that a gift was made at the date of the issuance of the note.[255]

B. Gift Tax Regulations and Section 7872

The general regulation for valuing notes for gift tax purposes states that the value is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date or maturity) or is uncollectible in whole or in part. The regulation provides,

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued inter-

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bers had 20-year term, with balloon principal payment at end of 20-year term, borrowers made timely interest payments and were good credit risks; I.R.S. disallowed any discount from face; court concluded that discount-to-face for gift tax purposes in three separate years was 15%-25%, lower than discounts of 50%-60% allowed for estate tax purposes, because prime rate was only 7% at the date of the gift and increased to 9.75% at the date of death).

[254] Olster v. Comm'r, 79 T.C. 456 (1982) (court determined that the notes were worthless when the I.R.S. attempted to value notes at face); Kronenberg v. Comm'r, 64 T.C. 428 (1967) (income tax case valuing note issued by a company in liquidation; note was interest-free, nonnegotiable, with no set date for repayment, and debtor had limited financial resources; court allowed 37.5% discount from face); Clayton v. Comm'r, 42 T.C.M. (CCH) 670 (1981) (80% discount on notes issued as low-interest second mortgages with terms of up to 30 years to facilitate purchase of homes by high-risk individuals who could not pay down payments and who had a history of being delinquent on payments; small balances on the notes meant that foreclosure proceedings were not economically feasible); Scott v. Comm'r, 38 T.C.M. (CCH) 115 (1979) (taxpayer valued note at 70% discount based on sale of similar note in arm's length transaction; court concluded taxpayer did not show sufficient similarity to the prior transaction and allowed 30% discount based on nonrecourse nature of note, subordinated status of lien, limited nature of security, subsequent default of maker, and timely receipt of interest payments).

[255] INTERNAL REVENUE MANUAL ch. 800, § 842.

> est, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it.[256]

Section 7872 provides rules for determining the amount of gifts incurred by making below-market loans. The gift amount is the amount of the forgone interest.[257] The statute does not address other factors that may impact the value of the notes—it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. The statute does not address the gift tax implications of a note that has an interest rate that is equal to or greater than the AFR. However, the clear implication of § 7872 is that a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Indeed, the I.R.S. took that position in *Frazee v. Commissioner*,[258] and has consistently applied that same position in subsequent private letter rulings.[259]

Even following the adoption of § 7872, the value of notes apparently can be discounted because of factors stated in the general estate tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with § 7872 that purport to override the general gift tax valuation principles for notes under Treasury Regulation Section 25.2512-4. Proposed Regulation Section 25.7872-1, which addresses the gift tax implications of below market loans under § 7872, makes no reference to discounting the value of loans for reasons other than comparison of the interest rate on the note to the AFR.[260] Proposed regulations under § 2512, issued in conjunction with proposed regulations issued under § 7872, simply make reference to § 7872: "See Section 25.7872-1 for special rules in the case of gift loans (within the meaning of Section 1.7872-4(b)) made after June 6, 1984."[261]

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[256] Treas. Reg. § 25.2512-4.

[257] I.R.C. § 7872(e)(2).

[258] 98 T.C. 554 (1992). *See also* Estate of True v. Comm'r, 82 T.C.M. (CCH) 27 (2001) (§ 7872 applied to determine gift tax consequences of purchase under a buy-sell agreement providing for a deferred payment), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004).

[259] *E.g.*, PLR 9535026 (Sept. 1, 1995); PLR 9408018 (Feb. 25, 1994). *See also* Estate of True v. Comm'r, 82 T.C.M. (CCH) 27 (2001), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). See *infra* Part XI.A for a more detailed discussion of *Frazee*, *Estate of True*, and those letter rulings.

[260] Prop. Treas. Reg. § 25-7871-1.

[261] Prop. Treas. Reg. § 25.2512-4.

The preamble to those proposed gift tax regulations simply states that "Proposed Section 25.7872-1 implements section 7872(a) by providing that the amount transferred by the lender to the borrower and characterized as a gift is subject to the gift tax provisions." Keep in mind that a "gift loan" is a below-market loan where the forgone interest is in the nature of a gift.[262] Therefore, a loan that bears adequate interest and that is therefore not a below-market loan, by definition is not a "gift loan." Therefore, even the brief reference in gift tax proposed regulations issued in conjunction with the proposed regulations under § 7872 would not apply to loans that bear interest at a rate equal to the applicable AFR or greater.

C. Estate Tax Regulations and Section 7872

The general estate tax regulation regarding the valuation of notes is very similar to the gift tax regulation quoted above, and provides that the estate tax value is the amount of unpaid principal plus interest accrued to the date of death, unless the executor establishes that the value is lower by satisfactory evidence that the note is worth less than the unpaid amount (e.g., because of the interest rate or the date of maturity) or that the note is uncollectible by reason of insolvency of the maker and because property pledged as security is insufficient to satisfy the obligation.[263]

If economic conditions change from the time the note was given and interest rates generally rise by the time of the holder's death, the value of the note may be discounted—based on the changed conditions—as provided in the estate tax regulations. A particularly interesting issue is whether a note providing for interest at the AFR can be discounted for estate tax purposes merely because interest at the AFR is below what the market would charge for a similar note, even if interest rates have not generally increased from the time the note was given to the date of the holder's death. We know that § 7872 provides an artificially low interest rate—the rate at which the United States government can borrow. Stated differently, if the estate were to try to sell the note, with an interest rate at the AFR, a hypothetical willing buyer would not pay full face value because the AFR is based on the safest of debt instruments—one from the U.S. government. Can the estate tax valuation reflect that reality?[264] The Tax Court in *Estate of Duncan v. Commis-*

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[262] *See* I.R.C. § 7872(c)(1)(A).

[263] Treas. Reg. § 20.2031-4.

[264] *See* Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?* 32 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 1507.1 (1998).

sioner[265] observed that under fiduciary principles, an irrevocable trust would be questioned for loaning money to another trust (even having the same trustee and beneficiaries) if the interest rate were not greater than the AFR, because the AFR is based on the yield on U.S. government obligations.[266]

While § 7872 addresses gift issues, and subsequent authority recognizes that notes with interest at the AFR will not be discounted merely for gift tax purposes because of the interest rate, there is no such similar certainty for estate tax purposes. As discussed below, however, a proposed regulation under § 7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed.[267] However, that regulation has never been finalized.

Does that mean that the note can be discounted for estate tax purposes because there are no regulations on point for estate tax purposes? Because there is no coordinating regulation some attorneys take the position that general valuation principles should be applicable, and it may be possible to discount the note for estate tax purposes if the note uses the AFR as the interest rate. *Be aware, however*, the I.R.S. estate tax agent may feel that taking a discount for this reason alone is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the sale or loan transaction. One appraiser reports an example of having appraised a note for estate tax purposes at about half the outstanding balance of the note—and having the value accepted in the estate tax audit.[268]

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[265] 102 T.C.M. (CCH) 421 (2011).

[266] *Duncan* involved whether interest paid on a "Graegin loan" could be deducted as an administrative expense for estate tax purposes. An irrevocable trust created by the decedent's father loaned $6.5 million to the decedent's revocable trust in order to pay estate taxes. The $10.7 million of interest that was due on the loan at the end of 15 years was deducted. Among other things, the I.R.S. argued that the 6.7% interest rate under the note exceeded the long-term AFR of 5.02% and was unreasonable. The court disagreed, stating that a note from the revocable trust is obviously a riskier investment than a government obligation and therefore a higher interest rate than the AFR is justified. Indeed, the court said that using the AFR "would have been unfair to the Walter Trust." *Id*. at 425.

[267] Prop. Treas. Reg. § 20.7872-1.

[268] Lance S. Hall, *The FMV Solution*, FMV Opinions, Inc. (Sept. 15, 2009), http://www.fmv.com. In the situation described, FMV Opinions, Inc. applied a discount rate based upon required rates of return for highly rated publicly traded debt issued by REITs, adjusted for the substantial differences between the note and the public debt. Specifically, while the trust was well capitalized as of the date of death, the note was unsecured and lacked protective covenants. Additionally, both the note and the underlying assets of the trust were not readily marketable.

Section 7872 specifically authorizes the issuance of regulations addressing the valuation of notes in light of § 7872. Section 7872(i)(2) states that "[u]nder regulations prescribed by the Secretary, any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans.]" Commentators observe that regardless of what Congress meant, it merely authorized regulations (final regulations have never been issued) "and did not write a self-executing rule."[269]

The I.R.S. has issued a proposed regulation for estate tax purposes that directly addresses the estate tax value of a "gift term loan" following the issuance of § 7872 and that may even address the value of notes having adequate interest. The proposed regulation conceivably purports to say that the value of the note could not be discounted for estate tax purposes except to make adjustments where the stated interest rate under the note is lower than the AFR in effect at the date of death or where the facts impacting the collectability of the note have changed "significantly since the time the loan was made."[270] In this regard, the proposed regulation may impose a stricter standard for discounting notes for estate tax purposes because of uncollectability issues than the standards described in the general estate tax regulation for valuing notes, which do not impose the requirement of a "significant" change. Proposed Regulation Section 20.7872-1 provides,

> For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan (within the meaning of Section 1.7872-4(b)) that is made after June 6, 1984, shall be valued at the lesser of:
>
> (a) The unpaid stated principal, plus accrued interest; or
>
> (b) The sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.
>
> No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectability of the loan have changed significantly since the time the loan was made. This section applies with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement, and *regardless of whether that*

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[269] Ronald D. Aucutt, *Installment Sales to Grantor Trusts*, ALI CLE Planning Techniques for Large Estates 615, 677 (2013).

[270] Michael D. Mulligan, *Fifteen Years of Sales to IDITs – Where are We Now?* 35 ACTEC J. 227 (2009).

> *interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made.*[271]

The proposed regulation says that it applies to valuing a "gift term loan," which would be a below market loan (with interest less than the relevant AFR). However, the last sentence says that it applies to any term loan made with donative intent *even if the interest rate exceeds the AFR* on the day the loan was made. Query, does the "with donative intent" phrase simply mean that the loan was not a compensation related loan or corporation-shareholder loan as referenced in § 7872(c)(1)(B-C), or does it refer to a loan that was intended as a gift even though it had an interest rate higher than the relevant AFR? Arguably, the note given in a sale transaction does not reflect a loan "with donative intent." In any event, this regulation has never been finalized.

What is the effect of proposed regulations? The I.R.S. may support a position by reference to proposed regulations but insists that they cannot be relied on to support a position that contradicts a position being taken by the I.R.S.[272] Courts view proposed regulations as merely a source of "informed judgment" and accord them "no more weight than a litigant's position."[273] However, courts may follow proposed regulations if neither the taxpayer nor the I.R.S. challenges their validity.[274]

D. Valuation of Notes in Entity

If the note is in an entity that is valued on an asset-value basis, the note may be discounted, and the decedent's interest in the entity may subsequently be discounted as well for lack of control or lack of marketability. However, the I.R.S. may raise objections if a note is contributed to an LLC or partnership for the sole purpose of achieving an additional "wrapper" discount. For example, if an asset is sold to a grantor trust in return for an installment note, and the if the note is contributed to an LLC and the LLC interest is given to another grantor trust with the same beneficiaries, the I.R.S. may raise objections if a substantial valuation discount is claimed on the value of the LLC interest that contains the note as its sole asset.

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[271] Prop. Treas. Reg. § 20.7872-1 (emphasis added).

[272] *See* Sheldon I. Banoff & Burton W. Kanter, *What is the Legal Effect of Proposed Regs.*? 69 J. TAX'N 279 (Oct. 1988).

[273] KTA-Tator Inc. v. Comm'r, 108 T.C. 100 (1997).

[274] Gary Rozenshteyn, *Below-Market Loans Offer Tax Arbitrage Potential*, 64 PRAC. TAX. STRAT. 260, 261 (May 2000); *See* Arens v. Comm'r, 59 T.C.M. (CCH) 589 (1990).

E. Income Tax Impact of Discounting Note Values

In deciding whether to take the position that a note is discounted for income tax purposes, the planner must realize that while the discount may result in estate tax savings, there may be adverse income tax implications attributable to that discount as payments are later received on the note. If an individual inherits a note (other than an installment sale note) that is valued below face, and if the individual receives payments on the note exceeding the discounted value of the note, the excess is treated as ordinary income.[275] Sections 1271-1275 deal with OID by requiring the debt holder to take the discount into income as ordinary income, not as capital gain.[276] In addition, the debt holder may be required to accrue the discount over his holding period without regard to his usual method of accounting. If there is no sale or exchange of the note, there would be no capital gain element of the income recognition. An example in a respected treatise illustrates this phenomenon:

> *EXAMPLE: Mom lends Son $1,000,000 at the then AFR of 7%. When she dies, the value of the note is $750,000, for whatever reason, even though $1,000,000 is still outstanding. If the note's value for estate tax purposes is $750,000, then when the $1,000,000 is paid, the recipient will have ordinary income of $250,000. If the note is distributed to Son, he will have cancellation of indebtedness income of $250,000 on the distribution.*[277]

The result should be different if an individual receives the note by gift. Under the dual basis rules of § 1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note up to the time of the gift would not result in a decreased basis for purposes of determining later gain on the note. If the note is an installment sale note, special rules apply if the note is satisfied at less than face value, if there is a disposition or cancellation of the note, or if related parties dispose of property purchased with the installment note within two years of the sale.[278]

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[275] I.R.C. §§ 1271(a)(1)(retirement of debt instrument treated as exchange), 1276(a)(1)(gain on disposition treated as ordinary income up to the accrued market discount), 1276(a)(2)(partial principal payments treated as ordinary income to the extent the payment does not exceed accrued market discount).

[276] *E.g.,* Treas. Reg. §1.1275-1(b)(3) (treatment of market discount for calculating OID accruals).

[277] HENKEL, *supra* note 61, ¶ 28.06[2].

[278] I.R.C. §§ 453(e)(1), 453B(a). *See generally* HENKEL, *supra* note 61, at Ch.30. *See infra* Part XI.C.3.

IX. Effect of Waiver, Cancellation or Forgiveness of Note Liability

A. No Discharge of Indebtedness Income for Promissory Notes

If the forgiveness or cancellation of the loan (other than an installment sale note) is in the nature of a gift, there is no discharge of indebtedness income, because § 102 excludes from the definition of gross income any amount received as a gift or bequest, and this overrides § 61(a).[279] The forgiveness of a family loan is typically intended as a gift. Section 108 contains special rules regarding discharge of indebtedness income. The Senate Finance Report accompanying the passage of § 108 specifically states that "debt discharge that is only a medium for some other form of payment, such as gift or salary, is treated as that form of payment rather than under the debt discharge rules."[280]

If the borrower is insolvent when the loan is forgiven with no further prospect of being able to repay the loan, the forgiveness may not be a gift but just a reflection of economic reality. There should be no discharge of indebtedness income if the forgiveness occurs in a bankruptcy case or when the obligor is insolvent.[281] In that circumstance, the lender may be able to take a bad debt deduction for the year in which the loan becomes worthless.[282] If the loan was made in the ordinary course of the lender's trade or business, it may result in a business bad debt deduction, which results in ordinary losses.[283] Much more common, in the intra-family loan context, is that the loan is a non-business debt, which results in short term capital loss.[284] However, special scrutiny applies to

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279 I.R.C. § 102(a). *See* Helvering v. Am. Dental, 318 U.S. 322 (1943) (interpreting predecessors to §§ 61 and 102); Bosse v. Comm'r, 29 T.C.M. (CCH) 1772 (1970) (deciding that § 102 applied because forgiveness was gratuitous).

280 Warren J. Rohrbach, *The Disposition of Property Secured by Recourse and Nonrecourse Debt,* 41 Baylor L. Rev. 231, 253 (1989).

281 I.R.C. § 108(a)(1). Section 108(a)(1)(B) provides various exceptions in which discharge of indebtedness does not result in taxable income, including if the discharge occurs in a Title 11 bankruptcy case or when the taxpayer is insolvent. See *Cancelled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*, I.R.S. Pub. 4681 (Jan. 15, 2013) for a general discussion of the tax effects of canceled debts for individuals.

282 Henkel, *supra* note 61, ¶ 28.05[2][b]. Courts have interpreted the wholly worthless requirement strictly in the intra-family context. *See*, *e.g.*, Buchanan v. United States, 87 F.3d 197 (7th Cir. 1996).

283 I.R.C. § 166(d).

284 I.R.C. § 166(d)(1) (providing the deduction can be taken only in the year the debt becomes totally worthless and suggesting that the lender will need to establish the worthlessness of the debt, perhaps by proving that the borrower is insolvent or that the lender attempted to collect on the debt with demand for repayment which was not forthcoming); *see also* I.R.C. § 6511(d)(1) (providing that there is a special 7 year statute of limitations

intra-family loans, and unless the lender can overcome the presumption that the loan was a gift when made,[285] no bad debt deduction is allowed.

Another exception is that discharge of indebtedness income up to $2 million of mortgage debt on the taxpayer's principal residence before 2014 is excluded from gross income. This applies to the restructuring of debt, foreclosure of a principal residence, or short sale of a principal residence in which the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance.[286]

If a parent loaned cash to a non-grantor trust for the parent's children and the trust becomes insolvent, the parent should be able to cancel the note and avoid discharge of indebtedness income by the trust under § 108(a)(1)(B) even without taking the position that the cancellation is a gift. Indeed, arguably the cancellation is not a gift because the note is worthless in any event. (However, if the note arose as a result of an installment sale, there are special rules that apply when installment sale notes are cancelled,[287] as discussed in Part XI.C.2, *infra*.)

Through 2012, a homeowner may exclude from income up to $2 million ($1 million if married filing separately) of debt incurred to buy, build or substantially improve his or her principal residence, which debt is reduced by mortgage restructuring or by forgiveness in connection with a foreclosure.[288] However, if the home mortgage arose by a loan from a family member, it is likely that the forgiveness results from a gift, in which event the full amount of debt forgiveness (even exceeding $2 million) would be excluded from income. However, a family member may in the appropriate situation take the position that the restructuring is not a gift but is in light of economic realities, and that even though the borrower may not qualify for the insolvency exception, the debt relief does not result in taxable income to the borrower.

For a grantor trust, a note from the grantor trust to the grantor (in return for a cash loan of a sale of assets) can be forgiven by the grantor

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for refunds due to non-business bad debt losses because of the difficulty in pinpointing the year in which the debt becomes totally worthless).

[285] *See supra* Part I.B.

[286] This exception was added in the Mortgage Forgiveness Debt Relief Act of 2007, and was extended for one year (2013) by the American Taxpayer Relief Act of 2012. I.R.C. §§ 108(a)(1)(E), 108(h)(2). The debt must have been used to buy, build or substantially improve the principal residence and be secured by that residence. There is no suggestion that the exception cannot apply to home mortgage loans between related parties.

[287] I.R.C. § 453B(a).

[288] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007) (amending I.R.C. § 108 to include I.R.C. § 108(a)(1)(E) allowing relief for cancellation of "'qualified principal residence indebtedness' [that] is discharged before January 1, 2013.").

without causing discharge of taxable income because the debt is treated as owned by the grantor for income tax purposes (i.e., a loan from the grantor to the grantor).[289] That is most helpful because the exception for insolvent taxpayers under § 108(a)(1)(B) would not apply even if the grantor trust is insolvent unless the grantor was also insolvent under proposed regulations. Proposed regulations provide that grantor trusts and disregarded entities will not be considered the "taxpayer" under § 108, but the grantor trust or entity owner is treated as the taxpayer.[290] Therefore, the § 108 exceptions are available for grantor trusts and disregarded entities only to the extent that the owner is insolvent or undergoing bankruptcy.

There are special rules governing the cancellation or forgiveness of an installment sales note, designed to prevent a seller from being able to avoid income recognition from the initial sale.[291]

B. Possibility of Avoiding Having to Recognize Unpaid Interest Income Upon Loan Forgiveness

Even though there is not discharge of indebtedness income on the forgiveness of a loan, that does not necessarily address whether the lender must recognize accrued but unpaid interest as taxable income. Section 7872 addresses the income and gift tax implications of below-market loans, but § 7872(i)(1)(A) specifically authorizes the issuance of regulations to provide that adjustments will be made to the extent necessary to carry out the purposes of § 7872 if there are waivers of interest.

The proposed regulations to § 7872 discuss the effect of forgiving interest payments.[292] While § 7872 generally applies to below-market loans, the proposed regulation appears to apply to loans with adequate interest and that are not below-market loans. (The regulation states that it applies to loans with stated interest that initially would have been subject to § 7872 had they been made without interest.)[293] The somewhat strangely worded regulation operates by negative implication. It says that a waiver of interest payments will be treated as if interest had been paid to the lender (requiring the lender to realize interest income) and then retransferred by the lender to the borrower (as a gift where the forgiveness is in the nature of a gift) *but only if* three conditions are satisfied:

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[289] Rev. Rul. 85-13, 1985-1 C.B. 184.

[290] Prop. Treas. Reg. § 1.108-9.

[291] I.R.C. § 453B(a). *See also infra* Part XI.C.2.

[292] Prop. Treas. Reg. § 1.7872-11(a).

[293] *Id.*

> (1) the loan initially would have been subject to section7872 had if been made without interest;
> (2) the waiver, cancellation or forgiveness does not include in substantial part the loan principal; and
> (3) a principal purpose of the waiver, cancellation, or forgiveness is to confer a benefit on the borrower, such as to pay compensation or make a gift, a capital contribution, a distribution of money under section 301, or a similar payment to the borrower.[294]

If a family loan is forgiven as a gift, the first and third requirements are satisfied. Therefore all three requirements will be satisfied (and the waived interest will have to be recognized as income by the lender) *only if* "the waiver, cancellation or forgiveness does not include in substantial part the loan principal." Stated a different way, this proposed regulation indicates that the lender will not be treated as having received interest that is forgiven if the forgiveness includes not only interest on the loan but also "in substantial part the loan principal." One respected commentator reasons that forgiveness of principal and accrued interest will be treated the same as if the principal had been forgiven before the interest accrued, so that no interest income will be recognized by the lender:

> Forgiveness of all principal and accrued interest has an economic consequence similar to an outright payment or forgiveness made before the interest accrued, and the authors of the proposed regulations apparently decided that taxpayers should neither be penalized nor given the opportunity to increase interest deductions when they execute a forgiveness later rather than sooner.[295]

There are various limitations and uncertainties regarding the ability to avoid having to recognize accrued but unpaid interest by forgiving the interest. (1) Because stated interest that is not paid in a year generally must be recognized each year under the OID rules,[296] it may be only the current year's accrued interest that can avoid recognition under this forgiveness approach, because accrued interest from prior years may have already been recognized as taxable income. (2) There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the

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[294] *Id.* (emphasis added).

