by Thomas O. Wells

Tax Consequences of Reducing the Principal and/or Interest of a Note Issued in an Intrafamily Sale by a Grantor Trust

A common estate planning technique is for a client to contribute property to a limited partnership, and for the client then to sell the limited partnership interest he or she owns to a grantor trust[1] in exchange for a promissory note. This kind of planning is often referred to as an intrafamily installment sale.[2] Under current law, the limited partnership interest being sold could be subject to an appraised aggregate discount ranging from 10 to 40 percent for lack of marketability and minority interest. If the fair market value of the assets owned by the partnership were $1 million, a 35 percent discount would result in the limited partnership interest having a $650,000 fair market value. The principal amount of the promissory note is equal to the discounted sale amount of the limited partnership interest with an interest rate equal to the applicable federal rate (the AFR) for the month of sale promulgated under I.R.C. §1274(d) (1986), as amended. The interest accruing on the promissory note is typically lower than the anticipated earnings of the partnership's assets. With this technique, the discounted portion of the partnership interest and the earnings and appreciation that exceed the interest payable on the promissory note pass to younger generations free of transfer taxes (*i.e.*, estate, gift, and generation skipping transfer taxes).

With the recent decline in the value of real estate and marketable securities and the decline in the AFR, what should a client do when the unpaid principal amount of the promissory note exceeds the current value of the limited partnership interest that was sold, or if the current AFR is less than the stated interest rate on the note? For example, assume that your client created a family limited partnership and contributed $1 million worth of marketable securities to the partnership. Assume that a third-party appraiser determined that the value of the limited partnership interest owned by the client was $650,000. The client created a grantor trust and transferred $65,000 to the trust as a gift.[3] In November 2007, the client sold the limited partnership interest to the grantor trust in exchange for a nine-year balloon promissory note with interest payable annually. The promissory note bears interest at the mid-term AFR for November 2007 (which was 4.39 percent), resulting in annual interest payments by the trust to the client of $28,535. The promissory note is collateralized by a pledge of the limited partnership interest. In March 2009, the assets owned by the partnership are valued at $500,000.[4] The client wants to decrease the principal amount of the note either to $325,000 or $390,000[5] and decrease the interest rate payable on the note to 1.94 percent,[6] which would reduce the annual interest payable to $6,305.

This article addresses the federal transfer tax and income tax consequences that the client may incur if the principal amount or the interest rate of the promissory note issued by a grantor trust in an intrafamily installment sale is decreased.

Transfer Tax Consequences

A tax is imposed on the transfer of any property by gift or testamentary transfer by a citizen or resident of the U.S.[7] A gift is a transfer for less than adequate and full consideration in money or money's worth.[8] An additional generation skipping transfer tax (the GST tax) is imposed on such transfers that are made to a trust in which all beneficiaries are persons who are two or more generations below the generation assignment of the transferor (defined as skip persons).[9] The GST tax may be an issue because the trust that purchases the limited partnership interest typically includes skip persons. For purposes of this article, transfer taxes mean federal estate, gift, and GST taxes.

• *Reduction in the Interest Rate on the Note* — The promissory note issued in the intrafamily sale should have an interest rate at least equal to the current AFR. A note with an interest rate that is lower than the AFR is a "gift-loan" under I.R.C. §7872(f)(3). The AFR is established monthly by the Treasury.[10] Although there are no published rulings, cases, or administrative pronouncements by the IRS on the reduction of the interest rate of a promissory note issued in an intrafamily sale, some practitioners have concluded that such reduction of the interest rate on the promissory note to the current AFR does not result in any transfer taxes provided the promissory note allows for prepayments.[11] The theory is that each note has a value equal to its stated face amount. Since the old note and the new note each have the same stated principal indebtedness, no transfer has taken place for transfer tax purposes.

