GOBLINS LAMENTATION LIST:
UNSCRAMBLING
"INSTALLMENT OBLIGATIONS"

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I. INTRODUCTION

A. Two of the most common tools used in estate planning are promissory notes (i.e., intra-family loans) and installment obligations or notes (i.e., a sale of property to an "intentionally defective grantor trust (IDGT) in exchange for an installment note). In most cases, these transactions are between a grantor and a grantor trust that is not includable in the estate of the grantor (i.e., IDGT) so that there are no income tax consequences. However, grantor trust status is not permanent, and when grantor trust status is lost, income taxes come into play.

B. Income tax planning often involves strategies that will defer a taxpayer's tax liability. The most common method of deferring a tax liability is to take advantage of the installment method of accounting. Generally, under the installment method of accounting, gain on an installment sale is spread over the period during which the installment payments are received, rather than being taxed in the year of sale. The installment method does not apply to losses sustained on an installment sale.

C. As we will see, installment obligations or notes utilized in a sale of property to an IDGT are treated very differently than installment notes in a taxable sale of property. For terminology purposes, let's refer to them as "IDGT Installment Notes or Obligations," as opposed to "Taxable Installment Notes or Obligations." The confusion that often arises when discussing the income tax consequences of promissory and installment notes is really a function of semantics. Installment obligations and promissory notes are essentially the same thing. Both involve a legal obligation by one party (the borrower or purchaser) to pay an amount (usually fixed in value) to another party (the lender or seller), and such amount can be satisfied with cash or property. Installment notes in an IDGT sale are not really "installment obligations" at all because there are no income tax consequences to the sale or the deferred payments of principal or income, provided grantor trust status is maintained. When grantor trust status is lost or when the grantor dies holding an intra-family promissory note ("Intra-Family Promissory Note") or installment note (IDGT or taxable), the income tax consequences are very different for each type of note or obligation.

D. One issue that has apparently never been discussed is if grantor trust status is lost while the IDGT Note is outstanding, does the conversion transform the obligation to a Taxable Installment Obligation? That seems to be the case. As discussed in these materials, the rules and restrictions regarding Taxable Installment Notes are very different than for IDGT Notes.

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II. TAXABLE INSTALLMENT OBLIGATIONS

A. Basic Rules

1. Section 453(b) of the Internal Revenue Code of 1986, as amended (the "Code") defines an "installment sale" as a "disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[2] Under the installment method, the seller will recognize gain as the seller receives each deferred payment, and each payment received is comprised of: (i) a nontaxable recovery of a portion of the adjusted basis of the sold property; (ii) a taxable portion of the realized gain; and (ii) taxable interest.[3] The amount of each payment that the seller must report as taxable gain is determined by multiplying the total amount of payments that the seller received during the taxable year by the gross profit percentage (or ratio), which is determined by dividing the gross profit by the total contract price.[4]

> Example: Seller sells property with an adjusted basis of $40,000 to a buyer for $1,000,000 payable in 10 equal annual installments ($100,000 per year plus interest). The gross profit to Seller is $60,000 ($1,000,000 selling price - $40,000 adjusted basis). The gross profit percentage is 60% ($60,000 of gross profit ÷ $1,000,000 total contract price). Each annual payment to Seller will be treated as $60,000 of gain (gross profit percentage 60% x $100,000 annual payment), $40,000 of nontaxable recovery of basis, and interest (ordinary income).

2. The foregoing assumes a situation that provides for annual payments of principal. That being said, there appears to be no prohibition from deferring principal payments (e.g., annual interest payments with a balloon payment of all principal at the end of the term). Furthermore, principal payments need not be the same each year. The principal payments can vary year-over-year.

3. Although the Code and the Treasury Regulations do not prescribe any limitations on the term of Taxable Installment Notes, the IRS has ruled if the term of a purported debt obligation is equal to or greater than the life expectancy of the seller, then the obligation will be treated as an annuity (taxed under section 72 of the Code).[5] In contrast, "If the stated monetary amount would be received by the transferor before the expiration of his or her life expectancy (as determined actuarially at the time of the sale agreement), then the transaction will be characterized as an installment sale."[6]

4. If the terms of the installment sale do not have a stated interest or the stated interest is too low, the seller is required to treat a portion of each installment as imputed interest

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[2] § 453(f)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted.

[3] §§ 453(c) and 61(a)(4).

[4] *Id.*

[5] GCM 39503 (05/19/86). The situation involved a purported self-cancelling installment note, and the ruling treated the transaction as a private annuity sale for transfer tax purposes.

[6] *Id.*

under sections 1272-1275 of the Code (original issue discount rules) or section 483, as the case may be. The amount of unstated interest or inadequate interest is based upon the applicable federal rate under section 1274(d) of the Code on the date of the sale.[7]

5. As discussed later, section 453A of the Code imposes an additional interest charge if the face amount of certain Taxable Installment Notes that are outstanding at the end of each taxable year exceeds $5 million.[8]

6. If the transaction otherwise qualifies as an installment sale, the installment method will by default apply unless the taxpayer elects out.[9] The election must be made no later than the due date for filing the taxpayer's return (including extensions) for the year in which the sale occurs.[10] There are a number of reasons why a seller might choose to elect out of the installment method. The seller may have unused losses that can be used to offset the gain in the year of the transaction. In addition, if the transaction will result in capital gain and capital gain tax rates are expected to be higher in the future, the taxpayer is likely to benefit from recognizing the gain in the year of the transaction, notwithstanding the acceleration of the tax liability.

7. Notwithstanding the election out of installment sale treatment, because there is no apparent prohibition against prepayment of the installment obligation (whether stated in the terms of the note or not), if a taxpayer has sufficient warning about higher tax rates in a future taxable a year, a cooperative buyer (perhaps even a related person) might agree to prepay the Taxable Installment Obligation in full before the tax rates become effective.

8. As mentioned above, the installment method only applies if the transaction results in gain to the seller. If the disposition of property results in a loss, the installment method is not available, even if payments are made in installments. If the loss is deductible, it is only deductible in the year of the transaction.[11]

9. From the standpoint of the buyer, notwithstanding the deferred payment obligation, the buyer receives a cost basis in the property acquired. If the buyer is not a related person, the interest paid or deemed paid is deductible, whereas if the buyer is related, it will likely be treated as nondeductible personal interest under section 163(h).

10. The treatment of Taxable Installment Obligations are detailed in sections 453, 453A, and 453B of the Code. Section 453 sets out the general rules of the installment method on sales of real or personal property by dealers and nondealers. Section 453A contains specific rules applicable to nondealers of certain types of property. For purposes of the examples in these materials, except as noted otherwise, it is assumed that the selling taxpayer is a nondealer. Section 453B provides special rules applicable to the disposition or transfer of Taxable Installment Obligations.

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[7] § 1274(c)(2) and Treas. Reg. § 1.1274-2(c).

[8] § 453A(c).

[9] § 453(d)(1).

[10] § 453(d)(2). *See also* Treas. Reg. § 301.9100-1 through § 301.9100-3.

[11] Rev. Rul. 70-430, 1970-2 C.B. 51.

B. Ineligibility for Installment Sale Treatment

1. Generally

a. The installment method of accounting is not available with certain types of property and transactions. These nonqualifying situations include:

(1) Dealer dispositions[12] (defined as any "disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan"[13] and "disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business."[14]);

(2) Sales of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the year;[15]

(3) Sales of "stock or securities which are traded on an established securities market"[16] or "property (other than stock or securities) of a kind regularly traded on an established market;"[17]

(4) Sale of depreciable property[18] to related persons;[19] and

(5) Portion of gain attributable to depreciation recapture which would be ordinary income under sections 1245 or 1250 (or section 751 as it relates to sections 1245 or 1250).[20]

2. Farming Exception to Dealer Dispositions

a. A "dealer disposition" does not include any property used in the trade or business of farming.[21] Farming is defined in sections 2032A(e)(4) and 2032A(e)(5) of the Code.

b. Section 2032A(e)(4) provides, "The term 'farm' includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges,

[12] § 453(b)(2)(A).

[13] § 453(l)(1)(A).

[14] § 453(l)(1)(B).

[15] § 453(b)(2)(B).

[16] § 453(k)(2)(A).

[17] § 453(k)(2)(B).

[18] Property that, in the hands of the transferee (not the transferor), is subject to the allowance for depreciation under section 167 of the Code. § 453(f)(7).

[19] § 453(g).

[20] § 453(i).

[21] § 453(l)(2)(A).

greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands."[22]

c. Section 2032A(e)(5) provides, "farming purposes" means:[23]

> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
>
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
>
> (C)(i) the planting, cultivating, caring for, or cutting of trees, or
>
> (D)(ii) the preparation (other than milling) of trees for market.

3. Dealer Election to Pay Interest: Residential Lots and Timeshares

a. If the taxpayer makes an election under section 453(l)(3) to pay an interest charge on the deferred tax resulting from the installment method, a dealer selling timeshares and residential lots to individuals in the ordinary course of business can use the installment method.[24] The timeshare right to use or ownership interest in residential property must not be for more than 6 weeks per year, and for purposes of the 6 week limitation, property held by the spouse, children, grandchildren or parents of an individual will be treated as held by such individual.[25] Any residential lot is eligible for this election, but only if the selling taxpayer (or any related person) may not make any improvements on the lot.

b. A dealer of timeshares or residential lots who makes the election under section 453(l)(3) will have to pay an interest charge on all payments received during any taxable year after the year of the sale. The amount of the charge is based on the *tax* attributable to the payments received during any subsequent year from the sale, and interest accrues on the amount of tax from the date of the sale to the date the payment is received.[26] The interest charge is at the applicable federal rate[27] (AFR) in effect at the time of the sale, compounded semiannually.[28] This interest charge is in addition to the other taxes due on the under the installment method (i.e., capital gain and stated or imputed interest).

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[22] § 2032A(e)(4).

[23] § 2032A(e)(5).

[24] § 453(l)(2)(B).

[25] § 453(l)(2)(B)(ii)(II) (also included is a right to use specified campgrounds for recreational purposes).

[26] § 453(l)(3)(B)(i)(I) and (II).

[27] § 1274.

[28] § 453(l)(3)(B)(i)(III).

Example: In year 1, Seller, an individual, in the ordinary course of business, sells an unimproved residential lot to a buyer for $200,000. The seller's adjusted basis in the lot is $50,000. The buyer purchases the lot with an installment note providing for 10 annual payments of principal equal to $20,000 (with an adequately stated rate of interest). Seller makes the election to use the installment method. The seller's gross profit is $150,000 ($200,000 selling price - $50,000 adjusted basis). The gross profit percentage is 75% ($150,000 of gross profit divided by $200,000 total contract price). Each annual payment to Seller will be treated as $15,000 of gain (gross profit percentage 75% x $200,000 annual payment), $5,000 of nontaxable recovery of basis, and interest (ordinary income) at the stated market rate.

In addition, the seller must pay interest on the deferred tax attributable to the first installment payment in year 2. As noted above, the capital gain to the seller is $15,000. Assuming the seller's capital gain tax rate is 20%, the tax attributable to the payment in year 2 is $3,000 ($15,000 x 20%). As a result, the seller must add to the tax due on the year 2 payment an interest charge equal to $3,000 multiplied by the applicable semiannual AFR in effect at the time of the sale in year 1.

4. Inventory

a. "Inventory" is not defined in section 453 of the Code. However, section 1221(a)(1) would define it as "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[29]

b. Generally, the sale of a partnership interest is treated as a sale of a capital asset, in contrast to characterization based on each individual asset owned by the partnership.[30] However, one exception to this rule applies to a selling partner's share of his or her partnership interest attributable to partnership unrealized receivables and inventory items. A selling partner must recognize ordinary income to the extent of his or her allocable share of these items.[31]

c. The Treasury Regulations do not provide that a sale of a partnership interest should be treated as a sale of the selling partner's share of each asset of the partnership. However, the IRS has ruled that income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's "substantially appreciated" inventory, which would not be eligible for installment treatment if sold directly.[32] For this purpose, inventory is considered "substantially appreciated" if the fair market value of the inventory exceeds 120 percent of the adjusted basis of the inventory.[33] Notably, the

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[29] § 1221(a)(1).

[30] *See* § 741.

[31] § 751(a).

[32] Rev. Rul. 89-108, 1989-2 C.B. 100.

[33] *See* 751(b)(3)(A).

IRS stated that the holding in the ruling should not be construed as an interpretation of section 453A(e) of the Code, which authorizes the Treasury Department to promulgate regulations "providing that the sale of an interest in a partnership or other pass-thru entity will be treated as a sale of the proportionate share of the assets of the partnership or other entity."[34]

d. The IRS has ruled that a taxpayer who sold a partnership interest could not use the installment method to the extent that the purchase price was attributable to unrealized receivables for the payment of services rendered under section 751(c)(2) of the Code.[35] The courts have agreed with this position, particularly if the unrealized receivables are compensation for services.[36] It should be noted that under the partnership rules, there is another category of unrealized receivables. Pursuant to section 751(c)(1), "unrealized receivables" also includes payment for "goods delivered, or to be delivered, to the extent that the proceeds would be treated as amounts received from the sale or exchange of property other than the sale of a capital asset."[37] Theoretically, this latter category of receivables would be eligible for installment sale treatment, even though the income therefrom would be ordinary income.

5. Marketable Securities

a. If marketable securities are sold in exchange for deferred payments, because the sale is ineligible for the installment method, all payments to be received on the installment obligation are treated as received in the year of the sale.[38] For such purposes, the fair market value of the installment obligation is considered to be the same as the fair market value of the marketable securities on the date of the sale.[39]

b. The Code gives the IRS authority to issue regulations disallowing the use of the installment method for transactions where the restrictions barring the use of the installment method for sales of publicly traded property could be avoided through related parties, pass-through entities, or intermediaries..[40] To date, these Treasury Regulations have not been promulgated. According to the legislative history, these Treasury Regulations would apply to sales of property where a substantial portion of the property's value is attributable to gain from publicly traded property.[41]

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[34] § 453A(e).

[35] CCA 200722027.

[36] *Mingo v. Commissioner*, 773 F.3d 629 (5th Cir. 2014), *aff'g* T.C. Memo 2013-149. *See also Sorensen v. Commissioner*, 22 T.C. 321 (1954), and *Hyatt v. Commissioner*, T.C. Memo 1961-318, aff'd, 325 F.2d 715 (5th Cir. 1963).

[37] § 751(c)(1).

[38] § 453(k), flush language.

[39] S. Rep. No. 99-313, at 131 (1986).

[40] § 453(k), flush language.

[41] S. Rep. No. 99-313, at 131 (1986).

c. However, according to legislative history, the installment method will be available if the taxpayer cannot directly sell, or cause the direct sale of, publicly traded stocks or securities.[42]

> Example: A retiring partner in an investment partnership sells his partnership interest in exchange for an installment note. A substantial portion of the value of his partnership interest is attributable to publicly traded stocks and securities held by the partnership. If the retiring partner cannot sell, or cause the partnership to sell, the stocks and securities directly, the partner may use the installment method to report his gain on the sale of his partnership interest.[43]

d. In the foregoing example, if the investment partnership makes a section 754 election (or has one in place), then the purchasing partner would immediately get the benefit of an inside basis adjustment under section 743 of the Code that would increase the basis of partnership property by the excess of the outside basis (selling price) of the partnership over the partner's proportionate share of the adjusted basis of the partnership property.[44]

6. Sale of Depreciable Property to an Unrelated Buyer

a. If there is a sale of depreciable property to an unrelated person, the seller must recognize any income recaptured as ordinary income under sections 1245 and 1250 of the Code in the year of sale, but any portion attributable to capital gain would continue to be taxed under the installment method.[45] This rule applies to all sales of depreciable property whether it is purchased by a related or unrelated buyer. Section 1250 generally provides that upon a sale or exchange of depreciable real property, all or part of any depreciation deductions in excess of straight-line depreciation is recaptured as ordinary income.[46] Section 1245 generally provides that upon a sale of depreciable personal property, the amount of gain equal to prior depreciation deductions is recaptured as ordinary income.[47] If recapture property is sold in a deferred payment sale, the adjusted basis of the property is increased by the amount of recapture income recognized in the year of the sale.

> Example: Seller, an individual taxpayer, sells depreciated personal property which has an adjusted basis of $30,000 for $100,000, payable in 10 annual payments of $10,000 plus adequately stated income. Seller does not elect out of installment sale treatment. The seller has taken $40,000 of depreciation deductions, all of which will be subject to recapture under section 1245 as ordinary income. The seller must recognize $40,000 of ordinary income in the year of the sale (without having received any payments). For purposes of determining the gross profit, the seller is deemed to have $70,000 of adjusted basis ($30,000 of adjusted basis + $40,000 of recapture income). As a result, the gross profit is $30,000 ($100,000

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[42] *Id.*

[43] *See* S. Rep. No. 99-313, at 131 (1986).

[44] § 743(b)(1).

[45] § 453(i).

[46] § 1250(a)(1).

[47] § 1245(a).

selling price - $70,000 adjusted basis). The gross profit ratio is 30% ($30,000 gross profit divided by the contract price of $100,000).

b. A partner who sells a partnership interest must include in income his or her allocable share of the partnership recapture income (taxed as ordinary income) in partnership property.[48] Thus, if the partner sells the partnership interest in exchange for a deferred payment obligation, the portion of the gross profit allocable to recapture income will be fully taxable in the year of sale, but the remainder of the gross profit would be eligible for installment sale treatment.

c. If a taxpayer sells depreciable property that is not recaptured under section 1250 as ordinary income, it is "unrecaptured section 1250 gain," which is defined as "the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent."[49] Essentially, "unrecaptured §1250 gain" is the amount of straight-line depreciation taken on the property. The Treasury Regulations provide when unrecaptured section 1250 gain is reported on the installment method, "the unrecaptured section 1250 gain is taken into account before the adjusted net capital gain."[50] As a result, the capital gain portion of each installment payment will be taxed as unrecaptured section 1250 gain (taxable at a maximum rate of 25%) first, until all of the straight-line depreciation has been recaptured.

Example: Seller, an individual taxpayer, purchases rental property for $500,000 and claims straight-line depreciation for a number of years totaling $200,000. At a time when the adjusted basis is $300,000, the seller sells the property for $600,000 payable in 6 annual payments of $100,000 plus adequately stated interest. The gross profit is $300,000 ($600,000 selling price – $300,000 adjusted basis). The gross profit ratio is 50%. ($300,000 gross profit divided by contract price of $600,000). Each annual payment will be considered $50,000 of gain, $50,000 of nontaxable recovery of basis, plus interest. The gain in the first 4 years will be unrecaptured section 1250 gain taxable at 25% ($200,000 in total), and the gain in last 2 years will be long-term capital gain taxable at 20% ($100,000 in total).

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[48] §§ 453(i)(2) and 751(c), flush language ("For purposes of this section and sections 731, 732, and 741…, such term also includes... section 1245 property (as defined in section 1245(a)(3))… section 1250 property (as defined in section 1250(c))… but only to the extent of the amount which would be treated as gain to which section … 1245(a),… 1250(a),… would apply if (at the time of the transaction described in this section or sections 731, 732, or 741, as the case may be) such property had been sold by the partnership at its fair market value.").

[49] § 1(h)(6)(A)(ii).

[50] Treas. Reg. § 1.453-12.

7. Sale of Depreciable Property to a Related Buyer

a. If there is a sale of depreciable property between "related persons," as defined in section 453(g)(3), the installment method is unavailable for the transaction.[51] In that case, all payments to be received pursuant to a sale of depreciable property are treated as received in the year of sale.[52] In addition, the related person purchaser may not increase the basis of any property acquired by any amount before the time such amount is includible in the gross income of the seller.[53] As discussed above, the installment method does not apply any income recaptured under sections 1245 and 1250 as ordinary income

> Example: Seller, an individual taxpayer, sells depreciable property with an adjusted basis of $50,000 for $500,000, payable in 5 annual payments of $100,000 plus adequately stated interest, to a related person. The sale does not qualify for the installment method. Seller will recognize $450,000 of income in the year of the sale, some of which could be recaptured under sections 1245 and 1250 as ordinary income and some of which could be taxed as unrecaptured 1250 gain.

b. Section 453(f)(7) of the Code defines "depreciable property" as "property of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in section 167."[54] Because it is determined in the hands of the transferee, the buyer, there could be instances where a related party sale would inadvertently not qualify for the installment method because the property was not depreciable in the hands of the seller but would be depreciable in the hands of the related person buyer. For example, the sale of a personal residence by a seller to a related person (as defined below) who intends on renting the residence to third parties and taking depreciation deduction on rental property would be considered a sale that would not qualify for the installment method.

c. If depreciable property makes up a portion of a parcel of property sold to a related person in an installment sale, it does not disqualify the entire sale from installment treatment. Thus, if a taxpayer sells both non-depreciable property (i.e., land) and depreciable property (i.e., building) to a related person, the installment method applies to the transfer of the non-depreciable property. The installment sale rules will apply to the portion of the selling price allocable to the non-depreciable property.

d. This rule denying installment sale treatment on the sale of depreciable property to related persons does not apply if it can be established to the satisfaction of the IRS that the sale did not have as one of its principal purposes the avoidance of Federal income taxes.[55]

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[51] § 453(g)(1)(A).

[52] § 453(g)(1)(B)(i). The Code also provides in the case of payments that are contingent as to the amount but with respect to which the value cannot be reasonably ascertained, the basis will be recovered ratably by the seller. § 453(g)(1)(B)(ii).

[53] § 453(g)(1)(C).

[54] § 453(f)(7).

[55] § 453(g)(2).

e. The defined term, “related persons,” applicable to sales of depreciable property, is much narrower than the same term when applied to the related party resale rules under section 453(e) of the Code, which is discussed later in these materials.[56] In the context of depreciable property, “related persons” is defined in section 1239(b), except that it includes “2 or more partnerships having a relationship to each other described in section 707(b)(1)(B).”[57]

(1) Section 1239(a) of the Code provides, “In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167.”[58] Section 1239 has its own definition of “related persons” but borrows the constructive ownership rules of section 267(c) of the Code. The definition describes “related persons” in three broad categories of relationship:

(a) A person and all “controlled entities” with respect to such person;

(b) A taxpayer and any trust in which the taxpayer (or spouse) is a beneficiary (unless the interest is a remote contingent interest[59]); and

(c) An executor of an estate and a beneficiary of such estate (other than a sale or exchange in satisfaction of a pecuniary bequest).[60]

(2) The term “controlled entity” means, with respect to any person:

(a) A corporation more than 50 percent of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person;[61]

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[56] Section 453(f)(1), which defines “related person” for purposes of the related party resale rule provides, “Except for purposes of subsections (g) and (h),...” Subsection (g) applies to sales of depreciable property between related persons, and subsection (h) applies to installment obligations received by a shareholder in certain corporate liquidations.

[57] § 453(g)(3).

[58] § 1239(a). The IRS has ruled that the sale or exchange of property constituting oil and gas reserves is not subject to section 1239(a) of the Code because the reserves are subject to depletion allowances under section 611(a), not depreciation under section 167 of the Code. However, section 1239(a) of the Codes does apply to any improvements which are subject to the allowance for depreciation under sections 611(a) and 167 of the Code. PLR 200602018.

[59] *See* § 318(a)(3)(B)(i) of the Code (“a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property”).

[60] § 1239(b).

[61] § 1239(c)(1)(A).

(b) A partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person;[62] and

(c) Any entity which is a related person to such person under paragraph (3), (10), (11), or (12) of section 267(b) of the Code.[63]

(3) Pursuant to the section 267(b) (3), (10), (11), and (12), persons are related if the following relationships exist (in all instances, ownership is determined measuring actual as well as constructive ownership under Section 267(c), other than paragraph section 267(c)(3)):[64]

(a) Two corporations that are members of the same controlled group;[65]

(b) A shareholder and a corporation that more than 50% of the stock of which is owned directly or indirectly by or for that shareholder;[66]

(c) A partner and a partnership that more than 50% of the capital interest or profit interest in which is owned directly or indirectly by or for that partner;[67]

(d) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation, and more than 50% of the capital interest, or the profits interest, in the partnership;[68]

(e) An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation;[69] and

(f) An S corporation and a C corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.[70]

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[62] § 1239(c)(1)(B).

[63] § 1239(c)(1)(C).

[64] § 1239(c)(2). Section 267(c)(3) of the Code provides an individual owning any stock in a corporation (but not including any stock deemed to be owned by the individual by virtue of stock owned, directly or indirectly, by his or her family) shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

[65] § 267(b)(3). Controlled group is generally defined in section 1563(a) of Code but with "more than 50 percent" substituted for "at least 80 percent." *See* § 267(f).

[66] § 267(b)(10)(A).

[67] § 267(b)(10)(B).

[68] § 267(b)(10)(A) and (B).

[69] § 267(b)(11).

[70] § 267(b)(12).

(4) As noted above, the constructive ownership rules in section 267(c) will cause stock owned by one related party to be deemed owned by another. Section 1239(c)(2) provides, "For purposes of this section, ownership shall be determined in accordance with rules similar to the rules under section 267(c) (other than paragraph (3) thereof)."[71] Thus, when section 267 refers to "corporation" or "stock," it could extend to "partnership" or "partnership interest." In any case, these rules reattribute direct and indirect ownership of certain other owners to the owner being tested for related party status:[72]

(a) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;[73]

(b) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family— brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants;[74] and

(c) In applying the foregoing, stock constructively owned by a person by reason of the application of (a) above shall be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of (b) above shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.[75]

(5) Section 707(b)(1)(B) of the Code disallows losses from the sales or exchanges of property directly or indirectly, between[76] "two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests."[77] The flush language of section 707(b)(1)(B) provides, "For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b)." As such, it includes partnerships (but does not include corporations or trusts) owned (or created) by the following related persons:[78]

(a) Members of a family, which is defined as including brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants;

(b) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

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[71] § 1239(c)(2), emphasis added.

