Trust Basis and Promissory Notes:
In Life and At Death for Grantor Trusts

The Presenter

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The materials are based on a presentation I prepared with Stephanie Vara for the ABA Tax Section meeting on February 11, 2023 and for the 49th Annual Notre Dame Tax & Estate Planning Institute on September 20, 2023. I would like to thank Stephen Breitstone and Jerry Hesch for their comments and suggestions.

Overview of Presentation

- **Part 1**: Background Tax Rules of Relevance
- **Part 2**: What Basis Regime Applies to IDGT Assets When Grantor Dies?
- **Part 3**: What Happens at Shut-off if IDGT Owes Note to Grantor?
- **Part 4**: What Happens at Death if Grantor Owes Note to IDGT?
- **Part 5**: Less Common Variations on IDGT Promissory Notes

Part 1

Background Tax Rules of Relevance

Relevant Federal Transfer Tax Rules

- Gift tax
- Estate tax
- Generation-skipping transfer (GST) tax

Note: Presentation focused on purely domestic fact patterns

Income Taxation of Trusts

- Trusts generally taxed the same as individuals with some important distinctions (*e.g.*, more compressed tax brackets)
- Three regimes for understanding income taxation of trusts—trusts can be taxed partly under each regime, and can toggle between them:
  - Nongrantor trusts: Trust treated as separate taxpayer for income tax purposes (but distributions shift income)
  - Grantor trusts: Disregarded from grantor for income tax purposes
  - Beneficiary-deemed-owned trust (BDOT): Disregarded from beneficiary for income tax purposes
    - Often common to refer to BDOTs as types of grantor trusts—kept distinct in this presentation

Grantor Trust and BDOT Rules

- IRC §§673-679 state certain facts which, if met, cause certain persons to "be treated as the owner of [a] portion of a trust" for income tax purposes

- Rules no longer apply once deemed owner dies, or power causing grantor trust/BDOT status "toggled off"

- What does it mean to be treated as the ***owner*** of a portion of a trust?

  - Passthrough-like treatment: *Rothstein*, 735 F.2d 704 (2d Cir. 1984) (holding this way due to technical language under §671 describing ownership)

  - Disregarded entity (DRE)-like treatment (IRS view, state of the law): Rev. Rul. 85-13 (disagreeing with *Rothstein*'s apparent view Congress meant to impute trust income to grantor but not trust assets)

    - IRS bound by Rev. Rul. which remains in effect

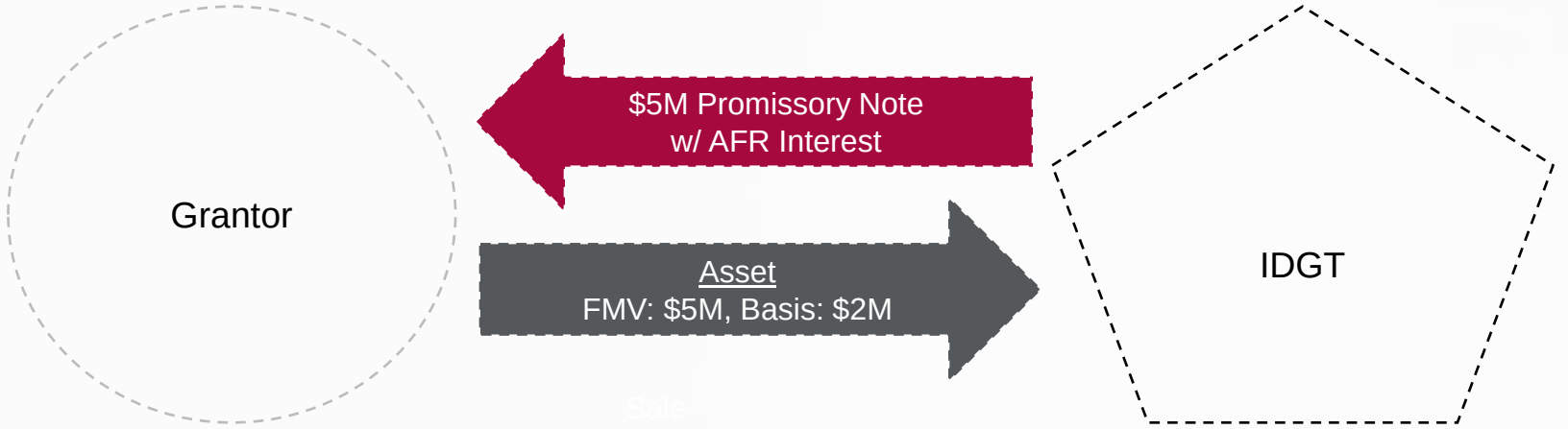
The Intentionally Defective Grantor Trust (IDGT)—Estate Planning In a Nutshell

- Income tax treatment: Grantor trust.

- Federal transfer tax treatment: Grantor trust is a separate taxpayer for the transfer taxes.
  - *Estate tax treatment*: No estate tax inclusion
  - *Gift tax treatment*: Completed gift
  - *GST tax treatment*: GST exemption may be allocated

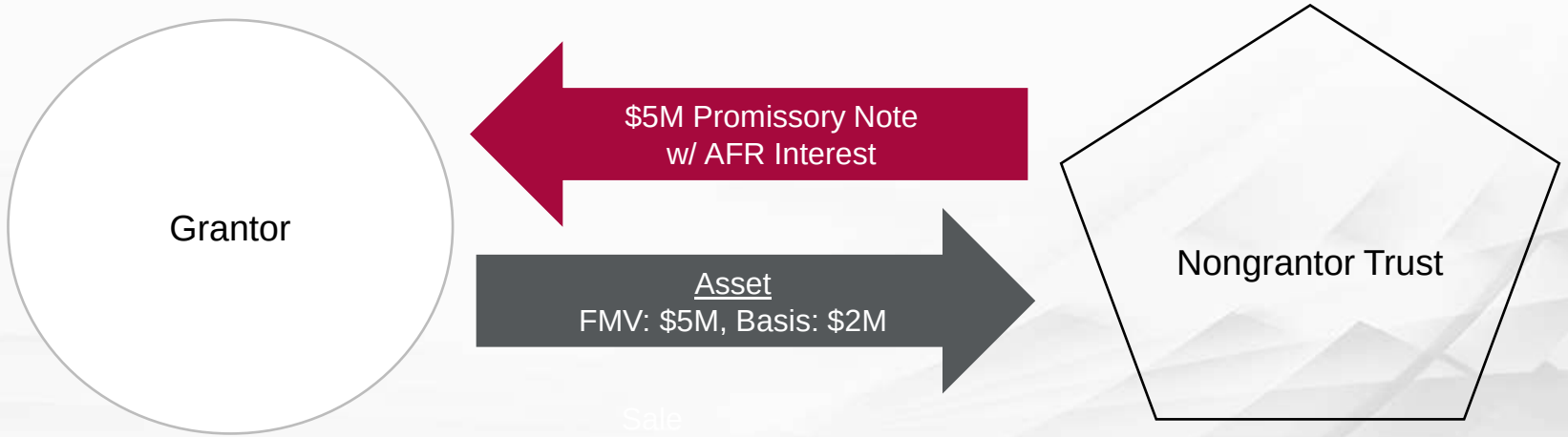
- Significant benefits:
  - *Rev. Rul. 2004-64*: No gift by paying income tax on taxable income created by grantor trust's assets (the "burn"). Cannot make a gift by paying your own obligation.
  - *Rev. Rul. 85-13*: No income tax consequences on transactions between a grantor and their grantor trust. No gain realized on sale to a grantor trust; no income tax reporting of interest income/deduction on a loan between the grantor and the grantor trust.