• *Reduction in the Principal In-*

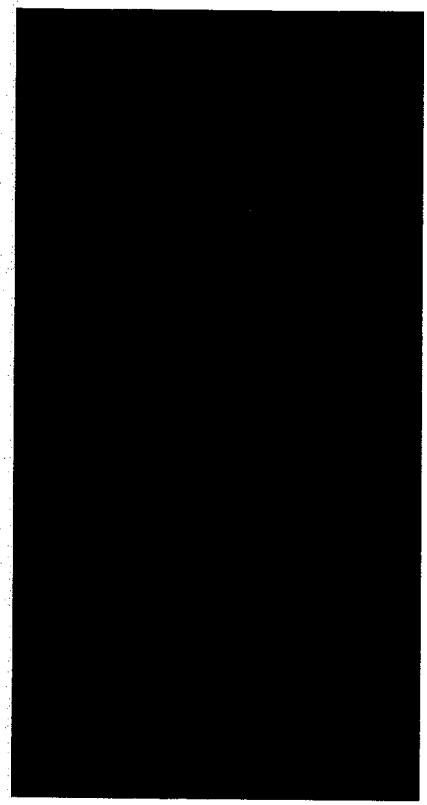
debtedness of the Note — There is little tax law addressing whether a reduction in the principal amount of a promissory note issued in an intrafamily sale under the facts of the example set forth above constitutes a gift by the seller/creditor or cancellation of debt (COD) income to the purchaser/borrower.[12] In the absence of services, such reduction is either a gift or COD income taxable to the maker of the promissory note under I.R.C. §61(a)(12).[13] The determination of whether it is a gift or COD income likely turns on a *Duberstein* analysis: If the seller/creditor reduces the principal amount of the promissory note due to detached and disinterested generosity out of affection, respect, admiration, charity, or like impulses, there is a gift, but if the creditor/seller does so in order to improve his or her opportunity to collect upon the remaining outstanding indebtedness of the promissory note, there is COD income to the purchaser/borrower.

Since the purchaser/borrower is a grantor trust in the foregoing example and is disregarded as being separate from the seller/creditor for income tax purposes under Rev. Rul. 85-13, the debt reduction is unlikely to create any COD income. However, the exceptions to recognizing COD income under I.R.C. §108 may be important to characterize the debt reduction as not constituting a gift under I.R.C. §102.[14]

The insolvency exception to COD income under I.R.C. §108(a)(1)(B) allows the principal of the promissory note to be decreased to $390,000 to eliminate the trust's insolvency.[15] Note that the client's sole recourse for the promissory note in the above example is the initial $65,000 funded to the trust and the limited partnership interest pledged as collateral for the repayment of the promissory note that now has a reduced value of $325,000. In addition, if the client could obtain a pledge of additional collateral[16] or a third-party guaranty to enhance his or her position as a creditor of the trust in exchange for the reduction of the debt to $390,000, the creditor would be in a better position after such reduction than he or she would have been immediately prior to such reduction if the credi-

tor had foreclosed upon the limited partnership interest pledge worth $325,000 and the $65,000 originally contributed to the trust. The IRS would have difficulty in successfully arguing that the reduction of the principal amount of the promissory note by the creditor falls within the *Duberstein* definition of a gift because the creditor has enhanced his or her position as a creditor. Although not free from doubt, a reduction in the principal amount of the promissory note should not likely result in a gift from the client to the trust based on the foregoing authority.[17]

Another exception to COD income is the statutory purchase price adjustment under I.R.C. §108(e)(5). This exception recharacterizes the initial sale as a transfer of $325,000 worth of limited partnership interest by the client to the trust in exchange for a promissory note with a principal indebtedness equal to $325,000. The legislative history of I.R.C. §108(e)(5) was intended to specifically address the reduction of a purchase money obligation resulting from the decline in value of the purchased property as in the example set forth above.[18] Assuming that the IRS applied the concepts of a statutory purchase price adjustment to a reduction in the principal of the note issued in the intrafamily sale, no gift would occur in connection with such debt reduction provided the client obtained an additional pledge of collateral or a third-party guaranty that enhances the creditor's position.[19]



Income Tax Consequences

When the purchaser/borrower in the intrafamily sale is a grantor trust, neither the trust (as the purchaser/borrower) nor the client (as the seller/creditor) is likely to have any income tax consequences from the reduction of the interest rate or reduction of the principal amount of the promissory note.[20]