[72] § 267(c)(1) through (5), but excluding (3).

[73] § 267(c)(1).

[74] §§ 267(c)(2) and 267(c)(4), for the definition of family.

[75] § 267(c)(5).

[76] § 707(b)(1).

[77] § 707(b)(1)(B).

[78] § 267(b)(1) through (13).

(c) Two corporations which are members of the same controlled group (as defined in section 1563(a) of the Code but with "more than 50 percent" substituting for "at least 80 percent");

(d) A grantor and a fiduciary of any trust;

(e) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(f) A fiduciary of a trust and a beneficiary of such trust;

(g) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(h) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(i) A person and a tax exempt organization under section 501 of the Code and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(j) A corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership;

(k) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(l) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; and

(m) An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

f. The surprising result is, for purposes of sales of depreciable property under section 453(g), a "related person" does not include an installment sale to children, more remote descendants, and trusts for the benefit of the same. The manner in which "related person" is defined in section 453(g) seems to be intentional, so that the prohibition of installment sales of depreciable property to a related party will only include sales to "alter egos" of the selling taxpayer. In other words, the prohibition seems to have been drafted to prevent a taxpayer from selling fully depreciated property to any other entity or person that could give the benefit of future depreciation deductions (because of newly-created cost basis) back to the original taxpayer. Thus, by way of example, section 453(g) prohibits a taxpayer from selling depreciable property to:

(1) A trust that is for the benefit of the taxpayer (or his spouse, who might be filing jointly with the taxpayer);

(2) A partnership or S corporation in which the taxpayer has more than a 50% ownership interest; and

(3) A partnership or S corporation in which the taxpayer and his or her family (spouse, descendants, siblings, and ancestors) has more than a 50% interest.

While the last example above includes a partnership and S corporation that includes ownership by the taxpayer's descendants (a "controlled entity" under section 1239), "related person" in this context does not include a trust for the benefit of the taxpayer's descendants, whether created by the taxpayer or not.

g. As discussed later in these materials, this provides an interesting planning opportunity that could allow a taxpayer, for example, to sell depreciated property under the installment method to a trust for the benefit of the taxpayer's children. The trust for the children could, in turn, could eventually sell the depreciated property under the installment method to a trust for the benefit of the taxpayer's grandchildren. From a tax rate perspective, the owner of the property gets the benefit of depreciation deductions which can offset rental income at ordinary rates (37%/39.6%), and upon sale, recapture the deductions at 25% under section 1250, deferred under the installment method. This can be accomplished by "refreshing basis" and "resurrecting depreciation" deductions for each generation, at the children's and grandchildren's level.

C. Calculating Gain When Property Is Subject to Debt

1. In determining the amount of gain to be recognized each year in an installment sale, the taxpayer must determine the following:

a. Selling price;[79]

b. Gross profit[80] (selling price – adjusted basis of the property[81]);

c. Contract price;[82] and

d. Gross profit ratio (gross profit divided by the contract price).[83]

The gross profit ratio determines the portion of each payment that will be received under the installment sale that will be considered recognized gain.

2. "Selling price" is the total consideration received by the seller, including:[84]

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[79] Temp. Reg. § 15a.453-1(b)(2)(ii).

[80] Temp. Reg. § 15a.453-1(b)(2)(v).

[81] Expenses that relate to the sale of the property paid by the seller are added to the adjusted basis of the property. *See* IRS Pub. 537, Installment Sales.

[82] Temp. Reg. § 15a.453-1(b)(2)(iii).

[83] Temp. Reg. § 15a.453-1(b)(2)(i).

[84] *See* Temp. Reg. § 15a.453-1(b)(2)(ii) and IRS Pub. 537, Installment Sales.

a. Any money and the fair market value of any property to be received by the seller (regardless of when it is to be received by the seller[85]);

b. Any mortgage or other indebtedness the purchaser assumes, pays, or takes the property subject to; and

c. Any of the seller's expenses that relate to the sale of the property and that are paid by the buyer.

3. "Gross profit" is equal to the excess of the selling price over the seller's adjusted basis in the property.[86]

> Example: Seller, an individual taxpayer, sells property with a fair market value of \$1,000,000 and an adjusted basis of \$400,000. The property is subject to a mortgage of \$300,000. Buyer makes a cash down payment of \$100,000 of cash, agrees to make 6 annual payments of \$100,000 with adequately stated interest, and assumes the mortgage.
>
> Selling price is \$1,000,000 (\$100,000 down payment + \$600,000 in 6 equal installments + \$300,000 assumed mortgage).
>
> Gross profit is \$600,000 (\$1,000,000 selling price – \$400,000 adjusted basis).

4. Pursuant to the Treasury Regulations, "contract price" is the selling price reduced by any "qualifying indebtedness" assumed or taken subject to by the buyer, but only to the extent that the indebtedness does not exceed the seller's adjusted basis in the property.[87] "Qualifying indebtedness" means "a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property."[88] In this calculation, the seller's adjusted basis is deemed to include commissions and other selling expenses.[89]

> Example: Seller, an individual taxpayer, sells property with a fair market value of \$1,000,000 and an adjusted basis of \$400,000. The property is subject to a mortgage of \$300,000. Seller pays \$20,000 of selling expenses. Buyer makes a cash down payment of \$100,000 of cash, agrees to make 6 annual payments of \$100,000 with adequately stated interest, and assumes the mortgage.

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[85] The obligations of the purchaser are included at face value, regardless of their fair market value. *See Frizzelle Farms, Inc. v. Commissioner*, 61 T.C. 737 (1974), *aff'd per curiam*, 511 F.2d 1009 (4th Cir. 1975) and *Pokusa v. Commissioner*, 37 T.C.M. 434 (1978).

[86] Temp. Reg. § 15a.453-1(b)(2)(v).

[87] Temp. Reg. § 15a.453-1(b)(2)(iii).

[88] Temp. Reg. § 15a.453-1(b)(2)(iv).

[89] Temp. Reg. § 15a.453-1(b)(2)(iii).

Selling price is $1,000,000 ($100,000 down payment + $600,000 in 6 equal installments + $300,000 assumed mortgage).

Gross profit $580,000 ($1,000,000 selling price – $420,000 adjusted basis, including selling costs).

Contract price is $700,000 ($1,000,000 selling price – $300,000 qualifying indebtedness).

Gross profit ratio is 82.86% ($580,000 gross profit ÷ $700,000 contract price).

82.86% of each payment ($100,000 down payment and $600,000 in 6 equal installments) will be recognized in the year received, for a total aggregate recognized gain of $580,000 (the gross profit amount).

5. As noted above, contract price is reduced by qualifying indebtedness but only to the extent of the seller's adjusted basis. The practical effect of having indebtedness in excess of basis is that the gross profit ratio will be 100%. In addition, the assumed debt that is in excess of basis will be treated as a payment under the installment rules.[90]

Example: Seller, an individual taxpayer, sells property with a fair market value of $1,000,000 and an adjusted basis of $400,000. The property is subject to a mortgage of $500,000. Seller pays $20,000 of selling expenses. Buyer makes a cash down payment of $100,000 of cash, agrees to make 4 annual payments of $100,000 with adequately stated interest, and assumes the mortgage.

Selling price is $1,000,000 ($100,000 down payment + $400,000 in 4 equal installments + $500,000 assumed mortgage).

Gross profit $580,000 ($1,000,000 selling price – $420,000 adjusted basis, including selling costs).

Contract price is $580,000 ($1,000,000 selling price - $420,000 qualifying indebtedness limited to basis).

Gross profit ratio is 100% ($580,000 gross profit ÷ $580,000 contract price).

100% of each "payment" will be recognized in the year received ($100,000 down payment, $80,000 "payment" from assumed qualifying indebtedness in excess of adjusted basis of $420,000, and $400,000 in 4 equal installments), for a total aggregate recognized gain of $580,000 (the gross profit amount).

6. When dealing with sales of partnership interests under the installment sale, similar rules will apply. Qualifying liabilities of the partnership will reduce the contract price but only to the extent of the partner's outside basis in his or her partnership interest. Any qualified liabilities in excess of the outside basis will be treated as a payment in the year of sale.

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[90] Temp. Reg. §§ 15a.453-1(b)(3)(i) and 15a.453-1(b)(5), Ex. 3. *See also Crane v. Commissioner*, 331 U.S. 1 (1947) and *Commissioner v. Tufts*, 461 U.S. 300 (1983).

Example: Partner, a 25% partner in a partnership, sells his entire partnership interest for $250,000 to buyer. The buyer agrees to make a $50,000 cash down payment and to pay the 10 annual payments of $20,000 with adequately stated interest and becomes a 25% partner in the partnership. At the time of the sale, the partnership had $400,000 of nonrecourse qualified liabilities (selling partner's share of those liabilities is 25% or $100,000), and the selling partner had an outside basis of $75,000.

Selling price is $350,000 ($50,000 down payment + $200,000 in 10 equal installments + $100,000 of debt relief).

Gross profit is $275,000 ($350,000 selling price - $75,000 outside basis).

Contract price is $275,000 ($350,000 selling price - $75,000 qualified indebtedness limited to outside basis).

Gross profit ratio is 100% ($275,000 gross profit ÷ $275,000 contract price)

100% of each "payment" will be recognized in the year received ($50,000 down payment, $25,000 "payment" from assumed qualifying indebtedness in excess of outside basis of $750,000, and $200,000 in 10 equal installments), for a total aggregate recognized gain of $275,000 (the gross profit amount).

7. If in the partnership interest sale example immediately above the partnership liabilities were not qualifying liabilities, then those nonqualifying liabilities would not reduce the contract price at all. The calculations would be as follows:

Selling price is $350,000 ($50,000 down payment + $200,000 in 10 equal installments + $100,000 of debt relief).

Gross profit is $275,000 ($350,000 selling price - $75,000 outside basis).

Contract price is ($350,000 selling price with no reductions).

Gross profit ratio is 78.57% ($275,000 ÷ $350,000 contract price).

78.57% of each "payment" will be recognized in the year received ($50,000 down payment, $100,000 "payment" from assumed nonqualifying indebtedness, and $200,000 in 10 equal installments), for a total aggregate recognized gain of $275,000 (78.57% x $350,000 selling price which is also the gross profit amount).

D. Contingent Payment Sales

1. Generally

a. A contingent payment sale is a sale of property in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale or disposition occurs.[91] Unless the taxpayer elects out, all contingent payment sales must be reported on the installment method.[92] Under the Treasury Regulations, a contingent payment sale does not include, "transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term."[93] A full and complete discussion of the treatment of contingent payment installment sales is beyond the scope of these materials, but some discussion is warranted.

b. The Treasury Regulations provide rules for three different types of contingent sales:

(1) Stated Maximum Selling Price;[94]

(2) Fixed Period (but no stated maximum selling price);[95] and

(3) Neither Stated Maximum Selling Price Nor Fixed Period.[96]

2. Stated Maximum Selling Price

a. If a maximum selling price is determinable, the Treasury Regulations provide, "The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement."[97] Then, the seller's basis is allocated to payments received and to be received under a state maximum selling price by treating it as the selling price for purposes of the calculations.[98]

b. The stated maximum selling price will be the selling price "unless and until that maximum amount is reduced, whether pursuant to the terms of the original agreement, by subsequent amendment, by application of the payment recharacterization rule … or by a

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[91] Temp. Reg. § 15a.453-1(c)(1).

[92] *Id.*

[93] *Id.*

[94] Temp. Reg. § 15a.453-1(c)(2).

[95] Temp. Reg. § 15a.453-1(c)(3).

[96] Temp. Reg. § 15a.453-1(c)(4).

[97] Temp. Reg. § 15a.453-1(c)(2)(i)(A).

[98] *Id.*

subsequent supervening event such as bankruptcy of the obligor."[99] When the maximum amount is reduced, then the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which the event requiring reduction occurs.[100]

c. From a recovery of basis standpoint, the methodology under the Treasury Regulations for stated maximum selling price sales is least desirable to the seller because it initially assumes all of the payments will be made and the basis is allocated ratably under that assumption.

3. Fixed Period (No Stated Maximum Selling Price)

a. If the maximum period over which payments will be paid is fixed, but the stated maximum selling price cannot be determined, the Treasury Regulations provide, "the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. In making the allocation it is not relevant whether the buyer is required to pay adequate stated interest."[101] Basis will be recovered ratably over the fixed term, unless the "terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component unless, taking into account all of the payment terms of the agreement, it is inappropriate to presume that payments under the contract are likely to accord with the variable component."[102]

b. If no payment is received in a taxable year, no loss is allowed unless the taxable year is the final payment year or unless it is "otherwise determined in accordance with the rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless."[103] When no loss is allowed, "the unrecovered portion of basis allocated to the taxable year shall be carried forward to the next succeeding taxable year."[104]

4. Neither Stated Maximum Selling Price Nor Fixed Period

a. The Treasury Regulations provide, "If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized."[105]

b. If it is determined that there has been a sale, based on the pertinent facts, then the Treasury Regulations provide that the taxpayer's basis (including selling expenses) will be recovered in equal annual increments over a period of 15 years.[106]

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[99] *Id.*

[100] *Id.*

[101] Temp. Reg. § 15a.453-1(c)(3)(i).

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] Temp. Reg. § 15a.453-1(c)(4).

[106] *Id.*

c. If no payment is received in a taxable year or the payment is less than the ratable basis for that year, no loss is allowed the taxable year is the final payment year or unless it is "otherwise determined in accordance with the timing rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless; instead the excess basis shall be reallocated in level amounts over the balance of the 15 year term."[107] If any basis has not been recovered by the end of the 15th year, it is carried forward to the next year, and will continued to be carried forward from year to year, "until all basis has been recovered or the future payment obligation is determined to be worthless."[108]

5. Income Forecast Method

a. In certain circumstances, the Treasury Regulations allow taxpayers to use the income forecast method to recover basis. "Specifically, when the property sold is depreciable property of a type normally eligible for depreciation on the income forecast method, or is depletable property of a type normally eligible for cost depletion in which total future production must be estimated, and payments under the contingent selling price agreement are based upon receipts or units produced by or from the property, the taxpayer's basis may appropriately be recovered by using an income forecast method."[109] The appropriate types of situations include sales of mineral property, a motion picture film, a television film, or a taped television show.[110]

b. The income forecast method permits a seller under a contingent payment agreement to recover a portion of his her adjusted basis in the property sold each year based on the percentage that the payment received in the taxable year bears to the total forecasted or estimated payments to be received under the sales agreement.[111] This percentage is then multiplied by the seller's basis in the property sold to determine the basis recovered with respect to the payment received in that year.[112] If, it is discovered that the income forecast was substantially overestimated or underestimated because of some circumstance occurring in later years, the income forecast for such later year is adjusted upward or downward in computing the amount of basis recovery.[113]

c. The Treasury Regulations provide, "The total forecast of estimated payments to be received under the agreement shall be based on the conditions known to exist at the end of the taxable year for which the return is filed. If a subsequent upward or downward revision of this estimate is required, the revision shall be made at the end of the subsequent taxable year based on additional information which became available after the last prior estimate."[114] Similar rules for disallowing losses, as discussed previously with other allowable methods, are applicable when there are no payments or they are less than the projected basis under this method.

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[107] *Id.*

[108] *Id.*

[109] Temp. Reg. § 15a.453-1(c)(6)(i).

[110] Temp. Reg. § 15a.453-1(c)(6)(ii).

[111] Temp. Reg. § 15a.453-1(c)(6)(iii).

[112] *Id.*

[113] *Id.*

[114] *Id.*

6. Other Considerations

a. A taxpayer can request a ruling from the IRS to use an alternative method of basis recovery if the taxpayer is able to demonstrate, before the due date of the return (including extensions) for the tax year in which the first payment is received, that application of the normal basis recovery rules will substantially and inappropriately defer recovery of basis.[115]

b. The IRS may find that the normal basis recovery rules will substantially and inappropriately accelerate the recovery of basis. In such cases the IRS may require an alternative method of basis recovery unless the seller can demonstrate either: (1) that the method of basis recovery required by the IRS is not a reasonable method of ratable recovery; or (2) that it is not reasonable to conclude that the seller over time is likely to recover basis twice as fast under the normally applicable rules than he would under the method proposed by the IRS.[116]

E. Payments Defined

1. The Treasury Regulations provide that the term "payment" on an installment obligations does not include the receipt of evidences of indebtedness of the person acquiring the property (i.e., an installment obligation), whether or not payment is guaranteed by a third party (including a government agency) or supported by a standby letter of credit.[117] For this purposes, a standby letter is "a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit."[118] A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

2. The Treasury Regulations provide the following will be considered payments:[119]

a. Evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent (certificate of deposit or treasury note);

b. Cash or other property, including foreign currency, marketable securities, and evidences of indebtedness payable on demand or readily tradeable;

c. Evidence of indebtedness of a person other than the person acquiring the property;

d. The amount of qualifying indebtedness assumed or taken subject to by the person acquiring property, but only to the extent it exceeds the basis of the property.

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[115] Temp. Reg. § 15a.453-1(c)(7)(ii).

[116] Temp. Reg. § 15a.453-1(c)(7)(iii).

[117] Temp. Reg. § 15a.453-1(b)(3)(i).

[118] Temp. Reg. § 15a.453-1(b)(3)(iii).

[119] Temp. Reg. § 15a.453-1(b)(3)(i).

3. As noted above, the receipt of a third party evidence of indebtedness is considered a payment equal to the fair market value of the debt. Because the debt is treated as a payment in the year of receipt, any future payments received by the seller on the note from the third party are not included in income.

4. Generally, funds deposited into an escrow account will be considered a payment.[120] However, if the escrow arrangement imposes a substantial restriction on the seller's ability to receive the deposited fund, the funds are not considered a payment.[121] The substantial restriction must serve a bona fide purpose of the buyer that is a real and definite restriction on the seller or a specific economic benefit conferred on the buyer.[122]

> Example: Seller, an individual taxpayer, sells a business to Buyer in exchange for a $100,000 installment note, with payments to be received in equal annual installments over 5 years. Buyer sets up an irrevocable escrow account from which the payments will be made. The receipt of payments from the escrow account are contingent on seller refraining from entering into a competing business for a period of 5 years. The escrow agreement imposes a substantial restriction and the funds in the account are not considered a payment.[123]

5. Option payments received by the seller from the buyer prior to the year of the sale are nontaxable under the "open transaction" doctrine until the option is exercised or expires. If the option is exercised, the amount given to the seller to buy the option is considered as part of the amount realized in the year of the sale. If the option is not exercised, the amount is included in the income of the seller in the year the option expires.[124]

F. Special Rules for Nondealers: The Interest Charge and Pledge Rules

1. Generally

a. Section 453A of the Code sets out two special rules applicable to nondealers who report a sale under the installment method. The first rule requires interest to be paid on the deferred tax liability (the "Interest Charge Rule"),[125] and the second rule provides that a pledge of an installment obligation to secure an indebtedness will be considered a taxable payment (the "Pledge Rule").[126]

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[120] Temp. Reg. § 15a.453-1(b)(5), Ex. 8.

[121] *Porterfield v. Commissioner*, 73 T.C. 91 (1979).

[122] *See, e.g.*, *Porterfield v. Commissioner*, 73 T.C. 91 (1979), *Stiles v. Commissioner*, 69 T.C. 558 (1978), *Oden v. Commissioner*, 56 T.C. 569 (1971)..

[123] *See Murray v. Commissioner*, 28 B.T.A. 624 (1933).

[124] *Koch v. Commissioner*, 67 T.C. 71 (1976), *Commissioner v. Dill Co.*, 294 F.2d 291 (3d Cir. 1961), *aff'g* 33 T.C. 196 (1959).

[125] § 453A(a)(1).

[126] §453(d)(1).

b. The Interest Charge and Pledge Rules apply to any obligation arising from a nondealer[127] installment sale of any property under the installment method, but only if the sales price exceeds $150,000.[128] For this purpose, all sales or exchanges "which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange."[129]

c. Section 453A(e) of the Code provides that Treasury Regulations will be issued to carry out the purposes of the Interest Charge and Pledge Rules, including:

(1) "disallowing the use of the installment method in whole or in part for transactions in which the rules of this section otherwise would be avoided through the use of related persons, pass-thru entities, or intermediaries,"[130] and

(2) "providing that the sale of an interest in a partnership or other pass-thru entity will be treated as a sale of the proportionate share of the assets of the partnership or other entity."[131]

d. Three types of installment obligations are specifically excluded from the Interest Charge and Pledge Rules. They include dispositions of these types of property:

(1) Personal use property within the meaning of section 1275(b)(3) [132] of the Code by an individual;[133]

(2) Property used or produced in the trade or business of farming within the meaning of Sections 2032A(e)(4) or 2032A(3)(5), as discussed earlier;[134] and

(3) Timeshares and residential lots by a dealer who elects to have the payment of interest rules under section 453(l)(3) apply, as discussed earlier.[135]

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[127] See § 453A(b)(4) excluding dealer transactions with timeshares and residential lots from the Interest Charge and Pledge Rules.

[128] § 453A(b)(1).

[129] § 453A(b)(5).

[130] § 453A(e)(1).

[131] § 453A(e)(2).

[132] "[T]he term "personal use property" means any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212." § 1275(b)(3).

[133] § 453A(b)(3)(A).

[134] § 453A(b)(3)(B).

[135] § 453A(b)(4).

2. The Interest Charge Rule

a. $5 Million Threshold

(1) Section 453A(b)(2) of the Code provides the Interest Charge Rule applies only if the installment obligation is outstanding at the close of the taxable year, and only to the extent the face amount of all such installment obligations held by the taxpayer exceeds $5 million.

(2) The Code further provides, except as provided in the Treasury Regulations, all persons treated as a single employer for purposes of section 52(a) (controlled groups of corporations) and section 52(b) (employees of partnerships, proprietorships, etc. that are under common control) are treated as one person for purposes of the $5 million threshold.

(3) The IRS has ruled that if a partnership or other pass-through entity owns the installment obligation, the $5 million threshold and the Interest Charge Rule is applied at the partner, shareholder, or owner level, not at the entity level.[136]

(4) For purposes of the $5 million threshold, TAM 9853002 ruled that spouses are treated as separate taxpayers.[137] The situation in the ruling involved a sale of the assets of an S corporation to a purchaser in exchange for a contingent installment note. Simultaneous with the sale of the assets, taxpayer, a shareholder of the S corporation, gifted a portion of the stock to his or her spouse. As a result each held a portion of the S corporation which, in turned, owned the contingent installment note. The spouses filed separately. The IRS ruled:[138]

> While section 453A(b)(2) provides a limited attribution rule for persons treated as a single employer under section 52(a) and (b), these provisions do not apply, by their terms, to Taxpayer and his spouse. Moreover, we do not believe that this attribution rule should be expanded beyond the specific parameters of section 52. In particular, if Congress had intended that married individuals be treated as one taxpayer for purposes of applying the $5,000,000 limitation set out in section 453A, it could have easily provided for this attribution in express terms rather than resort to a strained and unlikely interpretation of section 52 and 1563. In fact, in numerous other Code provisions, Congress has specifically provided for the allocation of various limitations among married individuals. See, e.g., section 38(c)(3) (limitation on the general business credit); section 163(h) (limitations on amounts treated as acquisition or home equity indebtedness); section 179(b)(4) (limitation on election to expense certain depreciable business assets); section 1211(b) (limitation on capital losses). Where Congress is silent on this point, as in section 453A, we do not believe that an allocation between married individuals can be implied.
>
> In addition, section 453A(b)(2) specifically states that this section shall apply to certain installment obligations only if "the face amount of all such obligations held

[136] IRS Notice 88-81, 1988-2 C.B. 397.

[137] TAM 9853002.

[138] *Id.*

by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000." This language indicates that the $5,000,000 limitation is applied to the installment obligations held by the "taxpayer." Generally, married individuals are treated as separate taxpayers under the Code. See section 1 (imposing a tax on the taxable income of every married individual whether they file joint or separate returns). Since Taxpayer and his spouse are considered separate taxpayers under the Code, it follows that each individual should be entitled to apply the $5,000,000 limitation to installment obligations that each separately holds. This result is even more warranted in the present case where Taxpayer and his spouse filed separate tax returns.

(5) The IRS has consistently taken the position that the Interest Charge Rule applies to a contingent payment obligation, with or without a maximum stated selling price.[139] The IRS has opined that, for purposes of this $5 million threshold, when a contingent payment obligation does not have a stated maximum selling price or other stated face amount, it is reasonable to look at the taxpayer's calculation of value for the transferred property (used in calculating its gain on the transaction).[140]

b. Calculating the Interest Charge

(1) The Interest Charge is an amount that is added to the tax liability of the taxpayer for that year.[141] In other words, this is not simply deemed additional interest that is taxable as ordinary income to the taxpayer but a dollar-for-dollar amount of additional tax payable by the taxpayer.

(2) The Interest Charge is equal to:[142]

The "Applicable Percentage" of the "Deferred Tax Liability"
Multiplied By
The Underpayment Rate[143]
(for the month of the end of the taxable year ends)

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[139] *See* FAA 20080101F, PLR 200728039, and TAM 9853002.

[140] FSA 199941001 (The contingent payment obligation had no face value but provided for a production payment measured by the volume of gas produced from the property burdened by the production payment and the sale price of that gas).

[141] § 453(c)(1) ("If an obligation to which this section applies is outstanding as of the close of any taxable year, the tax imposed by this chapter for such taxable year shall be increased by the amount of interest...")