Differing Income Tax Treatments of Sales to Trusts (for Promissory Note)—Can Occur Via "Toggle Off"



Results in Sale to Grantor Trust:

- No gain, interest income/expense, or basis change
- Grantor owes asset-related income taxes

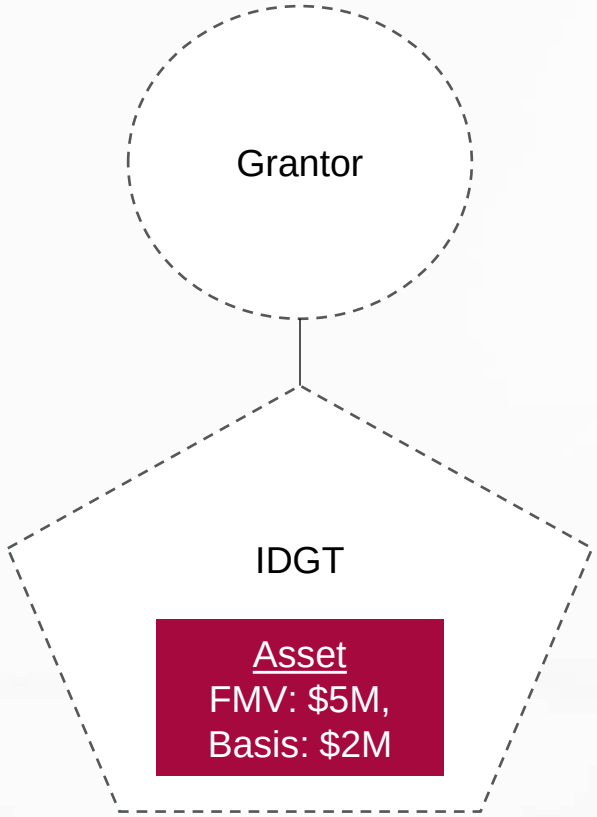


Results in Sale to Nongrantor Trust:

- $3M gain, §453 may apply
- Interest income/expense recognized
- Trust has $5M asset basis, owes income tax on asset-related income

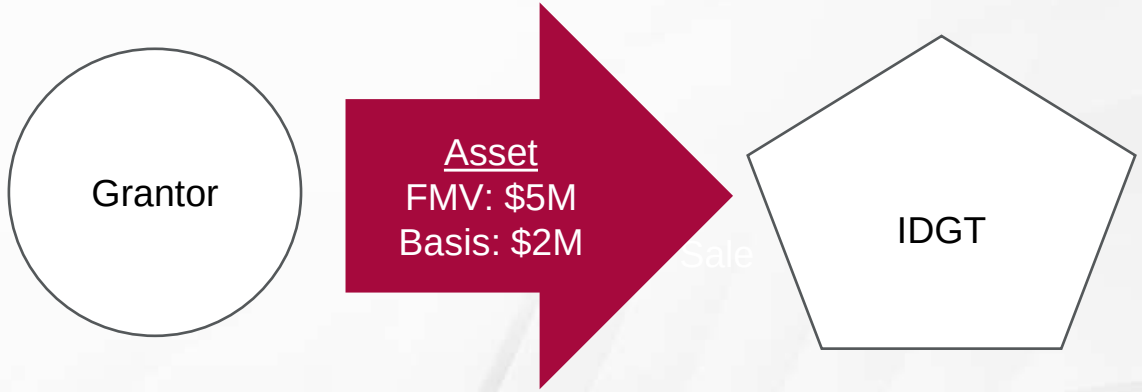
Grantor Trust Toggling and Discussion of Select Tax Effects (No Debt)

Grantor Trust Status "On"



Grantor deemed to own asset for income tax purposes despite IDGT having actual ownership.

Grantor Trust Status "Off"



Ownership of asset deemed to transfer from grantor for income tax purposes.

Part 2

What Basis Regime Applies to IDGT Assets When Grantor Dies?

Assumes no promissory note is outstanding b/w grantor and IDGT at grantor's death

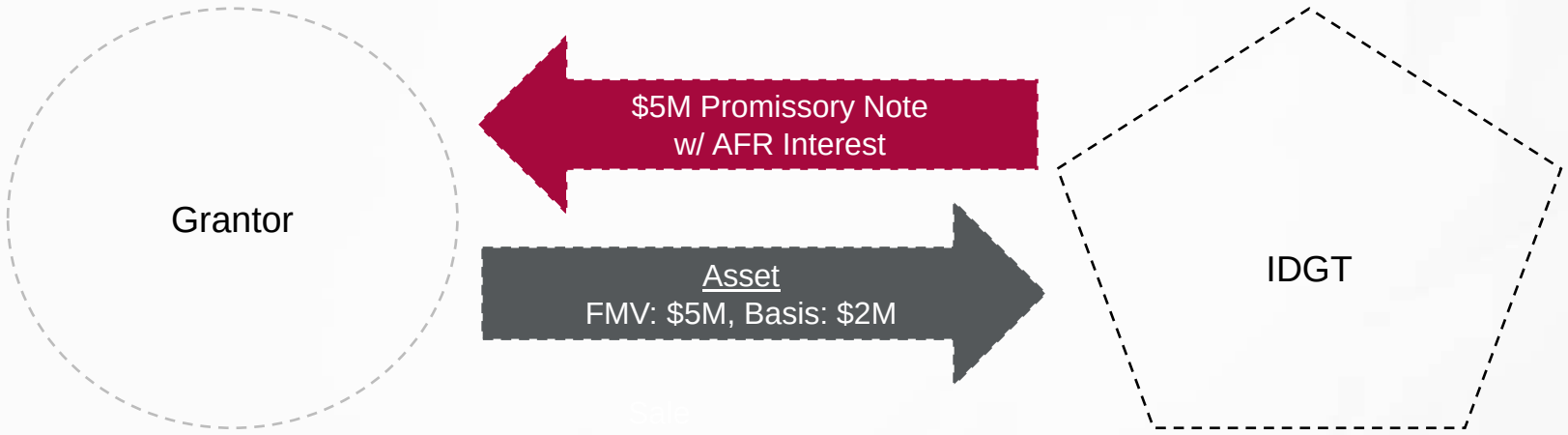
The Applicable Income Tax Basis Regime When One Taxpayer Transfers an Appreciated Asset to Another Taxpayer

The transfer of an asset can occur:

- By a sale to the purchaser for adequate consideration. *§1012.*
- By certain at-death transfers (e.g., bequests) described in §1014(b). *§1014(a).*
- By a gift while the asset owner is living. *§1015(a)*
- In trust without being a gift or bequest. *§1015(b)*

Part-sale transactions specifically contemplated for §1015(a) and (b).

Assumed Facts for Part 2 for Gift to IDGT



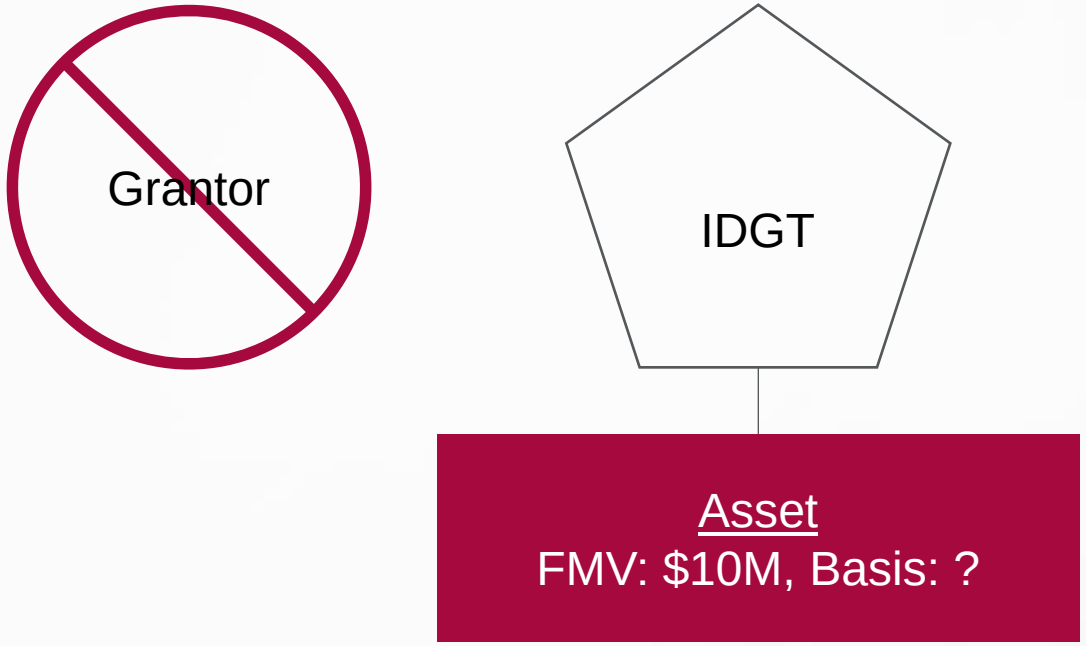
Transfer Tax Consequences

- $5M taxable gift
- Completed gift; trust considered new owner of asset

Income Tax Consequences

- IDGT takes carryover basis of $2M for asset
- Grantor trust for income tax purposes

Assumed Facts for Part 2 for Gift to IDGT



- Asset appreciated, while its basis depreciated to $1M (immediately prior to grantor's death)
- Trust ceases to be grantor trust, it is now a separate taxpayer from the grantor's estate
- Question: What is the basis of the IDGT's asset (1) pre-death and (2) post-death?