[295] Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 55.2.3, at 58-49 (2d ed. 2006). Interestingly, the third edition of this treatise does not include that helpful discussion.

[296] *See supra* Part V.B.

forgiveness includes "*in substantial part* the loan principal."[297] For example, if the accrued interest for the year is $30,000 on a $1 million outstanding loan, can the forgiveness be for $60,000, forgiving $30,000 of principal and the $30,000 of accrued interest? Does "substantial part" mean that the forgiveness of principal is only about 25% or more of the total forgiveness? Many would say that 25% of something is a "substantial part" of that thing. Or is 50% or more required for this purpose? Or does the forgiveness have to include a substantial part of the outstanding principal on the loan (such as 25% of the full $1 million loan amount)? The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the loan principal. (3) This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades appears to provide comfort in taking the position that the forgiveness of accrued interest in that manner can avoid ever having to recognize that accrued interest as income. Proposed regulations are considered in determining whether there is "substantial authority" for purposes of avoiding taxpayer or preparer penalties.[298] (4) If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer.[299] Indeed, an I.R.S. response to a letter from a practitioner suggests that having a plan to forgive the interest in each year may result in recasting the transaction as an interest-free loan under the

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[297] Prop Treas. Reg. § 1.7872-11(a).

[298] Treas. Reg. § 1.6662-4(d)(3)(iii) (listing types of authority considered in determining whether substantial authority exists for avoiding taxpayer penalty); Treas. Reg. § 1.6694-2(b)(1), -2(d)(2) (incorporating standards under § 6662 regulations for determining whether substantial authority or reasonable basis standard is met to avoid preparer penalties).

[299] Miller v. Comm'r , 71 T.C.M. (CCH) 1674 (1996). The factors listed in *Miller v. Commissioner* include (1) whether interest was charged, (2) whether a demand for repayment was made, and (3) whether any actual repayment was made. Consistently forgiving all interest payment would seem inconsistent with those factors. *See supra* Part I.B (discussing *Miller* and the other cases addressing whether the note is treated as debt or equity).

§ 7872 rules, which would seem to mean that the imputed forgone interest would be recognized each year.[300]

X. Loans to Grantor Trusts and Corollary Issues Regarding Loans to Individuals

Loans may be made to individuals; alternatively loans may be made to grantor trusts. Many of the advantages of sale transactions to grantor trusts could also be achieved with loans to grantor trusts. (The grantor would pay income tax on the trust income, GST exemption can be allocated to the trust, etc.) Special considerations for loans made to grantor trusts are addressed.

A. Does Demand Loan to Trust Cause Grantor Trust Treatment?

Several cases have upheld arguments by the I.R.S. that the grantor's ability to demand repayment at any time of a demand note from the trust causes the trust to be treated as a grantor trust under § 674(a) of the Code, at least where the loan constituted the entire trust corpus.[301] The cases arose before the Supreme Court's decision in *Dickman*,[302] and before the passage of § 7872, when interest-free loans were often used as an income shifting and wealth transfer strategy. As a separate taxpayer, the trust may have owed a very low income tax rate (the facts arose before the compressed income tax rates were applied to trusts).

Section 674(a) provides the general rule that the grantor is

> treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

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300 I.R.S. Field Service Advice 087777 (June 24, 1991) (response of I.R.S. Regional Technical Coordinator responding to submission from practitioner requesting amendment or clarification of § 7872):

> The legislative history of section 7872 reveals that the conferees recognized that a term loan with deferred interest at a rate equal to or greater than the AFR, and a related gift to defray all or part of the interest payable on the loan, may be the economic equivalent of an interest-free loan with a principal amount equal to the sum of the actual stated amount of the loan and the amount of the gift. The conferees anticipated that under regulations, such a transaction would be treated in accordance with its economic substance.

(citing H.R. Rep. No. 98-861 (1984), *reprinted in* U.S.C.C.A.N. 1445).

301 *See*, *e.g.*, Wysong v. Comm'r, 55 T.C.M. (CCH) 1456 (1988).

302 465 U.S. 330 (1984).

The cases conclude that the grantor's power to demand repayment of the trust assets to repay the demand loan constitutes "an independent power of disposition over the beneficial enjoyment of the corpus or income."[303]

In *Kushner v. Commissioner*,[304] the grantor initially gave $100 to a trust for his children and a month later loaned $100,000 to the trust in return for a demand note. The loan was repaid a year later, and a new $150,000 loan was extended on a demand note. The trust earned interest income over $16,000 in each of 1982 and 1983. The I.R.S. argued that the grantor should have reported the interest income under the grantor trust rules. The Tax Court concluded,

> . . . petitioner's ability to demand payment of the loans enabled him to maintain direct dominion and control over the beneficial enjoyment of the trust's corpus. Thus, petition is to be treated as owner of the trust to the extent of the amounts which he loaned to the trust.[305]

There are no reported cases in which the I.R.S. has made this argument following the adoption of § 7872, which removed the income tax advantages of interest-free demand loans.

B. Ability of Trust to Repay Loan

For sales to grantor trusts, the common "folklore" is that the trust should end up with equity value of about 10% after the sale (meaning that the note value would not exceed 9 times the equity value of the trust). There is no statue, regulation, or case law imposing that requirement, but the general theory is that the trust must have some net equity value to support that the note is worth its face amount. (Otherwise, any decline at all in the trust assets would leave the trust in a position that it could not pay the note in full.) The same rationale would seem to apply to loans to trusts. If a parent loans $1 million cash to a trust that has an equity value of $10, the I.R.S. might be expected to take the position that the note is not worth $1 million, and that the transaction results in a gift (and opens the possibility of an argument that § 2036 applies to cause inclusion of the trust assets in the parent's estate at his or her death). A possible counterargument is that there is no necessity of having a minimum trust amount in several situations sanctioned by regula-

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303 McGinnis v. Comm'r, 65 T.C.M. (CCH) 1870 (1993).

304 91 T.C.M. (CCH) 98 (1991), *aff'd,* 955 F.2d 41 (4th Cir. 1992).

305 *Id*. at 100. *See also McGinnis*, 65 T.C.M. (CCH) 1870; Wysong v. Comm'r, 55 T.C.M. (CCH) 1456 (1988); Batson v. Comm'r, 46 T.C.M. (CCH) 1301 (1983).

tions where the trust will owe annuity payments to the grantor, such as a grantor retained annuity trust or charitable lead annuity trust.[306]

Cases addressing whether assets transferred to a trust in return for a private annuity are included in the transferor's estate under § 2036 as a transfer with a retained interest have pointed to various factors, including: (i) annuity payments were limited to or substantially equal to the income generated by the assets; (ii) the obligor's personal liability for the annuity payments is in some manner limited to the income generated by the assets; (iii) the obligor lacks the economic means from which to make annuity payments other than the income generated by the assets; and (iv) the annuitant maintains managerial control over the assets.[307] Items (i)-(iii) of that list all relate to whether there are assets in the trust other than just the assets transferred in return for the private annuity.[308] Conservative planners structure transactions for parents to make gifts to trusts and build equity value in trusts in other ways to support the value of notes that the trusts gives for subsequent cash loans or sales to the trust.[309]

C. Necessity That Individual Borrowers Have Financial Ability to Repay

A corollary question to a requirement that a trust has "seeding" to support a loan is whether the same approach should apply to cash loans and to individuals. Should the individuals have sufficient net worth to have the ability to repay the loans? The ability to repay loans is not a factor under § 7872 in determining the amount of gift that occurs by reason of making a below-market loan, and the proposed regulation under § 7872 addressing the gift tax implications of below-market loans

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306 Treas. Reg. § 25.2702-3 (providing GRATs have no limitation on needing minimum equity amount in trust above present value of annuity payments); Treas. Reg. § 20.2055-2(f)(2)(iv) (providing that in the case of a testamentary CLAT, where actuarial value of annuity payments to charity exceeded the amount transferred to trust, the charitable deduction was the full value contributed to the trust and there was no taxable value of the remainder).

307 Zaritsky & Aucutt, *supra* note 62, § 12.05[3][a][i].

308 However, some cases have held that § 2036 did not apply even though the trust that paid for assets with a private annuity was minimally funded. *E.g.*, Stern v. Comm'r, 747 F.2d 555 (9th Cir. 1984) (even though trust was minimally funded, there was no direct tie-in between trust income and annuity payment and annuitant had limited powers over trust). See Jerome M. Hesch & Elliot Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales,* 34 U. Miami Heckerling Inst. on Est. Plan. ¶ 1601.1 n.55 (2000) for cases referring to the requirement of a direct connection to paying the annuity from trust income [hereinafter Hesch & Manning, *Beyond the Basic Freeze*].

309 Hesch & Manning, *Beyond the Basic Freeze*, ¶ 1601.1G ("[O]nly those who are willing to take substantial risks should use a trust with no other significant assets [for sales transactions with a trust].").

makes no reference to any factors other than comparison to the interest rate on the note to the AFR.[310] The ability to repay loans is a factor that is considered in whether the transaction is respected as resulting in debt rather than an equity transfer.[311] In addition, there have been cases that determined that gifts occurred when sales were made to individuals for notes where, among other factors, the individuals did not have the ability to repay the notes.[312] Some of the cases involving transfers to individuals in return for private annuities have also applied § 2036 where the individual had no ability to make the annuity payments other than with the transferred assets.[313] Interestingly, the private annuity cases involving transfers to *individuals* in return for private annuities have not focused so closely on the net value of the individuals as compared to private annuity transactions involving trusts.[314] However, there have been some cases that have not respected transfers for private annuities promised by individuals where the individuals did not have the financial wherewithal to pay the annuity.[315] For example, in *Hurford v. Commissioner*,[316] a mother transferred all of the limited partnership interests of a partnership to two of her children in return for private annuities from the two children. The court held that § 2036(a)(1) applied for various reasons, including that the children had no ability to make the annuity payments other than from the assets in the partnership.[317]

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[310] Prop. Treas. Reg. § 25.7872-1.

[311] *E.g.* Miller v. Comm'r, 71 T.C.M. (CCH) 1674 (1996). *See supra* Part I.B.

[312] *E.g.*, Estate of Reynolds v. Comm'r, 55 T.C. 172 (1970) (units in voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years, interest-free except that 4% interest rate applied to late payments; $30,000 of payments were made on each of two of the notes and $27,000 of payments were made on the third note; court agreed with I.R.S. that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts; factors included interest-free nature of the note (until a payment default), large note amounts, ability of children to repay, fact of default on payments and that no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes).

[313] *See, e.g.*, Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006).

[314] *See, e.g. Miller*, 71 T.C.M. (CCH) 1674.

[315] *E.g.,* Estate of Mitchell v. Comm'r, 43 T.C.M. (CCH) 1034 (1982) (determining § 2036 applied where children had no financial ability to make annuity payments and never intended to make annuity payments).

[316] 96 T.C.M. (CCH) 422 (1998).

[317] *Id.* The court pointed to other factors as well, including that the mother continued to exercise managerial control over the partnership and its assets after the transfer to the children. In addition, while the assets were transferred to two of her children, there was an understanding they would share benefits of the assets with a third child. The Court also applied I.R.C. §§ 2036(a)(2), 2038.

D. Non-Recourse Loans to Individuals

A further corollary issue is whether non-recourse loans can be made to individuals, secured only by what the individuals buy with the loan proceeds. Economically, this is no different than a recourse loan to a trust whose only assets are assets that the trust acquires with the loan proceeds. If the general thinking is that trusts should have adequate "coverage" (the rule of thumb is 10% coverage) for sales or loans, does that mean that nonrecourse loans to individuals would not be respected as having full value? Interestingly, § 1274 addresses the effects of non-recourse loans.[318] (Various tax shelter arrangements previously involved "flipping" properties acquired with nonrecourse indebtedness in excess of the fair market value of the property. Section 1274(b)(3) provides that where nonrecourse debt is used, the "issue price" for purposes of determining the amount of OID cannot exceed the value of the property transferred in return for the nonrecourse note.) However, § 7872 does not address nonrecourse loans. Furthermore the cases addressing whether loan transactions are recognized as debt or equity transactions do not specifically address nonrecourse loans as a factor in that analysis, but they do include the borrower's ability to repay the loan as a factor, which would seem to suggest that having a nonrecourse loan would be a negative factor in the debt-equity analysis.[319] Some cases have discounted the value of notes, in part because of the nonrecourse nature of the notes.[320]

E. Guaranties

A variety of commentators have addressed the impact of guaranties of notes in sale to grantor trust situations.[321] Arguments can be made that the a guaranty by a trust beneficiary of the trust's note should not be a gift, but merely represents the beneficiary's effort to protect his or her interest in the trust.[322] However, there is uncertainty as to whether a beneficiary's guaranty of the trust's note in a sale context constitutes some kind of gratuitous transfer to the trust by the guarantor, and many

[318] I.R.C. § 1274(b)(3).

[319] *See*, *e.g.*, Miller v. Comm'r, 71 T.C.M. (CCH) 1674 (1996). *See supra* Part I.B.

[320] *E.g.,* Scott v. Comm'r, 38 T.C.M. (CCH) 115 (1979) (taxpayer valued note at 70% discount based on sale of similar note in arm's length transaction; court concluded taxpayer did not show sufficient similarity to the prior transaction and for income tax purposes; allowed 30% discount based on nonrecourse nature of note, subordinated status of lien, limited nature of security, subsequent default of maker, and timely receipt of interest payments).

[321] *See infra* Part XII.A.1 (providing a detailed discussion of the effect of guaranties in sale-to-grantor-trust transactions).

[322] *See* Milford B. Hatcher & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000).

planners structure sale to grantor trust transactions so that the trust pays market value for any guaranties of the trust's obligations.

There does not seem to be any difference in the analysis for loan transactions with trusts as opposed to sale transactions with trusts. Indeed, PLR 9113009,[323] the I.R.S. letter ruling that initially raised concerns about the gift tax effects of loan guaranties, addressed the guaranty of *loans* (as opposed to sale notes) made by the guarantor's children. While PLR 9113009 was withdrawn by PLR 9409018,[324] which addressed only other issues requested in the original ruling request without mention of gift tax issues, the earlier ruling nevertheless provides the I.R.S.'s analysis of why gift guaranties may include gift elements. The I.R.S. reasoned generally that the guaranty confers an economic benefit from the date it is given and the promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made.[325] Cautious planners will treat the use of guaranties as a way of providing "coverage" for loans transactions the same as in sale transactions. For a discussion of further issues involving the use of guaranties, such as whether

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323 *See* PLR 9113009 (Mar. 29, 1991).

324 *See* PLR 9409018 (Mar. 4, 1994).

325 The I.R.S.'s full analysis of this issue in PLR 9113009 is as follows:

> The gift tax was designed to encompass all transfers of property and property rights having significant value. The transfer of a valuable economic right or benefit is a property interest that is subject to the gift tax. The valuable economic right is generally readily measurable by reference to current interest rates. *See* Dickman v. Commissioner, 465 U.S. 330 (1984). The term "gifts" was meant to be used in its broadest and most comprehensive sense in order to ". . . hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech." Comm'r v. Wemyss, 324 U.S. 303, 306 (1945). The agreements by T to guarantee payment of debts are valuable economic benefits conferred upon the shareholders of the acquiring companies and entities. You state that, without those guarantees, those shareholders (T's children) may not have obtained the loans or, in the very least, would have had to pay a higher interest rate to obtain the loans. Consequently, when T guaranteed payment of the loans, T transferred a valuable property interest to the shareholders. The promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made. *See* Rev. Rul. 84-25, 1984-1 C.B. 191. Accordingly, the enforceable agreements by T to guarantee the loans on behalf of the shareholders are transfers (subject to gift tax) of the economic benefit conferred upon the shareholders on the dates they are entered into by T. Likewise, in the event that the primary obligors subsequently default on the loans and T pays any outstanding obligation under the terms of the agreements, any amounts paid by T, less any reimbursement from the primary obligors, will be gifts subject to the gift tax.

a fee must be paid for the guaranty and how to determine an appropriate amount to pay for the guaranty,[326] see Part XII.A.1, *infra*.

XI. Intra-Family Installment Sales (Other Than Sales to Grantor Trusts)

Planners have long used intra-family sales to freeze the estate tax value of the assets sold, and to provide liquidity by replacing an illiquid asset with cash. These advantages are balanced against the disadvantages of a sale, among them the recognition of gain, loss of control over the asset, and loss of income from the asset. To avoid the immediate recognition of gain, sales to family members are often structured as installment sales. The installment method permits a sale of property without the seller being required to report the gain until the actual receipt of the payments (subject to the exceptions noted).

Although the installment sale method will generally be available under § 453(a),[327] there are significant exceptions. In particular, the installment sale method is not available for a sale of marketable securities and other property regularly traded on an established market.[328] It is also not available to the extent that the gain in question is depreciation recapture and may not be available at all if the sale consists of depreciable property and is to a controlled entity.[329] Finally, sales of inventory or dealer property will not generally qualify for installment treatment.[330]

Even if the installment method is available, there may be limits on its use. First, interest may be charged on the deferred tax liability if the aggregate face amount of all of the seller's installment obligations from sales during the year exceeds $5,000,000.[331] Also, a pledge of the installment note will trigger gain recognition.[332] Lastly, a gift or other disposition of the installment note, or the sale of the purchased property by a related purchaser within two years of the installment sale, may cause the balance of the deferred gain to be recognized.[333]

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[326] *See generally* Martin M. Shenkman, *Role of Guarantees and Seed Gifts in Family Installment Sales*, 37 Est. Plan. 3 (Nov. 2010) (providing an excellent discussion of various issues involving the use of guaranties in loan transactions).

[327] In fact, if a disposition qualifies as an installment sale, the installment method is mandatory and automatically applies unless the taxpayer elects out under § 453(d)(1).

[328] I.R.C. § 453(k)(2).

[329] I.R.C. § 453(i), (g).

[330] I.R.C. § 453(b)(2).

[331] I.R.C. § 453A.

[332] I.R.C. § 453A(d).

[333] I.R.C. §§ 453(e), 453B.

A. Safe Harbor Interest Rate

One primary, unresolved, issue involving gift loans under § 7872[334] involves sales of property that may be regarded as part-sale, part-gift. For example,[335] assume a mother of an adult child decides to sell a tract of undeveloped land for $500,000, paid $100,000 in cash and $400,000 by a 15-year promissory note at 6% per annum, compounded semi-annually. Total payments over the term of the note will be $907,905. Assume the AFR is 10%. The present value of the payments under the contract, discounted at the AFR, is $234,243. The difference between this amount and the loan amount, $400,000, is $165,757. Because the present value of the total payments under the loan is less than the amount loaned, this is a below-market loan under § 7872, at least according to the I.R.S.

Under similar circumstances, however, taxpayers have argued, and the Seventh Circuit has agreed, that no gift has occurred in the example because the transaction falls under the *income tax safe harbor of § 483(e)*, which provides a 6% safe harbor for land sales between relatives.[336] The I.R.S., the Tax Court, and the Eighth[337] and Tenth Circuits,[338] however, disagree, and would assert that § 483(e) only provides an income tax safe harbor, *not* a gift tax safe harbor.

What has happened to the relatively straightforward scheme outlined to this point in this paper? We have departed from the relative safety of intra-family loans and stepped into the murk of intra-family sales. This area has not garnered much attention in the past decade or so because of the low interest rate environment. In contrast to June 1981, when the average prime rate was 20.3%, today 6% is not a valuable safe harbor.[339] However, if and when interest rates (and therefore, the AFR) rise, the sleeping bear may be roused.

As noted above, prior to the enactment of § 7872, Congress first entered the realm of interest rate safe harbors in the context of installment sales. Congress enacted or amended income tax statutes §§ 483 (1964, amended in 1984) and 1274 (1984) to address a problem not involving the gift tax. Under these statutes, certain debt instruments is-

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[334] *See* discussion *supra* Part II.B (providing "gift" loans are not necessarily gifts, just one type of loan to which § 7872 applies).

[335] *See* John A. Lynch, Jr., *Taxation of Below-Market Loans Under Section 7872: This Could be a Lot Simpler!*, 21 Akron Tax J. 33, 66-67 (2006).

[336] Ballard v. Comm'r, 854 F.2d 185 (7th Cir. 1988).

[337] *See* Krabbenhoft v. Comm'r, 939 F.2d 529 (8th Cir. 1991).

[338] *See* Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995).

[339] Cases that spawned the conflict over which rates should be applied to avoid income tax and gift tax include *Ballard v. Commissioner*, 854 F.2d 185 (I.R.S. alleged applicable gift tax discount rate of 18%), *Krabbenhoft v. Commissioner*, 939 F.2d 529 (11%), and *Schusterman v. United States*, 63 F.3d 986 (11.5%).

sued in connection with installment sales must bear interest at the AFR to ensure that it provides "adequate stated interest." The statutes were aimed at installment sales transactions where the parties opted to inflate the sales price and impose reduced or no interest payments. This allowed the seller to convert ordinary income to capital gain and allowed the buyer to treat all payments as basis. Thus, although they employ the same methodologies for imputing interest as § 7872, these sections ostensibly address not valuation issues, but rather *characterization of income*.

Section 7872(f)(8) explicitly states that § 7872 does *not* apply to a loan given in consideration for the *sale or exchange of property*; this area is, at first glance, covered by §§ 483 and 1274. This is so even if §§ 483 and 1274 do not apply by reason of exceptions or safe harbor provisions.[340] This straightforward statement is modified somewhat by the regulations and proposed regulations, and transmogrified by case law (see below).

As a brief overview, § 1274 provides the general rule for income tax treatment of installment sales; it applies to a note issued in a sale or exchange unless the note is excepted from its application. Section 1274(d)(2) provides that in a sale or exchange, the appropriate AFR is the lowest such rate for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." The appropriate AFR for sales transactions is based not on the term of the note, but on its weighted average maturity.[341] The *weighted average maturity* of an obligation equals the sum of the amounts obtained by multiplying the number of complete years from the issue date until the payment is made by a fraction. The numerator of the fraction is the amount of each payment under the instrument (other than qualified stated interest), and the denominator is the stated redemption price at maturity.[342] Once an instrument's term is calculated, the discount rate used is the lowest AFR in effect during the three-month period ending with the first month a binding written contract for the transaction exists.