[142] § 453A(c)(2). *See also* CCA 201021020.

[143] § 6621(a)(2). The underpayment rate is the Federal short-term AFR plus 3 percentage points.

(3) The "Deferred Tax Liability" is equal to:[144]

Amount of unrecognized gain
(as of the close of the taxable year)
Multiplied By
The maximum rate of tax for the taxpayer[145]
(for such taxable year)

(4) The "Applicable Percentage" is equal to:[146]

Aggregate face amount of obligations in excess of $5 million
(outstanding at the end of the taxable year)
Divided By
Aggregate face amount of all obligations
(outstanding at the end of the taxable year)

c. Interest Charge Example

Example: Seller, an individual taxpayer, sells long-term capital gain property with an adjusted basis of $6,000,000 to a buyer for $15,000,000. Seller receives a cash down payment of $3 million and a $12 million installment note, with payments to be received in equal annual installments of $2 million over 6 years, with adequately stated interest.

Selling price is $15,000,000 ($3,00,000 down payment and $12,000,000 in 6 equal installments).

Gross profit $9,000,000 ($15,000,000 selling price – $6,000,000 adjusted basis)

Contract price is $15,000,000 ($15,000,000 selling price, no reductions).

Gross profit ratio is 60% ($9,000,000 gross profit divided by $15,000,000 contract price).

In the year of the sale, Seller will report capital gain of $1,800,000 million (60% x $3,000,000 down payment).

At the close of the year, $12 million of the installment note still remains outstanding.

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[144] § 453A(c)(3).

[145] Individual or corporate rate under sections 1 or 11 of the Code. For purposes of the maximum rate of tax, if the gain would be long-term capital gain when recognized, the maximum rate on net capital gain under section 1(h) of the Code will apply. § 453A(c)(3), flush language. The Deferred Tax Liability does not include the 3.8% net investment income tax because it is due under section 1411 of the Code, not sections 1 or 11.

[146] § 453A(c)(4).

The Applicable Percentage is 58.3% (($12,000,000-$5,000,0000) ÷ $12,000,000).

The Deferred Tax Liability is $1,440,000 ((60% gross profit ratio x $12,000,000 outstanding on installment obligation) x 20% maximum capital gain tax rate).

The Interest Charge is $42,000 (58.3% Applicable Percentage x $1,440,000 Deferred Tax Liability x 5% (assumed) Underpayment Rate).

$42,000 is added to the Seller's income tax liability for the year of the sale.[147]

3. The Pledge Rule

a. The Pledge Rule provides if a taxpayer uses an installment obligation as security for a loan, the net proceeds[148] from that loan will be treated as a payment on the installment obligation.[149] The debt associated with the loan is referred to in the Code as the "secured indebtedness."

b. The Code provides, a secured indebtedness exists when "indebtedness is secured by an installment obligation to the extent that payment of principal or interest on such indebtedness is directly secured (under the terms of the indebtedness or any underlying arrangements) by any interest in such installment obligation. A payment shall be treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or a portion of the indebtedness with the installment obligation."[150] It is unclear whether a secured indebtedness exists if a taxpayer pledges an interest in a partnership that holds a Taxable Installment Obligation.

c. When loan proceeds are treated as a payment received on an installment obligation, the taxpayer recognizes gain in an amount equal to the net loan proceeds multiplied by the gross profit ratio applicable to that installment obligation.[151] The net proceeds of the loan are considered a payment received on the installment obligation as of the later of the date the loan becomes secured, or the date that the taxpayer received the loan proceeds.[152]

d. The Code puts a limit on the amounts treated as a payment from a secured indebtedness to the total contract price reduced by amounts that reduce the contract price up until the deemed payment resulting from the secured indebtedness.[153] If there is a deemed payment under the Pledge Rule, the Code provides that any subsequent payments on the installment payment "shall not be taken into account for purposes of section 453 to the extent that the aggregate of such

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[147] Taxpayer will report the Interest Charge on Line 15 of Schedule 2 of the Form 1040 (2021).

[148] The gross proceeds of the loan less the direct expenses of obtaining the loan. § 453A(d)(1).

[149] § 453A(d)(1).

[150] § 453A(d)(4).

[151] H.R. Rep. No. 100-495, at 930 (1987) (Conf. Rep.).

[152] §§ 453A(d)(1)(A) and 453A(d)(1)(B).

[153] § 453A(d)(2).

subsequent payments does not exceed the aggregate amount treated as"[154] a payment under the Pledge Rule.

e. As noted earlier, taxpayers may prefer to have the buyer prepay the installment obligation before the end of the term, if the taxpayer anticipates higher tax rates in future taxable years. Of course, that is at the option of the buyer. One way for the seller to cause a "prepayment" of the obligation is to intentionally trigger the Pledge Rule by borrowing funds and posting the Taxable Installment Note as collateral.

G. Resales of Purchased Property by a Related Person

1. If a person "disposes" of property under the installment method to a related party (the "first disposition"), and the related-party purchaser thereafter "disposes" of the property within two years after the first disposition (the "second disposition"), before the original seller has received all payments due with respect to the first disposition, the amount realized by the related party on the second disposition is treated as a payment received at that time by the original seller.[155] Any payments deemed to be paid to the original seller under the resale rule will be taxable to the original seller by applying the gross ratio of the first disposition. For purposes of this rules, a "second disposition" is broadly defined and includes a sale, exchange, gift, or cancellation of the installment obligation.

2. The two year prohibition on resales of purchased property came in large part due to the ruling in *Rushing v. Commissioner*,[156] where the taxpayers, husband and wife, who each owned 50% of a corporation, sold their shares to irrevocable non-grantor trusts, taking back Taxable Installment Notes, just prior to the taxable liquidation of the corporation. The trustee of the non-grantor trusts was a corporate trustee. The court held that the taxpayers could defer the gain under the installment method. In the opinion, the court stated, "We think it clear … that a taxpayer may, if he chooses, reap the tax advantages of the installment sales provision if he actually carries through an installment sale, even though this method was used at his insistence and was designed for the purpose of minimizing his tax."[157] The court opined that the key element is control: "As we understand the test, in order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom."[158]

3. The amount treated as received by the original seller for any taxable year as a result of the second disposition by the related party cannot exceed:

a. The lesser of:

(1) The total amount realized by the related party on the second disposition before the close of the taxable year, or

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[154] § 453A(d)(3).

[155] § 453(e).

[156] *Rushing v. Commissioner*, 441 F.2d. 593 (5th Cir. 1971) *aff'g* 52 T.C. 888 (1969).

[157] *Id.* at 597.

[158] *Id.* at 598.

(2) The total contract price for the first disposition,

b. Reduced by the sum of:

(1) The total payments received by the original seller on the first disposition before the close of such year, plus

(2) The amounts treated as received on the first disposition in prior taxable years as a result of this related-party resale rule.[159]

> Example. Seller sells property with an adjusted basis of $600,000 to seller's daughter for $1,000,000 in exchange for an installment note payable in 5 equal annual payments of $200,000 plus adequately stated interest. The gross profit ratio is 40%. After the first installment payment of $200,000, daughter sells the property for $1,200,000. Seller is deemed to receive a payment of $800,000 ($1,200,000 amount realized on the second disposition but limited to the $1,000,000 contract price of the first disposition, reduced by $200,000 of payments received by the original seller). Seller is deemed to recognize $320,000 of gain (40% gross profit ratio x $800,000).

4. If a second disposition by a related-party buyer results in a deemed payment and the recognition of gain to the original seller, any actual ongoing payments received by the original seller from the related-party buyer in subsequent taxable years (because the original installment obligation may still be outstanding) are not treated as payments received until the total of such payments exceeds the amount deemed received on the resale.[160] If the second disposition is not a sale or exchange, the fair market value of the property disposed of is substituted for the amount realized.[161] Thus, if the related party buyer gifted the purchased property to a trust, the amount realized for purposes of calculating the deemed payment to the original seller would be the fair market value of the property at the time of the gift.

5. According to the legislative history, if the related-party buyer transfers the installment note to the third-party buyer in a second disposition, the amount realized by the related-party buyer, for purposes of computing deferred gain recognized by the original seller, would not include relief of indebtedness upon transfer of the installment note. Generally, relief from indebtedness is considered an amount realized. However, in this context, the transfer of the original installment note, does not generate amount realized for purposes of accelerating gain recognition to the original seller. It should also be the case if the related-party buyer does not transfer the installment note but instead takes back a new installment note from the third-party buyer and the terms of that note are substantially equivalent to, or longer than, the terms of the original installment note.[162]

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[159] § 453(e)(3)(A) and (B).

[160] § 453(e)(5).

[161] § 453(e)(4).

[162] S. Rep. No. 96-1000, at 3–4, 16 (1980).

6. Notably, two years following the first disposition, the related party who has an adjusted basis equal to cost basis from the first disposition can sell the property with little or no gain.

> Example: Seller sells property with an adjusted basis of $4,000,000 to a related party for $10,000,000 payable in 10 equal annual installments ($1,000,000 per year plus adequately interest). The related party is a non-grantor trust created by the seller for the benefit of his or her descendants. The gross profit percentage is 60%. Over the next two years, seller receives two annual payments if $1,000,000 per year plus interest, recognizing in aggregate $1,200,000 of gain (60% of $2,000,000 in payments over 2 years), $800,000 of nontaxable recovery of basis, and interest (ordinary income). Seller is also subject to the Interest Charge Rule.
>
> Soon thereafter, more than two years after the first disposition, the non-grantor trust sells the property for $10,000,000 in cash to a third party, recognizing no gain on the second disposition. After the second disposition, the trust holds $10,000,000 of cash from the sale with a remaining obligation to pay $8,000,000 to the seller over the next 8 years (plus interest). Seller has only recognized $1,200,000 of gain at the time of the second disposition.

7. The foregoing example assumes the property purchased in the first disposition did not depreciate in value over the two-year period. If taxpayers could be assured the property would not lose value during the two-year period, then it could be a powerful way for families to sell property under the installment method (deferring gain) but receive 100% of the consideration within two years. To that end, the Code provides, the "running of the 2-year period … shall be suspended with respect to any property for any period during which the related person's risk of loss with respect to the property is substantially diminished by:"[163]

a. The "holding of a put with respect to such property (or similar property),"[164]

b. The "holding by another person of a right to acquire the property,"[165] or

c. A "short sale or any other transaction"[166] that effectively reduces the risk of loss (by the related party).

8. For purposes of these related party resale rule, the term "related person" includes more relationships than "related persons" is used with depreciable property installment sales under sections 453(g)(1) and 453(g)(3) of the Code. "Related person" means:

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[163] § 453(e)(2)(B).

[164] § 453(e)(2)(B)(i).

[165] § 453(e)(2)(B)(ii).

[166] § 453(e)(2)(B)(iii).

a. "a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property,"[167] or

b. "a person who bears a relationship described in section 267(b) to the person first disposing of the property."[168]

9. In pertinent part, the following relationships are "related persons" and people who are deemed to be related to the first seller:

a. Spouse (unless legally separated under a divorce decree or separate maintenance decree), children (including legally adopted children), grandchildren (and other lineal descendants), brothers and sisters (including half siblings), parents, and grandparents (and other ancestors);[169]

b. A partnership in which the original seller is a partner;[170]

c. An estate of which the original seller is a beneficiary;[171]

d. A trust of which the original seller is a beneficiary or treated as an owner (i.e., grantor trust);[172] and

e. A corporation in which the original seller owns, directly or indirectly, 50% or more of the value of the stock.

10. In addition to the foregoing, the relationships defined in sections 267(b)(3) through 267(b)(13) of the Code fall within the meaning of "related persons" for purposes of resales of purchased property. They are:

a. Two corporations which are members of the same controlled group (as defined in section 1563(a) of the Code but with "more than 50 percent" substituting for "at least 80 percent");[173]

b. A grantor and a fiduciary of any trust;

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[167] § 453(f)(1)(A).

[168] § 453(f)(1)(B).

[169] §§ 453(f)(1)(A), 318(a)(1), 267(b)(1) and §267(c)(4).

[170] § 318(a)(2)(A).

[171] *Id.*

[172] § 318(a)(2)(B).

[173] *See* 267(f). There is also constructive ownership and attribution from partnerships (partner having an interest of 5% or more in either capital or profits of the partnerships), estates and non-grantor trusts (beneficiary with an actuarial interest of 5% or more, assuming maximum exercise of discretion by trustee for the benefit of the beneficiary), grantor trusts, other corporations (5% or more in value), spouses, minor children and certain adult children, grandchildren, parents, and grandparents. *See* § 1563(e).

c. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

d. A fiduciary of a trust and a beneficiary of such trust;

e. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

f. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

g. A person and a tax exempt organization under section 501 of the Code and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

h. A corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership;

i. An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

j. An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; and

k. An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

11. As noted above, a "second disposition" is broadly defined and includes a sale, exchange, gift, or cancellation of the installment obligation. That being said certain types of "dispositions" are excluded from these rules.

a. If the first disposition is a sale or exchange of stock to the issuing corporation (i.e., redemption), any subsequent disposition by the corporation is not treated as a second disposition.[174]

b. A compulsory or involuntary exchange within the meaning of section 1033 and any transfer thereafter will not be considered a second disposition if the first disposition occurred before the threat or imminence of the conversion.[175]

c. Importantly, any transfer after the earlier of the death of the seller in the first disposition, or the death of the related person who acquired the property, any transfer thereafter

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[174] § 453(e)(6)(A).

[175] § 453(e)(6)(B).

will not be considered a "second disposition."[176] If spouses hold a Taxable Installment Note or hold property as related buyers as community property, joint tenants, or joint tenants by the entirety, this exception applies upon the death of either spouse.[177]

d. Finally, the Code provides the resale rules will not apply to a second disposition (and any transfer thereafter) if "it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax."[178]

H. Basis, Bequests, Gifts, Exchanges, and Other Dispositions

1. Adjusted Basis of Taxable Installment Obligations

a. Section 453B(b) of the Code provides, "The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full."[179]

b. As such, the initial basis of an installment obligation, assuming the entire gain that is deferred under the installment method will be the total gross profit at the time of the sale (i.e., no down payment or presale consideration), will be the basis of the purchased property. However, as each installment is paid to the buyer, basis of the installment note will increase because the face value will remain the same, but the "income which would be returnable" goes down.

> Example: Seller sells property with an adjusted basis of $40,000 to buyer for $100,000 payable in 10 equal annual installments ($10,000 per year plus adequately stated interest). The gross profit to S is $60,000. The gross profit ratio is 60%. Each annual payment to S will be treated as $6,000 of gain, $4,000 of nontaxable recovery of basis, and interest.
>
> Prior to the first payment, seller's adjusted basis in the installment obligation is $40,000 (face value of $100,000 less $60,000 of income which would be returnable if the obligation is satisfied in full).
>
> After the first payment, S's adjusted basis is $46,000 (face value of $100,000 less $54,000 the remaining unrealized gain).
>
> After the second annual payment, S's adjusted basis is $52,000 (face value of $100,000 less $48,000 the remaining unrealized gain).
>
> The remaining 8 annual payments of principal will reduce the remaining unrealized to zero (8 x $6,000 of gain each year).

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[176] § 453(e)(6)(C).

[177] S. Rep. No. 96-1000, at 16 (1980)

[178] § 453(e)(7).

[179] § 453B(b).

Note that the basis of the installment note does not increase each year by the nontaxable recovery of basis each year ($4,000 per year in this example).

2. Transfers at Death

a. The transfer of an installment obligation due to the death of the holder of the installment obligation (installment note) is not considered a taxable disposition.[180] The installment obligation (the remaining unrealized gain of the obligation) is considered income in respect of a decedent (IRD).[181] As a result, there is no step-up in basis under section 1014 of the Code, and the unrealized gain and interest will be taxable to the estate and the beneficiaries as payments are received by them.[182]

b. If the installment obligations is distributed by bequest, devise, inheritance, or other transfer after the death of the holder to the obligor (buyer), such transfer is considered a taxable disposition and gain must be reported by the holder's estate.[183]

c. If the estate sells the installment obligation, the estate recognizes income to the extent of the fair market value of the obligation at the time of the transfer or the consideration received for the transfer, whichever is greater, reduced by the adjusted basis of the obligation.[184] The income reportable by the estate upon such a sale or exchange retains the same character as that which would have been reported by the decedent had the obligation been disposed of by him.[185]

d. If, however, the estate distributes the obligation to a beneficiary in satisfaction of a specific bequest or as a part of a residuary bequest, it is not regarded as a (taxable) transfer for purposes of section 691 of the Code.[186]

e. If an installment obligation is held in joint tenancy with right of survivorship, the passage of ownership to the survivor upon the death of one of the joint tenants is not treated as a taxable disposition.[187]

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[180] § 453B(c).

[181] *See* § 691(a),

[182] §§ 1014(c), 691(a)(4) and Treas. Reg. § 1.691(a)-5(a).

[183] § 691(a)(5).

[184] Treas. Reg. § 1.691(a)-5(b).

[185] § 691(a)(3).

[186] § 691(a)(2).

[187] Rev. Rul. 76-100, 1976-1 C.B. 123.

3. Taxable Dispositions Generally

a. Section 453B(a) of the Code provides if (i) an installment obligation is satisfied for other than its face value, or (ii) distributed, transmitted, sold, or otherwise disposed of, then gain or loss will be recognized. As a result all of the following are considered taxable dispositions:

(1) A sale or exchange of an installment obligation, including the sale of a fractional interest;[188]

(2) A gift of an installment obligation;[189]

(3) If a partnership holds an installment obligation, a sale, exchange, or gift of an interest in the partnership;[190] and

(4) Cancellation[191] (or unenforceability) of an installment obligation.[192]

b. The amount of gain or loss is measured by the difference between the adjusted basis of the obligation and either:

(1) The "amount realized, in the case of satisfaction at other than face value or a sale or exchange,"[193] or

(2) The "fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange."[194]

c. The latter measure of gain and loss is applicable if the seller cancelled the buyer's indebtedness[195] or the seller gifted the obligation.[196] However, if the obligor and 36blige are related persons, within the meaning of section 453(f)(1) of the Code, the fair market value will be treated at no less than the face amount of the obligation.[197]

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[188] § 453B(a) and Rev. Rul. 76-530, 1976-2 C.B. 132.

[189] Rev. Rul. 79-371, 1971-2 C.B. 294.

[190] Rev. Rul. 60-352, 1960-2 C.B. 208.

[191] *Cf. Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *rev'g in part* 98 T.C. 341 (1992). *See also* Rev. Rul. 86-72, 1986-1 C.B. 253.

[192] § 453B(f). Treated as a disposition other than a sale or exchange.

[193] § 453B(a)(1).

[194] § 453B(a)(2).

[195] § 453B(f).

[196] Rev. Rul. 79-371, 1979-2 C.B. 294.

[197] § 453B(f)(2).

4. Trust Related Transfers

a. The transfer of an installment obligation to a trust constitutes a taxable disposition if the seller (grantor) is not considered the owner of the trust under the grantor trust rules.[198] A court has held that the fact that the grantor retained a life estate is immaterial where the transfer is to an irrevocable trust and the transferor is not regarded as the owner.[199]

b. The distribution of an installment obligation by a trust to a beneficiary, if the installment obligation arose from a sale of property by the trust, is also a taxable disposition.

c. A distribution of an installment obligation in satisfaction of a specific dollar amount, or at the termination of a trust, is also a taxable disposition.[200]

d. A distribution from grantor trust to the grantor (beneficiary) is not a taxable disposition.[201]

e. A transfer of a Taxable Installment Note to a spouse (but not in trust for the spouse) or a former spouse (if the transfer is incident to a divorce) is not a taxable distribution.[202] In such instance, the transferee spouse recognizes the remaining unreported gain as the installment payments are received in the same manner as would have applied to the transferor.[203]

5. Non-Taxable Dispositions

a. In 2014, the IRS issued proposed regulations[204] that provide there is no gain or loss under section 453B of the Code on certain tax free exchanges, including:[205]

(1) Transfers to a corporation under sections 351 (tax free exchange of property for stock in a controlled corporation) and 361 of the Code (distributions pursuant to a tax free reorganization);[206]

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[198] Rev. Rul. 67-167, 1967-1 C.B. 107, and Rev. Rul. 74-613, 1974-2 C.B. 153. *See also* PLR 9149026.

[199] *Marshall v. U.S.*, 26 F. Supp. 580 (S.D. Cal. 1939).

[200] Treas. Reg. § 1.661(a)-2(f)(1) and Rev. Rul. 55-159, 1955-1 C.B. 391.

[201] PLR 8001045.

[202] § 453B(g).

[203] §§ 453B(g)(2) and 1041(a).

[204] REG-109187-11 (Dec. 23, 2014).

[205] Prop. Reg. § 1.453-1(c)(1)(i).

[206] Prop. Reg. § 1.453-1(c)(1)(i)(A).

(2) Contributions to a partnership[207] under section 721 of the Code (tax free contribution in exchange for a partnership interest);[208] and

(3) Distributions from a partnership to a partner under section 731 of the Code (general rule that distributions of partnership property in-kind are tax free), except as provided by sections 704(c)(1)(B), 736, 737, and 751(b) of the Code (i.e., disguised sale and mixing bowl rules that are exceptions to general tax free distribution rule).[209]

b. The foregoing exception does not, however, apply to any disposition that results in a satisfaction of an installment obligation, even if there is no recognition of gain or loss on the disposition under the Code. Specifically, these transaction include, but are not limited to:

(1) The receipt of stock of a corporation from the corporation in satisfaction of an installment obligation of the corporation,[210] and

(2) The receipt of an interest in a partnership from the partnership in satisfaction of an installment obligation of the partnership.[211]

c. If an S corporation distributes an installment obligation in a complete liquidation, the distribution is not treated as a taxable disposition as long as receipt of the obligation is not treated as payment for the stock.[212] Thus, except for tax imposed by subchapter S, the S corporation will not recognize gain or loss on the distribution.[213] The character of gain or loss subsequently reported by the shareholder will be determined by reference to the character of the gain or loss that would have been reported by the S corporation.[214]

d. Other transactions that do not give rise to taxable dispositions include:

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[207] The Treasury Regulation provides that if a partnership disposes of section 704(c) property in an installment sale, the installment obligation received by the partnership is treated as the new section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership. Treas. Reg. § 1.704-3(a)(8)(ii). The amount of remaining built-in gain is calculated by taking into account any gain recognized on the installment sale. *Id.* The installment obligation received by the partnership in exchange for the section 704(c) property is considered section 704(c) property for purposes of both sections 704(c)(1)(B) and 737. Treas. Reg. § 1.737-2(d)(3)(ii).

[208] Treas. Reg. § 1.453-9(c)(2) and Prop. Reg. 1.453-1(c)(1)(i)(B).

[209] Prop. Treas. Reg. § 1.453B-1(c)(1)(i)(C).

[210] Prop. Treas. Reg. § 1.453B-1(c)(1)(ii)(A).

[211] Prop. Treas. Reg. § 1.453B-1(c)(1)(ii)(B).

[212] §§ 453B(h)(1) and 453B(h)(2). Section 453(h)(1) of the Code provides rules on when the receipt of an installment obligation is not treated as payment for stock.

[213] § 453B(h), flush language.

[214] *Id.*

(1) A renegotiation of the sale price where there is a reduction in the selling price. When this occurs, the amount of the remaining deferred gain, after the renegotiated price, is recognized ratably over the remaining installments.[215]

(2) The receipt by the seller of new installment notes of a new obligor upon the resale of the property in exchange for substantially identical notes.[216]

(3) Changes to or modifications to an installment obligation that are not substantial and do not result in a material change in, or the disappearance of, the rights of the seller.[217]

I. Imputed Interest

1. Generally

a. As noted, if a Taxable Installment Note does not have adequately stated interest (at least the applicable AFR at the time of the disposition), the seller is required to treat a portion of each installment payment of principal as imputed interest. The imputed interest rules do not require an increase in the total amount of payments agreed to by the parties to a transaction. These rules merely recharacterize as interest, for federal tax purposes, a portion of the payments denominated as principal by the parties.

b. In the case of transactions to which section 1274 applies, imputed interest is treated as original issue discount (OID) and is accounted for under those rules.[218] OID is taxed as ordinary income. In the case of transactions subject to section 483, imputed interest (and any stated interest) is accounted for under section 446. A complete discussion of the imputed interest rules are beyond the scope of these materials but some details are warranted.

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[215] Rev. Rul. 55-429, 1955-2 C.B. 252, and. Rev. Rul. 72-570, 1972-2 C.B. 241.

[216] Rev. Rul. 74-457, 1972-2 C.B. 196.

[217] *See* Rev. Rul. 68-419, 1968-2 C.B. 196 (deferral of payment and increase in interest rate is not a taxable disposition), Rev. Rul. 74-157, 1974-1 C.B. 115 (the substitution of the new promissory notes and deeds of trust for the existing promissory note and deed of trust is not a satisfaction or disposition of an installment obligation), and Rev. Rul. 75-457, 1975-2 C.B. 196 (a disposition occurs when the rights accruing to the seller under an installment sale either disappear or are materially altered so that the need for postponing recognition of gain ceases, but no taxable disposition when an installment purchaser of property resold the property to a new purchaser, a new note was substituted for the note originally received by the seller, and both notes set forth the same payment terms). *Cf.* Rev. Rul. Rev. Rul. 82-188, 1982-2 C.B. 90 (taxable distribution when there was a substantial increase in the face amount of the note in exchange for the waiver of the right to convert the note into common stock materially altered the rights of the oblige taxpayer).

[218] §§ 1272-1275.