What Determines Basis of IDGT's Assets Pre-Death?

- Does §1015(a) apply to the basis of the properties upon receipt by the IDGT (meaning loss limitation rule applies)?
- Better view: IDGT has the *same basis* as the grantor. *See*, *e.g.,* PLR 9535026, Rev. Rul. 72-406
- But an authority indicates the date of gift for §1015(a) purposes occurs when the IDGT is created; does that mean §1015(a) and loss limitation rule applies on funding IDGT?
  - PLR 9109027 (dealing with asset gifted to and distributed by IDGT)
- It is possible to read foregoing authorities harmoniously, where asset has same basis while in IDGT but §1015(a) then applies once IDGT toggles off or distributes asset
  - Why? See later discussion of why §1015(a) probably applies to IDGT assets on grantor's death

Possible Basis Outcomes for IDGT Asset Post-Death

Primary Possibilities

- §1014—if applicable, results in adjustment of basis to FMV ($10M in example); generally, very good outcome
- §1015(b)—if applicable, carryover basis except to the extent any gain or loss is recognized
- §1015(a)—if applicable, carryover basis (subject to loss limitation rule applying at the time of the gift)

IRS View

- In Rev. Rul. 2023-2, IRS directly rejected §1014's application
- However, IRS did not decide between §1015(a) and (b)
- Not all commentators agree Rev. Rul. 2023-2 successfully rejects §1014 theory

Best View: §1015(a), as will be discussed (after discussing others' pro-§1014 and pro-§1015(b) views)

Rev. Rul. 2023-2's Reasoning to Reject §1014 for IDGT Asset Post-Death

- Section 1014(a) can step up basis only if §1014(b) triggered (citing *Collins*)
- On death of grantor of IDGT, only §1014(b) trigger that may apply to IDGT assets is §1014(b)(1) (for "[p]roperty acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent")
- However, case law has held, and Congress apparently intended, that this statement refers to state law meanings of bequest, devise, inheritance and the decedent's estate; accordingly, §1014(b)(1) refers only to probate estate assets
  - *Bacciocco v. United States*, 286 F.2d 551, 554-55 (6th Cir. 1961), H.R. Rep. No 83-1337 at 4407-08 (March 9, 1954), *Collins v. United States*, 318 F. Supp. 382, 386 (C.D. Cal. 1970)
- Many, many other reasons exist to reject §1014 for IDGTs which are not even covered in the Rev. Rul.

Why Some Misled §1014 Proponents Still Persist Despite Rev. Rul. 2023-2

- Proponents note other IRC references to bequest, devise, inheritance (as under §102) are read broadly with a special income tax meaning differing from state law; strange for §1014(b)(1) to not follow this
- PLR 201245006 indicates §1014(b)(1) should apply broadly like §102—but many reasons PLR seems to not merit reliance
- Some argue Rev. Rul. 2023-2 misses the significance of Rev. Rul. 85-13 and the consequence of disregarding IDGT's separate ownership of property
  - Under this view, Rev. Rul. 85-13 changed the law, and now if grantor dies with IDGT in existence, income tax "sees" grantor effectively bequeathing or devising IDGT assets to new nongrantor trust on death
  - Proponents believe that taking Rev. Rul. 85-13's deemed ownership view seriously and consistently means respecting this deemed transfer as a bequest or devise for all income tax purposes, including §1014(b)(1)
- Ultimately, proponents' view is unpersuasive
  - Rev. Rul. 85-13 probably not actually a change in law
  - No logical reason §1014(b)(1) cannot follow state law while Rev. Rul. 85-13 and §102 follow tax law; income tax provisions do use same term different ways
  - Add that to existing precedent cited in Rev. Rul. 2023-2, and hard to see court following §1014 view

Section 1014 Verdict

- Rev. Rul. 2023-2's reasoning is correct
  - If anything, it leaves out arguments against §1014
- Proponents' further arguments in favor of §1014 are unpersuasive
  - Rev. Rul. 85-13 probably not actually a change in law
  - No logical reason §1014(b)(1) cannot follow state law while Rev. Rul. 85-13 and §102 follow tax law; income tax provisions do use same term different ways
  - Add that to existing precedent cited in Rev. Rul. 2023-2, and hard to see court following §1014 view

§1015(b) Theory for IDGT Assets Post-Death

- §1015(b) Theory
  - Until IDGT toggles off, grantor simply has not made any transfer of trust property for income tax purposes
  - Therefore, when grantor dies, we see a transfer that is not subject to §1014 (as discussed), and because this occurred at death there is no gift (so §1015(a) is inapplicable)
  - Since this is a transfer in trust, §1015(b) wins by default
- Textual reading of §1015(b) seems initially plausible, but it is odd §1015(b) has never been used in closely analogous circumstances (closest is trust division, which seems very different from a grantor → trust transfer)
- Moreover, §1015(a) is more persuasive and avoids tax downsides (see §1245, §1250, possibly §1202)

Basic Argument for §1015(a)

- Per Reg. §1.1015-1(c), after gift, <u>all</u> resulting property interests are deemed gifts arising at time of original gift, including resulting transfers to a "successor in interest" like "a [remainder] beneficiary of . . . the corpus of a trust"