Section 1274(c)(3) lists exceptions to the application of the section, which exceptions include transactions to which § 483(e) applies. Section 1274A provides a safe harbor of 9% compounded semiannually for certain qualified debt instruments. For 2007, a qualified debt instrument included any debt instrument given in exchange for property (other than § 38 property) that has a stated principal amount of not more than

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[340] I.R.C. § 7872(f)(8).

[341] Treas. Reg. § 1.1274-4(c), referring to Treas. Reg. § 1.1273-1(e)(3).

[342] See Treas. Reg. § 1.1273-1(f) for examples. For definitions of these terms, see *supra* Part V.B.3.

$4,800,800.[343] However, a debt instrument issued in a sale/leaseback transaction cannot be a qualified debt instrument.[344] This rate applies only to bona fide sales between *unrelated parties*. For sale/leaseback transactions involving the transferor or any related party, the discount rate is 110% of the AFR, compounded semiannually, and *not* limited to 9%.[345] The § 1274 rules are discussed in more detail in Part V.B, *supra.*

Section 483 of the Code applies, in limited circumstances, to debt instruments issued in a sale or exchange of property excepted from § 1274 (see below). "Unstated interest" is determined pursuant to § 483(b) in a manner similar to the determination of the imputed principal amount in § 1274(b); that is, interest will be imputed to the Seller, at the appropriate AFR, by discounting all payments to the date of sale (i.e., by applying OID rules). Generally, § 483 applies to the most debt obligations excepted from § 1274, which include: (1) sales for $250,000 or less;[346] (2) sale of a farm for less than $1,000,000;[347] (3) sale of a principal residence;[348] and (4) sales of land between family members.[349] Most important in the intra-family sales context is § 483(e), which provides an exception to the AFR requirement. Under § 483(e), if a family member contracts to sell land to another family member at a price of $500,000 or less,[350] the family members may use a 6% safe harbor interest rate.[351]

The § 483(e) safe harbor is directly applicable, and has attracted the interest of taxpayers and the I.R.S. because of the value of a 6% safe harbor in time of high interest rates. By enacting § 483(e), Congress unequivocally bestowed favorable tax treatment to intra-family real estate sales in the context of imputed interest. The issue, discussed fully below, is whether Congress intended, or even considered, whether this favorable tax treatment should be extended to *gift tax*. Unfortunately,

343 I.R.C. § 1274A(b); Rev. Rul. 2007-4, 2007-4 I.R.B. 351.

344 Treas. Reg. § 1.1274A-1(b)(1).

345 I.R.C. § 1274(e).

346 I.R.C. § 1274(c)(3)(C).

347 I.R.C. § 1274(c)(3)(A).

348 I.R.C. § 1274(c)(3)(B). If a buyer uses the real property as a personal residence, he or she is exempted also from § 483, although the seller will in most cases remain subject to I.R.C. § 483.

349 I.R.C. § 1274(c)(3)(F).

350 I.R.C. § 483(e)(3).

351 I.R.C. § 483(e)(2) provides that a "qualified sale" means any sale or exchange of land by a person to a member of such person's family within the meaning of I.R.C. § 267(c)(4), which limits a person's family to siblings, spouses, ancestors and lineal descendants. Under Treas. Reg. § 1.483-3(b)(2)(iii), if the property sold or exchanged includes any property other than land, § 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

§ 483 contains no language that clearly excludes its application in the gift tax context.

> **Practice Note**: If an intra-family sale transaction does not involve real property, and therefore falls within the general ambit of §§ 483 or 1274 of the Code (as opposed to § 483(e)), the stakes in the conflict described below are lower: the difference between the income tax safe harbor interest rates (§§ 483 or 1274) and the § 7872 gift and income tax interest rate safe harbor is not as profound. With the income tax safe harbor statutes, the taxpayer may use the three-month AFR, an option which is not available under § 7872. In these circumstances, the judicious practitioner will bite the bullet and use the § 7872 rate.

The Proposed Regulations under § 7872 "clarify" that the exception of § 7872 from transactions where 483 or 1274 applies, set forth in 7872(f)(8), is a *general* rule only, and that § 7872 *will* apply to such a loan if it is a gift loan that is 1) a demand loan[352] or 2) issued in a sale or exchange where the property will be held by the buyer for personal use and the seller does not make sales on the same terms and conditions to the general public.[353] A fixed-term mortgage note given by a child in purchasing a home from his parent is an example of a personal use note.

The scheme certainly implies, to the extent it may not be explicit, that the statutes are mutually exclusive. Either §§ 1274 and/or 483 apply to the exclusion or § 7872 applies, or vice versa. Section 7872(f)(8) explicitly states that where § 483 applies, § 7872 shall not apply. Under narrow assumptions (intra-family gift loan in connection with a sale or exchange, for personal use property) it is fairly clear that § 7872 applies exclusively. Unfortunately no parallel provision in § 483 closes the loop – no provision explicitly states that where § 483 applies, it trumps § 7872 and therefore, as is implied, applies for gift tax purposes in those limited circumstances. In other words, there is no explicit statement in the statutes that where §§ 483 and/or 1274 apply, they apply to the exclusion of § 7872 for both the income tax *and* gift tax applications.[354]

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352 Prop. Treas. Reg. § 1.7872-2(a)(2)(ii)(A). *Accord* Treas. Reg. §§ 1.1274-1(b)(3)(ii), 1.483-1(c)(3)(iii).

353 Prop. Treas. Reg. § 1.7872-2(a)(2)(ii)(C). The term "personal use" means use in other than a trade or business or in connection with an investment. I.R.C. § 1275(b)(3); *See* Treas. Reg. 1.483-1(c)(3)(ii)-(iii) (note Prop. Treas. Reg. § 1.7872-2(a)(2)(ii)(C) is broader than its counterpart, Treas. Reg. 1.483-1(c)(3)(ii), in that it excludes the application of §§ 483 and 1274 to both parties to the described transaction, rather than just the obligee (seller)).

354 In fact, a line of cases has adopted this reasoning, initially prior to the enactment of § 7872, and then, in the *Frazee* case, after the enactment of § 7872. See *Frazee v.*

For example, what about an intra-family installment sale to a child who intends to use the property for *business* use?[355] This appears to be covered by § 483(e), and thereby completely excluded from § 7872 income *and gift tax* treatment by § 7872(f)(8), or so it would seem. These are the facts of *Frazee v. Commissioner*,[356] discussed immediately below.

The integration of these code sections runs into darkness and fog, when, in search of a consistent policy, the courts attempt to divine the intent of Congress. In the face of Congressional silence, the courts have had a difficult time processing the issue, taking the ambiguity of the scheme and running with it, mainly against the taxpayer. The muddled result is that if §§ 483 or 1274 applies to an intra-family installment sale or exchange, the I.R.S. and the courts, for the most part, do not respect the apparent exclusivity of the schemes, and apply both § 7872 and the applicable income tax safe harbor statute (§§ 483 or 1274).

Frazee was the culmination of the I.R.S.'s efforts through the early 1980s and into the 1990s to restrict the safe harbors of § 483 (and, theoretically, § 1274) to the income tax province, against efforts of taxpayers to use the lowest safe harbor rate as a safe harbor for both income and gift tax.[357] The I.R.S.,[358] the Tax Court, Eighth[359] and Tenth Circuits[360] contend that § 483 does not act as a safe harbor for gift tax purposes, and that a taxpayer utilizing § 483 will incur a gift tax if the AFR exceeds the § 483 safe harbor. The reasoning of this group, in a nutshell, is

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Commissioner, 98 T.C. 554 (1992), and its antecedents such as *Krabbenhoft v. Commissioner*, 939 F.2d 529 (1991).

[355] One example in the Regulations misses the opportunity to further clarify the relationship between § 7872 and its income tax counterparts. *See*, *e.g.*, Prop. Treas. Reg. § 1.1274-1(c). In Prop. Treas. Reg. § 1.1274-1(c), Example 3 assumes a term loan payment for an intra-family sale of non-farm real property, and applies §§ 1274 and 483(e) to a note in the amount of $650,000 — ignoring the potential application of § 7872. Adding the detail of whether the child intended to use the property for personal or business use would have been extremely helpful because as it is, the Section assumes a business use is the only way to reconcile section (i) of this example with the § 7872 of the proposed regulations. Likewise, section (ii) assumes the amount not subject to § 483(e) will be subject to § 1274, again contradicting the § 7872 Proposed Regulations. *Compare* Prop. Treas. Reg. § 1.1274-1(c) *and* I.R.C. § 483(e) *with* Prop. Treas. Reg. § 1.7872.

[356] 98 T.C. 554.

[357] *See* Estate of True v. Comm'r, 82 T.C.M. (CCH) 27 (2001) (following *Frazee* for the proposition that I.R.C. § 7872 can apply to deferred payment arrangements in intra-family sales).

[358] *See* I.R.S. Gen. Couns. Mem. 39,566 (Oct. 23, 1986).

[359] *Krabbenhoft*, 939 F.2d at 534.

[360] The 10th Circuit is aligned with this group of taxpayer nemeses as well, having held that the prefatory language of § 483 ("For purposes of this title. . .") does not preclude the I.R.S. from valuing an installment sales contract using prevailing market rates. *See Schusterman*, 63 F.3d 986.

that § 483 addresses only the characterization of payments as income or principal under an installment sale, NOT valuation of the installment obligation for gift tax purposes. A concurring opinion in the Eighth Circuit's *Krabbenhoft* case, however, noted the anomalies of the decision to apply § 483 only for income tax purposes:

> Looking at section 483 in isolation and ignoring subsequent litigation, it is possible to conclude the "safe harbor" provision is applicable only to the income tax. In reaching this technical conclusion, one must accept the proposition that Congress either intended, or else simply failed to consider, the possible "gift tax traps" that would be created any time market rates rose above six percent.[361]

A ray of hope, however, was also indicated in Judge Henley's opinion, which noted that, like *Ballard*,[362] the *Krabbenhoft* transaction occurred before the enactment of §§ 1274 and 7872:

> Unfortunately, Congress did not get around to dealing with the problem until the 1983-1984 term when it created a uniform market-based system of interest rates. Through Sections 1271-1274, Congress enacted a market rate system for different types of loans that is updated periodically through Revenue Procedures. As government's counsel confirmed at oral argument, sections such as 483 and 7872 (low interest or no interest loans) now govern the *gift and income* tax treatment of most loans.[363]

In opposition to the authorities who apply § 483 only as an income tax safe harbor stands the Seventh Circuit, which, in *Ballard*, held that the qualifying introductory language of § 483 mandates its application to both gift and income tax, and constitutes a safe harbor from all adverse tax consequences under Title 26 of the United States Code.[364]

The confusion in this area reached its glorious apex with the puzzling Tax Court holding in *Frazee v. Commissioner*,[365] a case that, unlike *Ballard* and *Krabbenhoft*, involved a dispute occurring *after* the enactment of § 7872. *Frazee* involved the installment sale of real property ripe for development by a mother to her three children. The interest rate for the note was 7%, compounded semiannually, which exceeds the § 483(e) rate but was lower than the AFR at the time. The taxpayer

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361 Krabbenhoft v. Comm'r, 939 F.2d 529, 534 (1991) (Henley, J., concurring).

362 Ballard v. Comm'r, 854 F.2d 185 (7th Cir. 1988); *See supra* Part XI.A.

363 *Krabbenhoft*, 939 F.2d at 534 (emphasis in original) (Judge Henley's assumption was not borne out in the *Frazee* case).

364 *Ballard*, 854 F.2d 185.

365 Frazee v. Comm'r, 98 T.C. 554 (1992).

argued that § 483(e) applied to protect her from imputed income and gift tax liability. In its opinion, the court first disregarded contemporary proposed regulations that stated that § 483 would govern for gift tax purposes.[366] After holding (correctly) that § 483(e) (providing a 6% safe harbor) applied to the transaction for income tax purposes, the Court fudged its way around newly enacted § 7872(f)(8), stating that "[t]he presence of Section 7872(f)(8) signaled Congress' belief that Section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of Section 7872, but rather, to apply the provision as drafted."[367] In other words, since § 483 applies only for income tax characterization purposes, § 7872(f)(8) applies only to exclude § 7872 as an income tax safe harbor when both sections otherwise apply. This reasoning is circular.[368]

Although the taxpayer lost in *Frazee*, it could have been worse. What if the I.R.S. had urged, and the Court had held, that i) § 483(e) applies for income tax purposes but not gift tax purposes; therefore ii) § 7872 does not apply for any purpose because § 7872(f)(8) states that it shall not apply; and iii) in the absence of a controlling statute, the fair market approach of *Ballard v. Commissioner*[369] shall be employed? This is certainly a logical progression.[370] Fortunately for taxpayers, since the enactment of § 7872, the I.R.S. has conceded this point in *Frazee* and subsequent private letter rulings.[371] In *Frazee*, the court reasoned that § 7872 applies in seller financing situations,[372] and

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[366] *Id.* at 588 (dismissing proposed regulations as "no more than a litigation position.").

[367] *Id.*

[368] *See*, *e.g.*, Courtney N. Stillman, *Choosing Interest Rates for Family Transactions to Avoid a Gift as Well as Imputed Income*, 83 J. TAX'N 155 (1995).

[369] 854 F.2d 185 (7th Cir. 1988); *Accord* Blackburn v. Comm'r, 20 T.C. 204 (1953).

[370] This is similar to the reasoning reemployed by the Tenth Circuit in *Schusterman,* which involved a transaction prior to the enactment of § 7872. Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995). In *Schusterman*, the Court applied fair market value analysis for gift tax purposes to promissory notes issued by related irrevocable trusts for family stock. The court held that § 483, although it applies to all of Title 26, only applies to re-characterize income and principal payments when below-market interest rates are charged – it is not a valuation provision applicable to the gift. *Id.* at 992-93.

[371] TAM 8552007 (Sept. 18, 1985); PLR 8806048 (Nov. 17, 1987); PLR 9535026 (Sept. 1, 1995).

[372] Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted.

Frazee v. Comm'r, 98 T.C. 554, 588 (1992).

acknowledged the I.R.S. concession that § 7872 applied for gift tax purposes rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of § 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept."[373] Similarly, in *Estate of True v. Commissioner*,[374] the court held that § 7872 applies to a purchase transaction under a buy-sell agreement for a deferred payment.

Relatively recent PLRs confirm the I.R.S. position that § 7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions, regardless of the application of §§ 1274 or 483 to the transaction for income tax purposes, and that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note.

Private Letter Ruling 9535026[375] involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the § 7872 rate (i.e., the AFR), with a balloon payment of principal at the end of 20 years. The ruling summarizes the provisions of § 7872 and discusses the *Frazee* case (which it summarizes as concluding that § 7872 is not limited to loans of cash but is broadly interpreted to include any extension of credit). The ruling reasoned that neither § 483 nor § 1274 applies for valuing the note for gift tax purposes, but that § 7872 was enacted specifically to address the gift tax treatment of below-market loans. It further reasoned that § 7872 is not limited to loans of cash but "is broadly interpreted to include any extension of credit."[376] The ruling observes that the stated interest rate on the notes in question equals the § 7872 rate.

> Thus, we conclude that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to

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[373] *Id*. at 590.

[374] 82 T.C.M. (CCH) 27 (2001) ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004).

[375] PLR 9535026 (Sept. 1, 1995).

[376] *Frazee*, 98 T.C. at 590.

their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt.[377]

Private Letter Ruling 9408018[378] addressed whether the redemption of a mother's stock from a corporation, where her son was the remaining shareholder, constituted a gift. The note's interest rate equaled the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under § 1274(c)(2) (which is tied to the applicable federal rate). The ruling employed similar reasoning in PLR 9535026, and concluded that because the interest rate on the note will be at least equal to the applicable federal rate for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note.[379] (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.)

The bottom line is that this issue will remain submerged so long as the AFR remains around 6%, unless Congress intervenes.[380] When the AFR climbs above 6%, in intra-family land sales transactions, careful planners will apply the AFR unless gift taxes are not an issue. Aggressive planners outside of the Eighth and Tenth Circuits may always choose to use the 6% safe harbor, relying on *Ballard,* common sense, and fairness.[381]

With intra-family sales transactions involving sales of personal use property (i.e., not land held for investment), at least under the § 7872 proposed regulations, § 483 is not applicable and § 7872 should be used. The penalty for using the 7872 safe harbor in that case, however, is not burdensome, as the § 483 or 1274 AFR (permitting the lowest of the prior three months' AFRs) is usually not substantially better than the § 7872 AFR.

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[377] *Id.*

[378] PLR 9408018 (Feb. 25, 1994).

[379] Frazee v. Comm'r, 98 T.C. 554, 590 (1992).

[380] *See* Stephen J. Wolma, *Ambushed in a Safe Harbor*, 33 Val. U. L. Rev. 309 (1998) (advocating Congressional action to resolve the conflict, short of Supreme Court intervention).

[381] The Eighth and Tenth Circuits hold that the 6% safe harbor does not apply for gift tax purposes. Krabbenhoft v. Commissioner, 939 F.2d 529 (8th Cir. 1991); Schusterman v. United States, 63 F.3d 986 (10th Cir. 1995). The Seventh Circuit has held that the 6% safe harbor does apply for gift tax purposes as well. Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988).

B. Consequence of Inadequate Stated Interest

If either of §§ 483 or 1274 applies, and the applicable safe harbor interest rate is not utilized (the note does not call for qualified stated interest), interest will be imputed under § 483 as "imputed interest" or under § 1274 as "OID" (Original Interest Discount). Both are calculated in the same manner. However, they differ as to the timing of recognition of unstated interest.

When § 1274 applies, OID is determined on a daily basis and is income to the seller and deductible by the buyer (unless the buyer is an individual and the interest is personal interest) without regard to the taxpayer's use of the accrual or cash method. The practical effect when OID is imputed is that OID will be allocated daily, thus thwarting the tax deferral effects of the delayed interest payments. By contrast, in the limited situations in which § 483 still applies, the taxpayer's accounting method (i.e., cash or accrual) controls the timing for reporting unstated interest; interest is not included or deducted until a payment is made or due. The computation of OID is discussed in Part V.B.3, *supra*.

C. Income Tax Implications for Seller

1. *Recognition of Gain or Loss*

An installment sale is a disposition of property in which one or more payments are to be received after the year of the disposition.[382] Under § 453(a), "income from an installment sale" is usually reported by "the installment method." With the installment method, gross profit is determined by subtracting the seller's adjusted basis from the selling price. The gross profit is then divided by the selling price (less any "qualifying indebtedness" assumed or taken subject to by the buyer) to arrive at the "gross profit ratio."[383] Each payment of principal received by the seller is then multiplied by the gross profit ratio to determine the amount of each payment allocable to the gain and to nontaxable return of basis.[384]

> **Example**: If property with an adjusted basis of $30 is sold for $50, payable $10 at the closing and $10 annually for four years thereafter, with interest at an adequate rate on the deferred payments, the gross profit is $20 (contract price of $50 less adjusted basis of $30), resulting in a gross profit ratio of 40% ($20/$50). Thus, the seller has gain for the year of sale of $4 (40% of $10), and 40% of each later installment will be simi-

382 I.R.C. § 453(b)(1).
383 Temp. Treas. Reg. § 15A.453-1(b)(2)(1)(i)-(iii).
384 Temp. Treas. Reg. § 15A.453-1(b)(2)(i).

larly includable in income when the installment is collected.[385] If the selling price is less than the seller's basis, a loss would be realized, but would most likely be disallowed under § 267(a) because the purchaser would likely be a member of the seller's family to whom § 267(b)(1) would apply, or a trust created by the grantor to which § 267(b)(4) would apply.

2. *Disposition of Installment Note*

A potential tax issue of which practitioners should be aware is caused when the selling family member disposes of an installment obligation. In that case the seller will be required to recognize all or part of the deferred gain if the installment obligation "is satisfied at other than its face value or distributed, sold, or otherwise disposed of" before the buyer completes the payments.[386]

Giving an installment note back to the obligor is also a disposition, and giving an installment obligation to a related party recognizes the entire unpaid principal balance on the note at the time of the gift.[387] Often a related party seller will forgive installment payments as they come due. In such case the donor/seller will be taxed on both the interest and gain portions of the forgiven installment, even though no cash is received. The forgiven gains are taxed as a partial disposition of the obligation under § 453B(f), and the donor will recognize the previously untaxed gain portion of the forgiven installment.

Example:[388] Parent sells an asset to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10%. Parent forgives the first installment and Parent consents to gift split. They intend to forgive each subsequent installment in the same manner. The I.R.S. does not successfully challenge the transaction. Child's payments amortize the installment debt as follows:

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385 *See* Bittker & Lokken, *supra* note 87, ¶ 108.1, at 108-2.
386 I.R.C. § 453B(a).
387 I.R.C. § 453B(f).
388 *See* Zaritsky & Aucutt, *supra* note 62, § 12.02[4][a].

Year	Payment	Principal	Interest
1	$20,000	$10,000	$10,000
2	20,000	11,000	9,000
3	20,000	12,100	7,900
4	20,000	13,310	6,690
5	20,000	14,640	5,360
6	20,000	16,106	3,894
7	20,000	17,716	2,284
8	5,640	5,128	512

When Parent forgives the first $20,000 installment, Parent still must report $10,000 of interest income and $8,000 of long-term capital gain (the capital gain on the sale was $80,000 of the total $100,000 sales price, so 80% of each principal payment is a capital gain). Assuming that Parent is in the 35% marginal income tax bracket, Parent must pay $4,700 of income tax in the first year, even though Parent receives no cash (35% × $10,000 interest) + (15% × $8,000 capital gain).

Upon the death of the holder of the installment note, a bequest of an installment obligation that arose during the seller's lifetime to someone other than the obligor on the note does *not* trigger gain,[389] but the income is IRD — the recipient of the obligation recognizes gain on the future payments to the extent the seller would have recognized it.[390] A bequest of an installment note to the obligor cancels the note (because a merger of interest has occurred) and accelerates the incidence of taxable IRD,[391] causing the decedent's estate to recognize the difference between the face amount and the decedent's basis in the obligation.[392] Such a bequest to an unrelated party, however, will cause the estate only to recognize the difference between the note's *fair market value* and the decedent's basis immediately before death, without regard to the actual outstanding balance.