An Alternative Approach — Converting the Grantor Trust to a Nongrantor Trust

There is no significant tax law addressing a reduction of the interest rate or principal amount of a promissory note issued in an intrafamily sale by a grantor trust. However, another option that is supported by tax law is to convert the grantor trust to a nongrantor trust by having the grantor renounce the trust powers that cause the trust to be taxable as a grantor trust.[21] Under Treas. Reg. §1.1001-2(c), Example 5, the renunciation of such trust powers causes a deemed sale between the grantor trust and the nongrantor trust. This may be a more conservative approach to the reduction of the principal and interest rate of the promissory note because there is a Treasury Regulation promulgated in 1980 that sets forth the tax effects of such a conversion. Under Rev. Rul. 85-13, the promissory note issued prior to the renunciation of the grantor trust power is disregarded for income tax purposes. If a new promissory note is presented at the time the grantor trust is converted to a nongrantor trust, the new promissory note is treated as the amount realized by the client in the deemed sale of limited partnership interest to the nongrantor trust.[22] The trust would acquire an outside adjusted tax basis in the partnership interest under I.R.C. §1012 equal to the principal amount of the new promissory note. If the client's outside adjusted tax basis in the partnership interest (which would be $1 million in the above example) is greater than the principal amount of the new promissory note (which would be $390,000 based on the new value of the limited partnership interest and the $65,000 originally contributed to the trust), the client would incur a capital loss from such sale, but could not likely recognize such loss due to I.R.C. §§267(a) and 267(b)(4). The transfer of a note with a lower AFR to the converted nongrantor trust is unlikely to cause any income tax consequences to the trust.[23]

If the partnership has a "substantial built-in loss" under I.R.C. §743(d) at the time of the conversion of the grantor trust to a nongrantor trust, the partnership will have to decrease its inside adjusted tax basis from $1 million to $325,000 under I.R.C. §§743(a) and 743(b)(2). The partnership's adjusted tax basis decrease does not create a corresponding loss to the client. A substantial built-in loss occurs when the partnership's inside adjusted basis exceeds more than $250,000 of the fair market value of the partnership's assets at the time of a transfer of a partnership interest.

To avoid a decrease in the partnership's inside adjusted basis, the client could cause the partnership to recognize the built-in loss by selling its assets to a third party prior to the conversion of the grantor trust to a nongrantor trust. If the partnership sold marketable securities with an adjusted tax basis of $1 million in exchange for $500,000, the client would have a $500,000 capital loss from such transaction because such loss flows through to the client during the period that the trust qualifies as a grantor trust. When the deemed sale occurs due to the conversion of the grantor trust to a nongrantor trust, I.R.C. §743(a) does not apply because the partnership could qualify as an "electing investment partnership" under I.R.C. §743(e)(6) and there would not be a $250,000 built-in loss required to trigger the substantial built-in loss rules under I.R.C. §743(d)(1).

Conclusion

Although not free from doubt, no transfer tax is likely to result in 1) a reduction of the interest rate to the current AFR; or 2) a reduction of the principal of the promissory note to the fair market value of the trust's assets if the client obtains additional collateral or a third-party guaranty in connection with the reduction. No income tax is likely to result in the reduction of the interest rate or principal amount of the promissory note if the purchaser/borrower is a grantor trust. Because there is no significant primary authority supporting the foregoing conclusions, a more conservative approach is to convert the grantor trust to a nongrantor trust because such conversion is treated as a sale under Treas. Reg. §1.1001-2(c), Example 5. Prior to converting to a nongrantor trust, if the partnership should consider selling any built-in loss assets to allow such capital loss to flow through to the client. Absent such a sale, the partnership has a substantial built-in loss, the conversion could require the partnership to reduce its inside adjusted tax basis in its assets without any corresponding tax benefit to the client.❑

[1] This article will primarily focus on grantor trusts rather than nongrantor trusts. Grantor trusts are disregarded as being separate from the grantor for income tax purposes. *See* REV. RUL. 85-13, 1985-1 CB 184 and PLR 9535026 (a note sale by a grantor to his or her grantor trust 1) will be considered to be incomplete for income tax purposes, 2) will not constitute a gift as the fair market value of the property sold equaled the face amount of the note which was subject to proper I.R.C. §7872 interest rate, and 3) will not be subject to I.R.C. §§2701 or 2702 so long as the note was debt).

[2] *See* 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 AND TR. J. 3 (Jan./Feb. 1999); Jerome M. Hesch, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34TH ANN. U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN, Ch. 14 (2000).