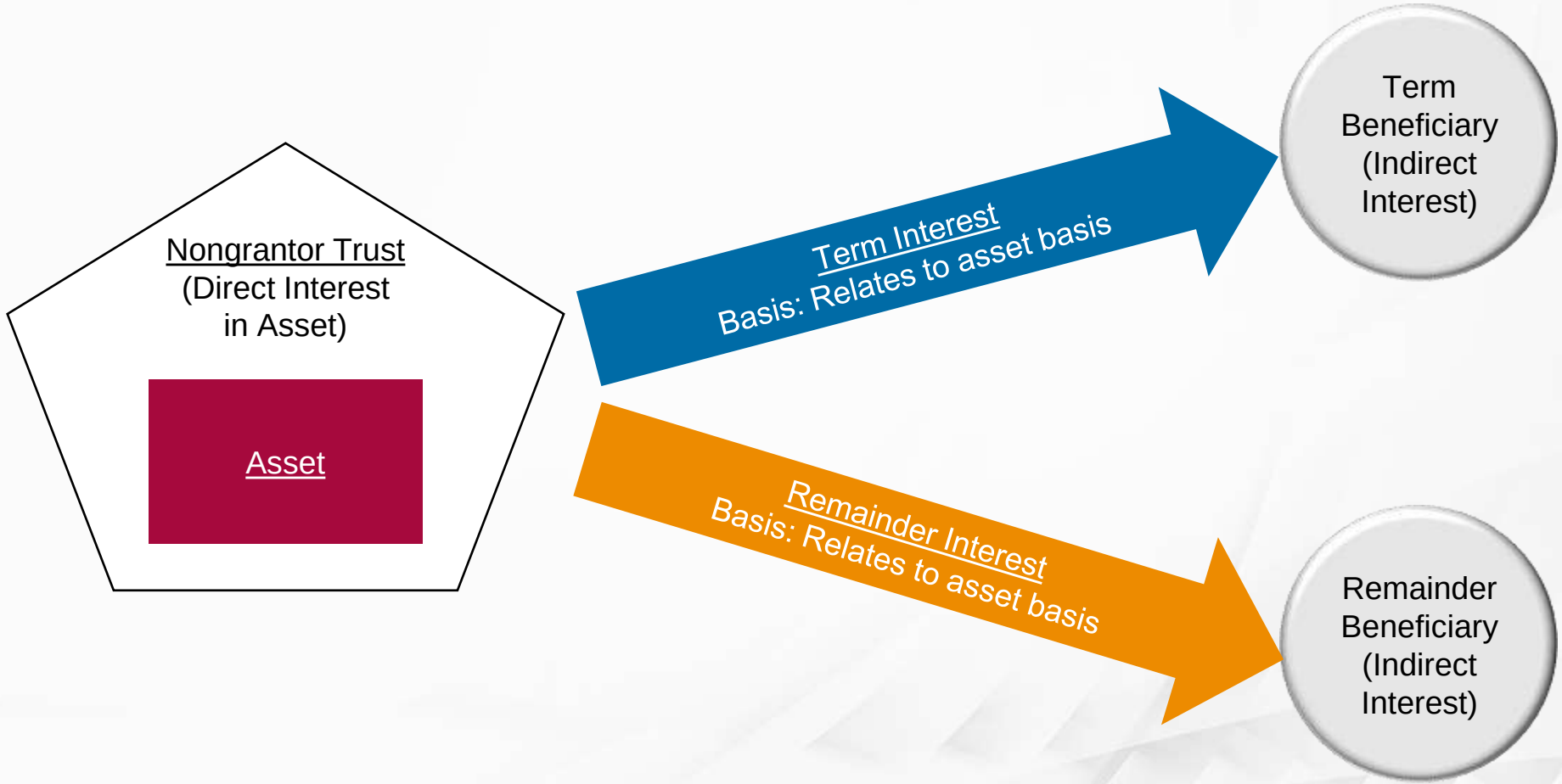
- Thus, if you make gift of asset to trust, and it distributes it to trust remainder beneficiary, that remainder beneficiary is considered to have been gifted the asset at the time *the trust* was gifted the asset, *not the time of the distribution*!

  - Note that it is possible to be a successor-in-interest even before existing; thus, if a child is born and becomes a remainder beneficiary after IDGT formation, they still have a successor interest that arose when IDGT was formed

- For IDGT-held asset, upon being transferred to a nongrantor trust, the nongrantor trust receives the asset as "successor in interest" to grantor

- Therefore, under Reg. §1.1015-1(c)'s plain language, now-nongrantor trust received the asset as a gift arising at time of IDGT funding (*i.e.*, income tax transfer <u>*relates back*</u>)

Reg. §1.1015-1(c) and the Uniform Basis Rules



- When nongrantor trust was gifted asset, under Reg. §1.1015-1(c), beneficiaries also simultaneously were gifted their assets. Moreover, if beneficiaries are distributed interests in the asset, *those* are considered to have been received when asset was gifted to trust!
- Same concept applies for different trusts, and even if trust sells and buys new asset.

But How Does §1015(a) Square with Rev. Rul. 85-13?

- One would have thought a gift should not be able to occur on IDGT funding when Rev. Rul. 85-13 causes grantor to still own the gifted asset for income tax purposes
- But one would be wrong: There is no doubt a gift in fact *did* occur when IDGT was formed—each IDGT beneficiary received a trust interest (although direct interest in property retained by grantor)
  - If you doubt this, try making a non-spendthrift IDGT and having remainder beneficiary transfer their interest—they had to have received this interest somehow without facing income tax
- In fact, case law (not apparently affected by 85-13) long ago established §1015(a) gifts occur when an irrevocable trust is funded, even if the trust is a grantor or an incomplete gift trust
  - *Newman v. Commissioner*, 4 T.C. 226 (1944) (gift occurred for basis rules on funding irrevocable trust, explicitly notwithstanding fact grantor retained discretion over distributions so (1) trust was taxable to/deemed owned by grantor under *Clifford* and (2) gift to trust was incomplete for gift tax); PLR 9109027 (citing *Post v. Commissioner*, 26 T.C. 1055 (1956), acq., 1958-1 C.B. 5)
- Even if nongrantor trust does not exist until time of grantor's death, they can still be a successor-in-interest such that Reg. §1.1015-1(c)'s relation-back rule causes that nongrantor trust to be deemed gifted the asset prior to decedent's death
  - Better view is that grantor trust rules do not mean trusts are disregarded entities; rather, only their ownership is disregarded. That means they always had successor interest. Regs. §1.671-4, Reg. §1.671-5(b)(22); *Textron* and *Kanter*

Part 3

What Happens on Grantor Trust Shut-Off If IDGT Owes Note to Grantor?

First, a Brief Review of General Income Tax Debt Rules!

- Payments of interest
  - Recipient generally taxable on interest income
  - Generally deductible as interest expense for payor (although limitations often swallow this general rule)
- Payments of principal treated as fulfillment of two groups: gain amount and basis recovery amount
  - General rule is each payment of principal comes *pro rata* from these amounts, with special rules changing apportionment (*e.g.*, §453, doubtful collectability)
- Certain rules override or build on the foregoing, aiming to ensure payments relating to time value of money (or failures to collect such payments) are treated like interest
  - *E.g.,* market discount and original issue discount (OID) rules—see next slide
- No income recognized on borrowing money because of offsetting liability; however, recognition *does* occur if liability reduced in exchange for lesser value under cancellation of debt income (CODI) rules

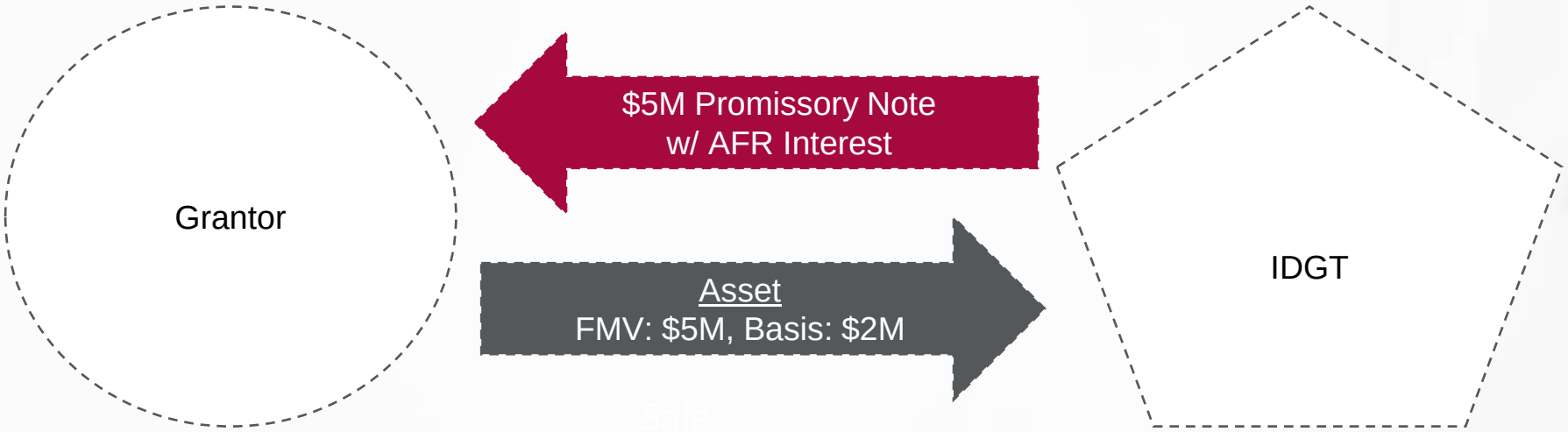
Interest Imputation and Recharacterization Rules