2. Section 1274 Transactions

a. Generally, section 1274 applies to any debt instrument issued in exchange for property if: (i) neither the debt instrument nor the property is publicly traded;[219] and (2) one or more of the payments under the debt instrument are due more than six months after the date of the sale or exchange.[220] Section 1274 does not apply to the following transactions:

(1) Sale or exchange of a farm[221] by an individual, estate, testamentary trust, or small corporation or partnership[222] if the sales price of the farm does not exceed $1,000,000;[223]

(2) Sale or exchange by an individual of the individual's principal residence;[224]

(3) Sale or exchange of property if the sum of all the payments (including principal and interest) under any debt instrument and the value of any other consideration does not exceed $250,000;[225] and

(4) A qualified sale within the meaning of §483(e), discussed below, if the stated principal amount of the debt instrument does not exceed $500,000.[226]

b. OID is the excess of a debt instrument's "stated redemption price at maturity" over its "issue price."[227]

(1) The "stated redemption price at maturity" is the sum of all payments due under a debt instrument other than payments of qualified stated interest.[228] Qualified stated interest is interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate (or at certain specified floating rates).[229]

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[219] § 1274(c)(3)(D).

[220] §§ 1274(c)(1) and 1274(c)(3)(D).

[221] Within the meaning of section 6420(c)(2) of the Code.

[222] § 1244(c)(3) (Generally, "a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed $1,000,000.").

[223] § 1274(c)(3)(A).

[224] § 1274(c)(3)(B). *See* § 121.

[225] § 1274(c)(3)(C).

[226] § 1274(c)(3)(F).

[227] Treas. Reg. 1.1273-1(a).

[228] § 1273(a)(2) and Treas. Reg. § 1.1273-1(b).

[229] Treas. Reg. § 1.1273-1(c)(1).

(2) The "issue price" is the amount borrowed. In particular, if the debt is issued in exchange for property (as it would with an installment sale), the issue price is determined as either:

(a) The fair market value of the debt (or the fair market value of the property) at the time of the exchange; or

(b) The face value of the debt, adjusted for unstated or understated interest.

(3) Generally, the "issue price" equals either:

(a) The stated principal amount of the debt in situations where the debt provides for adequately stated interest; or

(b) The "imputed principal amount" of the debt where the debt does not provide for adequately stated interest.

(4) If a debt instrument, like a Taxable Installment Obligation, is issued for property and there is no stated interest or does not have adequately stated interest, the issue price under the OID rules is the "imputed principal amount."

(a) A debt instrument's "imputed principal amount" is the present value of all payments due under the debt instrument, discounted at a specific risk-free interest rate — the AFR, relevant to the issue.[230] The Treasury Regulations provide rules for determining the specific AFR to be used, referred to as the "test rate."[231]

(b) Generally, the "test rate" is the lowest of each monthly AFR for the 3-month period ending with the month in which there is a "binding commitment" for the sale or the month of sale. Thus if the contract for sale is entered into 3 or more months before the actual sale, the test rate is the lowest AFR for six discrete months — the three consecutive months that end with the month of binding sale commitment and the three consecutive months that end with the date of sale. Other than variable rate debt instruments, the test rate is based on the term of the debt instrument.[232]

> Example: Seller sells property to buyer for $1,000,000 for equal annual payments for $100,000 for 10 years. No interest is stated. If the applicable test rate is 3%, the "imputed principal amount" is determined to be $853,020.[233] As such, because there is no qualified stated interest, the amount of OID for this debt instrument is $146,979 ($1,000,000 stated redemption price at maturity - $853,020 issue price/imputed principal amount).

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[230] § 1274(c).

[231] Treas. Reg. § 1.1274-4.

[232] *See* § 1274(d).

[233] $PV = FV \frac{1}{(1+r)^n}$: PV =present value; FV=future value; r = rate of return (AFR); n = number of periods.

The seller is required to include OID for an accrual period ratably over the days of the period, regardless of the holder's overall method of accounting.[234] Thus, a cash method taxpayer is required to account under an accrual method, as opposed to a holder who has qualified stated interest which is included in income as it is received under the cash method.[235] OID is allocated on a constant yield basis over the term of the obligation.[236] The practical result is the amount of OID each year over the 10 year term will increase over time, but the aggregate of the OID of the term will be equal $146,979.

3. Section 483 Transactions

a. Section 483 applies to sales or exchanges of non-publicly traded property excepted from §1274.[237] As a result, section 483 applies to the following transactions:

(1) The sale or exchange of a farm if the sales price does not exceed $1,000,000;

(2) Sales of principal residences; and

(3) Qualified sales.[238]

b. Section 483 does not apply to:

(1) Any sale or exchange of property if the sales price does not exceed $3,000;[239] and

(2) In the case of a purchaser, any amount that is treated as containing interest under §163(b).[240]

c. When section 483 applies to a debt instrument, the issue price is by definition equal to its stated redemption price at maturity.[241] Thus, it cannot have OID. Section

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[234] Treas. Reg. § 1.272-1(b)(2)(iv).

[235] See Treas. Reg. § 1.446-2(a)(1).

[236] Treas. Reg. § 1.272-1(b)(1)(iv).

[237] § 483(d)(1).

[238] Also applies to certain cash method debt instruments to which section 1272 does not apply. § 1274A(c).

[239] § 483(d)(2).

[240] § 483(d)(3). Section 163(b) deals with personal property or educational services purchased under a contract which provides that payment of part or all of the purchase price is to be made in installments and in which carrying charges are separately stated but the interest charge cannot be ascertained.

[241] § 1273(b)(4).

483 applies to any payment[242] on account of the sale or exchange of property which constitutes part or all of the sales price (not included stated interest) and is due more than six months after the date of the sale or exchange under a contract.[243] In order to determine whether a debt instrument has understated interest the following must be determined:

(1) The sum of all deferred payments (payments of the sales price due more than six months from the date of sale).

(2) The sum of the present values of:[244]

(a) All deferred payments, and

(b) All payments of interest due (regardless of when due), by discounting such payments to the date of sale at the AFR appropriate to the debt instrument (contract of sale).

If the first amount (a) is greater than the amount (b) above, such excess is the debt instruments total unstated interest. To determine the present values under the above rules, the payments are discounted from the date they become due to the date of the sale at the test rate of interest applicable to the contract.[245] The test rate of interest for a contract is the same as the test rate that would apply for OID purposes, as discussed above.[246]

d. Generally, the amount of interest (other than qualified stated interest) that accrues during an accrual period is determined under rules similar to the OID rules discussed above, regardless of any contrary formula agreed to by the parties.[247]

e. Under section 483(e), in the case of any "qualified sale" the discount rate used in determining unstated interest cannot not exceed 6% compounded semiannually.[248] A qualified sale is defined as any sale or exchange of land by an individual to a member of such individual's family.[249] This test rate does not apply, however, to any qualified sale between individuals made during a calendar year to the extent the sales price for such sale (when added to the aggregate sales price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.[250]

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[242] Including any liability assumed by the purchaser. Treas. Reg. § 1.483-1(b)(2).

[243] § 483(c) and Treas. Reg. § 1.483-1(b)(2).

[244] Treas. Reg. § 1.483-2(a)(1)(i).

[245] Treas. Reg. § 1.483-2(b)(2).

[246] Treas. Reg. § 1.483-3(a).

[247] Treas. Reg. § 1.446-2(c)(1).

[248] § 483(e)(1).

[249] § 483(e)(2). Family, within the meaning of section 267(c)(4) of the Code.

[250] § 483(e)(3).

III. DETOUR: GRANTOR TRUSTS, IDGTs, CONVERSIONS, AND TOGGLING

A. Generally

1. In Article IV of these materials, the discussion turns to IDGT Installment Notes, but before that can be discussed, we need to take a detour on the grantor trust rules and what happens when grantor trust status is changed.

2. A complete discussion of the grantor trust rules of Part E of Subchapter J (section 671-679 of the Code) is beyond the scope of these materials.[251] From an income and estate planning perspective, based on the IRS's position in Revenue Ruling 85-13 (discussed in the following section), grantor trust status has two significant results: (i) the grantor is deemed to own all of the assets of the trust for all Federal income tax purposes; and (ii) any transaction between the grantor and the grantor trust will be ignored for all Federal income tax purposes. From a practical standpoint this means the grantor reports all of the trust's tax items on his or her income tax return, and the grantor is responsible for paying any resulting income taxes. Furthermore, the grantor's payment of the resulting income taxes is not considered a gift to the trust's beneficiaries, and if the trustee has discretion to reimburse the grantor for the income tax liability, the mere existence of that discretion by itself (whether or not exercised) will not cause the trust's assets to be included in the grantor's gross estate.[252] That being said, the most significant result is that the grantor and the grantor trust can participate in a myriad of transactions that otherwise would be taxable events had the parties been separate taxpayers. Instead, they are simply disregarded. All of this remains true as long as the grantor is still alive, and the powers or interests that trigger grantor trust treatment remain in effect.

3. Importantly, the trust must also be a grantor trust as to the entire trust. Frequently overlooked are the "portion" rules which point out that grantor trust status does not necessarily apply to the entire trust.[253] The Code provides that the grantor is treated as the owner of only that portion of a trust as to which the requisite power or interest exists, and "portion" can be defined in a number of ways. For example, a grantor with a reversion or a power to revoke the trust in its entirety may be treated as the owner of the entire trust under section 676 of the Code, meaning that every item of income, deduction, and credit in the trust is attributed to that deemed owner. Similarly, the grantor (or any nonadverse party who is a trustee) with unrestricted powers over income and corpus would generate entire trust portion treatment under section 674 of the Code. On the other hand, if grantor trust status is conferred by section 677(a) of the Code alone (income that may be paid to the grantor or the grantor's spouse), the trust is a grantor trust only as to the income portion (not the corpus).[254] Not only must grantor trust status apply to both income and corpus of the trust but it must apply to all of the assets of the trust. For example, under section 675(3) of the Code (borrowing of the trust's assets by the grantor), it is unclear whether grantor

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[251] For an excellent article on the grantor trust rules, *see* Stephen R. Akers, Jonathan G. Blattmachr, and F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 Real Prop., Tr. and Est. Law J. 207 (Summer 2009).

[252] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[253] *See* Treas. Reg. § 1.671-3.

[254] *See* § 677(a) and Treas. Reg. § 1.677(a)-1(g), Ex. 1.

trust status relates only to amounts actually borrowed and not repaid by the end of the taxable year, or whether it applies to all income or corpus that could have been borrowed.[255]

4. For purposes of this discussion, we assume grantor trust status is over the entire trust and over all income and corpus. Indeed, the most common power retained by grantors who intend on transacting with their grantor trusts is under section 675(4)(C) of the Code (the power, exercisable in a nonfiduciary capacity, to reacquire assets by substituting assets of equivalent value). If this power is, as often is the case, over all of the assets of the trust, the grantor is deemed the owner of the entire trust, including all of the income and corpus.

5. To further complicate matters, grantor trust status can be conferred on taxpayers who are not grantors at all. Section 678 of the Code describes certain situations where a person other than a grantor will be treated as the owner of trust assets. Section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself,"[256] or (ii) the person "previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."[257] Under section 678(b) of the Code, traditional grantor trust status will trump this "third party" ownership status, if the actual grantor is regarded as the owner of the same portion of the trust, thereby avoiding taxation of the same items of taxable income to two different taxpayers.[258] As discussed later, section 678(a) of the Code is the linchpin of planning with BDOTs and BDITs.

6. What is less known is what are the income tax consequences when grantor trust status is lost, either during the grantor's lifetime or upon the grantor's death. Are there instances when losing grantor trust status (whether intentionally or not) will be considered a taxable event? What is the resulting basis of any assets in an IDGT if grantor trust status is terminated during the lifetime of the grantor? Would it be different if grantor trust status is terminated due to the death of the grantor? What happens when a non-grantor trust becomes a grantor trust?

B. *Rothstein* and Rev. Rul. 85-13: Transactions with Grantor Trusts

1. In *Rothstein v. United States*,[259] the taxpayer held 300 shares of a corporation that built warehouses for rental. The taxpayer contributed the shares to an irrevocable trust for the benefit of his three children. The taxpayer's wife was the trustee. A few years later, the taxpayer purchased the remaining 300 shares held by the other shareholder for $500,000, to be paid at a later

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[255] *See Bennett v. Commissioner*, 119 T.C. 157 (2002) with *Benson v. Commissioner*, 76 T.C. 1041 (1981).

[256] § 678(a)(1).

[257] § 678(a)(2).

[258] By its terms, section 678(b) of the Code only refers to grantor powers over income, commentators have stated that limiting this to just income (and not items of corpus) is nonsensical and akin to a drafting error. Ferguson, Freeland, & Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries*, § 10.16[C] (3d ed. 2011). *See also* PLRs 201235006, 200730011, 200606006, and 200603040.

[259] *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984).

date. Soon thereafter, the taxpayer then purchased from the trust the 300 shares he had originally contributed in exchange for an "unsecured promissory note" (in actuality, an installment note) for a principal amount of $320,000, bearing interest at 5%. A few months later, the taxpayer who now owned 100% of the shares of the corporation, dissolved the corporation, with all of the property of the corporation distributed to the taxpayer in liquidation. The taxpayer then replaced and refinanced the existing $200,000 mortgage with a $700,000 mortgage and used the excess $500,000 of loan proceeds to pay the other shareholder. On the taxpayer's return, the taxpayer claimed deductions for $16,000 in interest on the promissory note to the trust and a short-term capital loss of $33,171 on the liquidation of the corporation.[260]

2. The IRS assessed a deficiency against the taxpayer based on a disallowance of the interest deduction and based upon a position that the liquidation resulted in a gain, not a loss. The IRS based both conclusions on the contention that the irrevocable trust was a grantor trust under section 675(3) of the Code. The foregoing provides that a grantor trust status is created if "[t]he grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor."[261] If the trust is a grantor trust, then under section 671 of the Code the grantor is treated as the "owner" of the property. As such, the IRS argued, the interest deduction should be disallowed, the sale by the trust should be ignored for income tax purposes, and as a result, the basis of the shares in the corporation on liquidation should be reduced by $320,000.

3. The court agreed that the trust was a grantor trust under section 675(3). However, notwithstanding that, the court held for the taxpayer. In coming to that conclusion it examined what "ownership" under the grantor trust rules means. To wit, section 671 of the Code provides:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[262]

Pursuant to a strict reading of the foregoing, the court concluded that "ownership" means that the trust's income, deductions, and credits will be attributed to the grantor. As stated by the court:

> Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/"owners" be governed by what might otherwise seem the sensible general

[260] Amount realized by the taxpayer is fair market value of the liquidated property of $1,054,580, reduced by assumed corporate liabilities of $267,751 (net $785,829), with a cost basis in the stock of $820,000 ($500,000 from the stock purchased from the other shareholder, and $320,000 on the stock purchased from the trust). *Id.* at 705.

[261] § 675(3).

[262] § 671.

principle that a taxpayer may not have meaningful dealings with himself. Rather, the statute envisions (1) that the income and deductions of the grantor and the trust will be computed in the normal fashion, the trust being treated as a fully independent taxpaying entity, and (2) that the relevant "items of income, deductions, and credits against tax" that would ordinarily appear on the trust's return will instead "be included in computing the taxable income and credits of the grantor". Nowhere does § 671 direct that the grantor's basis in property purchased from the trust be deemed any different from what it would otherwise be, namely, his cost in acquiring it—in this case $320,000, the amount of taxpayer's note. Nor does the statute contain anything authorizing the Commissioner to disallow an interest deduction on the ground that grantor's payments were made to the trust. Consistently with the objective of *Clifford* to prevent high-bracket taxpayers from shifting income to low-bracket trusts over which they retain or exercise excessive controls, § 671 dictates that, when the grantor is regarded as "owner", the trust's income shall be attributed to him—this and nothing more.[263]

4. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor/grantor trust transactions being ignored for income tax purposes:[264]

> The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . ." The significance of this is found in §671:
>
> > Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.
>
> Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored…
>
> In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.
>
> The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.

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[263] *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984), at 709.

[264] *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event.

5. Notwithstanding the foregoing, the IRS issued Revenue Ruling 85-13,[265] and on facts similar to *Rothstein*, the IRS ruled the taxpayer in question did not obtain a new cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[266]

> In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.
>
> The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

6. The estate planning implications of Revenue Ruling 85-13 are far reaching. Most notably, it has given rise to installment sales to IDGTs—trusts that are grantor trusts for

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

[266] *Id. See also* Rev. Rul. 2007-13, 2007-1 C.B. 684 (sale of a life insurance policy from one grantor trust to another grantor trust is not a transfer for income tax purposes because the grantor is treated as the owner of the assets of both trusts)), Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent).

income tax purposes but the assets of which will not be includible in the estate of the grantor.[267] Installment sales to IDGTs allow grantors to "sell" appreciated assets, often with valuation discounts applied to the purchase price, in exchange for an installment note bearing interest at the AFR. The estate planning result of this transaction is the grantor owning an asset that is "frozen" in value (principal amount of the note, the return on which is generally at a low interest rate) and all future appreciation on the asset removed from the gross estate of the grantor. All of this is accomplished without any income tax implications as long as the grantor is still alive and grantor trust status is maintained at least until the note is satisfied.

7. It has also given rise to transactions between beneficiaries and their beneficiary deemed owner trusts[268] (BDOTs) or beneficiary deemed inheritor's trust (BDITs)[269]—trusts the assets of which are not includible in the estate of the beneficiary but which are deemed "owned" by the beneficiary under section 678 of the Code.[270] Unless and until the IRS revokes Revenue Ruling 85-13, it is obligated to follow its published rulings.[271] More importantly for purposes of these materials, the IRS has not definitively ruled on a number of critical income tax issues: (i) what is the basis of assets sold to an IDGT when grantor trust status is terminated due to the death of the grantor?; (ii) is there a taxable event if grantor trust status is terminated due to the death of the grantor and the IDGT holds assets with debt in excess of basis?; and (iii) if an IDGT holds a promissory note from the grantor and grantor trust status is terminated, what is the basis of the promissory note?

C. Income Tax Consequences of Changes in Grantor Trust Status

1. Introduction

a. When grantor trust status is terminated or when a non-grantor trust becomes a grantor trust, the obvious end result is that the "owner" of the trust asset for Federal income tax purposes changes. When grantor trust is terminated, the trust becomes a separate taxable entity (non-grantor trust), and when a non-grantor trust becomes a grantor trust, the grantor (or someone other than the grantor under section 678 of the Code) becomes the owner of the trust's

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[267] *See, e.g.,* Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

[268] *See* Edwin P. Morrow, *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)* (April 19, 2018). Available at SSRN: https://ssrn.com/abstract=3165592 and Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009).

[269] *See* Jerome M. Hesch, Lawrence Brody, Richard A. Oshins & Susan P. Rounds, *A Gift From Above: Estate Planning on a Higher Plane — The Unique Design of a BDIT Minimizes — Even Eliminates — Many Tax and Non-Tax Problems*, 150 Tr. & Est. 17 (Nov. 2011).

[270] The IRS has section 678 beneficiary owned trust on its list of areas in which rulings will not ordinarily be issued and list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise. Rev. Proc. 2021-3, 2021-1 I.R.B. 140, sections 4.01(42) and 5.01(10).

[271] *See Rauenhorst v. Commissioner*, 119 T.C. 157 (2002).

assets for Federal income tax purposes. From an income tax perspective, how does that change in ownership occur?

b. If the change in ownership is treated like a gift, then as previously discussed, the receipt of the trust property is not income to the recipient, and the property will have a carryover basis under section 1015 of the Code? If the change in ownership is caused by the death of the grantor, then like bequests or other transfers as death, do the trust assets get a basis adjustment under section 1014 of the Code? Could the change in ownership be considered a taxable sale or exchange, with gain and possibly loss recognition? Or could this transfer of ownership be akin to a tax free exchange? If the change in ownership is not a taxable event, if debt is in excess of basis, do the holdings in *Crane* and *Tuft* require a recognition gain?

2. Grantor to Non-Grantor Trust During Grantor's Lifetime

a. In Revenue Ruling 77-402,[272] the IRS held that when grantor trust is terminated during the grantor's lifetime, the grantor is deemed to have transferred the trust property to a separate taxable entity. If the transferred property is subject to debt and the debt is in excess of basis, then the grantor, as the transferor, will recognize gain. In the ruling, A, an individual, created a T, an irrevocable trust (IDGT for the benefit of A's descendants) which is a grantor trust as to the entire trust due to certain retained powers. A contributed some funds to T, and the trustee used those funds to purchase a partnership interest in P, a partnership with a principal activity of investing in real property, using both recourse and nonrecourse financing. P elected accelerated depreciation. The resulting deduction were allocated to the partners of P, including T and in turn, deducted on A's income tax returns.

b. When the adjusted basis of the partnership interest was nearly zero (deductions and other losses are limited to the amount basis in the partnership interests) and the real property had started generating net income, A, as grantor, renounced the powers that made T a grantor trust. The IRS ruled, "at the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor, A."[273]

c. When a partner transfers an interest in a partnership and the transferor's share of partnership liabilities are reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the amount of reduced or eliminated liabilities. The IRS thus concluded, "A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest … immediately prior to the change in T's tax status."[274] The ruling went on to say, the result would be the same if the termination of grantor trust status occurred due to the expiration or lapse of the powers or due to

[272] Rev. Rul. 77-402, 1977-2 C.B. 222.

[273] *Id.*

[274] *Id. See also* G.C.M. 37228 for a more detailed discussion of the reasoning supporting the revenue ruling.

the exercise, release, renunciation, expiration or lapse of certain powers held by party other than the grantor.

d. In 1980, the IRS issued section 1.1001-2 of the Treasury Regulations which addressed the discharge of liabilities in determining gain or loss on a sale, exchange, or other disposition. The Treasury Regulations provide, "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[275] In particular, the Treasury Regulations provide the following special rules:[276]

> --(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;
>
> --(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);
>
> --(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;
>
> --(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and
>
> --(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

e. These Treasury Regulations also include an example[277] that is similar to Revenue Ruling 77-402. In the example, C, an individual, creates an irrevocable wholly owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers, and the trust then ceased to be a grantor trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was $11,000. The example concludes when C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for income tax purposes. Consequently, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities ($11,000) was treated as the amount realized by C. C's resulting gain was $9,800 ($11,000 - $1,200).

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[275] Treas. Reg. § 1.1001-2(a)(1).

[276] Treas. Reg. § 1.1001-2(a)(4)(i) through (v).

[277] Treas. Reg. § 1.1001-2(c), Ex. 5

f. The taxpayers in *Madorin v. Commissioner*[278] challenged the validity of the foregoing example in the Treasury Regulations, essentially taking the position of the *Rothstein* court (discussed earlier). Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to section 674(a) of the Code. The trusts bought limited partnership interests in a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits (the *Rothstein* ruling). The IRS disagreed with the taxpayer and assessed a deficiency. Basing its position on the aforementioned example in the Treasury Regulations, the IRS contended that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests. The Tax Court ruled for the IRS. In coming to that conclusion, the court stated, "Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word "owner," we will apply the usual, ordinary, and everyday meaning of the word."[279]

g. Given all of the foregoing precedents, the termination of grantor trust status during the grantor's lifetime is treated as a transfer by the grantor of the trust's assets to the trust (now a separate taxpayer) in exchange for any consideration the trust may give to the grantor. The foregoing consideration will include any discharge of liabilities of the grantor that results from such transfer. In particular, if nonrecourse debt encumbers the trust property and such debt exceeds basis, then grantor will recognize gain on the deemed transfer. If the property is not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The result is that the trust will not realize income when the deemed transfer occurs, no sale or exchange occurs, and the trust will take a basis in the property as determined under section 1015 of the Code.

3. Grantor to Non-Grantor Trust Due to Grantor's Death

a. If grantor trust status is terminated due to the grantor's death, clearly the grantor-decedent is no longer considered the owner of the trust property for income tax purposes. The IRS has ruled that upon the death of the grantor, the trust springs into existence as a separate taxpayer.[280] Clearly, the trust assets are deemed to be transferred to the new taxpayer, but it's not clear what type of transfer it is, and whether, under some circumstances, it could be considered a taxable event.

b. Notably, while acknowledging there is no Code section that explicitly addresses the issue, some commentators have asserted categorically that gain or loss is not

[278] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[279] *Id.* at 673.

[280] Rev. Rul. 57-51, 1957-1 C.B. 171. *See also* Treas. Reg. 1.671-4(h) ("Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section.").

recognized by a transfer in connection with the death of the owner.[281] They cite *Crane*, *Diedrich*, section 1.1001-2 of the Treasury Regulations (all previously discussed) in support of the claim that dispositions of property with debt in excess of basis only results in gain recognition with lifetime transfers, although they do not, collectively or individually, say that. This view is exacerbated by an IRS ruling that gratuitously stated "death … is generally not treated as an income tax event,"[282] even though the ruling itself was not addressing the income tax consequences of a conversion of a trust's status due to the death of any individual. In furtherance of this notion that a transfer at death is never a recognition event, some commentators have pointed to Revenue Ruling 73-183.[283] In the ruling, a taxpayer purchased stock at $30 per share and later died when the stock had a fair market value of $20 per share. Under section 1014 of the Code, the stock's basis was adjusted to $20 per shares. Notwithstanding the foregoing, the estate of the taxpayer sought guidance on whether a loss is recognized on the taxpayer's final income tax return as a result of the transfer of the stock to the estate. The ruling held that no gain or loss is recognized when stock is transferred from the decedent to the estate, whether the adjusted basis prior to death was less than or in excess of the fair market value on the date of death. These arguments ignore the fact that most transfers at death result in a basis adjustment to fair market value under section 1014 of the Code. If a decedent dies with appreciated property, subject to a nonrecourse debt that is in excess of the property's tax basis prior to death, when the property is "stepped-up" to fair market value, the property no longer has debt in excess of basis.

c. Estates of decedents who died in 2010 could elect to apply the modified carryover basis regime of now repealed section 1022 of the Code instead of being subject to the estate tax regime that had been reinstated retroactively for that year.[284] Generally, section 1022 of the Code provided that recipients of property from estates that elected out of the estate tax would receive property with a basis equal to the lesser of the adjusted basis of the decedent or the property's fair market value.[285] It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to $1.3 million, [286] with additional increases of up to $3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.[287] The drafters of the Code section clearly understood that if property passes by death but with carryover basis, rather than with a basis adjustment under section 1014 of the Code, gain would be recognized if any property had debt in excess of basis. To that end, they added a specific provision which provides, "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary other than a tax-exempt

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[281] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 96 J. Tax'n 149 (2002) and Elliott Manning and 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 (1999).