[3] Hesch, *Beyond the Basic Freeze* at 8, discusses whether the trust needs to be funded with 10 percent of the value of the property being purchased by the trust. Although there is no published ruling, case, or administrative pronouncement by the IRS in which a 10 percent funding of the trust is required, most practitioners recommend such funding so that the sale will be recognized for transfer tax purposes.

[4] The opening price of the Dow Jones Industrial Average on November 1, 2007, was $13,924 and the closing price on March 1, 2009, was $7,062.93, resulting in a 49 percent decline in value. Based on such decline in value, the partnership could own assets with a fair market value of $500,000 and the fair market value of the limited partnership interest would equal $325,000 after applying the same 35 percent discount as was used in the initial sale of the limited partnership interest to a grantor trust.

[5] The value of the trust's assets is $390,000 (the sum of $65,000 contributed as equity to the trust plus the $325,000 current value of the limited partnership interest). If the principal amount of the promissory note was decreased to the extent of the insolvency of the trust under I.R.C. §108(a)(1)(B), the principal would be reduced from $650,000 to $390,000. If the principal amount of the promissory note was decreased as a purchase price adjustment under I.R.C. §108(e)(5), the principal

of the promissory note would be reduced from $650,000 to $325,000.

[6] The mid-term AFR for annual interest payments as promulgated by the IRS for March 2009 was 1.94 percent.

[7] I.R.C. §§2001(a) and 2501(a)(1).

[8] I.R.C. §2512(b). TREAS. REG. §25.2512-8 provides that for purposes of I.R.C. §2501(a), a gift includes not only traditional donative transfers but also "below market" sales, exchanges, or other transfers where the value of the property transferred exceeds the value of the consideration received. Pursuant to *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960), a gift arises from "detached and disinterested generosity . . . out of affection, respect, admiration, charity or like impulses." The intent of the transferor determines whether a payment constitutes a gift or something else (*e.g.*, a loan or compensation for services). *See Duberstein* at 285-286; *see also Goodwin v. United States*, 67 F.3d 149, 151-152 (8th Cir. 1995); and *Estate of Cronheim v. Commissioner*, 323 F.2d 706, 707 (8th Cir. 1963), *aff'g.*, T.C. Memo. 1961-232.

[9] *See* I.R.C. §§2601 and 2613(a).

[10] TREAS. REG. §1.1274-4(b).

[11] *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. OF TAXATION 31 (2008).

[12] *But see Hughes v. Commissioner*, T.C. Memo. 1992-438 (The IRS asserted that approximately $18,000 advanced by a successful real estate developer brother to his younger brother was self-employment income in the absence of any formal loan documents or other agreements. Based on testimony from each brother and the older brother's history of making gifts to friends and family members, the Tax Court determined that $10,000 was a gift to the younger brother, $5,000 was an outstanding loan to the younger brother, and $3,000 was self-employment income to the younger brother.).

[13] *See Commissioner v. Jacobson*, 336 U.S. 28 (1949) (repurchase by maker of secured negotiable bonds issued at face value for less than face amount did not involve gift). *See also DiLaura v. Commissioner*, T.C. Memo 1987-291 (no evidence gift intended on discharge of indebtedness); and *Randolph v. Commissioner*, T.C. Memo 2000-248 (corporate shareholder realized discharge of indebtedness income in connection with corporate cancellation of promissory note, not gift, statute of limitations had run on family note transaction). *But see Helvering v. American Dental Co.*, 318 U.S. 322, 331 (1943) (The Supreme Court applied the gift exception to cancellation of indebtedness income in the case of a corporate debtor whose accrued obligations for back rent and interest had been cancelled by its creditors; the court explained that since the "forgiveness was gratuitous, a release of something to the debtor for nothing, [such action was] sufficient to make the cancellation here gifts within the statute."). However, in *Jacobson*, the Supreme Court expressly abandoned the view that a release of "something for nothing" necessarily implied a gift, and instead adopted a "motive" test under which the presence or absence of donative intent on the part of the creditor becomes dispositive.

[14] REV. RUL. 85-13 held that the intrafamily sale did not constitute a gift because the fair market value of the property sold equaled the face amount of the note issued by the purchaser when the note has an interest rate equal to the AFR.