- Market discount
  - *Goal:* If interest rates go up, I can sell my bond (which now has a below-market interest rate) for less than its face value. The person who bought it, however, will eventually be paid the face value—that discount between their purchase price and face value is the equivalent of interest and should be so taxed.
  - *Mechanism:* Converts gain from principal to ordinary income (generally, taxed like interest) to the extent applicable to economically accreted market discount
- Original issue discount (OID)
  - *Goal:* If I pay $100 for a bond at original issuance that will repay me $110 in two years, that $10 is the equivalent of interest and should be so taxed
  - *Mechanism:* To the extent the amount paid for the note (the *issue price*) at issuance plus regular interest (*qualified stated interest (QSI)*) is less than the total payments owed on the note (the *stated redemption price at maturity (SRPM)*), that difference is *OID* and essentially taxed as interest on the accrual method
- Recharacterization of gain or imputation of interest when debt instrument charges below AFR interest
  - §7872 (imputing such interest in the case of gift loans, tax avoidance loans, and certain others); §483 and §1274 (recharacterizing gain as interest)

Gratuitous Issuance of Debt for Income Tax Purposes

- Debt must be binding and enforceable under state law purposes to be respected as debt for income tax purposes (and for interest payable on such debt to receive treatment as interest)—has occurred, *e.g.*, for debt issued under seal (where seal can substitute for consideration)
- Pecuniary gifts/bequests through estates and trusts are likely recognized as debt for income tax purposes (although also as beneficial interests for other purposes), making statutory interest payable on such amounts taxable as interest
- No authority appears to directly discuss many core tax characteristics of gratuitously issued debts, *e.g.*
  - Basis of such debt?
  - Will gain trigger on payment of principal if basis is below face value?
  - Issue price of such debt, as needed to determine OID?

Installment Sale Occurs During Life . . .



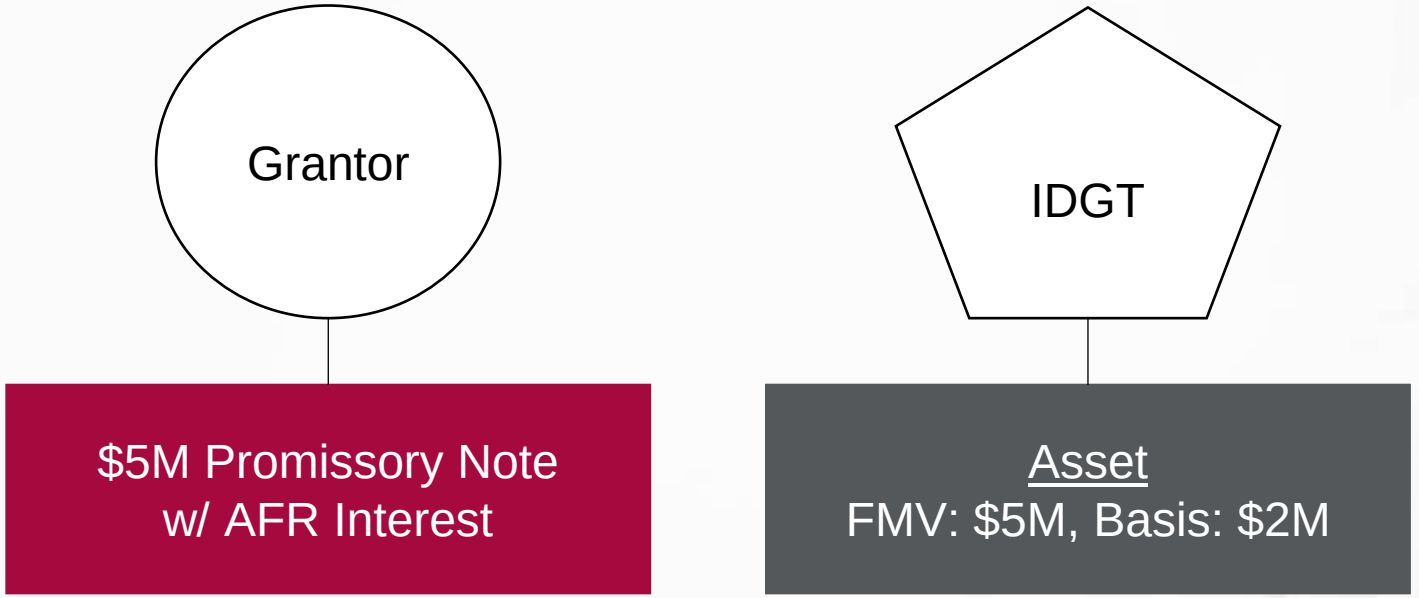
Transfer Tax Consequences:

- No taxable gift

Income Tax Consequences:

- No realized gain
- No interest income or expense
- IDGT takes carryover basis

. . . Then Grantor Trust Status Toggled-Off During Life



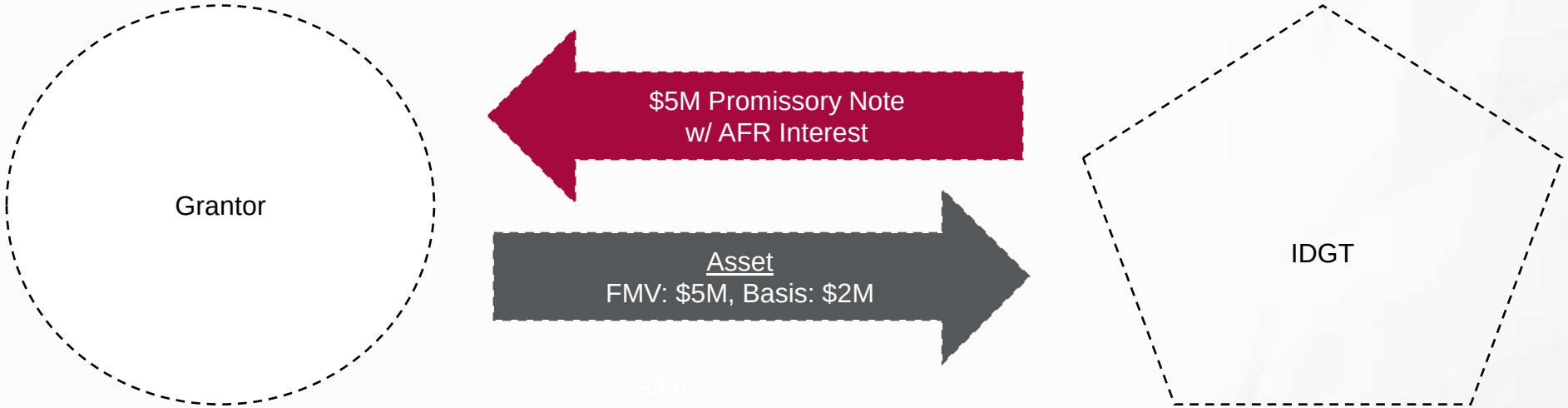
Income Tax Consequences

- Installment sale comes into existence at time IDGT converts to nongrantor trust
- Gain realized to the extent note principal then exceeds property basis ($4.8M)
- All sale-of-property-for-note considerations apply

Sale-of-Property-for-Note Considerations

- Basis increased for purchase
- Holding period should begin anew generally, but some uncertainty
- If more than one asset, apportionment of consideration over purchased assets
  - Interesting questions on how this apportionment might be applied
- Debt-in-excess of basis gain may apply (if asset secured debt to third-party)
- §453 may apply
- Related party sale rules apply
- Imputed interest under §1274 or §483
- Possible §163 interest expense deduction limitation

Installment Sale Occurs During Life . . .