[282] CCA 200923024 (Dealing with a conversion from non-grantor to grantor trust status, discussed later in these materials).

[283] Rev. Rul. 73-183, 1973-1 C.B. 364.

[284] The election out of the estate tax regime is not in the Code. *See* Notice 2011-66, 2011-35 I.R.B. 184, Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notice 2011-76, 2011-40 I.R.B. 479.

[285] § 1022(a)(2).

[286] § 1022(b)(2)(B)

[287] § 1022(c)(1).

beneficiary, and from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded."[288] What is particularly telling is, as written, if property with debt in excess of basis had passed from the estate to a tax exempt beneficiary (i.e., charitable organization), gain would have been recognized.

d. In the mid-1970's, with the 1976 Tax Reform Act, [289] Congress eliminated the step-up in basis and enacted a carryover basis regime under predecessor section 1023 of the Code which would have been applied for decedents dying after December 31, 1979. At that time, learned commentators noted that, on the death of the decedent, gain will be recognized upon a transfer of the decedent's property in an amount equal to the difference between basis and liability.[290] In coming to that conclusion they concluded, "transfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return."[291] The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.[292] One of the reasons for the repeal was likely the debt in excess of basis issue.

e. The debatable issue at hand does not involve property included in the gross estate of a decedent and which gets a basis adjustment under section 1014 of the Code. There is no question that upon the death of the grantor, property in a revocable living trust, for example, that is "transferred" to a trust that is now a non-grantor trust, even if encumbered by a mortgage that is in excess of its basis, will not be considered a recognition event.[293] That is because of the basis adjustment at death. The issue is what happens when IDGT assets, which are designed not to be included in the estate of the grantor-decedent, are "transferred" to a non-grantor trust. What is the resulting basis of the assets in the IDGT? Is there recognition of gain if the assets are subject to a debt (i.e., the IDGT installment obligation) that is in excess of the basis of the assets?

f. Notwithstanding arguments to the contrary,[294] the conventional view is that if the assets in the IDGT are not included in the grantor's gross estate, the trust assets will not receive a "step-up" in basis under section 1014. In Chief Counsel Advice 200937028[295] a taxpayer transferred assets into a trust and reserved the power to substitute assets, and the trust assets did

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[288] § 1022(g)(1).

[289] P.L. 94-455 (Oct. 4, 1976). *See also* P.L. 95-600 (Nov. 6, 1978).

[290] Louis A. DelCotto and Kenneth F. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

[291] *Id.* at 569.

[292] P.L. 96-223 (Apr. 2, 1980).

[293] Query what would happen if the amount of nonrecourse debt exceeded both basis and the fair market value of the property? Would the holding in *Tufts* require a recognition of gain to the extent of the debt in excess of fair market value?

[294] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002). This is not true for nonresident alien decedents; a basis adjustment is allowed regardless of whether assets are includable in the gross estate. Rev. Rul. 89-139, 1984-2 C.B. 168.

[295] CCA 200937028.

not qualify for a basis adjustment under section 1014(b)(1) through (b)(10) of the Code. In the ruling, the Chief Counsel quotes from section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the Chief Counsel concludes, "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."[296]

g. Most practitioners and commentators take the position that whatever assets owned by the IDGT at the time of the grantor's death carry their historical tax basis. Hence, the reason swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor. A termination of grantor trust status upon the death of the grantor is effectively a transfer of the underlying trust assets, as if the assets had been transferred by gift under section 1015(a) or, alternatively, section 1015(b), as proposed in an excellent article (but which gets to the same result). In that article, the authors argue that section 1015(b) of the Code specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is caused by the death of the grantor. Section 1015(b) of the Code provides if property is acquired "by transfer in trust (other than by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer."[297] Thus, if the death of the grantor is not a taxable event for income tax purposes, then the acquired basis is simply the donor's basis prior to death. In addition, if the property secures a nonrecourse debt that is in excess of the property's basis, then gain will be recognized (and the amount of gain will be added to the resulting adjusted basis of the property). The IRS has implied this result already. For example, the IRS ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution. [298]

h. One possible alternative view about what happens when grantor trust status is terminated (and the IDGT Installment Note is still outstanding) is that the trustee of the IDGT is deemed to purchase the assets for the outstanding amount of the installment note at the time of the grantor's death. The basis of the assets would thus be determined under section 1012 of the Code. However, this necessarily requires practitioners to take the position that an exchange occurs at the death of the grantor, which may give rise to adverse income tax consequences to the estate with respect to the note. That does not seem to be the position of the IRS. In a private letter ruling involving a sale from one grantor trust to another, the IRS provided, "when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A's death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the

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[296] *Id.*

[297] § 1015(b)

[298] Rev. Rul. 72-406, 1972-2 C.B. 462. *See also Pierre S. Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930).

termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053."[299]

i. In 2015, the IRS added "Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise."[300] This continues to be an area of study to this day. In the 2022-2023 Priority Guidance Plan of the IRS listed, "Guidance regarding availability of §1014 basis adjustment at the death of the owner of a grantor trust described in §671 when the trust assets are not included in the owner's gross estate for estate tax purposes."[301]

j. In the foreign trust context, there are some conflicting, possibly misleading, rulings. In PLR 201544002, husband and wife (both of whom are foreign citizens and non-residents of the United States) funded a joint foreign revocable trust with their community and separate property. Each spouse retained the right to revoke the trust with respect to his or her community property and separate property held in trust. Under the trust agreement, the surviving spouse has the power to appoint the trust assets to his or her estate by will. The IRS held that upon the first death of a spouse, the surviving spouse would receive a step-up (or step-down) in basis under section 1014(b)(2) of the Code with respect to the decedent's spouse's separate property and one-half share of the community property. The IRS further held that upon the death of the surviving spouse (who held a general power of appointment), to the extent the surviving spouse exercises the general power of appointment by will, the trust assets will receive a step-up (or step-down) in basis under section 1014(b)(4) of the Code. The ruling acknowledged the no-rule policy as mentioned above, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced in 2015 and became effective.

k. In PLR 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust. The taxpayer ("Taxpayer") was a foreign citizen and non-resident of the United States. Taxpayer proposed to transfer assets to an irrevocable trust ("Trust") established under the laws of Taxpayer's country ("Country"). The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange. The trustees of Trust are Taxpayer and X, an unrelated party ("Trustees"). Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion. Upon Taxpayer's death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue. If Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.

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[299] PLR 200434012.

[300] Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (effective for all requests received after June 15, 2015). Continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126.

[301] *See* 2022-2023 Priority Guidance Plan.

(1) The IRS ruled that the foreign trust was a grantor trust for U.S. income tax purposes. The IRS then ruled that the basis of the property held in trust would be the fair market value of the assets as provided under section 1014(a) of the Code.

(2) Significantly, the IRS ruled that section 1014(b)(9) of the Code (requiring the property to be included in determining the value of the decedent's gross estate) was inapplicable. Rather, the assets received by the grantor's issue would fall under section 1014(b)(1) of the Code (property acquired by bequest, devise, or inheritance). The IRS reasoned:

> Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.

(3) In coming to the foregoing conclusion, the ruling points out that "Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b)." In other words, inclusion in the gross estate may not necessarily be the only avenue to receive a "step-up" in basis.

(4) While some practitioners may seek to interpret this ruling as allowing a "step-up" in basis for assets in an irrevocable grantor trust that are not otherwise included in the gross estate of the grantor, in actuality, it appears the drafters of the ruling at the Treasury Department may have mistakenly referred to section 1014(b)(1) of the Code ("Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.") in the ruling. Based on conversations with the attorney that acquired the private letter ruling, the ruling should have referred to section 1014(b)(3), which provides for a "step-up" in basis for "property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust."[302] While not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.[303] As such, this ruling may not stand for the proposition that assets in an IDGT can receive a "step-up" in basis, notwithstanding the fact the assets are not includible in the estate of the grantor.

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[302] § 1014(b)(3).

[303] The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if "the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor." § 672(f)(2)(A)(ii).

4. Non-Grantor to Grantor Trust

a. A few private rulings have discussed the income tax consequences of a conversion of a non-grantor trust to a grantor trust.[304] Chief Counsel Advice 200923024 involved trusts created by a parent and three adult children, all of whom held S corporation shares. The S corporation had filed with the SEC to do an initial public offering. Each taxpayer transferred their shares to a partnership, then formed an irrevocable non-grantor trust, funded with $100,000 in cash, and sold his or her partnership interest to his or her respective trust, in exchange for unsecured private annuities. The partnership had a section 754 election in place and, as a result, the partnership increased the basis of the partnership's stock to fair market value (based on the purchase price of the partnership interests) under section 734 of the Code, and then the partnership sold all the shares of the corporation after the IPO for an amount roughly equal to the partnership's basis in the shares (due to the inside basis adjustment). In other words, the partnership (and the trust) recognized little or no gain on the sale of the stock after the IPO. After the sale, the trust advisor removed the corporate trustee of the non-grantor trust and replaced by a person who would be considered a "subordinate party" under section 672(c) of the Code, thereby converting the trusts into grantor trusts under section 674(a) and (c) of the Code. After the trusts became grantor trusts, the taxpayers claimed to "own" all of the partnership interests and reported no gain or other taxable income attributable to any future payments on the private annuity sales.

b. The IRS agent sought to treat the conversion from non-grantor to grantor trust as a transfer of the underlying assets (partnership interest) to the grantor trusts (the new owner) as a taxable exchange. The non-grantor trusts would recognize little or no gain on the transfer because the outside basis of the partnership interests was equal to their fair market value. On the other hand, the transferee (grantor trusts) would realize taxable income on the receipt of the partnership interests. To that end, the IRS agent cited Revenue Ruling 77-402, section 1.1001-2(c), example 5, of the Treasury Regulations, and *Madorin* (as discussed earlier, all of the foregoing cited authorities stand for the proposition that when converting from a grantor to a non-grantor trust, there is a deemed transfer from the grantor to the trust, and if debt is in excess of basis, there is recognition of gain to the extent of such excess). The IRS Chief Counsel rejected this argument because the authorities only deal with recognition of income to the transferor (not the transferee). In its discussion, the IRS stated the rule set forth in the foregoing authorities is narrow in that it only applies to inter vivos lapses of grantor trust status and then inexplicably and gratuitously adds "not that caused by the death of the owner which is generally not treated as an income tax event."[305] It's the foregoing phrase that consistently gets quoted to stand for the proposition that the IRS does not believe termination of grantor trust caused by the death of the grantor is not a taxable event, despite the fact that the ruling itself does not involve the death of any taxpayer and the conversion in question is the opposite of the termination of grantor trust status. As to the first issue, whether the conversion of a non-grantor trust to a grantor trust is a transfer for income tax purposes of the property held by the non-grantor trusts to the owners of the grantor trusts requiring recognition of gain to the owners, the IRS Chief Counsel ruled that it is "not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner."[306]

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[304] CCA 200923024 and PLR 201730018

[305] *Id.*

[306] *Id.*

c. According to the IRS Chief Counsel, asserting that a conversion like this results in taxable income to the grantor would have an impact on non-abusive situations. The IRS Chief Counsel then provides examples of how a non-grantor trust can become a grantor trust; "examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b)." The rule in Revenue Ruling 85-13 provided that the grantor could not engage in a taxable transaction with the grantor trust. Thus, while the IRS Chief Counsel agreed that the transaction at hand was abusive, the IRS should not take the position that it results in taxable income to the grantor.

d. On the second issue, the IRS agent asserted that the private annuity transaction (the sale of the partnership interests to the trusts) should be treated as an indirect borrowing of the trust assets, causing the trusts to be grantor trusts under section 675(3) pf the Code. As a result, under Revenue Ruling 85-13, the IRS agent argued, the trusts did not get a cost basis upon purchase of the partnership interests and there would be no inside basis adjustment to the stock held by the partnership. The IRS Chief Counsel ruled that this private annuity transaction could not be recast as a loan under section 675(3) of the Code. Despite the positive results for the taxpayer, the memorandum concludes, "Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case… Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction."[307]

e. It's unclear what practitioners can take away, if anything, from Chief Counsel Advice 200923024. It could be interpreted to mean that a conversion from non-grantor trust to grantor trust is not a transfer for income tax purposes at all or, at the very least, not a transfer that will result in a recognition event to the grantor. In the one other ruling which, involved the conversion of a non-grantor charitable lead annuity to a grantor trust, the IRS wrote, "Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision."[308] In any case, it's hard to see how the Chief Counsel Advice 200923024 can be read to stand for the proposition "the death of the owner … is generally not treated as an income tax event," as is so often quoted by commentators.

5. Effective Date of Changes in Trust Status

a. Many grantor trust powers can be drafted so the grantor or other power holder can release it at any time and terminating grantor trust status. In addition, the trust may give an independent third party, often acting in a non-fiduciary capacity, the power to re-grant the released power to the grantor, or a nonadverse party, and "toggle" grantor trust status back on. If a significant income tax event is anticipated, tax planners may choose to terminate grantor trust status or toggle it back on, depending on which taxpayer (grantor or non-grantor trust and its

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[307] *Id.*

[308] PLR 201730018.

beneficiaries) should be responsible reporting the tax items on their respective income tax returns.[309]

b. Neither the Code or the Treasury Regulations provide any guidance on the effective date of a termination of grantor trust status, however, many believe that the release or elimination of the power that created grantor trust status will immediately make it a taxable non-grantor trust from that point forward. Support for this can be found in *Madorin* (discussed above). The power to add charitable beneficiaries was released on January 1 and was held effective from that day. As such, if a taxpayer wants to release a power and make the trust taxable for the next taxable year, the release should be made effective at midnight on December 31 of the current taxable year. The effective date of a conversion from non-grantor to grantor trust status would seem to be effective on the date on which the event[310] that causes the conversion.[311]

c. An exception to the foregoing timing rule may exist if the operative grantor trust provision is section 675(3) of the Code which provides, "The grantor shall be treated as the owner of any portion of a trust in respect of which—The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year."[312] The IRS has ruled that a trust is a grantor trust for any year (and for the entire taxable year) in which a loan under section 675(3) of the Code was outstanding.[313]

D. Section 678 Ownership by Beneficiaries or Other Entities

1. As mentioned above, section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself,"[314] or (ii) the

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[309] *See* Laura H. Peebles, *Mysteries of the Blinking Trust*, 147 Tr. & Est. 16 (Sept. 2008). *See also* David Kirk, Nickolas Davidson, and Paul Schuh, *Turning Off Grantor Trust Status: Mechanics, Tax Implications, Effect on Entities, Abusive Transactions, and State Law Obstacles*, 45 Est., Gifts & Tr. J. 06 (11/12/20) for an excellent discussion on terminating grantor trust status and certain tax attributes that would transfer to the non-grantor trust (e.g., section 465 at-risk deduction limitations and section 469 passive activity loss and credit limitations) and those that would be retained by the grantor (e.g., section 1212 capital loss carrybacks and carryovers).

[310] For example, (i) if the trust allows distributions without a reasonably definite standard, changing trustees so that more than half of the trustees are related or subordinate parties will result in grantor trust status under sections 674(a) and 674(c) of the Code if those trustees are, in fact, subservient to the wishes of the grantor or if the grantor's spouse is the trustee; (ii) converting a domestic trust into a foreign trust under section 679 of the Code by adding a foreign trustee or co-trustee or replacing the trustee with a foreign trustee; and (iii) decanting the assets of the non-grantor trust over to a grantor trust pursuant to a power or state statute.

[311] *See* CCA 200923024 and PLR 200848017.

[312] § 675(3). It does not apply to "a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor." *Id.*

[313] Rev. Rul. 86-82. 1986-1 C.B. 253.

[314] § 678(a)(1).

person "previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."[315]

2. A trust where a person other than the grantor is conferred "grantor trust" by a "power exercisable solely by himself to vest the corpus or the income therefrom in himself" under section 678(a)(1) of the Code is more commonly referred to as a beneficiary deemed owner trust or BDOT.[316] Common examples of this type of situation include section 2056(b)(5) marital trusts pursuant to which the spouse has a general power of appointment over the entire trust or trusts that permit withdrawal by a beneficiary as an alternative to mandatory termination or distribution when the beneficiary reaches a certain age. The foregoing examples involve the power to vest corpus. An example of a power to vest "the income therefrom" is described in PLR 201633021.[317] The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee "proposes to transfer funds from Trust 1 to Trust 2."[318] The IRS concluded, "Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2."[319]

3. The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 "transfers funds" to Trust 2. The language of the ruling implies the Trust 1 will be treated as a beneficiary of Trust 2 but also "as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a)." The language doesn't necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time. If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the

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[315] § 678(a)(2).

[316] For an in-depth discussion of the BDOT, *see* Edwin P. Morrow*, IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (2020) available at https:// papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592, a large portion of which was published previously as LISI Estate Planning Newsletter #2587 (Sept 5, 2017).

[317] PLR 201633021.

[318] *Id.*

[319] *Id.*

latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2's income and capital gain could significantly increase Trust 2's trust assets over time and decrease the assets in Trust 1.

4. In PLR 202022002,[320] the trust agreement of a Trust 1 prohibited the distribution of Shares (likely shares of stock of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of the Shares. Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for membership interest in LLC. The same restrictions on the Shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust's assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also has the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, "because A has a power exercisable by herself to vest the proceeds of Subtrust's LLC interest in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."[321]

5. The IRS's conclusions in the two rulings are very different. In PLR 201633021 Trust 1 held the power to revest the net income of Trust 2, and the IRS ruled, "Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2." In contrast, in PLR 202022002, A had the power to vest the proceeds of Subtrust's LLC (the only asset of the Subtrust), and the IRS ruled, "the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."

IV. IDGT INSTALLMENT NOTES

A. IRD or Step-Up?

a. As noted above, while grantor trust status is maintained, nothing is deemed to have occurred between the grantor and the grantor trust for Federal income tax purposes. That includes any subsequent exchanges of other property of equivalent value, including an exchange of the originally sold property to the IDGT. As such, the grantor-seller holding an installment note pursuant to a sale property to an IDGT (IDGT Installment Note) effectively has no finally determined tax basis in the installment obligation. The concept of tax basis is moot until grantor trust status terminates, on death or otherwise.

b. Upon the death of a grantor of owning an IDGT Installment Note, it is clear that the IDGT Installment Note will not be considered IRD like a Taxable Installment Note and as such should be entitled to a step-up in basis under section 1014 of the Code. Despite the

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[320] PLR 202022002.

[321] *Id.*

similarities between IDGT and Taxable Installment Notes, they are fundamentally different. An IDGT Installment Note included in a holder's estate can never be IRD as long as Revenue Ruling 85-13 remains effective. IRD can only include property that would have been taxable "in the hands of the decedent if the decedent had lived and received such amount."[322] As such, the basis adjustment at death under section 1014 of the Code makes the issue of the adjusted basis of the IDGT installment note of no consequence. IDGT installment notes likely satisfy the definition of the capital asset under section 1221(a) of the Code, but even if it doesn't, capital asset status is irrelevant for purposes of section 1014 of the Code.[323]

B. Adjusted Basis of IDGT Installment Notes

1. The basis of an IDGT installment note becomes relevant if the grantor transfers the IDGT installment note or grantor trust status is terminated during the grantor's lifetime. Unfortunately, there has been no guidance about whether an IDGT installment note has tax basis and if so, what the basis might be. It seems that the only sensible answer is the IDGT installment note can only have an adjusted basis equal to the property that was exchanged in the installment sale to the IDGT. An analogy to this treatment is a taxpayer who make a tax free exchange of property with the IDGT, receiving in the exchange an asset (IDGT installment note) that has a carryover basis of the exchanged property. This is explored in a series of examples below.

2. Example 1: Grantor sells to his or her IDGT property having an adjusted basis of $40,000 in exchange for an IDGT installment note having a face value of $100,000 payable in 10 equal annual installments ($10,000 per year plus interest at the appropriate AFR). Property collateralizes the $100,000 installment obligation to Grantor. Immediately after the sale, Grantor releases a power and terminates grantor trust status.

a. As discussed above, the termination of grantor trust status is treated as a transfer of the property to the trust and because there is debt of $100,000 in excess of the basis ($40,000), Grantor recognizes $60,000 of gain. What is Grantor's basis in his or her installment obligation prior to the exchange? It must be $40,000. This is because if Grantor had sold the property to a non-grantor trust and it qualified for installment sale treatment, then Grantor's installment obligation, as discussed above, would have a basis under section 453B(b) of the Code equal to $40,000. Selling to an IDGT and immediately terminating grantor trust status is effectively the same thing as a taxable installment sale with a non-grantor trust. However, the tax result, in this instance is considerably worse because G recognized $60,000 of gain, leaving Grantor with a Taxable Installment Obligation with a basis of $100,000, and the trust has property of basis equal to $100,000. Because basis is effectively a measure of the total after-tax investment of a taxpayer in property, this make sense. If Grantor purchased the property for $40,000 and recognized gain of $60,000, for a total amount after-tax investment of $100,000. The trust also carries the same after-tax investment of Grantor upon the deemed transfer of the property.

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[322] As discussed earlier, intellectual property in the hands of the creator is specifically excluded from the definition of capital asset. § 1221(a)(3). However, it is entitled to a step-up in basis under section 1014 and becomes a capital asset in the hands of the recipient.

[323] See e.g., § 1014(a)(3)

b. The only other possible options are the IDGT Installment Obligation, prior to the termination of grantor trust status, has a basis of zero or a basis equal to the trust's obligation to Grantor of $100,000. Neither of those make any sense.

(1) If the obligation had zero basis, then after the conversion, Grantor's resulting basis is $60,000 (because debt is in excess of basis) leaving Grantor with an additional $40,000 of unrealized gain. Grantor invested $40,000 and recognized an additional $60,000 of gain. If Grantor continues to hold an installment obligation with a basis of $60,000, then if Grantor sells the installment obligation for its face value of $100,000 Grantor would recognize an additional $40,000 for a total of $140,000 of after-tax investment in this transaction for a transferred property in trust that only has $100,000 of adjusted basis.

(2) If the obligation had a basis of $100,000 before the conversion, then Grantor would have $160,000 of basis, and Grantor would be able to sell the installment obligation for $100,000 and possibly generate a $60,000 loss, netting Grantor with a total $40,000 of after tax investment ($40,000 cost basis plus $60,000 of gain less $60,000 of loss).

3. Example 2 : Grantor sells to an IDGT property having an adjusted basis of $40,000 in exchange for an IDGT Installment Note having a face value of $100,000 payable in 10 equal annual installments ($10,000 per year plus interest at the appropriate AFR). Immediately after the sale, Grantor gifts the IDGT installment note (having a fair market value of $100,000) to Grantor's child. What is Child's adjusted basis in the installment obligation?

a. Assuming Grantor has a basis in the IDGT Installment Obligation of $40,000 at the time of the gift, then Child would get carryover basis on the note. With a Taxable Installment Note, under section 453B(a) of the Code, a gift of an installment obligation is considered a taxable disposition, which would cause the transferor to recognize gain.[324] However, if Grantor had continued to hold and receive payments on the IDGT Installment Obligation, Grantor would not have recognized any gain at all. Imposing $60,000 of gain on Grantor due to the gift would give Child an adjusted basis in the installment note of $100,000, but the IDGT would theoretically still be at $40,000. There doesn't seem to be any mechanism to "true-up" basis in the IDGT because there has been a taxable disposition (like a taxable sale of a partnership interest would entitle the partnership to make an inside basis adjustment under section 743 of the Code). The trust would get an increase in basis to $100,000 if Grantor terminates grantor trust status after the gift, in this example, but that would be at the cost of an additional recognition of gain of $60,000 by the Grantor because of the deemed transfer of the property with debt in excess of basis.

b. Assuming the gift is not a taxable disposition under section 453B(a) of the Code, Child has a carryover basis in the installment obligation. Both Child and the IDGT hold assets having a basis of $40,000 respectively, which provides parity, but that doesn't necessarily resolve other issues. For example, if after the gift to Child, Grantor terminates grantor trust status, then, as discussed above, Grantor will recognize $60,000 of gain, the trust will have $100,000 of basis in the property, but Child will only have $40,000 of basis in the installment obligation. That would mean that as the trust makes installment payments, Child might be required to recognize gain with each payment as a Taxable Installment Obligation. That seems inequitable. The correct result would be to increase the basis of the installment obligation under section 453B(b) to

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[324] *See* Rev. Rul. 67-167, 1967-1 C.B. 107, and Rev. Rul. 74-613, 1974-2 C.B. 153. *See also* PLR 9149026.

incorporate Grantor's recognized gain. In other words, "The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full,"[325] would take into account that Grantor recognized $60,000 of gain already. Under that interpretation, each annual payment to Child would be $10,000 of nontaxable recovery of basis and interest. If Grantor does not terminate grantor trust status, and the trust makes all of its payments to Child in satisfaction of its obligation, then over the 10 annual installments, Child will have, in aggregate, recognized $60,000 in gain (plus interest). A subsequent termination of grantor trust status by Grantor would not result in any more gain because debt no longer exists at the trust level. However, the trust will still have $40,00 in basis on the property, and a subsequent sale of the trust property would cause Grantor to recognize $60,00 in gain. Between Child and Grantor, $120,000 of gain is recognized, but the property (which had $40,000 of cost basis) is sold for $100,000 in total. That doesn't seem correct. Grantor could terminate grantor trust status after the installment obligation is fully paid. No gain would result on the termination, but it would leave the trust with $60,000 of unrealized gain. Again, that doesn't seem correct.

c. The only seemingly equitable way to treat a gift of an IDGT installment note is to treat the transfer like an open transaction. The initial transfer to Child would not be considered a taxable disposition under section 453B(a) of the Code. As an open transaction, if Grantor recognizes gain (due to a termination of grantor trust status or a sale by the trust of the property), then basis of the obligation would be adjusted to reflect the recognition of gain by Grantor, and the taxable portion of Child's installments would be adjusted. Unfortunately, there does not seem to be any mechanism in the Code or the Treasury Regulations to accomplish this.