In addition, any cancellation of such a note is treated as a transfer that triggers immediate gain on the note. If the decedent's will specifically bequeaths the note to someone other than the obligor of the note,

[389] I.R.C. § 453B(c). *See generally* Robert J. LeDuc, *Avoiding Unintended Dispositions of Installment Obligations*, 31 Est. Plan. 211 (2004).

[390] I.R.C. § 691(a)(4)-(5).

[391] *Id.* While I.R.C. § 453B(c) contains a general exception for distributing a decedent's installment note to beneficiaries of the estate that section applies "except as provided in section 691." *See* § 453B(c). Section 691(a)(5)(A)(i) provides that a transfer by the estate of a decedent's installment note to the obligor of the note will trigger recognition of gain on the note. I.R.C. § 691(a)(5).

[392] I.R.C. § 691(a)(4)(A). If the obligor is related to the decedent, within the meaning of I.R.C. § 453(f)(1), the amount of gain triggered by the disposition will be based on the full-face amount of the note instead of just the fair market value of the note, if the fair market value is lower. I.R.C. § 691(a)(5)(A)(iii), 691(a)(5)(B).

the gain should not be triggered to the estate. If the estate elects to make a non-pro rata distribution of the assets pursuant to authority in the will or state law, and if the executor elects to distribute an installment note to someone other than the obligor, it is not clear whether recognition of the gain to the estate will be avoided. The I.R.S. might conceivably take the position that there has been an indirect distribution of the note to the obligor.[393]

A cancellation of a note at death, or a bequest of an installment note to the obligor, will trigger recognition of inherent gain on the note to the estate. However, the triggering transfer and the related reporting of gain does not occur until the earliest of (1) the executor's assent to the distribution of the note under state law, (2) the actual cancellation of the note by the executor, (3) upon the note becoming unenforceable due to the applicable statute of limitations or other state law, or (4) upon termination of the estate.[394] For example, if an installment note passes by the residuary clause to the decedent's child, the accelerated gain is reported by the estate in the year in which the note is actually distributed to the child.[395]

If the estate made the sale after the decedent's death, a transfer of an installment obligation would generally cause the transferor immediately to recognize any remaining gain which has been deferred by the installment reporting method.[396] Of course, in many situations in which the estate sells an asset for an installment note, there should be little gain to recognize upon a disposition of the installment obligation due to the step-up in basis of the asset at death. If an estate asset is to be sold that has substantial appreciation above its stepped-up basis, consider distributing the asset to a beneficiary and allowing the beneficiary to make the installment sale.

3. *Sale by Related Buyer*

Additional tax issues arise if the party purchasing property using an installment note sells that property. Under § 453(e), the related buyer's sale of the purchased asset within two years of the date of the purchase

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[393] *See* PLR 8806048 (Nov. 17, 1987). *See generally* Jerome M. Hesch, *Dispositions of Installment Obligations by Gift or Bequest*, 16 TAX MGMT. EST., GIFTS & TR. J. 137 (1991).

[394] TAM 8552007 (Sept. 18, 1985).

[395] PLR 8806048.

[396] I.R.C. § 453B(a) (the exception under I.R.C. § 435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing *from a decedent*, rather than installment notes arising after the decedent's death); *See also* Rev. Rul. 55-159, 1955-1 C.B. 391.

is treated as a disposition by the original seller of the obligation.[397] Thus, an intra-family installment sale imposes a risk on the seller that the buyer will take some action that causes the seller's tax on the deferred gain to be accelerated.

> **Example**:[398] Parent sells a building to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10%. One year (and one payment) after buying the building, Child resells it for $125,000. Parent is deemed to have received a complete payment of Child's installment note and must recognize the previously unrecognized $70,000 gain on the sale ($80,000 total gain on the sale less $10,000 gain recognized on the first installment payment). Assuming that Parent is in the 15% capital gains tax bracket, this produces a $10,500 capital gains tax (15% × $70,000 = $10,500).

A related buyer need not *resell* the purchased assets to create a problem for the seller. If the buyer's "disposition" is something other than a sale or exchange, the amount the seller is deemed to have received is the fair market value of the asset at the time of the second disposition.[399] Certain transactions, including the transmission of the asset at death, are not acceleration events under this rule, but gifts, notably, are dispositions.[400]

XII. Installment Sales to Grantor Trusts

A. Description

A very effective method of freezing an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member.[401] The traditional disadvantage of an installment sale is that

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397 I.R.C. § 453(e). For this purpose, a related buyer includes the seller's spouse, child, grandchild, or parent, or a related trust, estate, partnership, or corporation. *See generally* I.R.C. § 453(f)(1). The seller's brother, sister, stepbrother, stepsister, aunt, uncle, or relative by marriage (other than the seller's spouse) is not a related party. *Id.*

398 *See* Zaritsky & Aucutt, *supra* note 62, § 12.02[2].

399 I.R.C. § 453(e)(4).

400 I.R.C. § 453(e)(6).

401 See Michael D. Mulligan, *Sale to Defective Grantor Trust: An Alternative to a GRAT*, Est. Plan. 3-10 (Jan. 1996), for an excellent discussion of the issues involved with sales to grantor trusts; *See also* Louis A. Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, 14 Prob. & Prop. 16, 17-23 (2000); Aucutt, *supra* note 269, at 617-681.

the donor has to recognize a substantial income tax gain as the installment payments are made. The gains would typically be taxed at 15% (without considering state income taxes), and the interest would be taxed at ordinary income tax rates. If the sale is made to a trust that is treated as a grantor trust for income tax purposes, but which will not be included in the settlor's estate for federal estate tax purposes, the estate freezing advantage can be achieved without the income tax costs usually associated with a sale. In addition, care must be taken to select a "defect" that would cause the grantor to be treated as the "owner" of trust income as to both ordinary income and capital gains.

There is a trade-off in the fact that the assets transferred in the sale will have carryover basis; however, if the low basis assets are purchased by the grantor prior to death, this loss of basis step-up would be avoided. The steps of planning an installment sale to a grantor trust are briefly outlined below.

1. *Create and Fund Grantor Trust*

The individual should create a trust that is treated as a grantor trust for federal income tax purposes (meaning that the grantor is the owner of the trust for income tax purposes). The trust will be structured as a grantor trust for income tax purposes, but will be structured so that the grantor is not deemed to own the trust for estate tax purposes.[402] This type of trust (which is treated as owned by the grantor for income but not estate tax purposes) is sometimes called a "defective trust".

The grantor trust should be funded (or "seeded") with meaningful assets prior to a sale.[403] There is lore that the value of equity inside the grantor trust must be 10% of the total value in order for the sale to be respected. In PLR 9535026,[404] the I.R.S. required the applicants to contribute trust equity of at least 10% of the installment purchase price in order to avoid association status for income tax purposes and to have the trust be treated as a trust. Various planners have suggested that is not required absolutely, and some respected national speakers said that the equity amount could be as low as 1% — depending on the situa-

[402] See Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 Real Prop. Tr. & Est. L.J. 207 (2009), for a detailed discussion of ways to structure the trust so that it is a grantor trust as to both income and principal; Howard M. Zaritsky, *Open Issues and Close Calls—Using Grantor Trusts in Modern Estate Planning,* 43 U. Miami Heckerling Inst. on Est. Plan. ch. 3 (2009); Amy E. Heller, *Grantor Trusts: Take Nothing For Granted,* 46 U. Miami Heckerling Inst. on Est. Plan. (Special Session Materials) (2012).

[403] See Shenkman, *supra* note 326, at 3, for an outstanding discussion of the various issues regarding the need for seeding of the trust prior to a sale and of the implications of using guarantees.

[404] PLR 9535026 (Sept. 1, 1995).

tion.[405] One planner (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough. The legal issue is whether there is debt or equity. (For example, if it is debt, it is permissible to use the AFR as the interest rate.) The issue is whether there is comfort that the "debt" will be repaid.

McDermott v. Commissioner[406] involved a 19.6 to 1 debt equity ratio (which translates to a 5.6% equity amount). The I.R.S. acquiesced in *McDermott*. One attorney uses that as a base point – he never uses less than 5.6% seeding. On the other hand, there is a published ruling involving a 20% contribution, and the I.R.S. ruled it was debt.[407] (That was not a sale to grantor trust situation.) In *Petter v. Commissioner*,[408] footnote 8 notes that the estate tax attorney involved in structuring the transaction "said he believed there was a rule of thumb that a trust capitalized with a gift of at least 10% of its assets would be viewed by the I.R.S. as a legitimate, arm's length purchaser in the later sale." At least this is a reference to the 10% rule of thumb in a reported case.

Under the 10% rule of thumb, the trust should hold approximately 10% in value of the eventual trust assets after a purchase occurs in step 2. As an example, if a $900,000 asset will be sold to the trust, the settlor might make a gift of $100,000 to the trust. After the trust purchases the asset, it would own assets of $1,000,000, and it would have a net worth of $100,000, or 10% of the total trust assets. (This is analogous to the 10% cushion requirement in § 2701(a)(4).) Stated differently, if the 10% seeding is based on analogy to the initial seeding, the gift should be 11.1% of the amount of the later sale to the trust (if values remain constant.) If the grantor transfers $11.10 to the trust, and later sells an asset for a $100.00 note, the $11.10 "seeding" would be 10% of the total $111.10 assets in the trust following the sale. That means there would be a 9:1 debt equity ratio.

In determining whether the note represents debt or equity, one must consider a variety of factors, including the nature (and volatility) of assets in the trust, and the risk profile of the clients. If there is experience of assets actually increasing in value after sales to the trust and payments actually being made, when the next grantor trust sale is considered, the grantor would seem to have good reason to be more comfortable using a lower equity cushion. Some commentators have

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405 *See* Richard A. Oshins, Robert G. Alexander, & Kristen E. Simmons, *The Beneficiary Defective Inheritor's Trust ("BDIT")*, Oshins.com (2008), http://www.oshins.com/images/BDIT_article.pdf

406 13 T.C. 468 (1949), *acq*. 1950-1 C.B. 3

407 *Id.*

408 98 T.C.M. (CCH) 534 (2009).

suggested that initial seeding should not be required as long as the taxpayer can demonstrate that the purchaser will have access to the necessary funds to meet its obligations as they become due.[409] Even those authors, however, observe that the § 2036 issue is an intensely factual one, and that "only those who are willing to take substantial risks should use a trust with no other significant assets."[410] The seed money can be accomplished either through gifts to the trust, or through transfers to the trust from other vehicles, such as a GRAT.

Most planners do not use joint trusts with both spouses as grantors. There is the theoretical concern of whether one spouse might be treated as selling the assets, which are eventually sold to the trust, to the portion of the trust treated as a grantor trust as to the spouse. If so, there would be no gain recognition on the sale (under § 1041), but interest on the note would be taxable.[411] Furthermore, there is significant uncertainty regarding the effect of a subsequent divorce or death of a spouse.

Can "Seeding" Be Provided by Guarantees? A guarantee by a beneficiary or a third party may possibly provide the appropriate seeding, sufficient to give the note economic viability. Beware that if the trust does not pay a fair price for the guarantee, the person giving the guaranty may be treated as making an indirect contribution to the trust, which might possibly result in the trust not being treated as owned wholly by the original grantor.[412]

Of particular concern is PLR 9113009.[413] This letter ruling initially raised concerns about the gift tax effects of loan guaranties made by the guarantor's children. While PLR 9113009 was withdrawn by PLR 9409018,[414] which addressed only other issues requested in the original ruling request without mention of gift tax issues, the earlier ruling nevertheless provides the I.R.S.'s analysis of why gift guaranties may include gift elements. The I.R.S. reasoned generally that the guaranty confers an economic benefit from date it is given and the promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made. The I.R.S.'s full analysis of this issue in PLR 9113009 is quoted in Part X.E, *supra*.

Some commentators argue, however, that a beneficiary who guarantees an indebtedness of the trust is not making a gift until such time, if

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409 Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.1.
410 Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.1.
411 *See* Gibbs v. Comm'r, 73 T.C.M. (CCH) 2669 (1997).
412 *See supra* note 326 and accompanying text.
413 PLR 9113009 (Mar. 29, 1991).
414 PLR 9409018 (Mar. 4, 1994).

at all, that the guarantor must "make good" on the guarantee. (Otherwise, the beneficiary would be treated as making a gift to him or herself.)[415] If the beneficiary has a real interest in the trust, and the beneficiary gives a guarantee to protect his or her own investment, the guarantee arguably is not a gift to the trust. The leading case is *Bradford v. Commissioner*,[416] in which the I.R.S. acquiesced. (If the beneficiary is making a gift to the trust, the beneficiary is a grantor to that extent, and the trust is no longer a wholly grantor trust as to the original grantor, so there could be bad income tax consequences to the grantor of the trust as well as gift tax consequences to the person giving the guaranty.)[417] The best analogy supporting that the beneficiary does not make a gift is in the life insurance area. There are various cases and acquiescences that if a beneficiary pays premiums to maintain the policy that is owned by a trust, that is not a gift to the trust.[418] Indeed, that is an actual transfer, not just a guarantee. The timing and amount of the gift from a beneficiary-guarantee, if any, is unclear.

> Probably the closest commercial analogy is a bank's charge for a letter of credit. Generally, the bank makes an annual or more frequent charge for such a letter. By analogy, there will be an annual gift, probably in the range of one to two percent of the amount guaranteed, so long as the guarantee is outstanding. However, it may also be argued that a much larger, one-time taxable gift will occur at the inception of the guarantee, especially if the loan precludes prepayment. [Citing Rev. Rul. 94-25, 1994-1 C.B. 191.] The final possibility is that no gift will occur until a beneficiary actually has to make a payment under the guarantee. In this event, the measure of the gift will presumably be the amount of the payment under the guarantee. [Citing Bradford v. Commissioner, 34 T.C. 1059 (1960).]
> It is by no means a given that a guarantee by a beneficiary is a gift. Instead, the clear weight of authority seems to support the absence of any gift by the beneficiaries to the trust, at least where the guarantee is a bona fide obligation of the beneficiary making the guarantee, and where the beneficiary has sufficient net worth to make good on the guarantee in the event of a default by the trust.[419]

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415 *See* Hatcher & Manigault, *supra* note 322.

416 34 T.C. 1059 (1960).

417 *Id.*

418 *See, e.g.*, Pleet v. Comm'r, 17 T.C. 77 (1951).

419 Milford B. Hatcher, Jr., *Planning for Existing FLPs,* 35 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 302.3.B.2 (2001). *See* Hatcher & Manigault, *supra* note 322. The author set forth a detailed rebuttal of a taxable gift being imputed by reason of a bona

If the planner is squeamish about guarantees by beneficiaries, the trustee could pay an annual fee to the beneficiary in return for the guarantee.[420] Some planners report using a fee between 1-2%. Other planners suggest that the fee would typically be higher (about 3%). The 1-2% (or lower) fee for a typical bank letter of credit is based on having a pre-existing relationship with a person who has substantial assets. The difficulty with paying a guaranty fee is determining the correct amount of the fee. There may be a gift if no fee or if an insufficient fee is paid for the guarantee. (Some planners have reported using Empire Financial to value these guaranties.) One planning alternative is to file a non-transfer gift tax return reporting the guarantee transaction.

Thus, in summary, the safest course is to pay for the guarantee and the safer alternative if that is not done is to have the guarantee be made by a beneficiary rather than a third party.

2. *Sale for Installment Note; Appropriate Interest Rate*

The individual will sell property to the grantor trust in return for an installment note for the full value of the property (taking into account appropriate valuation discounts). The note is typically secured by the sold asset, but it is a full recourse note. The note is often structured to provide interest-only annual payments with a balloon payment at the end of the note term. The interest is typically structured to be equal to the § 7872 rate. Often a longer term note is used to take advantage of the current extremely low AFRs for a number of years. Typically, the note would permit prepayment of the note at any time without penalty. The note should be shorter than the seller's life expectancy in order to minimize risks that the I.R.S. would attempt to apply § 2036 to the assets transferred in return for the note payments.

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fide, pro rata guarantee by a beneficiary of a defective grantor trust. Another favorable factor in avoiding a gift by a beneficiary-guaranty is where the upside potential from the beneficial interest of the guarantor-beneficiary is sufficient to warrant that guarantor-beneficiary take the downside risk posed by the guarantee.

420 Unfortunately, there is no safe harbor for the amount to be paid for the guarantee. The safe harbor AFR rate under § 1274 applies for intra-family loans, but there is no similar safe harbor for a guarantee fee. See generally Shenkman, *supra* note 326, for an excellent discussion of various approaches in determining appropriate fee, saying that some appraisers suggest guarantee fees in the range of 5% to 6%+ because of the nature of the underlying assets supporting the guarantee; Richard Oshins, Leveraged Gifting Transactions in the New Millennium 10 (2006) ("We take the conservative position and pay for the guarantee"); Hatcher, *Planning for Existing FLPs, supra* note 419, ¶ 302.3.B.2 (discussing if the I.R.S. succeeds in treating guaranty as gift, by analogy to bank charge for a line of credit, annual gift would probably in the range of 1-2%, but a larger, one-time gift may occur at the inception of the guarantee, especially if the loan precludes prepayment).

Many planners are using long term notes (over 9 years) in light of the extremely low long term rate because the interest rate is still relatively low; but they use a note term shorter than the seller's life expectancy. (The buyer could prepay the note if desired, but there would be the flexibility to use the low long term rate over the longer period.) Some planners structure the transaction to leave time between the time of the "seed" gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in *Holman v. Commissioner.*[421] *Pierre v. Commissioner*[422] applied a step transaction analysis to aggregate the gift and sale portions of LLC interests that were transferred within 12 days of each other for valuation purposes. A possible concern (though the I.R.S. has not made this argument in any reported case) is that the gift and sale may be aggregated and treated as a single transaction for purposes of applying § 2036, which would mean that the sale portion does not qualify for the bona fide sale for full consideration exception in § 2036.[423]

Some planners have suggested taking the position that the lowest AFR in the month of a sale or the prior two months can be used in a sale to defective trust situation, relying on § 1274(d). Section 1274(d) says that for any sale or exchange, the lowest AFR for the month of the sale or the prior two months can be used. However, relying on § 1274(d) is problematic for a sale to a defective trust — because such a transaction, which is a "non-event" for income tax purposes, may not constitute a "sale or exchange" for purposes of § 1274(d). The apparently unqualified incorporation of § 1274(d) in § 7872(f)(2) arguably gives some credibility to this technique. However, relying on a feature that depends on the existence of a "sale" as that word is used in § 1274(d)(2) [in the income tax subtitle] in the context of a transaction that is intended not to be a "sale" for income tax purposes seems unwise.

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421 130 T.C. 170 (2008) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership); *See also* Heckerman v. United States, 104 A.F.T.R.2d 2009-5551 (W.D. Wash. 2009) (holding step transaction doctrine applied for funding and gift of LLC interest on same day). While the Ninth Circuit in *Linton v. United States*, 630 F.3d 1211 (9th Cir. 2011) held that the step transaction doctrine did not apply to treat a donor as giving assets in an LLC rather than (discounted) interests in the LLC where the funding and transfers of interests occurred on the same day, the court observed that a timing test does apply under *Holman* and remanded the case for consideration under that test. *Compare Linton*, 630 F.3d 1211, *with Holman*, 130 T.C. 170. Some respected planners suggest leaving as long as possible between the "seed" gift and the subsequent sale (e.g., 30, 60, 90 days or even wait until the following taxable year).

422 99 T.C.M. (CCH) 1436 (2010) (finding lack of control discount reduced from 10% to 8% because of aggregating gift and sale portions to treat the aggregate 50% LLC interests transferred to each of two separate trusts).

423 *See infra* Part XII.I.

Most planners use the applicable federal rate, under the auspices of § 7872, as the interest rate on notes for intra-family installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and § 7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using § 7872 rates for sales is supported by the position of the I.R.S. in a Tax Court case and by a subsequent Tax Court case and in several private rulings,[424] as discussed in Part XI.A, *supra*.

3. *Operation During Term of Note*

Hopefully the trust will have sufficient cash to make the interest payments on the note. If not, the trust could distribute in-kind assets of the trust in satisfaction of the interest payments. Payment of the interest, whether in cash or with appreciated property, should not generate any gain to the trust or to the grantor, because the grantor is deemed to be the owner of the trust for income tax purposes in any event.

Because the trust is a grantor trust, the grantor will owe income taxes with respect to income earned by the trust. Payment of those income taxes by the grantor is not an additional gift to the trust.[425] To the extent that the entity owned by the trust is making distributions to assist the owners in making income tax payments, the cash distributions to the trust could be used by the trust to make note payments to the grantor/seller, so that the grantor/seller will have sufficient cash to make the income tax payments.

Consider having the seller elect out of installment reporting. The theory is that the gain would then be recognized, if at all, in the first year, but there should be no income recognition in that year.[426] Death during a subsequent year of the note arguably would be a non-event for tax purposes. Some (probably most) commentators believe that installment reporting is not even available for sales to a grantor trust, because the transaction is a non-event for income tax purposes.

4. *Pay Note During Seller's Lifetime*

Plan to repay the note entirely during the seller's lifetime. Income tax effects may result if the note has not been paid fully by the time of the seller's death. Income tax issues with having unpaid note payments due at the grantor's death and planning alternatives to avoid those issues are discussed in Part XII.E, *infra*. The installment note could be

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[424] Frazee v. Comm'r, 98 T.C. 554 (1992) (I.R.S. position was to apply § 7872); Estate of True v. Comm'r, 82 T.C.M. (CCH) 27 (2001); PLR 9535026 (Sept. 1, 1995); PLR 9408018 (Feb. 25, 1994).

[425] Rev. Rul. 04-64, 2004-2 C.B. 7.