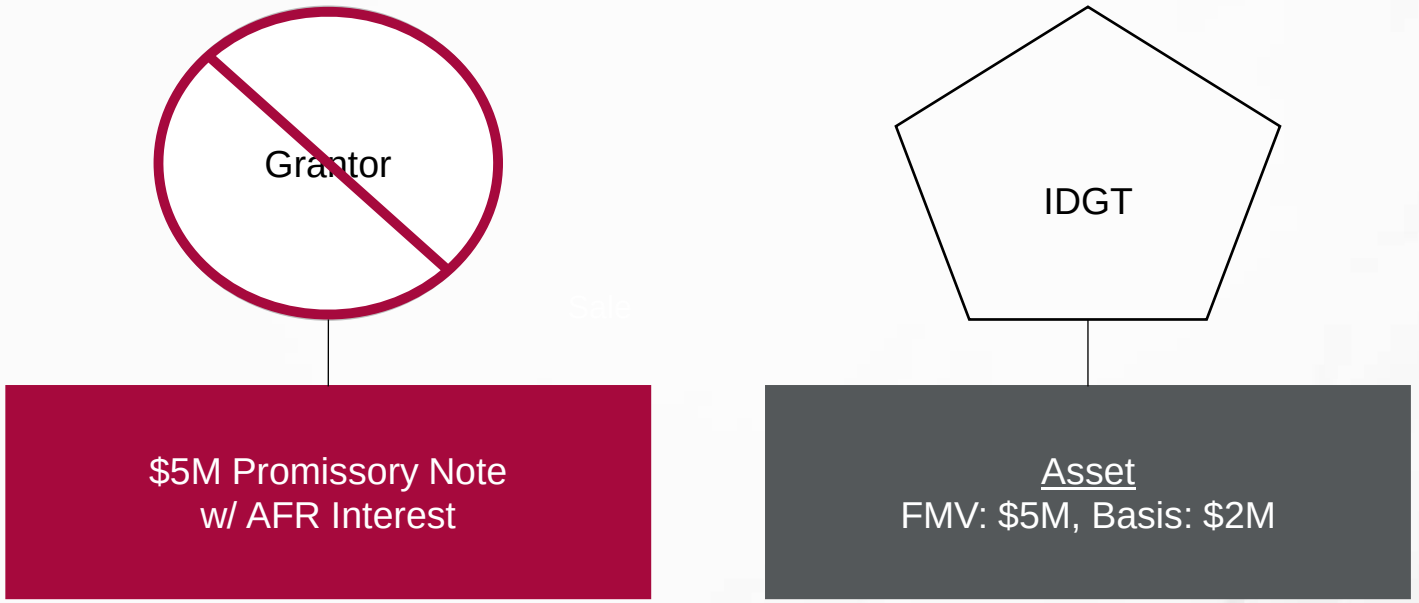
Transfer Tax Consequences:

- No taxable gift

Income Tax Consequences:

- No realized gain
- No interest income or expense
- IDGT takes carryover basis

. . . Then Grantor Dies and Note is Outstanding



Income tax consequences are not settled.

Commentators have different views.

What Occurs Upon Grantor's Death?

IF….	…THEN
Gain or loss recognized on the note	Same facts and considerations as if IDGT toggled-off during grantor's life
No gain or loss recognized on the note	Trust's basis in asset presumably the same as in Part 2 analysis; note presumably receives §1014 basis; other tax features of note uncertain

Minority View: Taxable Transfer on Death

- Commentators with this minority perspective view grantor as selling asset in final tax year immediately pre-death or estate coming into existence and immediately selling asset to IDGT (now a separate trust)
  - If sale occurs pre-death, resulting note may be §453-eligible and in turn §691-ineligible
- Reason 1: Why should a transfer at death be different from an inter vivos transfer? Still appears to be a transfer
  - *See* Rev. Rul. 77-402 (not apparently distinguishing between reasons for why grantor trust status lapses)
- Reason 2: Debt-exceeding-basis should be treated as gain under applicable regardless of the nature of transfer
  - Alternative argument: Debt-exceeding-basis should be income under tax benefit principles--seems like a long-shot argument considering §1014 is specifically designed without regard for tax benefit principles and *Estate of Backemeyer*

Majority View: No Taxable Transfer on Death

- Considerable authority indicates death does not lead to a realization event or even a disposition
- Taking actual timing of transaction seriously makes sale impossible and avoids IRD
  - Estate and non-grantor trust spring into existence simultaneously; no apparent exchange between them
  - Decedent never had any note for income tax purposes, so no exchange between decedent and the IDGT—*see Frane*
  - Seems more like decedent apportioning their assets over estate and IDGT than a sale or exchange between them
- Weakness: Many authorities appear to rely on §1014 or application of estate tax as reason to prevent a taxable transfer on death of debt-encumbered assets, and that likely does not apply to IDGT's assets (as discussed)
- ***Unless otherwise stated, we presume the majority view in the following slides***

Application of §1012 or Reg. §1.1015-4 Without Gain?

- Some commentators argue §1012 or Reg. §1.1015-4 (regarding part-sales, part-gifts) ought to apply to increase basis even if there is no gain
  - Theory is that the note was originally issued to purchase property, and this feature should be recognized when the note comes into existence for income tax purposes
- Can cost basis exist without a recognized transaction?
  - If it could, why did Rev. Rul. 85-13 even seek to disagree with *Rothstein*?
  - Does not seem to be how cost basis rules have been or are intended to apply
  - We proceed on the view the answer is “no”

Tax Consequences of No Gain (Majority) View

- Same basis as in Part 2, scenario where grantor dies, for IDGT asset
- No immediate gain on death
- Many income tax issues regarding the note are uncertain (see next slides)
- Other issues eliminated (*e.g.*, §691)
- Must ensure debt respected for estate tax purposes—do not want estate inclusion of trust assets (not our focus)

Taxation of the Note

- General view: §1014 basis equal to note's FMV in gross estate is appropriate for note from IDGT to grantor
  - Often results in note basis well-below face value of note due to low interest rate (usually AFR)

Does §7872 Apply at Death for Income Tax Purposes?

- Probably applies only at original issuance to IDGT during life
- §7872 appears intended to apply uniformly to both the gift and income tax
- On the deemed issuance of the notes on decedent's death for income tax purposes, the loan will not likely be one of the types subject to §7872
  - In other words, it is not a new gift, compensation-related, corporation-shareholder loan, regulation-designated loan, or qualified continuing care facility loan
  - Probably not a tax avoidance loan (as loan was not even intended to be below-market)
- Per §7872(f)(8), if this is a newly issued note for property, then interest imputation rules (§483, §1274) apply and not §7872

Taxation of Principal Payments

- If basis of the note *exceeds principal* (creating a premium), then bond premium may be electively amortizable as an offset to interest income (to holder), and will reduce any applicable interest expense deduction (to issuer)
- If basis of the note is *below principal*, in general:
  - Each principal payment is partly gain and partly a recovery of basis
  - On assumption no gain on death, the note is not an installment note. Accordingly, the general rule is that basis and gain portions for payments of principal are taken into account pro rata
  - Likely to be long-term capital gain (market discount rules appear inapplicable, but may be ordinary income under certain circumstances)
- For applying OID, what is the issue price for a debt instrument springing into existence at death?
  - OID rules for setting issue price unclear for note issued in exchange for nothing
  - If considered issued for property and interest rate is at least AFR, issue price equals SRPM, eliminating OID
  - If OID/similar rules do not apply and debt is not for sale or exchange of property, issue price is amount loaned

Treatment of Interest Accrued But Unpaid Pre-Death

- At the time of decedent's death, the effective principal of each note includes the originally stated principal plus the accrued but unpaid interest that had accrued through decedent's death

- Special election exists under Reg. §1.1273-2(m) to "back out" such pre-issuance accrued interest from OID computations if payable within one year of deemed note issuance, causing the payment of such interest to be a return of basis

Taxation of Interest Received and Paid

- If QSI, recipient generally taxable on interest income per their method of accounting; else, will be taxable on accrual basis under OID rules
  - Payments on note first generally discharge accreted but unpaid QSI before principal
- Deductible as interest expense for payor in same way (subject to §163 limitations)
  - Significant question of how interest limitations apply (see following slides)

Section 163 Limitations as Applied to Note

- Without seeing note as issued in exchange for something (an asset), it is difficult to determine how proceeds should be traced which is necessary to determine deductibility
- Any argument that note is exchanged for property seems to suggest a taxable transaction
- Best view may be that debt issuance is traceable to a gratuitous transfer and accordingly the interest payments are nondeductible personal interest
  - *Compare* PLR 9845016 (treating interest on pecuniary bequests as §163(h)-limited)

Can We View Debt as Pecuniary Gift from IDGT?