4. Example 3: Grantor sells to property 1 to an IDGT having an adjusted basis of $40,000 in exchange for an IDGT installment note having a face value of $100,000, payable in 10 equal annual installments ($10,000 per year plus interest at the appropriate AFR). Immediately after the sale, Grantor swaps property 2, which has an adjusted basis of $80,000 and a fair market value of $100,000. The lien on property 1 is released, and property 2 collateralizes the $100,000 obligation to Grantor. At the same time, Grantor terminates grantor trust status.

a. Upon termination, Grantor's basis in the installment obligation seems to be $80,000 and the termination of grantor trust status will cause Grantor to recognize $20,000 of gain (rather than $60,000 of gain).

b. This does bring up an interesting planning opportunity. What if the IDGT held other assets having an aggregate basis in excess of $100? The IDGT could agree to collateralize those assets and release the lien on property 2 (or even property 1, if the swap did not occur). Upon termination of grantor status, the deemed transfer would not result in a discharge of liability that is in excess of the basis of the assets.

C. When an IDGT Installment Note Becomes a Taxable Installment Note

1. When grantor trust status is terminated, it seems clear that the IDGT Installment Note becomes a Taxable Installment Note on the effective date of the conversion. In a certain sense, an installment sale is deemed to occur at the time of the conversion (a deemed transfer for income tax purposes in exchange for a deferred payment obligation). Under the Code, an

[325] § 453B(b).

"installment sale" means a "disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."[326] Importantly, the Code does not define an installment sale in terms of a taxable sale or exchange. Thus, by its terms, the outstanding IDGT Installment Obligation becomes a Taxable Installment Obligations, and the rules of sections 453, 453A, and 453B of the Code apply to the newly created Taxable Installment Note.

2. As the previous section illustrates, many issues are unclear when dealing with IDGT Installment Notes if grantor trust status is terminated, particularly when the termination occurs during the life of the grantor. Termination of grantor trust status due to the death of the grantor has the benefit of a step-up in basis on the IDGT Installment Note under section 1014. As such the beneficiaries of the installment obligation are shielded from recognizing gain as payments are made on the newly created Taxable Installment Note (but interest will be taxable and, as noted below, and the Interest Charge Rule likely applies).

3. As discussed above, if grantor trust status is terminated during the lifetime of the grantor, it seems that the newly created Taxable Installment Note will have a basis equal to the property that is deemed to be transferred to the trust upon conversion to a non-grantor trust. As discussed later in these materials, the adjusted basis of the deemed transferred property is not as straightforward as it might seem.

4. In addition, all of the rules dealing with Taxable Installment Notes are now applicable to the obligation, causing a myriad of issues that have not been previously discussed before in this context. By way of example, consider the following issues that spring into being upon a conversion:

a. If the IDGT installment note bears interest at a very low AFR but, at the time of the conversion, AFR rates are higher, the imputed interest rules at the higher AFR will apply to the holder of the obligation.

b. The newly created Taxable Installment Note will likely be subject to the Interest Charge Rule, requiring additional tax to be paid based on the deferred tax.

c. The Pledge Rule will likely apply to the newly created Taxable Installment Note.

d. The newly created Taxable Installment Note may evidence a transfer of property that is ineligible for installment sale treatment like marketable securities, causing immediate recognition gain.

e. The newly created Taxable Installment Note will be subject to the taxable dispositions rules of section 453B and, as a result, a gift of the newly created Taxable Installment Note will be considered a taxable payment to the holder of the obligation at face value or fair market value, whichever is greater.

f. The newly created Taxable Installment Note will be considered IRD at the death of the holder of the obligation, ineligible for a step-up in basis under section 1014.

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[326] § 453(b)(1).

g. If the conversion results in an installment sale under section 453 of the Code (the property is eligible for installment sale treatment), then the property deemed transferred will be subject to the related party resale rule, if the trust sells or exchanges the property within 2 years of the conversion.

h. If the trust property deemed transferred upon conversion is ineligible for installment sale treatment, then a fully taxable sale or exchange occurs for consideration equal to the face amount of the obligation, resulting in gain (and loss, but possibly suspended under the related party rules of section 267(a)(1) of the Code).

D. Eliminating Outstanding IDGT Installment Notes

1. As one can see, the existence of outstanding IDGT Installment Notes can cause unintended tax consequences particularly if grantor trust status is terminated and installment debt is in excess of the adjusted basis of the property collateralizing the debt. Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth $100x and an adjusted basis of $0, but the asset is encumbered by a $50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and with an outstanding principal amount of $50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) $50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

2. To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its $50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of $50x. Assuming, the net value of the asset and the promissory note were both equal to $50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.

3. The LLC, as a separate legal entity, now owns an asset with a gross value of $100x, has a debt liability of $50x, and it owns the right to receive the $50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth $100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.

4. Upon the death of the grantor, under Revenue Ruling 99-5,[327] there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes. Under the ruling, such a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes,

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[327] Rev. Rul. 99-5, 1999-1 C.B. 434, situation 1.

the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

5. Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

V. INTRA-FAMILY PROMISSORY NOTES

A. Interest and Income Tax Treatment of Interest

1. Intra-family loans are common ways for families to not only transfer wealth for estate planning purposes but to provide easy and hopefully inexpensive liquidity and capital to family members. In order to avoid adverse gift tax consequences, it is commonly understood that the loan (and the evidence of the indebtedness, the Intra-Family Promissory Note) must bear, at least, interest at the appropriate AFR.[328] If the loan does not bear sufficient interest, it is treated as a below-market loan under section 7872 of the Code and the "forgone interest" is treated as "transferred from the lender to the borrower," and "retransferred by the borrower to the lender as interest."[329] The foregone interest is treated as a gift by the lender to the borrower for transfer tax purposes,[330] and for income tax purposes, interest is deemed paid by the borrower and received by the lender.

2. Unless the loan is made between a grantor and a grantor trust, the lender's receipt of interest will be ordinary income to the lender,[331] and the borrower will not be able to deduct the interest for income tax purposes. Section 163(h)(1) of the Code provides, "In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year."[332] "Personal interest" is, in turn, defined by exception is "any interest allowable as a deduction"[333] other than: (i) interest paid on debt property

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[328] § 7872(g)(3) (The term "gift loan" means any below-market loan where the forgoing of interest is in the nature of a gift.). A "below-market loan" means a demand or term loan where the "interest is payable on the loan at a rate less than the applicable Federal rate" or the "amount loaned exceeds the present value of all payments due under the loan" (with present value determined with a discount rate equal to the applicable Federal rate). *See* 7872(e)(1), (f)(1), and (f)(3).

[329] §§ 7872(a) and 1274(d).

[330] Treas. Reg. § 25-2512-8.

[331] § 61(a)(4).

[332] § 163(h)(1).

[333] § 163(h)(2).

allocable to a trade or business (other the performance of services),[334] (ii) investment interest,[335] (iii) interest used to compute income or loss from the passive activity of the taxpayer under section 469 of the Code,[336] (iv) qualified residence interest,[337] (v) interest on deferred estate tax liabilities,[338] and (vi) interest on qualified education loans deductible under section 221 of the Code.[339]

B. Exchange or Substitution of Intra-Family Promissory Notes

1. When interest rates decline, it is common for estate planners to seek to exchange or substitute the Intra-Family Promissory Notes with those that have lower interest rates. It is commonly believed that such an exchange, as long as the substitution note bears interest at the appropriate AFR at the time of the exchange, will not be considered at taxable gift, particularly if the terms of the original loan contain a no prepayment penalty clause.[340] From an income tax perspective, if the exchange is between a grantor and a grantor trust, no gain or loss will be recognized under Revenue Ruling 85-13. The same would also apply to an exchange or substitution between spouses under section 1041 of the Code.

2. If the substitution is with another taxpayer other than those mentioned above, substitution of a note could be considered a taxable event for both parties. *Cottage Savings Association v. Commissioner*[341] and the Treasury Regulations provide, "the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[342] The Treasury Regulations also provide that a modification of the debt could be a taxable event.[343] The Treasury Regulations provide an exception for interest rate changes that are set out in the terms of the debt instrument or at the exercise of unilateral option in one party,[344] but do not provide an exception for a reduction in the interest rate exercised without a legal right to do so under the debt instrument.

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[334] § 163(h)(2)(A). *See also* Treas. Reg. 1.163(d)-8T for meaning of a trade or business.

[335] §§ 163(h)(2)(B) and 163(d)(3).

[336] § 163(h)(2)(C).

[337] §§ 163(h)(2)(D) and 163(h)(3).

[338] § 163(h)(2)(E).

[339] § 163(h)(2)(F).

[340] For an excellent discussion on the transfer and income tax consequences of not substitutions, *see* Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. Tax'n. 22 (July 2008). Consideration of how the obligor justifies the substitution of a new note with a lower interest rate is warranted under state law.

[341] *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991).

[342] Treas. Reg. § 1.1001-1(a).

[343] Treas. Reg. § 1.1001-3(a). *See* Rev. Rul. 89-122, 1989-2 C.B. 200, Rev. Rul. 87-19, 1987-1 C.B. 249, and PLR 9127003.

[344] *See* Treas. Reg. §§ 1.1001-3(c)(1)(ii) and 1.1001-3(c)(2)(ii).

3. If the substitution of an Intra-Family Promissory Note is deemed a taxable exchange (or significant modification), then the borrower (now obligated to pay interest at a lower rate) may have cancellation of debt (COD) income. The Code provides, "For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument."[345] The issue price is determined under sections 1273 and 1274 of the Code (although only section 1274 applies under these circumstances).[346] The Treasury Regulations further provide, "An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of Section 1.1275-1(b))."[347] Thus, the amount of COD is the difference between the "issue price" of the new promissory note and the "adjusted issue price" of the original promissory note.

4. Section 1274 of the Code provides when the new promissory note bears "adequate stated interest" (AFR), the "issue price" is the "stated principal amount" (face amount of the note).[348] The "adjusted issue price" is the "issue price of the debt instrument" increased by original issue discount (OID) includible in the gross income of the holder, and decreased by any payment previously made on the debt instrument, other than qualified stated interest. It is generally safe to assume under most family arrangements, the original Intra-Family Promissory Note will not be an OID. If (i) the original note was issued with the appropriate AFR, (ii) the new promissory note is also issued at the appropriate AFR, even if the AFR is lower than the interest rate on the original note, and (iii) the face value of the new note equals the remaining amount of debt on the original note, there should be no COD. Importantly, if there is a deemed cancellation of indebtedness between family members, then it could be treated as a gift from the lender to the borrower, which would not be income to the borrower under section 102 of the Code.

C. Intra-Family Promissory Notes: Adjusted Basis and Capital Asset

1. When a creditor loans cash to a borrower and receives a promissory note in return, the creditor's adjusted basis in the promissory note is equal to the cash loaned. The promissory note meets the definition of a capital asset under section 1221(a) of the Code, and if the note is included in the gross estate of the holder of the note, then the note will get a basis adjustment under section 1014 of the Code, much like IDGT installment notes (but unlike Taxable Installment Notes, which are IRD). If a creditor "loaned" property to a borrower, the "note" (or whatever evidence of the obligation to return the property) would have an adjusted basis equal to the basis of the loaned property, much like the lending of securities in a "short sale."[349]

2. Sometimes, under the swap power, a grantor exchanges his or her own promissory note for assets in an IDGT, the exchange and all payments on the promissory note will be ignored for Federal income tax purposes, as long as grantor trust status remains. If, however, grantor trust status is terminated (by death or during the lifetime of the grantor), it is unclear what

[345] § 108(e)(10)(A).

[346] § 108(e)(10)(B).

[347] Treas. Reg. § 1.61-12(c)(2)(ii).

[348] § 1274(a)(1).

[349] *See* § 1058(c).

tax basis the IDGT has in the promissory note. As discussed above, the promissory note, this obligation to pay, will have the same basis that the grantor had in the note at the time of the exchange. Unlike a traditional loan where funds are actually transferred, the issue at hand is whether a grantor has basis in his or her own promise to pay as evidenced by the promissory note held by the IDGT. If not, then the basis is likely to be zero. If the grantor does have basis, then the basis is likely to be the amount of the indebtedness.

3. If the basis in the promissory note is zero, then when grantor trust is terminated, the trust will have a zero basis in the note, such that when the note is ultimately satisfied by the debtor (the estate or beneficiaries of the estate), capital gain will be recognized by the trust.

a. The IRS position is that a debtor has no basis in his or her own promissory note.[350] The Tax Court has consistently held when partners have contributed promissory notes to a partnership, the contributing partner does not get increased adjusted basis in his or her partnership interest because the partner has no basis in the note.[351] In *Gemini Twin Fund III v. Commissioner*, the Tax Court wrote, "Even assuming, as petitioner argues, that a note is property under State law and for other purposes, a taxpayer has no adjusted basis in his or her own note. Until the note is paid, it is only a contractual obligation to the partnership. The existence of collateral does not change this result."[352]

b. However, in other contexts, the courts have held that an unsecured promissory note does, in fact, create basis, as long as the note represents a genuine indebtedness. In *Peracchi v. Commissioner*,[353] the taxpayer contributed real property to a corporation. The real property was encumbered by debt in excess of basis. Under section 357(c) of the Code, any liabilities in excess of basis will be considered gain upon contribution to a corporation (in this case, NAC) controlled by the taxpayer under section 351 of the Code. To avoid this gain, the taxpayer also contributed a promissory note in an amount equal to the excess liabilities, claiming the note had a basis equal to its face amount. The IRS argued that the note has a zero basis. The Ninth Circuit agreed with the taxpayer. The opinion provides:[354]

> We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. *See* Commissioner v.

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[350] *See, e.g.,* Rev. Rul. 80-235, 1980-2 C.B. 229 (liability created by the written obligation of a limited partner does not create basis in the limited partnership interest), and Rev. Rul. 68-629, 1968-2 C.B. 154 (contribution of promissory notes to a corporation did not create tax basis, resulting in gain under section 357(c) of the Code because the taxpayer contributed other assets with liabilities in excess of tax basis).

[351] *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, *Dakotah Hills Offices Ltd. Part. v. Commissioner*, T.C. Memo. 1998-134, *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315, aff'd without published opinion, 8 F.3d 26 (9th Cir. 1993), *Bussing v. Commissioner*, 88 T.C. 449 (1987), *Oden v. Commissioner*, T.C. 1981-184, *aff'd* without published opinion, 678 F.2d 885 (4th Cir. 1982).

[352] *Gemini Twin Fund III v. Commissioner*, T.C. Memo 1991-315.

[353] *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997). *But see Seggerman Farms Inc. v. Commissioner*, 308 F.3d 803 (7th Cir. 2002) and *Alderman v. Commissioner*, 55 T.C. 662 (1971).

[354] *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997) at 494.

> Tufts, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here Peracchi will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. *See*, *e.g.*, Levy v. Commissioner, 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.

The court then goes on to point out that if the note has a zero basis, then the corporation also will have a zero basis in the note,[355] which would create a subsequent gain if the note then was sold to a third party:[356]

> We find further support for Peracchi's view by looking at the alternative: What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for Peracchi, so too for NAC. *See* I.R.C. section 362(a). But what happens if NAC–perhaps facing the threat of an involuntary petition for bankruptcy–turns around and sells Peracchi's note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize $1,060,000 in phantom gain on the subsequent exchange, even though the note did not appreciate in value one bit. That can't be the right result. [Footnote omitted]

The dissenting judge in the *Perrachi* opinion remarked, "The taxpayer has created something – basis – out of nothing."[357]

4. It is unclear what this means for swap transactions with an IDGT and the tax ramifications upon repayment of the debt when the IDGT becomes a non-grantor trust. What is clear is that the IRS will claim that the grantor's note has no tax basis. There are sound arguments

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[355] *See Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 189). The court agreed with the IRS's argument that the note had a zero basis, but then concluded the note had a basis in the corporation's hands equal to its face value.

[356] *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1997) at 494.

[357] *Id.* at 497.

on both sides of the debate, although most believe these self-created promissory notes, where no funds or assets have been transferred, should have a basis of zero.[358]

D. Valuation and Inclusion of IDGT Installment and Intra-Family Promissory Notes

1. IDGT Installment Notes and Intra-Family Promissory Notes are very similar. They evidence the obligation of one party to pay the principal and stated interest. As mentioned, both are entitled to a basis adjustment to fair market value under section 1014 of the Code, and as to that valuation, the Treasury Regulations provide:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.[359]

2. The IRS has agreed that "all available data and all relevant factors affecting the fair market value must be considered"[360] in determining the value of a promissory note, and face value is not necessarily the value to be included in the gross estate. Many practitioners have, in the past, claimed valuation discounts on installment note obligations included in the estate due to a number of factors including a low interest rate, lack of security, and the obligor's inability to pay the note as it becomes due.[361] Practitioners may want to consider whether a valuation discount should be claimed today if the obligation will be entitled to a "step-up" in basis to fair market value at little or no transfer tax cost (assuming there is sufficient applicable exemption amount available at the time of the grantor's death). Note that valuation is an issue for gift tax purposes too. If a note has an interest rate in excess of the applicable rate on the date of a gift, the value of the note could exceed the stated principal value.

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[358] *See* Stuart Lazar, *Lessinger, Peracchi, and the Emperor's New Clothes: Covering a Section 357(c) Deficit with Invisible (or Nonexistent) Property*, 58 Tax Lawyer No. 1, 41 (Fall 2004); Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984); and Jerred G. Blanchard Jr., *Zero Basis in the Taxpayer's Own Stock or Debt Obligations: Do Those Instruments Constitute 'Property'?*, 2005 Tax Notes 1431 (March 21, 2005).

[359] *See* Treas. Reg. § 20.2031-4

[360] TAM 8229001.

[361] *See* M. Read Moore, *Valuation Discounts for Private Debt in Estate Administration*, 25 Est. Plan. 195 (1998) and Jerry M. Hesch, Alan S. Gassman, and Christopher J. Donicolo, *Interesting Interest Questions: Interest Rates ,for Intra-Family Transactions*, 36 Est. Gifts & Tr. J. 128 (2011).

VI. SELECTED PLANNING OPPORTUNITIES AND SCENARIOS

A. Not "Rushing" Related Party Sales

1. As discussed above, section 453(e) provides that if property is sold to a related party in exchange for a Taxable Installment Note and the purchased property is resold by the related party within two years of the original purchase, then the amount realized by the related party will be treated as a payment to the original seller. Thus, the deferred gain on the Taxable Installment Note is accelerated at the time of the second sale (to the extent of the amount realized on the second sale). Because the two year time period is relatively short, taxpayers should consider planning for the benefits of related party sales, especially if the taxpayers anticipate that an ultimate disposition of property is likely to occur two years or later in the future.

> Example: A and B, spouses, equally own property with an adjusted basis of $100,000 and fair market value of $10,000,000. A and B believe that the property will likely be sold in the next few years. A and B sell the property for $10,000,000 to two non-grantor trusts created by each of them for the benefit of their descendants. A and B collectively receive two Taxable Installment Notes with an aggregate face value of $10,000,000 from the non-grantor trust which provide for interest only at the long-term AFR for 30 years with a "balloon" principal payment of $10,000,000 at the end of the term. Both A and B have a life expectancy greater than 30 years. A and B live in a high income tax state. The non-grantor trusts are created in a state that does not impose state income tax.
>
> Immediately after the sale, the non-grantor trusts hold the property with an adjusted basis equal to $10,000,000. A and B hold two Taxable Installment Notes with an aggregate adjusted basis of $100,000, face value of $10,000,000, and gross profit ratio of 99%.
>
> Over the next two years (and for the foreseeable future), A and B receive interest payments which are taxable as ordinary income but deductible by the non-grantor trusts. A and B will never be subject to the Interest Charge because it is below their respective $5 million thresholds.
>
> In the third year, the non-grantor trusts sell the property for $11,000,000 in cash to a third party buyer. The non-grantor trusts will collectively recognize $1,000,000 in capital gain without any state income tax payable.
>
> Over the next 25 years, the after-tax proceeds of the resale grow to $35,000,000, at which point the non-grantor trusts pay the principal (two years early), leaving the trusts with $25,000,000. A and B will recognize $9,900,000 in gain. If during that time A and B have moved to a state that does not impose an income tax, then only the federal capital gain tax will be due at that time.

2. As the example above illustrates, an installment sale to a related party, followed by a resale of the purchased property after two years, can provide significant and long-term income tax deferral at both the Federal and state level. In addition to that it can provide substantial transfer tax savings. The $25,000,000 in the non-grantor trust are out of the gross estates of A and B. It can also provide flexibility. For example, if the taxpayers are worried that the survivor of A and B (assuming the first-to-die bequeaths his or her obligation to the other) may pass away holding an IRD asset like a Taxable Installment Note, the non-grantor trusts can prepay the obligation, at

which point the gross estate of the survivor will be reduced by the resulting income tax liability (thereby reducing any estate tax payable).

3. Practitioners may be tempted to convert the non-grantor trusts, in this example, to grantor trusts to get the advantages that such status brings (i.e., the grantor's payment of the income tax liability of the trust). This would necessarily need to happen after the resale by the related party. That being said, a conversion like this should be done with extreme caution. As noted above, the IRS has ruled that a conversion from non-grantor to grantor trust status will either not be treated as a transfer for income tax purposes or, at the very least, not a transfer that results in a recognition event to the grantor. That being said, it's unclear whether that would be the case with Taxable Installment Notes. There is a chance the IRS could treat the conversion as a prepayment, a taxable disposition under section 453B, or a substantial modification of the obligation, all of which would cause the deferred gain to be immediately recognized.

B. Depreciable Property Sales to or for Descendants

1. Generally

a. As discussed earlier, section 453(g) does not preclude an installment sale of depreciable property from a seller to his or her descendants or a non-grantor trust for the benefit of such descendants. While a partnership or corporation that is more than 50% owned by a seller's descendants is a "controlled entity," a non-grantor trust for the benefit of the seller's descendants is not. As such, the non-grantor trust is not a related person under sections 456(g)(3) (and by extension section 1239(b)).

b. Under the current depreciation system, all residential rental and nonresidential real property placed in service after 1986 must use straight-line depreciation.[362] Generally, the applicable recovery period for (i) residential rental property is 27.5 years; (ii) nonresidential real property is 39 years, and (iii) land improvements is 15 or 20 years.[363] Depreciation deductions can offset rental income, which is taxable at ordinary rates of 37% today and 39.6% after 2025 under the current tax law. As noted earlier, when depreciable property is sold, the Code taxes "unrecaptured section 1250 gain" (essentially, the amount of straight-line depreciation taken on the property) at a maximum rate of 15%. This provides the owner of the property with a tax arbitrage savings of 12%-14.6% (37%/39.6% less 25%), without even taking into account the time value of getting the deductions prior to the recapture of those deductions (when there is a taxable sale in the future).

c. Once property has been fully depreciated, other than a taxable sale or capital improvements to the property, the only way to "refresh" basis is with a "step-up" in basis at the death of the owner under section 1014. Unfortunately, this often comes at a 40% estate tax cost to the decedent's estate, unless the property is sheltered by the decedent's base exclusion amount under section 2010(c)(3) or the property is sheltered by the marital deduction under section 2056. If the depreciable property is held in an IDGT, the property will avoid inclusion in the gross estate for estate tax purposes, but the property will not receive a basis adjustment at the death of the grantor under section 1014.

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[362] § 168(b)(3)(A)-(B).

[363] § 168(c).

d. As a result, owners of depreciable property often must balance the cost of causing inclusion in their gross estates (costing as much as 40% of the value of the property) against the income tax savings of getting a basis adjustment under section 1014 for the benefit of their heirs. This is especially the case for an owner who has a very large estate (in excess of his or her remaining base exclusion) or who cannot rely on the marital deduction to shelter the inclusion of the asset from estate taxes (temporarily until the surviving spouse subsequently dies) because he or she will not have a surviving spouse. In such circumstance, an owner should consider selling fully depreciated rental property to a a non-grantor trust for the benefit of his or her children under the installment method. The property, in the hands of the non-grantor trust, will have a cost basis, as a result of the sale, providing depreciation deductions that can reduce the future rental income. The seller will have unrecaptured section 1250 gain taxable at 25%, but that gain (along with any additional gain taxable at regular long-term capital gain tax rates) will be deferred under the installment method. An additional benefit is the sale during the life of the seller effectively freezes the remaining estate tax value of the property in the form of the Taxable Installment Obligation. Furthermore, if the Taxable Installment Obligation is paid off during the seller's lifetime, the income taxes paid or payable on the obligation further reduces the seller's gross estate for estate tax purposes.