[426] *See* Rev. Rul. 85-15, 1985-1 C.B. 132; *see also Installment Sales*, I.R.S. Pub. 537, at 4 (Dec. 4, 2012).

structured as a self-canceling installment note ("SCIN") that is payable until the expiration of the stated term of the note or until the maker's death, whichever first occurs. SCIN transfers are discussed further in Part XIII, *infra*.[427]

B. Best Practices

In the context of sales of closely held business interests, a number of best practices can be identified. For example, one might, as a starting point, create voting and non-voting units. Perhaps 999 non-voting shares would be created for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business. Second, consider a gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt. Third, note that the installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests. Fourth, remember that cash from the investment assets or other assets could be used to make the gift to fund the initial equity of the trust. Fifth, consider making the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year).[428] Ideally, the initial gift to the trust will be cash so that the cash is available to help fund note payments. Sixth, note that the key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, real estate that is used by the business but that is leased by the business from the business owner could be transferred to the trust because it does have cash flow. Seventh, remember that cash flow from the business may be sufficient to assist making payments on the promissory note. Consider modeling anticipated cash flow from the business in structuring the note.

For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax distribution cash flow" may be enough to fund a substantial part of the note payments.

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[427] See Edward P. Wojnaroski, *Private Annuities and Self-Canceling* Notes, EST. TAX PORT. (BNA) 805-3d (2010) for excellent discussions of the use of notes with self-cancelling features, including how to value such notes; Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3; Hayes, *supra* note 104, at 21, 33. A key advantage of SCINs is that the cancellation feature removes any remaining value on the note from the seller's gross estate for estate tax purposes. However, any remaining gain must be reported on the estate's fiduciary income tax return, at least under the position of the Eighth Circuit. Estate of Frane v. Comm'r, 998 F.2d 567 (8th Cir. 1993).

[428] See the discussion of the *Holman*, *Heckerman*, *Linton*, and *Pierre* cases *supra* in Part XII.A.2.

The goal is to be able to pay off the note during the seller's lifetime. Lack of control and lack of marketability discounts would apply, based on the asset that is sold.

In terms of avoiding §§ 2036 and 2038 arguments, best practices include not making entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments). In addition, consider using a defined value clause to protect against gift consequences of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value," typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)

Note that interest rates are very low. For example, in December 2013 a nine-year note would have an interest rate of 1.65%.[429] If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is about 1.16%, so if the business has earnings/growth above that, there is a wealth shift each year. This approach takes advantage of opportunities that could be eliminated in the future, such as discounts, current large gift and GST exemption, and extremely low current interest rates.

C. Basic Estate Tax Effects

The installment note (including any accumulated interest) will be included in the grantor/seller's estate. There may be the possibility of discounting the note if the interest rate and other factors surrounding the note cause it to be worth less than face value.[430] However, the asset that was sold to the trust will not be includible in the grantor's estate, regardless how long the grantor/seller survives. (There is some risk of estate inclusion if the note is not recognized as equity and if the grantor is deemed to have retained an interest in the underlying assets. The risk is exacerbated if a thinly capitalized trust is used – less than 10% equity.)[431] The grantor's payment of income taxes on income of the grantor trust further decreases the grantor's estate that remains at the grantor's death for estate tax purposes.

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[429] Rev. Rul. 2013-26, 2013-50 I.R.B. 628.

[430] *See supra* Part VIII (regarding the possibility of discounting notes for gift and estate tax valuation purposes).

[431] *See infra* Part XII.H.

Note that a new question was added to Form 706[432] in October 2006 in Part 4, Question 13e. Question 13a asks "Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?" Question 13b asks: "Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest or trusteeship?" Question 13e now asks: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 13a or 13b?"[433] This question underscores the desirability of reporting sales of discounted interests in closely-held entities on a gift tax return.[434] Eventually the I.R.S. will learn about this transaction. This Form 706 question applies retroactively to all transfers made by decedents filing the Form 706. The question only applies to transfers to trusts and not to transfers to individuals.

D. Basic Gift Tax Effects

The grantor should "seed" the trust with approximately 10% of the overall value to be transferred to the trust by a combination of gift and sale. This could be accomplished with an outright gift when the grantor trust is created. Alternatively, the grantor trust could receive the remaining amount in a GRAT at the termination of the GRAT to provide seeding for a further installment sale. The sale to the trust will not be treated as a gift (assuming the values are correct, and assuming that there is sufficient equity in the trust to support valuing the note at its full

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[432] Dep't of the Treasury, Internal Revenue Serv., *United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706*, 3 (Rev. Aug. 2012) *available at* http://www.irs.gov/file_source/pub/irs-pdf/f706.pdf.

[433] Interestingly, there seems to be a way around the question. The obvious way around this question, to stay "under the radar screen," would be to create the grantor trust, sell to the grantor trust, have the grantor trust pay off the note while it is still a grantor trust (so there is no income recognition) then terminate the trust before the decedent dies. The trust would not be described in Question 13a or b, so the answer to Question 13e would be no. That would seem to work if the client wants the trust to terminate during his or her lifetime. (But that is not practical in many situations.) Query whether having the trustee "decant" the assets to a new trust created by the trustee under a decanting power would avoid answering Question 13a in the affirmative? Be careful in looking for technical ways to avoid this question. If the planner is "too clever," the I.R.S. may say the planner is being misleading and allege a Circular 230 violation. Furthermore, even if the planner could avoid the current question, the I.R.S. can change the form in the future in reaction to clever plans to avoid the question.

[434] See *infra* Part XII.I for further discussion of whether to report sales on gift tax returns.

face value.) There is no clear authority for using a valuation adjustment clause as exists under the regulations for GRATs.[435]

E. Basic Income Tax Effects

The initial sale to the trust does not cause immediate gain recognition, because the grantor is treated as the owner of the trust for income tax purposes.[436] In addition, because the grantor is treated as the owner of the trust, interest payments from the trust to the grantor should also be a non-event for income tax purposes. (On the other hand, if there are sales between spouses, while there is no gain recognition on the sale under § 1041, interest payments would constitute taxable income.)[437]

In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. Theoretically, this may be endangered if the trust contains a Crummey withdrawal clause. However, recent private letter rulings reconfirm the I.R.S.'s position that using a Crummey clause does not endanger the grantor trust status as to the original grantor.[438]

The grantor will be liable for ongoing income taxes for the trust income. This can further reduce the grantor's estate for estate tax pur-

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[435] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[436] *See* Treas. Reg. § 1.1001-2(c) ex.5; Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent the grantor is treated as the owner of the trust, the trust will not be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor). In Rev. Rul. 85-13, 1985-1 C.B. 184, the I.R.S. indicated that it would not follow *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984) to the extent it would require a different result. *See also* Rev. Rul. 2007-13, 2007-1 C.B. 684 (determining that in Situation 1 of the ruling, that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts); Rev. Rul. 92-84, 1992-2 C.B. 216 (finding a gain or loss on the sale of an asset by QSST, which is a grantor trust, is treated as a gain or loss of the grantor or other person treated as the owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to corpus rather than to income).

[437] *See* Gibbs v. Comm'r, 73 T.C.M. (CCH) 2669 (1996).

[438] PLR 200729005 (July 20, 2007); PLRs 200729007-200729011 (July 20, 2007); PLRs 200729013-200729016 (July 20, 2007); PLR 200730011 (July 27, 2007); PLR 201235006 (August 31, 2012). Even if the trust does continue as a grantor trust as to the original grantor, it is not clear what happens at the grantor's death and whether the trust becomes a grantor trust as to the Crummey beneficiary. *See* PLR 9321050 (May 28, 1993), *rev'g*, PLR 9026036 (June 29, 1990) (the I.R.S. initially ruled that the beneficiary would be treated as the owner. Several years later, the I.R.S. revoked that position and said the beneficiary would not be treated as the owner without further discussion). At the grantor's death, the trust may become a grantor trust as to the beneficiary, creating an extremely advantageous planning vehicle if the beneficiary also wishes to maximize transfer planning opportunities while still remaining a potential discretionary beneficiary of the trust. *See* PLR 9321050.

poses and allow the trust to grow faster. However, the grantor must be willing to accept this liability. Giving someone the discretion to reimburse the grantor for paying income taxes of the trust may be an alternative.[439] (An additional possible alternative for the sale to grantor trust strategy is that if the grantor's spouse is a discretionary beneficiary of the trust, the trust could make a distribution to the spouse that would be sufficient to pay the income taxes that would be payable on the joint return of the grantor and the grantor's spouse.)

If the seller dies before the note is paid off, the I.R.S. may argue that gain recognition is triggered at the client's death. The better view would seem to be that gain recognition is deferred under § 453 until the obligation is satisfied after the seller's death. The recipient of installment payments would treat the payments as income in respect of decedent. Presumably, the trustee would increase the trust's basis in a portion of the business interest to reflect any gain actually recognized. The income tax effect on the trust if the grantor dies before the note is paid in full has been hotly debated among commentators.[440] A concern

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[439] Rev. Rul. 2004-64, 2004-2 C.B. 7 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries (which applies to Situation 1). Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under § 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation (which applies to Situation 2). *Id*. at 9. However, the statement that the "full value of the trust assets" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death. Observe that if a reimbursement is mandatory and it is not paid, the grantor will be treated as making a gift. *Id.* In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law (which applies to Situation 3). *Id.* The Ruling provides that the I.R.S. will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004. *Id.* Some planners suggest allowing a third person to authorize the trustee to reimburse or to allow an independent trustee to reimburse the grantor for payment of income taxes attributable to the trust. Other planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors. Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. *See*, *e.g*., TEX. PROP. CODE ANN. § 112.035(d) (West 2013); N.H. REV. STAT. ANN. § 564-B:5-505(a)(2) (B) (2013). Where a discretionary reimbursement provision is used, the planner should select a state which has such a law to govern the trust.

[440] *Compare* Carol A. Cantrell, *Gain is Realized at Death*, TR. & EST., Feb. 2010, at 21-22 (grantor is treated as having transferred property to the trust and a gain is realized

regarding the possibility of immediate recognition of income at death is that if grantor trust status is terminated during the grantor's life while any part of the note is unpaid, the capital gain is accelerated and taxed immediately.[441] However, the result may be different following the death of the grantor. One of the articles addressing this issue provides the following arguments in its detailed analysis of why income should not be realized as payments are made on the note after the grantor's death.[442]

First, the authors assert that no transfer to the trust occurs for income tax purposes until the grantor's death (because transactions between the grantor and the trust are ignored for income tax purposes.)[443] They note that there is no rule that treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance such as an unpaid installment note.[444] However, the property does not receive a step up in basis because the property itself is not included in the decedent's estate. Moreover, the note itself is included in the decedent's estate, and the authors argue that the note should be entitled to a step up the basis.[445] A step up in basis is precluded only if the note constitutes income in respect to the decedent ("IRD") under § 691. They argue that the note should not be treated as IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount."[446] The

to the extent that the note balance exceeds the basis in the property), *and* Deborah D. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. TAX'N 49 (2001) (if a trust has outstanding liabilities upon termination of grantor trust status, gain will be recognized by the grantor to the extent the amount of those liabilities exceeds the grantor's basis in the assets deemed transferred to the trust), *with* Mitchell M. Gans & Jonathan G. Blattmachr, *No Gain at Death,* TR. & EST., Feb 2010, at 34 (no gain is recognized at death), *and* Elliot Manning & Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3, 21 (1999) (neither the grantor-seller nor his estate recognize gain on death). *See also* Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 162-64 (2000) (trust should not be entitled to any increase in the basis of its assets and gain is deferred until trust sells respective assets); Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (2002) (gain is not recognized by the transferor in connection with a testamentary or lifetime gift).

441 Madorin v. Comm'r, 84 T.C. 667, 678 (1985) (holding trustee's renunciation of power to add charitable beneficiaries was a deemed disposition of trust assets and a realization event); Treas. Reg. § 1.1001-2(c) ex.5; Rev. Rul. 77-402, 1977-2 C.B. 222.

442 *See* Manning & Hesch, *supra* note 440, at 3.

443 Manning & Hesch, *supra* note 440, at 7.

444 *See* Rev. Rul. 73-183, 1973-1 C.B. 364.

445 Manning & Hesch, *supra* note 440, at 21.

446 I.R.C. § 691(a)(3).

decedent would not have recognized income if the note were paid during life,[447] so the note should not be IRD. This position is supported by the provisions of § 691(a)(4) & (5), which provide rules for obligations "reportable by the decedent on the installment method under section 453."[448] The installment sale to the grantor trust was a nonevent for income tax purposes, and therefore there was nothing to report under § 453. This position does not contradict the policy behind § 691, because the income tax result is exactly the same as if the note had been paid before the grantor's death – no realization in either event. If the unpaid portion of the note were subject to income tax following the grantor's death, double taxation would result. The sold property, which is excluded from the grantor's estate, does not receive a stepped-up basis — so ultimately there will be an income tax payable when that property is sold.

One possible planning approach if the grantor does not expect to survive the note term is for the grantor to make a loan to the trust and use the loan proceeds to pay the installment note before the grantor's death. (A step transaction argument presumably could be avoided by having the trust borrow funds from someone other than the grantor to be able to pay off the note.)

Some authors have suggested a strategy they identify as "basis boosting."[449] If an individual sells assets to a grantor trust and the individual dies, most planners think gain should not be realized at death. But the answer is unclear. The authors suggest contributing other property to the grantor trust with basis sufficient to eliminate gains. Example: An individual sells an asset with a basis of 10 for a note for 50. The asset appreciates to 100 before the grantor dies. The potential gain would be 50 minus 10 or 40 when the trust is no longer a grantor trust. If the grantor contributes additional assets to the grantor trust with a basis of 40, that basis could be applied and offset the gain. However, it is not yet clear that this will work. The amount realized from the relief of liability (50 in the example) might have to be allocated between the two assets. If one must allocate the amount deemed realized between the two assets, the gain would not be totally eliminated.

The result might be better if the two assets are contributed to a partnership or LLC, which would require having another partner or member to avoid being treated as a disregarded entity. There would seem to be a stronger argument that there would be no apportionment of the amount realized between the two classes of assets in that situation.

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447 Rev. Rul. 85-13, 1985-1 C.B. 184, 185.

448 I.R.C. § 691(a)(4)-(5).

449 Deborah V. Dunn & Lucy K. Park, *Basis Boosting*, Tr. & Est., Feb. 2007, at 22.

Chief Counsel Memo 200923024[450] concluded that a conversion from nongrantor to grantor trust status is not a taxable event (addressing what seems to be an abusive transaction). An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of the authorities suggesting that a taxable event occurs if the trust loses its grantor trust status during the grantor's lifetime, the CCA observed, "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the *death of the owner which is generally not treated as an income tax event.*"[451]

The basis of a gifted asset under § 1015 is the donor's basis, except that for loss purposes, the basis is limited to the asset's fair market value at the time of the gift. There is no clear answer as to whether the basis of assets given to a grantor trust is limited to the asset's fair market value for loss purposes (if the donor's basis exceeds the fair market value). One commentator takes the position that the loss limitation does not apply to gifts to a grantor trust.[452]

If a donor makes a gift to the grantor trust in order to "seed" an installment sale, and if the donor has to pay gift tax with respect to the initial gift, can the trust claim a basis adjustment under § 1015(d) for the gift tax paid? There is no definitive authority as to whether the basis adjustment is authorized, but there would seem to be a good-faith argument that the gift-tax paid basis adjustment should be permitted even though the gift was to a grantor trust.

F. Generation-Skipping Transfer Tax Effects

Once the trust has been seeded, and GST exemption has been allocated to cover that gift, no further GST exemption need be allocated to the trust with respect to the sale (assuming that it is for full value). A potential risk, in extreme situations, is that if the sold asset is included in the transferor's estate under § 2036, no GST exemption could be allocated during the ETIP.

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[450] I.R.S. Chief Couns. Mem. 200923024 (June 5, 2009) (emphasis added).

[451] *Id.*

[452] Schneider, Determining the Income Tax Basis of Property Gratuitously Transferred to Grantor Trusts, AMER. BAR. ASSN. REAL PROP. TR. & EST. LAW SECTION NEWSLETTER, available at *http://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/TE_Schneider.authcheckdam.pdf.*

G. Advantages of Sale to Grantor Trust

A sale to a grantor trust offers a number of advantages over a grantor retained annuity trust. For example, the estate freeze is completed without the requirement for survival for a designated period. A corollary of this advantage is that the discount when selling a partial interest is locked in as a result of the sale. For example, if a client owns 100% of an entity and sells one-third of the entity to each of three trusts, with the one-third interests being valued as minority interests,[453] the discount amount is removed from the client's estate regardless of when the person dies. If the sale had not occurred and the client owned the 100% interest at his or her death, no minority discount would be available. Second, the interest rate on the note can be based on the § 7872 rate (which is based on the relatively low interest rates on U.S. government obligations). Third, the sale can be made to a GST exempt trust, or a trust for grandchildren, so that all future appreciation following the sale will be in an exempt trust with no need for further GST exemption allocation. Fourth, the installment note conceivably can be structured as an interest-only balloon note. (With a GRAT, the annuity payments cannot increase more than 120% in any year, requiring that substantial annuity payments be paid in each year.) However, the planner must judge, in the particular situation, if using an interest-only balloon note might raise the risk of a § 2036 challenge by the I.R.S. It would seem that a § 2036 challenge is much less likely if the transaction looks like a traditional commercial transaction. (Another aspect of avoiding § 2036 is that the trust should not, as a practical matter, simply use all of its income each year to make note payments back to the seller.) While there is no requirement that even the interest be paid currently, it "may be most commercially reasonable to require the payment of interest at least annually . . . even if all principal balloons at the end."[454] Finally, the estate freeze is completed without having to recognize any income tax on the sale of the assets as long as the note is repaid during the seller's lifetime. In addition, the interest payments will not have to be reported by the seller as income.

H. Potential Risks and Disadvantages

Under extreme circumstances, it is possible that the I.R.S. may take the position that the note is treated as a retained equity interest in the trust rather than as a mere note from the trust. If so, this would raise potential questions of whether some of the trust assets should be included in the grantor's estate under §§ 2036 and 2702. It would seem

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453 *See* Rev. Rul. 93-12, 1993-1 C.B. 202.

454 Aucutt, *supra* note 269, at 661-62.

that § 2036 (which generally causes estate inclusion where the grantor has made a *gift* of an asset and retained the right to the income from that asset) should not apply to the extent that the grantor has sold (rather than gifted) the asset for full market value.[455] If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller's gross estate under § 2036. This means that the analysis of whether the note is treated as debt or as a retained equity interest is vitally important. This issue is addressed in detail in Part I.B, *supra*. A number of cases have highlighted a variety of factors that are considered.[456] One Technical Advice Memorandum concluded that § 2036 did apply to property sold to a grantor trust in return for a note based on the facts in that situation.[457]

Analogy to private annuity cases would suggest that § 2036 should not typically apply to sale transactions. For example, the Supreme Court refused to apply the predecessor of § 2036 to the assignment of life insurance policies coupled with the retention of annuity contracts, because the annuity payments were not dependent on income from the transferred policies and the obligation was not specifically charged to those policies.[458] Various cases have followed that approach (in both income and estate tax cases).[459]

One commentator has suggested that there is a significant risk of § 2036(a)(1) being argued by the I.R.S. if "the annual trust income does not exceed the accrued annual interest on the note."[460] Much of the risk of estate inclusion seems tied to the failure to have sufficient "seeding" of equity in the trust prior to the sale.

Tax litigators have reported handling cases in which the I.R.S. takes the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the "eco-

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455 *See* PLR 9436006 (Sept. 9, 1994) (holding § 2702 does not apply to stock contributed to a grantor trust and other stock sold to the trust for a 25-year note); PLR 9535026 (Sept. 1, 1995) (holding that a note, interest-only AFR rate for 20 years with a balloon payment at end of 20 years, is treated as debt and the "debt instrument is not a 'term interest' within the meaning of Section 2702(c)(3)." The court specifically refrained from ruling on the § 2036 issue).

456 *E.g.,* Miller v. Comm'r, 71 T.C.M. (CCH) 1674 (1996); Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006).

457 TAM 9251004 (Dec. 18, 1992) (holding § 2036 applies to retained right to payments under a note, reasoning that note payments would constitute a major share, if not all, of the trust income, thus causing inclusion of trust property in estate).

458 Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274, 277 (1958).

459 See Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.1 n. 55, for a listing of cases that have addressed the application of § 2036 in the context of private annuity transactions where are the grantor is retaining the right to receive substantial payments from a trust.

460 U.S. TRUST, PRACTICAL DRAFTING 4365, 4367 (1996).

nomic realities of the arrangement . . . do not support a part sale,"[461] and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (This position conflicts with Treasury Regulation Section 25.2512-8, which provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore.")[462] If the note term is longer than the seller's life expectancy, the I.R.S. would have a stronger argument that § 2036 applies.

The I.R.S. has questioned the validity of a sale of limited partnership interests to a grantor trust in the *Karmazin* case,[463] (discussed below) which was settled in a manner that recognized the sale. The I.R.S. argued, among other things, that commercial lenders would not make similar loans because the nine-to-one debt/equity ratio was too high, there was insufficient security (no guarantees were used in that transaction), and there was insufficient income to support the debt.

> One commentator summarizes planning structures to minimize the estate tax risk.
>
> The reasoning in *Fidelity-Philadelphia Trust* suggests that the estate tax case is strongest when the following features are carefully observed:
>
> a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.
> b. The note yield and payments should not be tied to the performance of the sold asset.
> c. The grantor should retain no control over the trust.
> d. The grantor should enforce all available rights as a creditor.[464]

The same commentator summarizes the possible risks of thin capitalization as follows:

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[461] Hayes, *supra* note 104, at 6. The I.R.S. is taking this position in companion cases filed in the Tax Court on December 23, 2013. Estate of Donald Woelbing v. Comm'r, No. 30261-13; Estate of Marion Woelbing v. Comm'r, No. 30260-13. Mr. Woelbing sold stock to a trust (presumably a grantor trust) in return for a promissory note bearing interest at the AFR. The I.R.S. position is that the note should be treated as having a zero value for gift tax purposes under § 2702. For estate tax purposes, the I.R.S. position is that the note should not be included as an estate asset but the stock that was sold should be included in the estate under §§ 2036 and 2038. The Notices of Deficiency allege gift and estate tax liabilities over $125 million and penalties over $25 million.

[462] Hayes, *supra* note 104, at 6 n.28.

[463] Karmazin v. Comm'r, No. 2127-03 (T.C. Oct. 15, 2003) (stipulated decision).