- Not the form of the debt at issue
- In substance, for income tax purposes, gratuitously-issued debt owed by trust resembles pecuniary gift
- Trust and estate income tax rules for pecuniary gifts/bequests
  - Payment with property can produce gain (or loss) per *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940)
  - Principal payments may or may not be DNI-carrying distributions per §663(a)(1)
  - No gain to beneficiary from mere receipt of principal portion of pecuniary gift; basis has not been considered
  - Interest payments may be true interest (dominant view; Rev. Rul. 73-322) or DNI-carrying distributions
  - No apparent authority that OID, market discount apply to these interests
  - §163(h) (personal) limit on interest

If Note Has Negative Consequences Despite No Gain Recognition, Can We Fix Them After Death?

- Debt forgiveness?
  - COD should fall within §102(a) gift/bequest exclusion
  - But would that trigger the note's built-in gain or loss under the "last chance" doctrine? *See* Rev. Rul. 93-7
  - Transfer tax considerations
- Payment in newly-issued LLC (corporate or partnership interest) equity?
  - For example, former IDGT's debt assumed by LLC and LLC pays off debt with newly-issued equity
  - If done right (and interest large enough), seems §108(e)(8) could prevent COD; however, step transaction, various partnership tax rules (e.g., §752, disguised sale), and other tax issues may exist
  - Note basis would remain in existence (frozen into equity), so no apparent "last chance" issue

If Gain Occurs at Death (Majority View of No Gain Is Wrong), How Can We Plan to Mitigate Consequences?

- Pre-death replacement of note
  - Pay down note before death
  - Replace note with payment stream terminating on death (SCIN, private annuity)
  - Replace note with equity in partnership or disregarded entity co-owned with IDGT
  - Contribute note to wholly-owned S corp while keeping IDGT as grantor trust—no apparent gain on contribution
- Reducing §453A interest charge by making DNI distributions of capital gains
  - See Notice 88-81
- Reducing gain at death without eliminating note
  - Allocate debt among deemed transferred assets in proportion to their relative basis (if possible)
  - Swap in higher-basis properties to IDGT

If Gain Occurs at Death (Majority View of No Gain Is Wrong), How Can We Plan to Mitigate Consequences? (Con't)

- What if, at grantor's death, formerly revocable trust provides §678 interests to former IDGT (assuming revocable trust-based plan with no §645 election)?
  - Will §678 beneficial interest be respected as always existing while admin trust is separately regarded? What designs make that more or less likely?
  - If yes, could use §678 beneficial interest to increase basis of assets being transferred from grantor to former IDGT, possibly reducing gain at death
  - If yes, could use §678 beneficial interest to ensure note is never recognized for tax purposes (but where does the basis for the note go in that case?)

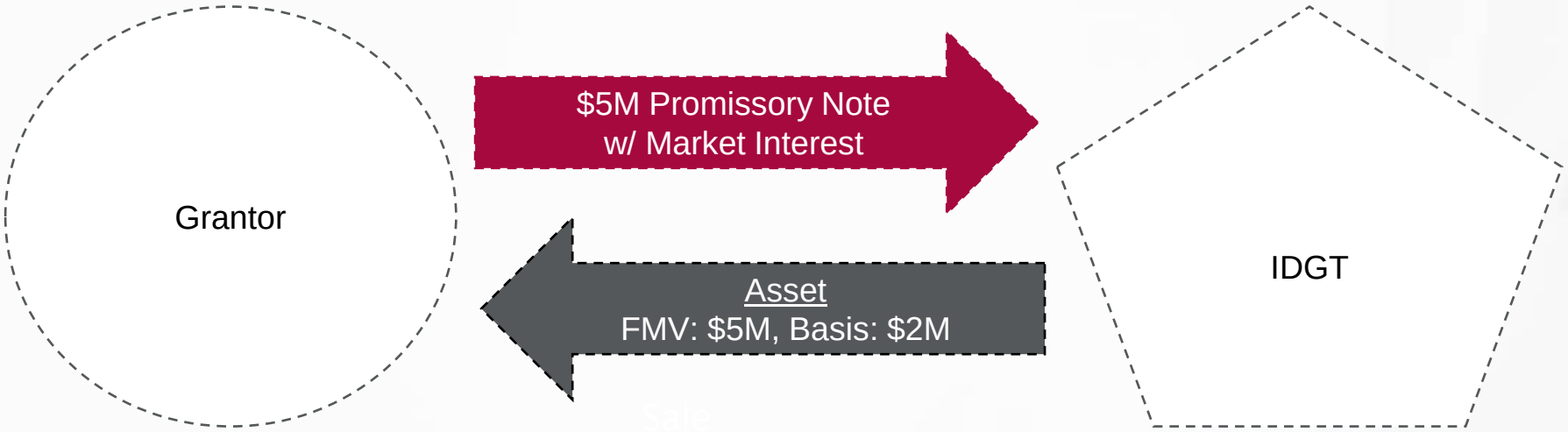
Part 4

What Happens at Death if Grantor Owes Note to IDGT?

The Main Reasons for Grantor to Die Owing Note to IDGT

- Goal is to improve basis step-up
  - Swap low-basis appreciated assets out of IDGT in exchange for cash or high-basis assets
  - Generally will not increase estate tax
- No gain at initial swap or (if debt financing is not used) grantor's later death
- Easy to achieve as most IDGTs have swap power (discussed in Part 1)
- What if you finance repurchase with debt (either by borrowing or issuing note to IDGT)?
  - If debt is deductible for estate tax purposes, then you have brought assets back into estate for step-up without increasing your taxable estate!
  - But people worry about tax impact—especially if repurchase done using grantor's own note
  - If borrowing, note economic impact of paying interest and interest tracing rules

Grantor Repurchases Asset During Life . . .



Transfer Tax Consequences:

- No taxable gift

Income Tax Consequences:

- No realized gain
- No interest income or expense
- Grantor takes carryover basis

. . . Then Grantor Dies and Note is Outstanding

Income tax consequences are not settled.

Commentators have different views.

Basis of Repurchased Asset and Estate Tax Treatment

- Under *Crane*, §1014(a) basis for asset equal to its full gross FMV (notwithstanding debt)
- For estate tax, grantor's debt obligation partly offsets inclusion of the asset in the grantor's estate (either reducing its value or creating a deduction for claims against the estate)
  - Debt must be respected as debt for estate tax purposes for this treatment to work—beyond the scope of this presentation

What Else Occurs After Grantor's Death?

IF….	…THEN
Gain or loss recognized on the note	Former IDGT (now nongrantor trust) would report gain/loss on asset sold in manner similar to grantor in Part 3; same trust would owe income tax on any interest payments from note
No gain or loss recognized on the note	No taxation at death, more uncertain treatment of note

Does Toggling-Off Produce a Taxable Transaction When Grantor Owes IDGT a Note?

- A taxable transaction can only occur if, for income tax purposes, the trust is temporarily respected as owning assets, which it then sells to the grantor or grantor's estate for the note
- There is no apparent technical basis for this outcome
  - The actual exchange of property occurred while grantor trust's direct ownership of assets was not respected
  - On toggling off grantor trust status, trust owned only the note; seemingly should be seen as immediately owning the newly, gratuitously issued note, rather than briefly owning something it then exchanges for the note
- The idea that toggling off grantor trust status "unfreezes" and causes the recognition of a previously deferred transaction resembles the modern consolidated return "intercompany transaction" rules
  - Those rules were a conscious rejection of the single-entity principle that previously applied
  - Because the grantor trust toggle-off more likely follows the single-entity principle, no gain should apply (rather than gain becoming "unfrozen")