2. Refreshing Basis and Resurrecting Depreciation

a. As noted above, the sale of depreciable property to a non-grantor trust for the benefit of the seller's descendants can provide income and transfer tax savings. In the right set of circumstances, this method of "refreshing basis" and "resurrecting depreciation" deductions can be achieved every time the property has been fully depreciated.

> Example: Scenario 1: A GST tax exempt IDGT created by G1, for the benefit of G1's children (G2), grandchildren (G3), and more remote descendants (G4), owns depreciable property with an adjusted basis of zero and a fair market value of $5,000,000. For purposes of simplicity, assume the depreciable property is residential real property subject to straight-line depreciation, has an applicable recovery period of 30 years, never changes in value, and always has a capitalization rate of 3.33%. Under the foregoing assumptions, the property will have annual net rental income of $166,667 (3.33% x $5,000,000 value), which cumulatively over 30 years will equal the $5,000,000 value of the property. It also means, with a 30 year recovery period, if the property had $5,000,000 of basis, the annual depreciation deduction would equal $166,667, exactly offsetting the annual rental income.
>
> Assume G1 dies in 30 years, followed by each subsequent generation passing away every 30 years. Over the course of 4 generations from G1 to G4 (120 years), the cumulative amount of after tax income each generation would accumulate is $3,020,000 ($5,000,000 of cumulative rental income over 30 years less $1,980,000 in taxes at a 39.6% ordinary income tax rate).[364] Thus, over 4 generations, assuming no return on investments, no spending of after tax income, and no

[364] Technically, the descendants will get the benefit of G1 paying the tax attributable to the IDGT during G1's lifetime, but on a net tax after income tax basis and ignoring the transfer tax savings of G2's payment of the income tax, each generation would net $3,020,000.

transfer taxes due as each generation passes, the GST tax exempt trust will own property worth $5,000,000 and $12,080,000 of cash.

Scenario 2: Instead of the foregoing, the IDGT sells the depreciable property to a non-grantor trust created by G1 for the initial primary benefit of G2 (G2 Trust) in exchange for a 30-year Taxable Installment Obligation that provides for annual payments of adequately stated interest and a balloon payment of $5,000,000 at the end of the term. Assume G2 Trust is minimally funded, GST tax exempt, and for the benefit of G2, G3, and G4. At the end of 30 years, after the last payment on the Taxable Installment Obligations, G2 Trust sells the depreciable property to a non-grantor trust created by G2 for the initial primary benefit of G3 (G3 Trust) in exchange for a 30 year Taxable Installment Obligation that provides for annual payments of adequately stated interest and a balloon payment of $5,000,000 at the end of the term. Assume G3 Trust is minimally funded, GST tax exempt, and for the benefit of G3 and G4. Assume the same pattern of activity happens after 30 years with a G4 Trust created by G3.

Assuming G1 dies in 30 years just after receiving the balloon payment on the Taxable Installment Obligation. Ignoring interest, G1 will net, after tax, $3,750,000 ($5,000,000 principal payment in year 30 less $1,250,000 of unrecaptured section 1250 gain taxable at 25%. Each subsequent generation passes away every 30 year also, just prior to that generation's non-grantor trust receiving its balloon payment on their respective Taxable Installment Obligation. Ignoring interest, each generation's trust will net, after tax, $3,750,000 ($5,000,000 of cumulative rental income over 30 years [fully offset by $5,000,000 of cumulative depreciation deductions] less $1,250,000 of unrecaptured section 1250 gain taxable at 25%). Thus, over 4 generations, assuming no return on investments, no spending of after tax income, and no transfer taxes due as each generation passes, the trust will own property worth $5,000,000 and $15,000,000 of cash.

The cumulative difference between scenarios 1 and 2 above is $2,920,000 (15,000,000 less $12,080,000 or $730,000 additional cash for each generational trust). This difference represents the 14.6% rate differential between the ordinary rate of 39.6% and the recapture rate of 25% against cumulative rental income of $20,000,000 over 120 years ($5,000,000 over 4 generations). If one assumes annual returns will be greater than the interest payable on the Taxable Installment Obligations,[365] the savings would be significantly greater.

C. Dealing with Grantor to Non-Grantor Trust Conversions

1. Avoiding Gain Upon Conversion at Death of the Grantor

a. As noted above, when a grantor trust is converted to a non-grantor trust, there is a deemed transfer (by the grantor to the trust) of all of the trust assets at the time of the conversion. It appears, whether the conversion is during the life of the grantor or occurs because

[365] One must also take into account any Interest Charge that may be payable by the seller, but in this example each installment sale was at the $5 million threshold.

of the grantor's death, if (i) the trust owes a debt to the grantor (i.e., evidenced by an IDGT Installment Note) and (ii) the amount of the outstanding indebtedness is in excess of the adjusted basis of the asset that collateralizes the debt, then the grantor will recognize gain to the extent of the excess. In contrast, the current position by the IRS is that if the same debt in excess of basis situation exists in a non-grantor trust, and the non-grantor trusts converts to a grantor trust, this is not an income taxable event.

b. In order to avoid the recognition of gain when debt is in excess of basis, there are a number of strategies that planners should consider prior to the conversion. These strategies may include:

(1) As discussed above, the contribution by the grantor and the grantor trust (IDGT) of (i) the property collateralizing the debt and (ii) the IDGT Installment Note, in exchange for interests in an LLC that is disregarded for federal income tax purposes. These contributions result in (i) the extinguishment of the IDGT Installment Obligation with no income tax consequences and (ii) the IDGT and the grantor owning LLC interest in proportion to the fair market values of their respective contributions. Upon conversion, the disregarded entity becomes a partnership for income tax purposes, and the non-grantor trust and grantor have partnership interests in the LLC. If the conversion to non-grantor trust occurs when the grantor is still alive, the outside basis of the interests held by the trust and the grantor will equal, in aggregate, the adjusted basis of the formerly collateralized property, and the outside basis is shared according to their respective shares in the LLC (now taxed as a partnership). If the conversion to non-grantor trust is due to the death of the grantor, as noted above, the outside basis of the non-grantor trust in the LLC will be its share of the formerly collateralized property without any basis adjustment under section 1014, and the deceased grantor's outside basis, under Revenue Ruling 99-5,[366] will be determined by the grantor's share of the formerly collateralized property (through the LLC) but with a basis adjustment under section 1014, as if the grantor directly owned that share of the property.

> Example: An IDGT holds property with an adjusted basis of $2,000,000 and a fair market value of $10,000,000. The property collateralizes a $6,000,000 IDGT Installment Obligation held by the grantor. Prior to the death of the grantor, an IDGT and a grantor contribute their respective interests in the property and the IDGT Installment Obligation to a LLC in exchange for 100% of the LLC interests. The result is the extinguishment of the $6,000,000 IDGT Installment Obligation, and the IDGT holding 40% and the grantor holding 60% respectively of the LLC. The LLC is still a disregarded entity.
>
> Upon the death of the grantor, the IDGT converts to a non-grantor trust and the LLC converts to a partnership for Federal income tax purposes. Assuming there are no changes in any values, the trust will own a 40% partnership interest in the LLC with an outside basis of $800,000 (40% of the $2,000,000 carryover basis of the property). Deceased grantor's estate will own a 60% partnership interest in the LLC with an outside basis of $6,000,000 (60% of the property's fair market value at the time of death due to a basis adjustment under section 1014). The LLC will own the property with an adjusted basis of $6,800,000. This is the correct result because under Revenue Ruling 99-5, (i) the trust is treated as if it owned 40% of

[366] Rev. Rul. 99-5, 1999-1 C.B. 434, situation 1.

the property (with no basis adjustment under section 1014); (ii) the deceased grantor is treated as if he or she owned 60% of the property (with a basis adjustment under section 1014); and (iii) the trust and decedent contribute their respective interests in the property to a newly created LLC in exchange for interests in an LLC that is taxed as partnership.[367]

(2) If the IDGT owns other assets in addition to the collateralized property, then the trustee and the grantor can agree to collateralize other assets with sufficient basis to eliminate the debt in excess of basis issue. If the IDGT does not have sufficient basis in the existing assets, the grantor could exercise his or her "swap" power under section 675(4)(C) of the Code and replace lower basis trust assets for higher basis assets with no income tax consequences. Even if the grantor does not possess a swap power, the trustee of the IDGT and grantor can agree to exchange assets and arrive at the same result, as long as the power retained by the grantor provides for grantor trust status over all of the assets (principal and income) under the portion rules.

Example: Grantor sells Property A with an adjusted basis of $300,000 and a fair market value of $500,000 to an IDGT, in exchange for an IDGT Installment Note within a face amount of $500,000, providing for annual payments of adequately stated interest with a single payment of principal at the end of the 20-year term. The property collateralizes the debt to the grantor. Fifteen years later, Property A has appreciated to $1,000,000.

If grantor dies with no other changes to the foregoing situation, as discussed above, the grantor will recognize $200,000 of gain because, upon the conversion to non-grantor trust, the $500,000 of outstanding debt is in excess of the $300,000 of adjusted basis in Property A. The IDGT Installment Note will be included in the grantor's estate and will get a basis adjustment under section 1014.

If, prior to death, grantor exercises a power to "swap" an asset of equivalent value for Property A, and that asset, Property B, has an adjusted basis of $500,000 and a fair market value of $1,000,000, then upon the death of the grantor, there will be no gain on the conversion to non-grantor trust. The IDGT Installment Note will be included in the grantor's estate and will get a basis adjustment under section 1014.

2. Conversion to Non-Grantor Trust During the Grantor's Lifetime

a. The income tax consequences of a conversion from grantor to non-grantor trust during the life of the grantor when an IDGT Installment Note is outstanding are much more complex. The results depend largely on whether the outstanding debt obligation is greater than the adjusted basis of the property that is deemed to be transferred (or disposed) on the date of the conversion. The type of property will also be significant, since there are many types of property that are not eligible for installment sale treatment.

b. When debt is not in excess of basis on the date of the conversion, there is no recognition of gain. Further, if the property transferred is eligible for installment sale treatment, then the grantor holds a newly created Taxable Installment Obligation.

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[367] *See* § 721.

Example: IDGT holds property eligible for installment sale treatment with an adjusted basis of $10,000,000 and a fair market value of $20,000,000. The property collateralizes a $10,000,000 IDGT Installment Obligation held by the grantor. At the time of the conversion to non-grantor trust, the IDGT Installment Note provides for 2 more years of interest only payments at 2% (the AFR when the IDGT installment sale occurred) and then 5 equal annual installments of principal of $2,000,000 plus interest at 2%. Upon the conversion there is a deemed transfer of the property, no gain is recognized, and the grantor now holds a Taxable Installment Note with a face value of $10,000,000.

It seems the basis of the grantor's Taxable Installment Note is $5,000,000. This is because the debt obligation is $10,000,000, which is equal to one-half of $20,000,000 fair market value. In other words, one-half of the property is being "disposed of" in "exchange" for the $10,000,000 Taxable Installment Note. Thus, one-half of the property's basis is assigned to such transfer. As a result, the transaction results in: (i) selling price of $10,000,000 (5 equal installments of $2,000,000); (ii) gross profit of $5,000,000 ($10,000,000 selling price - $5,000,000 of basis); (iii) contract price of $10,000,000 ($10,000,000 selling price with no reductions for qualifying indebtedness); and (iv) gross profit ratio of 50% ($5,000,000 gross profit ÷ $10,000,000 contract price).

If, at the time of the conversion, the applicable AFR is 5%, then the grantor's Taxable Installment Note will not have adequately stated interest. As a result, the grantor will be required to accrue imputed interest under the OID rules or section 483.

The Interest Charge Rule will apply, requiring the grantor to pay additional interest to the extent the Taxable Installment Note exceeds the $5 million threshold, at the underpayment rate in effect at the end of each taxable year.

In addition, the Taxable Installment Note held by the grantor will be considered IRD if the grantor owns the obligation at his or her death. Further, the obligation will be subject to the Pledge Rule, and a taxable disposition (i.e., gift) will be a taxable payment on the obligation.

c. Even if debt is not in excess of basis on the date of conversion, gain will be recognized if the property deemed transferred is ineligible for installment sale treatment.

Example. Same fact situation as immediately above, except the property in question are marketable securities, which are not eligible for installment sale treatment. Upon the conversion, there is a deemed transfer of the marketable securities, and the grantor now holds an obligation with a face value of $10,000,000.

Because marketable securities are not eligible for installment sale treatment, the grantor will recognize $5,000,000 of gain ($10,000,000 sale of one-half of the marketable securities - $5,000,000 of adjusted basis attributable to the purchased marketable securities). The non-grantor trust will hold marketable securities with $15,000,000 of adjusted basis and a fair market value of $20,000,000. Since the transaction is not an installment sale, the Interest Charge Rule and Pledge Rule do

not apply. In addition, the grantor's obligation is not IRD. The grantor holds an obligation with an adjusted basis and face value of $10,000,000, and the non-grantor trust has ongoing obligations to pay interest and principal for the next 7 years.

If, at the time of the conversion, the applicable AFR is 5%, then the grantor's taxable installment note will not have adequately stated interest. As a result, the grantor will be required to accrue imputed interest under section 483 (the OID rules are inapplicable because the debt obligation was issued for publicly traded securities).

d. If debt is in excess of basis, gain will be recognized to the extent of that excess, and if the property that is transferred is eligible for installment sale treatment, then the grantor will hold a Taxable Installment Note.

Example: IDGT holds property eligible for installment sale treatment with an adjusted basis of $2,000,000 and a fair market value of $10,000,000. The property collateralizes a $6,000,000 IDGT Installment Obligation held by the grantor. At the time of the conversion to non-grantor trust, the IDGT Installment Note provides for 10 more years of interest only payments at 2% (the AFR when the IDGT installment sale occurred) and then a "balloon" principal payment of $6,000,000. Upon the conversion there is a deemed transfer of the property, $4,000,000 of gain is recognized, and the grantor now holds a Taxable Installment Note with a face value of $6,000,000 with an adjusted basis of $6,000,000.

The obligation is still considered a Taxable Installment Obligation with a gross profit ratio of 0% ($0 gross profit ÷ $6,000,000 contract price). Thus, when the grantor receives the balloon principal payment in 10 years, no gain will be recognized. Technically, the Taxable Installment Obligation is subject to the Interest Charge and Pledge Rules. However, because the obligation has a basis equal to its face value, there is no interest charge payable and there is no recognition if it is pledged. Further, a taxable disposition (i.e., gift) of the obligation will not cause the grantor to recognize any additional gain.

If, at the time of the conversion, the applicable AFR is 5%, then the grantor's Taxable Installment Note will not have adequately stated interest. As a result, the grantor will be required to accrue imputed interest under the OID rules or section 483.

The Taxable Installment Obligation is considered IRD, but because its adjusted basis is equal to face value, the transferee of the obligation, at the death of the grantor should not recognize any gain upon payment of the principal. However, if the grantor's estate claims a valuation discount on the inclusion of the Taxable Installment Note, the adjusted basis of the obligation will be reduced (stepped-down) under section 1014. In that instance, the transferee of the obligation will recognize gain upon payment of the principal.

e. As the foregoing examples illustrate, taxpayers should seek to pay off IDGT Installment Notes if a conversion to non-grantor trust is pending. The consequences of "converting" the IDGT Installment Obligation to a Taxable Installment Obligation are complicated.

D. Partnership Planning Opportunities and Complications

1. Using Partnerships to Multiply the $5 Million Threshold

a. As noted earlier, the IRS has ruled that if a partnership (or other pass-through entity) owns an installment obligation, the $5 million threshold of the Interest Charge Rule will be applied at the partner level.[368] As such, a partnership is a convenient way to "multiply" the $5 million threshold among the partners, allowing the partnership to avoid or minimize an interest charge upon a sale of higher valued property in an installment sale.

> Example: A family partnership owns highly-appreciated property worth $50,000,000. The property is not section 704(c) property. The partnership has 10 family members as equal partners, consisting of 2 parents, 3 children, and 5 non-grantor trusts for the benefit of the grandchildren. The partnership sells the property in exchange for a $50,000,000 Taxable Installment Note, payable over 5 years. Assuming none of the partners have any other Taxable Installment Obligations outstanding over the next 5 years, the income tax items attributable to the payments on the obligation and allocated to each of the 10 partners (10% each) will include gain and interest income, but none of the partners will be subject to the Interest Charge Rule.

b. When calculating the $5 million threshold among the partners, it is logical to refer to each partner's share of the unrealized gain of the disposed property.

> Example: AB partnership owns an appreciated property worth $10,000,000. The property is not section 704(c) property. The partnership has two partners. Partner A holds a 60% partnership interest, and Partner B holds a 40% partnership. As such, if the property were sold for its fair market value, 60% of the gain would be allocated to A, and 40% would be allocated to B. AB partnership sells the appreciated property in exchange for a $10,000,000 Taxable Installment Note, payable in equal installments of $2,000,000 over 5 years.
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> In the year of the sale, $10,000,000 of the obligation is still outstanding at the end of the taxable year. Partner B will not be required by pay the Interest Charge (40% of $10,000,000 = $4,000,000 of outstanding obligations < $5 million threshold). Partner A will be subject to the Interest Charge Rule (60% of $10,000,000 = $6,000,000 of outstanding obligations > $5 million threshold), and the Applicable Percentage in the calculation will be 16.67% ($1,000,000 excess above the $5 million threshold ÷ $6,000,000 aggregate face amount of obligation).
>
> The following year, after the first installment payment of $2,000,000, $8,000,000 of the Taxable Installment Obligation is still outstanding at the end of the taxable year. Neither Partner A (60% of $8,000,000 = $4,800,000 of outstanding obligations < $5 million threshold) nor Partner B (40% of $8,000,000 = $3,200,000 of outstanding obligations < $5 million threshold) will be subject to the Interest Charge.

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[368] IRS Notice 88-81, 1988-2 C.B. 397.

c. When calculating the $5 million threshold among the partners, section 704(c) property must be accounted for. The Treasury Regulations provide, "If a partnership disposes of section 704(c) property in an installment sale as defined in section 453(b), the installment obligation received by the partnership is treated as the section 704(c) property with the same amount of built-in gain as the section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale)."[369]

> Example: A and B create AB partnership. Partner A contributes property with an adjusted basis of $2,000,000 and a fair market value of $8,000,000 to AB partnership in exchange for a 50% partnership interest. Partner B contributes $8,000,000 of cash to AB partnership in exchange for a 50% partnership interest. The contributed property appreciates to $10,000,000. AB partnership sells the property in exchange for a $10,000,000 Taxable Installment Note, payable in equal installments of $2,000,000 over 5 years.
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> When calculating the Interest Charge when dealing with section 704(c) property sold in an installment sale, there are two possible methods of calculation, although there does not appear to be any guidance on which is correct. They are described below as options 1 and 2 below.
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> Option 1: Under the section 704(c) allocation method chosen by the AB Partnership, if the property had been sold for its fair market value, $7,000,000 of gain would be allocated to Partner A consisting of $6,000,000 of pre-contribution gain under section 704(c) and $1,000,000 of post-contribution gain under section 704(b). $1,000,000 of post-contribution gain will be allocated to Partner B. As such, A's share of the gain represents 87.5% ($7,000,000 ÷ $8,000,0000) of the total gain, and B's share is 12.5% ($1,000,000 ÷ $8,000,0000). As a result, A's share of the total face amount of the Taxable Installment Obligation is $8,750,000 (87.5% of $10,000,000 = $8,750,000). B's share of the face amount of the obligation is $1,250,000.
>
> In the year of the sale, $10,000,000 of the obligation is still outstanding at the end of the taxable year. Partner B will not be required by pay the Interest Charge ($1,250,000 of outstanding obligations < $5 million threshold). Partner A will be subject to the Interest Charge Rule ($8,750,000 of outstanding obligations > $5 million threshold), and the Applicable Percentage in the calculation will be 42.86% ($3,750,000 excess above the $5 million threshold ÷ $8,750,000 A's share of the face amount of obligation).
>
> Option 2: The property sold in the installment sale is section 704(c) property. The value at the time of A's contribution was $8,000,000. In addition, an additional $1,000,000 of post-contribution gain would be allocated to A under section 704(b). As a resulting, A's share of the total face amount of the Taxable Installment Obligation is $9,000,000. B's share of the face amount of the obligation is $1,000,000.

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[369] Treas. Reg. § 1.704-3(a)(8)(ii).

In the year of the sale, $10,000,000 of the obligation is still outstanding at the end of the taxable year. Partner B will not be required by pay the Interest Charge ($1,000,000 of outstanding obligations < $5 million threshold). Partner A will be subject to the Interest Charge Rule ($9,000,000 of outstanding obligations > $5 million threshold), and the Applicable Percentage in the calculation will be 44.44% ($4,000,000 excess above the $5 million threshold ÷ $9,000,000 A's share of the face amount of obligation).

As mentioned, there is no definitive guidance on this particular issue. However, it seems that the latter option 2 seems the more accurate calculation method. If prior to contribution, A had sold the property in exchange for an Taxable Installment Obligation and then contributed the obligation to the partnership, the $8,000.000 face about would be allocable to A. That should be the same result if the partnership had sold the property in exchange for an Taxable Installment Obligation immediately after A's contribution of the property.

2. Sales of Partnership Interests and Inside Basis Adjustments

a. Generally

(1) If a partner sells his or her partnership interest in a taxable transaction, the character of the gain recognized by the selling partner is capital, subject to recharacterization under section 751(a) for partnership unrealized receivables and inventory items.[370] Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[371] As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the 3.8% net investment income tax, if applicable to the taxpayer) depending on the nature of the assets in the partnership. The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[372] As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

(2) The transferee takes a cost basis in the acquired partnership interest,[373] but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[374] The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.[375] Absent a section 754 election and a corresponding inside

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[370] § 741.

[371] § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

[372] Treas. Reg. § 1.1223-3.

[373] § 742.

[374] Treas. Reg. § 1.704-1(b)(2)(iv).

[375] Treas. Reg. § 1.704-3(a)(7).

basis adjustment under section 743(b), the outside basis of the partnership interest will have a cost basis, but the adjusted basis of the partnership assets will not be adjusted to reflect the sale.

(3) If the partnership has a section 754 election in place, the inside basis of the partnership's assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.[376]

(4) Essentially, the inside basis adjustment under section 743(b) is the difference between the outside basis that the transferee partner receives against the transferee's share of inside basis. As such, adjustments under section 743(b) result in either:

(a) An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property;"[377] or

(b) A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[378]

(5) A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[379] The partner's previously taxed capital is:[380]

(a) The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets;[381] increased by

(b) The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

(c) The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

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[376] In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2.

[377] § 734(b)(1).

[378] § 734(b)(2).

[379] Treas. Reg. § 1.743-1(d)(1).

[380] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[381] Treas. Reg. § 1.743-1(d)(2).

(6) Inside basis adjustments under section 743(b) do not change or affect capital accounts,[382] and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.[383] The partnership will compute its taxable income, gain, loss, and deduction without regard to the inside basis adjustments under section 743(b), and then allocate these amounts among all the partners under the principles of section 704(b) of the Code. At this point, the inside basis adjustments then come into consideration. The partnership will adjust the transferee partner's distributive share of income, gain, loss, and deduction to reflect the adjustments. For example, if the partnership sells an asset that has a basis adjustment, the amount of the adjustment will reduce or increase the transferee's distributive share of the gain or loss from the sale of the asset.[384] Also, If a positive adjustment is made to depreciable (or amortizable) property, then the adjustment will increase the transferee's share of depreciation (or amortization) from that property. In effect, the transferee is treated as if he or she purchased new property for a price equal to the adjustment.[385]

(7) The Treasury Regulations provide that the inside basis adjustment is divided between two classes of partnership assets: (i) "ordinary income property," and (ii) "capital gain property."[386] For these purposes, "capital gain property" includes capital assets and section 1231(b) property, and all other property (including unrealized receivables and recapture items under section 751(c) of the Code) is considered "ordinary income property."[387] Next the portion of the adjustment allocated to each class of assets is then further divided among the assets in each class. The mechanism for making the allocation in this second step is different depending on whether the inside basis adjustment is under section 734(b) (i.e., distributions of property) or section 743(b) (i.e., partnership interest transfers or death of a partner) of the Code.

(8) As mentioned above, inside basis adjustments under section 743(b) of the Code only apply to the transferee. The Treasury Regulations treat the total amount of these adjustments as a net amount, which means that positive adjustments can be made with respect to some assets (or one class of assets), and negative adjustments can be made with respect to other assets (or class). For purposes of calculating the amount to be allocated to each class and to each asset within a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you can calculate the transferee's allocable share of gain or loss from each asset if immediately after the transfer the partnership made a cash sale of all of the partnership assets for fair market value.[388]

(9) If the purchase price of a partnership interest is equal to the selling partner's share of the partnership assets, then the general result will be that the inside basis

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[382] Treas. Reg. § 1.704-1(b)(2)(iv)(m).

[383] Treas. Reg. § 1.743-1(j)(1). There is a limited exception in the case of certain distributions to a transferee partner. *See* Treas. Reg. § 1.734-2(b)(1).

[384] Treas. Reg. § 1.743-1(j)(3).

[385] Treas. Reg. § 1.743-1(j)(4).

[386] Treas. Reg. § 1.755-1(a).