[464] AUCUTT, *supra* note 269, at 667.

a. includibility of the gross estate under section 2036,
b. a gift upon the cessation of section 2036 exposure,
c. applicability of section 2702 to such a gift,
d. the creation of a second class of equity in the underlying property with possible consequences under section 2701,
e. possible loss of eligibility of the trust to be an S Corporation,
f. treatment of the trust as an association taxable as a corporation,
g. continued estate tax exposure for three years after cessation of section 2036 exposure under section 2035, and
h. inability to allocate GST exemption during the ensuing ETIP.

The section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain.[465]

The risks of thin capitalization were highlighted in *Karmazin v. Commissioner*,[466] in which the I.R.S. made a number of arguments to avoid respecting a sale of limited partnership units to a grantor trust, including §§ 2701 and 2702. The I.R.S. argued that the note in the sale transaction involved in that case should be treated as debt rather than equity for various reasons, including that (i) the only assets owned by the trust are the limited partnership interests, (ii) the debt is non-recourse, (iii) commercial lenders would not enter this sale transaction without personal guaranties or a larger down payment, (iv) a nine-to-one debt equity ratio is too high, and (v) insufficient partnership income exists to support the debt. Another potential risk of thin capitalization that is rarely mentioned is the risk of having the trust treated as an association, taxable as a corporation. The planners involved in securing PLR 9535026[467] indicate that the I.R.S. required having a 10% equity interest to avoid association status in that situation.

There is potential gain recognition if the seller dies before all of the note payments are made. The I.R.S. may argue that the gain is accelerated to the moment of death. It would seem more likely that the gain should not be recognized until payments are actually made on the note. Credible arguments can be made for no income realization either during or after the grantor's death, as discussed in Part XII.E, *supra*.

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465 AUCUTT, *supra* note 269, at 669.
466 *Karmazin*, No. 2127-03.
467 PLR 9535026 (Sept. 1, 1995).

If the I.R.S. determines that the transferred assets exceed the note amount, the difference is a gift. There is no regulatory safe harbor of a "savings clause" as there is with a GRAT.[468] One way that might reduce the gift tax exposure risk is to use a defined value clause, as discussed in Part XII.J, *infra.*

There is also a volatility risk. If the asset that is sold to the trust declines in value, the trust still owes the full amount of the note to the grantor. Thus, any equity that had been gifted to the trust prior to the sale could be returned to the donor or included in the donor's estate. Furthermore, if beneficiaries or others give guaranties to provide the 10% "seeding," the guarantors will have to pay the guaranteed amount to the trust if the trust is otherwise unable to pay the note. Realize that equity contributed to a grantor trust is really at risk. Also, appreciation in the grantor trust is at risk if there is a subsequent reversal before the note is repaid. If the trust is used for new purchases, that can have great benefit – but it also has risks.

I. Summary of Note Structure Issues

The term of the note usually does not exceed 15-20 years, to ensure treatment of the note as debt rather than a retained equity interest. The term of the note should be less than the grantor's life expectancy (whether or not a SCIN is used). The § 7872 interest rate is typically used. The note typically calls for at least having the interest paid currently (annually or semi-annually). While there is no absolute requirement to have interest paid currently, doing so makes the note appear to have more "commercial-like" terms than if interest merely accrues over a long term. Using a secured note is permissible. In fact, having security for the note helps ensure that the value of the note equals the value of the transferred property.

If the gift to the trust and the subsequent sale occur close to each other, the I.R.S. might conceivably attempt to collapse the two steps and treat the transaction as a part-sale and part-gift. However, that would not seem to change the overall result. Some planners structure the transaction to leave time between the time of the seed gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in *Holman v. Commissioner*.[469] (Conceivably, the I.R.S. might argue that the combined transaction is a transfer with retained interest that is not covered by the bona fide sale for full consideration exception

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[468] Treas. Reg. § 25.2702-3(b)(2).

[469] 130 T.C. 170 (2008), *aff'd on other grounds*, 601 F.3d 763 (8th Cir. 2010) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership). See further discussion of *Holman* and other relevant cases *supra* Part XII.A.2.

in § 2036 because of the gift element of the combined transaction. However, there are no reported cases where the I.R.S. has taken that position based on gifts and sales within a short period of time of each other.)

To be totally conservative and assure that the trust is treated as a grantor trust as to the original grantor, consider not using a Crummey clause. However, the I.R.S. has ruled numerous times that using a Crummey clause does not convert the trust to being partially a grantor trust as to the beneficiary rather than as to the owner.[470]

In general, the entire corpus of the trust should be liable for the note, not just the property sold in return for the note. The amount and timing of payments should in no way be tied to the performance of the sold asset—or else the note has the appearance of being a retained equity interest in the property itself. The grantor should retain no control over the sold asset. The risk of inclusion under § 2036, in a situation where the grantor is retaining payments from the transferred property, is exacerbated if the grantor also has any control over the transferred property. Preferably, the required ongoing note payments would be less than the income produced by the sold assets. Furthermore, the trust should not routinely make prepayments to distribute all trust income to the grantor as note payments. The trust should have sufficient assets to make principal and interest payments as they become due.

The existence of the notes should be reflected on financial statements and interest income and expenses must be properly reported. Various planners typically have not reported sales on gift tax returns. However, they may rethink that position in light of Question 12(e) on Form 706 about whether the decedent ever sold an interest in an entity to certain types of trusts. Even so, many planners still tend not to report sale transactions on gift tax returns in most circumstances. If the planner decides to report the transaction, how much should be disclosed?[471] Many planners attach copies of all of the sale documents, including any sales agreement, transfer documents, notes, security agreements, deeds of trust, UCC filings, etc. Disclosing all of that information illustrates that the transaction was treated and documented as an arms' length commercial transaction. Some attorneys also report adding to the dis-

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[470] *See supra* Part XII.E.

[471] Treas. Reg. § 301.6501(c)-1(f)(4) provides that

> "[c]ompleted transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed . . ., even if the transfer is not reported on a gift tax return, provided the transfer is property reported by all parties for income tax purposes."

The regulations give, as an example, the payment of compensation to a family member. The transfer of an interest in a business, however, would not be "made in the ordinary course of operating a business" and would not seem to be within the exception.

closure a statement that the return and all attachments, taken together, are intended to satisfy the requirements of the adequate disclosure regulations. The intent is to communicate that the planner is ready in case the case is selected for audit.

Some attorneys prefer giving cash to comprise the "10% gift element" in order to stay under the I.R.S.'s radar screen. If a partnership interest is given to the trust, the box on Schedule A must be checked on the gift tax return (Form 709) reflecting that the asset was valued with a discount. (That may have been what triggered the audit that resulted in the *Karmazin* lawsuit, discussed in Parts I.B and XII.H, *supra*.)

If at some point after the transaction, the value of the trust assets is less than the amount of the debt, the transaction may need to be revisited. Alternative approaches include: (1) renegotiating the interest rate if the AFR has become lower; (2) renegotiating the principal amount of the note (but why would the grantor renegotiate for a lower principal payment?; there seems to be no advantage to the grantor unlike the typical bank renegotiation in which the bank may renegotiate in order to receive some upfront payment or more favored position; the trust has nothing "extra" to grant to the grantor in a renegotiation; this approach seems risky); (3) having the grantor sell the note from the original grantor trust that purchased the asset to a new grantor trust (the note would presumably have a lower value than its face value; any appreciation above that value would inure to the benefit of Trust 2 even though Trust 1 ends up having to pay all of its assets on the note payments. A big disadvantage is that the new trust would have to be "seeded" and the value of the underlying asset could decrease even further so that the seeding to Trust 2 would be lost as well); or (4) having the grantor contribute the note from the grantor trust to a new GRAT (future appreciation would inure to the benefit of the GRAT remaindermen but there would be no new "seeding" requirement which could be lost as well if there were more deprecation in the value of the underlying assets).[472]

J. Defined Value Structures

As discussed above, a valuation risk is that a gift may result if the I.R.S. determines that the value of the transferred asset exceeds the consideration given in the sale transaction. One way that might reduce the gift tax exposure risk is to use a defined value clause—defining the amount transferred by way of a fractional allocation between an (1) irrevocable trust and (2) the spouse (or a QTIP Trust or a GRAT or a charity) to which the transfer would not generate gift taxes. The I.R.S.

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[472] *See* Milford B. Hatcher, *Underwater GRATs and ISGT*, Presentation at ACTEC 2008 Summer Meeting (June 27, 2008).

does not recognize defined value clauses on public policy grounds but several cases have now rejected that argument where the "excess amount" passes to charity.[473] Some of the cases have directly involved sales to grantor trusts.

Petter v. Commissioner[474] involved classic inter vivos gifts and sales to grantor trusts using defined value clauses that had the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The I.R.S. maintained that a lower discount should be applied, and that the initial allocation was based on inappropriately low values. The I.R.S. and the taxpayer eventually agreed on applying a 35% discount, and the primary issue was whether the I.R.S. was correct in refusing, on public policy grounds, to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision did not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.[475]

Similarly, *Hendrix v. Commissioner*[476] involved combined gifts and sales using defined value formula clauses. Parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund, to be allocated between them under a formula. The formula provided that shares equal to a specified dollar value were allocated to the trust and the balance of the shares passed to the charitable fund. The trust agreed to give a note for a lower specified dollar value and agreed to pay any gift tax attributable to the transfer. Under the formula, the values were determined under a hypothetical willing buyer/willing seller test. The transfer agreement provided that the transferees were to determine the allocation under the

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473 McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006) (public policy issue not before court), *rev'g*, 120 T.C. 358 (2003); Christiansen v. Comm'r, 130 T.C. 1, 16-18 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (formula disclaimer that operated like defined value clause); Petter v. Comm'r, 98 T.C.M. (CCH) 534 (2009), *aff'd,* 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642 (2011).

474 *Petter*, 98 T.C.M. (CCH) 534, 534.

475 *Id*. at 544-45.

476 Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642.

formula, not the parents.[477] The court recognized the effectiveness of the transfers of defined values under the formulas.[478]

One case has approved a straightforward defined value gift assignment of a dollar amount of LLC units that did not involve a charitable transfer.[479] A similar structure conceivably could be structured in a sale transaction, by providing that only a defined value of assets are sold in the sale transaction in return for the note given as consideration, if the rationale of that case is accepted by other courts.

Another possible "defined value" approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial "seed gift" to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to an incomplete gift trust. If a court ultimately determines that the note does not equal the full value of the asset that is sold to the trust, 90% of the gift element would pass to an incomplete gift trust, and there would be no immediate gift taxation on that portion.

Another possibility is to use a disclaimer even for a sale to a grantor trust. The trust would specifically permit a trust beneficiary to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula: "To the extent any gift is made by father to me, I disclaim 99% of the gift."

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[477] *Id*. The trust obtained an appraisal of the shares and the charitable fund hired independent counsel and an independent appraiser to review the original appraisal. *Id*. at 1643. The trust and charitable fund agreed on the stock values and the number of units that passed to each. However, this description is simplified; in reality, each of the parents entered into two separate transfer transactions involving a "GST trust" and an "issue trust" and the same Foundation using this formula approach. *Id*. at 1644.

[478] *Id.* As to the public policy argument, the court determined that the formula clauses do not immediately and severely frustrate any national or State policy. *Id.* at 1647. The *Procter* case was distinguished because there is no condition subsequent that would defeat the transfer and the transfers further the public policy of encouraging gifts to charity. *Contra* Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944). The court observed that there is no reason to distinguish the holding in *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009), that similar formula disclaimers did not violate public policy. *Hendrix*, 101 T.C.M. (CCH) at 1647.

[479] Wandry v. Comm'r, 103 T.C.M. (CCH) 1472, 1476-78. *Wandry* arguably is inconsistent with *Procter*, 142 F.2d 824. Companion cases recently filed in the Tax Court involve the sale of stock for a note providing that if the I.R.S. or a court re-determined the value of the stock, the number of shares transferred would automatically adjust so that the fair market value of the stock sold would equal the face value of the note. Estate of Donald Woelbing v. Comm'r, No. 30261-13 (T.C. filed Dec. 23, 2013); Estate of Marion Woelbing v. Comm'r, No. 30260-13 (T.C. filed Dec. 23, 2013). *See supra* note 461.

If the sale is made to a grantor trust for the client that is created by the client's spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor's estate, but the client would have achieved the goal of transferring as much as possible at the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse's grantor trust makes interest payments.[480]

XIII. Self-Cancelling Installment Notes

A. SCINs in General

A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder.[481] This feature can also be useful if the seller does not want to burden the purchaser with the continued obligation to make payments after the seller's death.

Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner*.[482] The Tax Court held that the amount of the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under § 2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."[483] There was been little

480 Gibbs v. Comm'r, 73 T.C.M. (CCH) 2669 (1996).

481 Hayes, *supra* note 104.

482 74 T.C. 1239 (1980), *action on dec.*, 1981-28 (Jan. 5, 1981).

483 *Id.* at 1246-47. In *Moss*, the parties stipulated that the SCIN sale transactions (between an employer and employees) were bona fide transactions for full and adequate consideration and that the cancellation provision was part of the bargained for consideration for the purchase price of the stock. The court observed that "there was nothing to indicate that his life expectancy would be shorter than the approximate 10 years of life expectancy which was indicated by generally accepted mortality tables." (The notes had varying terms, but one of the notes had a term of 9 years and 7 months, so the term of note was very close to the seller's life expectancy.)

case law regarding SCINS. In *Estate of Costanza v. Commissioner*,[484] the Sixth Circuit recognized a SCIN as providing valuable consideration in a gift tax case. In *Estate of Musgrove v. United States*,[485] a SCIN was not recognized as a bona fide transaction in an estate tax case.

The potential advantages of using SCINs for estate tax savings may be further enhanced by "backloading" the payments. That may result in a significantly smaller amount being paid to the seller during life and with a greater amount being cancelled, thus resulting in exclusion of more value from the seller's gross estate.[486] A potential disadvantage of the SCIN transaction is that if the seller outlives his or her life expectancy, the premium that is paid for the cancellation feature may result in more value being included in the seller's estate than if the cancellation provision had not been used.

As discussed below, the SCIN transaction works best when the seller/client dies prior to, and "preferably" materially prior to, his or her actuarial life expectancy. The ideal candidate is someone in poor health,

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[484] 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128. In *Costanza*, the decedent sold real property to his son in exchange for a SCIN that was fully secured by the real property. The note was payable over 11 years. The interest rate increased by one-half percent every 24 months, beginning at 6.25 percent and ending at 8.75 percent the last 12 months of the note. The decedent died unexpectedly five months after the note was issued, after payments had been made for only three months. (He had heart disease but medical experts testified that his life expectancy at the time of the SCIN transaction was between 5 and 13.9 years.) The Tax Court concluded that the sale was not a bona fide transaction and that the SCIN provided no consideration. The Sixth Circuit stated that "a SCIN signed by family members is presumed to be a gift and not a bona fide transaction." *Id.* at 597. However, the presumption could be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court concluded that, on the facts of the case, the estate "rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness." The Sixth Circuit remanded the case to the Tax Court to determine the value of the note and whether the SCIN constituted a bargain sale with some gift element. The parties settled.

In *Costanza*, the I.R.S. interestingly argued that the parties entered into the SCIN transaction because they presumed the father would die prior to the note being fully satisfied. "If they had thought [the father] would outlive the final payment due under the SCIN, . . . there would have been no reason to have signed the SCIN, as opposed to an unconditional promissory note." The Sixth Circuit rejected this argument, reasoning that it effectively would invalidate all SCINs, but SCINs were recognized in *Estate of Moss.*

[485] 33 Fed. Cl. 657 (1995). A demand-note SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note). As a result, the SCIN was included in the decedent's gross estate.

[486] *See infra* Part XIII.I.

but whose death is not imminent, or someone with a very poor family health history. As with all sophisticated tax planning strategies, the SCIN is not for all clients or all situations, especially since clients' actual life expectancies are never truly known in advance.

There are also numerous issues concerning the technique which have not yet been fully resolved. In addition to the obvious mortality issue, there are questions as to what base rates should be used (the § 7520 rate or the AFR?), what life expectancies should be used (the tables used under § 7520, the tables used under § 72, or the seller's actual life expectancy?), how the payments should be allocated for income tax purposes (what amounts are return of basis, interest, and gain?) and the effect of the cancellation of the note upon the seller's death for income tax purposes (is the cancellation a taxable event for the debtor?). As is the case for all intra-family notes, the taxpayer must be able to establish that the notes constitute "bona fide debt,"[487] and this issue is particularly significant for SCINs.[488] In any event, the use of SCINs adds a whole new dimension of tax uncertainties and complexities.[489]

B. Note Terms

Although it is tempting to apply the below-market safe harbor of § 7872 (and, arguably, § 1274(d)), there is an additional element at work with the SCIN that makes it advisable to structure the SCIN so that the value of the SCIN is at least equal to the value of the property sold. For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Since such a feature must be bargained for at arm's length to be respected, the seller must be compensated for the risk associated with the potential cancellation either by an increase in the purchase price or

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[487] *See supra* Part I.B.

[488] *See* Estate of Costanza v. Comm'r, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128 (taxpayer rebutted presumption that SCIN was not a bona fide transaction); Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995) (SCIN not recognized as a bona fide transaction for estate tax purposes). The I.R.S. is taking the position in a case pending before the Tax Court that SCIN transactions were not bona fide transactions, primarily because there was no reasonable expectation of repayment of the SCINs, which had a very large mortality risk premium. Estate of William Davidson v. Comm'r, Tax Court Cause No. 013748-13 (filed June 14, 2013). The *Davidson* case and the accompanying Chief Counsel Advice are discussed *infra*, Part XIII.B.

[489] See Wojnaroski, *supra* note 437, for an outstanding comprehensive discussion of the use of SCINs including their valuation and tax treatment. For a discussion of planning alternatives, including the relative low mortality premium that exists under current conditions, see Maher & Laffey, *Practical Planning With Self-Cancelling Installment Notes,* Tr. & Est., April 2012, at 22.

by a higher interest rate.[490] To calculate the premium, an advisor must determine what stream of payments is required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note.[491] There is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. Some commentators use the life expectancies in Table 90CM for May 1999-April 2009 and Table 2000CM from May 2009 forward,[492] and a rate equal to the greater of 120% of the mid-term AFR, assuming annual payments, as prescribed by § 7520, or the AFR for the actual term of the note, as prescribed by § 7872.[493] Others use the annuity tables under § 72[494] and the AFR as prescribed by § 7872.[495] Additionally, some commentators have recommended that the actual life expectancy be used.[496] While an advisor could determine these payment streams and resulting rates manually, or by use of a computer program, some commentators recommend that an actuary be employed.[497]

Although the matter is by no means free from doubt, some commentators are persuaded by the well-reasoned approach of Hesch and Manning.[498] The § 7872 AFRs are, more likely than not, appropriate, and the examples used in regard to SCINs will generally use AFRs, not § 7520 rates. Nonetheless, AFRs should not be used by the faint of heart. A conservative planner probably should use the higher of the § 7520 rate or the AFR for the actual term of the note, as recommended by Covey.[499] Clearly, many, if not most, practitioners are using the higher of the § 7520 rate or the AFR for the actual term of the note; the estate tax risk of using a rate that is too low is simply too great.

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490 *See* Sheldon I. Banoff & Michael O. Hartz, *Self-Canceling Installment Notes: New IRS Rules Expand Opportunities*, 65 J. TAX'N 146 (1986).

491 *See* Richard B. Covey, et al., *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 216 (1993).

492 Treas. Reg. § 20.2031-7(d)(7); *Actuarial Valuations, Book Aleph*, I.R.S. Pub. 1457, tbl.90CM (July 1999); *Actuarial Valuations, Version 3A*, I.R.S. Pub. 1457, tbl.2000CM (May 2009).

493 *Actuarial Valuations, Version 3A*, I.R.S. Pub. 1457, at 6; *See* Covey, *supra* note 491.

494 Treas. Reg. § 1.72-9, tbl.V.

495 *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.B(1)-(2).

496 *See* Sheldon I. Banoff & Michael O. Hartz, *Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?*, 59 TAXES 499, 515 (1981).

497 *See* Covey, *supra* note 491; Susan K. Smith & Alfred J. Olsen, *Fractionalized Equity Valuation Planning: Preservation of Post-Mortem Valuation Discounts*, 34 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 1103.3(F)(2) (2000).

498 Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.B(1)-(2).

499 Covey, *supra* note 491, ¶ 216.

The term of the SCIN should not equal or exceed the individual's life expectancy, or the SCIN might be recharacterized as a private annuity.[500] Even this conclusion is not universally accepted.[501] As noted above, however, there is a difference of opinion as to how life expectancy is to be determined. Are the 90CM estate tax tables (for May 1999-April 2009) and Table 2000CM (from May 2009 forward),[502] the Table V income tax annuity tables,[503] or the Seller's actual life expectancy to be used? While a conservative approach would be to structure the SCIN to have a term which is shorter than the shortest of all of these possible life expectancies, such a structure would materially detract from the primary advantage of the SCIN—the likelihood that a would-be seller with health problems or a poor family health history will die before he or she is "supposed to." If the seller has a "terminal illness," however, the actuarial tables should not be used.[504] If § 7520 applies for these purposes, "terminal illness" means that the individual has an "incurable illness or other deteriorating physical condition" which results in at least a 50% probability that he or she will die within one year.[505] If the person lives for 18 months or longer after the relevant valuation

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500 I.R.S. Gen. Couns. Mem. 39,503, Conclusion B (May 7, 1986). Conclusion C of G.C.M. 39,503 concludes that if the stated monetary amount would be received before the expiration of the transferor's life expectancy, the transaction will be treated as an installment sale rather than as an annuity.

In light of the uncertainty of whether the actuarial tables under § 7520 apply to SCINs, as discussed in notes 508-509 *infra*, some planners suggest that annuitites may be safer than SCINs, because § 7520 clearly applies to annuities. Possible disadvantages of annuities are (1) that the purchasing trust must have sufficient assets to make annuity payments to age 110 (perhaps requiring a large gift to the trust before the sale occurs), *see* Treas. Reg. § 25.7520-3(b)(2)(i) (commonly referred to as the "exhaustion test"), and (2) there is a risk of having to make payments for many years if the seller far outlives his or her life expectancy. (In addition, private annuities have special income tax complexities, but these should not apply if the private annuity sale is made to a grantor trust.) To use an annuity while avoiding these possible disadvantages, consider selling assets to a grantor trust in return for an annuity that will be paid until the earlier of the payee's death or a date that exceeds the payee's life expectancy. (As an example, a payee who has a 5-year life expectancy might sell assets in return for payments of $X per year to be made until the earlier of 6 years or the payee's death.) Gen. Couns. Mem. 39,503 appears to treat that as an annuity, because the amount would not be paid in a period less than the actual life or life expectancy of the transferor. The exhaustion test would not require funding to age 110 beause no payments are required beyond the 6-year annuity period.