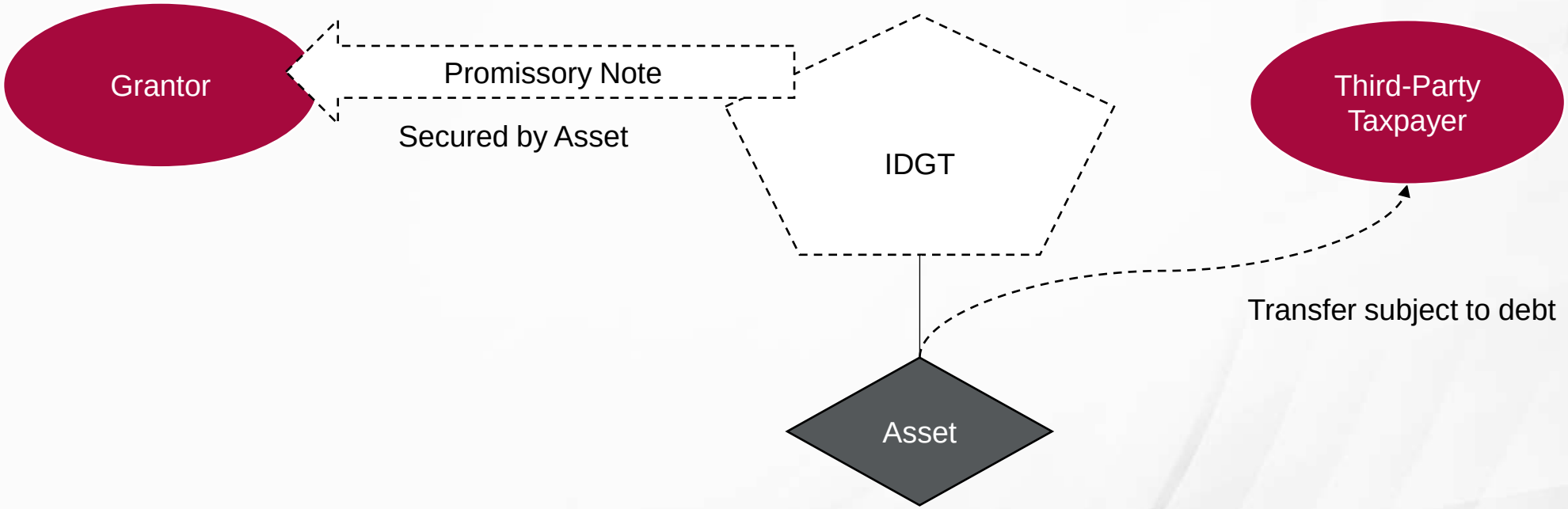
Taxation of Note Issued to IDGT If No Taxable Transfer

- Seems that note would be treated as if it were issued gratuitously but still enforceable
- Could it be treated like a pecuniary trust interest or like standard debt? See Part 3 discussion
- Basis if considered to be a debt-instrument? Does it matter? See discussion of gratuitously issued debt in Part 3
- Must ensure terms of debt do not draw estate tax scrutiny (*e.g.*, true debt, too low of interest rate/security could reveal a disguised beneficial interest)

Part 5

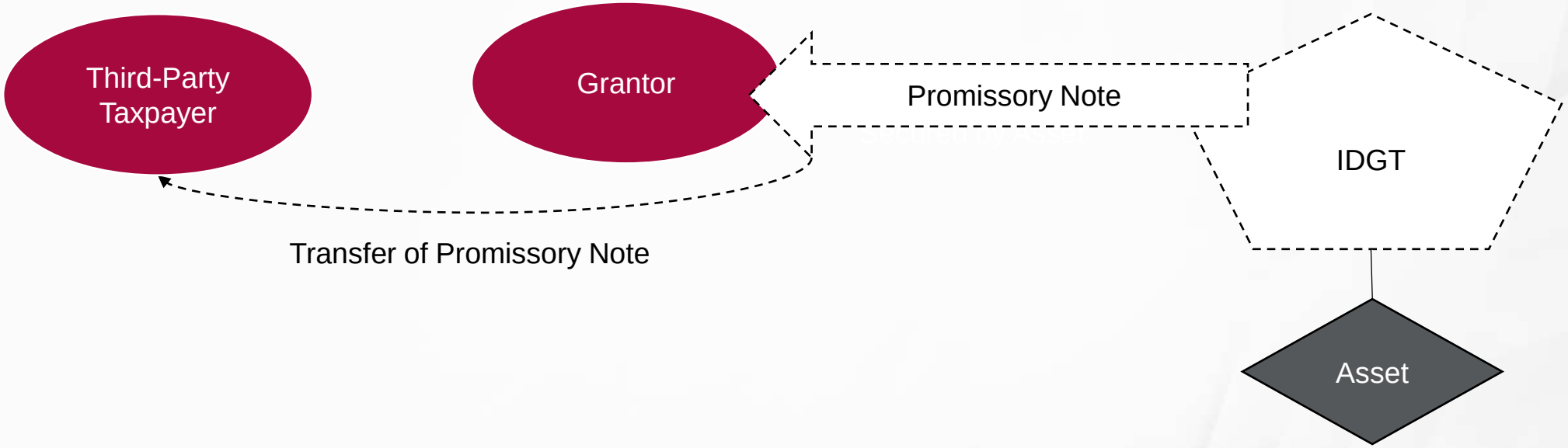
Less Common Variations on Promissory Notes and IDGTs

IDGT Transfers Asset to Third Party



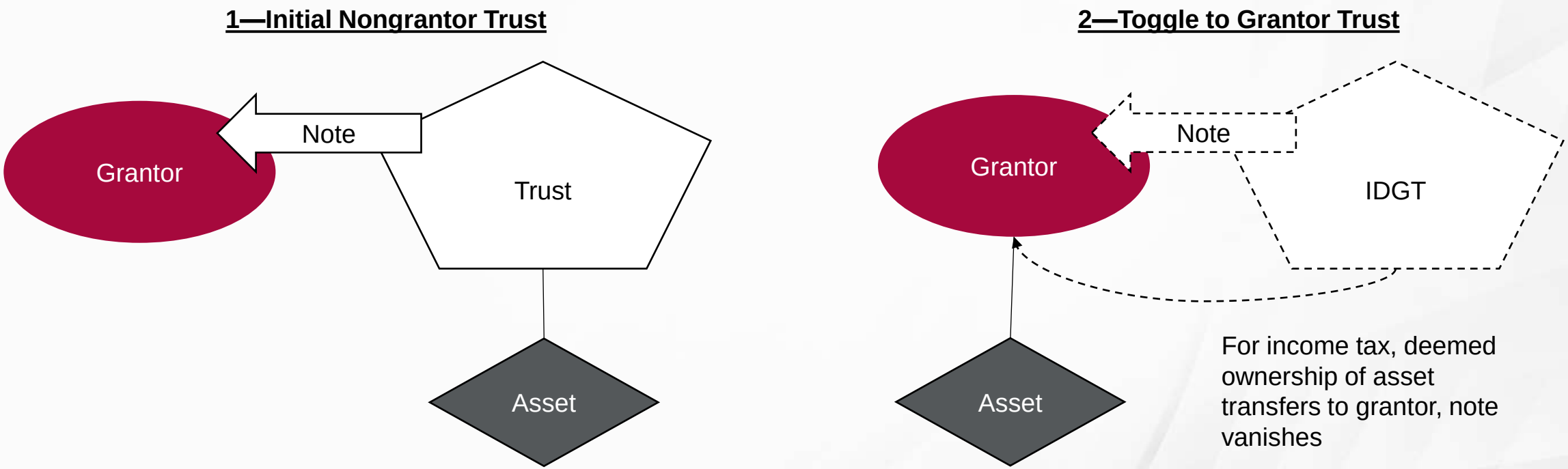
For income tax, as if grantor directly transferred asset to third-party
in exchange for newly-issued note (plus any other consideration from third-party)

Grantor Transfers Note to Third Party



- Note no longer disregarded
- Transfer should be taxed as though grantor newly issued note in exchange for any consideration provided by third-party (or, if not consideration is provided, as a gift)
- Can this trigger gain/loss to IDGT-held asset? No apparent mechanism for this; for income tax purposes, appears to be issuance of note secured by IDGT assets

Nongrantor Trust Owing Note Toggles to Grantor Trust



- Presumably, asset treated as if used to pay down note
- But overall unclear: IRS has reasoned in CCA 200923024 that toggling by itself does not trigger gain and it *might* indicate that toggling off is not recognized at all
- Even if toggling off is generally not recognized, if disappearing note subject to §453, then §453B gain applies

Questions?

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