[387] *Id.*

[388] Treas. Reg. §1.755-1(b)(1)(ii).

adjustments under section 743(b) will exactly offset the buyer's gain or loss inherent in each asset. However, that is not always the case. If the buyer pays a premium over asset value, then under the residual method utilized under section 1060 of the Code, the excess will be allocated to goodwill or other section 197 intangibles. If the buyer purchases at a discount below fair market value (or more likely in the estate planning context, the partnership interest is valued at a discount), the Treasury Regulations first allocate the adjustment to ordinary income property to the extent possible, and then provide a mechanism to allocate the shortfall based upon two factors: (i) unrealized appreciation in each asset, and (ii) each asset's relative fair market value.[389]

b. Installment Sales of Partnership Interests

(1) Generally, when a partner sells an appreciated partnership interest in exchange for a Taxable Installment Obligation, the purchasing partner immediately takes a cost basis in the partnership interest. If the partnership makes a section 754 election or has one in place, section 743(b) will generally increase inside basis of the purchasing partner's share of each of the partnership assets. If the purchasing partner acquires a large percentage of the partnership (i.e., 99%), then a large percentage of the assets will essentially get a "step-up" in basis. At that point, the partnership could choose to sell all of its assets for very little gain, at a time when the seller of the partnership interest has recognized very little or none of the gain under the Taxable Installment Note.

> Example: Partner A has a 99% interest in a partnership that owns a highly-appreciated property with a fair market value of $50,000,000. Partner A sells the 99% partnership interest to buyer in exchange for a 20 year $49,500,000 Taxable Installment Note with adequately stated interest. The partnership has a section 754 election in place. As a result of the inside basis adjustment under section 743(b), the partnership property has its basis adjusted upward to $49,500,000. Later in the year, the partnership sells the property, recognizing $500,000, all of which is allocated to the 1% partner. The original selling partner has not recognized any of the gain from the sale of the partnership interest.

(2) As the foregoing example illustrates, this can be a powerful income tax planning technique, but a number of variables need to be considered to determine whether it can be accomplished. Those variables include: (i) the identity of the buyer of the partnership interest (i.e., related party or third party); (ii) the nature of the partnership property (i.e., eligible for installment sale treatment or not); (iii) the time difference between the partnership interest purchase and the partnership property sale (i.e., less than 2 years); (iv) the identity of the buyer of the partnership property (i.e., related party or third party); and (v) who has control over the decision to sell the partnership property.

(3) The Treasury Regulations do not provide that a sale of a partnership interest will be treated as a sale of the selling partner's share of each asset of the partnership. However, the IRS has ruled that income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's "substantially appreciated" inventory, which would not be eligible for installment

[389] *See* Treas. Reg. § 1.755-1(b)(3)(ii).

treatment if sold directly.[390] For this purpose, "substantially appreciated" exists if the fair market value of the inventory exceeds 120 percent of the adjusted basis to the partnership of the inventory.[391] Notably, the IRS stated that the holding in the ruling should not be construed as an interpretation of section 453A(e) of the Code, which authorizes the Treasury Department to promulgate regulations "providing that the sale of an interest in a partnership or other pass-thru entity will be treated as a sale of the proportionate share of the assets of the partnership or other entity."[392]

(4) The IRS has ruled that a taxpayer who sold a partnership interest could not use the installment method to the extent that the purchase price was attributable to unrealized receivables for the payment of services rendered under section 751(c)(2) of the Code.[393] The courts have agreed with this position, particularly if the unrealized receivables are compensation for services.[394] It should be noted that under the partnership rules, there is another category of unrealized receivables. Pursuant to section 751(c)(1), "unrealized receivables" includes payment for "goods delivered, or to be delivered, to the extent that the proceeds would be treated as amounts received from the sale or exchange of property other than the sale of a capital asset."[395] Theoretically, this latter category of receivables would be eligible for installment sale treatment, even though the income therefrom would be ordinary income.

(5) There are other assets that, if sold directly to a buyer, would not qualify for installment sale treatment, for example, marketable securities. To that end, the Code gives the IRS authority to issue regulations disallowing the use of the installment method for transactions where the restrictions barring use of the installment method for sales of publicly traded property would be avoided by use of related parties, pass-through entities, or intermediaries.[396] To date, these Treasury Regulations have not been promulgated. According to the legislative history, these Treasury Regulations would apply to sales of property where a substantial portion of the property's value is attributable to gain from publicly traded property.[397] In the absence of Treasury Regulations providing otherwise, it seems that installment sale treatment may be available for partnerships that have both eligible and ineligible property types, depending on the amount of each.

(6) Other types of property that are ineligible for installment sale treatment include depreciable property sold to a related buyer, depreciable property that has recapture under section 1245 or 1250 that would be recaptured as ordinary income, inventory, and most dealer sales.

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[390] Rev. Rul. 89-108, 1989-2 C.B. 100.

[391] *See* 751(b)(3)(A).

[392] § 453A(e).

[393] CCA 200722027.

[394] *Mingo v. Commissioner*, 773 F.3d 629 (5th Cir. 2014), *aff'g* T.C. Memo 2013-149. *See also Sorensen v. Commissioner*, 22 T.C. 321 (1954), and *Hyatt v. Commissioner*, T.C. Memo 1961-318, aff'd, 325 F.2d 715 (5th Cir. 1963).

[395] § 751(c)(1).

[396] § 453(k), flush language.

[397] S. Rep. No. 99-313, at 131 (1986).

(7) Consider the following example, which is unlikely to work and accomplish what the taxpayers hope:

Example: AB Partnership owns a marketable security with an adjusted basis of zero and a fair market value of $10,000,000. Partner A and Partner B are spouses, and each owns 50% of the AB Partnership. Both Partner A and Partner B sell a 49% interest (98% in total) in the AB Partnership for an aggregate total of $9,800,000 to a non-grantor trust for the benefit of A and B's descendants in exchange for two Taxable Installment Notes that provides for interest only payments for 10 years and then 10 equal annual principal payments of $980,000. AB Partnership has a section 754 election in place, so under section 743(b) the adjusted basis of the marketable security is increased to $9,800,000. AB Partnership sells the marketable security soon thereafter.

This case is a transaction pursuant to which the taxpayers hoped the result would be: (i) an outside basis of $9,800,000 for the non-grantor trust's 98% partnership interest, (ii) an inside basis adjustment to the marketable security that increases the basis from zero to $9,800,000, (iii) a small amount of gain when the security is sold, (iv) no Interest Charge payable by A and B, (v) no claim that a related party had made a disqualifying resale of the purchased property, and (vi) deferral of the capital gain tax.

In this case, it is unlikely that the sale of the partnership interest will qualify as an installment sale. This structure clearly falls within the legislative history of section 453(k)[398] because a "substantial portion of the property's value is attributable to gain from publicly traded property."[399] Despite the lack of Treasury Regulations, the likely result is Partner A and Partner B will immediately recognize $9,800,000 of gain on the sale of their partnership interests. The basis of the marketable security will be adjusted under section 743(b) to $9,800,000, and the non-grantor trust buyer will own a 98% partnership interest with an outside basis of $9,800,000.

(8) Now consider the following example, which likely does work:

Example: AB Partnership owns a marketable security with an adjusted basis of zero and a fair market value of $10,000,000. AB Partnership also owns $30,000,000 of other asset that are eligible for installment sale treatment. Both Partner A and Partner B sell a 49% interest (98% in total) in the AB Partnership for a total of $39,200,000 to a non-grantor trust for the benefit of A and B's descendants in exchange for two Taxable Installment Note that provides for interest only payments for 10 years and then 10 equal annual principal payments of $3,920,000. AB Partnership has a section 754 election in place, so under section 743(b) the adjusted basis of the marketable security is increased to $9,800,000 (the

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[398] Giving the IRS authority to issue regulations disallowing the use of the installment method for transactions where the restrictions barring the use of the installment method for sales of publicly traded property could be avoided through related parties, pass-through entities, or intermediaries.

[399] S. Rep. No. 99-313, at 131 (1986).

adjusted basis of the other asset are also increased accordingly). AB Partnership intends to sell the marketable security as soon as possible.

Assuming that $9,800,000 of the unrealized gain attributable to the security would not be considered a "substantial portion" of the partnership interest's value ($39,200,000), then installment sale treatment is available to A and B. As such, the non-grantor trust buyer will, in aggregate, have a 98% partnership interest with an outside basis of $39,200,000. The basis of the marketable security will be adjusted under section 743(b) to $9,800,000.

If AB Partnership sells the security, it will recognize $200,000 of gain, which will be allocated to A and B. That incremental gain would seem a small price to pay to get immediate diversification of a zero basis, concentrated stock position, along with deferral of the gain that otherwise would have been recognized immediately.

The IRS could claim that there was a non-qualifying resale of the purchased property by a related party within 2 years, but in form, the property purchased was the partnership interest. If there is concern about this issue, then taxpayers should wait 2 years before selling the security. Alternatively, sell the partnership interest to a third party. Why would a third party agree to do that? What if the third party could purchase the partnership interest for $38,950,000 ($25,000 less) with assurances that the partnership assets would be sold and liquidated in a short period of time? One factor that might be significant is the extent to which A, B, or the non-grantor trusts had control over the decision to sell the marketable security. For example, what if the security is purchased due to the exercise of a call option held by a third party?

(9) As illustrated by the examples above, a sale of a partnership interest pursuant to an installment sale, along with a section 743(b) adjustment can be quite powerful as an income tax planning device, even with property that would not otherwise be eligible for installment sale treatment. However, it is highly dependent on the facts and the circumstances. Consider the following variation of the example above. In the example, there were $30,000,000 of other assets in the AB Partnership. What if those assets also had an adjusted basis equal to $30,000,000, and that basis is also reflected in the outside basis of Partner A and Partner B. In such a case, the deferred gain on the sale of a 98% interest in AB Partnership would be $9,800,000, all attributable to the marketable security owned by the partnership.

3. Contributions and Distributions of Installment Obligations

a. Contributions of Taxable Installment Obligations

(1) As discussed earlier, there is no gain or loss under section 453B of the Code on a contribution of a Taxable Installment Note under section 721 of the Code (tax free contribution in exchange for a partnership interest.[400] The partnership continues to report the same amount and character of gain under the installment method, as payments are received.[401]

[400] Treas. Reg. § 1.453-9(c)(2) and Prop. Reg. 1.453-1(c)(1)(i)(B).

[401] See Treas. Reg. § 1.453-9(c)(3).

(2) The deferred gain or any accrued interest is allocated to the contributing partner under section 704(c) when the partnership recognizes them. Under such circumstances, the contributing partner will be allocated the gain on under the Taxable Installment Note, but the interest will be allocated to all of the partners under section 704(b).

b. Distributions of Taxable Installment Obligations

(1) As discussed earlier, there is no gain or loss under section 453B of the Code on a distribution from a partnership to a partner under section 731 of the Code (general rule that distributions of partnership property in-kind are tax free), except as provided by sections 704(c)(1)(B), 736, 737, and 751(b) of the Code (i.e., disguised sale and mixing bowl rules that are exceptions to general tax free distribution rule).[402]

(2) If the distribution of a Taxable Installment Obligation is not a recognition event under sections 704(c)(1)(B), 736, 737, and 751(b) of the Code, there may be opportunities to shift the deferred gain to other partners (without triggering a taxable disposition). For Taxable Installment Notes contributed by one partner, it would require waiting 7 years to subsequently distribute to another partner to avoid a "mixing bowl" transaction under sections 704(c)(1)(B) and 737.

4. Basis Shifting with Partnership Installment Obligations

a. Basis Shifting Generally

(1) In simplistic terms, partnership basis shifting requires the following elements:

(a) A partnership that owns a low basis asset (or group of assets) and a high basis asset (or group of assets);

(b) The low and high basis asset must have either been purchased by the partnership or if they were contributed, they were contributed more than 7 years ago; and

(c) A partner (or group of partners) who has little or no outside basis in its partnership interest.

Assuming all of these elements are present, basis stripping and shifting occurs when the partnership makes a distribution of the high basis asset to the low outside basis partner when the partnership has a section 754 election in place.

> Example: ABC Partnership owns two assets and has a section 754 election in place. Asset A has an inside basis of $0x and a fair market value of $100x. Asset B has an inside basis of $100x and a fair market value of $100x. ABC Partnership has three partners, A, B, and C. The outside basis of C's partnership interest is $0x and a capital account of $100x. ABC Partnership distributes Asset B (the high basis asset) to C in liquidation of C's partnership interest.

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[402] Prop. Treas. Reg. § 1.453B-1(c)(1)(i)(C).

> Upon the distribution, Asset B will have its basis reduced to the outside basis of C's partnership interest, which is $0x.[403] This is sometimes referred to as the "basis strip." C owns Asset B outside of the partnership with an outside basis of $0x and a fair market value of $100x. It should be noted that if this was a non-liquidating "current" distribution (e.g., C's capital account was $150x), you would have the same result and C would still be a partner.[404]
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> Because ABC Partnership has a section 754 election in place, under section 734(b), the adjusted basis of partnership property (the only asset in the ABC Partnership is Asset A) is increased by the amount of basis what was stripped from Asset B upon the distribution to C. As a result, Asset A (as the only asset remaining in the partnership) will have its inside basis increased to $100x.[405] This is sometimes referred to as the "basis shift." The end result is the tax basis that was on Asset B has been "shifted" to Asset A.

(2) Although the elements of a basis strip and shift are straightforward, the path to creating an efficient structure to accomplish the shift is quite complex. If the assets used in this technique were contributed to the partnership, the 7-year holding period to avoid triggering gain under the mixing bowl rules is often the most difficult factual hurdle for many clients. It is just simply too long for many clients. In addition, in order to have an efficient basis shift (i.e., tax basis is added to a specific asset in an amount equal to or close to the fair market value of that asset), then the asset (or group of assets) receiving the basis must be the only asset left in the partnership. Otherwise, the basis increase created from the strip will be allocated across a number of partnership assets, none of which will likely get a full basis increase to fair market value. Furthermore, as noted above, both assets in the basis strip and shift must be of the same class (i.e., both capital assets or both ordinary income assets). Practitioners should also remember that if the partnership has "hot" (ordinary income) assets, a disproportionate distribution of a capital asset (or vice versa) may trigger gain under section 751. Thus, it is recommended that partnerships only hold one class of property (i.e., only capital assets). This is why partnership divisions are a critical step in basis shifting, in particular, vertical slice divisions. A vertical slice division is a tax free method of segregating classes of assets and, more importantly, isolating the low and high basis assets that will be the subject of the basis strip and shift into its own partnership. Lastly, the partner (or partners) receiving the distributed asset must have a low outside basis. As one can see, creating an efficient basis shift environment is much more difficult to create, than the actual mechanics of it. However, it is possible.

(3) Section 734(b) adjustments, which can occur when there is a distribution of property, are very different than section 743(b) adjustments (discussed above in the context of sales of partnership interests). Generally, a distribution triggers a *possible* (depending upon whether the partnership has a section 754 election in effect) section 734(b) adjustment whenever the distributee recognizes gain or loss, or takes a basis in the distributed property different from that which the partnership had in the property. Unlike adjustments under section 743(b), adjustments under section 734(b) are made to the common inside basis of the partnership

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[403] § 732(b).

[404] § 732(a)(1).

[405] §§ 734(b) and 755.

assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to "partnership property."[406] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[407] As mentioned above, adjustments under section 743(b) are not reflected in the capital accounts of the transferee partner or on the books of the partnerships.[408] On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.[409]

(4) When evaluating inside basis adjustments under section 734(b) of the Code, one must make a distinction between current and liquidating distributions.

(a) With a current distribution, only gain (not loss) can be recognized to a distributee partner. As such, an adjustment under section 734(b) is triggered when a distributee partner recognizes a gain on distribution of money in excess of outside basis. The amount of gain results in a corresponding increase in the inside basis of partnership property.[410]

(b) With a current distribution, when partnership property (other than money) is distributed, the basis of the property in the hands of the partner is the *lesser* of the inside basis of the property or the distributee partner's outside basis (after reducing outside basis by any money distributed).[411] When the distributee partner's outside basis is less than the inside basis of the distributed property, then the basis of the property is reduced. The amount of "lost" basis results in a corresponding increase in the remaining inside basis of partnership property.[412]

(c) Unlike current distributions, a distributee partner can recognize a loss on a liquidating distribution. Thus, on a liquidating distribution, the inside basis adjustment can increase the basis of partnership (for a gain) or decrease the basis of partnership property (for a loss).[413]

(d) Further, unlike a current distribution, when partnership property (other than money) is distributed in a liquidating distribution, the basis of the property can be increased if the liquidated partner's outside (after reducing outside basis by any money distributed) is greater than the inside basis of the asset distributed.[414] The inside basis of the

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[406] § 734(b)(1) and (2).

[407] § 743(b) (flush language).

[408] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*2*).

[409] Treas. Reg. § 1.704-1(b)(2)(iv)(*m*)(*4*) and (*5*).

[410] § 734(b)(1)(A).

[411] § 732(a)(1) and (2).

[412] § 734(b)(1)(B)

[413] § 734(b)(1)(A) and (2)(A).

[414] § 732(b) and Treas. Reg. § 1.732-1(b).

property has its basis replaced by the outside basis of the liquidated partnership interest.[415] If liquidated property has its basis increased, then the inside basis adjustment would correspond to a reduction of inside basis of remaining partnership property under section 734(b)(2)(B) of the Code.

(e) For liquidating distributions, unlike current distributions, there is a mandatory inside basis adjustment when there is a substantial basis reduction with respect to a distribution of partnership property.[416] This would occur if the partner recognized a loss of more than $250,000 upon liquidation, or the basis of liquidated property is increased by more than $250,000. Either of these events would require the partnership to reduce the basis of its remaining assets under section 734(b) of the Code by the total amount of the loss or basis increase even if a section 754 election was not in place.

(5) As mentioned above, the inside basis adjustment is divided between two classes of partnership assets: (i) "ordinary income property," and (ii) "capital gain property."[417] In contrast with the hypothetical sale approach used for section 743(b) adjustments, the Treasury Regulations under section 755 allocate the section 734(b) adjustments on the transaction that triggers the adjustment (e.g., gain or loss upon a distribution of cash or change in the basis of an asset upon distribution to a partner). If the adjustment is caused by the recognition of gain or loss to the distributee, the section 734(b) adjustment can only be applied to capital gain property.[418] If, on the other hand, the adjustment is caused by a change in the basis of any asset within a particular class (ordinary income property or capital gain property), then the adjustment must be assigned only to assets in the same class.[419] If the partnership has no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.[420]

(6) Once the adjustment is assigned to the appropriate class, positive adjustments (increases to the basis of partnership property) are first allocated to assets with unrealized appreciation in proportion to their relative appreciation. Once all of the unrealized appreciation has been eliminated, then the remaining amount is divided among the properties of the class in proportion to their relative fair market values.[421] Negative basis adjustments are allocated first to assets within the relevant class which have unrealized depreciation in proportion to their relative unrealized depreciation. Once all of the unrealized depreciation has been eliminated, then the adjustment is allocated among all assets in the class in proportion to their adjusted basis (not fair market value).[422] The inside basis of property cannot be reduced below zero.[423]

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[415] Certain limitations apply to section 751 assets. *See* § 732(c)(1)(A) and § Treas. Reg. 1.732(c)(1)(i).

[416] § 734(a), (b), and (d).

[417] Treas. Reg. § 1.755-1(a).

[418] Treas. Reg. § 1.755-1(c)(1)(ii).

[419] Treas. Reg. § 1.755-1(c)(1)(i).

[420] Treas. Reg. § 1.755-1(c)(4).

[421] Treas. Reg. § 1.755-1(c)(2)(i).

[422] Treas. Reg. § 1.755-1(c)(2)(ii).

[423] Treas. Reg. § 1.755-1(c)(3).

b. Shifting Basis to a Taxable Installment Obligation

(1) As discussed in these materials, the Code provides, "“The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.”[424] In addition, Taxable Installment Obligations are considered IRD, so a basis adjustment under section 1014 of the Code will not eliminate the deferred gain in the obligation.

(2) As discussed above, partnerships can sell property under the installment method, partner contributions of Taxable Installment Obligations to a partnership under section 721 of the Code are non-taxable, and distributions of partnership Taxable Installment Obligations to a partner or non-taxable (except as provided by sections 704(c)(1)(B), 736, 737, and 751(b) of the Code).

(3) The question at hand, then, is whether a partnership can shift basis to a Taxable Installment Obligation, thereby reducing or eliminating the deferred gain by increasing the basis of the obligation under section 734(b). The Code and the Treasury Regulations provide that It’s clear that a basis adjustment under section 743(b) that arises due to the death of a partner may not be applied to a Taxable Installment Obligation.[425] The Treasury Regulations provide:[426]

> Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) or section 1022(f), the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See Section 1.742-1. Accordingly, if a partnership interest is transferred as a result of

[424] § 453B(b).

[425] This make sense since the basis of a partnership interest acquired from a decedent is the fair market value at death but reduced by items of IRD. *See* Treas. Reg. § 1.742-1. You can’t have an inside basis adjustment without a basis adjustment to the outside basis. Section 691(e) provides, “For application of this section to income in respect of a deceased partner, see §753.” This language implies that section 753 is the exclusive rule for IRD with respect to a deceased partner. In turn, section 753 provides, “The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.” Because section 753 narrowly applies only to amounts includible under section 736(a) (payments for unrealized receivables and goodwill made to a retiring partner or a deceased partner’s successor in interest), some have argued that a deceased partner will have no IRD except for section 736(a) amounts. This assertion has been rejected by at least two court cases and goes against the Treasury Regulations that have been promulgated since the enactment of section 753 in 1954. *See George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd* 444 F.2d 90 (8th Cir. 1971) *acq.* 1970-2 C.B. [page unknown], and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972), *aff’g* T.C. Memo 1969-279.

[426] Treas. Reg. § 1.755-1(b)(4). *See also* §§ 1014(c), 691(a)(1), Treas. Reg. §§ 1.691(a)(1)-1(b), 1.755-1(a)(4)(i)(C), and 1.755-1(b)(4). S corporations do not have corresponding “inside” basis adjustments but, as with partnerships, when a decedent dies with an ownership interest in an S corporation that owns IRD assets, the shares do not get a basis adjustment under section 1014 for that portion of the corporation’s assets attributable to IRD assets. *See* § 1367(b)(4)(A) and (B).

> the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets. See Section 1.743-1(b).

However, there seems to be no corresponding limitations to the basis adjustment under section 734(b). There are no limitations for sales of partnership interests, but as discussed above, a sale, exchange, or gift of an interest in a partnership is a taxable disposition under section 453B of the Code.[427]

(4) Given the types of property that are not eligible for installment sale treatment (i.e., inventory, section 1245 recapture property, etc.) and the division of the inside basis adjustment between "ordinary income property" and "capital gain property," it's highly likely that the Taxable Installment Obligation and the asset to be distributed in the basis "strip" and "shift" will have to be capital gain tax property. In other words, the Taxable Installment Obligation will need to result from the sale of capital gain, section 1231 property, or collectible.

> Example: ABC Partnership owns two assets: (i) capital gain property with an adjusted basis of $1,000,000 and a fair market value of $1,000,000, and (ii) a Taxable Installment Obligation with an adjusted basis of zero and a face value of $1,000,000. The Taxable Installment Obligation arose from the sale of capital gain property by the partnership. The partnership property was not section 704(c) property and had been acquired by the partnership. Partner C has a 1% interest in ABC Partnership, but for purposes of this example, Partner C's interest is ignored. Partner A and B equally own the remaining interests in ABC Partnership (i.e., 50% each), so Partners A and B each have an outside basis in their respective interest of $500,000 and a capital account of $1,000,000. ABC Partnership has a section 754 election in place.
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> In liquidation of Partner B's interest, ABC Partnership distributes the capital gain property to Partner B. As a result, under § 732(b), B receives capital gain property with an adjusted basis of $500,000 (reduced from $1,000,000). Under section 734(b) of the Code, the adjusted basis of the remaining asset in the partnership, the Taxable Installment Obligation, is increased from zero to $500,000. The result of the transaction is B holds a capital gain tax asset with an adjusted basis of $500,000 and fair market value of $1,000,0000, and ABC Partnership owns a Taxable Installment Obligation with an adjusted basis of $500,000 and face value of $1,000,0000.

(5) As the foregoing example illustrates, it seems that an inside basis adjustment to increase the adjusted basis of a Taxable Installment Obligation is possible. The benefit in this example is if Partner B had died with a 50% interest in ABC Partnership, then Partner B's interest would not be entitled to an adjustment to basis attributable to his or her share of the Taxable Installment Obligation (considered IRD). However, with the liquidating distribution, upon B's death, B's estate would benefit from a step-up in basis to $1,000,000 due to the inclusion of the distributed capital gain property, with no inclusion of IRD.

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[427] Rev. Rul. 60-352, 1960-2 C.B. 208.

VII. CONCLUSION

A. Economically, Taxable Installment Obligations, IDGT Installment Notes, and Intra-Family Promissory notes are quite similar. All involve a legal obligation by one party (the borrower or purchaser) to pay an amount to another party (the lender or seller), and such amount can be satisfied with cash or property. In estate planning, many planning techniques involve a transaction between a grantor and his or her IDGT, and income tax issues are irrelevant. However, as noted, grantor trust status is not permanent, and all grantors or other deemed owners of trusts die. That's when income tax considerations become important.

B. Taxable Installment Obligations are one of the oldest and most important income tax planning tools.[428] Unlike IDGT Installment Notes, Taxable Installment Obligations come with a myriad of complicated rules and restrictions, but with that complexity comes substantial income tax savings. Because IDGT Installment Notes can become Taxable Installment Notes, estate planners need to familiarize themselves with the rules surrounding Taxable Installment Obligations. Finally, as discussed herein, taxpayers can use partnerships and non-grantor trusts in surprising ways to maximize the income and transfer tax savings that can be reaped from taxable installment sales.

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[428] The installment method first appeared in the Revenue Act of 1926, P.L. 20-69th, 44 Stat. 9 (1926).