501 *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.A.

502 Treas. Reg. § 20.2031-7(d)(7); *see Actuarial Valuations, Book Aleph*, I.R.S. Pub. 1457, tbl.90CM (July 1999); *Actuarial Valuations, Version 3A*, I.R.S. Pub. 1457, tbl.2000CM (May 2009).

503 Treas. Reg. § 1.72-9, tbl.V.

504 *See* Treas. Reg. § 20.7520-3(b)(3) (discussing that depending on whether § 7520 rates apply to SCINs, this section may or may not apply).

505 *Id.*

date, he will be presumed not to have been terminally ill at the time of the transaction, unless the existence of a terminal illness can be established by clear and convincing evidence.[506] Whether or not SCINs are technically subject to this regulation, it is probably wise not to use standard actuarial tables when a person is gravely ill.[507]

In Chief Counsel Advice 201330033 the I.R.S. takes the position that § 7520 does not apply *at all* in valuing SCINs, but that the value of the notes must be determined under the general willing-buyer willing-seller standard and that the seller's life expectancy should be determined "taking into consideration [the] medical history on the date of the gift."[508] The case to which C.C.A. 201330033 relates is a pending Tax

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[506] *Id.*

[507] *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.C.

[508] We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

C.C.A. 201330033 (February 24, 2012).

The C.C.A describes the following facts. Sales of stock were made in return for SCINs, some with a principal premium (almost double the value transferred), and others with a large interest premium. GRATs were also funded about the same time. The decedent was diagnosed with a serious illness "very shortly after" the SCIN and GRAT transactions and died less than six months after the transactions, having received no payments at all on the notes. The C.C.A. distinguished *Costanza v. Comm'r*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128, to support its position that the SCINs "lack the indicia of genuine debt." The C.C.A. observed that the SCINs had been valued based upon the § 7520 tables (presumably, meaning the relevant mortality tables under § 7520), but the I.R.S. position is that § 7520 does not apply in valuing SCINs.

The C.C.A. cites I.R.S. General Counsel Memorandum 39503 taking the same position that § 7520 does not necessarily apply in valuing notes for an installment sale (although that G.C.M. predated § 7520). I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986) ("unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of an installment sale. Thus, the taxpayer's particular health status may be considered.") In that respect, the position in the C.C.A. is basically consistent with prior position statements from the I.R.S. Various commentators have noted this position of the I.R.S. ROBERT A. ESPERTI, RENNO L. PETERSON, ROBERT S. KEEBLER, IRREVOCABLE TRUST: ANALYSIS WITH FORMS, § 16.06[4][A] (1998); BNA Tax Management Portfolio 805, ¶III(C)(3)("there is no requirement that the actuarial tables are to be used in determining the gift taxation of SCINs," quoting GCM 39503).

Other commentators, however, have suggested that the §7520 actuarial tables should apply unless there are serious health issues. *See* ZARITSKY & AUCUTT, *supra* note 62, § 12.02[3] ("Section 7520 states that it must be used to value 'an interest for life or a term of years,' which precisely describes the payments under a SCIN. Furthermore, the IRS

Court case, *Estate of William Davidson v. Comm'r,*[509] in which the I.R.S. assessed a deficiency of over $2.6 billion.

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publication 'Actuarial Values, Alpha Volume,' which implements the IRS actuarial tables under Section 7520, includes an example that uses the tables to determine 'the present worth of a temporary annuity of $1.00 per annum payable annually for 10 years or until the prior death of a person aged 65. . . .' This, too, appears to describe precisely the calculation of the premium for a SCIN. Thus, Section 7520 appears to apply to the valuation of a SCIN premium.").

A fairly recent case, *Dallas v. Comm'r*, T.C. Memo. 2006-212 appears to have used §7520 in valuing a SCIN. *See* ZARITSKY & AUCUTT, *supra* note 62, § 12.02[3] at n.19.8 ("It is not possible to replicate this calculation perfectly from the facts reported in the court's opinion and in the pleadings available online. It is, however, possible to get close enough to believe strongly that the Section 7520 tables were used by the IRS in its determination of the value of the SCIN in this case.")

[509] Tax Court Cause No. 013748-13 (Petition filed June 14, 2013). Based on information in the Petition, in *Davidson*, an 85-year old individual sold closely-held stock to trusts in return for SCINs in January 2009. Some of the SCINs were structured with a principal premium (combined transfers of $162.3 million of stock for $305.9 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 2.4% [the §7520 rate]; principal premium of about 88% over the stock value). Other SCIN transactions were in return for SCINs with an interest premium (combined transfers of $432 million of stock for $432 million face value, 5-year balloon SCINs, with annual interest payments at a rate of 15.83% [reflecting an interest rate premium of 13.43% over the §7520 rate]). The mortality tables under §7520 indicate that the life expectancy was 5.8 years at the time of the sale transactions (based on Table 90CM, which applied to transactions from May 1999-April 2009 [Table 2000CM applies to transactions from May 2009 forward]).

The facts relating to the decedent's life expectancy at the time of the transfers will obviously be quite significant. The decedent's primary physician wrote a letter in October 20, 2008 stating: "Mr. Davidson continues an active exercise schedule, and is routinely working at home or in the Guardian Headquarters Office. Based on regular medical assessments and oversight, I believe that Mr. Davidson is in good health commensurate with his age group, and participates in a healthy lifestyle, exercise regimens, and activities which require keen mental rigor. He has no current conditions which will impact his actuarial life expectancy." On December 16, 2008, the primary physician wrote another letter stating that he had completed a routine medical assessment of the decedent the prior week. He concluded that "there are no changes in his health and he has no current conditions which would impact his actuarial life expectancy and continues to work in his usual capacity." A specialist in physical medicine and rehabilitation examined the decedent in early January 2009 and wrote a letter stating: "I considered [Mr. Davidson's] prognosis for return to standing and short distance assisted ambulation within 6 months to be good." This letter indicates that the decedent had significant ambulatory limitations in January 2009.

One of the I.R.S.'s medical experts estimated that the decedent had a significantly shorter life expectancy, 2.5 years. He estimated that the decedent had only a 19.3% probability of surviving for five years. The expert never personally examined the decedent but based his estimates on the decedent's medical records as well as prognostic studies and statistical studies. The I.R.S.'s valuation of the SCINs was based on this medical expert's life expectancy estimate.

In connection with the estate tax audit the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom

As discussed above in the context of an installment sale to a grantor trust, a SCIN term which is too long may raise debt/equity concerns, especially when the sale is to a trust with comparatively few other assets. The mortality component of the SCIN increases as the term of the SCIN increases, for a greater risk premium must be added to the SCIN to compensate the seller for the higher probability that the seller will die prior to the expiration of the longer term.

If the risk premium is not reflected in a higher interest rate, then it must be added to the sales price and reflected in a higher face amount of the SCIN. As discussed below, a principal risk premium should be treated as a capital gain to the seller and increase the basis of the property in the hands of the purchaser.

If a self-amortizing note with equal principal and interest payments is used, there should be no difference for estate tax purposes between choosing an interest risk premium and a principal risk premium, as the annual payments under either structure would be the same. If, however, an interest-only SCIN or a level principal payment SCIN is used, then for estate tax purposes, the relative merits of choosing the principal premium or interest rate premium to compensate the seller for the risk of death occurring during the term of the SCIN should be analyzed, as the benefits depend upon the type of note used.

For income tax purposes, choosing to increase the principal balance of the purchase price will generally result in higher capital gains taxes and lower interest income being reported by the seller, with the buyer receiving a higher basis in the purchased asset and a lower current deduction, if any, for the payment of interest. If the asset being sold has a high basis, the seller may prefer the principal adjustment approach, because there may be minimal capital taxes payable in any event. Conversely, if the purchase price remains equal to the fair market value of the property sold and the interest rate is instead increased, then the seller will report more interest and less capital gains income. In turn,

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were selected by the I.R.S. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.

If the court gets beyond the "bona fide transaction" issue, because all of the medical consultants agree that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, the court presumably will be squarely faced with addressing whether § 7520 applies in valuing SCINs. If § 7520 applies in valuing SCINs, Treas. Reg. § 1.7520-3(b)(3) indicates that the § 7520 mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. The government's position in its Answer filed August 9, 2013 is that "whether or not the decedent was terminally ill within the meaning of Treasury Regulation § 1.7520-3(b)(3) is not relevant." Therein lies the dispute that may be squarely before the court.

purchaser will take a lower cost basis in the acquired property, but may have a higher current deduction for the increased interest payments.[510]

C. Income Tax Consequences to Seller for Sale to Family Member or Non-Grantor Trust

A sale of property to a family member or a non-grantor trust in exchange for a properly structured SCIN is a taxable event and, unless the seller elects otherwise, should generally result in installment sale treatment for the seller.[511] Under the installment method, it is assumed that the seller will outlive the term of the SCIN, and the maximum principal amount to be received by the seller in the SCIN transaction, including any principal premium, is the "selling price."[512] The seller's adjusted basis is then subtracted from this selling price to determine the gross profit, if the selling price exceeds the basis.[513]

A portion of each payment will also consist of interest, which may be calculated under one of two methods, depending upon whether the SCIN is treated as a maximum selling price installment sale, or as a contingent payment installment sale.[514] By treating the payment stream as a maximum selling price installment sale, the interest paid will be front-loaded. In contrast, if the payment stream is treated as a contingent payment installment sale, the interest paid will be back-loaded.

If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. The primary question is whether the deferred gain is properly includible (a) on the deceased seller's final return, in which event the resulting income tax liability should be deductible as a § 2053 claim against the estate for estate tax purposes, or (b) in the initial return of the deceased seller's estate as an item of income in respect of a decedent ("IRD") under § 691.[515]

When the issue arose in *Estate of Frane*,[516] the Tax Court agreed that gain should be recognized upon the death of the seller prior to the expiration of the term of the SCIN, but held that the gain was properly

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[510] Jerome M. Hesch & Elliot Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26 U. of Miami Heckerling Inst. on Est. Plan. ¶ 310.3.B (1992) [hereinafter Hesch & Manning, *Family Deferred Payment Sales*]. These basis/gains/interest effects likely will not apply for assets sold to a grantor trust in return for a SCIN. *See infra* Part XIII.D.

[511] Temp. Treas. Reg. § 15A.453-1(c)(1).

[512] Temp. Treas. Reg. § 15A.453-1(c)(2)(i)(A).

[513] Temp. Treas. Reg. § 15A.453-1(b)(2)(v).

[514] Hesch & Manning, *Family Deferred Payment Sales, supra* note 510, ¶ 310.3.B(4).

[515] *See* Banoff & Hartz, *supra* note 490, at 150-51; Hesch & Manning, *Family Deferred Payment Sales, supra* note 510, ¶ 310.1.F.

[516] Estate of Frane v. Comm'r, 98 T.C. 341, 354 (1992).

reportable by the seller on the seller's final return, not by the seller's estate. The Tax Court held that the income tax consequences of the cancellation were governed by § 453B(f), which had been enacted, in part, to overrule the outcome of *Miller v. Usury*,[517] so that the cancellation of a SCIN would be treated as a disposition.[518] Because the cancellation was in favor of a related party, the fair market value of the obligation would be no less than the face amount of the obligation.[519] Since the Tax Court held that the gain was properly reportable on the seller's final income tax return, it also held that the Seller's estate was not taxable under the IRD rules of § 691(a).

The Eighth Circuit Court of Appeals overturned the Tax Court in favor of the I.R.S.'s alternate position that the decedent's estate recognizes the deferred gain on its initial income tax return as an item of IRD. In *Estate of Frane*,[520] the Eighth Circuit held that the cancellation of a SCIN is not a "disposition" which is taxed to the seller under § 453B pursuant to § 453B(f), but is rather a "transmission" which is taxable as IRD to the estate under § 691 pursuant to § 453B(c).[521] The Eighth Circuit based this decision on the language in § 691(a)(5)(iii) that "cancellation occurring at the death of obligee shall be treated as a transfer by the estate, taxable under Section 691(a)(2)."[522] This holding is in accord with I.R.S.'s published position.[523] The Eighth Circuit decision in *Frane* may not be the final word on the issue of whether the deferred gain is includible in income by the deceased seller on his final return or by the estate of the deceased seller on its initial return. The Eighth Circuit's position has not been adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and § 453B(f).[524] Furthermore, some commentators argue that the cancellation should not result in any income recognition.[525]

If the seller dies before all note payments have been paid, the net effect is that the amount of the unpaid payments is excluded from the

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[517] 160 F. Supp. 368 (W.D. La. 1958).

[518] I.R.C. § 453B(f)(1).

[519] I.R.C. § 453B(f)(2).

[520] Estate of Frane v. Comm'r, 998 F.2d 567 (8th Cir. 1993).

[521] *Id.* at 572.

[522] *Id.*

[523] *See* Rev. Rul. 86-72, 1986-1 C.B. 253; I.R.S. Gen. Couns. Mem. 39,503 (May 7, 1986).

[524] *See* Wojnaroski, *supra* note 427, at VII.A.4.C ("Taxpayers outside the Eighth Circuit may argue, in the alternative, that if the seller must recognize gain, then an estate tax deduction is available to the extent of the decedent's share of income tax liability consistent with the Tax Court's majority opinion in *Frane.*").

[525] *See id.* (discussing the 5-judge dissent in the *Frane* Tax Court decision taking the position that no gain results to either the decedent or the decedent's estate).

gross estate for estate tax purposes, but is treated as income for income tax purposes. As the estate and income tax rates become closer in amounts, does using SCINs make sense? There is a net advantage, even if the estate and income tax rates are the same, because the estate tax savings is based on the entire amount of the remaining payments whereas the income tax cost is based on just the amount of taxable income, which is the amount of the remaining payments less basis attributable to those payments. For example, if a high basis asset is sold, the income tax cost may be relatively small.

D. Income Tax Consequences to Seller for Sale to Grantor Trust

As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust. If the grantor trust ceases to be a grantor trust during the grantor's lifetime, and if the SCIN is still outstanding at the time of such cessation, a taxable event is likely to be deemed to have occurred at the time the trust ceases to be a grantor trust.[526] Presumably, any gain will be based on the excess of the amount then due under the SCIN over the adjusted basis of the grantor trust's assets.

The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. Because of the cancellation feature, and because the sale never took place for income tax purposes during the life of the seller, the deferred gain that would normally be recognized upon the death of the seller under *Frane* arguably should not be recognized by the seller or the seller's estate, although the matter is not free from doubt.[527]

E. Income Tax Consequences to Purchaser for Sale to Family Member or Non-Grantor Trust

If the sale is to a family member or a non-grantor trust, the first income tax consideration for the buyer-debtor is the calculation of the

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[526] *See* Treas. Reg. § 1.1001-2(c) ex.5; Madorin v. Comm'r, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200010010 (Mar. 10, 2000).

[527] *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.4.

> In addition, planners may structure a SCIN transaction with an irrevocable grantor trust as the buyer. The logical argument follows that if the seller realized no gain during life, then death during the term of the SCIN cannot constitute a taxable event. Section 691 contemplates a realization event for income tax purposes. In effect, the gain remains deferred until the disposition by the buyer with a carryover or substitute income tax basis.

Wojnaroski, *supra* note 427, at VII.A.4.C; *See also supra* Part XII.E (concerning the income tax treatment upon the death of the seller before all payments are made on a normal installment sale to a grantor trust).

basis in the property received. Unfortunately, the manner in which basis is determined is not completely settled. G.C.M. 39503[528] concludes that the buyer-debtor acquires a basis equal to the maximum purchase price of the property. This result would be symmetrical to the treatment of cancellation at death in favor of a related party as a disposition under § 453B(f) and is arguably supported by what might be dicta in the Eighth Circuit's decision in *Frane*.[529] G.C.M. 39503 and the *Frane* appellate decision, however, both predate the final versions of Treasury Regulation sections 1.483-4 and 1.1275-4(c)(5), which provide that a purchaser only receives basis when payments are made on a contingent payment instrument, not when the contingent payment obligation is issued. Although it is not clear that a SCIN is a contingent payment instrument subject to these regulations, a conservative purchaser may choose to increase basis only to the extent that payments are made, especially because of the potential penalties under § 6662(e)(1)(A) and (h)(2) if the adjusted basis claimed exceeds 200% of the amount determined to be correct.[530]

The second income tax consideration for the purchaser is the amount and deductibility of interest. The amount of the interest component of each payment should be computed under one of the two methods discussed above in regard to the seller. As for the buyer's ability to deduct the interest, while G.C.M. 39503 states that "[in] the installment sale situation, . . . interest is fully deductible by the buyer," the purchaser will be subject to the typical limitations placed on the deductibility of interest, depending upon the nature of the assets purchased. Although the default classification of interest for an individual is nondeductible personal interest,[531] interest payments under a SCIN, unless issued in regard to the purchase of a personal use asset other than a primary or secondary residence, should generally be deductible as investment interest under § 163(h)(2)(B) (subject to the limitations of § 163(d)), as qualified residence interest with respect to a primary or secondary residence under § 163(h)(2)(D) and (h)(3), as passive activity interest under §§ 163(h)(2)(C) and 469, or as business interest under § 163(h)(2)(A). Finally, although the death of the seller during the term

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528 I.R.S. Gen Couns. Mem. 39,503.

529 *See* Estate of Frane v. Comm'r, 998 F.2d 567, 571 n.5 (8th Cir. 1993); Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.F. Other commentators conclude that the purchaser takes a basis equal to the maximum purchase price without noting any caveats, other than noting that there is no authority of what the purchaser's basis would be if it should be determined that no gain should be recognized either to the decedent or the decedent's estate. Wojnaroski, *supra* note 427, at VII.B.2.

530 *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.F (a SCIN should not be treated as a contingent payment obligation for these purposes).

531 I.R.C. § 163(h)(1)-(2).

of the SCIN arguably may represent cancellation of indebtedness, resulting in a reduction of the buyer's basis under § 108(e) (and possibly taxable income to the buyer to the extent that the cancellation of indebtedness exceeds basis), this result does not seem to comport with the intent of § 108(e).[532]

F. Income Tax Consequences to Purchaser for Sale to Grantor Trust

As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust. If the trust ceases to be a grantor trust during the grantor's lifetime, if the SCIN is still outstanding at the time of such cessation, and if a taxable event is deemed to have occurred at the time the trust ceases to be a grantor trust, then the trust will take either a cost basis for the purchased property, which presumably will equal the outstanding balance under the SCIN at the time the trust ceases to be a grantor trust, or possibly will take a basis for such property equal to the payments under the SCIN, as provided in the regulations for a contingent payment instrument.[533]

The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. As in the case of a typical installment sale to a grantor trust, the outcome is certainly not free from doubt, but because of the cancellation feature, and because the grantor trust would not be obligated to make any payments under the SCIN after the seller's death, the trust should take a basis under § 1015(b), which would typically be a carryover basis as opposed to a cost basis.[534]

G. Gift Tax Considerations

There are several gift tax considerations in regard to a SCIN transaction. These are substantially the same as those in regard to a typical installment sale to a grantor trust. First, there is the normal valuation issue with respect to the assets sold in the transaction. Second, if the value of the SCIN received is found to be worth less than the value of the property sold (or not "substantially equal" to the value under the standard set forth in G.C.M. 39503), then the transaction will be treated

532 *Compare* Burgess J.W. Raby & William L. Raby, *Self-Canceling Installment Notes and Private Annuities*, 91 TAX NOTES 2035, 2038 (June 18, 2001) (taking the position that I.R.C. § 108(e) applies), *with* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.3.F *and* Jerome M. Hesch, *The SCINs Game Continues*, 91 TAX NOTES TODAY 136-96 (2001) (making a persuasive argument that I.R.C. § 108(e) does not apply).

533 *See* Treas. Reg. §§ 1.1275-4(c)(5), 1.483-4.

534 *See* Hesch & Manning, *Beyond the Basic Freeze*, *supra* note 308, ¶ 1601.4.

as a part sale/part gift. The potential negative implications of such a bargain sale are very similar to those discussed above with respect to a typical installment sale to a grantor trust. Not only would a taxable gift result, but if the property is sold to a trust, the gift may even cause the assets in the trust to be ultimately includible in the grantor's gross estate, for estate tax purposes, at their date of death or alternate valuation date values, including any appreciation after the initial transfer of the assets to the trust.

If a trust is the purchaser in a SCIN transaction in which a principal premium approach is used, substantially greater "seed" funding may be required to insure that the SCIN will be regarded as bona fide debt. In all probability, the total trust assets, or access to assets (taking into account bona fide guarantees), should be at least 10% (or possibly 11.1%) more than the principal obligation under the SCIN, including the principal premium. Otherwise, the transfer to the trust may be treated as an equity contribution, which almost inevitably would result in a significant taxable gift.[535]

H. Estate Tax Considerations

If the SCIN is properly structured, and if there are no other retained interests in the SCIN or in a purchasing trust which would result in inclusion, the seller's death prior to the expiration of the SCIN term should result in the inclusion in the seller's gross estate, for federal estate tax purposes, of only the payments made or due under the SCIN during the seller's life (and any income or appreciation attributable to such payments). The balance due under the SCIN, exclusive of any payments due but not made during the seller's life, will be cancelled and will escape inclusion in the seller's gross estate.[536] In this regard, G.C.M. 39503 states that "in the case of an installment sale, when a death-extinguishing provision is expressly included in the sales agreement and any attendant installment notes, the notes will not be included in the transferor's gross estate for Federal estate tax purposes." This removal of assets from the seller's gross estate is the primary motivation for using a SCIN.

The obvious tradeoff from an estate tax standpoint of a SCIN, of course, is that if the seller lives longer than he or she is "supposed to" and thus survives the end of the SCIN term, the assets included in the seller's gross estate will be greater, and possibly much greater, than if the seller had sold the property in a typical installment sale. Because of

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[535] *See supra* Part XII.A.1 (regarding the structuring of installment sales to grantor trusts); *Cf.* PLR 9535026 (Sept. 1, 1995).