[15] The test for insolvency is determined immediately prior to the event causing COD income (*i.e.*, the reduction of the principal of the promissory note). Although not addressed under I.R.C. §108, the solvency of a grantor trust is likely measured based on the combined financial net worth of both the grantor trust and the grantor for income tax purposes under REV. RUL. 85-13 because the grantor trust is disregarded as being separate from the grantor. However, for transfer tax purposes, the grantor trust is treated as separate from the grantor under REV. RUL. 85-13. Accordingly, the solvency of trust for transfer tax purposes should not take into account the assets owned by the grantor, and the trust would be insolvent with a liability of $650,000 and assets of $390,000. Such insolvency supports a reduction of the principal of the promissory note under I.R.C. §108(a)(1)(B) from $650,000 to $390,000.

[16] Prior to the COD, the spouse of the client could contribute additional funds as a gift to the trust to enhance the payment of the reduced principal of the note. The gift should be subject to Crummey withdrawal powers in favor of the trust beneficiaries to avoid the accounting requirements for exempt and nonexempt portions of a GST trust.

[17] This conclusion is not free from doubt because there are no published rulings, cases, or administrative pronouncements by the IRS addressing this issue.

[18] The legislative history of I.R.S. §108(e)(5) provides that such section applies only when the debt of a purchaser of property to the seller of such property, which arose out of the purchase of such property, is reduced. *See* S. Rept. 96-1035 at 16 (1980), 1980-2 C.B. 620, 628. In cases where a purchase-money debt is owed to the seller, the reduction generally is treated as a purchase price adjustment under I.R.C. §108(e)(5). *See House v. Commissioner*, T.C. Memo. 1995-92.

[19] This conclusion is not free from doubt because there are no published rulings, cases, or administrative pronouncements by the IRS addressing this issue. In addition, the IRS could argue that I.R.C. §108(e)(5) does not apply because the grantor trust (as the purchaser/borrower) is disregarded as being separate from the grantor (as the seller/creditor) under REV. RUL. 85-13 and no sale occurred for income tax purposes. However, the trust is treated as separate from the grantor for transfer tax purposes under REV. RUL. 85-13 allowing for the principles of I.R.C. §108(e)(5) to apply.

[20] *See* REV. RUL. 85-13; *see also* Blattmachr, Crawford, and Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. OF TAXATION, at footnote 45 (2008), in connection with a reduction of the interest rate on the promissory note due to a subsequent reduction in the applicable federal rate; and Brendan P. Smith, *A Sale to an Entity Trust Will Have Better Results than a Sale to an Intentionally Defective Grantor Trust or a Transfer to a GRAT*, 23 TAX MGMT. EST., GIFTS AND TR. J. 8 at fn 21 (March/April 1998), stating that a reduction of the note due to a loss in value of the interest that was sold will have no income tax consequences because there is no completed sale for income tax purposes between the grantor and the grantor trust pursuant to TREAS. REG. §1.1001-2(c), Example 5.

[21] The use of or conversion to a nongrantor trust in an intrafamily sale has positive and detrimental tax consequences. *See* Smith, *Sale to an Entity Trust*, 23 TAX MGMT. EST., GIFTS AND TR. J. 8 (March/April 1998). As to the positive aspects, the sale is treated as a completed sale for income tax purposes such that any appreciation in the assets of the grantor trust at the death of the grantor will not be subject to additional potential income and gift taxes upon the deemed sale at such conversion of the grantor trust to a nongrantor trust under TREAS. REG. §1.1001-2(c), Example 5. As to the detrimental aspects: 1) the client cannot make additional transfer tax-free gifts to the trust beneficiaries by paying the income taxes applicable to the trust as provided in PLR 9543049; 2) if the principal balance of the promissory note exceeds $5,000,000 as of the end of the year, there may be a deferral interest charge under I.R.C. §453A(b); and 3) there could be income in respect of a decedent at the death of the grantor as to promissory note payments by the trust to the grantor's estate.

[22] Assume that there are no partnership liabilities at the time of such conversion which could increase the amount realized pursuant to I.R.C. §§741 and 752(b).

[23] *See* Blattmachr, Crawford, and Madden, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. OF TAXATION at 30 (2008).

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This column is submitted on behalf of the Real Property, Probate and Trust Law Section, John B. Neukamm, chair, and William P. Sklar and Richard R. Gans, editors.