[536] Estate of Moss v. Comm'r, 74 T.C. 1239, 1247 (1980), *acq. in result only*, 1981-1 C.B. 2.

the risk premium, the SCIN payments will be materially higher than typical installment payments, and unless the payments are consumed or otherwise insulated from estate tax inclusion, they will be includible in the decedent's taxable estate. Depending upon the total return on the assets sold and interest rates, the estate tax inclusion could be even worse than if the seller had done nothing.

I. Advantages and Disadvantages of SCINs

The conventional wisdom is that a SCIN will provide the maximum estate tax benefit only if the seller is expected to die prior to his or her actuarial life expectancy. If the seller obliges by passing away prior to, and "preferably" materially prior to, his or her actuarial life expectancy, the estate tax savings can be quite substantial. In so many words, the seller in a SCIN transaction is gambling on his or her premature death.

Unless the purchased property consists of personal use property (other than a primary or secondary residence), the interest paid by the purchaser under the SCIN should generally be deductible. This assumes that the purchaser in the SCIN transaction is not a grantor trust.

Although the issue is not free from doubt, the basis of a purchaser (other than a grantor trust) in a SCIN transaction should be the initial principal obligation under the SCIN, including any principal premium. In contrast, the purchaser's basis for property purchased in a private annuity transaction may be limited to the aggregate annuity payments, which could result in a lower basis, especially if the seller dies prematurely (as anticipated).

A payment deferred under either a SCIN or a private annuity is a payment that may never have to be made. Backloading of payments is much more easily structured under a SCIN, as opposed to a private annuity. Conceptually, either interest or principal should be deferrable to a date within the seller's actuarial life expectancy, but an appropriate principal premium or interest premium would have to be calculated and ultimately paid (unless the seller dies before the due date). However, in *Estate of Musgrove v. United States*,[537] a demand SCIN transaction was held to be a gift because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds). This permissible backloading is a distinct SCIN advantage.

The property sold in exchange for the SCIN can be used as security, thus better assuring the stream of payments if the seller is otherwise concerned that payments will not be made. In contrast, a private annuity should not be secured or guaranteed.[538] Although the issue is by no

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[537] 33 Fed. Cl. 657, 669 (1995).

[538] *See* Banoff & Hartz, *supra* note 490, at 149.

means free from doubt, there is a distinct possibility that the interest rate under the SCIN can be based on the generally lower AFR for the particular note pursuant to § 7872, as opposed to 120% of the mid-term AFR under § 7520. However, the planner must judge whether use of the § 7872 AFR is worth the gift tax risk and possibly the estate tax risk.[539]

With these many advantages to recommend it, one may ask why there are so few SCIN transactions in practice. Part of the answer is that, as outlined above, the SCIN is replete with tax uncertainties. In addition, if the seller dies before the SCIN matures, the deferred gain will be recognized for income tax purposes, upon cancellation of the note as of the seller's death, either in the deceased seller's final return or her estate's first return. This disadvantage is much more significant as the estate and income tax rates become closer to each other. However, even if the rates are close together, there may still be a significant advantage with a SCIN because the estate tax savings is based on the entire amount that is cancelled whereas the income tax cost is based on the amount cancelled less basis that is attributable to that amount. It is less clear whether the same, or similar, income tax results will follow if the purchaser is a grantor trust; arguably, the remaining deferred gain should not be recognized by the seller or seller's estate.[540]

XIV. Loans Involving Estates

Estates often have liquidity needs for a variety of reasons, not the least of which is to be able to pay federal and state estate taxes nine months after the date of death. Other family entities may have liquid assets that would permit loans to the estate. This is a very commonly occurring situation. A very important tax issue that arises is whether the estate will be entitled to an estate tax administrative expense deduction for the interest that it pays on the loan.

On other side of the coin (and of less importance), there may be situations in which beneficiaries need advances before the executor is in a position to be able to make distributions. One possible scenario where this can occur is if only one beneficiary needs assets from the estate quickly, but the executor wants to make pro rata distributions when distributions are made. An advance could be made to the one beneficiary with needs until distributions can be made.

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539 *See supra* Part XIII.B (discussion of the interest rate selection issue).

540 *See supra* Part XIII.D (regarding installment sales to grantor trusts for a SCIN); *See also supra* Part XII.D (regarding traditional installment sales to grantor trusts). Presumably, the income tax treatment would be similar for these two situations.

Section 2053 does not refer to the deduction of interest as such. To be deductible, interest must qualify as an administration expense.[541] Deducting interest as an estate tax deduction is not as attractive as at one time, because the interest would be recognized as income when received and the decrease in the estate tax rates reduces the amount of arbitrage on the rate differential between the estate tax savings and the income tax cost. Even so, substantial savings may be achieved because the estate tax reduction occurs nine months after date of death whereas the interest income may not be recognized until later years.

Interest payable to the I.R.S. on a federal estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law.[542] Unlike interest payable to the I.R.S. on deferred estate tax payments, interest on private loans used to pay estate taxes is *not* automatically deductible. The I.R.S. recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets.[543] Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets.[544] The interest is deductible only for the time period for which the loan is reasonably necessary for that purpose.[545]

Various cases have permitted an interest deduction where the funds were borrowed from a family-owned entity rather than being borrowed

[541] *See generally* Philip M. Lindquist, *Making Lemonade from Lemons—Deducting Interest on the Form 706*, 14 PROB. & PROP., May/June 2000 at 21-26 (outstanding general discussion); Michael Harmon, & William N. Kulsrud, *When is Interest Deductible as an Estate Administration Expense?*, 77 PRAC. TAX STRATEGIES 166 (Sept. 2006).

[542] *See* Estate of O'Neal v. Comm'r, 258 F.3d 1265 (11th Cir. 2001); Rev. Rul. 79-252, 1979-2 C.B. 333 (discussing interest on estate tax deficiency). The interest expense is deductible even if the interest accrues as a result of the estate's willful delay in filing the estate tax return and in paying the estate tax. Rev. Rul. 81-154, 1981-1 C.B. 470.

[543] Rev. Rul. 84-75, 1984-1 C.B. 193 (finding interest on a private loan obtained to pay federal estate taxes deductible because the loan was obtained to avoid a forced sale of assets).

[544] *See generally* Hipp v. United States, 29 A.F.T.R.2d 72-1498 (D. S.C. 1971); Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387 (1988); Estate of Sturgis v. Comm'r, 54 T.C.M. (CCH) 221 (1987); Estate of Webster v. Comm'r, 65 T.C. 968 (1976); Estate of Todd v. Comm'r, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; Estate of Huntington v. Comm'r, 36 B.T.A. 698, 726 (1937).

[545] Estate of Lasarzig v. Comm'r, 78 T.C.M. (CCH) 448 (1999). The court refused to allow the estate to deduct interest on borrowing to pay estate tax where the beneficiaries rather than the estate borrowed the funds after an extended period of time. The court was troubled by the estate's effort to keep the case open for up to 20 years after the parties had resolved all controversies, observing that the I.R.S. allowed deferral of payment of the estate tax for 5 years, "which seems to be a sufficient time to raise the funds to pay an agreed tax obligation."

from a bank.[546] In *Estate of Murphy*,[547] the estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The I.R.S. argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred because the estate illiquidity was the result of the decedent's transfer of assets to an FLP. The court disagreed because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes.[548] (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejected this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment."[549]

In *Beat v. United States*,[550] the estate owned largely illiquid farmland. The estate distributed the assets to the beneficiary subject to a refunding agreement, and the estate borrowed money from the beneficiary to pay estate taxes. The estate had not paid interest to the plaintiff; it was bankrupt and could not pay the interest. The court reasoned that even if the asset had not been distributed there would have had to be borrowing to pay the estate tax and that the borrowing was "necessary and beneficial to the Estate."[551]

An interest deduction was allowed on a Graegin loan in *Estate of Duncan v. Commissioner*.[552] A revocable trust (responsible for paying

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546 *See*, *e.g.*, Duncan v. Comm'r, 102 T.C.M. (CCH) 421 (2011); Estate of Thompson v. Comm'r, 76 T.C.M. (CCH) 426 (1998) (determining that after estate borrowed $2 million from irrevocable life insurance trust, regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary."); McKee v. Comm'r, 72 T.C.M. (CCH) 324 (1996) (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors"); *Graegin*, 56 T.C.M. (CCH) 387; Estate of Murphy v. United States, 104 A.F.T.R.2d 2009-7703 (W.D. Ark. 2009); Beat v. United States, 107 A.F.T.R.2d 2011-1804 (D. Kan. 2011); Keller v. United States, 104 A.F.T.R.2d 2009-6015 (S.D. Tex. 2009) ($114 million borrowed after death from FLP on a 9-year note).

547 104 A.F.T.R.2d 2009-7703.

548 *Id.* at 7720.

549 *Id.* at 7722 (citing McKee v. Comm'r, 72 T.C.M. (CCH) 324).

550 107 A.F.T.R.2d 2011-1804.

551 *Id.* at *9.

552 102 T.C.M. (CCH) 421 (2011). The decedent had transferred a substantial part of his estate, including oil and gas businesses to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under

estate taxes) borrowed funds from an almost identical irrevocable trust. The loan was evidenced by a 6.7%[553] 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict.[554] The estate claimed a deduction under § 2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan, which the court allowed because (i) the loan was bona fide debt,[555] (ii) the loan was actually and reasonably necessary,[556] and (iii) the amount of the interest was ascertainable with reasonable certainty.[557]

A deduction was similarly allowed in *Estate of Kahanic*.[558] The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes

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the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries. The irrevocable trust had liquidity and the revocable trust (which was responsible to pay the estate tax) did not.

[553] The 6.7% interest rate was the rate quoted by the banking department of one of the corporate co-trustee for a 15-year bullet loan (at the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%). *Id.* at 423.

[554] In fact, the revocable trust ended up being able to generate to over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years. *Id.* at 425.

[555] Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. *Id.* at 426.

[556] The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. *Id.* at 425. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. *Id.* The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. *Id.* The 15-year term was reasonable because of the volatile nature of the anticipated income. *Id.* The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. *See id.* at 425-26. The I.R.S. complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." *Id.*

[557] *Id.* The I.R.S. argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. *Id.* at 426. If a prepayment benefited one trust it would be a financial detriment to the other. *Id.*

[558] 103 T.C.M. (CCH) 1434 (2012). Observe, this case did not involve a "Graegin" loan, discussed in *Duncan*, because the loan could be repaid at any time. Accordingly, the estate in *Kahanic* did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan; the issue was merely whether the interest that had accrued up to the time of trial could be deducted under § 2053. *Id.* at 1435.

without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short-term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial because (i) the loan was bona fide debt,[559] (ii) the loan was actually and reasonably necessary,[560] and (iii) the interest will be paid by the estate.[561]

Cases have not always allowed the full estate tax deduction for interest when an estate borrows funds from a family entity. In *Estate of Koons v. Commissioner*[562] the court disallowed a $71 million interest deduction on a $10.75 million note. The estate had about $19 million of liquid assets and the return positions indicated that it owed about $21 million of estate tax and the decedent's revocable trust owed about $5 million of GST tax. (The I.R.S. position was that those liabilities were $64 million and $20 million, respectively.) The estate borrowed the cash in 2006 from an LLC owned 71% by the estate. Payments under the note were to be paid over 8 years (2024-2031) beginning *18 years* after the loan was made from an LLC. The court reasoned that the estate could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the

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[559] The I.R.S. argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefitted from the estate being able to pay its estate taxes because otherwise she would have been liable for some of the estate taxes because of transferee liability. The court responded that she did not demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the I.R.S.'s estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not mean to collect the loan. *Id.* at 1443-44.

The I.R.S. also argued that the estate never intended to repay the loan. The court disagreed, believing the executor's testimony that she intended to repay the loan when it was made but the estate financially deteriorated when the medical practice could not be sold as a going concern. *Id.* at 1444-45.

[560] The I.R.S. argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities, but the court stated that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the I.R.S. maintained that the estate could have sold its illiquid assets in time to pay the taxes. The court disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount. *Id.*

[561] The I.R.S. believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest. *Id.* at 1445.

[562] T.C. Memo. 2013-94.

estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years "hinders the 'proper settlement' of the Estate."

The court rejected an interest deduction for amounts loaned from an FLP to the estate in *Estate of Black v. Commissioner*.[563] An FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the I.R.S. gave in its "no bona fide loan" argument.[564] The partnership had to sell the stock, and it loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets—the company stock that was owned by the FLP was in fact sold by the FLP.[565] The partnership could have redeemed the estate's interest in the FLP and the estate could have sold the assets received from the partnership to pay the estate tax.[566]

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563 133 T.C. 340 (2009). The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The I.R.S. argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). For further discussion, see generally Stephen Liss, *Estate of Black: When Is It "Necessary" to Pay Estate Taxes With Borrowed Funds?*, 112 J. TAX'N 373 (2010).

564 The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate *Id.* at 384-85.

565 *Id.* at 384. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock.

566 John Porter (the attorney representing the estate) points out a business judgment problem with the redemption argument. *Id.* at 381. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the

In *Estate of Stick v. Commissioner*,[567] the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan.[568] (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)[569]

Technical Advice Memorandum 200513028[570] refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes.[571] The ruling gave various reasons for denying a deduction for the interest expenses. (The I.R.S. did not refer to the creation of the FLP as a self-imposed illiquidity as one of the reasons.) First, the I.R.S. reasoned that the loan was not necessary to the administration of the estate because one of the decedent's sons who was a co-executor of the estate was the remaining general partner of the FLP, the FLP was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to access the funds.[572] Second, the I.R.S. reasoned

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value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

[567] 98 T.C.M. (RIA) 2010-192 (2010).

[568] *Id.* at 1155.

[569] *See supra* note 549 and accompanying text.

[570] TAM 200513028 (Apr. 1, 2005)

[571] In that situation, the decedent created a family limited partnership with 90% of his assets, and died 5 ½ years later. The estate borrowed funds from the FLP to pay federal and state estate taxes under a 10-year note with principal and all interest payable on maturity, with a prohibition against any prepayments. The stated interest rate was 1% over the prime rate and 3% more than the 15-year mortgage rate on the date of the note. The estate's 99% interest in the FLP was pledged as security for the note. *Id.* at 2-3.

[572] *Id.* at 5. The I.R.S. rejected the notion that the estate could not require a distribution from the partnership since the estate possessed only a 99% assignee interest:

> 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

that the interest may not be repaid, and even if it is, the repayment has no economic impact on the parties.[573] The most likely scenario for paying the loan was that the FLP would distribute assets to the estate, which would then repay those assets back to the FLP in payment of the loan.[574]

Some I.R.S. agents have indicated informally that claiming an interest deduction on a Graegin loan for borrowing from a family limited partnership will draw close scrutiny as to whether § 2036 applies to include the partnership assets in the estate (without any discount).

When the estate receives an extension to pay estate tax under § 6161, the interest is deductible generally *only when it is actually paid.* In Revenue Ruling 80-250,[575] the I.R.S. gave two reasons for refusing to allow an "up-front deduction" for the interest.[576] First, an estate can accelerate payment of the deferred tax. Second, the interest rate of the deferred amount fluctuates, which makes it impossible to accurately estimate the projected interest expense.[577] In *Estate of Graegin v. Com-*

> 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.)

Id. at 5-6.

573 *Id.*

574 The limitation of the deduction for amounts actually paid "ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries." *Id.* at 6. In this case the interest payments have no economic effect on the beneficiaries. If the estate has any funds for making payments, the estate would make the payments to the FLP to pay the interest, which would proportionately increase the value of the beneficiaries' interests in the FLP. More likely, the FLP will distribute assets to the estate, which will then repay those assets back to the FLP in payment of the loan:

> 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.

Id. at 7. The I.R.S. attempted to further support this argument by analogizing to income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances involving circular transfers for making payments on purported loan transactions. *Id.*

575 Rev. Rul. 80-250, 1980-2 C.B. 278.

576 The Ruling actually involved interest payments on a § 6166 payout rather than an extension under § 6161. The law has since changed so that interest on a § 6166 extension is not deductible, but the interest rate is only 45% of the normal I.R.S. rate on underpayments (effectively allowing the benefit of a deduction at what was then a 55% marginal rate). However, the Ruling still gives the I.R.S.'s reasons for not allowing an "upfront" deduction for interest payments on payment extensions. *See id.*

577 Various courts agreed with the I.R.S.'s concerns, and refused to allow an upfront deduction of the estimated interest because of the fluctuating interest rate and the possibility of prepayment (or forced acceleration) of the deferred payments. *See e.g.*, Estate of Harrison v. Comm'r, 52 T.C.M. (CCH) 1306 (1987); Estate of Spillar v. Comm'r, 50

missioner,[578] however, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation.[579]

The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note.[580] The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest,"[581] but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case,"[582] but found the executor's testimony regarding his intention with respect to repayment of the note credible. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.[583]

The I.R.S. has approved the upfront deduction of interest in several Graegin loan situations.[584] The I.R.S.'s position in the letter rulings that all interest that would have been owed for the entire loan term must be paid upon default of the note may present usury problems in some states. An alternative planning possibility may be to have the lender waive the right to accelerate the note in the event of default.[585] Other I.R.S. rulings involving Graegin loans have refused to allow the interest deduction.[586]

Most of the cases involving Graegin loans have allowed the upfront interest deduction, in situations where the estate could establish a reason for the borrowing other than to generate the estate tax deduc-

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T.C.M. (CCH) 1285 (1985); Estate of Bailly v. Comm'r, 81 T.C. 246, *modified*, 81 T.C. 949 (1983).

[578] 56 T.C.M. (CCH) 387 (1988); *See generally* Louis S. Harrison, *Borrowing to Pay Estate Tax*, Tr. & Est., May 2009, at 46.

[579] 56 T.C.M. (CCH) 387.

[580] *Id.*

[581] *Id.*

[582] *Id.*

[583] *Id.*

[584] *See*, *e.g.*, PLR 200020011 (May 19, 2000) (allowing a current deduction for the projected interest payments after the loan is amended to provide that it cannot be prepaid and that upon default all interest that would have been owed throughout the loan term must be paid at the time of default); PLR 199952039 (Dec. 29, 1999) (ten year note providing for annual interest payments with a balloon principal payment at the end of ten years); PLR 199903038 (Jan. 22, 1999).

[585] That way, if there is a default, the terms of the note would continue to apply, and interest would continue to run to the end of the term of the loan.

[586] *E.g.*, TAM 200513028 (Apr. 1, 2005) (refusing to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes); See *supra* notes 570-574 and accompanying text for a more detailed discussion of TAM 200513028.

tion, and courts are reluctant to second guess the business judgment of the executor.[587] A few cases have also disallowed interest deductions in Graegin loan situations, where the estate could not demonstrate the necessity for the borrowing over the life of the loan.[588] I.R.S. officials have stated informally that the I.R.S. is continuing to look for vehicles to contest Graegin loans, particularly in situations involving family limited partnerships. The I.R.S.'s concern is that a deduction will be allowed but the interest in fact will not have to be paid over the entire term of the note.

The economics of this up-front deduction can be staggering. For example, assume a $10 million taxable estate. Assume the marginal estate tax bracket is 40%.[589] If sufficient lifetime gifts have been made so that the estate is in a 40% bracket, the estate would owe $4.0 million in estate taxes. However, assume the estate borrows $1.434 million [this amount is calculated in an interrelated calculation] from a closely-held company under a 15 year note, at 12.0% interest, with a balloon payment at the end of the 15 year period. The accumulated interest payment due at the end of the 15 years would be $6.415 million. Under the *Graegin* analysis, the interest expense would be currently deductible, yielding a taxable estate of $10 - $6.415 or $3.585 million, which would result in a federal estate tax (at a 40% rate) of $1.434 million. The $6.415 million of interest would be paid to the company (which in turn, is owned primarily by family members.) The overall result is a very considerable estate tax savings. The estate tax that is due 9 months after

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587 *E.g.*, Estate of Duncan v. Comm'r, 102 T.C.M. (CCH) 421 (2011); Estate of Gilman v. Comm'r, T.C.M. (RIA) 2004-286 (2004) (estate borrowed funds to pay (i) federal and state estate taxes, (ii) compensation to executors [who were also employees of the estate's closely held business and the will specified that they were not to receive executor's commissions but should continue to receive compensation from the business], and (iii) miscellaneous expenses; court concluded that loan was necessary because of estate's illiquidity and allowed interest deduction through date the notes were due); Estate of Murphy v. United States, 104 A.F.T.R.2d 2009-7703 (W.D. Ark. 2009); Keller v. United States, 104 A.F.T.R.2d 2009-6015 (S.D. Tex. 2009) ($114 million borrowed after death from FLP on a 9-year note). *Cf.* McKee v. Comm'r, 72 T.C.M. (CCH) 324 (1996) (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors.").

588 *E.g.,* Estate of Black v. Comm'r, 133 T.C. 340 (2009); Estate of Lasarzig v. Comm'r, 78 T.C.M. (CCH) 448 (1999) (court observed that no prior cases had allowed such deduction in a situation in which a taxpayer "seeks an extended delay (up to 20 years) so that a nonparty (family trusts of beneficiaries) can benefit from improved market conditions that may or may not occur.").

589 The American Taxpayer Relief Act of 2012 changed the estate tax rate to 40% for the portion of taxable estates in excess of the estate tax applicable exclusion amount. I.R.C. § 2001(c). This rate will not change without further legislative action.

the date of death is reduced from $4.0 million to a little under $1.5 million.

The interest income would be subject to income tax over the 15-year period, and the I.R.S. will take the position that the interest on loans to pay taxes is nondeductible personal interest. However, many families are willing to pay income taxes over the payment period if they can reduce the estate taxes that are due nine months after the date of death. Be aware that if a QTIP trust or funded revocable trust is the borrower rather than a probate estate, the I.R.S. may argue that, under § 2503(b), only interest actually paid within the estate tax statute of limitations period may be deducted.

The § 2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plans for 2009-2014 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.).[590] Graegin notes are also in the scope of that project.

[590] Dep't of the Treasury, 2013-2014 *Priority Guidance Plan* at 16 (August 9, 2013), www.irs.gov/uac/Priority-Guidance-Plan ("Guidance under § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate").