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CHAPTER 3 (edited version)

Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas

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Introduction

Ten years ago, we wrote about the taxation of private annuity sales in an installment sale world.[2] The article was written when the Installment Sales Revision Act of 1980 (the " 1980 Act") was new and was viewed as a major reform establishing the installment method as the basic method for treating deferred payment sales.[3] It was written to forecast and, frankly, to influence promised regulations dealing with the relationship between the 1980 Act and traditional private annuity sale treatment.

In the intervening ten years, the promised regulations have not appeared, even in proposed form. There has been only one IRS pronouncement on the subject, and that one, General Counsel's Memorandum 39503,[4] is not even officially published. There have, however, been a number of relevant developments. Amendments to the installment sale provisions have reduced the scope of installment reporting, so that it is now available primarily for casual sales of real estate and personal property, including only nonmarketable securities.[5] These changes raise doubts whether the installment method remains the basic method of taxation for deferred payment sales.[6]

In addition, there have been major developments in the understanding of, and treatment of, the time value of money for federal income tax purposes. These include major revisions in the original issue discount ("OID") provisions and extension of the OID rules to sales of property.[7] There are now prescribed minimum interest rates known as the applicable Federal rate ("AFR") for sales of property.[8] Similar rules apply market discount for the holder of a debt obligation,[9] OID rules apply to loans with below market interest rates,[10] and compound-interest rules apply to debt premium." Needless to say, none of these developments simplify or clarify the relation between the private annuity sale and installment sale provisions. Collectively, they make deferred payment sales of business or other financial assets within a family a true challenge to the tax professional.

Deferred payment sales of a business or other financial assets within a family can serve a variety of functions. In many families, there comes a time when it is appropriate to transfer management and control of a family business or other family financial assets, or even nonfinancial property, to the next generation. Although this time may be appropriate occasion for the making of major family gifts, frequently, the older generation needs to retain some financial stake in the family business or other financial assets to finance its retirement after it is time to transfer control. At the same time, those taking over the closely held business or other property usually do not have independent financial resources to pay for them, and cannot, or are not willing to, obtain the necessary financing from third-party commercial sources.

A seller-financed, deferred payment sale can fill the gap, and permit the future cash flow from the newly-acquired assets to provide the primary source of funds needed to satisfy the obligation undertaken by the purchasing younger family member. The deferred payment arrangement can be a standard installment note, a self-cancelling installment note ("SCIN") or a private annuity sale. A standard installment note calls for a specified number of fixed payments over a set period with designated interest. A SCIN is simply a standard installment note that also provides that the payments terminate upon specified contingencies, usually the death of the selling senior family member or members. This termination feature means that the value of a SCIN is less than that of a standard installment note providing for equivalent payments over the maximum term. Accordingly, to provide an equivalent initial value, a SCIN must provide greater interim and potential total payments than a standard installment note. A private annuity sale provides for specified payments for a term of uncertain duration, usually the life of the selling senior family member. Although a private annuity sale, like any commercial annuity, involves an implicit interest factor, the interest usually is not expressly stated.

Although there are significant differences in the financial terms and economic risks associated with the three types of deferred payment financing, in the final analysis, all three provide economically equivalent payment arrangements for the assets transferred. Any difference in the risks related to the different payment terms should be taken into account, either by difference in the amounts provided as deferred payments for the assets or, if it is not, in the portion of the value of the assets transferred that is a gift, compensation, or other taxable event. Nevertheless, the current differences in the Federal income and transfer tax treatment of the three financing arrangements are disproportionate to the financial differences among them.

Under traditional tax principles, the timing of reporting any gain realized by the senior family member seller under the annuity rules is significantly different from that under the installment method. There are similar differences in the basis of the property to the younger generation buyer. The buyer in a private annuity sale is entitled to an initial basis for the property purchased measured by the actuarial value of the annuity, and capitalizes the amount treated by the selling senior family member as annuity income, but the younger generation buyer in an installment sale involving contingent payments includes the payments in basis only as made.

Even greater differences apply to the income taxation of the interest or other time value of money factor inherent in each payment. Although the selling senior family member reports interest income as such in an installment sale and, implicitly, as annuity income in a private annuity sale, the reporting of the time-value of money is significantly different. Similarly, although the younger generation buyer is entitled to an interest deduction (subject to the investment interest or other interest limitations) in an installment sale, the buyer is not allowed any deduction for the amount the selling senior family member treats as annuity income in a private annuity sale. In addition, differences can occur because only an unsecured private annuity sale is governed by the private annuity rules, while a secured private annuity sale on identical terms is apparently governed by the installment reporting rules. Another distorting factor is the use of different interest rate and mortality assumptions for income tax purposes than those used for transfer tax purposes. This distortion is exacerbated by the apparent use of the income tax tables in determining whether a gift is made in installment sales, but not in private annuity sales.

This paper seeks to provide a comparative analysis of the current income and transfer tax treatment of these three financing vehicles (in so far as it is clear) to show how the selling senior family member and younger generation buyer are taxed at the following crucial times:

1. the time of the initial sale;
2. the time each payment is made; and
3. the death of the senior family member seller during the payment period.

In so doing, the analysis questions how much of the traditional view, particularly the taxation of private annuity sales, is proper, in light of the 1980 Act and subsequent developments.

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¶ 301 Installment Method for Fixed Payment Obligations

The installment method defers taxes; it allows a selling senior family member who is to receive deferred payments on the sale of property to postpone reporting any gain realized on from the date of sale to the time when payments are received. The installment method spreads the reporting of gain over the taxable years of payment by linking the reporting of gain to the receipt of payment. Specifically, a fraction of each payment, the gross profit ratio, which is the gross profit divided by the selling price, is included in income.

> **Example 1**: A senior family member sells family financial assets worth $1,000 that have a basis of $100, for ten payments of $100 each, plus adequate stated interest. The gain, or gross profit, is $900 ($ 1,000 - $100). Under the installment method, the gross profit ratio is 90% ($900/$1,000). Thus, 90% to or $90 of each $100 principal payment on the note is included in income as gain on the sale.

Regardless of the younger generation buyer's method of accounting, the obligation to make fixed principal payments is part of the basis of the property acquired from the date of sale. With de minimis exceptions, a portion may be OID, characterized as interest unless interest, at prescribed rates, is payable at least annually.[12]

A selling senior family member can elect out of the installment method for a deferred payment sale,[13] and report the entire gain in the year of sale for most fixed payment obligations and for many contingent payment obligations.[14] A selling senior family member who elects out of the installment method is rarely permitted to recover basis first.[15]

The senior family member can arrange for part or all of the family business interest to be redeemed by the corporation or partnership instead of being purchased by the younger generation family member. The redemption has the same economic effect as a sale if the younger generation already owns an interest in the business, or if such an interest is transferred as part of the transaction. A corporate redemption for deferred payments, including one by an S corporation, that qualifies as a sale or exchange, and is not a dividend, is an installment sale.[16] Accordingly, the income tax treatment of the selling senior family member is the same as in a direct sale to the younger family member. Any interest deduction, however, belongs to the corporation (or S corporation shareholders). The corporation does not have any basis in the shares redeemed and the younger family members do not increase the basis of their shares for the redemption price.[17] The taxation of a deferred payment redemption of a partnership interest is determined under special partnership provisions and not under the installment method.[18]

Terms of the Sale

All initial cash amounts received, and the value of all assets initially received (other than the buyer's evidences of indebtedness), in a deferred payment sale of family business or other financial assets are treated as payments in the year of sale under the installment method. Demand obligations of the younger generation buyer, or obligations of a corporate buyer regularly traded on an active securities market, do not qualify as the buyer's evidence of indebtedness, so that the deferral under the installment method is not available for these notes.[19] The installment method is also not available for various types of property.[20]

The buyer's evidences of indebtedness may be received in an installment sale without immediate gain recognition, regardless of the solvency of the buyer. The installment method is the basic approach to taxing deferred payment sales that qualify; its availability does not depend on the taxpayer's method of accounting or on lack of certainty of payment.[21] All other amounts received, including any third party debt obligations, are payments in the year of sale and result in immediate recognition of gain.[22]

Gain realized on sale can be reported under the installment method even when the younger generation buyer's obligation is secured.[23] Common forms of security include a mortgage on the property sold, a third-party guarantee or even a standby letter of credit.[24] It is possible to go too far. An obligation secured by an escrow or by a cash equivalent, for example, government securities, is treated as a payment in the year of sale.[25]

Liabilities Transferred

When liabilities are transferred as part of the sale of the family business or other financial assets, the liabilities are part of the selling price, included in both the selling senior family member's amount realized and the younger generation buyer's basis.[26] When property is sold subject to liabilities, special rules apply under the installment method. The liabilities are, in effect, applied first against basis instead of simply being considered additional payments. The contract price instead of the selling price is used to calculate the gross profit ratio. It is defined as the selling price reduced by liabilities transferred that do not exceed basis.[27]

> **Example 2**: A senior family member sells property worth $1,000 with a basis of $600, subject to a mortgage of $400, for ten principal payments of $60 each. Although the sales price is $1,000, the contract price is $600 ($1,000 - the $400 mortgage), and the gross profit ratio is 66-2/3% ($400 gross profit/$600 contract price). $40 of each $60 payment is included in income as gain on the sale.

If the amount of the selling senior family member's transferred liabilities exceeds the basis for the business, the excess is "deemed" to be a payment in the year of sale, because otherwise the gross profit ratio would exceed 100%.[28]

Example 3: A senior family member sells property worth $1,000 with a basis of $100, subject to mortgage of $400, for ten principal payments of $60. The gross profit is $900 ($1,000 price - $100 basis), and the contract price would be only $600 ($1,000 price - $400 mortgage), resulting in a gross profit ratio of 133-1/3%. To prevent this, the mortgage offset in determining the contract price is limited to the $100 basis. Thus, the contract price is also $900, resulting in a gross profit ratio of 100%. The $300 excess is a "deemed" payment in the year of sale. This results in immediate recognition of gain in the amount of $300 because the entire basis has been fully recovered against the liability.[29]

Taxpayers have succeeded in avoiding immediate gain recognition when liabilities exceed basis by use of a wrap-around note.[30] In a wrap-around note, the selling senior family member does not transfer the liability, but remains primarily liable, agreeing to make payment on the indebtedness as it becomes due.[31] Although the IRS initially resisted this result,[32] it has now conceded that it works.[33]

Example 4: The facts are the same as in Example 3. The senior family member may avoid the gain on the excess of the liability over basis in the year of sale by agreeing to pay off the borrowing himself. He then receives ten annual principal payments of $100 each, and must use part of each payment (or other resources) to make the payments on the mortgage. He reports $90 of his gain as he collects each principal payment, and has no deduction or other offset for the mortgage payments.

Disposition

Because the deferral of tax under the installment method is considered an extraordinary benefit, almost any disposition by a selling senior family member of an installment obligation accelerates the unreported gain realized on the sale of the family business.[34] Even a gift by the selling senior family member is an early disposition that accelerates the reporting of gain.[35]

A disposition occasioned by the selling senior family member's death, however, does not accelerate the unreported gain. Instead, the deceased selling senior family member's successor-in-interest steps into the decedent's shoes, and, in turn, is subject to the early disposition provisions.[36] The amount included in the selling senior family member's gross estate should be the fair market value of the younger generation buyer's debt obligation, determined under normal valuation principles, and not the unpaid principal of the note.[37] The results are the same if an installment obligation that is not a SCIN is cancelled by a bequest to the younger generation buyer.[38]

Finally, use of the installment note as collateral for a loan is treated the same as an early disposition to the extent of the loan proceeds,[39] with the result that all or a portion of the deferred gain is reported at that time.[40]

Interest Charged by the Government

The benefit of the deferral of tax for large installment sales is lost, because the selling senior family member must pay interest on part of the deferred tax, beginning in 1989.[41] This interest is calculated at the interest rate applicable to tax deficiencies.[42] If the selling senior family member is an individual, the interest is, presumably, nondeductible.[43] This makes payment of interest prohibitively expensive.

The Buyer's Interest Deduction

Interest paid by noncorporate family buyers for shares of a family C corporation is investment interest deductible only within the applicable limits.[44] The character of interest paid by a noncorporate family buyer of an S corporation is determined by an allocation based on the nature of corporate assets, that is, business assets, investment assets, etc.[45] When the family buyer is a C corporation, the interest should be fully-deductible as business interest.[46]

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¶ 302 Private Annuity Sale Obligations

Private annuity sales are arrangements that permit a senior family member to receive a fixed amount periodically for the remainder of the seller's life or some other period. The traditional tax treatment of private annuity sales developed in a series of rulings and cases as an application of cash accounting principles in combination with some of the rules that apply to primarily commercial annuities, all without specific statutory authority.[92]

Tax Treatment of Annuities in General

An individual having a savings account with a bank must report the annual interest earned under the doctrine of constructive receipt even when he does not withdraw any monies from the account.[93] If the same individual saves by purchasing an annuity from an insurance company, the reporting of the interest income is deferred until withdrawals are made.[94]

Under an annuity arrangement, the insurance company receives one or more premium payments and agrees to make a prescribed series of future payments, usually measured by the annuitant's life, a specified term or some combination. The payments represent not only return of the premium but also an implicit interest element for the annuity term. Under § 72, a portion of each annuity distribution is treated as a tax-free return of the annuitant's initial deposit by use of a mechanism called the "exclusion ratio," and the balance, representing the time value of money, is annuity income.[95] In effect, any distributions representing the annuitant's cost in the annuity contract, referred to as the "investment in the contract,"[96] is a tax-free return of basis.[97] This investment in the contract, the numerator of the exclusion ratio, is the total of premiums the annuitant paid the insurance company. The denominator of the exclusion ratio is the total of all amounts the annuitant expects to receive under the annuity contract (without discounting to present value) determined by actuarial tables,[98] referred to as the "expected return."[99] The exclusion ratio in annuity taxation has a function similar to that of the gross profit ratio in the installment method as the mechanism for defining the recovery of basis.[100] The exclusion ratio, like the OID and unstated interest rules, determines the amount of income that effectively represents the time value of money. It differs in that it provides a straight-line allocation of the income on a cash basis rather than the compound-interest accrual approach of the OID and unstated interest rules.

When annuity payments are payable for a period measured by a life, the annuitant can die before or after the actuarial provided in the mortality table. An annuitant who dies exactly when his actuarial life expectancy ends excludes from income an amount exactly equal to the premiums paid. An annuitant who dies prematurely is permitted to deduct the unrecovered "investment in the contract" on the final income tax return.[101] An annuitant who survives beyond the table's life expectancy recovers the entire investment in the contract, and can no longer exclude any portion of subsequent annuity payments.[102]

Private Annuity Sales

When a senior family member sells family business or other financial assets to a junior family member on terms that measure the payments by the selling senior family member's (or another person s) life, the transaction is a private annuity sale. Traditional private annuity sale treatment is a special application of cash accounting principles, in which the gain on the sale is allocated over the payment period using the principles of annuity taxation.[103] A redemption by a family corporation can be a private annuity sale.[104]

During the actuarial life expectancy of the selling senior family member in a private annuity sale, the annuity payments are divided into three parts: (1) a basis recovery element, determined by allocating the basis of the shares over the selling shareholder's life expectancy under the income tax annuity tables; (2) a (capital) gain element, measured by any excess of the value of the annuity under the gift tax actuarial tables over the basis of the shares, which is also allocated over the income tax life expectancy; and (3) an annuity (or interest) income element, measured by the difference between the amount of the payment and the first two items, using the lower of the fair market value of the family business or the present value of the annuity to measure the payment.[105] Thus the recovery exclusion in a private annuity sale is divided between the recovery of the selling senior family member's basis in the family assets transferred and any unrealized gain inherent in those assets. Accordingly, private annuity sale treatment parallels the installment method, but with significant differences.[106]

If the selling senior family member outlives his life expectancy, all subsequent payments are ordinary annuity income.[107] If the family seller dies before recovering his entire basis, the reporting of gain stops,[108] and he is entitled to a loss deduction on the final income tax return for the unrecovered basis.[109] The same considerations apply to the timing and character of the deduction and its possible eligibility for election under § 1341(a)(5) as for contingent payment installment sales.[110]

Traditional private annuity sale treatment is not available for secured private annuity sales.[111] Although G.C.M. 39503 seems to assume that being ineligible for private annuity sale treatment means immediate recognition of gain,[112] this is questionable. The cases requiring immediate recognition for secured private annuity sales did so as an application of cash accounting principles and did not discuss installment sales, because, at that time, contingent deferred payment sales were not eligible for installment sale treatment. This is no longer true.[113] Accordingly, the IRS position may create an anomaly in that an unsecured SCIN or private annuity sale is taxed under annuity principles, while an identical secured one is an installment sale. This distinction is questionable and should be eliminated.[114]

The buying family member is not entitled to any interest deduction even though the portion of the payment representing the time value of money is annuity income for the selling family member.[115] On the other hand, the buyer's initial basis of the family assets transferred is measured by the anticipated payments to the extent of the fair market value of the annuity obligation.[116] Both of these results are inconsistent with those that apply to contingent payment installment sales,[117] but are consistent with the exclusion of annuity transactions from the OID rules.[118] Even with that exclusion, the denial of an interest deduction for the younger generation buyer is questionable.[119]

The younger generation buyer's initial tentative basis for the property is increased when payments exceed the initial basis estimate.[120] Because there is no interest deduction, this occurs well before the end of the selling senior family member's actuarial life expectancy and can lead to a final basis far in excess of value.[121] If the family seller dies before payments equal the tentative basis, the basis is reduced to payments already made.[122] A younger generation buyer who disposes of the property during the selling family member's lifetime generally computes gain or loss using the tentative basis at the time of the sale; subsequent payments are additional losses on sale of the family assets.[123]

When a private annuity sale provides the consideration for a transfer that is part-sale, part-gift, the IRS view is that the gift portion of the transaction is determined using the transfer tax tables instead of the AFR. Otherwise, the principles are the same as for part-sale, part-gift in a fixed payment installment sale.[124]

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¶ 304 Self-Cancelling Installment Notes

When Used?

A family seller not primarily concerned about building up her estate for tax or other purposes may desire a sale in which the payments are limited by her life expectancy. When the arrangement involves a fixed term with a limit based on life, it is sometimes called a self-cancelling installment note ("SCIN"). When the payment period extends throughout the selling family member's life with no other limit even if it has a minimum number of payments, it is a private annuity sale.

A SCIN is appropriate when the selling family member does not feel the need to receive payments for his or her entire life, as long as he or she receives an adequate capital value. The maximum term places a cap on how much the younger generation buyer pays, but limits the selling senior family member's life-time security. A SCIN is a hybrid, using the installment approach in determining the maximum amount the younger generation buyer will pay, and the private annuity sale approach in the event the selling senior family member dies before the end of the payment term. Because the selling senior family member no longer has a right to payment when the SCIN is terminated by its own terms on death, no amount is included in the gross estate.[158]

A major advantage of a private annuity sale to the senior family member seller is that the periodic payments for his life continue to fund his retirement even if he survives beyond the actuarial life expectancy age. The corresponding advantage to the younger generation buyer is that if the selling senior family member dies sooner than actuarially indicated, he or she may receive a bargain, paying less for the property than it is worth. Because of this risk, private annuity sales and SCINs are generally used only in sales between family members.

The IRS apparently resolves the ambiguity created by the hybrid nature of a SCIN by classifying SCINs as private annuity sales when the maximum period exceeds the selling senior family member's actuarial life expectancy, and as contingent payment installment sales when it does not.[159]

Valuation of a SCIN

Because there is both a cap on the amount the younger generation buyer will pay and a possibility the buyer will pay less than the maximum, the amount of each annual payment, and the potential total price if the seller lives to receive all payments, under a SCIN must be greater than the annual payments under an installment sale to have the same present value.[160] In other words, the risk factor attributable to the fact that the selling senior family member may die prematurely creates a premium that must be reflected if the parties want the present value of a SCIN obligation to equal the value of the property purchased. And, since there is a maximum term for the payments, this factor must also be recognized, resulting in an annual payment for a SCIN that is also larger than for a private annuity sale payment that extends throughout the selling senior family member's life.[161]

Comparing installment sales, private annuity sales and SCINs is complicated because the transfer tax valuation tables[162] use shorter life expectancies in determining the value of a deferred payment obligation than the annuity tables under § 72, and because § 7520 mandates use of a discount rate of 120% of the AFR.[163] Therefore, the principal amount of a deferred payment obligation determined for income tax purposes using the AFR and, if applicable, the annuity tables under § 72, may be greater than the value determined for transfer tax purposes.

The IRS position is that the transfer tax mortality tables and discount rates determine whether a gift has been made in the private annuity sale.[164] However, the IRS goes on to state that there is no requirement to use these transfer tax tables in valuing an installment sale, including a contingent payment sale, but that facts and circumstances approach may be used.[165] The anomaly is that a SCIN treated as an installment sale can use the AFR and the longer life expectancy multiples found in Reg. § 1.72-9 in determining its value for transfer tax purposes while a SCIN treated as a private annuity sale must use different interest rates and different life expectancy multiples.

Income Tax Treatment of a SCIN

It is not entirely clear when a SCIN is taxed under the installment reporting rules of § 453 or under the annuity rules of § 72. The IRS position is that if the selling senior family member's life expectancy, using the mortality assumptions in Reg. § 1.72-9, is less than the maximum term of the SCIN, it is a private annuity sale under § 72, and if the seller's life expectancy is greater than the loan term, it is taxable as an installment sale with a contingent sales price under Temp. Reg. § 15A.453-l(c).167 In addition to the effects of life expectancy and discount rate differences,[168] there are several crucial income tax differences between these two approaches. The timing of the selling senior family member's gain and ordinary income, the buyer's deductions for the time value of money, the buyer's basis, and the effect of the seller's premature death all differ. There is further confusion because a private annuity sale cannot be secured,[169] but an installment sale can be secured.[170]

A. Under the Annuity Rules

The annuity rules applied to a SCIN are the same as for a straight private annuity sale with only minor modifications to reflect the maximum term.

1. The seller

In calculating the "expected return," the two factor life expectancy multiple under Reg. § 1.72-9, Table VIII, must be used. A SCIN is a "temporary life annuity" because it has a maximum duration. The "exclusion ratio" so determined allocates the same amount of principal and annuity income to each payment.[171]

2. The buyer

Even though the income tax consequences are determined using the annuity tables of § 72, the younger generation buyer uses an initial tentative basis equal the present value of the SCIN obligation under the transfer tax valuation tables. As for a standard private annuity sale, the younger generation buyer is not permitted an interest deduction.[172]

3. When the SCIN is cancelled

When the annuity rules apply, and the SCIN is cancelled by the selling senior family member's death before the maximum payment term, the younger generation buyer's final basis under the annuity rules is limited to payments made.[173] Neither the selling senior family member nor the estate reports the remaining gain inherent in the cancelled payments because the early disposition rules of § 453B apply only to obligations reported on the installment method. The annuity reporting rules permit the selling senior family member to deduct any remaining basis on his final income tax return.[174]

B. Under the Installment Method

When a SCIN is treated as an installment sale under the IRS approach, the installment method as applied to contingent payment sales,[175] employs dramatically different rules from those that pertain to a SCIN classified as a private annuity sale.

1. The seller

A SCIN is a contingent payment sale with a stated maximum selling price.[176] The maximum selling price is the "selling price" that is used in the denominator of the "gross profit ratio," and determines the "gross profit" used in the numerator.[177]

It is not clear whether the entire premium representing the risk that the selling senior family member will die before the end of the note term must be treated as additional principal, or can be treated as additional interest as long as the interest does not become so high as to be excessive.[178] The IRS has not issued any guidance on this issue.[179]

2. The buyer

The proposed contingent payment regulations, Prop. Reg. § 1.1275-4(d)(2), take the position that a younger generation buyer does not have any initial basis for undertaking a contingent payment obligation. Instead, basis is obtained only as principal payments under the contingent payment obligation become fixed.[180]

3. When the SCIN is cancelled

If the tax treatment of a SCIN is governed by the contingent payment installment reporting rules, the remaining capital gain is accelerated upon cancellation of the obligation if it is an obligation of a related party.[181]

Although the entire capital gain inherent in the deferred payment obligation is reported even though the obligation is cancelled, there may be no symmetrical treatment for the younger generation buyer's basis. Under the proposed contingent payment regulations, the buyer undertaking a contingent payment obligation may obtain basis only for principal payments actually made.[182] This anomalous result should not apply, and the younger generation buyer's basis should equal the principal amount of the obligation.[183]

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PART II Comprehensive Description

¶ 307 Installment Method for Fixed Payment Obligations

In General

It is easy to compute the gross profit ratio and apply the installment method to simple sales. When the facts become more complicated, particularly when the property is mortgaged, so does the computation. Example I sets forth the basic facts that are used in many of the examples that follow. S is a senior family member who wishes to transfer control of family financial assets to B, a younger family member.

> **Example 1:** S owns land held as a capital asset with a basis of $1,700,000 and a value of $2,500,000. The land is subject to a $1,750,000 mortgage.
>
> B purchases the property from S on December 31, 1989, paying no cash at the December 31 closing. The sales contract requires B to pay $150,000 cash one day later on January 1, 1990, and take the property subject to the outstanding mortgage. At closing B delivers a note with a face or principal amount of $600,000, providing annual payments of $50,000, starting on January 1, 1991. The note also requires B to pay 10% interest on the unpaid balance with each annual payment. The long-term AFR at the date of sale was 8.7570, so there is no imputed interest.

The amount realized of $2,500,000 is composed of the $150,000 cash received the following day, the $1,750,000 mortgage, and the $600,000 principal of B's note. Accordingly, S's realized gain on the sale is $800,000.

For purposes of reporting the $800,000 capital gain under the installment method, the gross profit ratio is 100%. Even though the gross profit is $800,000 and the "sale price" is $2,500,000,[234] it is the "contract price" that is used as the denominator of the gross profit ratio. The contract price is defined as the selling price reduced by the portion of the qualifying indebtedness which does not exceed S's basis in the property.[235] In other words, the amount of the mortgage is subtracted from the selling price, but the maximum reduction in the denominator cannot be more than S's basis in the property sold. The remaining $50,000 of the mortgage is treated as a deemed payment at the time of sale. Therefore, the gross profit ratio is 100%, computed as follows:

(i) $2,500,000 - $1,700,000 = $800,000 (contract price)

(ii) $800,000/$800,000 = 100% (gross profit ratio)

In effect, the entire $1,700,000 basis in the land is applied against $1,700,000 of the outstanding mortgage. In other words, the deemed receipt of $1,700,000 is treated in its entirety as a return of basis. S's basis in the installment note is zero. Accordingly, the $800,000 gain is reported as follows:

At time of sale (excess liability)	$ 50,000
Jan. 1 of next year (down payment)	150,000
Annually (as payment received)	600,000
Total Gain	$ 800,000

Postponing receipt of actual payments does not postpone reporting of the deemed payment attributable to the excess liability transferred.

If S elects out of the installment method under § 453(d), she reports the entire $800,000 capital gain in year of sale,[236] so that her basis in the $600,000 note is equal to its face amount. Thus, all principal payments on the note are a nontaxable recovery of basis.

B's basis in the land is $2,500,000 from the date of sale, whether S uses the installment method or elects out.

A. Standard Installment Sale

In a standard installment sale with interest on the entire balance paid with each principal payment, the portion of each payment that is gain remains constant, but the amounts of total payments and of interest are greater in the earlier years.

Example 2: Following the sale described in Example 1, S collects all principal and interest payments on the $600,000 note. The following schedule shows the amount, character and timing of the income reported by S under the installment method:

Year	Total Payments	Basis	Capital Gains	Interest
1989[237]	$50,000	-0-	$50,000	-0-
1990	150,000	-0-	150,000	-0-
1991	110,000	-0-	50,000	$60,000
1992	105,000	-0-	50,000	55,000
1993	100,000	-0-	50,000	50,000
1994	95,000	-0-	50,000	45,000
1995	90,000	-0-	50,000	40,000
1996	85,000	-0-	50,000	35,000
1997	80,000	-0-	50,000	30,000
1998	75,000	-0-	50,000	25,000
1999	70,000	-0-	50,000	20,000
2000	65,000	-0-	50,000	15,000
2001	60,000	-0-	50,000	10,000
2002	55,000	-0-	50,000	5,000
Totals	$1,190,000	-0-	$800,000	$390,000

In this and the following examples, the gain is labeled capital gain for convenience, to distinguish it from the interest income (or in private annuity sales, the annuity income). If the family business or financial assets transferred are not capital assets, the gain may be ordinary income. In some cases the assets transferred may not qualify for the installment method.[238]

B. Installment Sale with Level Annual Payments

Generally, interest is reported as it financially accrues.[239] Accordingly, the annual payments for a deferred payment sale with level principal payments decrease each year as the unpaid balance, and the interest accruing on it, decline.

This type of installment sale is referred to as a "decreasing payment" obligation. The selling senior family member may prefer level annual payments over the term of the note. This type of installment sale is called a "level payment" obligation. Residential mortgages are examples of level payment obligations. Although the younger generation buyer's obligation is, in effect, equivalent to guaranteed annuity for a fixed term, it is not an annuity subject to annuity treatment under § 72 for purposes of the OID and unstated interest rules.[240] It is not dependent on anyone's life nor is it issued by an insurance company.

Since the value of this level payment obligation is the same as in a decreasing payment sale, the realized gain on the sale is the same. It is a self-amortizing installment obligation under the OID rules[241] that does not involve OID or unstated interest as long as the stated interest rate used to determine the payments is at least equal to the AFR.[242] Nevertheless, the reporting of interest resembles a mortgage amortization table or an OID computation, with an increasing portion of each subsequent payment treated as a principal payment on the note. The gross profit ratio is applied to the principal payments received each year. The total amount of the payments and interest is greater than with level principal payments because the principal is amortized more slowly.

Example 3: The facts are the same as in Examples 1 and 2, but B agrees to pay the $600,000 balance over 12 years in level annual payments. In determining the level annual payment necessary to purchase an asset worth $600,000 at a 10% rate of interest over a 12-year term, the factor is 6.8137.[243] Therefore, the annual payment is $88,058 per year for 12 years ($600,000 divided by 6.8137). This produces a deferred payment obligation (using a 10% discount rate) with a present value of $600,000. S's amount realized is $2,500,000 (the $150,000 cash, the $1,750,000 mortgage and the $600,000 value of the level payment obligation). S's realized gain is the same $800,000 as for a decreasing payment obligation. For purposes of reporting gain under the installment method, the gross profit ratio is 100% because the liability transferred exceeds the basis of the property transferred.

The following schedule shows the amount, character and timing of the income reported by S:

Year	Total Payments Received	Capital Gain[244]	Interest
1989[245]	$ 50,000	$ 50,000	-0-
1990	150,000	150,000	-0-
1991	88,058	28,058	$ 60,000
1992	88,058	30,864	57,194
1993	88,058	33,950	54,108
1994	88,058	37,345	50,713
1995	88,058	41,080	46,978
1996	88,058	45,188	42,870
1997	88,058	49,707	38,351
1998	88,058	54,677	33,381
1999	88,058	60,145	27,913
2000	88,058	66,160	21,898
2001	88,058	72,775	15,283
2002	88,058	80,781	7,277
TOTALS	$1,256,696	$800,000	$456,696

A comparison of the financial consequences of the two types of installment sales shows that the level payment approach results in additional payments of $66,696 over the 1 2-year term. This additional amount is interest and is attributable to the fact that the level payment does not amortize the principal on the loan as quickly as does the decreasing payment illustrated in Example 2. The outstanding principal during the term of the note for both payment arrangements is as follows:

Principal Balance on the Note

	Decreasing Payments Example 2	Level Payments Example 3
1990	$600,000	$600,000
1991	550,000	571,942
1992	500,000	541,078
1993	450,000	507,128
1994	400,000	469,783
1995	350,000	428,703
1996	300,000	383,516
1997	250,000	333,810
1998	200,000	279,133
1999	150,000	218,988
2000	100,000	152,829
2001	50,000	80,780
2002	-0-	-0-

Interest Income Reported

	Decreasing Payments Example 2	Level Payments Example 3
1990	$60,000	$60,000
1991	55,000	57,194
1992	50,000	54,108
1993	45,000	50,713
1994	40,000	46,978
1995	35,000	42,870
1996	30,000	38,351
1997	25,000	33,381
1998	20,000	27,913
1999	15,000	21,899
2000	10,000	15,283
2001	5,000	7,277
2002	-0-	-0-
Totals	$390,000	$456,696

The choice of deferred payment arrangement depends on the financial needs of the parties. Although the level payment arrangement defers more of the income until the later years, it does not provide as large an annual payment for the earlier years of the term. In Example 3, the income reported for 1992 by the selling senior family member using a decreasing payment obligation totals $105,000 ($55,000 interest and $50,000 gain), while a selling senior family member using a level payment obligation reports only $88,058 of income for 1992 ($57,294 interest and $30,864 gain).

Terms of Sale

Although the installment method is available even when the younger generation buyer's obligations are secured, [246] certain forms of security can convert the buyer's obligation into a current payment. Specifically, security in the form of a cash equivalent, such as a certificate of deposit, loses the deferral privilege.[247] The same is true for any form of escrow.[248] Later substitution of an escrow or cash equivalent terminates the deferral for a previously qualified installment sale.[249] On the other hand, a standby letter of credit is permissible security.[250] Thus, as a practical matter, when security other than the property sold is needed, a qualifying standby letter of credit should be used.

A selling senior family member may have suspended passive losses, for example, losses of an S corporation owned by a shareholder who does not materially participate or passive losses that were suspended when an activity was contributed in a § 351 transaction.[251]. A sale reported under the installment method is not a complete disposition that permits immediate deduction of suspended passive losses.[252] Instead, the suspended passive losses are deducted as gain is recognized.[253] By a parity of reasoning, losses suspended under the at-risk rules[254] should be deductible only as gain is recognized.[255] Losses of a partnership or S corporation that have been suspended because the selling senior family member's basis was not sufficient,[256] do not become deductible at the time of disposition. The sale does not provide the requisite basis. This is not inappropriate, since if deduction of the loss is taken, basis in the shares is reduced,[257] and gain on the sale is equivalently larger.

Liabilities Transferred

Liabilities relating to shares in a family corporation may include purchase money indebtedness, funds borrowed by the shareholder to contribute to the corporation,[258] or other liabilities related to the corporate business,[259] that may be transferred at the time of the sale.[260] Any transfer to the family buyer of obligations incurred by the selling shareholder in connection with the sale, such as any of the seller's legal or accounting fees, is a payment, and does not receive the benefit of being deducted in determining the contract price.[261] Similarly, any borrowing immediately before the sale to take advantage of the application of liabilities first against basis, is a sham.[262] Thus, the selling senior family member cannot receive tax-free cash in the transaction by borrowing immediately before the sale. Cancellation of any obligation owed by the selling shareholder to the family buyer is a payment rather than transfer of a liability.[263]

Any transfer of liabilities, whether recourse or nonrecourse, is part of the purchase price. This means that the liabilities transferred are part of the amount realized by the selling senior family member, and part of the basis for the buyer.[264] There is some dispute whether a recourse liability is transferred if the selling senior family member remains primarily or secondarily liable. The IRS takes the position that a liability is transferred when the buyer agrees to pay it even if the seller is not released.[265] The courts have been more reluctant to ignore retained liability, and have occasionally allowed the seller to avoid the consequences of the transfer of the liability at least at the time of the asset transfer.[266] Although the cases cannot be completely reconciled, the better view is that a liability is transferred unless the transferor expressly agrees to make the required payments as in a wrap-around note.[267]

When a wrap-around note is used to avoid immediate gain recognition for the selling senior family member, the younger generation buyer obviously wants to be sure that the wrapped indebtedness will be paid when due and may seek to make a portion of the payments on account of the wrap note directly to the creditor. If the buyer is successful, the wrapped indebtedness probably is transferred despite the form of the transaction.[268]

> **Example 4:** The facts are the same as in Example 2. S may avoid the gain on the excess of the liability over basis in the year of sale by agreeing to pay off the mortgage himself. He receives the $150,000 downpayment and a wrap-around note for the entire $2,350,000 balance. The tax results at the time of sale are the same as for a sale of unmortgaged shares. The gross profit percentage is 32%0 ($800,0000/ $2,500,000). Accordingly, S reports 3270 of the $ 150,000 downpayment (X48,000) and 3270 of each subsequent principal payment on the wrap-around note as gain, even though he is obligated to use a portion of the payments (or other funds) to pay the mortgage.

If S and B agree that B will pay directly to the mortgagee the amount of the mortgage payments, to assure B that these payments are made, the wrap-around note is likely to be disregarded and the mortgage treated as transferred, with the tax results described in Example 2.

A selling senior family member who does not account for the liability at the time of the transfer has additional tax consequences if the younger generation buyer subsequently pays the liability.[269] In most cases, the buyer's payment is an additional payment on account of the sale price, treated as a payment on account of the installment sale,[270] unless the selling senior family member has elected out or is not eligible.[271] A portion of the younger generation buyer's liability payment is likely to be interest under the OID and unstated interest rules.[272]

Obligations that represent accrued expenses that have been deducted by the selling senior family member are also part of amount realized.[273] The transfer should not invoke the tax-benefit doctrine, which treats a previously deducted item as ordinary income when an event that is fundamentally inconsistent with the deduction occurs.[274]

Certain of the obligations transferred may not have been deducted or otherwise taken into account for tax purposes by the selling family member by the time of the transfer.[275] These include such items as accounts payable and accrued expenses of cash basis taxpayers, and items where deduction is subject to delay under §§ 404(a) (5) or (d),276 461 (h),277 or similar provisions.[278] When these payables or similar obligations are transferred in connection with a family sale, the obligations should be included in the amount realized.

When obligations that have not been deducted are transferred, the corollary of including them in the amount realized is that the selling senior family member should be entitled to a deduction at the time of transfer,[279] unless the deduction is delayed under one of the special provisions described above. Such obligations cannot be deducted by the buyer when paid.[280] When the obligation is fixed, the delay in the selling family members deduction may cause a similar delay inclusion in the amount realized.[281] There is no reason for a similar delay in including the liability in the buyer's basis. If the deduction is delayed and the selling family member dies, the deduction may be lost,[282] but it should be a deduction in respect of a decedent under § 691 (b).

Example 5(a): The facts are the same as in Example 2 except that the mortgage includes $25,000 of accrued interest. The transfer of the accrued interest is as much a transfer of a liability as the transfer of the principal obligation. S is entitled to deduct the accrued interest at the time of the sale without regard to when B makes the mortgage payment. B cannot deduct the interest when he makes the payment. Instead, B's basis in the land includes the entire $1,725,000 principal plus the $25,0000 accrued interest on the mortgage.

Example 5(b): The facts are the same as in Example 5(a) except that the $1,750,000 liabilities transferred includes an obligation to make annual payments of $5,000 per year for five years (plus interest) to a slip-and-fall victim. The $25,000 liability may not be deducted by S or included in basis by B at the time of the transfer, but only when paid to the victim. S apparently includes the $5,000 payments in his amount realized and the interest payments in his income when B makes the payments. S should be entitled to deduct the damages and interest at the same time. B cannot deduct either the damages or the interest. Instead, the $25,000 liability should be part of his basis from the time of the sale.

Disposition

Although the statutory language "[i]f an installment note is . . . otherwise disposed of," generally requires gain recognition on any disposition of an installment obligation,[283] this does not apply when the installment obligation is transferred by the selling family shareholder to a controlled corporation in a transaction under § 351, or in certain other transfers in nonrecognition transactions with a transferred basis. Instead, the deferred installment gain is transferred and reported by the transferee when the obligation is collected or otherwise disposed of.[284] If a family shareholder who made an installment sale during lifetime dies, transmission of the obligation at death does not accelerate the unreported gain. Instead, the unrealized gain in the installment obligation is shifted to and eventually reported by her estate or other successor as income in respect of a decedent that does not receive a step-up in basis at death.[285] A gift, on the other hand, is a disposition.

If the senior family member's estate uses the note to satisfy an obligation of the estate, such as to fund a pecuniary formula marital deduction bequest, an early disposition occurs, because the estate is treated as having sold the note and the previously deferred gain is immediately reported in estate income.[286] The amount of gain accelerated upon an early disposition is (a) either (i) the amount realized if the note is sold or used to satisfy an obligation, or (ii) the value of the note, if transferred for no consideration, over (b) the selling senior family member's remaining unrecovered basis.[287] Unrecovered basis is the excess of the face amount of the note over the income that would have been reported if all remaining payments under the note had been received by the selling senior family member.[288]

If the aggregate sales price for the selling family member's shares is more than $150,000, the taxpayer loses the right to defer gain under the installment method for sales made beginning in 1989, to the extent that she borrows against the family buyer's installment obligations, and pledges the installment obligations as security for the borrowing.[289] The provision applies to senior family members who sell family business or financial assets for more than $150,000, even if the installment portion of the price is less than $ 150,000, and may apply to selling senior family members who receive less than $150,000 for their assets when the total price for property sold in a single transaction exceeds $150,000.[290] The theory is that since the taxpayer has the cash, she should pay the tax. This provision is triggered only if the taxpayer gives a direct security interest in the installment obligation. Accordingly, in the case of a selling senior family member who is able to borrow on an unsecured basis, albeit indirectly as a result of an improved balance sheet that includes the installment obligation, the tax is not accelerated. When the acceleration provision applies, the loan proceeds are treated as payments on the installment obligation, with the appropriate gross profit percentage of the loan proceeds treated as gain. Subsequent collections on the installment obligation are tax-free until they equal the amount of borrowing previously treated as payment.

> **Example 6:** The facts are the same as in Example 2. In 1992 after collecting two payments, S pledges B's note as security for a $200,000 loan. She is treated as having received payments of $200,000 and immediately reports gain of $200,000. She does not, however, report any additional gain when he receives the next $200,000 in principal payments on B's note.

A. Disposition by Gift

A gift of an installment obligations is an early disposition of the note within the meaning of § 453B(a).[291] On the other hand, the transfer of the note to an irrevocable grantor trust on which the seller-grantor remains taxable on trust income under the grantor trust rules[292] is not a disposition; the grantor is treated as the owner of the property in trust, and since one cannot make a gift to himself, no early disposition occurs.[293]

The fair market value of the obligation, not its face amount, determines the amount of gain to be accelerated upon the gift. As long as the donee is not the obligor on the note, so that the note continues in existence, it is irrelevant whether the donee is related (in the tax sense) to the selling senior family member.

> **Example 7(a):** The facts are the same as in Example 2. In 1996, when $300,000 of principal remains outstanding, S gives it to his son, as a gift. The donee-son is not B, the obligor on the note. Thereafter, the son collects all remaining payments on the note. At the time of the gift the note was worth $300,000. Since S's basis in the note is zero, S must report the remaining $300,000 capital gain at the time of the gift.
>
> Accordingly, the son's basis in the note is $300,000. Therefore, the son only reports the stated interest upon collection of the payments under the note.
>
> **Example 7(b):** The fact are the same as in Example 7(a) except that at the time of the gift the note is worth only $280,000. S must report a $280,000 capital gain at the time of the gift. His son's basis in the note is only $280,000. Therefore, the son reports not only the interest income, but also treats the additional $20,000 of principal on the note as income.
>
> The note is a market discount debt obligation in the hands of the son because he has, in effect, acquired it at a "tax cost" less than its face amount.[294] Therefore, the $20,000 represents market

discount.[295] All $20,000 is ordinary income,296 and the son reports $20,000 in income ratably as the annual payments on the note are received. In effect, $20,000 of capital gain is converted into ordinary income.

If there is a gift of a note to the obligor, the obligation becomes unenforceable because of the state law doctrine of merger. A gift of the note to the obligor is the functional equivalent of a cancellation.[297] If an installment obligation is cancelled, it is treated as an early disposition by gift, with one difference.[298] If the buyer and the seller are related parties,[299] the fair market value of the cancelled obligation is treated as at least equal to the face amount for purposes of determining the accelerated gain recognized on the disposition.[300] If the buyer and seller are not related parties, such as a son-in law, then the actual value of the note is used in computing the amount of gain accelerated under the early disposition rule.

Example 8: The facts are the same as in Example 2 except that B, the buyer and obligor on the note, is S's son. In 1996, when $300,000 of principal remains outstanding on the note, S gives it to B as a gift, thereby effectuating a cancellation on the note. At the time of the gift, the value of the note is only $280,000. B is a related party within the definition contained in § 267(c)(4). Since S's basis in the note is zero (all basis was, in effect, absorbed by the outstanding mortgage), and its value is deemed to be the $300,000 face amount, S must report a $300,000 capital gain in 1996. The amount of the gift for purposes of the gift tax is based on the actual value of the note, not its face amount. B's basis in the property he purchased from S remains $2,500,000.

In either case, the actual fair market value of the note, not its principal amount, should determine the amount of the gift for gift tax purposes. The value used to determine the gift tax should be the fair market value of the younger generation buyer's debt obligation using market interest rates, and not the AFR at the time of the sale or the time of death. Although § 483 states that it applies for all purposes of the Internal Revenue Code and § 1272 contains similar language that implicitly applies to § 1274, these provisions apply to the initial sale transaction and not to subsequent transfers. Accordingly, the logic of the Ballard case,[301] should not apply.[302] G.C.M. 39503 recognizes that the income and estate results are not required to be consistent when it concludes that no amount is included in the gross estate for a SCIN, but that the deferred gain is reported as income in respect of a decedent.[303]

A corollary of using the lower market value in determining both the amount of the gift and the amount realized when the seller and buyer are not related parties, should be that the buyer's basis is adjusted for the difference. The message of the Tufts case[304] and Reg. § 1.1001-2 is that the amount of a liability that has been taken into account for tax purposes must be accounted for when the liability is discharged. If the amount of the gift is the fair market value of the note, only that amount is entitled to exclusion under § 102. The balance is discharge of indebtedness that must be income or purchase price adjustment for a solvent donee-purchaser.[305]

Example 9: The facts are the same as in Example 8 except that B, the obligor, is S's son-in-law, and the gift is made to B. The 280,000 market value of the note determines the income reported by S upon the early disposition. Therefore, S must recognize a $280,000 capital gain in 1996. B's original $2,500,000 basis in the property he purchased is reduced by $20,000 under § 108(e)(5).

By treating the gift as only $280,000 for income tax purposes, the remaining $20,000 on the note is discharge of indebtedness income under § 61(a)(12).3°6 Since the obligor on the note is also the buyer of the property, § 108(e)(5) treats the $20,000 cancellation on the debt as a purchase price adjustment. This treatment is necessary in order to maintain tax symmetry between B and S. If S does not have to report $20,000 of his gain, B certainly should not get a basis with respect to that portion of the liability that initially gave rise to that unreported gain.

The only time a gift of an installment obligation does not trigger the early disposition rule is if it is a gift to a spouse while married or incident to a divorce.[307] Instead, the seller's spouse, or ex-spouse, steps into his shoes, and reports the remaining capital gain under the installment method. Even if the seller sells his installment note to his spouse for adequate consideration, the early disposition rule does not apply because, under § 1041, a sale to a spouse is entitled to nonrecognition.[308]

B. Disposition by Bequest

Unpaid amounts due on an installment note arising from a fixed payment installment sale are included in the gross estate of the selling senior family member.

1. Transfer of the note

A bequest of an installment obligation to a beneficiary who continues to hold and collect on the deceased selling senior family member's note is not an early disposition.[309] Instead, the beneficiary steps into the shoes of the deceased seller, and continues to report the gain and interest in the same manner that the seller would have had he survived.[310] Although the value of the note is included in the selling senior family member's gross estate under § 2033 as property owned at the time of his death, there is no tax-free step-up in basis under § 1014(a) for the deferred capital gain. The gain deferred under the installment method is income in respect of a decedent.[311] Similarly on a transfer of the installment obligation by the estate to a specific or residuary beneficiary, the estate does not recognize income, but the beneficiary does when the obligation is collected or disposed of.[312] When the beneficiary or other successor reports the capital gain upon the receipt of each installment payment, he is eligible for an income tax deduction under § 691(c), for the estate tax attributable to the unrealized gain in the selling senior family member's gross estate. The § 691(c) deduction may not be as favorable as an estate tax deduction of the income tax on the gain, as a debt of the senior family member's estate, that would apply if the gain is reported on the decedent's final return.[313]

As for a gift of the installment obligation, the value of the note should be determined under normal valuation principles and not fixed by the AFR either at the time of sale or the time of death.[314] The amount of the deduction for the estate tax attributable to the gain under § 691(c) should similarly be based on the amount actually included in the gross estate, not the principal amount.[315] Any difference between the amount included in the gross estate and the principal of the younger generation buyer's debt obligation should not be market discount. The difference between the principal amount and the selling senior family member's basis of the obligation is excluded from the definition of market discount, because it arose at original issue as part of the installment sale, and the estate or other successor acquires the obligation with a transferred basis.[316]

> **Example 10:** The facts are the same as in Example 2. S dies in 1996 when the unpaid principal balance of the obligation is $300,000. At the date of S's death the AFR is 12%, which would give the notes a present value of $284,262, but a realistic interest rate for B's debt obligation is 15%, which gives the note a present value of $263,074. The amount that should be included in S's gross estate for B's debt obligation is $263,074, the realistic value. Nevertheless, the entire $300,000 gain is reported by his estate or other successor as the payments are made. The deduction under § 691 (c) should be computed using the amount actually included in the gross estate.

A transfer of the installment obligation by either the selling senior family member's estate or the devisee can trigger the early disposition rule.[317] For example, an early disposition can occur if the estate sells the note to raise funds to pay estate expenses or to fund pecuniary bequests.[318] A distribution to the residuary devisee is not an early disposition by the estate.[319]

2. Cancellation of the obligation

If the selling senior family member cancels the note by a clause in his will or indirectly effects a cancellation because he bequeaths the note to the obligor, the fair market value of the note is still property included in the selling senior family member's gross estate.[320] A cancellation of a note on the death of the seller is, however, a disposition that results in the immediate reporting of gain previously deferred under the installment method.[321]

In Rev. Rul. 86-72,322 the IRS reached the questionable result that the accelerated gain upon the cancellation of a SCIN is reported by the estate.[323] A better view is that the accelerated gain should be reported on the selling senior family member's final income tax return.[324] Under the IRS view, the "transfer" treated as an early disposition within the context of § 691(a)(2) does not automatically occur at the moment of death. The IRS has ruled that the triggering transfer, and related recognition of gain, does not occur until the earlier of (i) the executor's assent to the distribution of the notes under state law, (ii) the cancellation of the notes by the executor under state law, (iii) the note becoming unenforceable, or (iv) termination of the estate administration for Federal income tax purposes.[325] In other words, state law controls when the obligations are transferred for purposes of determining when the taxable early disposition has occurred.

Example 11: S's residuary estate passes to her child, B, including installment notes owed her by B. Gain to the estate under § 691(a)(2) is reported in the year in which the notes are actually distributed to B or otherwise cancelled.[326]

If the obligor under the cancelled note is related to the decedent-seller and the value of the note is less than its face amount, then the amount (fair market value) included in the gross estate for estate tax purposes is irrelevant for income tax purposes. Instead, for purposes of determining the gain reported by the estate, the face amount of the note is determinative.[327] Thus, although the theory is different, the amount of gain recognized is the same as for a gift.

Example 12(a): The facts are the same as in Example 2. S dies in 1996 when $300,000 remains unpaid on the note. S leaves this note as a specific bequest to B, the obligor on the note, who is also his son. At the date of death the value of the note in S's gross estate is $280,000. S's basis in the note is zero. While alive S already reported $500,000 of the $800,000 gain realized upon the sale.[328] The Internal Revenue Service takes the position that S's estate is treated as having transferred the note for $300,000 under § 691(a)(2), and that the estate must report the remaining $300,000 of capital gain on its fiduciary income tax return. A better view, supported by the decision in the Frane case at notes 181 and 324, is that the gain should be reported on S's final income tax return. B's basis in the land purchased from his father should remain at $2,500,000, on the ground that the termination of the notes is a bequest, even though S only pays $2,200,000.

Example 12(b): The facts are the same as in Example 12(a) except that B, the obligor-buyer is, S's son-in-law. S's estate must report $280,000 of capital gain upon the effective cancellation of the note. B's $2,500,000 basis in the property he purchased by issuing his own note is reduced by $20,000 under § 108(e)(5).[329]

When the fair market value of the installment obligation is more than its face amount, the selling senior family member's estate recognizes gain measured by the value of the note.[330] The younger generation buyer should be able to increase his basis in the property purchased by the excess of value over face amount.[331] If the buyer whose note is cancelled by the selling senior family member's will is not a related party within the statutory definition, for example, a son-in-law, the fair market value of the note is used to determine the gain reported by the estate.[332] The rule that the value of the note is not less than its face amount only applies when the buyer is related to the selling senior family member.[333] The amount reported as income in respect of a decedent by the successor is the excess of value over the decedent's basis in the note.[334]

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Interest Charged by the Government

If the sale price for the family business or other assets exceeds $5,000,000, or the aggregate of different sales for the year exceed this $5,000,000 threshold, the selling senior family member incurs an interest charge on the deferred portion of the taxes that would have been incurred had the gain on the sale not been deferred.[335] Interest is required to be paid only if the aggregate sales price received by the senior family member for the property exceeds $150,000 and the senior family member has total installment obligations in excess of $5,000,000.[336] Thus, whether interest is required depends on both the amount realized by the selling senior family member (which only needs to exceed $150,000), and whether the taxpayer has deferred gain on other installment sales that brings his total outstanding installment obligations to more than $5,000,000. Interest is charged only on tax allocable to the portion of the gain attributable to the excess of the installment obligation over $5,000,000, but once an installment obligation becomes subject to the interest charge, it remains subject, even after the taxpayer's balance of installment receivables drops below $5,000,000.[337] The interest on the tax, computed at the top rate applicable to the year of computation,[338] is nondeductible personal interest.[339]

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Interest Deduction

Interest paid by individual family buyers for shares of a family C corporation is investment interest deductible within the applicable limits.[340] The character of interest paid by a noncorporate family buyer for shares in an S corporation or for an interest in a partnership is determined by an allocation based on the nature of the entity's assets as business assets, investment assets, etc.[341] If a family C corporation is conducting a trade or business, this rule may make it advisable to convert it to an S corporation prior to the sale to avoid the investment interest limits.[342] Interest paid by a family buyer that is a C corporation under a sale or redemption agreement should be fully deductible as business interest.[343]

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Exclusions

There is no installment reporting for a loss.[393] Sales of inventory assets, depreciation recapture assets and marketable securities, and sales of depreciable property between related parties do not qualify for installment sale treatment.[394] Nor do dispositions by dealers in personal property or real property (with an exception for dispositions of farm property, unimproved residential lots and time shares) qualify.[395] Although not expressly excluded, it is likely that tax benefit items are also not eligible because the sale is "fundamentally inconsistent" with the prior deduction that gives rise to the tax benefit problem.[396]

Reporting the recapture income increases the selling senior family member's basis in the younger generation buyer's debt obligation for purposes of determining the gross profit ratio under the installment method for the remainder of the gain. When the younger generation buyer takes over the selling senior family member's liabilities in a deferred payment sale of an asset with potential depreciation recapture income, the increase in the seller's basis resulting from the immediate reporting of the recapture income may reduce or even eliminate the "deemed" payment of cash that occurs when the liability transferred exceeds the seller's basis in the property sold.

> **Example 23**: The facts are the same as in Example 2 except that the asset sold is improved real estate depreciated using an accelerated method. (The building was acquired by S prior to 1987.) The real estate has $125,000 of depreciation recapture.
>
> S must report, as gain on the sale, $125,000 of ordinary income in 1989, the year of the sale. For purposes of determining the gross profit ratio applied to "all" payments received under the sales contract, S's basis in the asset is increased by the $125,000 of recapture income that was not eligible to be deferred under the installment method. With a redetermined basis of $1,825,000, the gross profit is now $675,000. The entire $1,750,000 mortgage reduces the $2,500,000 sales price to arrive at a $750,000 contract price. Since the mortgage does not exceed S's basis, as redetermined, no fictional payment of cash occurs. The resulting 90% gross profit ratio ($675,000/$750,000) is applied to the $150,000 down payment and $600,000 of principal payments on the note so that the $675,000 of the § 1231 or capital gain realized on the sale is reported under the installment method. The total gain on the sale remains at $800,000. The timing of this gain has changed because $125,000 of the gain is not eligible for the installment method.

¶ 308 Private Annuity Sale Obligations

Tax Treatment of Annuities in General

An individual who saves by depositing money in a bank savings account must report the interest earned each year under the doctrine of constructive receipt even if no withdrawals are made. Even an individual who buys a long-term certificate of deposit where early withdrawal incurs a penalty must report interest as earned under the OID rules.[406]

Example 25: A deposits $2,460.80 in a bank savings account on January 1, 1990. The bank pays 10.6% annual interest. A intends to withdraw $ 1,000 annually for the next three years beginning on December 31, 1990. The following illustrates the interest income earned each year:

Deposit on January 1, 1990	$2,461
Interest at 10.6% for 1990	+ 261
Withdrawal on December 31, 1990	-1,000
Balance on January 1, 1991	$1,722
Interest at 10.6% for 1991	+ 182
Withdrawal on December 31, 1991	-1,000
Balance on January 1, 1992	$ 904
Interest at 10.6% for 1992	+ 96
Withdrawal on December 31, 1992	-1,000
Balance	-0-

When the individual saves by purchasing an annuity, the implicit interest in the internal buildup in the policy is not taxed currently.[407] The doctrine of constructive receipt does not apply because the annuitant does not have a right to withdraw as the interest is earned.

The basic mechanism for taxing annuities is to allocate each payment between basis recovery and income on a straight line basis by use of the "exclusion ratio,"[408] the fraction determined by dividing the annuitant's "investment in the contract"[409] by the "expected return,"[410] that is, the total of the undiscounted payments to be made.[411] If all payments to be made are not subject to any contingencies, then the guaranteed number of payments is used to determine the expected return.[412] If there is a contingency, such as payments to be made for the rest of the annuitant's life, then the life expectancy of the annuitant at the "annuity starting date" is the multiple used to determine the expected return.[413] The annuity starting date is the date in the future the annuity payments are to commence.[414] The life expectancy multiples to be used in determining the expected return are prescribed in the Regulations under § 72.[415]

Example 26: B purchases an annuity on January 1, 1990, for $2,461, the present value of $1,000 a year for three years at 10.6%, the § 7520 rate. This annuity contract provides that B will receive $1,000 annually for three years, the first payment to be made on December 31, 1990.

The "investment in the contract" is $2,461. The "expected return" is $3,000. The "exclusion ratio" is 82.03%. Therefore, B must report $179 as income every time he receives a $1,000 annuity payment.

As Example 26 indicates, the annuity reporting rules do not change the aggregate amount of interest income reported. But the timing rules for annuities have a deferral advantage.

Table A

Year	Annuity Income	Interest Income
1990	$180	$261
1991	180	183
1992	180	96
Total	$540	$540

Private Annuity Sales

The traditional tax treatment of private annuity sales developed before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent payment sales,[416] presumably including those with payments in the form of an annuity.

The following facts will be used to illustrate the tax consequences of the private annuity sale and SCIN examples in the balance of Part II.

Example 27: S is 70 years old. On April 1, 1990, S sells the stock in a family business corporation to B for $ 1,000,000. S's basis for the stock is $200,000 and it is worth $1,000,000.

Under Reg. § 1.72-9, Table V, a 70-year old has a life expectancy of 16.0 years. However, the estate and gift tax valuation tables in Reg. § 20.2031-7(f) and the tables in the Alpha Volume use 10.8 years as the life expectancy of a 70year old.

As announced in Rev. Rul. 90-28,[418] the AFR annual interest rates for April, 1990 are:

Mid-term AFR	8.75%
Long-term AFR	8.75%
120% AFR, the § 7520 rate	10.60%

A. Installment Sale

For comparison purposes, we will first illustrate an installment sale in which the younger generation buyer makes a level annual payment over a fixed term. When all payments are fixed, the deferred payment arrangement is an installment sale governed by the installment reporting rules under § 453. The 16-year term for the payments corresponds to the selling senior family member's 16-year life expectancy used in the income tax tables.[419]

As discussed in § 302.7 G, the higher interest rate required under § 7520 (120% x midterm AFR), if applicable, can result in a deferred payment obligation having a lower value for gift tax purposes than the principal amount of the debt obligation determined under the OID and unstated interest rules under § 1274(d)(1) (the AFR).

Example 28: The facts are the same as in Example 27. On April 1, 1990, S sells his family business shares, with a basis of $200,000, to B for $1,000,000. S agrees to finance the entire $1,000,000 purchase price over 16 years. In order to avoid any imputed interest issues, B will pay interest at 8.8%. A gross profit ratio of 80% is applied to each principal payment to determine the amount of capital gain reported under the installment method.

(a) *Decreasing Payment Obligation.* One form of installment sale requires B to pay $62,500 annually for 16 years, plus 8.8,% interest on the unpaid balance. The first annual payment (principal and interest) is $150,000 ($62,500 principal and $87,500 interest). The annual payment decreases each year, and finally is only $67,969 ($62,500 principal and $5,469 interest) at the end of the 16-year term.

(b) *Level Payment Obligation.* An alternative is a level annual payment over the entire 16-year term of the loan. Using the actuarial tables for 8.8% interest, the present value of $1.00 annually for 16 years is 8.4161. Therefore, the annual payment is $118,820 ($1,000,000 divided by 8.4161).

For gift tax purposes, the present value of an obligation to pay $118,820 annually for 16 years would be discounted at 10.6% under § 7520, if it is applicable. Therefore, the value of B's obligation would beonly$897,327 ($118,820 X 7.5520), resulting in a potential gift of $102,673.[420]

For income tax purposes, B's basis is $1,000,000 because § 1274 using the AFR, treats $1,000,000 as both the imputed and the stated principal amount of B's obligation.

The amount, character and timing of S's income upon receipt of each annual payment, using an 80% gross profit ratio for each principal payment, is:

Year	*Payment*	*Basis*	*Capital Gain*	*Interest*
4-1-91	$ 118,820	$ 6,164	$ 24,656	$ 88,000
4-1-92	118,820	6,707	26,826	85,287
4-1-93	118,820	7,297	29,186	82,337
4-1-94	118,820	7,939	31,755	79,126
4-1-95	118,820	8,632	34,528	75,660
4-1-96	118,820	9,392	37,566	71,862
4-1-97	118,820	10,218	40,872	67,730
4-1-98	118,820	11,117	44,469	63,234
4-1-99	118,820	12,096	48,382	58,342
4-1-00	118,820	13,160	52,640	53,020
4-1-01	118,820	14,318	57,272	47,230
4-1-02	118,820	15,578	62,312	40,930
4-1-03	118,820	16,949	67,796	34,075
4-1-04	118,820	18,441	73,762	26,617
4-1-05	118,820	20,063	80,253	18,504
4-1-06	118,820	21,829	87,315	9,676
	$1,901,120	$200,000	$800,000	$901,120

As the above table indicates, the 80% gross profit ratio is applied each year to an increasing principal payment. And, as the outstanding principal balance is reduced each year, the interest portion of each succeeding payment decreases. If any of the seller-provided financing is later cancelled, the amount of the cancellation is a purchase price adjustment that reduces the buyer's basis.[421]

B. Traditional Treatment

When contingent payment sales did not qualify as installment sales, the IRS permitted deferred reporting of certain contingent sales under the annuity rules.[422]

If a private annuity sale is governed by the annuity rules, the younger generation buyer's basis initially equals the value of the private annuity obligation, but changes depending upon the amount the buyer pays under the annuity arrangement.[423]

This "tentative basis" is finally determined only after the selling senior family member dies, and all payments are finally fixed. The younger generation buyer's "final" basis is equal to the aggregate of all annuity payments made to the seller.

Once the total of all payments made exceeds the tentative basis amount, each additional payment is added to the buyer's basis. The basis only becomes final when the payments cease. If the selling senior family member dies before the total of the annuity payments made equals the tentative basis amount, then the final basis is an amount equal to the payments actually made. If the younger generation buyer sells the family business or other financial assets before the selling senior family member's death, there is a split basis, with gain determined using the tentative basis, but loss allowed only to the extent the sale price is less than payments made.[424] All subsequent payments are loss, whether gain or loss was realized on the interim sale of the family business or other financial assets.

No interest is imputed for any annuity payment made by the younger generation buyer.[425] The effect is that the entire amount of each annuity payment made by the buyer is treated as a principal payment. The inability of the buyer to treat any portion of an annuity payment as interest expense requires the buyer to capitalize, as part of his basis, what is realistically an interest expense. Because the younger generation buyer cannot treat any portion of the annuity payment as interest expense, the total of the actual payments will exceed the tentative basis amount well before the selling senior family member reaches his actuarial life expectancy. Therefore, a younger generation buyer using a private annuity sale arrangement can expect to have a basis for an asset far greater than the amount he paid for it (i.e., greater than its value).

Another distortion is caused when the higher interest rates (120% of the AFR as mandated by § 7520) and shorter mortality assumptions found in the gift tax valuation tables under Reg. § 20.2031-7(f) and the Alpha Volume are used to calculate the annuity payments. The amount of each annuity payment will be larger than if the lower income tax interest rate and longer income tax mortality assumptions were used. Since Rev. Rul. 55-119 requires the use of the gift tax valuation tables,[426] the younger generation buyer can end up undertaking an obligation that has a value greater than the value of the property purchased as determined under the OID and unstated interest rules. Consequently, if the buyer lives to the longer actuarial life expectancy used in Reg. § 1.72-9, Table V, the buyer will end up paying far more for the property than it may be worth, with a resultant basis greater than its value.

> **Example 29**: The facts are the same as in Example 27. B, the buyer, agrees to pay S an annual annuity payment for the rest of the S's life. If the annual annuity payment is computed using the transfer tax tables in the Alpha Volume at 10.6%, the § 7520 rate, it is $161,363 ($1,000,000 divided by 6.1972).
>
> The investment in the contract is $200,000. The expected return is $2,581,811 ($161,363 X 16.0 year life expectancy of the income tax annuity tables). Therefore, the exclusion ratio is 7.75%0.[427]
>
> Assume that S dies in the year 2009. Under the § 72 annuity rules the amount, character and timing of S's income is:

Date	Payment	Basis	Capital Gains	Annuity Income
4-1-91	$ 161,363	$ 12,500	$ 50,000	$ 98,863
4-1-92	161,363	12,500	50,000	98,863
4-1-93	161,363	12,500	50,000	98,863
4-1-94	161,363	12,500	50,000	98,863
4-1-95	161,364	12,500	50,000	98,864
4-1-96	161,363	12,500	50,000	98,864
4-1-97	161,363	12,500	50,000	98,863
4-1-98	161,363	12,500	50,000	98,863
4-1-99	161,363	12,500	50,000	98,863
4-1-00	161,364	12,500	50,000	98,864
4-1-01	161,363	12,500	50,000	98,863
4-1-02	161,363	12,500	50,000	98,863
4-1-03	161,363	12,500	50,000	98,863
4-1-04	161,363	12,500	50,000	98,863
4-1-05	161,364	12,500	50,000	98,864
4-1-06[428]	161,363	12,500	50,000	98,863
4-1-07	161,363	-0-	-0-	161,363
4-1-08	161,363	-0-	-0-	161,363
4-1-09	161,363	-0-	-0-	161,363
Total	$3,065,900	$200,000	$800,000	$2,065,900

As illustrated in Example 30, the younger generation buyer's basis in a private annuity sale reported under the annuity rules exceeds the value of the property purchased far before the selling senior family member reaches the end of his actuarial life expectancy. This is because the buyer cannot deduct any portion of his annuity payments as interest expense, and because the transfer tax tables used in determining the annual annuity payments use shorter life expectancies and higher interest rates, thereby increasing the amount of the annual annuity payment that is required to avoid gift tax.

Example 30: B's tentative basis for the private annuity sale in Example 29 is $1,000,000, the present value of the annuity obligation using the transfer tax tables at 10.6%, the § 7520 rate. As the annuity payments are made, B's tentative and final basis is as follows:

Date	Annual Payment	Payments to Date	Tentative Basis [429]
4-1-91	$161,353	$161,363	$1,000,000
4-1-92	161,363	322,726	1,000,000
4-1-93	161,363	484,089	1,000,000
4-1-94	161,363	645,452	1,000,000
4-1-95	161,364	806,816	1,000,000
4-1-96	161,363	968,179	1,000,000
4-1-97[430]	161,363	1,129,542	1,129,542
4-1-98	161,363	1,290,905	1,290,905
4-1-99	161,363	1,452,268	1,452,268
4-1-00	161,363	1,613,632	1,613,632
4-1-01	161,363	1,774,995	1,774,995
4-1-02	161,363	1,936,358	1,936,358
4-1-03	161,363	2,097,731	2,097,731
4-1-04	161,363	2,259,084	2,259,082
4-1-05	161,364	2,420,448	2,420,448
4-1-06	161,363	2,581,821	2,581,821
4-1-07	161,363	2,743,174	2,743,174
4-1-08	161,363	2,904,537	2,904,537
4-1-09	161,363	3,065,900	3,065,907

Example 31: The facts are the same as in Example 30. The annual private annuity payment, using an 8.8% interest rate and a 16.0 year life expectancy, is $118,820. This is the same annual amount as when B's obligation is a fixed 16-year installment obligation.[451]

If the selling senior family member in a private annuity sale reported under the § 72 annuity rules dies before reaching his actuarial life expectancy, there is an unrecovered "investment in the contract." Presumably, the seller may deduct any unrecovered basis on his final income tax return under § 72(b)(3)(A). The character of the loss for unrecovered basis should be determined by reference to the character of the property sold, rather than being viewed as a loss in an independent annuity transaction.[432] Where the asset sold is a capital asset, the loss is a capital loss. Nevertheless, when the buyer in a private annuity sale is related to the seller, the loss provided an annuitant for unrecovered basis on premature death should not be disallowed under the related party rule of § 267(a)(1) because it is not part of the sale, but of the annuity transaction.[433]

Example 32: The facts are the same as in Example 30. If S dies at the end of the year 2000 at age 80, having received only 10 of the expected 16 annual payments, the remaining, unrecovered basis is $75,000. S is permitted to deduct $75,000 on his final income tax return. B's basis is finally determined to be $1,613,630, the aggregate of all payments made.

****

¶ 310 Self-Cancelling Installment Notes

When Used?

The major nontax difference between an installment sale, a private annuity sale and a SCIN is the payment period. In an installment sale, the payment period is fixed. The specified payments continue even if the selling senior family member dies before the end of the payment term. The payments cease at the end of the specified period, even if the seller is still alive. Thus the payment period may be more or less than needed to fund the selling senior family member's retirement. A private annuity sale shifts this actuarial risk to the younger family member buyer, but at the cost of an obligation to make payments that may exceed the value of the property. A SCIN seeks to split the difference in part, but leaves the selling senior family member at risk if the capital value accumulated during the maximum period does not provide adequate funds for the rest of his or her life. The higher payments needed for a SCIN to have an initial value equal to the value of the property may help make

Valuation of a SCIN

The difference in payment terms between a SCIN and a fixed period installment sale on the one hand, and a private annuity sale on the other, requires use of different discount factors that take into account not only the maximum term and the life expectancy but the actuarial relation between them. The determination is complicated by the different life expectancy and discount rates used for income tax purposes under § 72 and the AFR than those used for transfer tax purposes and § 7520. The IRS has published a simplified method for determining the relevant divisor to be used in determining the annual payment for a SCIN.[505]

Example 43: The facts are the same as in Example 27. Several additional factors must be added to take into account the mixed nature of a SCIN.

The present value of a payment of $1 annually for the life of a 70-year old or 16 years, whichever is less, is:

Under the income tax annuity tables and at 8.8%, the AFR	$7.4899
Under the income tax annuity tables and at 10.6%, the § 7520 rate	$6.3981
Under the transfer tax tables and at 8.8%, the AFR	$6.5083
Under the transfer tax tables and at 10.6%, the § 7520 rate	$5.9331

Accordingly, the annual level payment needed to pay the price of $1,000,000 is:

Under the income tax annuity tables and at 8.8%, the AFR	$133,512
Under the income tax annuity tables and at 10.6%, the § 7520 rate	§156,297
Under the transfer tax tables and at 8.8%, the AFR	$153,649
Under the transfer tax tables and at 10.6%, the § 7520 rate	$168,546

If a SCIN, computed using the transfer tax tables, is taxed under the annuity rules, the expected return is $2,140,533.62 ($168,545.95 x 12.7 years).[506]

Income Tax Treatment of a SCIN

The income tax treatment of a SCIN depends on whether it is classified as an installment sale or as a private annuity sale. Under G.C.M. 39503, this in turn depends on whether the maximum term exceeds the selling senior family member's life expectancy under the income tax annuity tables of § 72. If it does not, it is an installment sale; but if it does, it is a private annuity sale. Thus, major consequences can depend on relatively minor differences in payment periods.

> **Example 44**: A selling senior family member who is 70 years old has an actuarial life expectancy of 16 years under the § 72 annuity tables. Accordingly, a SCIN that provides a maximum period of 15 years and 11 months is an installment sale, while one that provides a term of 16 years and 1 month is a private annuity sale under the IRS view.

G.C.M. 39503 indicates that gain on a secured sale that is classified as a private annuity sale under these rules is taxed in the year of sale, but this is questionable.[507] If being secured means that a private annuity sale does not qualify for traditional private annuity sale treatment, with the result that the transaction is an installment sale, the anomaly becomes greater because a secured sale may be classified as an installment sale if secured, while an unsecured sale with identical payment terms may be treated as a private annuity sale.

A. Under the Annuity Rules

The effect of the minor modifications of the annuity rules to deal with a SCIN classified as a private annuity sale are set forth in the examples that follow:

1. The seller

The only difference for the senior family member seller between a straight private annuity sale and a SCIN classified as a private annuity sale is the amount of the annual payment required to achieve a value equal to the desired sale price.

> **Example 45**: The facts are the same as in Example 43. S agrees to sell the $1,000,000 worth of shares in the family corporation to B for $168,546 a year over the next 16 years or until S's death, whichever occurs first. The payment provided has a present value of $1,000,000 under the transfer tax tables using the ¶ 7520 rate. The sale occurs on 4-1-90, and the first annual payment is due on 4-1-91.
>
> The $ 1,000,000 value of the property divided by the expected return of $2,140,534 gives an exclusion ratio of 46.72%, so that $78,740 of each annual payment is the principal and $89,806 is annuity income. The $78,740 principal is further broken down into $15,748 recovery of basis and $62,992 capital gain. After $1,000,000 of principal has been received (occurring after 12.7 years), the entire payment is treated as annuity income because the exclusion ratio is no longer be applied once the annuitant has recovered his entire investment in the contract.[508] The expected return is $2,140,534 (12.7 years X $168,546).
>
> The amount, character and timing of the income reported by S if he receives all 16 annual payments are as follows:

Date	Payment	Basis	Capital Gain	Annuity Income
4-1-91	$168,546	$15,748	$62,992	$89,806
4-1-92	168,546	15,748	62,992	89,806
4-1-93	168,546	15,748	62,992	89,806
4-1-94	168,546	15,748	62,992	89,806
4-1-95	168,546	15,748	62,992	89,806

4-1-96	168,546	15,748	62,992	89,806
4-1-97	168,546	15,748	62,992	89,806
4-1-98	168,546	15,748	62,992	89,806
4-1-99	168,546	15,748	62,992	89,806
4-1-00	168,546	15,748	62,992	89,806
4-1-01	168,546	15,748	62,992	89,806
4-1-02	168,546	15,748	62,992	89,806
4-1-03[509]	117,982	11,025	44,096	62,862
4-1-03	50,564	-0-	-0-	50,564
4-1-04	168,546	-0-	-0-	168,546
4-1-05	168,546	-0-	-0-	168,546
4-1-06	168,546	-0-	-0-	168,546
Total	$2,696,736	$200,000	$800,000	$1,696,736

2. **The buyer** Similarly, the younger generation buyer's only significant difference is in computing the initial tentative basis.

Example 46: At the § 7520 rate 10.670, the present worth of the right to receive $168,546 annually for 16 years or until the death of the person age 70, whichever is earlier, is $1,000,000 ($168,546 X 5.9331) under the transfer tax tables.[510] Therefore, B's tentative basis in the shares purchased from S is $1,000,000.

Since the younger generation buyer under a private annuity purchase is not permitted to deduct the interest component inherent in each annuity payment, the aggregate of the payments made will exceed the tentative basis amount well before the senior family member seller achieves the actuarial life expectancy used to determine the annual SCIN payment. Moreover, if the seller does survive to that age, the payments will exceed the value of the property by more than would be the case for a straight private annuity sale.

Example 47: The facts are the same as in Example 46. The annual and cumulative payments and B's tentative basis are as follows:

Date	*Annual Payment*	*Cumulative Payments*	*Tentative Basis*
4-1-91	$168,546	$168,546	$1,000,000
4-1-92	168,546	337,092	1,000,000
4-1-93	168,546	505,638	1,000,000
4-1-94	168,546	674,184	1,000,000
4-1-95	168,546	842,730	1,000,000
4-1-96	168,546	1,011,276	1,011,276
4-1-97	168,546	1,179,822	1,179,822
4-1-98	168,546	1,348,368	1,348,368
4-1-99	168,546	1,516,914	1,516,914
4-1-00	168,546	1,685,460	1,685,460
4-1-01	168,546	1,854,006	1,854,006
4-1-02	168,546	2,022,552	2,022,552
4-1-03	168,546	2,191,098	2,191,098
4-1-04	168,546	2,359,644	2,359,644
4-1-05	168,546	2,528,190	2,528,190
4-1-06	168,546	2,696,736	2,696,736

If S collects all 16 payments, B's final basis will be the total of all payments made, or $2,696,7356, an amount far in excess of the value of the property purchased and, because of the larger annual payment, more than the $2,581,821 tentative basis at the end of 16 years in a standard private annuity sale. See Example 30 in 11 308.2 B. There is, of course, the possibility that payments in a standard private annuity sale may continue for more than 16 years.

3. When SCIN is cancelled

Under the annuity rules the younger generation buyer's final basis is fixed when payments cease.

Example 48: The facts are the same as in Example 45, but S dies on June 1, 2000, at age 80, having received only 10 payments under the SCIN. B's final basis is $1,685,460. This is more than the $1,613,632 tentative basis if S had died on the same date in a standard private annuity sale. See Example 30 in 11 308.2 B.

The cancellation rules that apply upon the cancellation of a installment obligation at the death of the seller do not apply to a private annuity sale. Therefore, neither the selling senior family member nor the estate is required to report any of the capital gain that would have been reported upon receipt of the remaining payments. There no longer is a "right" to a payment because the obligation is cancelled by its own terms.[511] The selling senior family member should be able to deduct any unrecovered basis on the final income tax return.[512]

Example 49: The facts are the same as in Example 48. The $42,520 of unrecovered basis can be deducted on S's final income tax return. Although six payments were cancelled, only three contained unrecovered basis.

B. Under the Installment Method

When a SCIN is taxed under the installment method, the gross profit ratio determines the allocation of each principal payment between return of basis and capital gain. Even though the installment method regulations classify it as a maximum price sale, the contingent payment OID regulations may backload the interest.

The following examples will illustrate the income tax consequences of a SCIN treated as an installment sale by taking into account the two variables:

(i) whether the risk premium is to be treated as additional principal ("SCIN-PRIN") or as additional interest ("SCIN-INT"), and

(ii) whether the income tax mortality assumptions of the annuity tables and the AFR, or the transfer tax mortality assumptions and § 7520 rates apply .

The intermediate cases involving use of income tax mortality assumptions and the § 7520 rate, or using the transfer tax mortality assumptions and the AFR are not illustrated. The mortality assumptions create the major portion of the difference, so that the results of the former case are closer to those also using the AFR, and the latter case closer to those using the § 7520 rate.

If the premium required, because of the risk that the selling senior family member will die before the end of the maximum term of the obligation, is characterized as an additional principal amount, then the maximum sales price of the property is greater than for a fixed payment sale. This may result in additional capital gain and a larger basis for the younger generation buyer. If the risk premium is characterized as a higher interest rate, the principal, gain and basis are the same as for a fixed payment sale, but the interest is significantly more. The discounted value of the series of payments is the same no matter how the payments which are split between principal and interest are characterized, as long as the same discount rate and actuarial assumptions apply.

1. The seller

The literature on SCINs written during the last decade assumes that the gift and estate tax tables are used to determine the periodic SCIN payments. As previously discussed, this assumption is not appropriate in all situations. Therefore, the examples that follow will illustrate the tax treatment for

(i) a SCIN using the higher interest rates and shorter life expectancy multiples found in the Alpha Volume, and

(ii) a SCIN using the lower AFR interest rates and the longer life expectancy multiples found in Reg. § 1.72-9.

Examples 50 through 56 assume that the interest portion of each payment is based on the outstanding principal during each payment period. Therefore, the amount of principal inherent in each payment is arrived at by reducing the payment by the interest that has accrued on the outstanding principal balance. This approach front-loads the interest to the earlier years as occurs in the amortization of principal for a fixed payment obligation such as a mortgage loan. However, as illustrated in Example 57, the contingent payment installment sale regulations back-load the interest by assuming that each payment is a separate debt obligation with its own interest.[513]

Example 50: SCIN-PRIN at 8.8%.

Using the AFR of 8.8% and the 12.7-year actuarial period for a temporary life annuity, based on the lesser of 16 years of the life of a 70-year old, found in the income tax annuity tables, the annual payment for the purchase of $1,000,000 worth of shares is $133,512. See Example 43.

At 8.8%, the present value of $133,512 annually for 16 years is $1,127,150. Therefore, the risk premium of $127,160 is additional principal, increasing the seller's gain and the buyer's basis by an equal amount. With a sales price of $1,127,150 and a basis of $200,000.00, the gross profit ratio under the installment method is 82.26%.

The amount, character and timing of the income reported by *S* is:

Date	Payment	Interest	Basis	Capital Gain
4-1-91	$133,512	$ 98,627	$6,190	$28,695
4-1-92	133,512	95,575	6,732	31,205
4-1-93	133,512	92,254	7,321	33,937
4-1-94	133,512	88,645	7,961	36,906
4-1-95	133,512	84,714	8,658	40,140
4-1-96	133,512	80,448	9,416	43,648
4-1-97	133,512	75,805	10,239	47,468
4-1-98	133,512	70,756	11,135	51,621
4-1-99	133,512	65,265	12,110	56,137
4-1-00	133,512	59,293	13,169	61,050
4-1-01	133,512	52,799	14,322	66,391
4-1-02	133,512	45,736	15,575	72,201
4-1-03	133,512	38,056	16,937	78,519
4-1-04	133,512	29,704	18,420	85,388
4-1-05	133,512	20,620	20,031	92,861
4-1-06	133,512	10,742	21,784	100,986
Total	$2,136,192	$1,009,039	$200,000	$927,153

Example 51: SCIN-INT at 8.8,%.

Payments of $133,512 annually for the 16 year maximum term have a present value of $1,000,000 if the discount rate is 10.7% instead of the 8.8% AFR. With a $1,000,000 sales price and a $200,000 basis, the gross profit ratio under the installment method is 80%.

The amount, character and timing of the income reported by *S* is:

Date	*Payment*	*Interest*	*Basis*	*Capital Gain*
4-1-91	$ 133,512	$ 107,418	$ 5,218	$20,875
4-1-92	133,512	104,615	5,779	23,117
4-1-93	133,512	101,511	6,400	25,600
4-1-94	133,512	98,074	7,088	28,350
4-1-95	133,512	94,267	7,849	31,396
4-1-96	133,512	90,051	8,692	34,768
4-1-97	133,512	85,383	9,626	38,503
4-1-98	133,512	80,213	10,660	42,639
4-1-99	133,512	74,488	11,805	47,219
4-1-00	133,512	68,148	13,073	52,291
4-1-01	133,512	61,126	14,477	57,908
4-1-02	133,512	53,351	16,032	64,128
4-1-03	133,512	44,740	17,754	71,017
4-1-04	133,512	35,205	19,662	78,646
4-1-05	133,512	24,645	21,773	87,094
4-1-06	133,512	12,950	24,112	96,449
Total	$2,136,192	$1,136,192	$200,000	$800,000

If all payments are made, the total gain is $127,153 less and the total interest is $127,153 more than in Example 50.

2. The buyer

As previously discussed, under the contingent payment regulations, a younger generation buyer does not obtain any initial basis for undertaking a contingent payment obligation.[514] Basis is obtained only as payments become fixed or are made. The buyer is permitted to deduct the interest component inherent in each payment. The interest and basis increase of each payment vary depending upon the treatment of the risk premium.

Example 54: B's basis.

Using the transfer tax tables and the § 7520 rate:

(a) If the risk premium is characterized as an additional principal payment, then the amount of B's obligation and B's potential basis is $1,272,865. B's initial basis in the property purchased is zero. B's interest deductions will total $1,423,887 if all 16 payments are made.

(b) If the risk premium is characterized as additional interest, then the amount of B's obligation and B's potential basis is $ 1,000,000. B's initial basis in the shares is zero. B's interest deductions will total $1,696,755 if all 16 annual payments are made.

Using the income tax annuity tables and the AFR:

(a) If the risk premium is characterized as an additional principal payment, then the amount of B's obligation and B's potential basis is $1,1,127,153. B's initial basis in the property purchased is zero. B's interest deductions will total $ 1,009,039 if all 16 payments are made.

(b) If the risk premium is characterized as additional interest, then the amount of B's obligation and B's potential basis is $1,000,000. B's initial basis in the shares is zero. B's interest deductions will total $1,696,755 if all 16 annual payments are made.

3. When SCIN is cancelled

Under the contingent payment OID and unstated interest regulations, the younger generation buyer's basis may be limited to payments made. This is an anomalous result when the senior family member seller dies before the end of the maximum SCIN term in a related party sale, in that the younger generation buyer's basis can be less than the aggregate of the capital gain and return of basis reported by the seller or the estate. Whatever the merits of the position of G.C.M. 39503 in giving the buyer an initial basis measured by the contingent payment obligation, the logic of Rev. Rul. 86-74, requiring the decedent's estate to report the entire inherent gain, supports the view that the cancellation is a bequest to the younger generation buyer that should support a basis at least equal to fair market value at death.[515] A counter argument is that although the gain is reported by the selling senior family member, the value of the remaining payments is not included in the gross estate.[516] Nevertheless, the income tax result should prevail.

By similar logic, if the cancellation is during the selling senior family member's lifetime and thus, a gift, the younger generation buyer's basis should be the fair market value, although there is some chance that the gift rule of the higher of the donor's basis or purchase price applies.[517]

The effect of differences in the amount of principal depending on whether the risk premium is treated as interest or principal carries through to the consequences of termination of the SCIN upon the premature death of the selling senior family member. When the buyer and the seller are related parties, the value of the cancelled installment obligation is deemed to be equal to its face amount.[518] Since a SCIN-PRIN treats the risk premium as additional principal, there is more capital gain potential than in a SCIN-INT and a greater basis for the younger generation buyer. Again, when the gain is reported by the senior family member seller's estate, the full basis should be allowed the younger generation buyer.

Example 55: The facts are the same as in Example 54 except that S dies on June 1, 2000, having received only 10 annual payments. B's obligation to make the remaining six annual payments is cancelled. B and S are related parties. Therefore, the value of the cancelled payments is treated as equal to its face amount.

(a) SCIN-PRIN. The outstanding principal amount for the remaining payments is $721,340, and the unrecovered basis is $113,340. The decedent's final return or the estate reports $608,000 of capital gain upon cancellation of the obligation. B's basis in the shares should be $1,272,865, but, under the contingent price OID and unstated interest regulations, may be limited to $551,528, the principal payments actually made.

(b) SCIN-INT. The outstanding principal amount is $636,641, and the unrecovered basis is $127,328. The decedent's final return or estate reports $509,313 of capital gain. B's basis in the shares should be $1,000,000, but, under the contingent price OID and unstated interest regulations, may be limited to $ 363,359, the principal payments actually made.

As illustrated in Example 55, all of the capital gain inherent in the annual payments is eventually reported by the seller and the seller's estate. The only difference is that for a SCIN-PRIN there is an additional $272,865 of capital gain. Therefore, an advantage of a SCIN-INT is the potential for less aggregate income being reported in the event of the selling senior family member's premature death.

The irrebutable presumption that the value of the cancelled payments equals the principal amount does not apply if the buyer is not a related party, such as a son-in-law. The built-in termination reduces the amount received upon the disposition to zero, permitting the unreported realized gain on a sale to an unrelated party to escape income taxation. And, the tax savings are further increased because the selling senior family member should receive a deduction for any unrecovered basis.[519] Since the unrelated buyer's initial basis cannot include his initial obligation, the cancellation of the unrelated buyer's remaining obligation has a symmetrical effect with the capital gain reported by the seller.

Example 56: The facts are the same as in Example 55, except that B is S's son-in-law.

(a) SCIN-PRIN. B's initial basis in the shares is zero, even though B undertakes a contingent $1,272,865 obligation to make 16 annual payments of $168,547 each. Upon the death of S, the remaining $721,340 of principal payments becomes worthless. Therefore, none of the remaining capital gain is reported as income, and S can deduct the $113,340 of unrecovered basis on the final income tax return. B's basis in the shares is $551,528, the principal payments B made.

(b) SCIN-INT. B's initial basis in the shares is zero even though B undertakes a contingent $1,000,000 obligation to make 16 annual payments. Upon S's death, the remaining $636,641 principal obligation becomes worthless. None of the remaining capital gain is reported as income, and S can deduct the $127,328 of unrecovered basis on his final income tax return. B's basis in the shares is $363,359, the principal payments B made.

Endnotes

[2] See Manning and Hesch, *Pnvate Annuities After the Installment Sales Revision Act*, 6J. Indiv. Tax. 20 (1982).

[3] Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 NYU Ann. Inst. On Fed. Tax'n, Ch. 43 (1981); Lobenhofer, *The Income Taxation of Exchanges of Property for Pnvate Annuities: History and a Proposal*, 21 Pac. LJ. 271 (1990); Lefrak, *When to Use Private Annuities*, 40 NYU Ann. Inst. on Fed. Tax'n, Ch. 2 (1982).

[4] G.C.M. 39503, Jun. 28, 1985

[5] § 453(b)(2), (f)(2), (k) and (1)

[6] See Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 490-91,498-99 (1987) ("1986 Blue Book") (relating to publicly-traded property); S. Rep. No. 313, 100th Cong., 1st Sess. 160-65 (1987) (relating to dealer dispositions and interest on deferral); Note, *Fairness and Tax Avoidance in the Taxation of Installment Sales*, 100 Harv. L. Rev. 403 (1986).

[7] §§ 1271 to 1275 and 483; see Staff of Joint Committee on taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 108-23 (1984) ("1984 Blue Book").

[8] §§ 1274(d)(1) and 1274A; see H.R. Rep. No. 432, Pt. 2, 98th Cont. 2d Sess 1241 (1984); S. Rep. No. 169, 98th Cong., 2d Sess. 249 (1984); H.R. Rep. No. 87, 99th Cong., 1st Sess. 1 (1985); S Rep. No. 83, 99th Cong. 1st Sess. 1 (1985).

[9] §§ 1276 to 1278; see 1984 Blue Book at 93-100.

[10] § 7872; see 1984 Blue Book at 524-38.

[11] § 171(b)(3); see Staff of Joint Committee on Taxation, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation at 13-14 (1987).

[12] §§ 1273, 1274 and 1274A; Prop. Reg. §§ 1.1273-2, 1.174-1 and 1.1274A-1; see 11 301.7.

[13] § 453(d); Temp. Reg. § 15A.453-l(d).

[14] Temp. Reg. § 15A.453-l(d)(2).

[16] Prop. Reg. § 1.453-l(f)(4); see *Stiles v. Commissioner*, 69 T.C. 558 (1978), acq.; Priv. Ltr. Rul. 90-08-065 (Nov. 29, 1989) (redemption with deferred payments must be reported as installment sale; s

[17] See Manning, *supra* note 16, at § 108.

[18] See Reg. § 1.736-l(b)(5), (6) and (7). See McKee, Nelson and Whitmire, Federal Taxation of Partners and Partnerships 11 22.02[4] (2d ed. 1990) and Willis, Pennell and Postlewaite, Partnership Taxation § 155.03 (4th ed. 1989) for further discussion of the timing issues in deferred payment of redemptions of partnership interests.

[19] § 453(f)(4) and (5); Temp. Reg. § 15A.453-l(b)(3)(i) and (e)(l).

[21] See Ginsburg, *Taxing the Sale for Future Payment*, 30 Tax L. Rev.469 (1975).

[22] § 453(c) and (f)(3); Temp. Reg. § 15A.453-l(b)(3)(i); see *Holmes v. Commissioner*, 55 T.C. 53 (1970) (third party note guaranteed by the buyer was payment).

[23] § 453(f)(3); Temp. Reg. § 15A.453-l(b)(3)(i) and (iii); S. Rep. 1000, 96th Cong. 2d Sess. at 18.

[24] See Rev. Rul. 82-122, 1982-1 C.B. 80, Rev. Rul. 74-157, 1974-1 C.B. 115; Rev. Rul. 74-557, 1974-2 C.B. 301 (dealing with modifications of terms of installment sales secured by the property sold); Temp. Reg. § 15A.453-l(b)(3)(iii); S. Rep. 1000, 96th Cong., 2d Sess. at 18 (both relating to standby letters of credit); but cf. *Holmes v. Commissioner, supra* note 22.

[25] Temp Reg. § 15A.453-l(b)(3)(i)11 301.3 Liabilities Transferred

[26] Reg. § 1.1001-2(a); *Crane v. Commissioner*, 331 U.S. 1 (1947); *Commissioner v. Tuits*, 461 U.S. 300 (1983) (amount realized on transfer of property subject to nonrecourse liability is amount of liability even if value of property is less).

[27] Temp. Reg. § 15A.453-l(b)(2(iii)

[23] Temp. Reg. § 15A.453-l(b)(2)(iii) and (iv).

[29] Temp. Reg. § 15A.453-1 (b)(2)(iii) and (iv).

[30] See *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987), *acq.*

[31] Wrap-around notes are used for other purposes than avoidance of the payment in year of sale, most commonly to preserve for the selling senior family member benefit of a low interest rate loan. Cf. Prop. Reg. § 1.1274-7(c) (wrapped-indebtedness not treated as assumed for purposes of OID rules).

[32] See Temp. Reg. § 15A.453-l(b)(3)(ii).

[33] It has acquiesced in Professional Equities, supra note 30.

[34] § 453B. A transfer of an installment obligation incident to a divorce that meets the requirements for nonrecognition under § 1041 does not result in acceleration of gain, but transfers the unreported gain to the (often unsuspecting) transferee spouse. § 453B(g).

[36] § 691(a)(2). Since the deferred gain is "income in respect of a decedent," § 691(a)(4) and Reg. § 1.691(a)-l(b), the successor-in-interest cannot obtain a tax-free step-up in basis for the unreported gain. § 1014(c).

[37] See G.C.M.39503, Issue (3), supra note 4, determining that the unreported gain in a SCIN is income in respect of a decedent even though Issue (2)(A) concludes that no amount is included in the gross estate.

[35] Reg. § 20.2033-l(b).

[39] § 453A(d) (1).

[40] § 453A(a)(l) and (b)(l)

[41] § 453A(a)(l) and (b)(2).

[42] § 453A(c) (2)

[43] § 163(h); Reg. § 1.163-9T(b)(2)(i).

[44] § 163(d)(5); Reg. § 1.163-8T(b)(3).

[45] See Notice 89-35, Sec. IV.A, 1989-1 C.B. 675, 676. In Priv. Ltr. Rul. 91-16-008 (Jan. 10, 1991), the IRS applied this approach to a redemption of an S corporation shares, determining the character of the interest by the nature of the corporate assets.

[46] See § 163(d)(1) and (h) (investment interest and personal interest limits apply only to taxpayers other than C corporations).

[94] Under the tax rules that apply to life insurance companies, the insurance company also avoids tax on the income set aside for annuities. See §§ 805(a)(2) and 807(b)(2) and (3).

[95] § 72(b)(1); Reg. § 1.172-4.

[96] § 72(c)(1); Reg. § 1.72-6.

[97] § 72(b)(1); Reg. § 1.72-3.

[98] See Reg. § 1.72-9.

[99] § 72(c)(3), Reg. § 1.72-5.

[101] § 72(b)(3)(A); H.R. Rep. No 426, 99th Cong., 1st Sess. 731 (1985); S. Rep. No.313,99th Cong. 1st Sess. 607 (1986). No deduction for unrecovered basis is permitted if the annuitant dies before the annuity starting date.

[102] § 72(b)(2). Prior to 1987, the annuitant could exclude a portion of all annuity payments, including the mortality gain payments, and no deduction was permitted for unrecovered basis if there was a mortality loss.

[103] Rev. Rul. 69-74, 1969-1 C.B. 43. The IRS revoked its earlier position in Rev. Rul. 239 where it applied the open transaction approach and allowed all principal payments to first be a recovery of basis. See also Rev. Rul. 55-119, 1955-1 C.B. 352, dealing with the family buyer's basis.

[104] Cf. *Fehrs Finance Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1983), cert. den. 416. U.S.938 (applying § 304 to a redemption through a related corporation with the price paid in the form of a private annuity).

[105] Rev. Rul. 69-74, 1969-1 C.B.43; G.C.M. 39503, Issue (2)(C)(l)(a), *supra* note 4; see Reg. § 1.1011-2(c) Example (8).

[107] § 72(b)(2). There was previously a conflict between Rev. Rul. 69-74, *supra* note 103, and Reg. § 1.1011-2(c) Example (8) about what happened if the selling family member lived beyond the actuarial period.

[108] G.C.M. 39503, Issue (2)(C)(l)(b)(iii), *supra* note 4.

[109] § 72(b)(3)(A).

[111] See *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973); 212 *Corp. v. Commissioner*, 70 T.C. 788 (1978); G.C.M. 39503, Issue (2)(C)(l)(a), supra note 4, but see Priv. Ltr. Rul. 81-02-029 (Oct. 14, 1980) (applying traditional private annuity sale analysis to basis determination in a secured private annuity sale without comment).

[112] G.C.M. 39503, Issue (2)(C)(1)(A), *supra* note 4.

[115] See, e.g., *Dix v. Commissioner*, 392 F.2d 313 (4th Cir. 1968); G.C.M. 39503, Issue (2)(C)(3), *supra* note 4. See, *Rye v. United States*, 92-1 U.S.T.C. ¶ 50,186 (Cl. Ct. 1992), denying an interest deduction even though the

seller reported the transaction as an installment sale. The court in Rye explicitly states that there is no need for symmetry between the buyer and the seller.

[116] Rev. Rul. 55-119, *supra* note 103; G.C.M. 39503, Issue (2)(C)(2)(a), *supra* note 4. As the buying family member makes further payments, they are added to basis, apparently without regard to fair market value of the property. This converts the excess payment, a substantial part of which represents the time value of money, into a capital loss on disposition of the family business or financial assets.

[118] § 1275(a)(1)(B) (debt obligation does not include amounts taxed as annuities). In G.C.M. 39503, *supra* note 4, and Priv. Ltr. Rul. 90-09-064 (Dec. 8, 1989), the IRS indicated that it will continue to apply the § 72 annuity rules instead of the § 453 installment method to private annuity sales. In *Rye v. United States, supra* note 115, the court applied the § 72 annuity rules to a private annuity sale.

[120] Rev. Rul. 55-119, *supra* note 103; G.C.M. 39503, Issue (2)(C)(2)(a), *supra* note 2.

[122] Rev. Rul. 55-119, supra note 103; G.C.M. 39503, Issue (2)(C)(2)(a), supra note 4; s

[123] See Rev. Rul. 55-119, *supra* note 103;

[158] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980). *acq in result only*; Cain v. Commissioner, 37 T.C. 185 (1961).

[160] Banoff and Hartz, *Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete.?*, 59 Taxes 499, 501 (1981)

[162] Reg. §§ 20.2031-7(f) and 25.2512-5(f) and *Actuarial Values Alpha Volume: Remainder, Income and Annuity Factors for One Life, Two Lives, and Term Certains. Interest Rates from 2.2 Percent to 26.0 Percent. For Use in Income, Estate, and Gift Tax Purposes including Valuation of Pooled Income Fund Remainder Interest*, IRS Publication 1457 (8-89) (the "Alpha Volume") Table 80 CNSMT page 6-1 (using 1980 census data).

[164] G.C.M. 39503, Issue (2), *supra* note 4.

[165] *Id.*

[167] G.C.M. 39503, *supra* note 4. In Rev. Rul. 86-72, 1986-1 C.B. 253, the IRS discussed how the installment sale rules under § 453B and § 691(a) applied upon the death of a seller under a SCIN. The maximum term of the obligation in this ruling was 4 years and the seller's life expectancy was 21 years. See Example 44 in ¶ 310.3.

[174] § 72(b)(3)(A); see ¶ 302.1; see also Example 49 in ¶ 310.3 C.

[176] Temp. Reg. § 15A.453-l(c)(l) and (2).

[177] Temp. Reg. § 15A.453-l(c)(2)(i)(A), (b)(2)(ii) and (b)(2)(v).

[179] There has been a debate on the treatment of this risk premium. Compare Blum, *Self-Cancelling Installment Notes—The New SCIN Game?*, 60 Taxes 183 (1982), with Banoff and Hartz, *It's No Sin to SCIN! A Reply to Professor Blum*, 60 Taxes 187 (1982).

[181] Rev. Rul. 86-72, *supra* note 167, and G.C.M. 39503, *supra* note 4; *Estate of Frane v. Commissioner*, 98 T.C. _ No. 26 (1992).

[182] Prop. Reg. §§ 1.483-5(b)(3)(iv) and 1.1275-4(c)(4) Example (1)(iii); but see G.C.M. 39503, Issue (2)(C)(2)(b), *supra* note 4 allowing the buyer who purchases for a contingent price to include the maximum principal amount of the obligation in basis. In *Rye v. United States*, *supra* note 115, the court stated that symmetry between the buyer and seller is not required in a private annuity sale.

[234] Temp. Reg. § 15A.453-l(b)(2)(ii).

[235] Temp. Reg. § 15A.453-l(b)(2)(iii)

[236] Temp. Reg. § 15A.453-l(d)(2)(i) and (ii)

[237] Because the $1,750,000 mortgage exceeds S's $1,700,000 basis by $50,000, that excess amount is treated as a fictional payment of cash received in the year of sale. Temp. Reg. § 15A.453-l(b)(3)(i

[239] In Example 2, the $60,000 of interest for 1990 represents the interest accrued during the 1990 calendar year on the $600,000 principal outstanding during that 12-month period and paid on January 1, 1991. If B and S are cash basis taxpayers, they are eligible to elect to report the interest income and interest deduction in the year paid under § 1274A(c) because the principal amount of the note does not exceed $2,000,000. Therefore, S can defer reporting the interest income by one year but only if B defers the interest deduction. For a method of reporting the interest that is more realistic with financial principles, see Bankman and Klein, *Accurate Taxation of Long-Term Debt: Taking into Account the Term Structure of Interest*, 44 Tax L. Rev. 335 (1989).

[240] Prop Reg. § 1.1275-l(b)(2).

[241] Reg. § 1.1273-l(b)(iii) and (iv).

[242] Reg § 1.1274-2(b)(1).

[243] See Reg. § 20.2031-7(f) (fixed-term annuity tables); Alpha Volume, *supra* note 162, Table B, page 3-20.

[244] The principal payment on the note and the capital gain reported under the installment method are the same because the gross profit ratio is 100%. When there is basis to be recovered, the principal portion of the payment is divided between gain and basis recovery using the gross profit ratio.

[245] Fictional payment because liability exceeds basis.

[246] § 453(f)(3)

[247] Temp. Reg. § 15A.453-l(b)(3)(i). This regulation effectively overrules *Porterfield v. Commissioner*, 73 T.C. 91 (1979) (installment sale qualified even though the buyer's note was secured by escrow when court found escrow was intended as security not source of payment); see also *Sprague v. Commissioner*, 627 F.2d 1044 (l0th Cir. 1982) (impractical to evaluate security and whether its quality creates risk).

[248] *Oden v. Commissioner*, 56 T.C. 569 (1971) (certificates of deposit placed in escrow); *Pozzi v. Commissioner*, 49 T.C. 119 (1967) (escrow); Rev. Rul. 73-451, 1972-2 C.B. 158 (cash in escrow).

[249] Rev. Rul. 77-294, 1977-2 C.B. 173, *revoking* Rev. Rul. 68-246. 1968-1 C.B. 198, *amplified by* Rev. Ru1.79-91, 1979-1 C.B. 179 (installment sale ceased to qualify when escrow substituted for mortgage security).

[250] Temp. Reg. § 15A.453-l(b)(3)(iii); S. Rep. 1000, 96th Cong. 2d Sess. at 18.

[252] § 469(g).

[253] See 1986 Blue Book at 226.

[254] § 465.

[255] See Prop. Reg.§ 1.456-66.

[256] §§ 704(d) and 1366(d).

[257] § 1367(b)(2)(B).

[258] Cf. *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989) (borrowing by S corporation guaranteed by shareholder not treated as individual borrowing and contribution to capital); *Selfe v. Commissioner*, 778 F.2d 769 (11th Cir. 1985) (such borrowing may be treated as shareholder borrowing and contribution).

[259] Cf. Rev. Rul.73-555, 1973-2 C.B.159 (liabilities related to going business transferred).

[261] Rev. Rul. 76-109, 1976-1 C.B. 125.

[262] Temp. Reg. § 15A.453-1(b)(3)(i).

[263] § 453B(a); Temp. Reg. § 15A.453-l(b)(3)(i); Big "D" *Development Corp. v. Commissioner*, 30 T.C.M. (CCH) 646 (1971), *aff'd per curiam*, 453 F.2d 1365 (5th Cir. 1972), *cert. den.* 406 U.S. 945; but see *Kniffen v Commissioner*, 39 T.C. 553 (1962), *acq.* (liability to controlled corporation transferred in § 351 transaction treated as assumed and not boot); *Connell v Commissioner*, 42 T.C.M. (CCH) 423 (1981) (30% initial payment limited under prior law not violated by mutual pledging of notes of buyer and seller; notes did not offset each other).

[264] Reg. § 1.1001-2(a); *Crane v. Commissioner, supra* note 26; Tufts v. Commissioner, *supra* note 26 (amount realized on transfer of property subject to nonrecourse liability is amount of liability even if value of property is less); s

[265] Reg. § 1.1001-2(a)(4)(ii); but cf. Reg. § 1.752-l(d) (partner assumes partnership liability only when creditor is aware of assumption and has direct rights against partner).

[266] See *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983) (transferor shareholder does not recognize gain under § 357(c) on transfer of joint venture interest where corporate transferee did not assume primary liability and transferor remained liable); *Maher v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (taxpayer did not recognize gain under § 304 on transfer of shares subject to liability to controlled corporation even though corporation assumed liability, since shareholder remained secondarily liable; taxpayer did realize dividend when corporation paid liability); *Weeden v. Commissioner*, 685 F.2d 1160 (9th Cir. 1982) (donor recognizes gain on "net gift" when transferees pay tax, not in year of transfer since donor remained liable until tax paid). The *Jackson* opinion has been severely limited if not overruled in *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989), cert. denied 101 S.Ct. 1113 (1990) (partnership recognizes gain on transfer to wholly owned corporation measured by full amount of liabilities not reduced for liabilities guaranteed by partners or for which they remained liable). See also ¶ 301.3 relating to wraparound liabilities in installment sales.

[267] See *Professional Equities, Inc. v. Commissioner, supra* note 30; cf. Prop. Reg. § 1.1275-7.

[268] See *Voight v. Commissioner*, 68 T.C. 99 (1977), aff'd, 614 F.2d 94 (5th Cir. 1980); *Goodman v. Commissioner*, 74 T.C. 684 (1980); *Lamberth v. Commissioner*, 31 T.C. 302 (1958).

[269] See *Maher v. Commissioner, supra* note 266; *Weeden v. Commissioner*, *supra* note 266; *Professional Equities, Inc. v. Commissioner, supra* note 30.

[270] See Reg. § 1.1060-IT(f) providing for allocation of adjustments in consideration.

[273] See *Commercial Security Bank v. Commissioner*, 77 T.C. 145, (1981) (cash basis corporation which sold it assets under § 337 entitled to deduct cash basis obligations not deducted prior to sale; transfer of assets tantamount to payment since purchase price reduced to reflect obligations); *Commissioner v. Allan*, 856 F.2d 1169 (8th Cir. 1988) (interest and taxes accrued and deducted by partnership but paid by mortgagee to protect its interest and added to mortgage is part of amount realized on surrender of the property in lieu of foreclosure; not ordinary income under tax-benefit principle).

[274] See *Hillsboro National Bank v. Commissioner*, 457 U.S. 1103 (1983) (tax benefit gain recognized in former § 333 liquidation on distribution of feed properly deducted when purchased but still on hand when distributed by farming corporation; leaves open question whether gain measured by original cost or basis to shareholder). The sale is fundamentally inconsistent with the deduction. Manning, *The Service Corporation—Who is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482 and Section 351*, 37 U. Miami L. Rev. 657, 672-74 (1983).

[275] See § 357(c)(3) (such obligations are not liabilities for purposes of the liability over basis rule of § 357(a); 704(c) (similar rule for partnerships); former Reg. § 1.752-1T(g) (definition of liabilities that does not include amounts that have not given rise to a deduction; this provision was deleted without explanation in the final regulations); Rev. Rul. 80-198, 80-2 C.B. 113 (applies rule similar to § 357(c)(3) prior to the effective date).

[276] §§ 404(a)(5) and (d) postpone deductions for amounts of deferred compensation to employees or independent contractors until the recipient includes the amount in income. § 83(f) delays the deduction for property transferred in connection with performance of services at the time the recipient recognizes income.

[277] § 461(h) postpones deductions by accrual basis taxpayers until "economic performance" has occurred, which, in many cases means payment. See Reg. § 1.461-4(g)(1)(i).

[278] See, *e.g.*, § 267(a)(2) postponing deductions for payments to related taxpayers, and § 467 (providing for a special accrual method for certain payments for goods and services.

[279] See *Commercial Security Bank v. Commissioner, supra* note 273; Crane, *Accounting for Assumed Liabilities Not Yet Accrued by the Seller: Is a Buyer's Deduction Really Costless.?*, 48 Tax Notes 225 (1990); Shoukup, *Accounting for Assumed Liabilities Not Yet Accrued by the Seller: A Response*, 48 Tax Notes 637 (1990).

[280] See *David R. Webb Co. v. Commissioner*, 837 F.2d 309 (7th Cir. 1983).

[281] See Reg. § 1.461-4(g)(1)(ii)(C) (indicating that payment and inclusion in amount realized are simultaneous).

[282] See Tech. Adv. Mem.87-41-001 (Jun.16, 1989) (hypothetical seller under § 338 election has gain at time of election with no offsetting deduction because not in existence when deduction arises at time of payment) and Tech. Adv. Mem. 89-39-002 (Jun. 15, 1989).

[283] See generally Hesch, *Disposition of Installment Obligations by Gift or Bequest*, 17 Tax Management Est. Gifts and Tr. J. 137 (1991)

[284] Reg. § I 453-9(c).

[285] §§ 453B(c), 691(a)(4) and (5) and 1001(c); Reg. § 1.691(a)-2(b) Example (4).

[286] Cf. Rev. Rul. 55-159, 1955-1 C.B. 391, *Shannon v. Commissioner*, 29 T.C. 702 (1958).

[287] § 453B(a).

[288] § 453B(b).

[289] § 453A(a)(1), (b)(1) and (d).

[290] Cf. Prop. Reg. § 1.1274A-1 (d) (2) Example (3) (aggregating sales pursuant to a tender offer for purposes of the $2,800,000 limitation under § 1274A(d); and Prop. Reg. §§ 1.1274-1(b)(2)(iii), 1.1274-1(b)(4)(iii) and 1.483-1(c)(2)(ii), adopting it by reference for purposes of other amount limits.

[291] See, e.g. Rev. Rul. 67-167, 1967-1 C.B. 107 (gratuitous transfer of an installment note to an irrevocable reversionary trust distributing all income for the trust term to the grantor's sister is a taxable early disposition)

[292] § 677(a).

[293] Rev. Rul. 81-98, 1981-1 C.B. 40.

[294] § 1278(a)(1)(A).

[295] § 1278(a)(2)(A).

[296] § 1276(a)(1).

[297] In Rev. Rul. 55-157, 1955-1 C.B. 293, a taxable disposition occurred each time by foregoing the annual principal payments as they become due.

[298] § 453B(f)(1).

[299] As defined in §§ 453(f)(1), 318(a) and 267(b).

[300] § 453B(f)(2).

[301] *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir.1988), *rev'g* 53 T.C.M. (CCH) 325 (1987).

[303] G.C.M. 39503, Issues (2)(a) and (3), *supra* note 4.

[304] *Commissioner v. Tufts, supra* note 26; Reg. § 1.1001-2(c) Example (8); Rev. Rul. 90-16, 1990-1 C.B. 12; Rev. Rul. 91-31, 1991-20 I.R.B. 4.

[305] This may be seen more clearly by considering a situation in which a note is issued for cash. The original receipt of cash is not income because of the obligation to repay, nor is it a gift because of the note. If the note is discharged for a cash payment less than its face, there is discharge of indebtedness income even if the payment is the full fair market value of the obligation at the time of payment. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); see also *Commissioner v. Jacobson*, 336 U.S. 28 (1949). The same result follows if the note is cancelled as a gift and the amount of the gift is limited to the fair market value of the note; the obligor still has the cash.

[306] *Cf.* Rev. Rul. 90-16, 1990-1 C.B. 12; G.C.M. 39503, Issue (3), *supra* note 4.

[307] §§ 453B(g) and 1041(a).

[308] § 1041(a) applies to "all" transfers between spouses; Reg. § 1.1041-1T, Q&A-2 and Q&A-12 (dealing with sales between spouses).

[309] § 453B(c).

[310] Reg. §§ 1.453-9(e) and 1.691(a)-5, and § 691(a)(3).

[311] §§ 691(a)(4)(A) and 1014(c); Reg. § 1.691(a)-5(a).

[312] § 691(a)(2); Reg. § 1.691(a)-4(b)(3) and -5(a) and (b); Priv. Ltr. Rul. 90-07-016 (Nov. 16, 1989).

[313] Reg. § 20.2053-l(f)

[315] G.C.M. 39503 does not discuss the deduction under § 691(c), possibly because of its conclusion that nothing is included in the gross estate for a SCIN taxed under the installment method. But cf. Reg. § 1.753-l(b) (the entire partnership distributive share for the period in which death occurs even though only part is unwithdrawn at the date of death and identified on the estate tax return); this provision is distinguishable because the income withdrawn by the decedent is indirectly reflected by assets owned at death.

[316] § 1278(a)(l)(C).

[317] Reg § 1.691(a)-5(b).

[318] Reg. § 1.691(a)-5(c) example.

[319] § 691(a)(2), last sentence, and Reg. § 1.691(a)-5(b).

[320] Reg. § 20.2033-l(b) specifically provides that "[n]otes . . . held by the decedent are likewise included [in the decedent's estate] even though they are cancelled by the decedent's will." The rule is different for a SCIN, which expires upon the selling family member's death by its own terms.

[321] § 691(a)(5)(A)(ii).

[322] 1986-1 C.B. 253.

[323] § 691(5)(A)(iii).

[324] The Tax Court recently agreed that the gain is reported on the seller's final income tax return. *Estate of Frane v. Commissioner, supra* note 181.

[325] Priv. Ltr. Rul. 85-52-007 (Sep. 18, 1985).

[326] Priv. Ltr. Rul. 88-06-048 (Nov. 17, 1987).

[327] § 691 (a)(5)(B).

[328] See Example 2 for 1989 through 1996.

[330] Read § 691(a)(5)(B) carefully.

[331] See Lane and Zaritsky, Federal Income Taxation of Estates and Trusts, ¶ 15.07[3][c] (1988).

[332] § 691 (a)(4)(A).

[333] §§ 691(a)(5)(B) and 453B(f)(2).

[334] § 691(a)(4)(B).

[335] § 453A(a)(l) and (b)(2).

[336] § 453A(a)(l), (b)(2) and (c).

[337] § 453A(c)(4).

[338] § 453A(c)(2)

[339] § 163(h); Reg. § 1.163-9T(b)(2)(i) (interest on underpayments of income tax is nondeductible personal interest regardless of the source of income generating the underpayment).

[340] § 163(d)(5); Reg. § 1.163-8T(b)(3); see Abbin, *Interest Expense in Interfamily Installment Sales*, 74 J. Tax'n 389 (1991).

[341] See Notice 89-35, Sec. IV.A, 1989-1 C.B. 675, 676.

[342] Reg. § 1.163-8T uses a tracing method to determine when interest is business interest, investment interest or personal interest.

[343] See § 163(d)(1) and (h) (investment interest and personal interest limits for taxpayers other than corporations). The 1986 Act added a provision to confirm that payments in connection with redemptions, including expenses, "greenmail" payments and the cost of standstill agreements, are not deductible. § 162(k). This provision does not deny deduction of interest on obligations issued in a redemption. The deduction may be subject to limits on interest on acquisition indebtedness and high-yield discount obligations. See §§ 163(e) and 279.

[406] Prop Reg. § 1.1275-1(b).

[407] Cf. § 56(g)(4)(B)(ii) including such internal buildup in determining the adjusted current earnings adjustment for purposes of the corporate alternative minimum tax.

[408] § 72(b)(1).

[409] § 72(c)(1).

[410] § 72(c)(3).

[412] § 72(c)(3)(B).

[413] § 72(c)(3)(A).

[414] § 72(c)(4).

[415] Reg. § 1.72-9, Table V.

[416] See H.R. Rep. No. 1042, 96th Cong., 2d Sess. 10, note 12; S. Rep. No. 1000, 96th Cong., 2d Sess. 12, note 22; Manning and Hesch, *supra* note 2, at 20-21, 23-27;

[417] See G.C.M. 39503, *supra* note 4; But *cf. Rye v. United States*, *supra* note 115, insisting on using the annuity rates for a buyer in a private annuity sale even though the seller had reported the sale under the installment method.

[418] 1990-14 I.R.B. 10.

[419] Reg. § 1.72-9, Table V.

[420] If S uses 10.6% interest to determine the annual installment payment, it would be $132,415 ($1,000,000 divided by 7.5520), and under § 7250 the value of the buyer's obligation is $1,000,000, and no gift arises because

the consideration is adequate. However, for income tax purposes, using 8.8% interest, the principal amount of this obligation is $1,114,420.

[421] § 108(e)(5); see ¶ 307.4 A.

[422] Rev. Rul. 55-119, *supra* note 103; Rev. Rul. 69-74, *supra* note 103; see ¶ 302.2. At the time Rev. Rul. 69-74 was issued, the annuity rules under § 72 permitted the indefinite use of the exclusion ratio, thereby permitting an annuitant to continue to exclude from taxation a portion of all annuity payments as the investment in the contract even though he had previously recovered his entire investment in the contract. Effective for annuities starting after December 31, 1986, § 72(b)(2) eliminated this so-called mortality gain. The discrepancy between Rev. Rul. 69-74, treating the seller's basis in the property sold as his investment in the contract, and Reg. § 1.1011-l(b) Example (8), treating the value of the property sold as the investment in the contract, no longer has any tax significance because of § 72(b)(2) which precludes the use of the exclusion ratio once the entire basis is recovered.

[423] Rev. Rul. 55-119, *supra* note 103.

[424] *Id.*

[425] *Dix V. Commissioner, supra* note 115; *Rye v. United States, supra* note 115; *Bell v. Commissioner*, 76 T.C. 232 (1981). Under § 1275(a)(1)(B)(i), the OID and unstated interest rules do not apply. For the seller, the annuity rules under § 72 accomplish the same objective as the imputed interest rules under § 1274. Under § 72 the seller treats a portion of each payment as "annuity income." This is in effect the interest component.

[426] In *Estate of Bell v. Commissioner, supra* note 425, the court sanctioned the use of the estate and gift tax tables in valuing an annuity obligation under Rev. Rul. 55-119 for determining the buyer's tentative basis.

[427] By using a 16.0 year life expectancy under § 72, the seller will end up recovering his basis over a longer term than the 10.8 year life expectancy used to compute the amount of the annual annuity payment. In other words, the recovery of basis is over a 16-year period instead of over 10.8 years.

[428] Once basis fully recovered; all subsequent payments are annuity income. § 72(b)(2).

[429] Had an interest deduction been allowed consistent with the interest income reported by the seller, then only $62,500 of each annual annuity payment would have been applied towards basis so that the $1,000,000 tentative basis would not have been adjusted upward until the end of the 16th year.

[430] The buyer's basis in the shares purchased begins to exceed the $1,000,000 value of the shares by the seventh annual payment.

[431] See Example 28 in ¶ 308.2 A.

[432] See Arrowsmith v. Commissioner, *supra* note 221; see also ¶ 309.

[433] § 72(b)(3)(A).

[505] See Alpha Volume, *supra* note 162, at page 5, Example (9), illustrating the determination of factors involving one life and a term of years and *Factors at 10 Percent Involving One and Two Lives (Actuarial Values II)*, IRS Publication 723E (12-83).

[506] The 12.7 year life expectancy multiple used to determine the expected return is obtained from Reg. § 1.72-9, Table VIII.

[507] C.C.M. 39503, Issue (2)(C)(l)(a), *supra* note 4.; see ¶ 302.2.

[508] § 72(b)(2).

[509] The payment for the 13th year must be bifurcated because the exclusion ratio cannot be applied once the annuitant has recovered his entire investment in the contract. § 72(b)(2).

[510] See Alpha Volume, *supra* note 162, Example (9) at page 6.

[511] See § 691(a)(2), (4) and (5).

[512] § 72(b)(3)(A).

[513] See Temp. Reg. § 15A.453-l(c)(2)(ii).

[514] § 1.275-4(d)(2); see ¶¶ 303.2 and 309.2.

[515] See Rev. Rul. 67-96, 1967-1 C.B. 195 (basis of stock acquired through exercise of option provided in will is date of death value plus any consideration paid for option). In *Estate of Frane v. Commissioner*, *supra* note 181, the facts indicate that the buyer's basis only included the principal payments actually made. Presumably, the buyer should have claimed a basis measured by the contingent payment obligation. See ¶ 204.3. B.3 and 206.1. B. The authors feel that the approach taken in G.C.M. 39503, *supra* note 4, giving the buyer a basis for SCIN is consistent with the reporting of the remaining gain upon the cancellation of the note.

[516] See ¶ 304.1.

[517] See Reg. § 1.1015-4.

[518] § 691(a)(2), (a)(4)(B) and (5)(B).

[519] Temp. Reg. § 15A.453-1(3)(i) and (4). There is some argument for denying a deduction on the ground that the loss is not part of a transaction entered into for profit, see Rev. Rul. 72-193, 1972-1 C.B. 58, or that the loss did not occur until death so that it is essentially a reduction in value of the property at death.

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DEFERRED PAYMENT SALES TO GRANTOR TRUSTS, GRATS AND NET GIFTS: INCOME AND TRANSFER TAX ELEMENTS

By Elliott Manning and Jerome M. Hesch*

Abstract

Estate planners have long recognized the attractiveness of the various freeze techniques for transfer tax purposes. An outright gift is a freeze technique, but one that requires immediate payment of gift tax once the lifetime exemptions and annual exclusions are exhausted. Both grantor retained annuity trusts ("GRATs") and charitable lead trusts also accomplish the freeze objective, and at a reduced gift tax cost because of the reduction for the value of the grantor or charitable interests. Deferred payment sales are estate freeze vehicles that limit the transfer tax inclusion to the deferred payment right and interest, but require the recognition of gain, usually capital gain, albeit on a deferred payment basis if the sale qualifies of the installment method (or as a private annuity sale). When the deferred payment sale is to a grantor trust, however, the capital gain is eliminated, at least for payments during life. This article discusses the income tax and transfer tax savings available by using net gifts, GRATs, and deferred payment sales to grantor trusts. The deferred payment sale to the grantor trust can take be a sale for an installment note, a private annuity or a self-canceling installment note ("SCIN") without changing the income tax and freeze advantages, and, in the latter cases, with potential additional estate tax benefits. The article concludes that, in most circumstances at least, a deferred payment sale is a better approach than a GRAT, particularly when the risk that the grantor will not live out the GRAT period is taken into account. It also tends to be better for taxable generation skipping transfers. The article also concludes that neither the grantor-seller nor his estate realizes capital gain when grantor-trust status terminates while the deferred payment obligation is still outstanding.

Introduction

A number of recent articles have discussed deferred payment sales to nongrantor trusts and grantor trusts as estate planning techniques, particularly as estate freeze devices.[1] Some describe the

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[1] Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note - An End Run Around Chapter 14?*, 32ND ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN., Ch. 15 (1998); Shore and McClung, *Beyond the Basic Superfreeze - An Update and Additional Planning Opportunities*, 75 TAXES 41 (1997); Shore and Rosen, *Beyond Chapter 14—A Tale of Two (New) Freezes*, 71 TAXES 97 (1993); Nicholson, *Sale to a Grantor Controlled Trust: Better Than a GRAT?*, 37 TAX MGMT. MEM. 99 (1996); Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3 (1996); Covey, PRAC. DRAFT. at pp. 4833 to 4835 (April, 1997), pp. 4746 to 4747 (Jan. 1997) and pp. 4365 to 4370 (April, 1996). Hamill, *Intrafamily Sales of Appreciated Assets Offer Attractive Wealth Transfer Opportunities*, 13 J. TAX'N OF INV. 153 (1996). 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. 86 (1998). Oshins, King & McDowel III, *Sale to a Defective Trust: A Life Insurance Technique*, 137 TR. & EST. NO. 5, 35 (1998); Horowitz, *Succession Planning for the Family Business Enterprise: Sales, GRATs and Donative Transfers--The Comparative Advantages*, 74 TAXES 428 (1996) ("Horowitz Succession"); Horowitz, *MIGRATs^{SM} are Better Than Your GRATs Despite New Section 7520 Regulations*, 74 TAXES 299 (1996) ("Horowitz *MIGRATs^{SM}*"); Abbin, *[S]He Loves Me, [S]He Loves Me Not—Responding To Succession Planning Needs Through A Three-Dimensional Analysis of Considerations To Be Applied in Selection*

specific variation discussed with cute names like "Superfreeze,"[2] "megatrust™,"[3] IDIT trust,[4] IDIOT Trust™[5] and MIGRAT℠[6] some of which, as indicated, are considered to be proprietary. They also examine using as the purchaser a trust in which the seller is treated as the owner, for income tax purposes, of the assets sold to the trust under the grantor trust rules in order to avoid the recognition of the capital gain and interest income that normally accompanies an installment sale (on the ground that such sales are not "realization" events). These articles examine the claimed advantages deferred payment sales have over a grantor retained annuity trust ("GRAT").

A GRAT is a gift transaction in which the grantor retains an annuity for a term of years that is intended to end before his death.[7] Because the retained interest is deducted in determining the gift tax value of the transfer, gift tax is paid only on the present value of the remainder. This advantage is somewhat offset by the early payment of the gift tax and the resulting loss of earnings on that amount. If the grantor survives the annuity term, the trust assets are not included in the grantor's gross estate so that the gift tax paid on the remainder is the only transfer tax paid on passing the trust's assets to the next generation, subject only to the disadvantage of early payment of the transfer tax. Unfortunately, if the grantor does not survive, the entire value of the trust at the date of death is included in the gross estate,[8] so that not only is there no transfer tax saving, but there is the disadvantage of having lost the earnings on the gift tax paid since the credit for the gift tax paid is limited to the amount paid with no adjustment for early payment and with the risk that the full gift tax may not be creditable if the "second limitation"[9] applies.

From the Cafeteria of Techniques, 31st ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN, Ch. 13 (1997). Weinberg, *Reducing Gift Tax Liability Using Intentionally Defective Irrevocable Outstanding Trusts* (the IDIOT® Trust), 4 Journal of Asset Protection 62 (1999). Oshins, *Sales to Grantor Trusts: Expotential Leverage Using Multiple Installment Sales*, 13 Probate & Property 46 (1999).

2 Shore and McClung, *supra* note 1.

3 Oshins, King & McDowel, *supra* note 1.

4 Mulligan, *supra* note 1; Nicholson, *supra* note 1.

5 AP Briefs No. 26 (Dec. 19,1997) (on file with the authors) attributes this, without a source citation, to Michael E. Weinberg.

6 Horowitz *MIGRATs℠*, *supra* note 1

7 A similar device is a grantor retained unitrust ("GRUT"), in which the retained interest is a specified percentage of the value of the trust as redetermined annually. Some believe that a GRUT or similar arrangement is a superior device for eliminating issues of balancing successive interests and emphasizing total return. See Horn, *Prudent Investor Rule, Modern Portfolio Theory, and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust*, 33 REAL PROP. PROB. & TR. J. 1 (1998); Wolf, *Total Return Trusts—Can Your Clients Afford Anything Less?*, 33 REAL PROP. PROB. & TR. J. 131 (1998). Whatever the merits of a unitrust device as a trust matter, a fixed annuity is better as an estate freeze and general estate planning matter unless there is serious concern about total cumulative return on the trust (including income and appreciation), being less than the cumulative annuity obligation.

8 See Priv. Ltr. Rul. 94-51-056 (Sep. 26, 1994); Priv. Ltr. Rul. 93-45-035 (Aug. 13, 1993) (both requiring inclusion under § 2039 principles). But see Blattmachr and Slade, PARTIAL INTERESTS—GRATS, GRUTS, QPRTS (SECTION 2707) 836 T.M. AT A-35 (1996) (if GRAT is for a fixed term, only a portion of the total value needed to yield the fixed payment using the § 7520 rate should be included); Horowitz *Succession*, *supra* note 1, at 436 (recommends a series of short-term or rolling GRATs to mitigate the consequences).

9 The "second limitation" limits the credit to the portion of the estate tax determined to be attributable to the inclusion of the property in the gross estate. § 2012(a). It is an average rate computation and applies to the estate tax after the state death tax credit. Although it is not common, this limitation can provide a credit less than the gift tax paid.

The Internal Revenue Service ("IRS") has ruled that a deferred payment sale by an individual to a trust of which the ~~transferor is treated as the owner of all income~~ and principal for Federal income tax purposes is not treated as an income tax realization event.[10] Thus, like a transfer to GRAT, the deferred payment sale ~~to a grantor trust results in a transfer to the trust of~~ the grantor's basis in the assets "sold" to the trust and all other income tax attributes inherent in the assets.[11] Following the "sale," the grantor continues to report all of the income and losses generated by trust's assets, including any gain or loss on resale, as if the grantor were still the legal titleholder of the property.[12] ~~Nevertheless, the~~ sale is recognized as such for transfer tax purposes.[13] ~~so that all that the seller now~~ owns is the note. It is well-established that the transfer taxes (that is, the gift and estate taxes) are not in pari materia with the income tax,[14] so that it is not inconsistent to have a deferred payment sale that is ignored for income tax purposes, but recognized as a sale for adequate consideration in money or money's worth for gift and estate tax purposes. Although the grantor-trust rules[15] have similar functions to the "string" provisions of the estate tax,[16] their detailed rules are quite different, so that different results are inevitable.

This article addresses four major aspects of the use of deferred payment sales to grantor trusts. First, it compares the income and transfer tax consequences of (i) net gifts, (ii) transfers to GRATs, (iii) deferred payment sales to a nongrantor trust and (iv) deferred payment sales to a grantor trust, seeking to provide a more comprehensive analysis than the recent articles.[17] Second, it discusses the income tax consequences when the deferred payment obligation is satisfied while the trust is a grantor trust. Third, it discusses the income tax consequences of termination of grantor-trust status while the deferred payment obligation is outstanding while the grantor is alive and on the grantor's death. Some of the published articles disagree with our conclusions on some of these income tax consequences.[18] Fourth, as

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[10] Rev. Rul. 85-13, 1985-1 C.B. 184; Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (this ruling was obtained by the authors of the Mulligan and the Abbin articles, *supra*, note 1); Priv. Ltr. Rul. 90-10-065 (Dec. 13, 1989); Priv. Ltr. Rul. 93-52-017 (Sep. 30, 1993), Priv. Ltr. Rul. 93-51-005 (Sep. 16, 1993); Priv. Ltr. Rul. 95-04-021 (Oct. 28, 1994); Priv. Ltr. Rul. 94-44-033 (Aug. 5, 1994).

[11] Rev. Rul. 85-13, 1985-1 C.B. 184; Priv. Ltr. Rul. 95-35-026 (May 31, 1995); Rev. Rul. 77-402, 1977-2 C.B. 222; Reg. § 1.1001-2(c) Example 5. In *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984), the court determined that the grantor trust rules do not actually treat the grantor and the trust as one, but merely require that the grantor report all of the trust's items as his own and recognized a sale by; the trust to the grantor as allowing the grantor-purchase to use the purchase price as the basis of the assets); *Ringwalt v. United States*, 549 F.2d 89 (8th Cir. 1977), *cert den.* 432 U.S. 906 (1977) (imputing "control" of stock owned by trust to grantor to satisfy § 368(c)).

[12] Rev. Rul. 85-13, 1985-1 C.B. 184,185; Cf. Rev. Rul. 92-84, 1992-2 C.B. 216 (beneficiary of qualified subchapter S trust reports gain on sale of S corporation stock even though under local law gain is allocated to corpus.

[13] Rev. Rul. 77-193, 1977-1 C.B. 273; *Est. of Becklenberg v. Commissioner*, 233 F.2d 297 (7th Cir. 1959).

[14] See *Farid-es-Sultaneh v. Commissioner*, 160 F.2d 812 (2nd Cir. 1947) (pre-nuptial transfer provided fair market value basis because in consideration of promise of marriage even though it was a gift for transfer tax purposes); *Burnet v. Logan*, 283 U.S. 404 (1930) (receipt of difficult to value rights not realization for income tax purposes even though same rights valued for estate tax purposes)' *Lockwood v. Commissioner*, 166 F.2d 1349 (Ct. Cl. 1979) ("For the most part any correlation that may exist between the [income and gift] taxes is purely coincidental."); In *Gessner v. United States*. 600 F.2d 1349 (Ct. Cl. 1979) the court indicated that reliance on income tax rules to determine and estate tax issue would be "untenable." In Tech. Adv. Mem. 96-04-002 (Oct. 6, 1995), the IRS explained that: "The income tax and the estate tax are not in pari materia. The purpose of the income tax is to tax all accretions to wealth. . . . The federal estate tax is a tax on the transfer of wealth and is imposed on the value of property passing at death without regard to the form in which the property ultimately passes to the beneficiaries."

[15] See §§ 671-79.

[16] See §§ 2036-42.

[17] See articles cited in note 1, *supra*.

[18] Smith, *supra* note 1; Covey, *supra* 1

appropriate, it discusses ways to avoid some of the unresolved issues that arise when the trust ceases to be a grantor trust while the deferred payment obligation remains outstanding.

In providing our analysis, it is helpful to establish a uniform set of facts and assumptions that can be used to provide the basic analysis for this article. We do this recognizing that no single set of facts, even with variations, can capture all of the considerations needed to make an analysis of a course of action. We believe the assumed facts capture enough of the essential considerations to provide a useful analysis. We point out significant other factors when we consider them relevant.[19]

> *Assumed Facts*: Senior, age 70, owns an aggregate of income-producing investment assets worth $1,000,000, with a basis of zero that he does not need to maintain his lifestyle or to protect against emergencies. For income tax purposes, the life expectancy of a 70-year old individual is 16.0 years,[20] but based on Table 80CNMST, used for transfer tax purposes, his life expectancy is apparently only 13.3 years.[21] Senior has other assets so that his estate will be in the top 55% marginal estate tax bracket. Senior has already used his lifetime exclusion,[22] his generation skipping exemption and his "run up the brackets." The annual pre-tax rate of return on these assets is 9%, consisting of a combination of ordinary income and capital gains realized each year. The blended marginal income tax rate on this combination of ordinary income and capital gains is 30%.[23] Senior uses the income from these assets to pay the income tax attributable to that income. Thus, Senior must use $27,000 ($90,000 x 30%) of the $90,000 of income to pay the income tax on the earnings, accumulating the remaining $63,000 after-tax annual earnings. The § 7520 rate for the month of the transfer is 6.8% and the long-term AFR is 5.9%.[24]

Although a number of the articles deal with combining a GRAT or deferred payment sale to a grantor trust with a discount technique like a family limited partnership or LLC ("FLP"), the discount technique raises additional issues that unnecessarily complicate the comparative analysis we want to make. To the extent that the discount technique works or doesn't work,[25] the remaining results of the use of the net gift, the GRAT or sale to the grantor trust should be unaffected.[26]

As a base case, we start with an analysis of what happens if Senior does no estate planning and reinvests his after-tax earnings on the relevant assets each year. We make the simplifying assumption that Senior has used his annual exclusion, applicable unified credit amount, generation-skipping

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[19] Or at least when we think of them.

[20] Reg. § 1.72-9, Table V.

[21] We obtained this factor from Leimberg and LeClair, NUMBERCRUNCHER 98 (Benchmark Software 1998).

[22] The "applicable credit amount" is $650,000 for 1999, and increases to $1,000,000 by 2006. § 2010(c).

[23] At a 30% income tax marginal rate, a 9% before-tax rate of return becomes a 6.3% after-tax rate of return.

[24] The § 7520 rate is equal to 120% of the mid-term AFR. § 7520(a)(2). The rate used in the examples is that for April 1998 when we started working on the analysis..

[25] See DEPT. OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S REVENUE PROPOSALS 129 (Feb. 1998); JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1999 BUDGET PROPOSALS 176-80 (1998) (proposing statutory limits); see Tech. Adv. Mems. 97-19-006 (Jan. 14, 1997); 97-23-009 (Feb. 24, 1997); 97-25-002 (Mar. 3, 1997); 97-30-004 (Apr. 3, 1997); 97-36-004 (Jun. 6,1997); 97-35-003 (May 8, 1997) and 98-42-003 (Jul. 2, 1998) all disregarding FLPs, mostly created by terminally ill taxpayers, sometimes under durable powers of attorney, on a variety of grounds including sham, § 2703(a)(2) and § 2704(b).

[26] But see Horowitz *Succession*, *supra* note 1 suggesting advantages in meeting the GRAT or, implicitly, installment sale payments based on discounted value when the assets produce income on undiscounted value.

exemption and run up the brackets for comparability purposes although arguably it is inconsistent with the no-estate-planning case.

Example (1). Senior retains all $1,000,000 of income-producing assets and does no income tax or estate planning, paying the annual income taxes on the income, and reinvesting the after-tax proceeds each year. Senior will have accumulated $2,085,213 at the end of 12 years.[27] This represents the initial $1,000,000 augmented by the annual 6.3% after-tax rate of return. If Senior dies at that time, at the assumed 55% marginal estate tax rate, the estate taxes on this accumulated amount would be $1,146,867, leaving Senior's children with $938,346 after the payment of the estate taxes. If Senior's devise is also a direct skip subject to the GST tax, the combined effective rate of tax would be 79.75%,[28] resulting in combined taxes of $1,662,957, leaving only $422,256 for Senior's grandchildren. The distributees receive the assets with a stepped up basis upon Senior's death.

If Senior is alive and belatedly decides to make a gift at the beginning of year 13, the gift should be only the amounts left after taxes generated by the transfer, in effect, a net gift to be consistent with the idea that the transfer is the $1,000,000 of unneeded assets. Thus, the taxable net gift is to his children from the $2,085,213 of accumulated assets is $1,345,299, the amount on which gift tax at 55% equals $739,914 ($1,345,299 + $739,914 = $2,085,213). The dramatic difference from the death situation is a demonstration of the difference between the "tax inclusive nature" of the estate tax (that is, that the estate tax is imposed on the total assets transferred including those used to pay the estate tax) and the "tax exclusive" nature of the gift tax (that is, that the gift tax is imposed only on what the donee receives and not on the funds used to pay the tax). The net gift tax rate is 35.48%.[29]

If he makes a complete accounting, Senior should also take into account the capital gains tax on the assets disposed of to pay the gift tax and the capital gains tax itself. The facts assume that the basis of the original assets is zero. On the other hand, the reinvested earnings of $1,085,213 should have a basis near fair market value since no appreciation of such assets has been assumed. Although the original assets are now only 47.96% of the total, we will make the reasonable assumption that the high basis assets will be sold and ignore the capital gains tax at this point.[30]

A direct gift to the grandchildren is a direct skip that increases the gift tax by 55% of the amount of the GST tax.[31] The net gift tax rate when the GST tax and the gift tax on the GST tax is involved is 48.22%.[32] The distributees receive the assets with a transferred basis increased for the gift tax paid but not GST tax paid, with respect to the appreciation.[33] The additional gift tax

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27 Assuming there is no appreciation in the principal.

28 55% estate tax + 24.75% (55% of 45%) GST tax.

29 55% (the gift tax rate)/(1+ 55%)

30 This is consistent with the general approach on transfers subject to a liability that the liability is applied first against basis. It is not clear whether this is the aggregate basis of all assets or allocated asset-by-asset. If a ratable portion of the assets is applied, the effective capital gain rate is 9.59%.

31 § 2515. The effect of the gift is to impose the GST tax on a tax inclusive basis. See HARRINGTON, PLAINE AND ZARITSKY, GENERATION SKIPPING TRANSFER TAX ¶¶ 3.02[2], 8.02[1][c] (1996).

32 55% (gift tax) + 24.75% (GST tax) + 13.6125 (gift tax @ 55% on GST tax) = 93.3625%. 93.3625%/1.933625% = 48.22%

33 § 1015(d)(6); Reg. § 1.1015-5(c).

on the GST tax should also provide an increase in basis.[34] The results, after taking into account transfer and capital gains taxes, are:

Transfer in Year 13	Amount	Taxes on Transfer to Children	Net to Children	Taxes on Transfer to Grandchildren	Net to Grandchildren
Death[35]	$2,085,213	$1,146,867	$938,346	$1,662,957	$422,256
Gift[36]	$2,085,213	$739,914	$1,345,299	$1,005,490	$1,079,723

The advantages of the deferred gift shown above are overstated because if Senior dies within three years of making the gift, the gift tax paid is included in his gross estate, in effect requiring payment of additional estate taxes of $406,953 at 55% on the gift taxes whether the gift is to the children or to the grandchildren because the effect of the gift tax on the GST tax is the gross up of the gift tax to 55% on a tax inclusive basis. In the case of the gift to the grandchildren the additional tax is $377,754 at 55% on the $686,826 of gift tax. Based on Table 80CNSMT as set forth in Reg. § 20.2031-7, the basic estate tax regulations for determining the value of annuities, there is a more than 25% chance that Senior will not live the additional three years needed to avoid this result. We realize that with the over 80 group being reported as one of the fastest growing demographic groups, this may overstate the risk, but have no other easily available data, and we use this to highlight an often underemphasized risk in estate planing

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If the investment assets appreciate at a relatively modest annual growth rate of 3%,[37] the value of the assets increases to $2,908,979 at the end of the twelfth year. The results after taking into account transfer and capital gains taxes are:

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[34] § 1015(d)(1)(A).

[35] Basis = FMV of the assets received.

[36] Basis = $895,299, (the FMV of the remaining reinvested assets ($345,299) + a pro rata portion of the gift tax allocated to the original $1,000,000 of assets with an assumed basis of zero ($550,000) for the gift to the children) and $820,249 (the FMV or the remaining assets ($79,723) + the gift tax ($593,849) + the gift tax on the GST tax ($146,977) for the gift to the grandchildren). Neither the capital gain tax nor the GST tax provides basis.

[37] This brings the total return to 12%, which is not significantly different from the long-term rate of return on the Standard & Poors 500.

Item	Amount	Taxes on Transfer to Children	Net to Children	Taxes on Transfer to Grandchildren	Net to Grandchildren
Death[38]	$2,908,979	$1,599,938	$1,309,041	$2,319,911	$589,068
Gift[39]	$2,908,979	$1,032,106	$1,876,873	$1,404,561	$1,504,418

Again the advantages of the deferred gift shown above are overstated because if Senior dies within three years of making the gift, the gift tax paid is included in his gross estate in effect, requiring payment of additional estate taxes of $567,754 on the gift tax, which is the same for both children and grandchildren.

* * *

Senior can improve the results set forth above by use of a current net gift, GRAT or a deferred payment sale, particularly to a grantor trust, if, *but only if*, the actual rate of return earned by the assets is greater than the assumed rate of return used by the Internal Revenue Code in determining the transfer tax consequences of the transaction.[40] The next part of this article illustrates and compares the advantages of these alternatives.

I. CURRENT NET GIFT

Surprisingly, Senior can improve the situation significantly as compared with passing the assets through his estate by making a current transfer in the form of a net gift in year 1, despite having to pay the transfer tax much earlier and paying a capital gains tax.[41] On the other hand, the current net gift is only marginally better than a future net gift if Senior lives and only after the risk of premature death is taken into account.

Example (2). Senior transfers what is left of the $1,000,000 of income-producing investment assets to younger generation family members after deducting the amount necessary to pay the gift tax, any applicable GST tax and the capital gains tax on the funds used to pay the taxes (the proceeds of sale of the investment assets that are assumed to have a zero basis).[42] The combined effective capital gains and gift tax rate is 40.74%.[43] The net gift to the children is $592,592. The gift tax on that amount is $325,926 and the capital gains tax on zero basis assets to pay that gift tax and the capital gains tax is $81,482. At a 6.3% after tax rate of return on $592,592, the

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38 Basis = FMV of all assets.

39 Basis = $1,1,141,384 ($265,008 remaining accumulated earnings + $806,376, a pro rata portion of the $1,032,106 gift tax on the transfers to the children or grandchildren).

40 Either the three AFRs (§ 1274(d) or the § 7520 rate.

41 Katzenstein, *Running the Numbers: An Economic Analysis of GRATs and QPRTs*, 32nd ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN. Ch. 14 (1998); Hodgman and Stetter, *Analyzing GRATs: Does the Emperor Have Any Clothes?*, 134 TR. & EST. 41 (No.5 1995).

42 In a classic "net gift," the donor shifts the liability for the taxes to the donee and is treated as having made a sale of property for the amount of the liability transferred to the donee. If the liability can all be allocated to the high-basis reinvested securities, the result is the same as when the donor pays the tax. If the liability is allocated ratably, the capital gain tax increases because some of the zero basis assets are sold. In view of the uncertainty on this issue, it is better planning for the donor to control the assets sold.

43 .55 (the gift tax rate)/1.35 = (1 + .55 - .20 (the capital gains tax rate)).

children will have $1,233,549 at the end of 12 years. If the transfer is a direct skip to the grandchildren, the net gift is $461,461 after combined gift tax ($253,803), GST tax ($114,212), and gift tax on GST tax ($62,816) and capital gains tax on the whole mess ($107,708). This amount will grow to $910,581 after 12 years reinvested at 6.3% net after tax. The results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$407,408	$ 592,592	$538,539	$461,461
Accumulated Income	---	---	640,953	---	499,120
Totals[44]	$1,000,000	$407,408	$1,233,545	$538,539	$910,581

The advantages of a current net gift may be greater if the tax brackets of the younger generation recipients are lower than those of the donor. Because we have assumed a blended rate of 30%, we believe this advantage is likely to be small in our examples. The advantages of the net gift shown above are overstated because if Senior dies within three years of making the gift, the gift tax paid is included in his gross estate in effect, requiring payment of additional estate taxes of $179,259 at 55% on the $325,926 of gift taxes for the gift to the children and $174,180 on the $316,691 of gift taxes on the gift to the grandchildren. The difference in gift tax amounts is attributable to the capital gains taxes on the funds used to pay the gift taxes.

* * *

If the investment assets appreciate at a relatively modest annual growth rate of 3%, the results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$407,408	$ 592,592	$538,539	$461,461
Accumulated Income and Appreciation	---	---	1,138,782	---	879,997
Totals[45]	$1,000,000	$407,408	$1,731,374	$538,539	$1,341,458

Again the advantages of the deferred gift shown above are overstated because if Senior dies within three years of making the gift, the gift tax paid is included in his gross estate in effect, requiring payment of additional estate taxes of $179,259 and $174,180 on the gifts to the children and grandchildren, respectively.

44 Basis for children is $966,879 (the $325,926 gift tax + the accumulated income) and for the grandchildren is $815,811 ($316,691 total gift tax ($253,803 gift tax + $62,816 gift tax on GST) + the accumulated income). Neither the capital gain tax nor the GST tax provide basis.

45 Basis = $1,091,062 ($774,371, the accumulated earnings, + $316,691, the gift taxes on the transfers to the children or grandchildren).

II. TAX CONSEQUENCES OF A GRAT.

One major disadvantage of a net gift is that it requires payment of substantial taxes at inception, reducing the amount available for investment by younger generation family members particularly, because of high GST rates, when the transfer is to grandchildren. A GRAT seeks to reduce this disadvantage by reducing the transfer tax cost of the estate freeze inherent in the funding of the GRAT. The freeze is particularly potent because the earnings of the trust in excess of the amount of the annuity will escape transfer taxation if the transferor survives the GRAT term, as will any appreciation in the value of the trust assets. The IRS asserts that even an annuity for a fixed term with any balance at death to go to the estate of the decedent must be valued for gift tax purposes as an annuity for the shorter of the fixed term or life.[46] This has the effect of reducing the value of the annuity and increasing the amount of the taxable gift. This position is controversial, with those challenging the IRS position asserting that it has perverted the rule that interests other than the fixed annuity, such as contingent remainders should be ignored, by disregarding an interest that the grantor is bound to receive one way or another.[47] We first present an analysis disregarding this IRS position in order to improve comparability of a GRAT with a deferred payment sale where the issue of using a shorter life in valuation of the retained interest does not arise.

Because a GRAT is a grantor trust for Federal income tax purposes, Senior reports all of the trust income during the annuity term on his individual Federal income tax return each year. Senior's payment of the income taxes on income accumulating for, and passing to, the trust beneficiaries is not a further gift, but a satisfaction of an obligation imposed on Senior by the Code.[48] These benefits are illustrated in the following example:

> *Example (3)*. Senior transfers what is left of the \$1,000,000 of income-producing investment assets to younger generation family members after deducting the amount necessary to pay the gift tax, any applicable GST tax and the capital gains tax on the funds used to pay the taxes (the proceeds of sale of the investment assets that are assumed to have a zero basis). The corpus of the GRAT is \$762,085 and the annuity at 6.8% is \$51,822. The determination of the taxable gift of the remainder interest is \$346,060, based on the mandatory application of the § 7520 assumes that the trust principal is producing an internal rate of return equal to that rate, 6.8% in these examples. Initially the earnings accumulated by the trust are \$16,766, and they increase each succeeding year as accumulated earnings augment trust principal but do not adjust the annuity. These "excess" earnings, amounting to \$337,673 over the 12-year period, pass to the remainder beneficiaries of the trust at the end of the 12-year GRAT term free of gift or estate tax if the grantor survives. The GST equivalents are: GRAT corpus of \$653,620, remainder of \$296,804, and accumulated income of \$289,478 that is free of gift tax, but it is still subject to GST,[49] which is \$159,213 at 55% because of the absence of gift tax.[50] The entire excess of the pre-tax income

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46 Reg. § 25.2702-3(e) Examples 1 and 5.

47 See, *e.g.*, Horowitz MIGRATs[SM], *supra* note 1.

48 See Roth, *The Intentional Use of Tax-Defective Trusts*, 26th ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN Ch. 4, ¶ 406.1.L. (1992). See also Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995) withdrawing the paragraph in Priv. Ltr. Rul. 94-44-033 (Aug. 5, 1994) that had stated that there was no gift on payment of income tax by grantor-annuitant of a GRAT holding S corporation shares that had a provision for reimbursement of any income tax not covered by the annuity and that had stated that there would be a gift tax on payment of the income tax in the absence of reimbursement provision.

49 § 2642(f)(1) and (f)(2)(B). These provisions are commonly referred to as the estate tax inclusion period ("ETIP")

50 There is no gift tax on the GST because the transfer is from a trust that pays the tax, which effectively imposes the GST on a tax-inclusive basis. See Harrington, et al, *supra* note 31at ¶ 3.02[2].

of the trust over the annuity payment accumulates because Senior, as grantor, must pay the income tax on all trust income but does not include the annuity itself in income. The trust receives the assets with a transferred basis increased for the gift tax on the transfer in trust, even though the gift tax is only imposed on the value of the remainder. Assuming the income tax on the trust income is paid by Senior out of the annual annuity payment, Senior has $31,246 ($51,822 – 20,576 tax) to invest in the first year and declining amounts in subsequent years as the trust income taxed to him increases. If Senior invests this amount at the same 9% rate assumed for the GRAT and the income is taxed at the same 30% rate, Senior's accumulated net after-tax annuity amount will grow to $486,605[51] at the end of 12 years. The results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$237,915	$762,085	$346,680	$653,320
Accumulated Trust Income[52]	---	---	337,673	159,213	130,265
Senior's Net Accumulation[53]	---	172,666	313,939	201,419	215,739
Totals[54]	$1,000,000	$410,581	$1,413,697	$707,312	$999,324

The risk of inclusion of gift tax in the gross estate if Senior dies within three years after the GRAT period applies only to the gift taxes paid on Senior's net accumulation that we assume to have been transferred at the end of the period, and are $84,867 and $81,413 for the transfers to children and grandchildren respectively. That risk can be reduced by making annual transfers of the after-tax annuity amounts but at the cost of incurring gift tax that reduces the amount available for reinvestment.

* * *

If the investment assets appreciate at 3%, the value of the assets increases with the following results after taking into account transfer and capital gains taxes:

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51 This represents the twelve $51,822 annuity payments (total $621,864) reduced by the tax on the total trust income of $959,537 or tax of $287,861 and increased by the accumulated after-tax earnings on the remaining annuity amounts totaling $152,604.

52 $289,478 for the GRAT for grandchildren.

53 $486,605 from the annuity from the GRAT for children and $417,158 for that for grandchildren.

54 Basis = $846,954 ($337,673, the amount of the trust's accumulated income + $313,939, the after-tax amount of Senior's net accumulation + $190,332, the gift tax on the GRAT remainder) for the GRAT for children and $653,241 ($130,265, the amount of trust's accumulated income + $215,739, the after-tax amount of Senior's net accumulation + $173,542, the gift tax on the GRAT remainder and the gift tax on the GST tax) for the GRAT for grandchildren).

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$237,915	$762,085	$346,380	$653,620
Accumulated					
Trust Income			398,302	187,888	153,726
Appreciation	---	-0-	590,964	278,776	228,090
Senior's Net					
Accumulation[55]	---	171,729	312,235	200,323	214,565
Totals[56]	$1,000,000	$409,644	$2,063,586	$1,013,367	$1,250,001

Although the trust's accumulation is substantially more, Senior's is less because the additional income tax he pays on the income from the trust's assumed greater income resulting from the 3% growth increases slightly faster than the appreciation on his own reinvestment of his after-tax annuity. The risk of increased estate taxes if Senior dies within three years of transferring the net accumulation is $94,451 and $80,970 for the transfers to children and grandchildren, respectively.

In addition, because the GRAT has a transferred basis in the investment assets transferred, Senior will be taxed on any unrealized gains (or losses) in the assets transferred, if and when the trust shifts investments. This tax is an additional benefit to the GRAT and its beneficiaries, allowing them a tax-free step up in basis, while reducing the accumulation from the annuity. Our examples do not address this aspect.

* * *

When the IRS position on the reduction in the value of the annuity for the possibility that Senior will die before the end of the 12-year annuity term (even though his life expectancy is 13.3 or 16 years), is factored in, the higher gift (and GST) taxes reduce the principal of the GRAT and the ultimate benefit to the younger generation family members. The results, after taking into account transfer and capital gains taxes, are:

55 $483,964 for the GRAT for children and $414,888 for the GRAT for grandchildren.

56 Basis = $900,869 ($398,302, the amount of the trust's accumulated income + $312.235, the after-tax amount of Senior's net accumulation + $190,332, the gift tax on the GRAT remainder) for the GRAT for children and $616,197 ($228,090, the amount of trust's accumulated income + $214,565, the after-tax amount of Senior's net accumulation + $173,542, the gift tax on the GRAT remainder and the gift tax on the GST tax) for the GRAT for grandchildren).

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$275,886	$724,114	$392,741	$607,259
Accumulated Trust Income[57]	---	---	320,848	147,986	121,080
Senior's Net Accumulation[58]	---	164,063	298,297	187,219	200,528
Totals[59]	$1,462,360	$439,949	$1,343,259	$727,946	$928,867

The risk of increased estate taxes if Senior dies within three years of transferring the net accumulation is $90,235 and $75,673 for the transfers to children and grandchildren, respectively.

* * *

If the investment assets appreciate at 3%, the results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$275,886	$724,114	$392,741	$607,259
Accumulated Trust Income[60]	---		561,521	258,999	211,909
Appreciation[61]	---	---	378,456	174,563	142,822
Senior's Net Accumulation[62]	---	163,172	296,678	186,200	199,437
Totals[63]	$1,000,000	$439,055	$1,960,769	$1,012,503	$1,161,427

Although the trust's accumulation is substantially more, Senior's is less because the additional income tax he pays on the income from the trust's assumed greater income resulting from the 3%

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57 $269,066 for the GRAT for grandchildren.

58 $462,360 for the GRAT for children and $387,747 for the GRAT for grandchildren.

59 Basis = $839,854 ($320,848, the amount of the trust's accumulated income + $298,297, the after-tax amount of Senior's net accumulation + $220,709, the gift tax on the GRAT remainder) and $552,530 ($121,080, the amount of trust's after-tax accumulated income + 200,528, the after-tax amount of Senior's net accumulation + 230,902, the gift tax on the GRAT remainder and on the GST) for the gift to the grandchildren).

60 $470,908 for the GRAT for grandchildren.

61 $317,385 for the GRAT for grandchildren.

62 $459,850 for the GRAT for children and $385,637 for the GRAT for grandchildren

63 Basis = $1,078,908 ($561,521, the amount of the trust's accumulated income + $296,678, the after-tax amount of Senior's net accumulation + $220,709, the gift tax on the GRAT remainder) and $642,248 ($211,909, the amount of trust's after-tax accumulated income + $199,437, the after-tax amount of Senior's net accumulation + $230,902, the gift tax on the GRAT remainder and on the GST) for the gift to the grandchildren).

growth increases slightly faster than the appreciation on his own reinvestment of his after-tax annuity. The risk of increased estate taxes if Senior dies of transferring the net accumulation within three years is $89,745 and $75,261 for the transfers to children and grandchildren, respectively.

* * *

If Senior dies before the end of the annuity period, the GRAT's assets are included in his gross estate with significantly less favorable results. This means that the trust corpus including accumulated income is subject to the tax-exclusive estate tax, with a credit for the gift tax paid on the transfer to the GRAT,[64] and to GST tax on the amount included in the gross estate, but without inclusion of capital gains tax or gift tax[65] paid on the original transfer to the GRAT. The results, after also taking into account transfer and capital gains taxes on the original transfer, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$466,730.[66]	$533,270	$590,359.[67]	$409,641
Accumulated Trust Income[68]	---	185,720	151,953	230,859	58,619
Senior's Net Accumulation[69]	---	267,633	218,972	332,923	84,535
Totals[70]	$1,000,000	$920,083	$904,195	$1,154,141	$552,795

* * *

If the investment assets appreciate at 3%, the results, after also taking into account transfer and capital gains taxes on the original transfer, are:

64 § 2512.

65 To prevent double taxation of the value of the same gift, the prior transfer is not included in determining "adjusted taxable gifts" in determining the estate tax bracket (a factor not relevant in any event in our assumed fact pattern). § 2001(b); H.R. REP. NO. 1380 94TH CONG. 2ND SESS. 3, 13 (1976); see Rev. Rul. 84-25, 1984-1 C.B. 191. Although the gift tax paid is not technically excluded, it is, in effect, allowed as a credit in determining estate tax. § 2001(b)(2). The same process is followed for the GST tax on the prior transfer. § 2642(b)(2)(A).

66 Includes capital gains tax and gift tax on original transfer to GRAT.

67 Includes capital gains tax, gift tax and GST tax on original transfer and additional gift tax and GST tax at death.

68 $337,673 for GRAT for children and $289,478 for GRAT for grandchildren.

69 $486,605 for the GRAT for children and $417,458 for the GRAT for grandchildren.

70 Basis = FMV.

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$237,915	$762,085	$590,359	$409,641
Accumulated Trust					
Income[71]		325,030	265,934	404,034	102,592
Appreciation[72]	---	219,066	179,236	272,312	69,145
Senior's Net Accumulation[73]	---	266,180	217,784	330,554	83,934
Totals[74]	$1,000,000	$1,048,191	$1,425,039	$1,597,259	$665,312

* * *

Under the IRS approach to valuing the GRAT remainder, if Senior dies before the end of the annuity period, the benefits to younger generation family members are similarly less favorable than under a valuation based on a fixed annuity. The results, after taking into account transfer and capital gains taxes on the original transfer, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$453,440	$546,560	$562,837	$437,163
Accumulated Trust Income[75]	---	176,466	144,382	214,580	54,486
Senior's Net Accumulation[76]	---	254,298	208,062	309,228	78,519
Totals[77]	$1,000,000	$884,204	$899,004	$1,086,645	$570,168

* * *

If the investment assets appreciate at 3%, under the IRS approach to valuing the GRAT remainder, the results, after taking into account transfer and capital gains taxes on the original transfer, are:

71 $590,965 for the GRAT for children and $506,626 for the GRAT for grandchildren.

72 $398,302 for the GRAT for children and $341,457 for the GRAT for grandchildren.

73 $483,964 for the GRAT for children and $414,488 for the GRAT for grandchildren.

74 Basis = FMV.

75 $320,848 for the GRAT for children and $269,066 for the GRAT for children.

76 $462,360 for the GRAT for children and $387,747 for the GRAT for grandchildren.

77 Basis = FMV.

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$453,440	$546,560	$562,837	$437,163
Accumulated Trust					
Income[78]	---	308,837	252,684	375,549	95,359
Appreciation[79]	---	208,151	170,305	253,115	64,270
Senior's Net					
Accumulation[80]	---	252,918	206,932	307,546	78,091
Totals[81]	$1,000,000	$1,223,346	$876,481	$1,499,047	$674,883

* * *

The portion of the advantage of a GRAT resulting from our assumption that the internal rate of return is greater than the applicable § 7520 interest rate is illustrated by comparing the results in *Example (3)* above to the following example.

> *Example (4)*. If the annual earnings on the income producing assets Senior transfers to the GRAT are only 6.8%, consisting of a combination of ordinary income and capital gains. The taxable gift of the remainder interest is the same as in *Example (3)* because § 7520 prescribes use of a specified rate regardless of actual earnings. There are, of course, no accumulated earnings to pass on. The $51,822 trust earnings are taxed to Senior and leave $36,275 after tax to be invested at the assumed 6.3% after tax rate. Over the 12-year GRAT term, these accumulated earning amount to $622,874. When this amount is transferred to children in a net gift, the gift tax of $221,120 leaves $401,854 for the children that when added to the $762,085 in the GRAT are only $1,163,939.

* * *

To the extent actual earnings are less that the § 7520 rate, the amount passed to the next generation(s) is less than the amount used to determine the gift tax value of the remainder. Because interest rates, and consequently the § 7520 rate, are currently low, this is not a great risk. Those who remember the high interest rates of the late 1970s and early 1980s may be more concerned about the risks of interest rate fluctuations over a 12-year term unless long term investments that lock in the annuity rate can be obtained.

* * *

In addition to its view that the GRAT annuity must be valued at the shorter of the term or the life of the grantor, the IRS takes the position that it is impossible to completely avoid gift tax using a GRAT because a fund cannot support an annuity with a value equal to the total amount of the fund because of

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78 $561,521 for the GRAT for children and $470,908 for the GRAT for grandchildren.

79 $378,456 for the GRAT for children and $317,385 for the GRAT for grandchildren.

80 $459,850 for the GRAT for children and $385,637 for the GRAT for grandchildren

81 Basis = FMV.

the risks of exhaustion of the fund.[82] Under the IRS position relating to exhaustion of the fund, attempting to zero-out a GRAT or even reduce its value by providing an annuity at a rate in excess of the § 7520 rate can backfire. Under a pure actuarial value analysis for a fixed annuity, if 12.46% of the fund for 12 years at 6.8% has a value equal to that of the fund. Under the twin IRS views, there is still a substantial gift.

> *Example (5).* Senior transfers what is left of the $1,000,000 of income-producing investment assets to younger generation family members after deducting the amount necessary to pay the gift tax, any applicable GST tax and the capital gains tax on the funds used to pay the taxes (the proceeds of sale of the investment assets that are assumed to have a zero basis), retaining an annuity of 12.46% of the fund or $88,066. The corpus of the GRAT is $888,066. The taxable gift of the remainder interest is $162,812. Over the 12-year term of the annuity, the trust pays Senior amounts equal to all trust income plus $618,224 of the corpus, leaving the trust with only $269,842 at the end of the GRAT term. In the meanwhile Senior has accumulated $1,578,760 of after-tax annuity proceeds. Transfer and capital gains taxes on a net gift of this amount to the children leaves $986,056, for a total of $1,255,898, less than for a straight GRAT. If the investment assets appreciate, the picture is not quite as bleak, still not as good as a straight GRAT. The appreciation of $311,004 not taken into account in determining the taxable gift, largely offsets the $380,450 of annuity amounts in excess of trust income, leaving $818,620 in the trust at the end of the GRAT term. Senior has $1,779,811 of accumulated after-tax annuity proceeds, which attract transfer and capital gains taxes of $651,547, leaving $1,128,264 for the children. Together with the net trust corpus, this leaves them with $1,946,884, closer, but still less than the proceeds of straight GRAT. Accordingly, we conclude that the gift tax savings from trying to zero out the GRAT are not worth it as long as the regulations impose the IRS's versions of life expectancy and fund exhaustion limits.

* * *

III. TAX CONSEQUENCES OF A DEFERRED PAYMENT SALE TO A TRUST

Although, as indicated in section II, a GRAT is advantageous when the internal rate of return on the trust assets is greater than the applicable § 7520 rate, a deferred payment sale to a grantor trust is a better technique in a number of respects, but at the price of leaving the current value of the investment assets at the time of the sale in the gross estate.[83]

A. Nongrantor Trust

First it is useful to consider a deferred payment sale to a nongrantor trust or directly to younger generation family members. Because a note received in a bona fide deferred payment sale is not an annuity or term interest subject to § 7520,[84] the issue price and gift tax value of the note is equal to the principal amount if interest is payable at the AFR. It is not necessary to provide for payment at the § 7520 rate,[85] which is always an amount equal to 120% of the mid-term AFR.[86] Thus, there is no gift or

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[82] Rev. Rul. 77-454, 1977-2 C.B. 351; Reg. § 20.7520-3(b)(2)(i) and (v) Example 5. Because this principle applies if the annuity rate exceeds the § 7520 rate, it does not affect our analysis of GRATs with annuity rate equal to the § 7520 rate.

[83] The tax is thus postponed until death or disposition of the note.

[84] See Manning and Hesch, *Intrafamily Sales and OID Safe Harbors: Transfer Tax Anomalies*, 17 TAX MGT. EST. GIFTS AND TR. J. 131 (1992).

[85] § 7520(a)(2).

GST tax on the sale and since the interest rate on the note is lower, more of the earnings can be retained by the trust passed on transfer tax free. A nongrantor trust, the trust itself must pay the income tax on the excess earnings.[87] If the property qualifies for the installment method, as it usually does in casual intrafamily sales (other than sales of marketable securities), the capital gains tax is deferred until payments are made on the note. The deferred sale technique is probably not worth pursuing if it does not qualify because the tax on the gain significantly reduces the amount available for reinvestment on behalf of the younger generations. If the sale is large enough, (which it is not in our examples), the deferred tax may be subject to an interest charge under § 453A.

> *Example (6).* Senior sells the $1,000,000 income producing assets to a nongrantor trust, taking back the trust's note for $1,000,000 that provides annual interest of $59,000 (at the 5.9% long-term AFR) payable over the 12-year term of the note. All $1,000,000 of principal is due at the end of the 12-year term. The "excess" earnings are $31,000 in the first year, but after the 30% income tax, the net accumulation is $21,700, increasing in subsequent years as the trust's excess earnings are reinvested but the annual interest requirement is not. These earnings will accumulate to $372,554 at the end of 12 years as compared to the $443,096 that can accumulate in a GRAT. The trust's basis for the assets transferred to it is stepped up by the transaction, unless the assets are depreciable assets subject to § 453(g). On the other hand, the trust has only this amount to pass to the beneficiaries because it must pay the note and Senior still has the $1,000,000 in his estate. Unlike *Example (3)*, Senior pays income tax only on the $59,000 interest. Thus, his after tax earnings will grow to $709,055 over a 12-year period. When the note is paid, Senior realizes the gain previously deferred under the installment method and pays capital gains tax of $200,000 at 20%. If the net note proceeds and this additional amount are transferred to the younger generation on a net gift basis, the transfer tax will be $535,471 at 55%, leaving the children with $973,584 to add to the accumulated earnings. If the transfer is subject to GST, the accumulated trust earnings are subject to gift tax at 55%; Senior's gift of the note principal and his accumulated earnings is subject to a combined 79.75% rate and to add insult to injury, his payment of the GST tax is a further gift subject to tax.[88] The trust holds the original securities with a purchase price basis.[89]

> The results, after taking into account transfer and capital gains taxes, are:

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86 If the § 7872 rate (which is the same as the AFR) is used, that rate is also used to value the note for gift tax purposes. *Frazee v. Commissioner*, 98 T.C. 554 (1992); see Manning and Hesch, *supra* note 84

87 To the extent the trust does not have investment income at least equal to the interest on the note, it may be subject to the investment interest limitation of § 163(d) and current tax on more than the "excess."

88 § 2515.

89 As a practical matter, since the accumulated income is less than the amount of the purchase price obligation, at least part of the securities or their proceeds will be needed to pay the obligation.

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$483,871	$516,129	$586,269	$413,731
Accumulated Trust Income	372,554	---	372,554	---	372,554
Senior's Net Accumulation	709,055	251,600	457,455	342,358	366,697
Totals[90]	$2,081,609	$735,471	$1,346,138	$928,627	$1,152,982

The risk of increased estate taxes if Senior dies within three years of transferring the note proceeds and net accumulation is $294,509 for the transfers to both children and grandchildren

* * *

If the investment assets appreciate at 3%, the situation is considerably improved because neither the accumulated trust income nor the appreciation are subject to transfer taxes. The results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$483,871	$516,129	$586,269	$413,731
Accumulated Trust					
Income	558,270	---	558,270	---	558,270
Appreciation	501,842	---	501,842	---	502,842
Senior's Net Accumulation	846,855	300,497	546,358	408,893	437,962
Totals[91]	$2,906,967	$784,368	$2,122,599	$995,162	$1,911,805

The risk of increased estate taxes if Senior dies within three years of transferring the note proceeds and net accumulation is $321,402 for the transfers to both children and grandchildren

* * *

If Senior dies prematurely, the estate tax on the note and his net accumulation is computed on a tax inclusive basis that does not permit a net gift approach, but the accumulated trust income remains free of transfer tax. Assuming the assets sold qualified for reporting on the installment method, the unrealized gain is reported by his estate as income in respect of a decedent ("IRD")[92] with a deduction under § 691(c) of the estate tax attributable to the $1,000,000, leaving $450,000 net gain subject to a tax of $90,000. The results, after taking into account transfer and capital gains taxes, are:

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[90] Basis = FMV since all assets have been included in income.

[91] Basis = 1,621,057 for the children and $1,409,963 since the accumulated income does not provide basis

[92] See § 691.

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$640,000	$360,000	$887,491	$112,509
Accumulated Trust Income	372,554	---	372,554	---	372,554
Senior's Net Accumulation	709,055	389,981	319,074	565,471	143,584
Totals[93]	$2,081,609	$1,029,981	$1,051,628	$1,452,962	$628,647

* * *

If the investment assets appreciate at 3%, the tax-free transfer of the increased accumulated income and the appreciation, notwithstanding Senior's premature death, highlights the advantage of a deferred payment sale over a GRAT. The results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$640,000	$360,000	$887,491	$112,509
Accumulated Trust Income	558,270	---	558,270	---	558,270
Appreciation	501,842	---	501,842	---	501,842
Senior's Net Accumulation	846,855	465,770	381,085	675,.367	171,488
Totals[94]	$2,906,967	$1,105,770	$1,801,197	$1,562,858	$1,344,109

B. Grantor Trust

If the sale is to a grantor trust, the same rules apply for transfer tax purposes, allowing Senior to retain only a right to interest payments at the AFR,[95] thereby reducing augmentation of his estate, although the deferred payment sale price remains in the estate and the grantor remains taxable on all trust income as for a GRAT. The grantor trust thus retains a greater amount of the earnings for accumulation until the end of the trust term. There is, of course, no taxable gift, although the note remains in the taxable estate. Moreover, there is no taxable gain at the time of the sale, whether or not the assets sold qualify for the installment method, and no taxable gain when the proceeds are collected while the trust

93 Basis = FMV.

94 Basis = $1,299,355 for the children and $842,267 for the grandchildren because the trust's appreciation is not included in Senior's gross estate.

95 Arguably since the sale is not recognized for income tax purposes, there is no need to pay interest at the AFR. Since payment of interest at the AFR is recognized in Prop. Reg. § 20.2012-2(b)(1) and Prop. Reg. § 25.2512-8 as an element in a bona fide business transaction, it would be foolish not to provide interest at the AFR. Moreover, since the status as a grantor trust may terminate, the rate should be at least the § 7872 rate to the extent that is different.

remains a grantor trust. As discussed below,[96] we believe that there is still no taxable gain when grantor trust status terminates at death while Senior still holds the notes and the trust has a $1,000 purchase price basis in the investment securities. *Example (7)* illustrates these advantages:

Example (7). Senior sells the $1,000,000 income producing assets to a grantor trust, taking back the trust's note for $1,000,000 that provides annual interest of $59,000 (at the 5.9% AFR) payable over the 12-year term of the note. All $1,000,000 of principal is due at the end of the 12-year term. The "excess" earnings are $31,000 in the first year, increasing in subsequent years as the earnings are reinvested but the annual interest requirement is not. These earnings will accumulate to $624,361 at the end of 12 years as compared to the $443,096 that can accumulate in a GRAT. The basis of the assets transferred is unaffected by the transaction. On the other hand, the trust has only this amount to pass to the beneficiaries because it must pay the note and Senior still has the $1,000,000 in his estate. As in *Example (2)*, the grantor must pay the income taxes on all trust income, including the earnings on the accumulation. Assuming the income tax on the trust's $90,000 of income is paid by Senior out of the annual $59,000 interest payment, Senior has $32,000 ($59,000 - $27,000 tax) to invest in the first year and declining amounts in subsequent years as the trust income compounds, increasing the tax payable by Senior as grantor. If Senior invests this amount at the same 9% rate assumed for the GRAT and the income is taxed at the same 30% rate, the net after tax interest amount will grow to $457,237 at the end of 12 years. When it is time to pay the note, the trust will, as a practical matter have to resort to the investment securities for at least part of the "payment," which has the effect of returning the securities without gain recognition and without a basis step-up.[97] As a practical matter, the securities are likely to be held by the grantor to receive a step up in basis at death. If the original securities are now used to make a net gift and the reinvested earnings totaling $37,237 are transferred to the younger generation, the transfer tax will be $407,408 for a gift to children and $461,461 including GST tax for a gift to grandchildren of the securities, the same as if the securities had originally been transferred in a net gift. The difference is that the trust has been able to earn a return on the securities for 12 years without increasing the grantor's estate by those earnings. This leads to considerably better results than those of any of the foregoing examples. The results, after taking into account transfer taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$407,408	$ 592,592	$538,539	$461,461
Accumulated Trust Income	---	---	624,361	---	624,361
Senior's Net Accumulation	457,237	162,245	294,992	220,771	236,466
Totals[98]	$1,457,237	$569,653	$1,511,945	$759,310	$1,322,288

The risk of increased estate taxes if Senior dies within three years of transferring the net accumulation is $89,235 for the transfers to both children and grandchildren.

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[96] See *V. Capital Gains Tax When Deferred Payment Sale Notes Remain Unpaid at Death.*

[97] It was the claim of a basis step-up in *Rothstein, supra* note 11, that was at least a major impetus to issuance of Rev. Rul. 85-13.

[98] Basis = $1,245,289 ($624,361, the amount of the trust's accumulated income + $294,992, the after-tax amount of Senior's net accumulation + $325,936, the gift tax on the net note proceeds) and $1,192,103 ($624,361, the amount of trust's after-tax accumulated income + $236,466, the after-tax amount of Senior's net accumulation + $316,691, the gift tax on the net note proceeds) for the gift to the grandchildren).

* * *

If the assets grow at 3%, the amount passing to the younger generations increases but not the taxes on the trust's assets and are actually slightly lower because Senior's net accumulation after he pays income tax on the trust's increased earnings.. The results, after taking into account transfer and capital gains taxes, are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$407,408	$592,592	$538,539	$461,461
Accumulated Trust					
Income	---	---	926,983	---	926,983
Appreciation		---	545,025	---	545,025
Senior's Net					
Accumulation	348,148	123,536	224,612	168,098	180,050
Totals[99]	$1,348,148	$530,944	$2,289,212	$706,637	$2,113,519

The risk of increased estate taxes if Senior dies within three years of transferring the net accumulation is $67,945 for the transfers to both children and grandchildren.

* * *

It is when Senior dies within the 12-year note term that the advantages of the deferred payment sale become most dramatic. For a GRAT, the entire trust corpus, including accumulated income and appreciation, come back into the gross estate. In the case of a deferred payment sale, only the note or its proceeds and Senior's net accumulated income remains in the estate. As stated above, in our opinion, neither Senior nor his estate is liable for capital gains tax on the deferred payment note and the trust has a purchase price basis in the investment securities. Accordingly, they can be used t pay the note without gain.[100] The results, after taking into account transfer and capital gains taxes, are:

[99] Basis = $1,477,521 ($926,983, the amount of the trust's accumulated income + $224,612, the after-tax amount of Senior's net accumulation + $325,926, the gift tax on the net note proceeds) and $1,390,904 ($926,983, the amount of trust's after-tax accumulated income + $180,050, the after-tax amount of Senior's net accumulation + $316,691, the gift tax on the net note proceeds) for the gift to the grandchildren).

[100] See *V. Capital Gains Tax When Deferred Payment Sale Notes Remain Unpaid at Death, infra.*

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$440,000	$ 560,000	$ 638,000	$362,000
Accumulated Trust Income	---	---	624,361	---	624,361
Senior's Net Accumulation	457,237	251,480	205,757	364,647	92,590
Totals[101]	$1,457,237	$691,480	$1,390,118	$1,002,647	$1,078,951

* * *

If the assets grow at 3%, the amount passing to the younger generations increases but not the taxes. The transfer and capital gains tax results are:

Item	Amount	Taxes on Gift to Children	Net to Children	Taxes on Gift to Grandchildren	Net to Grandchildren
Initial Principal	$1,000,000	$440,000	$560,000	$787,500	$213,500
Accumulated Trust Income	---	---	926,983	---	926,983
Appreciation		---	545,025	---	545,025
Senior's Net Accumulation	348,148	191,481	156,667	277,648	70,500
Totals[102]	$1,348,148	$631,481	$2,188,675	$1,064,148	$1,756,008

If we are wrong and Senior or his estate is liable for capital gains tax on the deferred payment note, the net cost is only $90,000 whether the adjustment is for the $110,000 reduction in estate tax, if the capital gains tax is imposed on Senior's last return, or for the deduction under § 691(c) for estate tax ($550,000) attributable to the appreciation that reduces the capital gain to $450,000 and the capital gains tax to $90,000, if the capital gains tax is imposed on the estate. The small net cost of gain recognition is because we are discussing transfers to younger family members that are fully subject to transfer tax and obviously cannot qualify the marital deduction.

* * *

As with a GRAT, if the grantor survives until the end of the payment term, there is no problem of inclusion of any portion of the trust in the gross estate,[103] although the proceeds of the sale are included (unless previously given away as our examples assume. Accordingly, use of a maximum note term that is less that the grantor-seller's actuarial life expectancy reduces the exposure to a possible IRS attack that the interest is the practical equivalent of a retained life estate under § 2036(a)(1) that was

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101 Basis = FMV.

102 Basis = $1,643,650 for the children and $1,210,983 for the grandchildren because the trust's appreciation is not included in Senior's gross estate.

103 The provision of a 12-year note when the grantor has a 16-year life expectancy under Reg. § 1.72-9, Table V is intended to reduce the risk of death during the note term.

intended to assure a source of income for life. Similar considerations suggest that any extension of the note should be avoided, as should any right of the seller to extend the term of the note and continue to collect interest.

* * *

Because under current IRS positions,[104] a grantor's sale of assets to a grantor trust is not a realization event, none of the rules that apply to installment sales are applicable. An installment sale that is not an income tax realization event has at least the following advantages over a sale that is treated as a realization event for income tax purposes.

1. § 453A. Because no gain is realized, there is no deferred tax liability for sales, the interest charge imposed by § 453A on installment gain over $5 million does not apply.

2. Ineligible assets. Basically, only the gains realized on deferred payment sales of capital assets, including partnership interests (to the extent not subject to § 751) and stock in non-publicly-traded corporations, and quasi-capital (§ 1231) assets (to the extent not subject to depreciation recapture), as a practical matter, real estate, are eligible for reporting under the installment method. Because no sale occurs for income tax purposes, the value of the ineligible assets can be frozen for gift and estate tax purposes by use of a deferred payment sale recognized as a sale for estate and gift tax purposes without regard to the tax character of the assets.

3. Assignment of income. A direct gift of income producing property assigns the future income and appreciation to the donee, including any trust donee, without further transfer tax, but at the price of a full current transfer tax on the value assigned. A GRAT does the same but only for income in excess of the retained annuity, but at the price of a gift tax on the value of the remainder (and the risk of reinclusion if the grantor dies prematurely). A deferred payment sale to a nongrantor trust transfers a greater amount of future income and avoids the gift tax, but at the price of deferred gains tax and inclusion of the note in the grantor's estate. A deferred payment sale to a grantor trust avoids the capital gains tax[105] and allows the grantor to pay the income tax on the accumulated income. If, after the sale to the grantor trust, it becomes desirable for subsequent income earned by the trust assets, including a gain realized on its sale, to be reported by the trust or the trust beneficiaries under the nongrantor-trust rules, the grantor-trust status can easily be terminated,[106] but any gain inherent in any remaining note payments will be recognized when received.

The preceding list is not exhaustive; readers of this article will undoubtedly add their own, particularly those related to the specific situations of their clients.

C. Inclusion in Gross Estate

A recent article in this journal,[107] argues that a grantor's sale to a grantor trust in exchange for an installment note does not remove the trust corpus from the grantor's estate if the grantor dies while the note remains outstanding.[108] The author's analysis seems to be that since under income tax concepts

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[104] See text at notes 10 to 16, *supra.*

[105] This assumption is premised upon the income tax consequences discussed in section III, *infra.*

[106] The trust is a complex trust under §§ 661 and 662.

[107] 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 & TR. J. 86 (1998) (hereinafter referred to as "Smith."")

[108] Smith, *supra* note 107 at 87.

there is no sale and no gift for transfer tax purposes, because of the payment of consideration, there is no current transfer for estate tax purposes. Because no transfer by gift occurred, the author argues that you cannot use the dichotomy under which a transfer will be complete for gift tax purposes although the same transfer will be incomplete for income tax purposes.[109] The author's primary authority is Reg. § 1.001-2(c), Example 5 and *Madorin v. Commissioner*,[110] both of which find a deemed income tax transfer upon the trust's cessation of grantor-trust status that results in a realization of gain. This is because of the deemed distribution of cash that occurs under the partnership liability allocation rules under § 752. Thus, these authorities used the income tax concept of the grantor's ownership of the trust's assets to find an income tax transfer when the grantor-trust status terminated.[111] We believe, the author's extending that principle to the transfer tax area is too large a stretch. Moreover, there is no principled way to limit the author's gross estate inclusion to the case of a deferred payment sale to a grantor trust. Even when the sale price is paid, the grantor remains the owner of the trust for income tax purposes until death or another event causing the termination of grantor-trust status. If such an event was automatically a transfer for transfer tax purposes, we suspect that, like us, every reader has signed improper gift and estate tax returns. In fact, the IRS lost the only case where it argued that a gift occurred at death and has acquiesced.[112]

The issue for estate tax purposes is whether the grantor has a power or interest in the assets transferred in trust so as to apply one of the estate tax inclusion provisions.[113] For gift tax purposes, the issue is whether the original transfer was incomplete because of the grantor's retention of the powers that make it incomplete under the concept of a completed transfer.[114] If none of these provisions apply, the original transaction is a completed transfer. The application of an income tax principle that determines when a transfer occurs to the estate and gift taxes is not justified. As stated many times, the income taxes are not to be considered in pari materia with the estate and gift taxes.[115] The author also mentions the possibility that if the trust does not have the financial ability to make the payments on the note, the sale may not be considered bona fide. This issue is considered next.

Even if the grantor seller dies during the term of the deferred payment note there should be no inclusion. Some commentators have expressed concern that the interest payment under a deferred payment sale may be considered a retained life estate under § 2036(a)(1) with the result that the trust assets valued at the date of death including appreciation and accumulated income are included in the gross estate if the purchased assets are the entire trust corpus.[116] A similar concern is that the deferred

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109 *Id.* The author cites Reg. §1.1001-2(e), Ex. 5 and the *Madorin* case as authority for this position.

110 84 T.C. 667 (1985).

111 See text at note 143, *infra* for a discussion of these authorities.

112 See *Est. of DiMarco v. Commissioner*, 87 T.C. 6531 (1986), *acq. in result*, 1990-2 C.B. 1 (no transfer of employer death benefit to widow at death even though amount and right indeterminate until death; the court expressly rejected the IRS's contrary position in Rev. Rul. 81-31, 1981-1 C.B. 475); Rev. Rul. 92-68, 1992-2 C.B. 257 (fully acquiesces in *DiMarco* and revokes Rev. Rul. 81-31); but cf. *Levine v. Commissioner*, 90 T.C. 723 (1988) (death benefit included when the "employee" was also the dominant shareholder and a director, distinguishing *DiMarco* principally on these facts).

113 See §§ 2036-2038, 2039, and 2041.

114 Reg. § 25.2511-1; *Burnet v. Guggenheim*, 288 U.S. 280, 286 (1933) ("a gift is not consummate until put beyond recall.").

115 See note 14, *supra*.

116 See Oshins, *supra* note 1, at 36; Mulligan, *supra* note 1, at ¶¶ 1502.2.c. and 1505; Shore and McClung, *supra* note 1, at 43.

payment obligation may not be considered to be a bona fide debt.[117] If sustained, either contention substantially reduces the benefit of the deferred payment sale.

Both of these concerns apply primarily when the property sold is the entire or almost the entire corpus of the trust. On the other hand, there is clearly some point at which the corpus of the trust is sufficiently large, or that there are other assurances that the deferred payment obligation will be satisfied, that neither position can be sustained. Our analysis simply assumes that whatever is needed to assure this has been done. Because this is a *factual* issue, there is no clear guidance on when that point is reached.

Some commentators suggest that it is sufficient if the corpus is at least 110% of principal of the deferred payment note.[118] Analogy to the corporate thin-capitalization cases suggests that perhaps a more conservative 120% is wise. In addition, the grantor-seller must have reasonable assurances that the trust assets will not be dissipated and must "act like a creditor" throughout the term of the obligation. In this, as in other matters, the estate planner cannot abdicate the responsibility to exercise judgment. Only those who are willing to be aggressive in their approach to planning should use a trust with no other assets.[119]

On the other hand, we believe that a substantial argument can be made that even if the property sold is the entire trust corpus the note should be respected.[120] It is well recognized that the AFR is a relatively low rate of interest,[121] so the trust's ability to meet the interest obligation should not be a

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117 See Nicholson, *supra* note 1 at 100; BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 4.01 to 4.04 (6th ed. 1994).

118 Covey, *supra* note 1, at 4365-70; Mulligan, *supra* note 1, at 1505.2; Abbin, *supra* note 1, at ¶ 1300.1.O.

119 The grantor-seller does not have to be the source of all trust assets, but must provide some of the funding to be treated as the grantor under the grantor-trust rules. See *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975) ("a taxpayer is considered a grantor only with regard to the property actually contributed to the trust and owned by him at the time of the contribution); see also *Herberts v. Commissioner*, 10 T.C. 1053, 1062-63 (1948); *Parker v. Commissioner*, 166 F.2d 364 (9th Cir. 1948). Prop. Reg. § 1.671-1(e)(1) contains similar language. Accordingly, if the seller is not the source of all of the trust's assets, great care must be exercised to make sure that he is the grantor for proposes of determining the tax status of the assets sold.

120 Cf. *Commissioner v. Clay Brown*, 380 U.S. 563 (1965), respecting a sale-leaseback with a charity as a sale for income tax purposes even though the only source for the payments on the note could only come from the income produced by the purchased asset. Since the Supreme Court respects bootstrap sales for income tax purposes, such sales should also be respected for transfer tax purposes. See also *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq in result only*, Rev. Rul. 69-77, 1969-1 C.B. 21 (where value of property equaled agreed price, absence of personal liability in interest-only for 99 years, did not prevent bona-fide purchase). Subsequent cases have emphasized that a nonrecourse note may not be a "true debt" when the value of the property did not equal the amount of the note. *Est. of Franklin v. Commissioner* 544 F.2d 1045 (9th Cir. 1976); *Lebowitz v. Commissioner*, 1917 F.2d 1314 (2nd Cir. 1990 ("the proper question concerning the genuineness of the debt turns on whether the value of the acquired property at the time of purchase approximates the principal amount of the nonrecourse note."). In *Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3rd Cir. 1968), *cert. den. sub nom. Commissioner v. Prussin*, 493 U.S. 901 (1989) the court, in effect, adjusted the nonrecourse note to the fair market value of the property.

121 See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACTION OF 1984 at 115, n. 24 ("Congress believed that 110 percent of the applicable Federal rate was a reasonable approximation of the rate at which a good credit risk with adequate security could borrow. (For simplicity, the Act generally assumes that all taxpayers could borrow at this conservative rate.) Discounting all payments under the instrument at this rate should, therefor, provide a liberal (high) estimate of the principal amount of the loan . . . "). The subsequent change of the discount rate from 110% of the AFR to 100% increases the bias in favor of a low rate of interest.

serious risk. In short, the fact that the Code provides an artificially low rate of interest in valuing such a note for income tax purposes and that the IRS has accepted the same rate in determining that the transaction is a bona fide sale should not obscure the economic reality that the note does not represent 100% financing even if the trust has no other assets. Nevertheless, the artificial approach of the IRS in connection with a GRAT, measuring the risk of fund exhaustion by assuming that the trust earns only the § 7520 rate, may indicate a risk of a similar artificial approach here.[122] The requirement that the § 7520 rate be used for most transfers to a trust with a retained interest, however, implicitly recognizes that 120% of the AFR is a reasonable rate of return,[123] so that an obligation to pay only 100% of the AFR should be considered to be adequately protected and not viewed as a retained life estate. Several cases have refused to treat a private annuity interest in a trust as a retained life estate when there was no direct correspondence between the annuity and trust income, but this again in an intensely factual issue that requires a judgment based on the specific situation including the nature of trust assets and whether there are any limitations on disposition of trust assets or otherwise realizing maximum income.[124] The issue is likely to be particularly troublesome when the assets sold are an interest in a family business that involve not only issues of liquidity, but also problems of indirect control. Although, if the transfer to the trust is a family limited partnership interest or a similarly discounted property, the risk of nonpayment of principal is attenuated,[125] although making this argument to support the status of the deferred payment sale may be inconsistent with claiming the discount. Again, only those who are willing to be aggressive in their approach to planning should use a trust with interests in a family business or FLP as the sole assets.

A variation of a fixed payment installment sale is the SCIN. The estate tax advantage of a SCIN is that because the buyer's obligation terminates on the seller's death, nothing is included in the seller's gross estate for estate tax purposes.[126] On the other hand, a SCIN may require that something more than the AFR be paid on installment note in order for it to be recognized as a bona fide sale for transfer tax purposes.[127] To the extent that it does, the interest rate advantage of a deferred payment sale over a

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122 See discussion at notes 46 and 47, *supra*.

123 See Prop. Reg. §§ 1.1012-2(b), 25.2512-8; *Frazee v. Commissioner*, 98 T.C. 554 (1992) (used the § 7872 rate as acceptable rate to value a promissory note for gift tax purposes); Priv. Ltr. Rul. 95-35-026 (May 31, 1995) which adopted the rate determined under § 7872 which incorporates the AFR under § 1274. See § 7872(f). The long-term AFR is almost always less than the § 7520 rate, which is 120% of the mid-term AFR. For example, in April, 1998 the § 7520 rate is 6.8% while the mid-term AFR is 5.59% and the long-term AFR is 5.91%; see Manning and Hesch, *Intrafamily Sales and OID Safe Harbors: Transfer Tax Anomalies*, 17 TAX MGT. EST. GIFTS AND TR. J. 131 (1992).

124 *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984) (trust was minimally funded, but still no tie-in between trust income and annuity payment, annuitant had limited powers over trust); *La Fargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982) (no direct relationship between annuity amount and trust income); *Becklenberg Est. v. Commissioner*, 273 F.2d 297 (7th Cir. 1959) fixed annuity of $10,000 is not a right to trust's income; payment of annuity not restricted to income); *Fabric Est. v. Commissioner*, 83 T.C. 932 (1984) (trust obligation for annuity was as a true creditor; trustee was personally liable under local law if trust assets exhausted; no tie between annuity and trust's income); but see *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985) (direct correspondence between trust income and annuity amount); *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*. 1973-2 C.B. 2, *aff'd* 513 F.2d 824 (9th Cir. 1975) (annuitant could control trust, although indirectly); *Schwartz v. Commissioner*, 9 T.C. 229 (1947), *acq*. 1947-2 C.B. 4 (1947) (shortfall in trust income never made up in paying annuity); Rev. Rul. 68-183 C.B. 308 (not true bootstrap sale when only source of payment was income from purchased asset). See also Mulligan, *supra* note 1, at ¶ 1502.2.

125 See Horowitz *Succession*, *supra* note 1.

126 *Est. of Moss v. Commissioner*, 74 T.C. 1239 (1980), acq. in result, 1981-1 C.B. 2.

127 See Banoff and Hartz, *Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?*, 59 TAXES 499, 501 (1981); Banoff and Hartz, *It's No Sin to SCIN! A Reply to Professor Blum,* 60 TAXES 187 (1982); Abbin, *Interest Expense in Intrafamily Installment Sales*, 74 J. TAX'N 389 (1991)

GRAT is vitiated. Because we have assumed for comparison purposes that the note term is less than the seller-grantor's actuarial life expectancy, we are not factoring into the analysis the chance of avoiding transfer tax on the installment note.

If the seller takes back the purchaser's private annuity obligation, the gain realized on the sale is deferred and reported under the § 72 annuity rules instead of the § 453 installment method rules. There are two significant income tax disadvantages for private annuity sales which are magnified in situations where the seller does not die prematurely. The first is that the seller must report the interest element as ordinary income while the purchase cannot take an interest deduction for the interest element paid. The second is that after the annuitant survives his actuarial life expectancy age at the date the annuity commenced, the entire amount of the annuity payment is taxable as ordinary income since the investment in the contract has been fully recovered.[128] If a private annuity sale to a grantor trust is not a realization event, both of these problems disappear. On the other hand, since a private annuity sale is not subject to the rules relating to the AFR, it is likely that it would have to use the § 7520 rate. As with a SCIN, there is no inclusion in the gross estate.

Although use of either of these techniques eliminates the inclusion of the note in the gross estate if the seller dies early, it does not eliminate the issue whether the note is an interest in the trust that requires inclusion of the trust assets in the gross estate. The income tax issues for these transfers are discussed below under V. Income Tax When Deferred payment Sale Notes Remain Unpaid at Death.

IV COMPARING TRANSFER AND INCOME TAX CONSEQUENCES OF A CURRENT NET GIFT, A GRAT AND A DEFERRED PAYMENT SALE TO A TRUST

In summary, the principal factors in comparing a net gift, a GRAT and a deferred payment sale to a grantor trust are:

1. Assumed rate of return. In a deferred payment sale, payment of an interest rate equal to the applicable AFR is apparently sufficient to avoid any gift tax consequences even though this rate is less than the § 7520 rate. In order to shelter the excess earnings from transfer taxation, a GRAT must produce an internal rate of return in excess of the applicable § 7520 rate, which is 120% of the mid-term AFR.[129] Thus, a larger portion of the earnings can be accumulated free of transfer taxation in a deferred payment sale than in a GRAT.

2. Risk of inclusion in gross estate. If the grantor dies during the GRAT term, all of the assets in the trust will be included in the grantor's gross estate using the values at the date of death.[130] If this happens, the freeze objective is not accomplished. Although using a shorter GRAT term can reduce this risk, that increases the value of the taxable gift of the remainder interest. In contrast, a right to interest payments under a promissory note should not be viewed as a retained income interest in the trust assets under § 2036(a)(1).[131] Thus, there is reduced risk of estate tax inclusion of the trust property if the seller dies while the note is outstanding. On the other hand, the principal of the installment note remains in the gross estate.

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128 There is no return of basis or capital gain once the annuitant recovers his "investment in the contract". § 72(b)(2).

129 § 7520(a)(2).

130 But see Horowitz *MIGRATs^{SM}*, *supra* note 1, suggesting the inclusion may be less.

131 See discussion at notes 107 to 126, *supra*.

3. Taxable gift. Because there is frequently a gift of a remainder interest using a GRAT, there may be a taxable gift in excess of the amount that can pass gift tax free under the unified credit if the value of the assets placed in the GRAT is large enough. Because the grantor may not want to pay any gift taxes, using a GRAT for a significant amount creates some reluctance on the part of the grantor to use the GRAT vehicle, even under the net gift approach. In contrast, because the note used in a deferred payment sale will have a value equal to the property purchased, the sale technique will not result in any taxable gift, and will postpone transfer taxation of the frozen asset, (that is, the note), to the date of death, but unlike a GRAT, this transfer tax is not avoided if the transferor survives the payment term. The transfer tax may be avoided by use of a SCIN or a private annuity.[132]

4. Zero-out a GRAT. The IRS takes the position that the grantor cannot zero out a GRAT.[133] Hence, there will always be a taxable gift using a GRAT. In contrast, there is no similar restriction for a deferred payment sale. If the note bears interest at least equal to the § 7872 rate, the note will have a gift tax value equal to its face amount. As long as the value of the property and the value of the note are the same, the seller has received full and adequate consideration for the transfer of property and no gift element will be present. Of course, the note or its proceeds remain in the gross estate.

5. End-loading. The GRAT Regulations provide that the annual annuity payments cannot increase by more than 120% a year.[134] There is no similar limitation on the payment terms for a deferred payment sale. Therefore, the note can provide for interest only and the entire principal amount can be end-loaded to the maturity of the note. This reduces the practical compounding of the proceeds in the grantor's estate.

6. Estate Tax Inclusion Period for GST Taxes. The GRAT creates a GST problem because the amount of the GST transfer is the value of the trust corpus at the end of the GRAT term.[135] Assuming some appreciation in value and accumulated earnings, it is possible that the value at the end of the GRAT term will exceed the $1 million GST exemption. Because there is no gift transfer using a deferred payment a sale, there is no transfer subject to transfer taxes. Accordingly, the GST concerns are irrelevant. In fact, a deferred payment sale vehicle is ideal for GST planning just for this reason.

7. No distributions to Other Trust Beneficiaries. The GRAT regulations provide that during the GRAT term no distributions can be made to anyone other than the holder of the retained annuity interest.[136] There is, however, no similar restriction on distributions when a discretionary trust purchases the assets from the seller. For example, if the trust assets substantially appreciate during the GRAT term, none of that benefit can be distributed to the other beneficiaries of the GRAT until the end of the GRAT term.

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There are, of course, other freeze techniques. A family limited partnership ("FLP") or LLC under § 2701 accomplishes the objects of freezing values to that earnings in excess of the fixed payment and asset appreciation are passed free of transfer tax. One problem is that § 2701 does not provide a safe

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132 See III. and IV, *infra.*

133 Reg. §§ 25.2702-3(e), Example (5) and 25.7520-3(b)(2)(i) and (v), Example (5).

134 Reg. § 25.2702-3(b)(1)(ii).

135 § 2642(f).

136 Reg. § 25.2702-3(d)(2).

harbor rate. Indeed, the IRS has indicated that even the § 7520 rate may not be adequate.[137] Nevertheless, some commentators suggest combining an FLP with a GRAT or deferred payment sale.[138]

The following summary table compares the net transfers to children and grandchildren of our major examples:

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[137] See Priv. Ltr. Rul. 93-24-018 (Mar. 19, 1993) (specifically rejects use of rate under § 7520 to value qualified payment, but does not state appropriate rate nor how it is to be determined).

[138] See, *e.g.*, Horowitz *MIGRATs*^{SM}, *supra* note 1.

	Beneficiary					
	Net to Children			Net to Grandchildren		
	Gift	*Death*[1]	*Adjusted Gift*	*Gift*	*Death*[1]	*Adjusted Gift*
No Current Planning	$1,345,299[2]	$ 938,346	$1,050,075	$1,079,723[3]	$ 422,256	$ 729,382
With 3% Appreciation	1,876,873[4]	1,309,041	1,542,682	1,504,418[4]	589,068	1,011,013
Current Net Gift	1,233,545[5]	---	---	910,581[6]	---	---
With 3% Appreciation	1,731,374[7]	---	---	1,341,458[7]	---	---
GRAT (fixed term)	1,413,697[8]	904,195	1,170,264	999,324[9]	552,795	796,020
With 3% Appreciation	2,063,586[10]	1,425,039	1,760,124	1,250,001[11]	665,312	983,792
GRAT (IRS approach)	1,343,259[12]	889,004	1,128,808	928,867[13]	570,168	755,793
With 3% Appreciation	1,976,326[14]	1,176,481	1,591,597	1,161,427[15]	674,883	929,743
Sale to Nongrantor Trust	1,346,138[16]	1,051,628	1,172,289	1,152,982[16]	628,607	874,494
With 3% Appreciation	2,122,599[17]	1,801,197[18]	1,932,875	1,911,805[19]	1,345,911[20]	1,610,399
Sale to Grantor Trust	1,511,945[21]	1,390,118	1,412,214[22]	1,474,558[23]	1,078,951	1,171,738[22]
With 3% Appreciation	2,289,212[24]	2,188,675[25]	2,214,493[22]	2,265,789[26]	1,756,008[27]	1,921,800[22]

[1] Except as otherwise indicated, basis = FMV

[2] Basis = $895,299.

[3] Basis = $820,849.

[4] Basis = $1,151,384.

[5] Basis = $966,879.

[6] Basis = $815,811

[7] Basis = $1,091,062.

[8] Basis = $846,954.

[9] Basis = $519,546.

[10] Basis = $900,869.

[11] Basis = $616,197.

[12] Basis = $839,554.

[13] Basis = $552,510.

[14] Basis = $1,078,908.

[15] Basis = $642,248.

[16] Basis = FMV.

[17] Basis = $1,621,057.

[18] Basis = $1,299,355.

[19] Basis = $1, 403,263.

[20] Basis = $842,267.

[21] Basis = $1,245,289.

[22] Does not take into account the possibility that the decedent or his estate will be required to recognize gain on death, requiring payment of a net tax of $90,000. Under the actuarial analysis, this would reduce the adjusted gift for these items by $40,977.

[23] Basis = $1,294,518.

[24] Basis = $1,477,521.

[25] Basis = $1,643,650.

[26] Basis = $1,423,724.

[27] Basis = $1,210,983.

The Adjusted Gift column represents our attempt to quantify the effect of actuarial risk on each of the examples we have presented (other than zeroing out a GRAT, which we do not consider an appropriate approach). We have used the IRS's Table 80CNSMT as the basis for our computations although we recognize that its determinations are dated because we did not have better data. We believe it is important to highlight this factor that we believe is underemphasized in the literature even though we recognize our method is not completely accurate. In each example, it represents an actuarial interpretation of the risk that Senior will not survive the 12 years. We applied that risk, approximately 45%, to the difference between the gift results and the death results and further adjust for the approximately 25% risk that if he survives the 12-year term for less than three years, Senior's estate will incur additional estate tax with respect to the transfer of the amounts we have labeled Senior's net accumulation in the examples (or the total transfer in the no current planning example).

Although the results in the gift column with no current planning look surprisingly good if Senior survives for the twelve years, this potential advantage disappears in the adjusted gift column. Similarly, although the GRAT and the deferred payment sale are comparable, with small advantages to the deferred payment sale even to a nongrantor trust in the gift column for children, as reflected in the adjusted gift column, the differences in the result of premature death tip the advantage more strongly to the deferred payment sale. Although basis advantages of some cases may mitigate the valuation advantages at the transfer date, we do not believe they are sufficient to change the analysis based on the comparisons shown in the table. It is, however, in the examples involving generation skipping trusts for grandchildren that the difference becomes almost overwhelmingly in favor of the deferred payment sale approach. The tax-free transfer of the accumulated income and appreciation of the grantor trust in taxable generation-skipping arrangements produces results that are startlingly superior.

V. CAPITAL GAINS TAX WHEN DEFERRED PAYMENT SALE NOTES REMAIN UNPAID AT DEATH

When the grantor dies, the trust is no longer a grantor trust. There is disagreement among the commentators as to the resulting income tax consequences if the deferred payment note remains outstanding at the time of death.[139] All concur in the basic IRS position that upon termination of grantor-trust status, the grantor is treated as transferring the assets to the trust for income tax purposes at the time grantor-trust status is terminated.[140] The disagreement is whether this deemed transfer to the trust, usually presumed to be in exchange for the note, occurs the moment before death or the moment after death. Two major consequences are said to turn on this metaphysical question, the basis of the trust assets and realization of gain for unpaid notes. Our view is that the basis of the trust assets is a purchase price basis equal to the amount of the note, but that neither the grantor-seller nor his estate recognize gain on death and that the note receives a basis step-up because the note does not represent income in respect of a decedent ("IRD"). Many thoughtful tax professionals are uncomfortable with this position because it seems to represent a tax-free basis step-up in basis. We concur that this is the result, but believe that it is no more objectionable that the general basis step up at death for property that passes to the estate or otherwise under the provisions of § 1014(a) and (b). We note that the basis step-up is not to the fair market value of the property buy only to the amount of the deferred payment note.

Some of those who argue for the moment-after-death approach assume that, if it applies, the trust receives a basis step-up under § 1014(a).[141] In our view, the determination when the transfer occurs for income tax purposes is irrelevant to this issue. Because the basic premise of the sale to the grantor trust

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139 *See* articles cited in note 1.

140 *See* note 10 *supra*.

141 See Covey, *supra* note 1, at pp. 4833-35 (presenting comments by Joseph J. Hanna, Jr. of Portland Oregon, in a letter dated Feb. 10, 1997).

is that transfer of the assets to the trust for gift and estate tax purposes occurs at the time of the sale, the assets are owned by the trust not the grantor at death for transfer tax purposes, without regard to whether the income tax transfer occurs the moment before or the moment after. Accordingly, the property remains in the trust and cannot receive a step-up in basis at death since it does not pass at death under the provisions of § 1014(a) and (b).[142] Any adjustment to that basis must come, not as a consequence of death, but as a consequence of the purchase from the grantor-seller (or his estate).

Thus, we must turn our attention to the question of what occurs for income tax purposes on the termination of grantor-trust status and when it occurs. This is also important for characterizing the note issued in the original deferred payment transaction and in determining whether the note represents an item of income in respect of a decedent.

The issues may be highlighted by the following example.

> *Example (8).* Senior, in *Example (7)* dies at the end of the tenth year when the value of the property initially transferred to the trust is $1,350,000, not including accumulated trust income, and when the outstanding principal of the note remains at $1 million. It can be established that, because of the trust's other assets or other assurances of payment, the deferred payment obligation is neither a retained life estate nor equity under debt/equity standards. During the preceding 10 years, Senior has, of course, collected the interest on the note. Under the principles of Rev. Rul. 85-13, Senior is deemed to have transferred the trust property to the trust at death and the deferred payment note becomes an obligation for income tax purposes.

The questions are (i) how to characterize for income tax purposes the deemed transfer of the property and the recognition of the note and (ii) when the transaction as characterized occurs, immediately before or immediately after death. We believe that, in answering the first question, the fact that there may have been a sale, even a deferred payment sale, for transfer tax purposes at the time of the original transfer to the grantor trust is simply irrelevant. Under the principles of Rev. Rul. 85-13, nothing has occurred for income tax purposes until grantor-trust status terminates.

A regulation,[143] a case,[144] and a published ruling,[145] all involving a grantor trust that owned an interest in a partnership in which partner's share of partnership's liabilities exceeded the basis in its partnership interest held by the grantor trust, determined that when grantor-trust status terminated while the grantor was alive, the grantor had a taxable transaction. In all three, the transaction was a deemed transfer of the partnership interest, subject to the partner's share of partnership liabilities, to the trust. All determined that the transaction involved a transfer of the partnership interest subject to liability, and used the basis of the partnership interest and the amount of the liability at the time of termination of grantor-trust status as determining the gain recognized on the transfer. The timing of the deemed transaction as being before or after termination was irrelevant, because it would be reported in the same tax year.

In dealing with the character of the transaction, all three determined the results at that time, without any reference to any tax consequences to the grantor of "owning" the partnership interest in the meanwhile except in so far as they affected the key attributes of basis and liability amount at the time of termination. We believe this is the correct approach. The fact that the initial transaction took the form of

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142 See *Prokopov v. Commissioner*, 98-2 U.S.T.C. ¶ 60,329, 82 A.F.T.R. 2d ¶ 98,5423 (2nd Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2793; T.C. Memo. No. 1997-229 (no step-up basis for property over which the decedent had a special power of appointment because not included in gross estate).

143 Reg. § 1.1001-2(c), Example 5.

144 *Madorin v. Commissioner*, 84 T.C. 667 (1985).

145 Rev. Rul. 77-402,1977-2 C.B. 222.

a deferred payment sale for transfer tax purposes while being ignored for income tax purposes does not mean that the income tax transaction that occurs when grantor-trust status terminates is an installment sale.

Two recent provisions dealing with entities "springing" into existence provide interesting analogies that further support the irrelevance of any prior "history" of dealings between the grantor and the trust. A Qualified Subchapter S Subsidiary ("QSSS") is a wholly-owned corporate subsidiary of an S corporation that is treated as not being a separate corporation but as having all of its assets, liabilities and relevant tax attributes owned directly by the parent S corporation.[146] When a QSSS ceases to qualify, the parent S corporation is deemed to transfer the assets and liabilities to the "new" corporation,[147] presumably in a transaction under § 351. Any excess of liabilities over basis and any boot would be recognized as gain. The Code provides that this all occurs immediately before the termination, but the implications of this timing rule are not clear. What does seem clear, however, is that the prior transactions between the parent S corporation and the QSSS do not affect the consequences of the transfers to the "new" corporation. Similarly, the check-the-box regulations provide that certain legal entities that are not taxed as corporations are "disregarded" if they have a single owner.[148] Proposed regulations provide that when a partnership or disregarded entity "checks the box" to become an association, it is deemed to transfer its assets and liabilities to the association, but does not specify the timing.[149] Nevertheless, the Preamble to the proposed regulations indicates that the transaction has the tax consequences of a current transaction without regard to the history of dealings between the disregarded entity and the owner.[150] Both of these authorities strongly suggest that the transaction is to be characterized at the time of the termination of grantor-trust status without regard to anything that happened between the date of the original sale and the date of termination. Even though the former is a specific statutory provision and the latter an implicit regulatory one, we believe both state what should be the result on this issue in any event.

In contrast, the consolidated return regulations specifically provide that when a subsidiary leaves the group, certain previously deferred income and other tax consequences are recognized.[151] These, however, are legislative regulations dealing with a situation in which the separate entity status of the affiliated corporations is not ignored even though the consequences of some, but not all, transactions between affiliates is deferred.[152] Indeed, a basic premise of the regulations is that the amount and

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[146] § 1361(b)(3)(A) and (B); *see* August, *The New World of Controlled Subsidiaries Under Subchapter S*, 9 J. S CORP. TAX'N 1, 13-14 (1997); Collins, Kulish and August, *Qualified Subchapter S Subsidiaries: A Tax Planning Guide to the New Law*, 9 J. S CORP. TAX'N 219 (1997).

[147] § 1361(b)(3)(C).

[148] Reg. § 1.7701-3(b)(ii). Such a disregarded entity is sometimes referred to as a "tax nothing." *See* Miller, *The Tax Nothing*, 74 TAX NOTES 619 (Feb. 3, 1997) (explores a number of issues relating to organizing, operating, and terminating such an entity); Barton, *Much Ado About Nothing: The Taxation of Disregarded Entities*, 75 TAX NOTES 1883 (June 30, 1997) (similarly explores those issues and ones related to converting existing entities into disregarded ones, particularly in the context of a corporate group); Wright, *Disregarded Entities, Planning Opportunities and Pitfalls in Domestic Corporate Transactions*, 24 J. CORP. TAX'N 341 (1997).

[149] Prop. Reg. § 1.7701-3( )(i) and (iv).

[150] See also Rev. Rul. 80-228, 1980-1 C.B. 115 (obligation by newly created subsidiary to parent that represented account payable to another division of the parent was new obligation that was boot, not an assumption of a preexisting liability because parent could not be liable to itself prior to division's incorporation as a subsidiary; rejects contra decision in *United States v. Wham Construction Corp.*, 600 F.2d 1052 (4th Cir. 1979).

[151] Reg. § 1.1501-13(f).

[152] Reg. § 1.1502-13(a), (b) and (c).

character of income of the "selling" member is to be preserved.[153] Accordingly, the consolidated return regulations should not provide any precedent for termination of grantor-trust status.

To highlight what is at stake, it is useful to consider the results if the termination occurred while Senior was alive, and if, contrary to our prior assumptions, there had been payments on the note.

> *Example (9).* Senior, in *Example (7)* gives up the powers that had resulted in the trust's being classified as a grantor trust at the end of the tenth year. At that time, the value of the property initially transferred to the trust is $1,350,000, not including accumulated trust income. Contrary to the assumption in *Example (7)*, however, the note provided annual principal payments that have totaled $833,333, so that the balance due is only $166,667. It can be established that the deferred payment obligation is not equity under debt/equity standards. Under the principles of Rev. Rul. 85-13, Senior's receipt of the payments during the ten years the trust was a grantor trust had no income tax effect, although the transfer tax transaction was complete at the time of the initial sale. When grantor-trust status terminates, Senior is deemed to have transferred the trust property to the trust and the deferred payment note becomes an obligation for income tax purposes. When so characterized, the transaction can hardly been taxed as a bona fide sale for the amount of the note. Even if, contrary to our conclusions, the deemed transaction is taxable immediately before death, the most appropriate characterization is as a part sale, part gift for income tax purposes at that time. Gain (but not loss) would be determined by comparing the note principal[154] with the basis of the property.[155] Under this analysis, the gain and the cost basis of the securities would both be $166,667. There is no basis for requiring recognition of the installment gain initially represented by the $1,000,000 principal of the note. Under Rev. Rul. 85-13, that note never had income tax existence and the payments did not represent payments on an installment sale or any sale at all, but a payment by the grantor to himself.[156] This result is clearly consistent with the authorities cited above (other than any implication of the consolidated return regulations, which we do not consider to be an appropriate analogy).
>
> If, consistent with our basic example, there had been no payments on the note, and the initial trust assets had appreciated to, for example, $1,350,000, if the deemed transaction were determined to be taxable, the part sale, part gift analysis should still apply. The trust would have a cost basis in the assets of $1 million, measured by its obligation on the note. Consequently, the $350,000 of potential capital gain representing post-sale appreciation would remain. Senior would realize capital gain of $1 million on the sale portion that can be reported on the installment method if the investment securities are not marketable. Senior or his estate will recognize the gain when the note is paid. Senior would recognize the $1,000,000 gain immediately if the securities do not qualify for the installment method.

As indicated, we do not believe, however, that the transaction is taxable. This foregoing analysis was analysis was put forward solely to demonstrate that result if we are wrong. This leaves the remaining question of whether the deemed transfer at death results in gain recognition. Some believe

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[153] Reg. § 1.1502-13(c)(4).

[154] For income tax purposes, the relevant amount of the note should be determined by using the AFR at that time, not at the time of the original sale. Reg. § 1.1274-4(a)(1)(iii) provides for use of the AFR on the date the sale occurs in the absence of a binding sale contract.. Accordingly, it may be wise to include in the original note a provision for adjusting the interest rate if grantor-trust status terminates before the note is paid. The gift tax status of the note should not change.

[155] Reg. § 1.1015-4.

[156] A different result would be reached under the *Rothstein* case, *supra* note 11, but the IRS has specifically rejected the result and reasoning of that case in Rev. Rul. 85-13, properly in our view.

this turns on exactly *when* the deemed transaction occurs, specifically whether it occurs the moment before death or the moment after. As indicated above, since the timing issue was not important in the regulation, case and ruling relating to transfers of partnership interest, they do not provide any useful guidance.

The timing issue is somewhat analogous to the basic estate tax valuation question "whether the assets are to be valued at the moment before death or the moment after," that is, what is the effect of death on valuation? The estate tax valuation question has never been definitively answered; one can find authorities using the moment after and others using the moment before. Nevertheless, although there is contrary authority, the weight seems to be on the side of the moment after. Thus, in the classic case of *Goodman v. Granger*,[157] a contingent payment right was valued after death when the contingencies had been eliminated. Similarly, in the *Land* case,[158] a partnership interest was valued without regard to transfer restrictions that expired at death. On the other hand, in Priv. Ltr. Rul. 84-01-006 (Sep. 28, 1983), the IRS valued shares of preferred stock taking into account voting rights that expired at death, on the ground that the decedent could have liquidated immediately prior to death. Although *Est. of Harper v. Commissioner*[159] valued notes held by the decedent owed by insolvent relatives without taking into account bequests by the decedent that would make the relatives solvent,[160] seemingly valuing the moment before death, the better reading is that death is taken into account, but not the identity of, nor the effect of death on, the beneficiaries. The recent case of *Est. of McClatchy v. Commissioner*,[161] supports this analysis. In that case, the court valued shares that the decedent held subject to securities law restrictions because he was an affiliate subject to the restrictions even though the restrictions would not apply to the estate if the executor was not also an affiliate, because the identity of the executor could not be known until the will was probated. Although, to the best of our ability to determine, no one has even seriously proposed a statement of how to determine when before is more appropriate than after, we believe the authorities that use the moment after death for estate tax valuation purposes have the better of the estate tax argument, because the focus of the estate tax should be on what is passed not on what the decedent owned.[162] Although this seemingly permits tax avoidance in Priv. Ltr. Rul. 84-01-006, the proper response was the enactment of Chapter 14, not straining the basic valuation principle.

Even if the estate tax determination is conceded to be properly made at the moment after death, the applicability of that determination to the income tax timing question is unclear. After all, the transaction being analyzed is a schizophrenic one that is a deferred payment sale to a grantor trust that is completed for transfer tax purposes at the time of the initial exchange, but is disregarded for income tax

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157 243 F.2d 264 (3d Cir. 1957), *cert. den.*, 355 U.S. 835 (1958); see *Est. of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq*. (gross estate did not include notes owed to decedent that terminated on holder's death).

158 *United States v. Land*, 303 F.2d 170 (5th Cir. 1962), *cert. den.*, 371 U.S. 862; see *Carpenter v. Commissioner*, 64 T.C.M. (CCH) 274, T.C. Memo. 1992-653 (agreement with unrelated associate).

159 11 T.C. 717 (1948).

160 Cf. Priv. Ltr. Rul. 94-32-001 (Mar. 28, 1994) (minority block valued with discount even though gift made donee the majority shareholder); but cf. *Chenowith v. Commissioner*, 88 T.C. 1577 (1987) (marital bequest of controlling shares valued at more than a pro rata portion of value of decedent's 100% ownership); Tech. Adv. Mem. 94-03-005 (Oct. 14, 1993) (value decedent's majority block with control premium even though split by will into two minority blocks, but value marital bequest with minority discount; follows *Chenowith*). Moreover, although not stated, the court may have been aware that upholding the IRS position would, in effect, tax the bequest to the beneficiaries twice, one as the assets bequeathed and again as the increased value of the notes. See also Tech. Adv. Mem. 92-40-003 (Jun. 17, 1992) (follows *Harper* where decedent's will cancelled note; finds cancellation to be bequest, not discharge of indebtedness income to debtor-beneficiary).

161 147 F.3d 1089 (9th Cir. 1997).

162 See *Goodman v. Granger*, *supra* note 157; *Harper v. Commissioner*, *supra* note 159; *Est. of Smith v. Commissioner*, 57 T.C. 650 (1972); *Mullikin v. Magruder*, 55 F. Supp. 895 (D. Md. 1944).

purposes until death. Nevertheless, the relevance of estate tax determinations is more appropriate than for most income tax questions. As indicated above, we believe the transfer tax status of the grantor trust prevents the basis step-up for income tax purposes under § 1014(a) and (b). Moreover, a significant part of the issue is whether the note is an item of income in respect of a decedent ("IRD") under §§ 691 and 1014(c), two income tax provisions that significantly intersect with the estate tax.

Nevertheless, we believe that the issue is not one of timing, but whether a realization event occurs. Our conclusion is that the nonstatory, but unchallenged, concept that the transfer of appreciated or depreciated property from the decedent to his estate is not a recognition event[163] should apply equally to the deemed transfer to the no longer grantor trust. We can see no principled distinction between a transfer to the grantor's estate and any other transfer that occurs solely as a result of the death. Even items that are IRD are not realized at death, only denied the step up in basis under § 1014(a).

Some commentators[164] have asserted that the nonrecognition should not apply even to a transfer too the estate when the property is encumbered by a nonrecourse liability in excess of value. The rationale is that the decedent should be required to account for the advantage of the receipt of the mortgage proceeds in the same manner as he must do so upon a gift or other transfer during life.[165] We do not believe that this analysis is sound. We see no more reason to require a decedent to account for nonrecourse mortgage proceeds than for any other unrealized change in value of any asset or for that matter of any liability that might involve discharge of indebtedness income. We note that despite the large number of estates owning tax shelter investments that almost certainly have involved this issue, we have not seen any case in which such recognition was asserted much less upheld.

If the principle that the transfer of encumbered, as well as unencumbered, property to the estate is not a realization event is accepted, the next question is whether the fact that the property and the obligation pass to a grantor trust rather than the estate should change the result. We believe that it should not. Although clearly recognized as a trust for transfer tax purposes, the grantor trust's status for income tax purposes before the grantor's death (or another terminating event) is ambiguous.[166] A grantor trust appears to be more of an entity than a QSSS or a single-owner unincorporated "disregarded" entity, but less of one than a partnership that is often referred to as a quasi entity. § 671 and Reg. § 1.671-2 and 3(a) provide that the grantor is taxed as the owner of certain items of the trust as if it had not been in existence, implying a recognition of some remaining status even when the grantor is treated as the owner

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163 See Rev. Rul. 73-183, 1973-1 C.B. 364, *updating and restating* O.D. 219, 1 C.B. 180 (1919).

164 See Del Cotto and Joyce, *Inherited Excess Mortgage Property, Death and the Inherited Tax Shelter*, 34 TAX L. REV. 569 (1979) (relying in part on Rev. Rul. 77-402, *supra* note 145; Lee, *Negative Basis at Death: What To Do With Tax Shelters*, 13th ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN.Ch. 4, ¶¶ 4.02 and 4.03 (1979). Interestingly they and others became concerned about this issue at the time carryover basis at death was temporarily in effect, although Del Cotto and Joyce assert that carryover basis is not the relevant principle since it applies only to the estate or other successor. *Id.* at 574-75.

165 See *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Est. of Levine v. Commissioner*, 634 F.2d 12 (2nd Cir. 1980).

166 There is some similar ambiguity for transfer-tax purposes, The ultimate estate-tax nonentity, the revocable trust, can have some status even for transfer tax purposes. Thus, in *Est. of Jalkut v Commissioner*, 96 T.C. 675 (1991), *acq.* 1991 C.B. 1, annual exclusion gifts from a revocable trust made by other trustees while the decedent was incapacitated within three years of death were included in the decedent's gross estate even though direct transfers from the decedent would not have been. (Incidentally, the court considered the grantor-trust provisions treating the decedent as the owner of trust assets for income tax purposes as not being controlling for transfer tax purposes). On the other hand, transfers made pursuant to the decedent's reserved power to withdraw assets were not so included. *Jalkut, supra*: *McNeely v. United States*, 16 F.3d 303 (8th Cir. 1993), *cert. den.* 513 U.S. 860 (1994); *Kisling v. Commissioner*, 32 F.3d 1222 (8th Cir. 1994), acq. 1996-1 C.B. 5. The inclusion result of *Jalkut* was changed by the addition of § 2035(e) by the Taxpayer Relief Act of 1997. P.L. 105-34, § 1310(a); H.R. CONF. REP. No. 220 at 717. Interestingly, § 2035(e) refers to the grantor trust provisions in determining what trusts are to be disregarded.

of the entire trust. Similarly, Reg. § 1.671-4(a) provides reporting obligations for the trust, but provides that the items taxable to the grantor are not reported on the trust's Form 1041 but on a statement attached. Recently adopted regulations now permit the trustee to furnish the grantor's name, and TIN to all payors, but still continue some reporting obligations.[167] In addition, prior to the amendment of subchapter S to permit grantor trusts to own stock, transfer of S-corporation stock to even a revocable trust was held to terminate the election.[168] On the other hand, Rev. Rul. 85-13,[169] by disregarding a transaction between the grantor and the trust, and the authorities it relies on, have gone a long way toward disregarding a grantor trust while that status continues.[170] On balance, we believe that its tenuous status is not sufficient to distinguish it from the decedent's estate and required realization at death.

Several commentators, addressing the issue in timing rather than realization terms, take the position the transaction resulting from cessation of grantor-trust status occurs immediately before death.[171] Under this approach, the assets are transferred to the trust at that moment and the note for any unpaid installments is received as consideration.[172] If the deemed transfer to the grantor trust is considered to occur immediately before death and the assets sold are not eligible for the installment method, then the entire realized gain will be recognized and must be reported on the seller's final income tax return.[173] Recognition of the realized gain can be postponed if the assets sold are eligible for the installment method.[174] Those who take this position, rely primarily on the three authorities discussed above. These authorities hold that the gain resulting from liabilities exceeding basis took place simultaneously with the cessation of the grantor-trust status, but they did not have to address the

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167 Reg. § 1.671-4(b).

168 *American Nurseryman Publishing Co v. Commissioner*, 75 T.C. 271 (1980); *W & W Fertilizer Corp. v. Commissioner*, 527 F.2d 621 (Ct. Cls. 1975). Both cases gave effect to former Reg. § 1.1371-1(e) that expressly provided that transfer to a grantor trust terminated the election.

169 See test at note 10, *supra*.

170 See Rev. Rul. 81-98, 1981-1 C.B. 40 (transfer of installment obligation to *irrevocable* grantor trust is not a disposition triggering gain); Rev. Rul. 72-471, 1978-2 C.B. 201 (beneficiary, not trust is redeemed shareholder for purposes of applying § 302(c); although not explicit, avoids trust attribution rules); Rev. Rul. 66-159, 1966-1 C.B. 162 (grantor who lived in residence owned by grantor trust may use former § 1034 when trust sold residence and purchased a new one occupied by grantor; *Ringwalt v. United States*, 549 F.2d 89 (8th Cir. 1977) (grantor of trust owning stock in a corporation and grantor individually same shareholder for purposes of treating liquidation-reincorporation as D reorganization); but cf. Rev. Rul. 78-175, 1978-1 C.B. 144 (even though grantor was owner of entire trust under §§ 671 ff., he was not at risk for note that was recourse to the trust but on which grantor was not liable); Rev. Rul. 74-243, 1974-1 C.B. 107 (transfer of stock acquired on exercise of stock option to blind trust during government service is disposition under § 425(c), triggering income; no reference to fact that trust was a grantor trust, emphasizes transfer of legal title).

171 Covey, *supra* note 1 at p. 4368 and Nicholson, *supra* note 1, at p. 102. Mulligan at pp. 14-37 to 14-38 takes no position on the timing.

172 If the note is still held by the grantor at the time of his death, it is included in his gross estate under § 2033, as property owned at death. If the trust has no independent funding, a discount from the face amount may be available for estate tax valuation purposes, because the provisions relating to the use of the AFR do not apply. Furthermore, if the long-term AFR at the date of death is greater than the interest rate used for the note, a further discount is warranted. To carry this one step further, the higher §7520 rate can arguably be used to value the note in the gross estate. Accordingly, there may be a valuation advantage in holding the note to death. There is a practical risk that arguing too strongly for this discount may be deemed by an IRS agent to be inconsistent with arguing the original transfer was a bona fide sale. In addition, the discount is not likely to be large enough to offset the potential advantage of a net gift.

173 The additional income taxes could be deducted on the Form 706 as a claim against the estate under § 2053.

174 The deferred gain is income in respect of a decedent. See § 691(a)(4) and (a)(5).

metaphysical question of what simultaneous means. Interestingly, Rev. Rul. 77-402 does state that the basis and liability amounts are determined "immediately before" termination of grantor-trust status. The later version of the same situation in Reg. § 1.1001-2(c) *Example (5)* simply refers to the transaction occurring "at the time" grantor-trust status terminated.[175] Accordingly, much as we respect the commentators who take the "before" position, we cannot accept that these authorities provide significant support. Moreover, as stated above, we believe the issue is one of realization at death.

A provision dealing with a premature termination of grantor-trust status in another context is also suggestive, but ultimately not very helpful. The Code provides that when a grantor has received a charitable deduction for a transfer to a charitable lead trust and grantor-trust status terminates prior to the end of the term, the grantor must restore a portion of the deduction to income.[176] This is essentially an application of the broad tax benefit principle. The regulations provide that the restoration is by the grantor in the year of death,[177] but because it necessarily refers to a prior transaction by the decedent, provides little direct guidance on the realization or timing for the deferred payment sale to a grantor-trust situation where there was no prior transaction for income tax purposes.

Accordingly we conclude that the better reasoned view is that because the cessation of grantor-trust status and the resulting deemed transfer occurs by reason of death, the same principle as for a transfer to the estate should apply. Under this approach, there is no gain recognized by the decedent or the estate and the trust continues to hold the property with a transferred basis, that should be increased for the obligation of the note under the principles of the *Crane* case[178] to the amount of the note if that is higher.[179] The note would also receive a fair market value basis for the amount included in the gross estate. As indicated, we recognize that the inherent gain on the property is avoided, but view this as a consequence of § 1014(a) and no more objectionable than the fact that the gain would have been avoided if the decedent had held the property until death. As further support, we suggest an analogy to the situation that would occur if Senior had given away the note prior to death, but while grantor-trust status continued. The gift of the note would be subject to gift tax, but should not be subject to income tax.[180] The principles of Rev. Rul. 77-34, Reg. § 1.1001-2(c) Example (5) and the *Madorin* case[181] do not apply because the trust remains a grantor trust. Because the donee should hold the note with a zero basis, thus preserving the potential gain, there is no avoidance of the potential tax. Moreover, it is hard to see a transaction in which the note comes into existence for tax purposes as a disposition of an installment note. The trust should have a purchase price basis under the principles of *Crane*. When the grantor dies, the bequest is just like the gift except that under § 1014(a), the note receives a basis step-up.

Another analogy achieving a similar result is a transfer of property to a grantor trust subject to an obligation on the part of the trust to pay a specified sum to a third party on the occasion of the transferor's death. Under Rev. Rul. 85-13, there is no taxable transaction when the deferred payment

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175 The *Madorin* case essentially upheld the IRS's reliance on the regulation

176 § 170(f)(2)(B); Reg. § 1.170-6(c)(4).

177 Reg. § 1.170-6(c)(4) and (5) Example (3).

178 Joyce and Del Cotto implicitly agree, asserting that the issue of basis step-up at death for a nonrecourse obligation applies only to the equity interest. See note 164 *supra*.

179 See Reg. § 1.1015-4 (dealing with basis in part sale, part gift transactions).

180 *Cf. United States v. Wham Construction Corp.*, 600 F.2d 1052 (4th Cir. 1979) (obligation by newly created subsidiary to parent that represented account payable to another division of the parent was new obligation that was not boot in § 351 transaction, represented an assumption of a preexisting liability); but see Rul. 80-228, 1980-1 C.B. 115 (IRS will not follow *Wham* because parent could not be liable to itself prior to division's incorporation as a subsidiary).

181 See text at notes 143 to 145, *supra*.

note is issued. Clearly, the trust has a purchase price basis when death occurs. It is, however, hard to see any gain recognition transaction. There is only a contingent obligation at the time of the transfer and at the time of death. Accordingly, no immediate tax consequences should occur even when the transaction is recognized for income tax purposes.[182] The payment of the obligation may be deemed a gift or bequest by the donor for transfer tax purposes, but the trust should have a purchase price basis in the assets. Under our analysis, if the original transaction is a SCIN, there is no gain recognized, because the obligation arises at the same time it is canceled.

An alternate argument admits that there is no recognition, but suggests that the note does not receive a basis step-up because it represents IRD.[183] We believe the answer to this suggestion is similar to that for gain recognition. If the note had been canceled while the grantor-seller was alive and the trust was a grantor trust, no gain would be reported by the grantor-seller. Since § 691 only applies to income that would have been taxable to the decedent during his lifetime had he survived, there is no situation to which § 691 is intended to apply.[184] This argument can be further supported by suggesting that the IRS should be hoist on its own petard of its victory in the *Frane* case,[185] dealing with a SCIN sale directly to younger generation family members that was indisputably an installment sale under § 453 and a realization event for income tax purposes. The Tax Court in the *Frane* case held that the seller's final income tax return must report the capital gain that was recognized upon the cancellation of the note at death. The Eighth Circuit in the *Frane* case and the IRS in Rev. Rul. 86-72 required that the estate report the gain on its first fiduciary income tax return.[186] These authorities support the position that death was not a gain-triggering event. We distinguish the *Frane* IRD result on the ground that in that case there had clearly been a realization before death whereas in the deferred payment sale to a grantor trust there is no such realization event before death.

Although we acknowledge that the result we adopt is contrary to a visceral feeling of many tax lawyers that the gain ought to be recognized unless a clear reason for not doing so is articulated, we believe the analogy to our understanding of the rule for the transfer of overmortaged property[187] to the estate provides that reason. We believe that the "before" approach for QSSS termination and checking the box, termination of grantor-trust status in a charitable lead trusts and even the throw-away reference in Rev. Rul. 77-402 do not apply because all deal with what are clearly realization events and our question is whether there is such an event. For the reasons stated, we do not believe there is.

Another alternate argument suggests that the trust's note may not represent the purchase price of the property but may be deemed to spring into existence separately. Although a similar approach applies to transfer of encumbered property to a partnership,[188] we believe its application to the deemed

182 See Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent obligation is not a liability for purposes of § 357(c); tax consequences postponed until liability is fixed).

183 § 1041(c) denies a basis step up for IRD.

184 Shore and McClung, *supra* note 1, at p. 51.

185 *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992); Rev. Rul. 86-72, 1986-1 C.B. 253.

186 Since this is inconsistent with the position that the authors have previously asserted that the IRS and court were wrong in *Frane*, see Hesch and Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26TH ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. EST. PLAN. ¶ 306.1.C. (1992), we do not rely on this argument.

187 By overmortgaged property we mean property subject to a nonrecourse liability in excess of both the basis and the value of the property. See Manning and Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part 4)*, 11 TAX MGMT. REAL EST. J. 263.

188 See § 752.

transaction on death of the grantor-seller in a deferred payment sale to a grantor-trust simply ignores the inextricable interrelationship between the transfer of the property and the obligation on the note. That relationship is key to the transfer tax status of the transaction. Although we have acknowledged that the *legal* characterization of a transaction for income tax and transfer tax purposes often differ, that does not change the *fact* that there was a single transaction at the outset and that what happens at death is a simultaneous deemed transfer of the property and deemed issuance of the note and that the note is consideration for the property. To the extent that the consideration is not equal to the value of the property, what we have is a part sale, part gift. There is, in our view, simply no basis in fact or in tax principle for separating the component parts. Although we have heard the view that the IRS may push this position to prevent the basis step up, we have not been presented with any principled basis for such a separation. Although we acknowledge that the argument can be made, we do not believe it is sustainable.

If we are wrong, we believe that the sale or part sale, part gift occurs immediately before death and should be reported on decedent's final return to the extent that the installment method does not apply and under § 691 to the extent that it does. The effect of reporting the gain on the seller's final income tax return is that the resulting income tax liability can then be deducted on the Form 706 as a claim against the estate under § 2053,[189] while under the *Frane* result, any estate tax attributable to the gain can be deducted under § 691(c). We distinguish *Frane* on the ground that the note (unless a SCIN) does pass to the estate. Under this view, the note has a basis equal to any gain recognized and receives a step up (or down) in basis when included in the gross estate, except to the extent attributable to income in respect of a decedent that we consider to arise when the note springs into existence the moment before death.. Under this view, if the installment sale is in the form of a SCIN, we stick to our view that the gain should be reported on the decedent's final return. Reporting the gain accelerated upon cancellation on the seller's final income tax return places the gain where it belongs. Such treatment is consistent with the fact that there is nothing with respect to the SCIN included in the seller's estate for estate tax purposes. Furthermore, reporting the gain under § 691 is inconsistent with its purpose. Following the seller's death, the SCIN is not transferred to or possessed by the estate. Section 691 is intended to apply only when the IRD is not reported on the individual's final income tax return. Section 691(a)(1) makes it clear that IRD is "a right to receive an amount acquired from the decedent." The capital gain reported upon cancellation of the SCIN is not "an amount acquired from the decedent." The basis of the property to the trust should be increased for any gain recognized by the decedent or the estate. This recognizes the trust's cost basis equal to the amount of the note.

There appears to be a third, possibly arguable, position that neither of us finds appropriate. Under this approach, the property is considered to be transferred by the estate to the trust for income tax purposes only immediately after death in a gain recognition (including, if applicable installment sale) transaction. The trust has a purchase price basis. The note has received a fair market value basis at death. Any gain recognized increases the basis, so that eventually the estate recognizes gain on the property and an offsetting loss on the note. The situation is similar to that for an S corporation (or a partnership without a § 754 election[190]) with appreciated property. The inside basis of the property is not affected by the shareholder's (or partner's) basis step-up at death. Accordingly, when the inside gain is recognized, the basis in the S corporation shares (or the partnership interest) is stepped-up above fair

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[189] One way of ensuring that the cancellation gain is reported under § 453B(a) and (f) on the final income tax return is to elect out of the installment method under § 453(d) at the time of the SCIN sale to the grantor trust occurred. By electing out of the installment method under § 453(a), there is no longer "an installment obligation reportable by the decedent on the installment method under Section 453", and therefore, § 691(a)(5)(A) cannot be applicable. For § 691(a)(5) to apply, you need an "installment obligation" reportable under the "installment method." Since the Court in *Frane* relied on the language found on § 691(a)(5)(A), the election-out eliminates the ability to rely on § 691(a)(5)(A).

[190] See *Est of Dupree. v. United States*, 391 F.2d 753 (5th Cir. 1968).

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CHAPTER 16

Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*

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Synopsis

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¶ 1602 **Summary and Conclusions**

¶ 1600 Introduction

Estate planners have long recognized the attractiveness of the various freeze techniques for transfer tax purposes.[1] An estate freeze involves the current transfer of property or an interest in property that allows future income or appreciation or both to accrue to the benefit of the desired recipient without a transfer tax on the value represented by the anticipated returns.

Estate freezes can have important nontax objectives as well. Assets owned outright, in revocable trusts designed to avoid probate, or even in self-settled irrevocable trusts are exposed to claims of the creditors of the owner-grantor. Transferring ownership of assets to other family members or family entities is a well-accepted asset protection technique, but is subject to attack if a gratuitous or bargain transfer leaves the transferor insolvent. A sale for adequate consideration is not subject to such attack, and, although it leaves the consideration subject to such claims, it protects future income and appreciation. In addition, a transfer for consideration can convert a growth asset that has a low current return into one that produces a greater current return to the transferor in the form of interest on the promissory note given as consideration, while the growth, presumably at a greater rate, accrues to the transferees. Moreover, lifetime dispositions of property can also transfer part or all of the responsibility for managing or investing family assets among the junior family members to whom the assets are transferred or who become trustees of the family trusts that receive the assets. Separate trusts for each junior family member can allow each junior family member to make independent investment and other decisions with respect to their trust's assets. This may be especially important when the junior family members have different investment needs or philosophies.

An outright gift is perhaps the easiest freeze technique to implement and for the client to understand. Its major drawback is that a taxable gift in excess of the unified credit equivalent[2] requires the immediate payment

[1] The Federal transfer taxes referred to are the gift tax, the estate tax and the generation skipping transfer tax. All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.

[2] For 2000 and 2001 the lifetime exemption is $675,000. It increases to $1,000,000 by the year 2006, and it is not indexed for inflation. The $600,00 exemption became effective in 1987. If it were adjusted for inflation since that date on the same basis as the income tax brackets and other income tax amounts, the amount would be $884,370 for 2000.

of a gift tax, and possibly the immediate or future payment of the generation skipping transfer tax if the donor's GST exemption is exhausted. A grantor retained annuity trust (GRAT) also accomplishes the freeze objective, and at a reduced gift tax cost because of the retention of an annuity interest by the grantor.[3] For those with charitable inclinations, the charitable lead annuity trust (CLAT) for a fixed term accomplishes the freeze objective, also at a reduced gift tax cost because the annuity given to a charity qualifies for the charitable gift tax deduction as well as the charitable income tax deduction.[4] A taxable installment sale to the intended beneficiary or to an irrevocable (nongrantor) family trust can avoid any current gift tax if the sale is at fair market value, but at the price of a future, presumably capital gain, tax to the seller or the seller's estate on any realized appreciation. An installment sale to a grantor trust on the same terms can avoid both the gift tax and the income tax on any unrealized appreciation because, although the transfer should be recognized for transfer tax purposes, it is not recognized for income tax purposes. Deferred payment sales to family members or family trusts can accomplish a current transfer without requiring the children to provide the necessary cash from their own resources or having to resort to commercial financing. The significant transfer tax advantages of an estate freeze transaction should not subject the transaction to effective attack by the IRS as impermissible tax avoidance.[5]

Last year we published an article that compared net gifts, GRATs, taxable installment sales and nontaxable installment sales to grantor trusts as estate freeze vehicles.[6] That article briefly mentioned the use of self-canceling installment note sales ("SCINs") and private annuity sales, but did not analyze the tax consequences of these two contingent payment alternatives. This article examines the income and transfer tax consequences of SCINs and private annuity sales to a grantor trust (that are free of income tax on unrealized gain) and to a purchaser that is not a grantor trust (that

[3] The IRS takes the position that the value of the remainder interest in a GRAT cannot be reduced to zero. Reg. § 25.7520-3(b)(2)(i).

[4] Since the value of the remainder interest in a fixed term CLAT can be reduced to zero, the gift tax can be completely avoided. Reg. §§ 25.2522(c)-3(d)(2) Example 1 and 20.2055-2(f)(2) Example 1 permit zeroing out a CLAT for a term of years, but Reg. §§ 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i) and 25.7520-3(b)(2)(v) Example 5 provide that zeroing out a CLAT for life is not permitted.

[5] Paul, The Lawyer As A Tax Advisor, 25 Rocky Mountain Law Review 412 (1953). *See* Judge Learned Hand's statement in *Commissioner v. Neuman*, 159 F.2d 848, 850-851 (2d Cir. 1947), *cert. denied*, 331 U.S. 859 (1947): "There is no moral turpitude and nothing sinister in arranging one's affairs so as to keep taxes as low as possible."

[6] Manning and 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. 14, 1999) ("M&H, Grantor Trusts").

are subject to income tax). It also examines planning issues in assuring that the chosen form of deferred payment sale achieves its goals and post-sale planning alternatives when subsequent events imperil the desired freeze benefits.

¶ 1601 Forms of Deferred Payment Sales

As indicated, there are three basic forms for deferred payment sales, fixed payment sales, SCIN sales[7] and private annuity sales. Traditionally, the IRS distinguished between SCINs and private annuities on the basis of the maximum term of the deferred payment obligation—if the maximum term was shorter than the transferor-seller's actuarial life expectancy,[8] a sale was classified as a installment sale under § 453; if longer, it was classified as a private annuity governed by § 72.[9] A SCIN for a maximum term exceeding the seller's life expectancy is sometimes referred to as a private annuity for a term of years (a "PATY"), with income tax reporting generally under the § 72 annuity rules. As discussed below in ¶ 1601.3.A *Impact of Reg. § 1.1275-1(j)*, a recent regulation amendment designed primarily to prevent noninsurance company financial institutions offering tax-sheltered investments[10] may require treating PATYs as installment sales under § 453, in effect, as SCINs, leaving only annuities for life with no term limits or refund features subject to traditional private annuity taxation.

As indicated, any of the three deferred payment sale transactions can either be a sale to a grantor trust that is not treated as a sale for Federal income tax purposes or to another purchaser that is treated as a sale for Federal income tax purposes, even if the sale is to a partnership or S corporation in which the transferor-seller is substantially the sole owner.[11]

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7 Frequently referred to simply as SCINs although technically a SCIN is the form of promissory note that contains the cancellation feature, usually based on the seller's death.

8 Using the Reg. § 1.72-9 Table V mortality table. The lives in Table V are based on a 1983 study of individuals who purchased annuities. Annuity purchasers tend to live longer than people of the same age in the general population, presumably because they are self-selected and have better living conditions.

9 See G.C.M. 39503, Jun. 28, 1985; see Hesch and Manning, Family Deferred Payment Sales: Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas, 26th U. Miami Philip E. Heckerling Inst. on Est. Plan. Ch. 3, ¶ 310.3 (1992) ("H&M, SCINs and Private Annuities").

10 See the Preambles for the proposed and final regulations. FI-33-94, 1995-1 C.B. 920, 921-22 and T.D 8754, 1998-1 C.B. 146, 146-48.

11 If Senior's grantor trust is a 100% shareholder in an S corporation, or a 99% limited partner in a partnership, a sale by Senior to his controlled entity is a taxable sale despite the fact that Senior is deemed to be the income tax owner of the purchasing entity under the grantor trust rules. Under Reg. § 1.707-3(a)(3) and (f) Example 1, a transfer may be a sale only in part if the amount paid is less than the fair market value of the property. Under Reg. § 1.707-5(a)(1) and (f) Example 1 a transfer of property subject to a liability

The following facts are used to illustrate the deferred payment sale transactions.

Senior and his wife, Mrs. Senior, are both 70 years old. They have two adult children, a son and a daughter. The largest portion of their assets consists of stock in the family business with substantial unrealized appreciation in value. Both Senior and Mrs. Senior desire to use a deferred payment sale to pass $1,000,000 worth of assets with a negligible basis on to their two children without making a taxable gift. Their primary goal is an estate freeze, sheltering future increases in the value of their assets from all transfer taxes. Both individuals have fully used the $650,000 amount they can transfer free of gift taxes for 1999 and will be in the 55% bracket for estate and gift tax purposes and the 79.75% combined GST rate for transfers at death. They would also like to minimize, if possible, any income taxes that would be paid if the family business is sold while they are alive. The are in the highest income tax brackets, 39.6% for ordinary income and 20% for capital gains. Their investment assets annually produce a pretax return of 10% of which 4% is ordinary income and 6% is capital gain, for an after-tax return of 7.216%. The annual long-term AFR is 6.47%, the annual mid-term AFR is 6.20% and the § 7520 rate is 7.4% (all based on December 1999 rates).[12] Their life expectancies at age 70 are 16.0 years under Reg. § 1.72-9 Table V and 13.9 years under Table 90CM in the Aleph Volume.[13] Their joint life expectancies with both age 70 are 20.6 years and 18.4 years, respectively. If the Senior retains the $1,000,000 of assets until his death in 15 years, they will increase in value to $2,843,767, which, after estate tax, will leave $1,279,695 net to their children, and after generation skipping transfer tax will leave $575,863 net to their grandchildren.

The income tax and transfer tax consequences of the three basic deferred payment sale situations as sales to nongrantor trusts and to grantor

is a disguised sale only to the extent that a share of the liability is shifted to other partners. Thus, if the note is considered a distribution, the transfer is a sale because it equals the fair market value of the property, but if it is analyzed as a transfer subject to a liability, only the portion attributable to other partners is a sale. The grantor trust provisions (§§ 671-679) do not apply related party or attribution rules similar to those found in the income tax area, §§ 267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in Chapter 14. See § 2701(e)(3). In the absence of specific statutory authority, a sale by a grantor to an entity owned by a grantor trust is not treated as a sale to the grantor trust. See discussion at ¶ 1601.2 *Situation Two—Installment Sale to a Grantor Trust, infra.*

12 See Rev. Rul. 99-48, 1999-49 I.R.B. 600.

13 IRS Publication 1457.

trusts are discussed in the balance of this article. As always, the discussion assumes that the sales are not shams.[14]

¶ 1601.1 Situation One—Installment Sale to a Nongrantor Trust

Example: Senior sells $1,000,000 of appreciated assets that qualify for the installment method to a family trust that is not a grantor trust, taking back the purchaser's promissory note for the entire purchase price. The promissory note is for a fixed 15-year term at 6.47% and has no termination at death contingency. Senior has a zero basis in the assets.

The transaction is a taxable sale for Federal income tax purposes. The reporting of the gain is postponed under the installment method and is reported only as principal payments on the note are received.[15] If Senior dies during the 15-year term of the note, the note is included in his gross estate at its fair market value. Because the gain was realized while Senior was alive, it is income in respect of a decedent ("IRD").[16] Consequently, there will be no tax-free step-up in basis for the note.[17] Under Section 691(a)(4), the successor-in-interest will report the capital gain and interest income as payments are made on the promissory note, subject to a deduction under § 691(c) for any estate tax attributable to inclusion of the note in Senior's gross estate.[18] The nongrantor family trust has a cost basis in the property equal to the principal amount of the note. That cost basis is not affected by Senior's death, so that any predeath appreciation that escapes transfer tax is subject to, presumably capital gain, tax to the family trust. Since the estate tax is usually 55% and the capital gain tax is 20% and may be further delayed, the tradeoff is usually a good one. If there is a decline in value, the reverse may be true, except to the extent that the value of the promissory note is correspondingly reduced.[19]

A. Assets Eligible for the Installment Method

Generally, only capital gains, long-or short-term, can be postponed under the installment method. Section 453 does not list eligible assets; it lists

[14] See *Stokes v. Commissioner*, 77 T.C.M. (CCH) 2206 (1999) (disregards private annuity sale to a family trust, arranged with the assistance of what was apparently a professional promoter, shortly before a sale of the business for cash, because nothing changed with respect to the operation of the annuitant's pizza business after the private annuity sale and prior to the resale).

[15] Unless the reporting of Senior's gain is accelerated as a result of a second disposition of the property under § 453B(a). See ¶ 1601.1.A *Assets Eligible for the Installment Method.*

[16] § 691(a).

[17] § 1014(c).

[18] See M&H, Grantor Trusts at 11-12; H&M, SCINs and Private Annuities at ¶ 307.4.B.1.

[19] See ¶ 1601.8 *Defrosting the Freeze.*

specific assets and transactions—inventory,[20] dealer dispositions,[21] depreciation recapture,[22] marketable securities,[23] sale of depreciable property to a controlled entity,[24] and sales for demand or marketable obligations[25] —that are not eligible for the installment method. Therefore, gain from the sale of ordinary income assets that are not inventory or stock and trade may be eligible for deferral under the installment method. For example, the income from intellectual property is typically characterized as ordinary income.[26] The gain from a sale of this income stream could potentially be reported under the installment method.[27] A taxpayer who has a royalty right or a fee under a licensing arrangement may also be able to defer the recognition of the ordinary income by using seller-provided financing, although there is a significant argument that the transfer is taxable immediately as an assignment of income.[28]

If the nongrantor trust or other family purchaser resells the property within two years (or at any time for marketable securities), the deferred gain is accelerated under the anti-*Rushing* rule.[29]

B. Abolition of Installment Method for Accrual Taxpayers

A provision in the December 1999 extender act,[30] eliminated the use of the installment method for accrual method taxpayers.[31] Because any taxpayer in the business of selling inventory or stock in trade is required to use the accrual method of accounting, these taxpayers are ineligible for the installment method even when they sell the complete business for a

[20] § 453(b)(2)(B).

[21] Other than unimproved lots and timeshares. § 453(b)(2)(A) and (l)(2)(B).

[22] § 453(i)(1)(A).

[23] § 453(k)(2)(A).

[24] § 453(g)(1)(A) and (f)(7).

[25] § 453(f)(4).

[26] § 1221(3).

[27] There is a possibility that the deferred payment sale may be viewed as an anticipatory assignment of income and the promissory note may be viewed as a payment in kind. Also, consider the impact of the anti-churning rule under § 197(f)(9) on the purchasers. The installment method is not available if the purchaser is a related party who amortizes or depreciates the purchased asset. § 453(g)(1)(A).

[28] See *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *United States v. Dresser Industries*, 324 F.2d 56 (5th Cir. 1963); *Fox v. Commissioner*, 84 T.C. 50 (1985); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

[29] § 453(e)(1) and (2), which changed the result of *Rushing v Commissioner*, 441 F.2d 593 (5th Cir. 1971), *aff'g* 52 T.C. 888 (1969) (sale to family trust eligible for installment method notwithstanding immediate resale by trust). See H.R. Rep. No. 833, 96th Cong. 2nd Sess. 48-51 (1980).

[30] Tax Relief Extension Act of 1999, P.L. 106-170, 113 Stat. 1960.

[31] *Id.* at § 536, adding new § 453(a)(2).

promissory note. This means that all corporations, partnerships or individuals that use the accrual method of accounting can no longer qualify for the installment method, even for their otherwise eligible capital assets and section 1231 assets. A cash method shareholder in a C or S corporation or cash method partner who sells his stock or partnership interest can still use § 453 even if the corporation or partnership uses the accrual method.[32] Thus, this legislation creates an additional distinction depending on the form of the transaction as a sale of assets or of stock or a partnership interest. Although it is not clear, presumably even a sale of stock of an S corporation with a § 338(h)(10) election would be treated as an asset sale for this purpose, making the installment method unavailable. The enactment has drawn considerable belated controversy and there are calls for repeal or amendment, but it is not clear how successful these efforts will be.[33] Several bills have been introduced to repeal or modify the new provision, including a small business (under $5,000,000) exception,[34] and the IRS is studying possible ways to reduce the burden of the change.[35]

C. Avoid Installment Sale of Assets with Suspended Passive Activity Losses

Taxpayers should avoid selling any assets with a suspended passive activity loss (a "PAL") for a promissory note, or, if they must sell, they should elect out of the installment method. Although suspended PALs normally become deductible upon a taxable complete disposition of the passive activity,[36] a suspended PAL cannot be taken into account until there is a final recognition disposition of the passive activity asset. When the asset is disposed of in an installment sale, § 469(g)(3) provides that the suspended PALs are released, (i.e. deductible to offset nonpassive income), in the same ratio that gain is recognized under the installment method. An installment sale for an interest-only promissory note would postpone the use of the suspended PALs until the end of the note term.

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[32] See H.R. Rep. No. 238, 106th Cong. 1st Sess. 390 (1999); Sen. Rep. No. 120, 106th Cong., 1st Sess. 201 (1999); H.R. Conf. Rep. No. 1180, 106th Cong. 1st Sess. at III.F. (1999).

[33] See Shepard, Installment Method Repealed for Whom? 86 Tax Notes 8 (Jan. 3, 2000); Blanchard, Why the Installment Method Repeal was a Big Mistake, 86 Tax Notes 429 (Jan. 17, 2000); Harper, Accrual Method S Corps.' Use of Installment Method, 86 Tax Notes 557 (Jan. 24, 2000); Glenn, Installment Method Repeal Needs Legislative Fix, 86 Tax Notes 1328 (Mar. 6, 2000).

[34] H.R. 3568, 106th Cong., 2nd Sess. (Feb. 2, 2000); H.R. 3594, 106th Cong., 2nd Sess. (Feb. 9, 2000); S. 2005, 106th Cong., 2nd Sess. (Jan. 26, 2000); S. 2246, 106th Cong., 2nd Sess. (Mar. 9, 2000) (exception for businesses with gross receipts under $5,000,000).

[35] See Prepared Statement of Treasury Tax Legislative Counsel Joseph Mikrut at Ways and Means Oversight Subcommittee Hearing on Installments Sales (Feb. 29, 2000).

[36] § 469(g)(1).

D. Installment Sale of Section 1231 Property

As indicated in ¶ 1601.1.A *Assets Eligible for the Installment Method,* most section 1231 assets are eligible for the installment method. This allows a taxpayer to plan to take advantage of the benefit that net section 1231 gains are taxed at capital gains rates, while net section 1231 losses are treated as ordinary losses. The basic netting is of gains and losses *recognized* in the taxable year.[37] Accordingly, even if section 1231 gain and loss assets are sold in the same year, any gains deferred under the installment method are not offset against losses realized in the same year. When a taxpayer has net section 1231 losses treated as ordinary losses, § 1231(c) treats net section 1231 gains recognized in the subsequent five years as ordinary income to the extent of the earlier net section 1231 losses. To avoid this unfavorable result, principal payments on the installment note must be postponed until at least the sixth succeeding taxable year to insure capital gain treatment for the section 1231 gains.

E. Use of Leases Instead of Installment Sales

If the nongrantor trust or other family purchaser wishes to dispose of the property Senior sold to it under the installment method before the end of the two-year acceleration period,[38] immediate recognition may be avoided by use of a lease. The family trust can delay the sale by leasing the property with an option in favor of the lessee to purchase the property after the two-year holding period has expired. Similarly, if the installment disposition must be made by Senior before the requisite one year holding period for long-term capital gain treatment has occurred because of year-end transfer tax or other considerations, the transaction with the family trust might be made by lease-option. The option payment is not income even though received in cash.[39] The tax detriment is minimal because the ordinary income the seller would report would be rental income instead of interest income. Although depreciation deductions on the asset leased may offset the ordinary income, the lessee-purchaser should take the corresponding loss of depreciation into account in setting the rent. The estate planner must take care to avoid problems under reality-of-sale principles,[40] that seek to distinguish leases from disguised deferred

[37] § 1231(a)(3).

[38] See text at note 29, *supra.*

[39] See *Commissioner v. Dill Co.,* 294 F.2d 291 (3d Cir. 1961); Rev. Rul. 78-182, 1978-1 C.B. 265 (CBOE options).

[40] See, *e.g., Frank Lyon Co. v. United States,* 435 U.S. 561 (1978); *Rice's Toyota World v. Commissioner,* 752 F.2d 89 (4th Cir. 1985), *aff'g* 81 T.C. 184 (1983). A more detailed discussion of the factors considered in deciding whether it was a lease or sale is beyond the scope of this paper. See, *e.g.,* Phillip Holthouse, Creative Uses of Leases in Lieu of Installment Sales, 45 Tax Mgmt. Mem. 51 (1999).

payment sales by examining the relevant facts, including examining the amount of any option payment to determine whether it is sufficiently large to make exercise a foregone conclusion.[41]

Section 453B provides that pledging an installment note as collateral for a loan requires the deferred gain to be reported in the year the loan proceeds are received. The loan proceeds are treated as if they were a payment of principal and the gross profit ratio applied to the loan proceeds determines the amount of the accelerated gain. A long-term lease with an option to purchase does not have any such pledging rule. Mortgaging leased property, even on a nonrecourse basis, does not involve any similar acceleration of the gain,[42] although the lessor will want to assure that the mortgage does not risk its rights to possession of the property.

F. Avoiding § 453A—Exceeding the $5,000,000 Maximum Without Interest on the Deferred Tax Liability

Section 453A provides for interest on the taxes on the gain deferred under the installment method if outstanding installment obligations exceed $5,000,000, but only by aggregating deferred payment sales made in the same tax year. The rate of interest to be used is the Federal short-term rate, determined each quarter, plus 3%.[43] This is the interest rate charged on tax underpayments. This interest charge eliminates much of the time value of money benefit from deferring the tax under the installment method. A close reading of § 453A shows that each taxpayer is tested under this $5,000,000 threshold separately. The threshold can be increased to $10,000,000 when two taxpayers, even if related, each make a deferred payment sale for $5,000,000 or less. It is simple for a senior family member to gift $5,000,000 worth of property to each of his or her children. For example, if, prior to the sale, Senior gives a portion of the property to be sold to one or more children, the amount that could be sold without incurring an interest charge would be increased. Unfortunately, the gift would involve a gift tax liability that is likely to be more expensive than the interest charge. Since gifts between spouses that qualify for the unlimited marital deduction avoid gift taxes and since each spouse is a "taxpayer" notwithstanding joint returns,[44] the threshold can be increased

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41 See *Green v. Commissioner*, 367 F.2d 823 (7th Cir. 1966).

42 See *Woodsam Associates Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).

43 §§ 453A(c)(2)(B) and 6621(a)(2).

44 See §§ 151(b) and 6013(a) providing for joint returns and for each taxpayer taking a personal exemption. A close examination of the language in § 6013(a) shows that a joint return is filed by two taxpayers. See Tech. Adv. Mem. 98-53-002 (Issue 2), Sep. 11, 1998 (spouses are separate taxpayers for purposes of the $5,000,000 threshold; relies on Notice 88-81, 1988-2 C.B. 327, which provides that installment obligations of partnerships and S

$10,000,000 for each tax year without a gift tax. Of course, gifts immediately before a sale run the risk of being disregarded under the step-transaction principle.[45]

Another way of increasing the threshold is to sell part of the property in one taxable year and another part in a subsequent taxable year, increasing the threshold to $10,000,000. For example, an individual contemplating a sale in December can, instead, sell a one-half interest in December and the other one-half interest in January of the following year. Combining the bifurcation of the sale among two separate taxable years with gifts to a spouse increases the threshold to $20 million.

A lease with an option to purchase is another way of increasing the threshold. If there were a ten-year lease, there could be a sale of $5,000,000 each year for ten years, so that an installment sale of $50,000,000 could avoid the interest threshold under § 453A.

Of course, each of these arrangements is subject to attack under sham, reality-of-sale and step-transaction principles. The planner must be sure not only to use them only if justified by the facts, but also to have sufficient authority to avoid accuracy related penalties.

G. Minimum Funding of the Family Trust—Is 10% of the Installment Note Required?

The recent commentary on installment sales to grantor trusts has established a guideline that the grantor trust must have independent funding in an amount equal to 10% of the value of the property it purchases from the grantor.[46] Although addressed primarily to grantor trusts, since the issue is one of the reality of the sale for income and transfer tax purposes, the same issues arise for nongrantor trusts. Nowhere in any published ruling, case or other administrative pronouncement of the Internal Revenue Service is there a 10% rule, although some have

corporations are owned by the partners or shareholders applying the definition in § 453A(b)(2) that incorporates the definition of single owner in § 52 so that no attribution to family members is appropriate).

[45] See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1951); *American Bantam Car. Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949); *Turner Broadcasting Systems, Inc. v. Commissioner*, 111 T.C. 315 (1998); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1998).

[46] See *e.g.*, Abbin, She Loves Me, She Loves Me Not, 31st U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶ 1300.1 (1997); Mulligan, Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?, 32nd U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶ 1505.2 (1998); Oshins, Sales to Grantor Trusts, 13 Prob. & Prop. 46, 48 (1999).

suggested[47] that it is based on an analogy to the requirement of § 2701 that the junior equity interest have a value of at least 10% of the value of the enterprise.[48] The minimum 10% funding guideline is easy to understand and has assumed an authority of its own.

The grantor of the trust may have to make a taxable gift of a substantial amount in order to provide such funding unless there is an existing grantor trust with existing assets. In addition to the gift tax, providing the minimum funding becomes doubly expensive when the grantor has already fully used the available GST exemption for both himself and his spouse.[49]

The income tax cases dealing with the reality-of-sale issue indicate that the sale will be respected if (i) the amount of the seller-provided financing does not exceed the value of the asset purchased,[50] and (ii) it can be expected that the purchaser will be able to meet the financial obligations on the note as they become due. Accordingly, the crucial question to ask is "can it reasonably be expected that the purchaser will be able to meet its financial obligations on the promissory note as they become due?" The taxpayer must be able to demonstrate that the purchaser will have access to the necessary funds to meet its obligations as they become due. This can be accomplished in a variety of ways.

A major source of funds for the trust to meet its financial obligations on the promissory note as they become due can always be the cash flow expected to be generated by the asset purchased from the grantor. Bootstrap sales, even with 100% nonrecourse financing, have long been accepted for Federal income tax purposes.[51] A reasonable written financial projection is a practical necessity if cash flow is relied on to support the reality of sale theory. The ability to use the purchased asset as collateral for a loan from an unrelated party is an alternate source of funds. For this to provide a possible justification, the security agreement that almost inevitably is used in a deferred payment sale must permit the purchased asset to be pledged as collateral for an outside commercial loan, but only if the loan proceeds will be used to satisfy the obligations on the promissory note. Accordingly, a written indication of the availability of such outside

[47] See, *e.g.*, Hatcher and Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, 92 J. Tax'n 152, 159 (2000). As the authors correctly note, if this is the basis for the 10%, gross up principles require that the funding be 11% of the note.

[48] § 2701(a)(4); Reg. § 25.2701-3(c), determined by including indebtedness to family members in enterprise value, § 2701(a)(4)(A)(ii); Reg. § 25.2701-3(c).

[49] The GST exemption is indexed for inflation and is $1,030,000 for 2000.

[50] In *Lebowitz v. Commissioner*, 917 F.2d 1314 (2d Cir. 1990), the court stated that "the proper question concerning the genuineness of the debt turns on whether the value of the acquired property . . . approximated the principal amount of the . . . note."

[51] See *Commissioner v. Clay Brown*, 380 U.S. 563 (1965); *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq.* Rev. Rul. 69-77, 1969-1 C.B. 59.

financing can be another basis for supporting the reality of the sale. Similarly, personal guarantees by the beneficiaries of the grantor trust of all or maybe only a portion of the note principal can support the economic substance of the family trust's obligation, without the need for current funds that might require a gift.[52] In order to avoid treating beneficiary guarantees as gifts,[53] each beneficiary should be paid a reasonable fee for their guarantee to avoid having the guarantee treated as a taxable gift by the beneficiaries and having them become additional grantors of the trust.

In addition, the planner should bear in mind that, since a major purpose of the transaction is likely to be an estate freeze, the issue is not whether the sale is respected for income tax purposes, but whether the sale to the family trust is respected for transfer tax purposes, and, in particular, whether the promissory note can be viewed as a retained life estate. As discussed in our prior article, a fixed payment installment note that is bona fide debt should not be treated as a retained interest in the trust.[54] In addition, several cases have refused to treat a private annuity as a retained life estate when there was no direct correspondence between the annuity and trust income.[55] Nevertheless, the issue is an intensely factual one, requiring a careful exercise of judgment by the estate planner, including sound advice to the client concerning the degree of risk involved, with our advice remaining that only those who are willing to take substantial risks should use a trust with no other significant assets.[56]

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52 See Hatcher and Manigault, *supra* note 47, at 159; Priv. Ltr. Rul. 95-15-039, Jan. 17, 1995.

53 See *Bradford v. Commissioner*, 34 T.C. 1049 (1960); August, IRS Reverses Prior Ruling on the Impact of Guarantees on the Marital Deduction, 80 J. Tax'n 324 (1994).

54 See M&H, Grantor Trusts at 17.

55 *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984) (trust was minimally funded, but still no tie-in between trust income and annuity payment, annuitant had limited powers over trust); *La Fargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982) (no direct relationship between annuity amount and trust income); *Becklenberg Est. v. Commissioner*, 273 F.2d 297 (7th Cir. 1959) (fixed annuity of $10,000 is not a right to trust's income; payment of annuity not restricted to income); *Fabric Est. v. Commissioner*, 83 T.C. 932 (1984) (trust obligation for annuity was as a true creditor; trustee was personally liable under local law if trust assets exhausted; no tie between annuity and trust's income); but see *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985) (direct correspondence between trust income and annuity amount); *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq.* 1973-2 C.B. 2, *aff'd* 513 F.2d 824 (9th Cir. 1975) (annuitant could control trust, although indirectly); *Schwartz v. Commissioner*, 9 T.C. 229 (1947), *acq.* 1947-2 C.B. 4 (1947) (shortfall in trust income never made up in paying annuity); Rev. Rul. 68-183, 1968-1 C.B. 308 (not true bootstrap sale when only source of payment was income from purchased asset). See also M&H, Grantor Trusts at 17.

56 See M&H, Grantor Trusts at 17; see Mulligan, *supra* note 46, at ¶ 1507.1; Nicholson, Sale to a Grantor Trust: Better Than a GRAT?, 37 Tax Mgmt. Mem. 99 (1996); see also Hatcher and Manigault, *supra* note 47 at 158 (suggests trust with no resources other than property purchased is difficult to distinguish from a GRAT).

H. Computation and Summary

The results of the transaction in Situation One if Senior dies in the end of 15 years after collecting on the note may be summarized as follows:

Senior's assets at death[57]	$1,798,506	
Less: Estate Tax[58]	989,178	
Net		$809,328
Plus: Trust's Assets[59]		776,256
Total Assets to Children[60]		$1,575,834

The computation is based on the sale being of assets that qualify for the installment method and assumes that there is no subsequent disposition by the family trust that accelerates the installment gain by a cash method taxpayer. Because of the amounts involved, the interest charge on large installment sales is not involved. For larger sales, we have suggested methods to reduce or eliminate the charge. We have also suggested other techniques for section 1231 property and for dispositions that should not trigger the early disposition rules.

¶ 1601.2 Situation Two—Installment Sale to a Grantor Trust

Example: Senior makes the installment sale to an irrevocable family trust, that is nevertheless a grantor trust because of retained administrative powers that do not require inclusion of the trust assets in Senior's gross estate. A grantor-seller must provide some funds by gift in addition to the property sold, so that the trust can be treated as a grantor trust.[61]

57 Includes the $1,000,000 note valued at its principal amount plus accumulated after-tax interest received on the note and after-tax earnings on the accumulation, reduced by the capital gain tax on the installment sale.

58 Estate tax. If the promissory note is paid immediately after Senior's death, the estate tax is higher, but this is offset by the capital gain tax reduction for the estate from the § 691(c) deduction.

59 Original assets purchased, less payment of promissory note, plus accumulated income net of interest paid on the note. This assumes that all accumulated income, including capital gain, is realized. If there is unrealized appreciation, particularly unrealized appreciation on the assets sold in the initial installment sale transaction, the immediate transfer to the children is increased, subject, of course, to future, presumably capital gain, tax on realization. Thus, this calculation does not take into account the time value of money benefits of deferring tax on unrealized appreciation other than deferral of the appreciation in the assets initially sold to the trust under the installment method.

60 A generation skipping transfer increases the transfer taxes by $445,130 and reduces the total assets passing to the grandchildren to $1,130,453.

61 See *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975) (a taxpayer is considered a grantor only with regard to the property actually contributed to the trust and owned by the taxpayer at the time of contribution). Prop. Reg. § 1.671-1(e)(1) takes a similar approach.

Such a family trust is sometimes called a "defective" grantor trust,[62] but it is not defective since the grantor trust status is intentional. Perhaps a better term is intentional or deliberate grantor trust.

Under Rev. Rul. 85-13,[63] no sale has occurred for Federal income tax purposes when the property is exchanged for the note. Because there is no sale, principal and interest payments on the Family trust's promissory note have no tax effect and none of the installment sale issues discussed in ¶ 1601.1 *Situation One—Installment Sale to a Nongrantor Trust,* arise. Despite the title of this section, it is not necessary to limit this technique to assets that qualify for the installment method: The technique can be used, for example, to transfer marketable securities. It can also be used by accrual method taxpayers not eligible to use the installment method.

If Senior dies before payment of the promissory note, the value of the note is included in his gross estate. As discussed below, we believe that since there was no gain realized while Senior was alive, the rights under the installment note are not IRD.[64] The estate's basis in the note is stepped up to its value at the date of death, based on the AFR at that time.[65] The family trust is deemed to have acquired the assets by purchase for income tax purposes at the time of death when its grantor trust status terminates. It takes a cost basis in the assets, which should be equal to its principal amount if the interest provided is at least equal to the AFR, at the time of Senior's death.[66] The trust is not entitled to a stepped-up basis in the assets under § 1014(a).[67] Thus, if the property has appreciated before death, the negative effect of the estate freeze and the exclusion of the appreciation from the gross estate is the loss of the income tax advantage of the basis step up above the principal (or other tax amount) of the

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[62] See, *e.g.*, Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT, 23 Est. Plan. 3 (1996); Oshins, King and McDowell, Sale to a Defective Trust: A Life Insurance Technique, 137 Tr. & Est. 35 (1997); Weinberg, Reducing Gift Taxes Liability Using Intentionally Defective Irrevocable Outstanding Trusts, 4 J. Asset Prot. 62 (1999); Hatcher & Manigault, *supra* note 47.

[63] 1985-1 C.B. 184; Reg. § 1.1001-2(c) Example 5. *Cf.* Rev. Rul. 92-84, 1992-2 C.B. 216 (income beneficiary of qualified subchapter S trust is taxed on gain on sale of S corporation stock allocated to corpus because treated as grantor and therefore as owner of trust's assets).

[64] See ¶ 1601.2.A.1 *Termination on Grantor's Death, infra.*

[65] The terms of the note may provide for a rate adjustment to avoid creating OID at that time. One commentator believes that the note may be valued at less than its principal because the AFR is likely to be less than prevailing interest rates; see Mulligan, *supra* note 46 at ¶ 1507.1; but some believe that § 7872 requires valuation at principal. See Hatcher and Manigault, *supra* note 47.

[66] § 1274(a)(1); Reg. § 1.1274-2(b)(1); *Mayerson v. Commissioner,* 47 T.C. 340, 352, *acq.* Rev. Rul. 1969-77, 1969-1 C.B. 59; *Bolger v. Commissioner,* 59 T.C. 760 (1973), *acq.* 1976-1 C.B. 1; see M&H, Grantor Trusts at 11 and 21.

[67] See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

promissory note. As discussed below, it is the authors' opinion that, because the death of Senior is not a realization event, no gain is recognized by Senior or his estate upon the death of Senior despite the termination of grantor trust status for any excess of the note over the pretransfer basis in the property.[68]

A. Termination of Grantor Trust Status

Even though, or perhaps more accurately because, the "sale" to the grantor trust is not a realization event for income tax purposes (even though it is a disposition for transfer tax purposes), termination of the grantor trust status on the grantor's death or by transactions during life do have income tax consequences.

1. Termination on Grantor's Death

As we discussed in our earlier article,[69] it is our opinion that termination of grantor trust status as a result of the grantor's death while the promissory note is outstanding does not result in the realization of the gain inherent in the assets initially transferred to the grantor trust. The analytic difficulty arises in significant part because of the dual nature of the original transaction—it is an effective disposition to a family trust for transfer tax purposes, but is disregarded for income tax purposes. When the grantor dies, the result is the mirror image—no transfer for estate tax purposes, but a realization event for income tax purposes. The family trust simply continues to own the assets originally sold to it, subject to the obligation on the promissory note. The grantor's death does not entitle the trust to a step-up in basis because there has been no transfer to it under § 1014(a). The family trust does not hold the assets as a gift with a transferred basis under § 1015 since the original transaction was a purchase.[70] Since the family trust's note is now recognized for income tax purposes, its basis should be a cost basis measured by the principal amount, or, more accurately, the tax amount of the obligation.[71] That amount should be the principal amount of the promissory note, discounted, if appropriate, by any OID that may result if the interest rate is not equal to the AFR on the date of death.[72] Thus, the family trust will eventually pay income tax on

[68] See M&H, Grantor Trusts at 23-25; ¶ 1601.2.A.1 *Termination on Grantor's Death.*

[69] See M&H, Grantor Trusts at 21-26.

[70] See ¶ 1601.2.A.1 *Termination on Grantor's Death, infra.*

[71] As discussed in M&H, Grantor Trusts at 25-26, some commentators suggest that the note does not represent the purchase price of the property but a separate obligation that springs into existence at death.

[72] § 1274(a)(1); Reg. § 1.1274-(4)(a)(1) (specifying use of the AFR at the time of the contract of sale).

is that transfer of the assets to the trust for gift and estate tax purposes occurs at the time of the sale, the assets are owned by the trust not the grantor at death for transfer tax purposes, without regard to whether the income tax transfer occurs the moment before or the moment after. Accordingly, the property remains in the trust and cannot receive a step-up in basis at death since it does not pass at death under the provisions of § 1014(a) and (b).[142] Any adjustment to that basis must come, not as a consequence of death, but as a consequence of the purchase from the grantor-seller (or his estate).

Thus, we must turn our attention to the question of what occurs for income tax purposes on the termination of grantor-trust status and when it occurs. This is also important for characterizing the note issued in the original deferred payment transaction and in determining whether the note represents an item of income in respect of a decedent.

The issues may be highlighted by the following example.

Example (8). Senior, in *Example (7)* dies at the end of the tenth year when the value of the property initially transferred to the trust is $1,350,000, not including accumulated trust income, and when the outstanding principal of the note remains at $1 million. It can be established that, because of the trust's other assets or other assurances of payment, the deferred payment obligation is neither a retained life estate nor equity under debt/equity standards. During the preceding 10 years, Senior has, of course, collected the interest on the note. Under the principles of Rev. Rul. 85-13, Senior is deemed to have transferred the trust property to the trust at death and the deferred payment note becomes an obligation for income tax purposes.

The questions are (i) how to characterize for income tax purposes the deemed transfer of the property and the recognition of the note and (ii) when the transaction as characterized occurs, immediately before or immediately after death. We believe that, in answering the first question, the fact that there may have been a sale, even a deferred payment sale, for transfer tax purposes at the time of the original transfer to the grantor trust is simply irrelevant. Under the principles of Rev. Rul. 85-13, nothing has occurred for income tax purposes until grantor-trust status terminates.

A regulation,[143] a case,[144] and a published ruling,[145] all involving a grantor trust that owned an interest in a partnership in which partner's share of partnership's liabilities exceeded the basis in its partnership interest held by the grantor trust, determined that when grantor-trust status terminated while the grantor was alive, the grantor had a taxable transaction. In all three, the transaction was a deemed transfer of the partnership interest, subject to the partner's share of partnership liabilities, to the trust. All determined that the transaction involved a transfer of the partnership interest subject to liability, and used the basis of the partnership interest and the amount of the liability at the time of termination of grantor-trust status as determining the gain recognized on the transfer. The timing of the deemed transaction as being before or after termination was irrelevant, because it would be reported in the same tax year.

In dealing with the character of the transaction, all three determined the results at that time, without any reference to any tax consequences to the grantor of "owning" the partnership interest in the meanwhile except in so far as they affected the key attributes of basis and liability amount at the time of termination. We believe this is the correct approach. The fact that the initial transaction took the form of

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142 See *Prokopov v. Commissioner*, 98-2 U.S.T.C. ¶ 60,329, 82 A.F.T.R. 2d ¶ 98,5423 (2nd Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2793; T.C. Memo. No. 1997-229 (no step-up basis for property over which the decedent had a special power of appointment because not included in gross estate).

143 Reg. § 1.1001-2(c), Example 5.

144 *Madorin v. Commissioner*, 84 T.C. 667 (1985).

145 Rev. Rul. 77-402,1977-2 C.B. 222.

character of income of the "selling" member is to be preserved.[153] Accordingly, the consolidated return regulations should not provide any precedent for termination of grantor-trust status.

To highlight what is at stake, it is useful to consider the results if the termination occurred while Senior was alive, and if, contrary to our prior assumptions, there had been payments on the note.

Example (9). Senior, in *Example (7)* gives up the powers that had resulted in the trust's being classified as a grantor trust at the end of the tenth year. At that time, the value of the property initially transferred to the trust is $1,350,000, not including accumulated trust income. Contrary to the assumption in *Example (7)*, however, the note provided annual principal payments that have totaled $833,333, so that the balance due is only $166,667. It can be established that the deferred payment obligation is not equity under debt/equity standards. Under the principles of Rev. Rul. 85-13, Senior's receipt of the payments during the ten years the trust was a grantor trust had no income tax effect, although the transfer tax transaction was complete at the time of the initial sale. When grantor-trust status terminates, Senior is deemed to have transferred the trust property to the trust and the deferred payment note becomes an obligation for income tax purposes. When so characterized, the transaction can hardly been taxed as a bona fide sale for the amount of the note. Even if, contrary to our conclusions, the deemed transaction is taxable immediately before death, the most appropriate characterization is as a part sale, part gift for income tax purposes at that time. Gain (but not loss) would be determined by comparing the note principal[154] with the basis of the property.[155] Under this analysis, the gain and the cost basis of the securities would both be $166,667. There is no basis for requiring recognition of the installment gain initially represented by the $1,000,000 principal of the note. Under Rev. Rul. 85-13, that note never had income tax existence and the payments did not represent payments on an installment sale or any sale at all, but a payment by the grantor to himself.[156] This result is clearly consistent with the authorities cited above (other than any implication of the consolidated return regulations, which we do not consider to be an appropriate analogy).

If, consistent with our basic example, there had been no payments on the note, and the initial trust assets had appreciated to, for example, $1,350,000, if the deemed transaction were determined to be taxable, the part sale, part gift analysis should still apply. The trust would have a cost basis in the assets of $1 million, measured by its obligation on the note. Consequently, the $350,000 of potential capital gain representing post-sale appreciation would remain. Senior would realize capital gain of $1 million on the sale portion that can be reported on the installment method if the investment securities are not marketable. Senior or his estate will recognize the gain when the note is paid. Senior would recognize the $1,000,000 gain immediately if the securities do not qualify for the installment method.

As indicated, we do not believe, however, that the transaction is taxable. This foregoing analysis was analysis was put forward solely to demonstrate that result if we are wrong. This leaves the remaining question of whether the deemed transfer at death results in gain recognition. Some believe

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153 Reg. § 1.1502-13(c)(4).

154 For income tax purposes, the relevant amount of the note should be determined by using the AFR at that time, not at the time of the original sale. Reg. § 1.1274-4(a)(1)(iii) provides for use of the AFR on the date the sale occurs in the absence of a binding sale contract.. Accordingly, it may be wise to include in the original note a provision for adjusting the interest rate if grantor-trust status terminates before the note is paid. The gift tax status of the note should not change.

155 Reg. § 1.1015-4.

156 A different result would be reached under the *Rothstein* case, *supra* note 11, but the IRS has specifically rejected the result and reasoning of that case in Rev. Rul. 85-13, properly in our view.

purposes until death. Nevertheless, the relevance of estate tax determinations is more appropriate than for most income tax questions. As indicated above, we believe the transfer tax status of the grantor trust prevents the basis step-up for income tax purposes under § 1014(a) and (b). Moreover, a significant part of the issue is whether the note is an item of income in respect of a decedent ("IRD") under §§ 691 and 1014(c), two income tax provisions that significantly intersect with the estate tax.

Nevertheless, we believe that the issue is not one of timing, but whether a realization event occurs. Our conclusion is that the nonstatory, but unchallenged, concept that the transfer of appreciated or depreciated property from the decedent to his estate is not a recognition event[163] should apply equally to the deemed transfer to the no longer grantor trust. We can see no principled distinction between a transfer to the grantor's estate and any other transfer that occurs solely as a result of the death. Even items that are IRD are not realized at death, only denied the step up in basis under § 1014(a).

Some commentators[164] have asserted that the nonrecognition should not apply even to a transfer too the estate when the property is encumbered by a nonrecourse liability in excess of value. The rationale is that the decedent should be required to account for the advantage of the receipt of the mortgage proceeds in the same manner as he must do so upon a gift or other transfer during life.[165] We do not believe that this analysis is sound. We see no more reason to require a decedent to account for nonrecourse mortgage proceeds than for any other unrealized change in value of any asset or for that matter of any liability that might involve discharge of indebtedness income. We note that despite the large number of estates owning tax shelter investments that almost certainly have involved this issue, we have not seen any case in which such recognition was asserted much less upheld.

If the principle that the transfer of encumbered, as well as unencumbered, property to the estate is not a realization event is accepted, the next question is whether the fact that the property and the obligation pass to a grantor trust rather than the estate should change the result. We believe that it should not. Although clearly recognized as a trust for transfer tax purposes, the grantor trust's status for income tax purposes before the grantor's death (or another terminating event) is ambiguous.[166] A grantor trust appears to be more of an entity than a QSSS or a single-owner unincorporated "disregarded" entity, but less of one than a partnership that is often referred to as a quasi entity. § 671 and Reg. § 1.671-2 and 3(a) provide that the grantor is taxed as the owner of certain items of the trust as if it had not been in existence, implying a recognition of some remaining status even when the grantor is treated as the owner

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[163] See Rev. Rul. 73-183, 1973-1 C.B. 364, *updating and restating* O.D. 219, 1 C.B. 180 (1919).

[164] See Del Cotto and Joyce, *Inherited Excess Mortgage Property, Death and the Inherited Tax Shelter*, 34 TAX L. REV. 569 (1979) (relying in part on Rev. Rul. 77-402, *supra* note 145; Lee, *Negative Basis at Death: What To Do With Tax Shelters*, 13th ANN. U. MIAMI PHILIP E. HECKERLING INST. EST. PLAN.Ch. 4, ¶¶ 4.02 and 4.03 (1979). Interestingly they and others became concerned about this issue at the time carryover basis at death was temporarily in effect, although Del Cotto and Joyce assert that carryover basis is not the relevant principle since it applies only to the estate or other successor. *Id.* at 574-75.

[165] See *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Est. of Levine v. Commissioner*, 634 F.2d 12 (2nd Cir. 1980).

[166] There is some similar ambiguity for transfer-tax purposes, The ultimate estate-tax nonentity, the revocable trust, can have some status even for transfer tax purposes. Thus, in *Est. of Jalkut v Commissioner*, 96 T.C. 675 (1991), *acq.* 1991 C.B. 1, annual exclusion gifts from a revocable trust made by other trustees while the decedent was incapacitated within three years of death were included in the decedent's gross estate even though direct transfers from the decedent would not have been. (Incidentally, the court considered the grantor-trust provisions treating the decedent as the owner of trust assets for income tax purposes as not being controlling for transfer tax purposes). On the other hand, transfers made pursuant to the decedent's reserved power to withdraw assets were not so included. *Jalkut, supra*: *McNeely v. United States*, 16 F.3d 303 (8th Cir. 1993), *cert. den.* 513 U.S. 860 (1994); *Kisling v. Commissioner*, 32 F.3d 1222 (8th Cir. 1994), acq. 1996-1 C.B. 5. The inclusion result of *Jalkut* was changed by the addition of § 2035(e) by the Taxpayer Relief Act of 1997. P.L. 105-34, § 1310(a); H.R. CONF. REP. No. 220 at 717. Interestingly, § 2035(e) refers to the grantor trust provisions in determining what trusts are to be disregarded.

metaphysical question of what simultaneous means. Interestingly, Rev. Rul. 77-402 does state that the basis and liability amounts are determined "immediately before" termination of grantor-trust status. The later version of the same situation in Reg. § 1.1001-2(c) *Example (5)* simply refers to the transaction occurring "at the time" grantor-trust status terminated.[175] Accordingly, much as we respect the commentators who take the "before" position, we cannot accept that these authorities provide significant support. Moreover, as stated above, we believe the issue is one of realization at death.

A provision dealing with a premature termination of grantor-trust status in another context is also suggestive, but ultimately not very helpful. The Code provides that when a grantor has received a charitable deduction for a transfer to a charitable lead trust and grantor-trust status terminates prior to the end of the term, the grantor must restore a portion of the deduction to income.[176] This is essentially an application of the broad tax benefit principle. The regulations provide that the restoration is by the grantor in the year of death,[177] but because it necessarily refers to a prior transaction by the decedent, provides little direct guidance on the realization or timing for the deferred payment sale to a grantor-trust situation where there was no prior transaction for income tax purposes.

Accordingly we conclude that the better reasoned view is that because the cessation of grantor-trust status and the resulting deemed transfer occurs by reason of death, the same principle as for a transfer to the estate should apply. Under this approach, there is no gain recognized by the decedent or the estate and the trust continues to hold the property with a transferred basis, that should be increased for the obligation of the note under the principles of the *Crane* case[178] to the amount of the note if that is higher.[179] The note would also receive a fair market value basis for the amount included in the gross estate. As indicated, we recognize that the inherent gain on the property is avoided, but view this as a consequence of § 1014(a) and no more objectionable than the fact that the gain would have been avoided if the decedent had held the property until death. As further support, we suggest an analogy to the situation that would occur if Senior had given away the note prior to death, but while grantor-trust status continued. The gift of the note would be subject to gift tax, but should not be subject to income tax.[180] The principles of Rev. Rul. 77-34, Reg. § 1.1001-2(c) Example (5) and the *Madorin* case[181] do not apply because the trust remains a grantor trust. Because the donee should hold the note with a zero basis, thus preserving the potential gain, there is no avoidance of the potential tax. Moreover, it is hard to see a transaction in which the note comes into existence for tax purposes as a disposition of an installment note. The trust should have a purchase price basis under the principles of *Crane*. When the grantor dies, the bequest is just like the gift except that under § 1014(a), the note receives a basis step-up.

Another analogy achieving a similar result is a transfer of property to a grantor trust subject to an obligation on the part of the trust to pay a specified sum to a third party on the occasion of the transferor's death. Under Rev. Rul. 85-13, there is no taxable transaction when the deferred payment

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175 The *Madorin* case essentially upheld the IRS's reliance on the regulation

176 § 170(f)(2)(B); Reg. § 1.170-6(c)(4).

177 Reg. § 1.170-6(c)(4) and (5) Example (3).

178 Joyce and Del Cotto implicitly agree, asserting that the issue of basis step-up at death for a nonrecourse obligation applies only to the equity interest. See note 164 *supra*.

179 See Reg. § 1.1015-4 (dealing with basis in part sale, part gift transactions).

180 *Cf. United States v. Wham Construction Corp.*, 600 F.2d 1052 (4th Cir. 1979) (obligation by newly created subsidiary to parent that represented account payable to another division of the parent was new obligation that was not boot in § 351 transaction, represented an assumption of a preexisting liability); but see Rul. 80-228, 1980-1 C.B. 115 (IRS will not follow *Wham* because parent could not be liable to itself prior to division's incorporation as a subsidiary).

181 See text at notes 143 to 145, *supra*.

transaction on death of the grantor-seller in a deferred payment sale to a grantor-trust simply ignores the inextricable interrelationship between the transfer of the property and the obligation on the note. That relationship is key to the transfer tax status of the transaction. Although we have acknowledged that the *legal* characterization of a transaction for income tax and transfer tax purposes often differ, that does not change the *fact* that there was a single transaction at the outset and that what happens at death is a simultaneous deemed transfer of the property and deemed issuance of the note and that the note is consideration for the property. To the extent that the consideration is not equal to the value of the property, what we have is a part sale, part gift. There is, in our view, simply no basis in fact or in tax principle for separating the component parts. Although we have heard the view that the IRS may push this position to prevent the basis step up, we have not been presented with any principled basis for such a separation. Although we acknowledge that the argument can be made, we do not believe it is sustainable.

If we are wrong, we believe that the sale or part sale, part gift occurs immediately before death and should be reported on decedent's final return to the extent that the installment method does not apply and under § 691 to the extent that it does. The effect of reporting the gain on the seller's final income tax return is that the resulting income tax liability can then be deducted on the Form 706 as a claim against the estate under § 2053,[189] while under the *Frane* result, any estate tax attributable to the gain can be deducted under § 691(c). We distinguish *Frane* on the ground that the note (unless a SCIN) does pass to the estate. Under this view, the note has a basis equal to any gain recognized and receives a step up (or down) in basis when included in the gross estate, except to the extent attributable to income in respect of a decedent that we consider to arise when the note springs into existence the moment before death.. Under this view, if the installment sale is in the form of a SCIN, we stick to our view that the gain should be reported on the decedent's final return. Reporting the gain accelerated upon cancellation on the seller's final income tax return places the gain where it belongs. Such treatment is consistent with the fact that there is nothing with respect to the SCIN included in the seller's estate for estate tax purposes. Furthermore, reporting the gain under § 691 is inconsistent with its purpose. Following the seller's death, the SCIN is not transferred to or possessed by the estate. Section 691 is intended to apply only when the IRD is not reported on the individual's final income tax return. Section 691(a)(1) makes it clear that IRD is "a right to receive an amount acquired from the decedent." The capital gain reported upon cancellation of the SCIN is not "an amount acquired from the decedent." The basis of the property to the trust should be increased for any gain recognized by the decedent or the estate. This recognizes the trust's cost basis equal to the amount of the note.

There appears to be a third, possibly arguable, position that neither of us finds appropriate. Under this approach, the property is considered to be transferred by the estate to the trust for income tax purposes only immediately after death in a gain recognition (including, if applicable installment sale) transaction. The trust has a purchase price basis. The note has received a fair market value basis at death. Any gain recognized increases the basis, so that eventually the estate recognizes gain on the property and an offsetting loss on the note. The situation is similar to that for an S corporation (or a partnership without a § 754 election[190]) with appreciated property. The inside basis of the property is not affected by the shareholder's (or partner's) basis step-up at death. Accordingly, when the inside gain is recognized, the basis in the S corporation shares (or the partnership interest) is stepped-up above fair

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[189] One way of ensuring that the cancellation gain is reported under § 453B(a) and (f) on the final income tax return is to elect out of the installment method under § 453(d) at the time of the SCIN sale to the grantor trust occurred. By electing out of the installment method under § 453(a), there is no longer "an installment obligation reportable by the decedent on the installment method under Section 453", and therefore, § 691(a)(5)(A) cannot be applicable. For § 691(a)(5) to apply, you need an "installment obligation" reportable under the "installment method." Since the Court in *Frane* relied on the language found on § 691(a)(5)(A), the election-out eliminates the ability to rely on § 691(a)(5)(A).

[190] See *Est of Dupree. v. United States*, 391 F.2d 753 (5th Cir. 1968).

CHAPTER 16

Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*

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ELLIOTT MANNING***

Synopsis

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of a gift tax, and possibly the immediate or future payment of the generation skipping transfer tax if the donor's GST exemption is exhausted. A grantor retained annuity trust (GRAT) also accomplishes the freeze objective, and at a reduced gift tax cost because of the retention of an annuity interest by the grantor.[3] For those with charitable inclinations, the charitable lead annuity trust (CLAT) for a fixed term accomplishes the freeze objective, also at a reduced gift tax cost because the annuity given to a charity qualifies for the charitable gift tax deduction as well as the charitable income tax deduction.[4] A taxable installment sale to the intended beneficiary or to an irrevocable (nongrantor) family trust can avoid any current gift tax if the sale is at fair market value, but at the price of a future, presumably capital gain, tax to the seller or the seller's estate on any realized appreciation. An installment sale to a grantor trust on the same terms can avoid both the gift tax and the income tax on any unrealized appreciation because, although the transfer should be recognized for transfer tax purposes, it is not recognized for income tax purposes. Deferred payment sales to family members or family trusts can accomplish a current transfer without requiring the children to provide the necessary cash from their own resources or having to resort to commercial financing. The significant transfer tax advantages of an estate freeze transaction should not subject the transaction to effective attack by the IRS as impermissible tax avoidance.[5]

Last year we published an article that compared net gifts, GRATs, taxable installment sales and nontaxable installment sales to grantor trusts as estate freeze vehicles.[6] That article briefly mentioned the use of self-canceling installment note sales ("SCINs") and private annuity sales, but did not analyze the tax consequences of these two contingent payment alternatives. This article examines the income and transfer tax consequences of SCINs and private annuity sales to a grantor trust (that are free of income tax on unrealized gain) and to a purchaser that is not a grantor trust (that

[3] The IRS takes the position that the value of the remainder interest in a GRAT cannot be reduced to zero. Reg. § 25.7520-3(b)(2)(i).

[4] Since the value of the remainder interest in a fixed term CLAT can be reduced to zero, the gift tax can be completely avoided. Reg. §§ 25.2522(c)-3(d)(2) Example 1 and 20.2055-2(f)(2) Example 1 permit zeroing out a CLAT for a term of years, but Reg. §§ 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i) and 25.7520-3(b)(2)(v) Example 5 provide that zeroing out a CLAT for life is not permitted.

[5] Paul, The Lawyer As A Tax Advisor, 25 Rocky Mountain Law Review 412 (1953). *See* Judge Learned Hand's statement in *Commissioner v. Neuman*, 159 F.2d 848, 850-851 (2d Cir. 1947), *cert. denied*, 331 U.S. 859 (1947): "There is no moral turpitude and nothing sinister in arranging one's affairs so as to keep taxes as low as possible."

[6] Manning and 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. 14, 1999) ("M&H, Grantor Trusts").

The following facts are used to illustrate the deferred payment sale transactions.

Senior and his wife, Mrs. Senior, are both 70 years old. They have two adult children, a son and a daughter. The largest portion of their assets consists of stock in the family business with substantial unrealized appreciation in value. Both Senior and Mrs. Senior desire to use a deferred payment sale to pass $1,000,000 worth of assets with a negligible basis on to their two children without making a taxable gift. Their primary goal is an estate freeze, sheltering future increases in the value of their assets from all transfer taxes. Both individuals have fully used the $650,000 amount they can transfer free of gift taxes for 1999 and will be in the 55% bracket for estate and gift tax purposes and the 79.75% combined GST rate for transfers at death. They would also like to minimize, if possible, any income taxes that would be paid if the family business is sold while they are alive. The are in the highest income tax brackets, 39.6% for ordinary income and 20% for capital gains. Their investment assets annually produce a pretax return of 10% of which 4% is ordinary income and 6% is capital gain, for an after-tax return of 7.216%. The annual long-term AFR is 6.47%, the annual mid-term AFR is 6.20% and the § 7520 rate is 7.4% (all based on December 1999 rates).[12] Their life expectancies at age 70 are 16.0 years under Reg. § 1.72-9 Table V and 13.9 years under Table 90CM in the Aleph Volume.[13] Their joint life expectancies with both age 70 are 20.6 years and 18.4 years, respectively. If the Senior retains the $1,000,000 of assets until his death in 15 years, they will increase in value to $2,843,767, which, after estate tax, will leave $1,279,695 net to their children, and after generation skipping transfer tax will leave $575,863 net to their grandchildren.

The income tax and transfer tax consequences of the three basic deferred payment sale situations as sales to nongrantor trusts and to grantor

is a disguised sale only to the extent that a share of the liability is shifted to other partners. Thus, if the note is considered a distribution, the transfer is a sale because it equals the fair market value of the property, but if it is analyzed as a transfer subject to a liability, only the portion attributable to other partners is a sale. The grantor trust provisions (§§ 671-679) do not apply related party or attribution rules similar to those found in the income tax area, §§ 267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in Chapter 14. See § 2701(e)(3). In the absence of specific statutory authority, a sale by a grantor to an entity owned by a grantor trust is not treated as a sale to the grantor trust. See discussion at ¶ 1601.2 *Situation Two—Installment Sale to a Grantor Trust, infra.*

12 See Rev. Rul. 99-48, 1999-49 I.R.B. 600.

13 IRS Publication 1457.

specific assets and transactions—inventory,[20] dealer dispositions,[21] depreciation recapture,[22] marketable securities,[23] sale of depreciable property to a controlled entity,[24] and sales for demand or marketable obligations[25] —that are not eligible for the installment method. Therefore, gain from the sale of ordinary income assets that are not inventory or stock and trade may be eligible for deferral under the installment method. For example, the income from intellectual property is typically characterized as ordinary income.[26] The gain from a sale of this income stream could potentially be reported under the installment method.[27] A taxpayer who has a royalty right or a fee under a licensing arrangement may also be able to defer the recognition of the ordinary income by using seller-provided financing, although there is a significant argument that the transfer is taxable immediately as an assignment of income.[28]

If the nongrantor trust or other family purchaser resells the property within two years (or at any time for marketable securities), the deferred gain is accelerated under the anti-*Rushing* rule.[29]

B. Abolition of Installment Method for Accrual Taxpayers

A provision in the December 1999 extender act,[30] eliminated the use of the installment method for accrual method taxpayers.[31] Because any taxpayer in the business of selling inventory or stock in trade is required to use the accrual method of accounting, these taxpayers are ineligible for the installment method even when they sell the complete business for a

[20] § 453(b)(2)(B).

[21] Other than unimproved lots and timeshares. § 453(b)(2)(A) and (l)(2)(B).

[22] § 453(i)(1)(A).

[23] § 453(k)(2)(A).

[24] § 453(g)(1)(A) and (f)(7).

[25] § 453(f)(4).

[26] § 1221(3).

[27] There is a possibility that the deferred payment sale may be viewed as an anticipatory assignment of income and the promissory note may be viewed as a payment in kind. Also, consider the impact of the anti-churning rule under § 197(f)(9) on the purchasers. The installment method is not available if the purchaser is a related party who amortizes or depreciates the purchased asset. § 453(g)(1)(A).

[28] See *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *United States v. Dresser Industries*, 324 F.2d 56 (5th Cir. 1963); *Fox v. Commissioner*, 84 T.C. 50 (1985); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958).

[29] § 453(e)(1) and (2), which changed the result of *Rushing v Commissioner*, 441 F.2d 593 (5th Cir. 1971), *aff'g* 52 T.C. 888 (1969) (sale to family trust eligible for installment method notwithstanding immediate resale by trust). See H.R. Rep. No. 833, 96th Cong. 2nd Sess. 48-51 (1980).

[30] Tax Relief Extension Act of 1999, P.L. 106-170, 113 Stat. 1960.

[31] *Id.* at § 536, adding new § 453(a)(2).

D. Installment Sale of Section 1231 Property

As indicated in ¶ 1601.1.A *Assets Eligible for the Installment Method*, most section 1231 assets are eligible for the installment method. This allows a taxpayer to plan to take advantage of the benefit that net section 1231 gains are taxed at capital gains rates, while net section 1231 losses are treated as ordinary losses. The basic netting is of gains and losses *recognized* in the taxable year.[37] Accordingly, even if section 1231 gain and loss assets are sold in the same year, any gains deferred under the installment method are not offset against losses realized in the same year. When a taxpayer has net section 1231 losses treated as ordinary losses, § 1231(c) treats net section 1231 gains recognized in the subsequent five years as ordinary income to the extent of the earlier net section 1231 losses. To avoid this unfavorable result, principal payments on the installment note must be postponed until at least the sixth succeeding taxable year to insure capital gain treatment for the section 1231 gains.

E. Use of Leases Instead of Installment Sales

If the nongrantor trust or other family purchaser wishes to dispose of the property Senior sold to it under the installment method before the end of the two-year acceleration period,[38] immediate recognition may be avoided by use of a lease. The family trust can delay the sale by leasing the property with an option in favor of the lessee to purchase the property after the two-year holding period has expired. Similarly, if the installment disposition must be made by Senior before the requisite one year holding period for long-term capital gain treatment has occurred because of year-end transfer tax or other considerations, the transaction with the family trust might be made by lease-option. The option payment is not income even though received in cash.[39] The tax detriment is minimal because the ordinary income the seller would report would be rental income instead of interest income. Although depreciation deductions on the asset leased may offset the ordinary income, the lessee-purchaser should take the corresponding loss of depreciation into account in setting the rent. The estate planner must take care to avoid problems under reality-of-sale principles,[40] that seek to distinguish leases from disguised deferred

[37] § 1231(a)(3).

[38] See text at note 29, *supra.*

[39] See *Commissioner v. Dill Co.*, 294 F.2d 291 (3d Cir. 1961); Rev. Rul. 78-182, 1978-1 C.B. 265 (CBOE options).

[40] See, *e.g.*, *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Rice's Toyota World v. Commissioner*, 752 F.2d 89 (4th Cir. 1985), *aff'g* 81 T.C. 184 (1983). A more detailed discussion of the factors considered in deciding whether it was a lease or sale is beyond the scope of this paper. See, *e.g.*, Phillip Holthouse, Creative Uses of Leases in Lieu of Installment Sales, 45 Tax Mgmt. Mem. 51 (1999).

$10,000,000 for each tax year without a gift tax. Of course, gifts immediately before a sale run the risk of being disregarded under the step-transaction principle.[45]

Another way of increasing the threshold is to sell part of the property in one taxable year and another part in a subsequent taxable year, increasing the threshold to $10,000,000. For example, an individual contemplating a sale in December can, instead, sell a one-half interest in December and the other one-half interest in January of the following year. Combining the bifurcation of the sale among two separate taxable years with gifts to a spouse increases the threshold to $20 million.

A lease with an option to purchase is another way of increasing the threshold. If there were a ten-year lease, there could be a sale of $5,000,000 each year for ten years, so that an installment sale of $50,000,000 could avoid the interest threshold under § 453A.

Of course, each of these arrangements is subject to attack under sham, reality-of-sale and step-transaction principles. The planner must be sure not only to use them only if justified by the facts, but also to have sufficient authority to avoid accuracy related penalties.

G. Minimum Funding of the Family Trust—Is 10% of the Installment Note Required?

The recent commentary on installment sales to grantor trusts has established a guideline that the grantor trust must have independent funding in an amount equal to 10% of the value of the property it purchases from the grantor.[46] Although addressed primarily to grantor trusts, since the issue is one of the reality of the sale for income and transfer tax purposes, the same issues arise for nongrantor trusts. Nowhere in any published ruling, case or other administrative pronouncement of the Internal Revenue Service is there a 10% rule, although some have

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corporations are owned by the partners or shareholders applying the definition in § 453A(b)(2) that incorporates the definition of single owner in § 52 so that no attribution to family members is appropriate).

[45] See, *e.g.*, *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1951); *American Bantam Car. Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949); *Turner Broadcasting Systems, Inc. v. Commissioner*, 111 T.C. 315 (1998); *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1998).

[46] See *e.g.*, Abbin, She Loves Me, She Loves Me Not, 31st U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶ 1300.1 (1997); Mulligan, Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?, 32nd U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶ 1505.2 (1998); Oshins, Sales to Grantor Trusts, 13 Prob. & Prop. 46, 48 (1999).

financing can be another basis for supporting the reality of the sale. Similarly, personal guarantees by the beneficiaries of the grantor trust of all or maybe only a portion of the note principal can support the economic substance of the family trust's obligation, without the need for current funds that might require a gift.[52] In order to avoid treating beneficiary guarantees as gifts,[53] each beneficiary should be paid a reasonable fee for their guarantee to avoid having the guarantee treated as a taxable gift by the beneficiaries and having them become additional grantors of the trust.

In addition, the planner should bear in mind that, since a major purpose of the transaction is likely to be an estate freeze, the issue is not whether the sale is respected for income tax purposes, but whether the sale to the family trust is respected for transfer tax purposes, and, in particular, whether the promissory note can be viewed as a retained life estate. As discussed in our prior article, a fixed payment installment note that is bona fide debt should not be treated as a retained interest in the trust.[54] In addition, several cases have refused to treat a private annuity as a retained life estate when there was no direct correspondence between the annuity and trust income.[55] Nevertheless, the issue is an intensely factual one, requiring a careful exercise of judgment by the estate planner, including sound advice to the client concerning the degree of risk involved, with our advice remaining that only those who are willing to take substantial risks should use a trust with no other significant assets.[56]

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[52] See Hatcher and Manigault, *supra* note 47, at 159; Priv. Ltr. Rul. 95-15-039, Jan. 17, 1995.

[53] See *Bradford v. Commissioner*, 34 T.C. 1049 (1960); August, IRS Reverses Prior Ruling on the Impact of Guarantees on the Marital Deduction, 80 J. Tax'n 324 (1994).

[54] See M&H, Grantor Trusts at 17.

[55] *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984) (trust was minimally funded, but still no tie-in between trust income and annuity payment, annuitant had limited powers over trust); *La Fargue v. Commissioner*, 689 F.2d 845 (9th Cir. 1982) (no direct relationship between annuity amount and trust income); *Becklenberg Est. v. Commissioner*, 273 F.2d 297 (7th Cir. 1959) (fixed annuity of $10,000 is not a right to trust's income; payment of annuity not restricted to income); *Fabric Est. v. Commissioner*, 83 T.C. 932 (1984) (trust obligation for annuity was as a true creditor; trustee was personally liable under local law if trust assets exhausted; no tie between annuity and trust's income); but see *Ray v. United States*, 762 F.2d 1361 (9th Cir. 1985) (direct correspondence between trust income and annuity amount); *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq.* 1973-2 C.B. 2, *aff'd* 513 F.2d 824 (9th Cir. 1975) (annuitant could control trust, although indirectly); *Schwartz v. Commissioner*, 9 T.C. 229 (1947), *acq.* 1947-2 C.B. 4 (1947) (shortfall in trust income never made up in paying annuity); Rev. Rul. 68-183, 1968-1 C.B. 308 (not true bootstrap sale when only source of payment was income from purchased asset). See also M&H, Grantor Trusts at 17.

[56] See M&H, Grantor Trusts at 17; see Mulligan, *supra* note 46, at ¶ 1507.1; Nicholson, Sale to a Grantor Trust: Better Than a GRAT?, 37 Tax Mgmt. Mem. 99 (1996); see also Hatcher and Manigault, *supra* note 47 at 158 (suggests trust with no resources other than property purchased is difficult to distinguish from a GRAT).

Such a family trust is sometimes called a "defective" grantor trust,[62] but it is not defective since the grantor trust status is intentional. Perhaps a better term is intentional or deliberate grantor trust.

Under Rev. Rul. 85-13,[63] no sale has occurred for Federal income tax purposes when the property is exchanged for the note. Because there is no sale, principal and interest payments on the Family trust's promissory note have no tax effect and none of the installment sale issues discussed in ¶ 1601.1 *Situation One—Installment Sale to a Nongrantor Trust,* arise. Despite the title of this section, it is not necessary to limit this technique to assets that qualify for the installment method. The technique can be used, for example, to transfer marketable securities. It can also be used by accrual method taxpayers not eligible to use the installment method.

If Senior dies before payment of the promissory note, the value of the note is included in his gross estate. As discussed below, we believe that since there was no gain realized while Senior was alive, the rights under the installment note are not IRD.[64] The estate's basis in the note is stepped up to its value at the date of death, based on the AFR at that time.[65] The family trust is deemed to have acquired the assets by purchase for income tax purposes at the time of death when its grantor trust status terminates. It takes a cost basis in the assets, which should be equal to its principal amount if the interest provided is at least equal to the AFR, at the time of Senior's death.[66] The trust is not entitled to a stepped-up basis in the assets under § 1014(a).[67] Thus, if the property has appreciated before death, the negative effect of the estate freeze and the exclusion of the appreciation from the gross estate is the loss of the income tax advantage of the basis step up above the principal (or other tax amount) of the

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[62] See, *e.g.*, Mulligan, Sale to a Defective Grantor Trust: An Alternative to a GRAT, 23 Est. Plan. 3 (1996); Oshins, King and McDowell, Sale to a Defective Trust: A Life Insurance Technique, 137 Tr. & Est. 35 (1997); Weinberg, Reducing Gift Taxes Liability Using Intentionally Defective Irrevocable Outstanding Trusts, 4 J. Asset Prot. 62 (1999); Hatcher & Manigault, *supra* note 47.

[63] 1985-1 C.B. 184; Reg. § 1.1001-2(c) Example 5. *Cf.* Rev. Rul. 92-84, 1992-2 C.B. 216 (income beneficiary of qualified subchapter S trust is taxed on gain on sale of S corporation stock allocated to corpus because treated as grantor and therefore as owner of trust's assets).

[64] See ¶ 1601.2.A.1 *Termination on Grantor's Death, infra.*

[65] The terms of the note may provide for a rate adjustment to avoid creating OID at that time. One commentator believes that the note may be valued at less than its principal because the AFR is likely to be less than prevailing interest rates; see Mulligan, *supra* note 46 at ¶ 1507.1; but some believe that § 7872 requires valuation at principal. See Hatcher and Manigault, *supra* note 47.

[66] § 1274(a)(1); Reg. § 1.1274-2(b)(1); *Mayerson v. Commissioner,* 47 T.C. 340, 352, *acq.* Rev. Rul. 1969-77, 1969-1 C.B. 59; *Bolger v. Commissioner,* 59 T.C. 760 (1973), *acq.* 1976-1 C.B. 1; see M&H, Grantor Trusts at 11 and 21.

[67] See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

any gain attributable to appreciation during the grantor's life over the tax amount of the promissory note, when realized by disposition of the property (or other realization event, such as depreciation).

As stated before, the promissory note is included in the grantor's gross estate at its fair market value.[73] The contentious issue is whether there is a taxable transfer at the time of death for income tax purposes by the grantor to the family trust of the property originally "sold" to it, because it is transferred subject to the obligation of the promissory note. We conclude that the transfer at death should not result in recognition any more than a transfer of property to the estate subject to an obligation owed to a third party secured by a mortgage in an amount in excess of the decedent's basis in the property results in gain recognition.[74] Death is simply not a realization event.[75] Thus, because the termination is at death, we conclude that the decedent does not realize taxable gain on any excess of the balance of the tax amount of the note over the basis of the property transferred. Similarly, there is no IRD under § 691 because there was no gross income prior to death. Since the initial "sale" to the family grantor trust was not a realization event for income tax purposes it cannot satisfy the terms of § 691(a).

In our prior article, we concluded that, if there were payments on the principal of the note prior to death, the family trust's basis should be determined by applying part sale, part gift principles if there was a balance on the note or gift only principles if there was not.[76] We based this conclusion on the disregard of the interim payments for income tax purposes under Rev. Rul. 85-13. Since basis is a purely income tax concept, this approach is necessary to reflect that the initial installment sale transaction is not recognized for income tax purposes. As long as grantor trust status persists, the family trust's basis in the property is irrelevant for income tax purposes even though the trust is recognized as the owner of the property for transfer tax (and legal ownership) purposes. This analysis means that the only "cost" to the family trust when it comes into income tax existence at death is the outstanding balance of the note. Even though there is no "event" at the time of Senior's death for transfer tax purposes, there is for income tax purposes—a transfer subject to the obligation on the promissory note. Since, as discussed above,[77] the transfer does not qualify for the basis step-up under § 1014(a), basis must be determined under other income tax principles. We believe that, even though there is

[73] See text at note 64, *supra.*

[74] See M&H, Grantor Trusts at 23-24.

[75] *Id.*

[76] *Id.* at 22-23.

[77] See text at note 67, *supra.*

any gain attributable to appreciation during the grantor's life over the tax amount of the promissory note, when realized by disposition of the property (or other realization event, such as depreciation).

As stated before, the promissory note is included in the grantor's gross estate at its fair market value.[73] The contentious issue is whether there is a taxable transfer at the time of death for income tax purposes by the grantor to the family trust of the property originally "sold" to it, because it is transferred subject to the obligation of the promissory note. We conclude that the transfer at death should not result in recognition any more than a transfer of property to the estate subject to an obligation owed to a third party secured by a mortgage in an amount in excess of the decedent's basis in the property results in gain recognition.[74] Death is simply not a realization event.[75] Thus, because the termination is at death, we conclude that the decedent does not realize taxable gain on any excess of the balance of the tax amount of the note over the basis of the property transferred. Similarly, there is no IRD under § 691 because there was no gross income prior to death. Since the initial "sale" to the family grantor trust was not a realization event for income tax purposes it cannot satisfy the terms of § 691(a).

In our prior article, we concluded that, if there were payments on the principal of the note prior to death, the family trust's basis should be determined by applying part sale, part gift principles if there was a balance on the note or gift only principles if there was not.[76] We based this conclusion on the disregard of the interim payments for income tax purposes under Rev. Rul. 85-13. Since basis is a purely income tax concept, this approach is necessary to reflect that the initial installment sale transaction is not recognized for income tax purposes. As long as grantor trust status persists, the family trust's basis in the property is irrelevant for income tax purposes even though the trust is recognized as the owner of the property for transfer tax (and legal ownership) purposes. This analysis means that the only "cost" to the family trust when it comes into income tax existence at death is the outstanding balance of the note. Even though there is no "event" at the time of Senior's death for transfer tax purposes, there is for income tax purposes—a transfer subject to the obligation on the promissory note. Since, as discussed above,[77] the transfer does not qualify for the basis step-up under § 1014(a), basis must be determined under other income tax principles. We believe that, even though there is

[73] See text at note 64, *supra.*

[74] See M&H, Grantor Trusts at 23-24.

[75] *Id.*

[76] *Id.* at 22-23.

[77] See text at note 67, *supra.*

The conclusion that termination during life is a realization event is not inconsistent with the judgment that the automatic termination of grantor trust status at death is not a realization event. Transmission of property at death is, as far as we know, the only disposition that is not a realization event and that generally eliminates unrealized gain or loss because of the basis adjustment under § 1014(a). Most so-called nonrecognition transactions involve both basis carryover and recognition to the extent of boot. Donative family transactions involve recognition if consideration is received, including consideration in the form of a liability transfer.[83] Even transfers in connection with a divorce under § 1041 can involve recognition under assignment of income principles.[84] At most, transmission at death can result in a transfer, not a realization, of IRD.[85]

3. Grantor Trust Disposes of Purchased Asset Subject to the Promissory Note

Even though it does not involve a termination of grantor trust status, the family trust's disposition, while it is a grantor trust, of the purchased asset subject to the obligation on the promissory note, must result in a similar taxable event for income tax purposes. The grantor now has a third-party obligor and is no longer taxable on the income from the purchased property transferred to the obligor. Under the principles of Rev. Rul. 85-13, the grantor has made a taxable sale of the property for income tax purposes at that time. The taxable gain should be measured by the tax amount of the promissory note, determined under the OID rules based on the AFR at that time, plus any additional consideration received by the family trust.[86]

4. Grantor's Disposition of the Family Grantor Trust's Note

Even though it does not involve a termination of grantor trust status, the grantor's disposition of the promissory note issued by the family trust while it is a grantor trust, must result in a similar taxable event for income tax purposes. The note that was disregarded for income tax purposes as

[83] See *Est. of Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980); *Ebban v. Commissioner*, 783 F.2d 906 (8th Cir. 1986); *Diedrich v. Commissioner*, 457 U.S. 191 (1982); Rev. Rul. 81-163, 1981-1 C.B. 433.

[84] Temp. Reg. § 1.1041-1T(a) Q&A-4; *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996); *Yonadi v. Commissioner*, 21 F.3d 1292 (3d Cir. 1994); *Balding v. Commissioner*, 98 T.C. 368 (1992); *Gibbs v. Commissioner*, 73 T.C.M. (CCH) 2669 (1997).

[85] § 1014(c); but cf. Rev. Rul. 87-112, 1987-2 C.B. 207 (accrued interest on Series E bond recognized by donor on transfer to ex-spouse in connection with divorce).

[86] See Tech. Adv. Mem. 2000-11-005, Nov. 23, 1999 (gain realized by grantor on termination of grantor trust when corpus of GRAT transferred to remainder trust subject to loan incurred to pay GRAT); Tech. Adv. Mems. 2000-10-010 and 2000-10-011, Nov. 23, 1999 (apparently identical rulings).

an obligation owed by the grantor to himself, when owed to a third party, can no longer be disregarded.[87] In the first instance, the grantor's transfer of the note should have the same consequences as would apply if the grantor issued the note to the transferee. If the note is given to a charity, it represents a charitable contribution, albeit one that probably cannot be deducted until paid.[88] The fact that the legal obligor on the note is the family trust probably does not change the general rules on payment since, under Rev. Rul. 85-13,[89] the grantor is not merely taxed on the income of the trust, but owns the trust.[90] Similarly, if the family trust's note is transferred to a family member without consideration, it is a gift.[91] If the note is transferred in consideration of goods or services, it amounts to payment for those goods or services and has the appropriate tax character under general income tax principles as deductible, capitalizable or neither, when appropriate under the taxpayer's method of accounting.

The more difficult question is whether the transfer should also be treated as a taxable sale for income tax purposes of the property previously transferred to the family trust. Although the matter can hardly be considered free from doubt, a substantial argument can be made that since the grantor still owns the family trust corpus for income tax purposes and will still be taxed on the family trust's income used to pay the note, the note does not represent consideration for the property.[92] Under this construction, the family trust would not be entitled to a cost basis or even a part sale, part gift basis in the property. On the other hand, the initial transaction was an installment sale, disregarded it is true for income tax purposes, that has become a transaction recognized for tax purposes

[87] Cf. *U.S. v. Wham Construction Corp.*, 600 F.2d 1052 (4th Cir. 1979) (liability owed by one corporate division to another is not treated as a liability assumed by the transferee when the division is incorporated, but is treated as boot paid).

[88] See, *e.g.*, *Don E. Williams Co. v. Commissioner*, 429 U.S. 569 (1977) (corporation's note not deductible contribution to a qualified pension plan because not cash); Rev. Rul. 68-174, 1968-1 C.B. 81 (taxpayer's note not deductible charitable contribution); Rev. Rul. 82-197, 1982-2 C.B. 22 (written option on corporation's stock granted to charity not deductible until exercised, no payment).

[89] Rev. Rul. 85-13, *supra* note 63

[90] But see *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984). In that case, the court determined that the grantor trust rules do not actually treat the grantor and the trust as one, but merely require that the grantor report all of the trust's items as his own and recognized a sale by the trust to the grantor as allowing the grantor-purchaser to use the purchase price as the basis of the assets. A taxpayer who initially treated the transaction under Rev. Rul. 85-13 would almost certainly be bound by a duty of consistency in treating the transfer of the note.

[91] Rev. Rul. 67-396, 1969-2 C.B. 351 (gift of donor's note, assumed to be unenforceable under state law, is not gift until paid or transferred for value); Rev. Rul. 84-25, 1984-1 C.B. 191 (gift of enforceable note is gift when delivered).

[92] *Cf. U.S. v. Wham Construction Corp.*, note 87, *supra.*

no current gift for transfer tax purposes, it is appropriate to characterize the transaction as a part sale, part gift for income tax purposes and apply the basis principles of § 1015 to the gift portion.

Example: At the time of Senior's death the property originally sold to the grantor trust had appreciated in value from $1,000,000 to $1,300,000 and the balance of the note had been reduced by principal payments from $1,000,000 to $400,000. Under the part sale, part gift approach, the family trust's cost is the $400,000 balance of the note and does not include the $600,000 payments made while the trust was a grantor trust. This $400,000 will be its basis. If Senior's basis is $750,000 instead of zero, the family trust is entitled to the higher transferred basis. There is no basis step-up for the trust under § 1014(a) since the trust corpus was not included in Senior's gross estate. The $900,000 excess of the value of the property ($1,300,000) over the amount of the promissory note ($400,000), is not a taxable gift (or bequest) for transfer tax purposes, because there is no transfer at death; that transfer was made at the time of the initial installment sale. The excess of the amount of the note over Senior's zero basis in the property is not realized for income tax purposes because the transfer is at death. The $300,000 appreciation has no current tax consequence.

The alternate approach is to treat the transaction as a sale in which the family trust's basis is determined under § 1012 as cost measured solely by the outstanding principal of the note, if any, with a basis equal to zero (if the note has been paid in full prior to death). In the example, that would mean a basis of $400,000 even if Senior's basis is $750,000. The problem with this pure sale approach is that it would appear to involve a sale by Senior for income tax purposes at the time of death, with gain realized for any excess of the value of the property over the outstanding tax amount of the promissory note. As we believe we have amply demonstrated, there is no basis for treating a transfer at death as a sale or other realization event even if the balance of the note exceeds the decedent's basis immediately prior to death. Although the initial transfer was recognized as a bona fide sale for transfer tax purposes, it is ignored for income tax purposes under the grantor trust rules. These rules also ignore interim payments of principal and interest. Accordingly, the economics of the transaction cannot properly be measured for income tax purposes at death. When the transaction is viewed as of the time of death, a time when there is no correlation between the balance of the promissory note and the value of the property, it is hard to justify it as a bona fide sale at that time. Any difference between those values, however, cannot be a gift or bequest for transfer tax purposes because the effective disposition for that purpose occurred at the time of the original installment sale. This should not, however, obscure that the transaction is essentially a family transaction.

In context, any determination that the initial price represented a bargain sale would almost inevitably result in a determination that the excess value represented a gift for both transfer tax and income tax purposes.[78] Accordingly, for income tax purposes, any such difference between the then value of the property and the then balance of the promissory note at the time of the deemed transfer at death should be viewed as a gift under § 102 even though not a gift under § 2501. Indeed, even Rev. Rul. 85-13 and Reg. § 1.1001-2(c) Example 5 do not characterize the transaction as a sale, they merely require treating the liability transferred as consideration for the transfer of the property, the result that applies in a part sale, part gift transaction. Both are concerned with the excess of the liability over basis; neither authority suggests that any excess of value over the deemed consideration has current income tax consequences.

2. Termination During Grantor's Life

If Senior relinquishes the power(s) that intentionally made the family trust a grantor trust during his life, a realization event has occurred for income tax purposes.[79] The issue of the family trust's basis for the property is the same as that discussed in ¶ 1601.2.A.1 *Termination on Grantor's Death*—whether it should be a basis determined under the part sale, part gift provisions of § 1015,[80] or should be a cost basis. We believe the considerations discussed there apply equally to transfers during the grantor's life. On the other hand, since the transfer is during life, Senior now realizes gain on the installment sale. Because the sale for income tax purposes occurs only upon termination of grantor trust status, it does not relate back to the time when the original sale was made for transfer tax purposes.[81] The gain is measured using the then tax amount of the balance of the installment note, not the original sale price, and the then basis of the property. The tax balance of the note is, in turn, determined using the AFR at that time.[82] The then basis of the property is determined with appropriate adjustment for any depreciation since the transfer, any capital expenditures made by the trust and any other appropriate items.

[78] See, *e.g., Anderson's Est, v. Commissioner*, 8 T.C. 706 (1947), *acq.* 1947-2 C.B. 1; Rev. Rul. 80-196, 1980-2 C.B. 32.

[79] Rev. Rul. 85-13, 1985-1 C.B. 184; Reg. § 1.1001-2(c) Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; G.C.M. 37228 (Aug. 23, 1977).

[80] See Reg. § 1.1015-4.

[81] See M&H, Grantor Trusts at 22-23, Example 9.

[82] See text at note 66, *supra*.

simultaneously with the transfer of the note. The note is an obligation of the family trust as a matter of state property law, whatever the grantor trust rules may provide as a matter of tax law. Accordingly, it appears more appropriate to view the transaction as involving a transfer of the property to the trust at that time for the note followed immediately by Senior's *transfer* of the note. Under this approach, Senior's transfer of the family trust's note is a taxable installment sale, so that the disposition rules under § 453B would then apply to require the grantor to recognize the inherent gain in the property and, incidentally to provide the family trust with a cost basis. The tax fiction of Rev. Rul. 85-13 should not be carried to the point of completely disregarding a transaction that has effect under both local law and the transfer tax. Disregarding the transaction for income tax purposes under the grantor trust rules does not change its nature as an installment sale that should be so characterized for income tax purposes when it is no longer disregarded.

5. Conversion of a Nongrantor Family Trust to a Grantor Trust

Although not a termination of grantor trust status, similar issues arise when a family trust, for example the trust in Situation One, is converted into a grantor trust, either intentionally or by mistake. Under principles analogous to those of Rev. Rul. 85-13,[93] a taxable event has occurred; the transfer of the assets from the trust to the grantor.[94] The family trust should recognize gain, but only for any difference between amount of the liability on the promissory note at that time and its cost basis in the property.

What is clear is that the liability no longer exists for income tax purposes because of the merger of the obligor and the obligee by application of the grantor trust rules. The seller-now grantor, on the other hand, should realize gain on the deemed receipt of the family trust property in satisfaction of the installment obligation, because the conversion means that the grantor is now the owner of the family trust's property for income tax purposes and the family trust's note has been satisfied by his "receipt" of the property in settlement of the note.[95] Any future conversion of the

93 See also Reg. § 1.1001-2(c) Example 5.

94 *Cf.* Rev. Rul. 99-5, 1999-6 I.R.B. 8 (dealing with converting an LLC taxed as a partnership into a single member LLC that is a disregarded entity); Reg. § 1.1361-4(a)(1)(i) and (ii) and (a)(4) (dealing with the effect of an election to treat a qualified subchapter S subsidiary as, in effect, a division).

95 See Rev. Rul. 73-423, 1973-2 C.B. 161 (transfer of installment obligation by seller to debtor in § 351 transaction treated as taxable settlement by seller); *Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner*, 341 F.2d 466 (5th Cir. 1965) (corporate-purchaser transferee does not realize gain because it issued its stock under § 1032 to settle obligation); Manning, The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries, 39 Tax L. Rev. 159 (1984).

grantor trust back to nongrantor trust status has the consequences discussed above, although with lesser consequences because the grantor-seller has now realized the gain and has a purchase price basis in the property.

B. Income Tax Issues of Grantor Trust Status

While the family trust continues as a grantor trust for Federal income tax purposes, the grantor is treated as the income tax owner of the trust's assets.[96] If the assets are S corporation stock or a partnership interest, the grantor must report the S corporation or partnership income on his individual income tax return even if the S corporation or the partnership makes no distributions.[97] The grantor should correspondingly increase the basis of the shares or interest for the income reported.[98]

> *Example:* Senior sells stock in an S corporation to a grantor trust for a $1 million promissory note. Senior's basis in the stock is $200,000. During the next several years, the corporation retains substantial earnings so that Senior's basis in the stock has increased to $1,600,000. The stock is now worth $4 million and the promissory note is still $1 million.

If grantor trust status terminates on Senior's death, under the basic principles discussed above, the grantor trust's basis is a purchase price basis of $1,000,000 and the potential $600,000 loss is lost as a result of what is, in effect, a step-down in basis. As discussed above, this is the negative consequence of excluding the property from the gross estate.

If grantor trust status terminates while Senior is alive, Senior is deemed to sell the S corporation stock with a basis of $1,600,000 for the $1,000,000 promissory note, thereby realizing a $600,000, presumably capital, loss. Unfortunately, the loss is likely to be disallowed under § 267(a). The disallowed loss, however, can be used to offset future trust gain under § 267(d).

C. Dangers of Crummey Powers

We understand that some drafters of grantor trusts used for installment sales provide *Crummey*[99] withdrawal powers to assure an annual exclusion in the event the settlor makes subsequent contributions to the trust. The terms of the intentional grantor trust rarely provide mandatory income distributions that qualify for the annual exclusion since they are usually intended as family accumulation arrangements. Unfortunately, including

96 Rev. Rul. 85-13, *supra* note 63; Reg. § 1.1001-2(c) Example 5. *Cf.* Rev. Rul. 92-84, *supra* note 63

97 §§ 705(a)(1)(A) and 1367(a)(1)(A).

98 §§ 702(a) and 1366(a)(1).

99 *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

the *Crummey* power may create a problem with the installment sale if the grantor makes a subsequent transfer to the trust and, as is usual, the withdrawal power is not exercised. Although the lapse of the power does not create a transfer tax issue to the extent that it is a "five or five" power,[100] there is no similar rule for income tax purposes.[101] Accordingly, a beneficiary who allows a *Crummey* power to lapse may become a proportionate grantor of the trust. Although it is not certain that treating the beneficiaries as grantors automatically makes a proportionate part of the installment sale taxable,[102] the risk is sufficient to make automatic reliance on a *Crummey* power for an intentional grantor trust unwise.

Omitting the *Crummey* power should not be a significant disadvantage, Typically, the settlors of grantor trusts have already made annual exclusion gifts in other contexts, such as gifts to life insurance trusts, outright cash gifts, gifts of discounted limited partnership interests or discounted nonvoting stock in an S corporation. If additional gifts to the same trust are essential, the risk of accelerating installment gain must be carefully weighed against the transfer tax savings of a *Crummey* arrangement at that time. We have difficulty seeing any reason for undertaking the uncertainty resulting from including a *Crummey* power in a grantor trust document, especially one establishing an irrevocable intentional grantor trust to be used as an installment purchaser.

D. Valuation Adjustment Clauses

When the asset sold to the grantor trust is a limited partnership interest or nonvoting stock in an S corporation that has been discounted for transfer tax purposes, there is the obvious risk that the IRS may successfully challenge the amount of the discount. To the extent that this occurs,

[100] §§ 2041(b)(2) and 2514(e) provide that a lapse of a power to withdraw the greater of $5,000 or 5% of the value of the trust is not treated as the lapse of a general power of appointment.

[101] See Moore, Tax Consequences and Uses of "Crummey" Withdrawal Powers: An Update, 22nd U. Miami Philip E. Heckerling Inst. on Est. Plan. Ch. 11, ¶ 1104 (1988); Casner & Pennell, 2 Estate Planning § 5.11 (6th ed. 1997); Slade, Life After Execution of an Insurance Trust, 40 Tax Mgmt. Mem. 375, 388-89 (1999); Adams & Abendroth, Beware the Tax Consequences of Powers of Withdrawal, 127 Tr. & Est. 37 (1988).

[102] Although some commentary expresses concern on this issue, no regulation or published ruling supports it and a series of private letter rulings indicates that the settlor-grantor continues as the owner of the entire trust even after the lapse of *Crummey* powers. See Priv. Ltr. Rul. 93-09-023, Dec. 3, 1992; Priv. Ltr. Rul. 91-41-027, Jul. 1, 1991; Priv. Ltr. Ruls. 2000-22-054, 2000-11-055 and 2000-11-058, all Dec. 15, 1999; Gopman, The Income Tax Consequences of an Irrevocable Life Insurance Trust, 22 Tax Mgmt. Est. Gifts & Tr. J. 211 (1997) (holders of *Crummey* powers should not be treated as owners under § 678 when grantor is owner under §§ 671-77); Slade, *supra* note 102; but see Priv. Ltr. Rul. 93-21-050, Feb. 25, 1993, indicating a contrary position.

without more, the original promissory note does not cover the "corrected" value, leaving a bargain element in the sale that may be treated as a taxable gift. To avoid this, some estate planners include provisions either to increase the amount of the promissory note to cover the additional value of the limited partnership interest or nonvoting S corporation stock, or to reduce the interest in the partnership or S corporation sold to equal the amount under the promissory note. We believe that such clauses are of doubtful efficacy,[103] and that, even if they work, they are probably not worth the red flag that they create. At worst, a portion of the freeze has been converted into one by outright gift, a valid freeze technique.[104] The problem is, admittedly, more severe when the additional taxable gift could expose the grantor trust to the GST tax. The estate planner must weigh the merits of retaining GST exemption to deal with the risk against the benefits of early use of the maximum GST exemption. If there are no GST concerns, the valuation increase is beneficial in supporting the reality of the sale and reducing the risk that the promissory note is a retained life estate under § 2036. In short, an outright gift is an efficient freeze technique because it eliminates the so-called leaky freeze of a grantor trust sale.[105]

E. Reporting of Interest on Installment Note After Termination of Grantor Trust Status

When grantor trust status terminates, the value of the promissory note and the right to any accrued but unpaid interest are assets included in Senior's gross estate. Since neither the note nor the right to the accrued interest is IRD, the estate's basis in both assets equals their value.

Similarly, as discussed above,[106] the grantor's rights under the promissory note, including rights to accrued but unpaid interest, acquire status for income tax purposes at death. The question is how interest accrued while the trust was a grantor trust, but paid after, is to be reported for income tax purposes. As a general rule, the reporting of interest income and interest expense is governed by the taxpayer's method of accounting.[107] During the grantor trust period, the note did not exist for Federal

[103] *Commissioner v. Procter*, 152 F.2d 824 (4th Cir. 1944) (provision purporting to revoke transfer if found to be taxable gift void as being against public policy; transfer was a taxable gift); see also *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1996); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Est. of McLendon v. Commissioner*, 66 T.C.M. (CCH) 946 (1993).

[104] See M&H, Grantor Trusts at 6.

[105] *Id.*

[106] See ¶ 1601.2 *Situation Two—Installment Sale to a Grantor Trust.*

[107] Reg. § 1.1272-1(a)(1).

income tax purposes. Therefore, only interest accrued after the termination of grantor trust status is properly reportable as income by the estate and a deduction by the trust. The interest that accrued while the trust was a grantor trust is not IRD because there was no income-tax-recognized obligation on which interest could accrue.[108] The collection of the obligation is simply realization on a claim by the estate; the payment by the family trust is simply settlement of a claim that existed when the trust's income tax existence began.

F. Computation and Summary

The results of the transaction in Situation Two if Senior dies at the end of 15 years may be summarized as follows:

Senior's assets at death[109]	$1,722,198[110]	
Less: Estate Tax	947,209	
Net		$ 774,989
Trust's Assets[111]		1,121,569
Total Assets to Children[112]		$1,896,558

The improved results are attributable primarily to avoiding tax on the unrealized gain on the property transferred to the grantor trust and to the greater amount accumulated in the family trust without transfer tax consequences because the grantor is required to pay tax on the trust's income. If the installment note is paid before Senior's death, the $1,000,000 unrealized appreciation in the asset sold is potentially subject to capital gain tax. This additional $200,000 of capital gain tax reduces the total assets to the children (or grandchildren) by that amount.[113] The installment sale to the grantor trust still produces better results than the sale to the nongrantor trust.

108 See *Deputy v. Dupont*, 308 U.S. 488 (1940) (interest is payment for use of borrowed funds); *Albertson's Inc. v. Commissioner*, 42 F.3d 537 (9th Cir. 1995) ("interest" on deferred compensation not deductible until compensation is paid; exact basis of opinion is obscure).

109 Includes the $1,000,000 note valued at its principal amount plus accumulated after-tax interest on the note as further reduced for income tax incurred by Senior on the family trust's income that was retained by the trust. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

110 There is no capital gain tax on the unrealized installment gain because death is not a realization event.

111 Includes accumulated income net of interest payments, without income tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

112 A generation skipping transfer increases the taxes by $426,244 and reduces the total assets passing to the grandchildren to $1,470,314.

113 If $1,000,000 of appreciated assets are used by the family trust to prepay the promissory note while Senior is alive, the gain is eliminated by the step-up in basis at Senior's death.

¶ 1601.3 Situation Three—Self-Canceling Installment Note Sale to a Nongrantor Trust

Example: The facts are the same as in Situation One except that the installment note is a SCIN cancelled on Senior's death. Because of the possibility that all or part of the principal of the SCIN will be cancelled on Senior's death, the total specified payments under a SCIN must be greater than those for a fixed payment installment sale if the promissory note is to have a value equal to the value of the property transferred.[114] As discussed below, the premium can make a SCIN a negative freeze if Senior lives to collect the entire sale price.

The SCIN term cannot be set to expire too far beyond the grantor's life expectancy because of both practical and reality-of-sale considerations. As a practical matter, the greater the SCIN term, the greater the risk premium and corresponding increase in interim interest payments. Moreover, under reality-of-sale principles, if the principal payment is postponed to a date that makes payment of principal during the grantor's life highly unlikely, the transaction is likely to be recast as an annuity of the interest only for Senior's life.[115] Possibly because of the practical considerations, there has been little discussion of the maximum SCIN term.[116] One possible analogy is Reg. § 1.1275-1(j)(6)(iii) that treats an annuity with a time limit greater than twice the annuitant's life expectancy as not being subject to a significant limitation,[117] which suggests the contrary—that a SCIN for a term greater than twice the decedent's life will not be treated as a bona fide sale for a stated principal amount. We do not believe, however, that the negative pregnant—that a sale for any shorter period will be treated as bona fide—is sound. Whatever actuarial table is used to measure the decedent's life expectancy already has a built-in assumption that approximately 50% of the class of persons measured—the general population in Table 90CM and annuitants in Reg. § 1.72-9 Table V—will die before the specified term. Accordingly, any term more than a small period beyond that date is subject to substantial risk. Since we believe that Reg. § 1.72-9 Table V more closely reflects the individuals who are likely to engage in the types of transactions considered in this article,[118] we have used the 16.0 year life expectancy specified for a 70-year old in our illustrations, and have

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[114] See ¶ 1601.3.B *Valuation of a SCIN.*

[115] Cf. Rev. Rul. 77-454, *infra* note 231 (treats private annuity from exhaustible fund as annuity for lesser of life or estimated date of exhaustion of fund) discussed in ¶ 1601.6.B *Minimum Funding of Private Annuity Trust.*

[116] See Hartz & Banoff, Planning Opportunities Available Using a Private Annuity for a Terms of Years, 65 J. Tax'n 302, 308 (1986).

[117] See ¶ 1601.3.A *Impact of Reg. § 1.1275-1(j).*

[118] See discussion in note 8, *supra.*

set the SCIN term at 15 years even though the life expectancy under Table 90CM is only 13.9 years. We believe any period longer than the Reg. § 1.72-9 Table V life is risky, and should be used only for clients who take an aggressive approach to estate planning even recognizing that, because of the risk premium, a SCIN is only a good deal if the grantor-seller dies before payment of the principal on the promissory note

When Senior dies, any unpaid balance on the SCIN is not included in Senior's gross estate because of the self-canceling feature.[119] Nevertheless, the trust has a cost basis in the assets measured by the initial principal amount of the SCIN.[120] This is because notwithstanding the cancellation of the note at death, it is deemed to be satisfied at its principal amount because the obligee is a related party,[121] so that the previously realized but deferred gain is recognized. Although the *Frane* case held that the gain is reported as IRD on the estate's income tax return, we continue to believe that the better rule is that the accelerated gain is reported on the decedent's final income tax return.[122]

A. Impact of Reg. § 1.1275-1(j)

Prior to the effective date of Reg. § 1.1275-1(j),[123] it was generally conceded that a SCIN for a fixed term greater than the seller's life expectancy, as determined by Reg. § 1.72-9, Table V, was characterized as an annuity so that its income tax consequences were determined under the § 72 annuity rules rather than the § 453 installment sale rules.[124] With the issuance of Reg. § 1.1275-1(j), it is likely that few PATYs, even ones with a maximum terms significantly greater than the seller's life expectancy, can be "annuities."[125]

The OID rules generally require current accrual of interest on "debt instruments" as defined in § 1275(a)(1) and Reg. § 1.1275-1(d). Annuities are exempted from the application of the OID rules,[126] which has the effect

[119] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result only* 1981-1 C.B. 2; *Cain v. Commissioner*, 37 T.C. 185 (1961), *acq.* 1961-2 C.B. 4.

[120] See discussion *infra* at ¶ 1601.3.F *Basis to Purchaser.*

[121] § 453B(g); see *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992); Rev. Rul. 86-72, 1986-1 C.B. 253.

[122] H&M, SCINs and Private Annuities at ¶ 306.1.C.; M&H, Grantor Trusts at 26.

[123] Reg. § 1.1275-1(j)(8)(i) provides an effective date of February 9, 1998.

[124] G.C.M. 39503 (Issue (1)), Jun. 28, 1985.

[125] There appears to be an exeeption for annuities with a maximum payout period that is more than twice the annuitant's life expectancy, determined, not by Reg. § 1.72-9 Table V, but by the tables prescribed in § 417(e)(3)(A)(ii)(I) relating to determining present value for purposes of restrictions on cash-out of joint and survivor annuities under qualified pension plans.

[126] § 1275(a)(1)(B)(i) exempts an annuity contract to which section 72 applies if the contract depends (in whole or in part) on the life expectancy of 1 or more individuals.

of allowing the "inside buildup" of annuity contracts to escape taxation until amounts are paid out on the annuity.[127] To limit financial arrangements that take advantage of this tax shelter in a manner the IRS considers improper, Reg. § 1.1275-1(j) limits the annuity exception to contracts containing terms ensuring that the life contingency under the contract is both "real and significant."[128] Reg. § 1.1275-1(j) takes the position that the contract is "real and significant" only if, on the day the contract is purchased, there is a *high* probability that total distributions under the contract will increase commensurately with the longevity of the individual over whose life the distributions are to be made.[129] The regulation identifies terms and provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, including a maximum payout provision.[130] This applies to most PATYs and SCINs because the regulation defines a maximum payout provision as a contractual provision that provides that no distributions under the contract may be made after some date even if the terminating death has not occurred.[131] Although the Regulation provides a situation whereby the existence of a maximum payout provision can co-exist with an annuity,[132] it is highly unlikely that a SCIN or PATY would qualify. Although apparently not intended to deal with private annuities, the Regulations eliminating the G.C.M. 39503 distinction based on the relation between the maximum term and the seller-annuitant's life expectancy is sound tax policy.[133] Indeed, although not appropriate for an OID regulation, we believe it would probably be sound policy to treat all private annuities, even those with no maximum term, as contingent payment installment sales subject to the OID rules.[134]

B. Valuation of a SCIN

As discussed above, a risk premium must be added because of the possibility that the note will never be paid. The premium may be reflected in either a higher interest rate or a greater principal amount, or some combination.[135] Since the process of determining the value of the note

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127 See H&M, SCINs and Private Annuities at ¶¶ 308.1 and 302.1.

128 Reg. § 1.1275-1(j)(1).

129 Reg. § 1.1275-1(j)(2)(i)(B).

130 Reg. § 1.1275-1(j)(6)(i).

131 Reg. § 1.1275-1(j)(6)(ii).

132 Reg. § 1.1275-1(j)(6)(iii).

133 See H&M, SCINs and Private Annuities at ¶¶ 306.1.F; 306.3; and 311.3.

134 See *Id.* at ¶¶ 306.3 and 311; Manning and Hesch, Private Annuities After the Installment Sales Revision Act of 1980, 6 Rev. Tax'n Indiv. 20, 32 (1982).

135 See *Id.* ¶ 310.3.B.

is one of discounting, the issues become (i) which of the rates prescribed by the Code for discounting—the AFR prescribed in §§ 1274 and 7872 or the § 7520 rate prescribed for valuing certain term interests—applies and (ii) whether the income tax mortality table prescribed under Reg. § 1.72-9 Table V or the one prescribed in the Aleph Volume for transfer tax purposes applies. We believe that it is clear that the AFR, not the § 7520 rate, applies and that, with somewhat less certainty, the longer lives under Reg. § 1.72-9 Table V should apply.

1. Discount Rate

§ 7520 prescribes rates (120% of the midterm AFR) to be used for valuing annuities, life estates, remainders and term interests. Since, as discussed below,[136] a SCIN is not an annuity, the question is whether it is a term interest. The same considerations that lead to the conclusion that an installment note is not a retained life estate[137] also lead to the conclusion that it is not a term interest.[138] This is consistent with (i) the analysis in Reg. § 1.1275-1(j) that a SCIN is treated as a debt obligation subject to the OID rules, including the provisions of § 1274, and (ii) the similar conclusion in G.C.M. 39503 for a SCIN with a maximum term less than the seller's life expectancy is treated under the installment sale rules of § 453.[139] Similarly, according to the Tax Court in *Frazee v. Commissioner*,[140] the interest rate to use in determining the value of the note for both income tax purposes and for gift tax purposes is determined by using § 7872. Furthermore, the proposed regulations under § 7872 and related provisions properly recognize that the appropriate-term § 7872 rate controls.[141]

2. Mortality Tables

There is no clear authority whether the life expectancies in Table 90CM[142] or the longer life expectancies in Reg. § 1.72-9 Table V should be used to value a SCIN.[143] Nevertheless, we believe that the correct

136 See ¶ 1601.3.D *Application of Estate Freeze Rules To SCINs, infra.*

137 See text at notes 54 to 56 *supra*; M&H, Grantor Trusts at 16-17.

138 See text at note 155 *infra*; H&M, SCINs and Private Annuities at ¶ 302.3.

139 Rev. Rul. 86-72, 1986-1 C.B. 253; G.C.M. 39503, Jun. 28, 1985. See Reg. § 1.1275-1(j) for a PATY.

140 98 T.C. 554 (1992).

141 Prop. Reg. §§ 1.7872-1(a), -2(a), 1.1012-2(b) and 25.2512-8.

142 See Reg. § 20.2031-7T(d)(7); Aleph Volume (Pub. 1457).

143 Under Table 90CM, the life expectancy of a 70-year old is 13.9 years. Under Reg. § 1.72-9 Table V, it is 16.0 years. The reason the annuity tables have longer life expectancies is that they are based on a sample pool of individuals who purchase annuities, which is by self-selection, a healthier group than the general population.

approach is to use the income tax annuity tables.[144] In part our conclusion is based on the same reasoning as that supporting the use of the AFR, that a SCIN is not a term interest under § 7520. Although the § 7520 regulations prescribe use of Table 90CM,[145] there is no corresponding provision in the contingent-payment installment-sale regulations.[146] In a broader sense, however, there is no requirement for any prescribed rate. The underlying assumption for exclusion of installment sales to family trusts, including SCINs from giving rise to taxable gifts is that they are excluded as bona fide business transactions.[147] Accordingly, the question is whether the transaction in a family transaction is on arm's length terms. Unrelated parties, of course, are free to use any reasonable basis for actuarial adjustments. Related parties should have the same freedom provided they can show that they have acted within the range of arm's length bargaining.[148] On the other hand, it is doubtful that there are many SCIN transactions entered into by unrelated parties.[149]

However computed, providing for the risk premium by increasing principal rather than interest provides two advantages, the premium is eligible for capital gains rates and may be deferred until payment of principal (or even eliminated if the seller dies before the end of the SCIN term). The deferral and chance of elimination can be maximized by providing payment of interest only during the SCIN term with a balloon payment of principal at the end. The interest will, however, be increased to reflect the increased principal. On the other hand, such a deferral will increase the absolute amount of the principal payment.

3. Comparison and Summary

The effect of the combinations of choice of discount rate and actuarial assumptions can be exemplified by the following table based on a SCIN

[144] See Shore and McClung, Beyond the Basic Super Freeze—An Update and Additional Planning Opportunities, 75 Taxes 41, 50 (1997), mentioning that there is no authority requiring uses of the transfer tax tables and suggests use of Reg. § 1.72-9 Table V.

[145] Reg. § 25.7520-1T(b)(2).

[146] See Reg. § 15A.453-1(c) relating to contingent payment sales. The absence of a regulation may be due to the fact that the installment sale regulations do not even refer to actuarial issues.

[147] Reg. § 25.2512-8; see H&M, SCINs and Private Annuities, at ¶¶ 302.3 and 308.3; Mulligan, *supra* note 46, at 1505.1.

[148] *Cf.* § 2703(b); Reg. § 25.2703-1(b)(1) to (4) (excluding buy-sell agreements on terms "comparable to similar arrangement entered into in arms' length transactions").

[149] See Zerah, Private Annuities and Self-Cancelling Installment Notes, The CPA Journal Online (www.luca.com) (Dec. 1993); Strizever, Self-canceling notes increase planning risks of a sale over private annuities, 12 Tax'n for Law. 298 (1984).

for $1,000,000 of property sold by Senior and payable at the end of 15 years:[150]

Mortality and Interest Factors	*Risk Premium* *Interest Rate Increase*	*Principal Increase*
AFR (6.47%) and Reg. § 1.72-9 Table V (16.0 years)	3.36% $33,612	$347,962 22,513
AFR (6.47%) and Table 90CM (13.9 years)	4.75% $47,462	$508,880 32,925
§ 7520 rate (7.4%) and Reg. § 1.72-9 Table V (16.0 years)	3.31% $33,172	$319,794 23,664
§ 7520 rate (7.4%) and Table 90CM (13.9 years)	4.70% $46,959	$466,703 34,536

The second line of the Interest Rate Increase column represents the additional dollar amount of interest on the $1,000,000 purchase price incurred by adding the interest rate increase. The second line in the Principal Increase column represents the additional interest at the AFR or § 7520 rate, as the case may be, applied to the increased principal specified in the first line. In either case, the increased interest reduces the cash flow of the family trust and increases the cash flow of Senior, but subject to the effect of any interest deduction for the trust and tax on the interest for Senior.

As the chart indicates, the choice of actuarial table has a much greater effect on the risk premium than the choice of interest rate. Indeed, when the premium is assigned to principal, it can increase the purchase price by between 32 and 51% on the assumed facts. If Senior lives to collect the principal, this can significantly reduce the benefit of the freeze.

C. Disregarding Actuarial Assumptions for a SCIN

Reg. § 20.7520-3(b)(3) provides that the mortality component described under § 7520 may not be used to determine the present value of an

[150] Although we assume that interest only is payable before the end of the maximum term, there probably should be at least one payment that is not cancelled by death due in the year after the sale to assure compliance with the definition of an installment sale as one where "at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." § 453(a). A literal reading of this provision could disqualify a SCIN since there may be no payment to be received after the year of disposition if Senior dies in that year.

annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is "terminally ill" at the time of death. Technically, the position taken in this regulation does not apply to a SCIN because a promissory note is not an annuity or future interest as described in that regulation.[151] However, the better view is that the statement in the regulation is generally illustrative of situations in which the impending death of the individual should be taken into account and that standard actuarial tables do not apply. Indeed, since SCIN transactions of the type being discussed depend for their effectiveness on being treated as bona fide business transactions, applying the actuarial tables for a terminally ill individual would hardly satisfy the standard.

The regulation provides an 18-month safe harbor—if the individual survives more than 18 months, that individual shall be presumed to not have been "terminally ill" unless the contrary is established by clear and convincing evidence. The regulation is an estate tax regulation, which means that the IRS can apply it with the benefit of hindsight. Unfortunately, that type of perfect 20-20 vision is not available when the terms of a SCIN are established. It can only provide limited, after the fact, protection if the grantor-seller survives the 18 months.

D. Application of Estate Freezes to SCINs

Even though it has a contingent payment, a SCIN should not be disregarded in determining whether a SCIN sale to a family trust involves a gift. First, the special valuation rules of § 2701 only apply in determining "the amount of the gift,"[152] and a properly crafted SCIN is a sale for transfer tax purposes not a gift.[153] In addition, since a SCIN is a debt obligation, it cannot be an applicable retained interest subject to the special valuation rules.[154] For similar reasons, it is not a lapsing right subject to § 2704 even though it may terminate on death. Section 2704 applies only to voting rights and limitations on liquidation, neither of which describes a SCIN. Although § 2704(a)(4) gives the Secretary the power to treat "other restrictions" as interests to be disregarded, there are no such regulations. Furthermore,

[151] See ¶ 1601.3.B.1 *Discount Rate, supra.*

[152] Reg. § 25.2701-1(b)(1); see Mulligan, *supra* note 46 at ¶ 1511; Nicholson, *supra* note 56 at 100; Lewis and Laning, Estate Freezes and Grantor Trust for Business Owners, 1 Bus. Ent. 10 (1994).

[153] Reg. § 25.2512-8; Prop. Reg. § 25.2512-8 (Mar. 27, 1986).

[154] § 2701(a)(1) applies only to a transfer of an "interest" in a corporation or partnership when there is an applicable retained "interest." Reg. § 25.2701-2(b)(1) defines an applicable retained interest as an "equity" interest is a corporation or partnership. See e.g. Priv. Ltr. Rul. 94-36-006, Mar. 14, 1994 (debt is not an interest subject to § 2701); Priv. Ltr. Rul. 95-35-026, May 31, 1995 (same).

as the IRS has recognized,[155] § 2702 should not apply because the SCIN, event though subject to contingencies, is a debt obligation of, not a beneficial interest in, the family trust.[156] The note holder's rights are governed by the contract, not the terms of the trust.

E. Inclusion in Gross Income

Despite the breadth of § 61's provision that all benefits received are gross income and must be reported unless an exclusion applies, the cancellation of the SCIN at death should not result in gross income to the family trust. As discussed above,[157] transfer of even property subject to a liability at death does not give rise to gross income for the decedent. Similarly, as recognized by § 102(a), for receipt of property as a result of death. This is not inappropriate since any unrealized gain is either reported at death under § 453B(f) if the SCIN was still outstanding, or represented by a transferred basis if it was not.

F. Basis to the Purchaser

Under general income tax principles, a contingent liability is not taken into account by the purchaser in determining basis or by the seller in determining amount realized.[158] Without more, a SCIN is a contingent liability because of the possibility it may never have to be paid. When the SCIN sale is to a related party so that under § 453B(f) the termination of the obligation at death is treated as payment at its face amount, a SCIN should not be treated as a contingent liability. Accordingly, the family trust-purchaser should be entitled to include the SCIN principal in basis and the grantor-seller in determining amount realized and the selling price for installment sale purposes.[159]

The 1980 Act added § 453B(f) to overturn the result in *Miller v. Usry*,[160] which refused to apply the pre-1980 version of the disposition rule except to actual sales of the note for cash, and to make it clear that a disposition by gift should also be subject to the § 453B(a) disposition rule.[161] The

155 See Priv. Ltr. Rul. 94-36-006, Mar. 14, 1994 (valuation rules of § 2702 do not apply to debt because it is not a term interest); Priv. Ltr. Rul. 95-35-026, May 31, 1995 (same).

156 See Mulligan, *supra* note 46, at ¶ 1507.2.

157 See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

158 *Albany Car Wheel Company v. Commissioner*, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); Reg. §§ 1.338-4T(b)(2)(ii), -4T(d)(2), -5T(b)(2)(ii) and -5T(e)(1).

159 See G.C.M. 39503 (Issue (2)(C)(2)(b), last sentence), Jun. 28, 1985, H&M, SCINs and Private Annuities at ¶ 310.3.B.2.

160 160 F. Supp. 368 (W.D. La. 1958).

161 A disposition by gift comes within "any other disposition" and is necessary to prevent an assignment of income already realized by the noteholder.

Committee Report makes it clear that in deeming that a payment is received, it also intended that a payment is deemed to be made by stating that:

> The court [in *Miller v. Usry*] did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale.

Accordingly, the payment that is certain to be either received or deemed received by the seller under a SCIN should also be considered certain to be paid by the purchaser, who should receive an immediate basis in the property purchased with a SCIN. The IRS indicated that it approves of this analysis. "We therefore think it appropriate to allow the buyer-obligor to include the full face value of a note in its basis in the property acquired in the transaction."[162]

The contingent payment OID regulations determine the amount and timing of the interest income to be reported when there is a contingent payment sale.[163] The examples illustrate that the contingent payment OID regulations[164] take the position that a buyer obligated on a contingent payment obligation receives no basis upon incurring the contingent liability and the seller does not initially treat the contingent liability as part of its amount realized. The OID regulations go on to illustrate that the contingent liability gives rise to basis and amount realized only when the obligation becomes fixed or is paid. These regulations do not, however, define the term "contingent payment." The question is whether a SCIN obligation of a related party (as defined for purposes of § 453B(f)) is a contingent payment obligation for purposes of these regulations and, if so, whether they change the result in G.C.M. 39503. We do not believe it should be. Under a SCIN, even one with a balloon payment, interest will be paid on fixed basis until death or another terminating event occurs. As indicated, under a SCIN to a related party of the type we are discussing, the principal will be paid or deemed paid on or before a fixed date. Accordingly, such a SCIN should not be considered a contingent liability and the IRS position in G.C.M. 39503 remains supportable.

The legislative history to the Installment Sales Revision Act of 1980 also provides support for the position that the purchaser can include the principal amount of the SCIN obligation as part of its initial basis in the purchased property. It explicitly states that the deferred gain recognized at such time is the "quid pro quo" for the buyer's cost basis.[165] Accordingly, the IRS would be justified in denying a cost basis for the obligation to the

[162] G.C.M. 39503 (Issue (2)(C)(1)(b), last sentence), June 28, 1985.

[163] Reg. § 1.1275-4.

[164] Reg. §§ 1.483-5 and 1.1275-4(c).

[165] See S. Rept. No. 96-1000, 96th Cong., 2d Sess. 25 (1980).

buyer only if it were to concede that gain is not recognized upon the extinguishment of the note. Those commentators who have addressed the issue of the buyer's basis for the SCIN obligation come to the conclusion that the face amount of the note, even if the note is self-canceling, should be included in the basis.[166] Furthermore, the Eighth Circuit in *Frane v. Commissioner*[167] mentioned in footnote 5 that it was of the opinion that the buyer is entitled to an initial cost basis for the SCIN obligation. Although this statement was only *dicta* in the *Frane* case, the court in *Frane* went on to conclude that since the G.C.M. 39503 clearly shows that the plain language of § 453B requires that the obligee recognize the gain, it follows that consistent treatment can be afforded to the obligor and no injustice results.

Nor should § 108(e)(5) require an adjustment in the purchaser's basis. Section 108(e)(5) is intended to apply to situations where the noteholder is able to deduct the cancelled obligation as a bad debt. Applying this tax symmetry analysis to the SCIN sale illustrates that § 108(e)(5) does not apply. The cancellation of the SCIN is not treated as a cancellation because, as discussed above, § 453B(a), in conjunction with § 453B(f), treats the cancellation as a deemed payment. Applying the tax symmetry principle, the noteholder cannot take a bad debt deduction because § 453B(a) deems that the noteholder received a payment equal to the amount of the liability cancelled. Therefore, the fictions created by the § 453B disposition rule remove the cancellation of the liability from the reach of § 108(e)(5).

G. Computation and Summary

The results of the transaction in Situation Three, computed using the AFR and the longer lives in Reg. § 1.72-9 Table V, may be summarized as follows:

Senior Does Not Survive SCIN Term[168]

Senior's assets at death[169]	$936,637
Less: Estate Tax	515,150

[166] Massey & Englebrecht, Self Cancelling Installment Notes and Private Annuities: An Analysis, 72 Taxes 27, 28 (1994); Banoff and Hartz, Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?, 59 Taxes 499, 506 (1991). See *Frane v. Commissioner*, *supra* note 121 at footnote 5 stating that most commentators agree.

[167] 998 F.2d 567 (8th Cir. 1993).

[168] Assumes death after the 14th interest payment and before the final payment of principal and interest is due.

[169] Includes accumulated after-tax interest on the note and income on reinvestment of the accumulated interest, net of the $269,542 capital gain tax imposed on the $1,347,961 gain on termination of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

Net		$ 421,487
Family Trust's Assets[170]		1,247,707
Total Assets to Children[171]		$1,669,194

Senior Survives SCIN Term

Senior's assets at death[172]	$2,424,316	
Less: Estate Tax	1,333,374	
Net		$1,090,942
Family Trust's Assets[173]		-62,696
Total Assets to Children[174]		$1,028,246

The difference in result, depending on whether Senior survives or does not survive the SCIN term is dramatic. It is attributable to the transfer of the $1,347,961 SCIN price (as increased by the risk premium) from the family trust (where it is not subject to estate tax) to Senior, where it increases his gross estate. The increase is partially offset by the payment of capital gain tax on the payment, which is, in turn, partly offset by the corresponding reduction in estate tax. The total assets to the children may be increased by the higher basis in the assets purchased reflecting the $347,961 in risk premium on the purchase. This can save $69,592 in capital gains taxes.

Even the result in the case in which Senior does not survive, so that the purchase price is not paid by the family trust and the capital gain tax is paid by Senior, is only marginally more favorable than for a fixed payment installment sale to a nongrantor trust in Situation One. This is because of the increased interest that must be paid on a SCIN.[175] The result in the case in which Senior does survive is worse than the result if Senior simply retains the assets. Thus, a SCIN sale to a nongrantor trust should be undertaken only when it is not likely that Senior will live out the SCIN term,

170 Includes accumulated income net of interest payments.

171 A generation skipping transfer increases the taxes by $231,818 and reduces the total assets passing to the grandchildren to $1,437,376.

172 Includes the $1,347,961 payment of the SCIN principal (including risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest, net of the $269,542 capital gain tax imposed on the gain on collection of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

173 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

174 A generation skipping transfer increases the taxes by $600,018 and reduces the total assets passing to the grandchildren to $428,228.

175 $87,213 annually instead of $64,700 annually. See ¶ 1601.3.B *Valuation of a SCIN.*

but his health is not sufficiently bad to make use of the actuarial tables unreasonable.[176]

The negative value of the family trust in the case in which Senior survives highlights the minimum funding issue. It shows that even when the trust's earnings are at a rate greater than the interest rate on a SCIN, a trust funded only with the assets sold would not be sufficient to pay the price if Senior survives. This is primarily because of the risk premium designed to compensate for the possibility that Senior will not survive.

¶ 1601.4 Situation Four—Self-Canceling Installment Note Sale to a Grantor Trust

Example: The promissory note is a SCIN issued by a grantor trust in the amount of $1,347,962 (with the risk premium as balloon principal) with interest at the AFR of 6.47% on the total principal.

This is a combination of Situations Two and Three. Accordingly, even though the grantor trust means that there is no current income tax effect of the sale transaction, the principal and interest payments on the SCIN must be the same as in Situation Three to satisfy the requirements of a bona fide sale for gift tax purposes. When Senior dies, the SCIN is not included in his gross estate.[177] Because the SCIN sale was not recognized for income tax purposes before death, the cancellation of the SCIN at death does not result in the recognition of gain under § 453B(f) and *Frane,*[178] or otherwise under § 61.[179] Similarly because the family trust is not obligated under the SCIN after death, it cannot have a cost basis in the property. Accordingly, as discussed above,[180] the family trust's basis should be a transferred basis under § 1015.

The results of the transaction in Situation Four, computed using the AFR and the longer lives in Reg. § 1.72-9 Table V, may be summarized as follows:

Senior Does Not Survive SCIN Term[181]

Senior's assets at death[182]	$1,294,658

[176] See ¶ 1601.3.C *Disregarding Actuarial Assumptions for a SCIN.*

[177] *Estate of Moss v. Commissioner, supra* note 119; *Cain v. Commissioner, supra* note 119.

[178] See *Frane v. Commissioner, supra* note 121.

[179] See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

[180] See ¶ 1601.2.A.2 *Termination During Grantor's Life.*

[181] Assumes death after the 14th interest payment and before the final payment of principal and interest is due.

[182] Includes accumulated after-tax interest on the SCIN and income on reinvestment of the accumulated interest. There is no capital gain tax imposed on the deemed gain on the termination of the SCIN because the sale was never recognized for income tax purposes. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

Less: Estate Tax	712,062	
Net		$ 582,596
Family Trust's Assets[183]		1,357,714
Total Assets to Children[184]		$1,940,310

Senior Survives SCIN Term

Senior's assets at death[185]	$2,785,456	
Less: Estate Tax	1,532,001	
Net		$1,253,455
Family Trust's Assets[186]		58,311
Total Assets to Children[187]		$1,311,766

Again, the difference in results depending on Senior's survival is dramatic. There is, however, no capital gain tax in either case. On the other hand, although the results if Senior does not survive the SCIN term are better than for a fixed payment sale to a grantor trust, the increase is not significant if Senior lives most of the SCIN term. Accordingly, the conclusion is the same, the SCIN is worthwhile only when there is a reasonable chance that Senior not only will not survive the SCIN term, but also will not live to collect most of the interest payments. A major additional disadvantage, not quantified in the computation, is that in either case the family trust's basis in the assets is a transferred basis, not a cost basis, because, unlike a fixed price installment sale to a grantor trust, the family trust is not subject to a debt obligation after Senior's death.

¶ 1601.5 Situation Five—Self-Canceling Installment Note (Two Lives) Sale to a Grantor Trust

Example: The SCIN is intended to provide income not only for the seller-grantor, but also, as is not unreasonable or uncommon, for his surviving

183 Includes accumulated income net of interest payments.

184 A generation skipping transfer increases the taxes by $320,428 and reduces the total assets passing to the grandchildren to $1,619,882.

185 Includes the $1,347,962 payment of the SCIN (including the risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest. Despite the payment, there is no capital gain tax imposed on collection of the SCIN, because the transaction was never recognized for income tax purposes. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

186 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

187 A generation skipping transfer increases the taxes by $689,400 and reduces the total assets passing to the grandchildren to $622,366.

spouse, so that it does not terminate until the death of the last to die of Senior and Mrs. Senior. Because the joint lives reduce the actuarial risk, the required risk premium is less than needed only for Senior's life as discussed in Situation Four. If Mrs. Senior dies first, however, the results are the same as a SCIN based solely on Senior's life, but more favorable because of the reduced risk premium.

If Senior dies before Mrs. Senior, the note continues in existence, and presumably, will pass to Mrs. Senior. The value of the note is included in Senior's gross estate. Presumably, the transfer qualifies for the marital deduction so that no estate tax is incurred. The note is not a terminable interest because no interest in the note passes to another when Mrs. Senior dies. There is no IRD because no gain was realized while Senior was alive.[188] Senior's death terminates grantor trust status with the consequences discussed above.[189] The now nongrantor family trust has a cost basis in the transferred assets based on the balance of the promissory note, or if greater, Senior's transferred basis. When Mrs. Senior dies, the SCIN is cancelled with the tax consequences described above for a SCIN sale to a nongrantor trust.[190] Because the note is deemed to be satisfied by the deemed payment, the deferred installment gain is recognized, but only to the extent, if any, that the principal amount exceeds Mrs. Senior's basis in the note, that is, the fair market value, presumably its $1,176,470 principal (including the risk premium) included in Senior's estate (resulting in no gain if the note was not discounted).[191] Although at first blush this appears to give an improper cost basis to the family trust without the corresponding IRD that would occur on a initial sale to a nongrantor trust, it is essentially the result that we believe occurs for Senior's sale to a grantor trust.[192]

The results of the transaction in Situation Five, computed using the joint lives of Senior and Mrs. Senior to compute the risk premium, may be summarized as follows:

Senior Does Not Survive SCIN Term; Mrs. Senior Does Not Collect SCIN Principal.[193]

[188] See ¶ 1601.2.A.1 *Termination on Grantor's Death, supra.*

[189] See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

[190] See ¶ 1601.3 *Situation Three—Self-Canceling Installment Note Sale to a Nongrantor Trust.*

[191] *Id.*

[192] See ¶ 1601.2.A.1 *Termination on Grantor's Death.*

[193] Assumes Senior dies after receiving the 14th interest payment, but before the final payment of principal and interest is due.

Mrs. Senior's Assets at Death[194]	$984,262	
Less: Estate Tax	541,324	
Net		$442,918
Family Trust's Assets[195]		1,668,109
Total Assets to Children[196]		$2,111,027

Senior Does Not Survive SCIN Term; Mrs. Senior Collects SCIN Principal.[197]

Mrs. Senior's Assets[198]	$2,277,731	
Less: Estate Tax	1,252,752	
Net[199]		$1,024,979
Family Trust's Assets[200]		564,194
Total Assets to Children[201]		$1,589,173

[194] Includes accumulated after-tax interest on the SCIN paid to Senior and income on reinvestment of the accumulated interest by Senior as reduced for income tax incurred by Senior on the family trust's income that was retained by the trust, on the assumption that the SCIN and the accumulated income pass to Mrs. Senior as a marital deduction bequest. Because the SCIN terminates on Mrs. Senior's death, it is not included in her assets at death. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

[195] Includes accumulated income net of interest payments plus property sold to it for the SCIN. The property has a cost basis of $1,176,470, reflecting the conversion of the trust to a nongrantor trust when Senior died. The consequent conversion of the SCIN note into one taken into account for income tax purposes means that the family trust has a basis in the property sold to it equal to the tax balance of the SCIN.

[196] A generation skipping transfer increases the taxes by $243,605 and reduces the total assets passing to the grandchildren to $1,867,422.

[197] Assumes Senior dies after the 14th interest payment, but before the final payment of principal and interest is due.

[198] Includes the assets passing from Senior, as above, plus Mrs. Senior's accumulated after-tax interest on the SCIN for one year and the principal on the SCIN. Even though the termination of the SCIN at Mrs. Senior's death is a taxable settlement, there is no capital gain tax because of the step-up in the basis of the SCIN on Senior's death. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

[199] A generation skipping transfer increases the taxes by $302,558 and reduces Mrs. Senior's net after-tax estate to $247,547.

[200] Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior for the period prior to his death, see M&H, Grantor Trusts at 13, plus accumulated after-tax income for the year after Senior's death reduced for the payments to Mrs. Senior.

[201] A generation skipping transfer increases the taxes by $563,738 and reduces the total assets passing to the grandchildren to $1,025,435.

Senior Survives Mrs. Senior; But Does Not Collect SCIN Principal.[202]

Senior's assets at death[203]	$984,262	
Less: Estate Tax	541,344	
Net[204]		$ 442,911
Family Trust's Assets[205]		1,668,109
Total Assets to Children[206]		$2,111,027

Senior Survives Mrs. Senior and Collects SCIN Principal.

Senior's assets at death[207]	$2,261,434	
Less: Estate Tax	1,243,789	
Net		$1,017,645
Family Trust's Assets[208]		582,333
Total Assets to Children[209]		$1,599,978

The significant differences between the results if Senior or Mrs. Senior does or does not survive persist. The overall results are, however, better than for a SCIN for Senior's life only. Although the nominal results are comparable whether Senior or Mrs. Senior is the surviving spouse, the basis

202 Assumes Senior dies after the 14th interest payment and before the final payment of principal and interest is due.

203 Includes accumulated after-tax interest on the SCIN and income on reinvestment of the accumulated interest, as further reduced for income tax incurred by Senior on the family trust's income that was retained by the trust. There is no capital gain tax on the termination of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

204 A generation skipping transfer increases the taxes by $243,605 and reduces the total to $1,867,422.

205 Includes accumulated income net of interest payments without tax on realized income because that tax is imposed on Senior for the period prior to his death. See M&H, Grantor Trusts at 13. Because the family trust remains a grantor trust until Senior's death, it has a transferred zero basis in the property originally sold to it.

206 A generation skipping transfer increases the taxes by $243,605 and reduces the total assets passing to the grandchildren to $1,867,422.

207 Includes the $1,176,470 payment of the SCIN (including the risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest, as further reduced for income tax incurred by Senior on the family trust's income that was retained by the trust. There is no capital gain tax on the termination of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

208 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

209 A generation skipping transfer increases the taxes by $559,705 and reduces the total assets passing to the grandchildren to $1,040,273.

step-up on Senior's prior death makes the pattern in which he is the first to die significantly better. Although the results when neither survive are very good, the risk that one will survive the SCIN term seem to be significant enough to make the risk one worth taking primarily when both are in below average physical condition.

¶ 1601.6 Situation Six—Private Annuity Sale to a Nongrantor Trust

Example: If Senior sells the assets to a nongrantor trust for a private annuity payable for the rest of his life instead of a SCIN, the income tax consequences may differ significantly. First, in a private annuity transaction, it is clear that the discount rate is the § 7520 rate and the mortality assumptions are based on Table 90CM. On the other hand, since the annuity terminates on Senior's death, there is still nothing included in his gross estate.[210] Second, when the annuity rules of § 72 apply instead of the installment sale and OID rules, the gain Senior realizes on the taxable sale of his assets is taxed quite differently under the § 72 annuity rules.[211]

There is, however, some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Reg. § 1.1275-1(j), because there are no provisions that can significantly reduce the probability that total distribution under the contract will increase commensurately with Senior's longevity as there would be for a SCIN (or PATY). On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method.[212] Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of § 453(j)(2) that expressly recognizes contingent payment installment sales.[213] Accordingly, if it is not a private annuity under § 72, a disposition of qualifying property for a secured private annuity based solely on Senior's life must qualify as an installment sale. The obligation, however, apparently is not a debt obligation under Reg. § 1.1275-1(j), since security is not one

210 *Estate of Moss v. Commissioner, supra* note 119; *Cain v. Commissioner, supra* note 119; see H&M, SCINs and Private Annuities at ¶ 308.2.

211 Rev. Rul. 69-74, 1969-1 C.B. 43.

212 *Est. of Bell v. Commissioner,* 60 T.C. 469 (1973); *212 Corp. v. Commissioner,* 70 T.C. 788 (1978); *cf.* Reg. § 1.83-3(e); G.C.M. 39503 (Issue (2)(c)(1)(a)); H&M, SCINs and Private Annuities at ¶ 302.2.

213 Sen. Rep. No. 1000, *supra* note 165, at 12, 1980-2 C.B. at 496; see H&M, SCINs and Private Annuities at ¶ 308.2; Manning and Hesch, *supra* note 134 at 21 (1982).

of the factors listed for qualifying for the annuity exclusion. Something has to give!! Since we find it inconceivable that an installment obligation might not be subject to OID, thereby making all payments amounts realized from the sale of the property, we believe that if a secured private annuity is taxed as an installment sale, it is subject to the contingent payment OID rules of Reg. § 1.1275-4(c). Since we also believe that it is unsound to have radically different tax treatment of secured and unsecured private annuities, we favor treating all private annuities as installment sales.[214] Since our recommendation has not yet been adopted by any regulations, ruling or other published IRS authority despite Congressional authority to do so,[215] or by any court decision, traditional private annuity treatment apparently remains available for unsecured private annuities.

The capital gain realized on the private annuity sale is realized ratably over the life expectancy of the annuitant, but the life expectancy for this purpose is that in Reg. § 1.72-9 Table V instead of the one used to determine the annual annuity under Table 90CM. Under Table 90CM an individual age 70 has a life expectancy of 13.9 years. Under the Section 72 table, an individual age 70 has a life expectancy of 16.0 years.[216] Obviously, the younger the individual, the longer the life expectancy and longer deferral can be achieved. A joint and survivor annuity for the senior family member and that individual's spouse increases the deferral. For example, the joint life expectancy of two individuals, both age 70, is 20.6 years for Section 72 purposes, as opposed to the 16.0 years for one individual age 70.[217]

Under traditional private annuity treatment, gain is reported and basis is recovered pro rata as each annuity payment is received, amortizing the seller's basis and the principal over the seller's life expectancy using the mortality assumptions contained in Reg. § 1.72-9 Table V.[218] If Senior dies before his entire basis is recovered, any unrecovered basis can be deducted on his final income tax return.[219] The purchaser's "tentative basis" in the asset purchased is equal to the value of the annuity obligation undertaken.[220] The purchaser's "final basis" is determined upon the annuitant's death by taking into account only the annuity payments actually made. Since the entire annuity payment is part of the purchaser's tentative

214 H&M, SCINs and Private Annuities at ¶ 306.

215 See Sen. Rep. No. 1000, *supra* note 165, at 23; 1980-2 C.B. at 506.

216 As adjusted in Reg. § 1.72-5(a)(2)(1) if the payments are less frequent than quarterly.

217 Annual annuity of $105,905 instead of $129,416, but for two lives.

218 As adjusted for the frequency of payment if less often than quarterly. Reg. § 1.72-5(a)(2)(i).

219 § 72(b)(3)(A).

220 Rev. Rul. 55-119, 1955-1 C.B. 352.

approach is to use the income tax annuity tables.[144] In part our conclusion is based on the same reasoning as that supporting the use of the AFR, that a SCIN is not a term interest under § 7520. Although the § 7520 regulations prescribe use of Table 90CM,[145] there is no corresponding provision in the contingent-payment installment-sale regulations.[146] In a broader sense, however, there is no requirement for any prescribed rate. The underlying assumption for exclusion of installment sales to family trusts, including SCINs from giving rise to taxable gifts is that they are excluded as bona fide business transactions.[147] Accordingly, the question is whether the transaction in a family transaction is on arm's length terms. Unrelated parties, of course, are free to use any reasonable basis for actuarial adjustments. Related parties should have the same freedom provided they can show that they have acted within the range of arm's length bargaining.[148] On the other hand, it is doubtful that there are many SCIN transactions entered into by unrelated parties.[149]

However computed, providing for the risk premium by increasing principal rather than interest provides two advantages, the premium is eligible for capital gains rates and may be deferred until payment of principal (or even eliminated if the seller dies before the end of the SCIN term). The deferral and chance of elimination can be maximized by providing payment of interest only during the SCIN term with a balloon payment of principal at the end. The interest will, however, be increased to reflect the increased principal. On the other hand, such a deferral will increase the absolute amount of the principal payment.

3. Comparison and Summary

The effect of the combinations of choice of discount rate and actuarial assumptions can be exemplified by the following table based on a SCIN

144 See Shore and McClung, Beyond the Basic Super Freeze—An Update and Additional Planning Opportunities, 75 Taxes 41, 50 (1997), mentioning that there is no authority requiring uses of the transfer tax tables and suggests use of Reg. § 1.72-9 Table V.

145 Reg. § 25.7520-1T(b)(2).

146 See Reg. § 15A.453-1(c) relating to contingent payment sales. The absence of a regulation may be due to the fact that the installment sale regulations do not even refer to actuarial issues.

147 Reg. § 25.2512-8; see H&M, SCINs and Private Annuities, at ¶¶ 302.3 and 308.3; Mulligan, *supra* note 46, at 1505.1.

148 *Cf.* § 2703(b); Reg. § 25.2703-1(b)(1) to (4) (excluding buy-sell agreements on terms "comparable to similar arrangement entered into in arms' length transactions").

149 See Zerah, Private Annuities and Self-Cancelling Installment Notes, The CPA Journal Online (www.luca.com) (Dec. 1993); Strizever, Self-canceling notes increase planning risks of a sale over private annuities, 12 Tax'n for Law. 298 (1984).

annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is "terminally ill" at the time of death. Technically, the position taken in this regulation does not apply to a SCIN because a promissory note is not an annuity or future interest as described in that regulation.[151] However, the better view is that the statement in the regulation is generally illustrative of situations in which the impending death of the individual should be taken into account and that standard actuarial tables do not apply. Indeed, since SCIN transactions of the type being discussed depend for their effectiveness on being treated as bona fide business transactions, applying the actuarial tables for a terminally ill individual would hardly satisfy the standard.

The regulation provides an 18-month safe harbor—if the individual survives more than 18 months, that individual shall be presumed to not have been "terminally ill" unless the contrary is established by clear and convincing evidence. The regulation is an estate tax regulation, which means that the IRS can apply it with the benefit of hindsight. Unfortunately, that type of perfect 20-20 vision is not available when the terms of a SCIN are established. It can only provide limited, after the fact, protection if the grantor-seller survives the 18 months.

D. Application of Estate Freezes to SCINs

Even though it has a contingent payment, a SCIN should not be disregarded in determining whether a SCIN sale to a family trust involves a gift. First, the special valuation rules of § 2701 only apply in determining "the amount of the gift,"[152] and a properly crafted SCIN is a sale for transfer tax purposes not a gift.[153] In addition, since a SCIN is a debt obligation, it cannot be an applicable retained interest subject to the special valuation rules.[154] For similar reasons, it is not a lapsing right subject to § 2704 even though it may terminate on death. Section 2704 applies only to voting rights and limitations on liquidation, neither of which describes a SCIN. Although § 2704(a)(4) gives the Secretary the power to treat "other restrictions" as interests to be disregarded, there are no such regulations. Furthermore,

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151 See ¶ 1601.3.B.1 *Discount Rate, supra.*

152 Reg. § 25.2701-1(b)(1); see Mulligan, *supra* note 46 at ¶ 1511; Nicholson, *supra* note 56 at 100; Lewis and Laning, Estate Freezes and Grantor Trust for Business Owners, 1 Bus. Ent. 10 (1994).

153 Reg. § 25.2512-8; Prop. Reg. § 25.2512-8 (Mar. 27, 1986).

154 § 2701(a)(1) applies only to a transfer of an "interest" in a corporation or partnership when there is an applicable retained "interest." Reg. § 25.2701-2(b)(1) defines an applicable retained interest as an "equity" interest is a corporation or partnership. See e.g. Priv. Ltr. Rul. 94-36-006, Mar. 14, 1994 (debt is not an interest subject to § 2701); Priv. Ltr. Rul. 95-35-026, May 31, 1995 (same).

Committee Report makes it clear that in deeming that a payment is received, it also intended that a payment is deemed to be made by stating that:

> The court [in *Miller v. Usry*] did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale.

Accordingly, the payment that is certain to be either received or deemed received by the seller under a SCIN should also be considered certain to be paid by the purchaser, who should receive an immediate basis in the property purchased with a SCIN. The IRS indicated that it approves of this analysis. "We therefore think it appropriate to allow the buyer-obligor to include the full face value of a note in its basis in the property acquired in the transaction."[162]

The contingent payment OID regulations determine the amount and timing of the interest income to be reported when there is a contingent payment sale.[163] The examples illustrate that the contingent payment OID regulations[164] take the position that a buyer obligated on a contingent payment obligation receives no basis upon incurring the contingent liability and the seller does not initially treat the contingent liability as part of its amount realized. The OID regulations go on to illustrate that the contingent liability gives rise to basis and amount realized only when the obligation becomes fixed or is paid. These regulations do not, however, define the term "contingent payment." The question is whether a SCIN obligation of a related party (as defined for purposes of § 453B(f)) is a contingent payment obligation for purposes of these regulations and, if so, whether they change the result in G.C.M. 39503. We do not believe it should be. Under a SCIN, even one with a balloon payment, interest will be paid on fixed basis until death or another terminating event occurs. As indicated, under a SCIN to a related party of the type we are discussing, the principal will be paid or deemed paid on or before a fixed date. Accordingly, such a SCIN should not be considered a contingent liability and the IRS position in G.C.M. 39503 remains supportable.

The legislative history to the Installment Sales Revision Act of 1980 also provides support for the position that the purchaser can include the principal amount of the SCIN obligation as part of its initial basis in the purchased property. It explicitly states that the deferred gain recognized at such time is the "quid pro quo" for the buyer's cost basis.[165] Accordingly, the IRS would be justified in denying a cost basis for the obligation to the

[162] G.C.M. 39503 (Issue (2)(C)(1)(b), last sentence), June 28, 1985.

[163] Reg. § 1.1275-4.

[164] Reg. §§ 1.483-5 and 1.1275-4(c).

[165] See S. Rept. No. 96-1000, 96th Cong., 2d Sess. 25 (1980).

Net		$ 421,487
Family Trust's Assets[170]		1,247,707
Total Assets to Children[171]		$1,669,194

Senior Survives SCIN Term

Senior's assets at death[172]	$2,424,316	
Less: Estate Tax	1,333,374	
Net		$1,090,942
Family Trust's Assets[173]		-62,696
Total Assets to Children[174]		$1,028,246

The difference in result, depending on whether Senior survives or does not survive the SCIN term is dramatic. It is attributable to the transfer of the $1,347,961 SCIN price (as increased by the risk premium) from the family trust (where it is not subject to estate tax) to Senior, where it increases his gross estate. The increase is partially offset by the payment of capital gain tax on the payment, which is, in turn, partly offset by the corresponding reduction in estate tax. The total assets to the children may be increased by the higher basis in the assets purchased reflecting the $347,961 in risk premium on the purchase. This can save $69,592 in capital gains taxes.

Even the result in the case in which Senior does not survive, so that the purchase price is not paid by the family trust and the capital gain tax is paid by Senior, is only marginally more favorable than for a fixed payment installment sale to a nongrantor trust in Situation One. This is because of the increased interest that must be paid on a SCIN.[175] The result in the case in which Senior does survive is worse than the result if Senior simply retains the assets. Thus, a SCIN sale to a nongrantor trust should be undertaken only when it is not likely that Senior will live out the SCIN term,

170 Includes accumulated income net of interest payments.

171 A generation skipping transfer increases the taxes by $231,818 and reduces the total assets passing to the grandchildren to $1,437,376.

172 Includes the $1,347,961 payment of the SCIN principal (including risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest, net of the $269,542 capital gain tax imposed on the gain on collection of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

173 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

174 A generation skipping transfer increases the taxes by $600,018 and reduces the total assets passing to the grandchildren to $428,228.

175 $87,213 annually instead of $64,700 annually. See ¶ 1601.3.B *Valuation of a SCIN.*

Less: Estate Tax	712,062	
Net		$ 582,596
Family Trust's Assets[183]		1,357,714
Total Assets to Children[184]		$1,940,310

Senior Survives SCIN Term

Senior's assets at death[185]	$2,785,456	
Less: Estate Tax	1,532,001	
Net		$1,253,455
Family Trust's Assets[186]		58,311
Total Assets to Children[187]		$1,311,766

Again, the difference in results depending on Senior's survival is dramatic. There is, however, no capital gain tax in either case. On the other hand, although the results if Senior does not survive the SCIN term are better than for a fixed payment sale to a grantor trust, the increase is not significant if Senior lives most of the SCIN term. Accordingly, the conclusion is the same, the SCIN is worthwhile only when there is a reasonable chance that Senior not only will not survive the SCIN term, but also will not live to collect most of the interest payments. A major additional disadvantage, not quantified in the computation, is that in either case the family trust's basis in the assets is a transferred basis, not a cost basis, because, unlike a fixed price installment sale to a grantor trust, the family trust is not subject to a debt obligation after Senior's death.

¶ 1601.5 Situation Five—Self-Canceling Installment Note (Two Lives) Sale to a Grantor Trust

Example: The SCIN is intended to provide income not only for the seller-grantor, but also, as is not unreasonable or uncommon, for his surviving

[183] Includes accumulated income net of interest payments.

[184] A generation skipping transfer increases the taxes by $320,428 and reduces the total assets passing to the grandchildren to $1,619,882.

[185] Includes the $1,347,962 payment of the SCIN (including the risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest. Despite the payment, there is no capital gain tax imposed on collection of the SCIN, because the transaction was never recognized for income tax purposes. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

[186] Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

[187] A generation skipping transfer increases the taxes by $689,400 and reduces the total assets passing to the grandchildren to $622,366.

Mrs. Senior's Assets at Death[194]	$984,262	
Less: Estate Tax	541,324	
Net		$442,918
Family Trust's Assets[195]		1,668,109
Total Assets to Children[196]		$2,111,027

Senior Does Not Survive SCIN Term; Mrs. Senior Collects SCIN Principal.[197]

Mrs. Senior's Assets[198]	$2,277,731	
Less: Estate Tax	1,252,752	
Net[199]		$1,024,979
Family Trust's Assets[200]		564,194
Total Assets to Children[201]		$1,589,173

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194 Includes accumulated after-tax interest on the SCIN paid to Senior and income on reinvestment of the accumulated interest by Senior as reduced for income tax incurred by Senior on the family trust's income that was retained by the trust, on the assumption that the SCIN and the accumulated income pass to Mrs. Senior as a marital deduction bequest. Because the SCIN terminates on Mrs. Senior's death, it is not included in her assets at death. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

195 Includes accumulated income net of interest payments plus property sold to it for the SCIN. The property has a cost basis of $1,176,470, reflecting the conversion of the trust to a nongrantor trust when Senior died. The consequent conversion of the SCIN note into one taken into account for income tax purposes means that the family trust has a basis in the property sold to it equal to the tax balance of the SCIN.

196 A generation skipping transfer increases the taxes by $243,605 and reduces the total assets passing to the grandchildren to $1,867,422.

197 Assumes Senior dies after the 14th interest payment, but before the final payment of principal and interest is due.

198 Includes the assets passing from Senior, as above, plus Mrs. Senior's accumulated after-tax interest on the SCIN for one year and the principal on the SCIN. Even though the termination of the SCIN at Mrs. Senior's death is a taxable settlement, there is no capital gain tax because of the step-up in the basis of the SCIN on Senior's death. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

199 A generation skipping transfer increases the taxes by $302,558 and reduces Mrs. Senior's net after-tax estate to $247,547.

200 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior for the period prior to his death, see M&H, Grantor Trusts at 13, plus accumulated after-tax income for the year after Senior's death reduced for the payments to Mrs. Senior.

201 A generation skipping transfer increases the taxes by $563,738 and reduces the total assets passing to the grandchildren to $1,025,435.

step-up on Senior's prior death makes the pattern in which he is the first to die significantly better. Although the results when neither survive are very good, the risk that one will survive the SCIN term seem to be significant enough to make the risk one worth taking primarily when both are in below average physical condition.

¶ 1601.6 Situation Six—Private Annuity Sale to a Nongrantor Trust

Example: If Senior sells the assets to a nongrantor trust for a private annuity payable for the rest of his life instead of a SCIN, the income tax consequences may differ significantly. First, in a private annuity transaction, it is clear that the discount rate is the § 7520 rate and the mortality assumptions are based on Table 90CM. On the other hand, since the annuity terminates on Senior's death, there is still nothing included in his gross estate.[210] Second, when the annuity rules of § 72 apply instead of the installment sale and OID rules, the gain Senior realizes on the taxable sale of his assets is taxed quite differently under the § 72 annuity rules.[211]

There is, however, some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Reg. § 1.1275-1(j), because there are no provisions that can significantly reduce the probability that total distribution under the contract will increase commensurately with Senior's longevity as there would be for a SCIN (or PATY). On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method.[212] Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of § 453(j)(2) that expressly recognizes contingent payment installment sales.[213] Accordingly, if it is not a private annuity under § 72, a disposition of qualifying property for a secured private annuity based solely on Senior's life must qualify as an installment sale. The obligation, however, apparently is not a debt obligation under Reg. § 1.1275-1(j), since security is not one

[210] *Estate of Moss v. Commissioner*, *supra* note 119; *Cain v. Commissioner*, *supra* note 119; see H&M, SCINs and Private Annuities at ¶ 308.2.

[211] Rev. Rul. 69-74, 1969-1 C.B. 43.

[212] *Est. of Bell v. Commissioner*, 60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 788 (1978); *cf.* Reg. § 1.83-3(e); G.C.M. 39503 (Issue (2)(c)(1)(a)); H&M, SCINs and Private Annuities at ¶ 302.2.

[213] Sen. Rep. No. 1000, *supra* note 165, at 12, 1980-2 C.B. at 496; see H&M, SCINs and Private Annuities at ¶ 308.2; Manning and Hesch, *supra* note 134 at 21 (1982).

and final basis, the purchaser cannot deduct the interest expense element.[221]

A. Comparison of Private Annuities and SCINs

In addition to the factors highlighted above, there are a number of other differences between traditional private annuity treatment and the treatment of SCINs. The exclusions from installment sale treatment,[222] including those for marketable securities,[223] recapture property,[224] sales of depreciable property to related parties,[225] do not apply to private annuities. Similarly, the second disposition rules for resales by related parties,[226] the anti-*Rushing* rules, do not apply.[227] Moreover, the interest charge on the deferred capital gains taxes for installment sales of $5 million for the year,[228] and the acceleration rules for pledging an installment obligation as collateral for a loan[229] do not apply to private annuities.

On the other hand, a major drawback to a taxable private annuity sale is that the interest element, reportable as annuity income by the annuitant, is not deductible as interest expense by the purchaser.[230] This disadvantage for the purchaser may more than offset the benefit of the deferral of the gain realized by the grantor-seller, especially if the asset purchased is not depreciable or amortizable, for example, corporate stock.

B. Minimum Funding of Private Annuity Trust

In Rev. Rul. 77-454[231] the IRS imposed a minimum funding standard on a private annuity trust that had only one annuitant. The basis of the concern was that the valuation factor used to determine the value of the

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221 *Dix v. Commissioner*, 392 F.2d 313 (4th Cir. 1968); *Rye v. United States*, 92-1 U.S.T.C. ¶ 50,186 (Cl. Ct. 1992); *Bell v. Commissioner*, 76 T.C. 232 (1981), *aff'd* 668 F.2d 448 (8th Cir. 1982).

222 See ¶ 1601.1.A *Assets Eligible for the Installment Method.*

223 § 453(k)(2)(A).

224 § 453(i).

225 § 453(g).

226 § 453(e).

227 But see *Stokes v. Commissioner*, 77 T.C.M. 2206 (1999) (disregards, as sham, private annuity sale of business to a nongrantor trust shortly before its resale by the trust to third parties, because nothing changed with respect to the operation of the business after it was sold to a nongrantor trust).

228 § 453A. See ¶ 1601.1.F *Avoiding § 453A—Exceeding the $5,000,000 Maximum Without Interest on the Deferred Tax Liability.*

229 § 453A(d); Rev. Rul. 65-185, 1965-2 C.B. 153. See ¶ 1601.1.E *Use of Leases Instead of Installment Sales.*

230 *Dix v. Commissioner, supra* note 221; *Rye v. United States, supra* note 221; and *Bell v. Commissioner, supra* note 221.

231 1974-2 C.B. 351.

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231 1974-2 C.B. 351.

annuity includes the possibility that the annuitant will live beyond his actuarial life expectancy. Accordingly, it determined how many annual payments could be made by the trust taking into account its initial corpus plus earnings at the assumed rate used in computing the value of the annuity.

Under Table 90CM the life expectancy of a 70-year old individual is 13.9 years. An annuity, payable quarterly, at the § 7520 rate of 7.4% on $1,000,000 is $129,416.[232] By definition a 70-year old individual who lives to age 83.9, will have consumed the entire original corpus plus income at 7.4% at age 83.9. Accordingly, Rev. Rul. 74-454 determines the gift by recasting the annuity as one for the lesser of 13.9 years or life, which has a value of $572,021, resulting in a taxable gift of $427,979. In order to have a value of $1,000,000, the initial corpus must be sufficient to fund the annuity to age 110, the maximum age on table 90CM, or $1,748,187. Accordingly, to avoid any gift tax, the family trust must have additional funding of $748,187. Presumably, as with family trusts used for installment sales, the additional funding can be provided by arrangements other than current or prior transfers, including guarantees.[233] If the purchaser is an individual, there is no extra funding requirement as it is presumed an individual has the ability to obtain additional funds by his or her ability to earn future income. One way to lower the capital reserves is to use an annuity for joint lives. For example, an annuity for the joint lives of a married couple, both age 70, is $105,864 and the amount of the required capital reserve is $348,300.[234]

C. Transfer of Purchased Property to a Partnership or S Corporation

If the family trust (or other purchaser) transfers the property purchased for a private annuity to a partnership, an S corporation or even a C corporation, retaining the annuity obligation, the tentative basis is, in effect, doubled as the transferred "inside" basis to the partnership or S or C corporation and as the exchanged "outside" basis of the family trust in the partnership interest or S or C corporation stock. If the seller-annuitant dies before gross payments on the private annuity equal the tentative

232 If the annuity payments are less frequent than quarterly, an adjustment is required by Reg. § 1.72-5(a)(2)(i). For a 70-year old individual, the adjustment for an annual annuity is -0.5 years. Thus, the 16.0-year life expectancy for a 70-year old is reduced to 15.5 years for determining the "exclusion ratio."

233 See ¶ 1601.1.G *Minimum Funding of the Family Trust—Is 10% of the Installment Note Required?*; Hatcher & Manigault, *supra* note 47 at 152.

234 The joint life expectancy of two individuals, both age 70, is 18.4 years under Table 90CM and 20.6 years under Reg. § 1.72-9 Table V.

basis,[235] the family trust's "final basis" in the exchanged basis property (the partnership interest or corporation shares) is reduced to the total amount of annuity payments made. When annuity payments by the family trust exceed the tentative basis, its outside basis is increased. The issue, in each case, is whether the transferee's inside basis is similarly adjusted. Normally an adjustment to outside basis does not affect the inside basis of an S or C corporation or, unless a § 754 election is in effect, or made, by a partnership. Conversely, when the annuity obligation is transferred with the property, the question is whether there is an adjustment of the family trust's outside basis equivalent to the entity's inside basis adjustment.

On the one hand, the outside (or inside) basis adjustment assures that the family trust will eventually suffer the tax consequences of the difference so that there is no real issue of tax avoidance or even of the necessity of applying tax benefit principles. Post-transfer differences between inside and outside basis are an inevitable effect of the entity characterization that applies in different degrees to all three forms of business entity. In a partnership, on the other hand, there may be support for the adjustment of inside basis in the application of the aggregate approach of *Quick Trust*[236] and *Woodhall*[237] which refused to allow a step-up in basis for the portion of the value of a partnership interest attributable to partnership assets that would be IRD if held by the deceased partner before the enactment of § 753.[238] If the transfer is to a C corporation, or even an S corporation, the aggregate approach is probably not available even though the issue is the same.

On the other hand, failure to make an adjustment converts a "tentative" basis into a final basis for the transferee when the annuity obligation is not transferred and for the transferor when it is. Accordingly, the issue is application of the transferred basis and exchanged basis concept. We believe that concept appropriately includes applying adjustments in the tentative basis to both the transferee and transferor. There is considerable authority that transferred basis includes not only the dollar amount of the transferor's basis but also other characteristics that are closely entwined

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[235] Because the economic interest inherent in the annuity cannot be deducted by the purchaser, see ¶ 1601.6 *Situation Six—Private Annuity Sale to a Nongrantor Trust,* this occurs well before the seller-annuitant's actuarial life expectancy. See H&M, SCINs and Private Annuities at ¶¶ 302.2 and 308.2.B, Example 30.

[236] *Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971).

[237] *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

[238] See § 1367(b)(4)(B) applying similar rule to S corporations; Rev. Rul. 89-108, 1989-2 C.B. 100 (applies look through approach to sale of partnership interest to deny installment sale treatment to the portion of the proceeds attributable to substantially appreciated inventory).

with basis,[239] or liabilities transferred.[240] We believe the same principles should apply to require subsequent adjustments to the tentative transferred basis because the potential adjustment was inherent in the basis at the time of transfer. Moreover, although not directly supported by the cited authorities, we believe the same adjustment is appropriate for the exchanged outside basis, regardless of the type of business entity—partnership, S corporation or C corporation.

D. Computation and Summary

The results of the transaction in Situation Six, assuming Senior survives for exactly 16 years may be summarized as follows:

Senior's assets at death[241]	$2,533,206	
Less: Estate Tax	1,393,263	
Net		$1,239,943
Family Trust's Assets[242]		-255,294

239 See, *e.g.*, *Commissioner v. Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738 (2d Cir. 1968), *rev'g* 46 T.C. 698 (1966) (subsidiary required to retain parent's LIFO inventory layers for property transferred under § 351 transaction); Rev. Rul. 70-565, 1970-2 C.B. 110 (follows *Seagram*); Rev. Rul. 79-127, 1979-1 C.B. 189 (transferee of partnership reporting inventories using lower of cost or market must restore write-downs by transferor to income as a condition of electing LIFO); *Philadelphia and Reading Corp. v. United States*, 602 F.2d 338 (Ct. Cl. 1979) (transferee in § 351 transaction entitled to amortize mining development expenditures made by transferor); *cf. Hempt Bros. Inc. v. United States*, 490 F.2d 1172 (3d Cir. 1974) (transferee corporation must report, as ordinary income, receivables transferred by cash method partnership and has zero basis in inventory when predecessor partnership improperly expensed costs).

240 See, *e.g.*, Rev. Rul. 80-198, 1980-2 C.B. 113 (transferee in § 351 transaction entitled to deduct accounts payable of cash method transferor); Priv. Ltr. Rul. 2000-13-044, Jan. 5, 2000 (follows Rev. Rul. 80-198); Rev. Rul. 95-74, 1995-2 C.B. 36 (contingent obligations on transfer under Section 351, whether deductible or capital, taken into account by transferee corporation); Rev. Rul. 75-154, 1975-1 C.B. 186 (former partners entitled to deduct retirement payments to previously retired partner even after partnership terminated); *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943) (same); Rev. Rul. 83-155, 1983-2 C.B. 38 (same for payments by corporation succeeding to partnership business); GCM 39054, Nov. 24, 1981 (same; background for Rev. Rul. 83-155; expressly follows Rev. Rul. 80-198). It is not accurate to refer to these as characteristics of "liabilities" because the obligations are not "liabilities." §§ 357(c)(3), 704(c)(3) and 108(e)(2); see Manning and Hesch, Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part One), 11 Tax Mgmt. Real Est. J. 19, 19-20 (1995). See also *Helvering v. Metropolitan Edison Co.*, 306 U.S. 522 (1939) (transferee in § 332 type transaction entitled to deduct unamortized discount and expense on liabilities assumed; prior to enactment of § 381); Reg. § 1.1232-1(b)(1)(iv) (original issue discount carries over when a new obligation is exchanged for another obligation in a nonrecognition transaction).

241 Includes the annuity payments net of tax on the annuity income and the capital gain on the property sold recognized on each annuity payment plus income on reinvestment of the accumulated interest. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

242 Includes accumulated after-tax income net of the nondeductible payments.

Total Assets to Children[243]	$884,649

The results here are the worst of any of the computations. The family trust is in a deficit primarily because of its inability to deduct any portion of the annuity payments (even the portion equal to Senior's annuity income) that gives it a negative cash flow. For what it is worth, it has a basis in the property originally transferred of $2,069,721, probably well above the property's value. The results are improved to the degree that the family trust can make use of the basis during (or after) the annuity term, but probably not enough to make a private annuity worth serious consideration unless property not eligible for the installment method must be transferred and Senior's health indicates a reasonable chance of not surviving for a majority of the annuity period. On the other hand, the results may be worse if Senior survives significantly beyond his 16-year Reg. § 1.72-9 Table V life expectancy, because, unlike a SCIN, the payments continue indefinitely. That problem could be eliminated by a PATY taxed as a traditional private annuity, but we do not believe that is a viable option under Reg. § 1.1275-1(j).[244] Even if it is, the results for a PATY for the lesser of 16 years or life would be less favorable than set forth above if Senior lived 16 years because the annuity payments would have to be increased to reflect the 16 year limit.

¶ 1601.7 Situation Seven—Private Annuity Sale to a Grantor Trust

If the sale is to a grantor trust, there is never a sale for Federal income tax purposes; Senior reports the income earned by the grantor trust's assets throughout his life. Since the annuity obligation terminates at Senior's death, as with a SCIN sale to a grantor trust,[245] there never is a sale and the family trust has a transferred basis. The minimum independent funding required by Rev. Rul. 77-454 is still necessary to satisfy the "reality of sale" test for transfer tax purposes.

The results of the transaction in Situation Seven may be summarized as follows:

Senior's assets at death[246]	$3,041,774

[243] A generation skipping transfer increases the taxes by $626,969 and reduces the total to $257,680.

[244] See ¶ 1601.3.A *Impact of Reg. § 1.1275-1(j).*

[245] See ¶ 1601.4 *Situation Four—Self-Canceling Installment Sale to a Grantor Trust.*

[246] Includes the $1,347,962 payment of the SCIN (including risk premium) plus accumulated after-tax interest on the note and income on reinvestment of the accumulated interest, net of the capital gain tax imposed on the gain on collection of the SCIN. As in Situation One, see *supra* note 59, the computation assumes that all accumulated income, including capital gain, is realized.

Less: Estate Tax[247]	1,672,976	
Net		$1,368,798
Family Trust's Assets[248]		7,199
Total Assets to Children[249]		$1,375,997

The use of a grantor trust makes a private annuity possibly a viable transaction, particularly if the assets do not qualify for the installment method or Senior's health is below average, or, better yet, both.

¶ 1601.8 Defrosting the Freeze

All estate freezes rely on the assumption the property transferred will appreciate in value and those transactions made in the form of sales of the type we discussed are based on the assumption that the property sold plus subsequent appreciation and income will exceed the purchase price and any interest obligation. If that assumption turns out to be mistaken, the attempted freeze can increase transfer taxes over what they would have been if there had been no planning at all.

Example: If, after the installment sale considered in Situation One, the property declines in value from $1,000,000 to $800,000, but because of the minimum funding or other steps taken to assure the reality of the sale, the promissory note is still worth $1,000,000, Senior's estate will include a note worth $1,000,000 instead of the $800,000 asset that would have been included with no sale.

Given the long-term inflation and corresponding increases in asset values measured in nominal dollars that have occurred almost constantly over the last sixty years, this is more likely to be a short-term than a long-term problem. Accordingly, the problem is less likely to arise if there is a substantial period from the date of the sale and the date of death, particularly if the trust's assets are not dissipated in the short run by substantial payments on the purchase price. In other words, balloon payment arrangements are likely to be more effective than installment payment arrangements that amortize principal. This advantage can be reduced or lost during periods in which the fixed interest obligations on the note are higher than then current rates of return on the property sold. The period for trust accumulation can be extended by renewal of the promissory note, but such renewal will have to be made at then prevailing

247 There is no capital gain tax on the unrealized installment gain.

248 Includes accumulated income net of interest payments, without tax on realized income because that tax is imposed on Senior. See M&H, Grantor Trusts at 13.

249 A generation skipping transfer increases the taxes by $752,839 and reduces the total assets passing to the grandchildren to $623,158.

interest rates, the AFR or § 7520 rate as appropriate, to avoid a taxable gift.

A promissory note with an interest rate below the AFR and a correspondingly higher principal amount may help preserve cash for the family trust, particularly if the initial income from the property is lower than expected future income. This approach involves OID, which gives the family trust a deduction without cash outlay,[250] and the grantor-seller income without cash, requiring use of other assets to pay the tax.

In a grantor trust, if it appears that the wrong assets were sold, that is assets with less potential appreciation than assets Senior retained, he and the trust can exchange assets without recognition of gain by using the power of substitution under § 675(4)(C) that is a frequent power retained to make the trust a grantor trust. A fair market value exchange is not a recognition event even without such a power since the grantor owns all of the assets for tax purposes before and after the "exchange" so that he is merely changing the pocket in which he holds the property. A settlor-seller and a nongrantor trust can make a nonrecognition exchange under a § 675(4)(C) power or otherwise, only if the exchange qualifies under § 1031 as a like-kind exchange (which usually applies to real estate), or under another nonrecognition provision, such as § 1035 (exchanges of insurance policies).

Trust assets that are expected to continue to decline in value can be used to prepay a portion of the purchase obligation without recognition of gain or loss by a grantor trust. Similar use by a nongrantor trust is a recognition transaction in which gain may be recognized, but loss will be likely to be disallowed under § 267.

A more sophisticated version of the exchange between the grantor and the family trust when the assets have initially appreciated but are now likely to decline in value is to use a type of freeze in which the family trust transfers the assets to a limited partnership for a frozen preferred interest and an unfrozen common interest and then transfers the unfrozen common interest to the grantor in a nonrecognition exchange or as a prepayment in a grantor trust. A nongrantor trust is almost certain to have a taxable exchange in this scenario since a partnership interest is not eligible for a like-kind exchange under § 1031,[251] although under certain circumstances interests in a partnership can be rearranged in a partnership recapitalization without recognition.[252]

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[250] Subject to the limits of § 163(i) (the limitation of adjusted high yield debt obligations).

[251] § 1031(a)(2)(D).

[252] See Rev. Rul. 84-52, 84-1 C.B. 157.

¶ 1602 Summary and Conclusions

The comparative results of the Seven Situations we have considered may be summarized as follows:

	Net to Children	*Net to Grandchildren*
Senior Makes No Disposition	$1,279,695	$ 575,863
Situation One—Installment Sale to a Nongrantor Trust	1,575,834	1,133,453
Situation Two—Installment Sale to a Grantor Trust	1,896,558	1,470,314
Situation Three—Self-Canceling Installment Note Sale to a Nongrantor Trust—Senior Survives	1,028,246	428,228
Situation Three—Self-Canceling Installment Note Sale to a Nongrantor Trust—Senior Does Not Survive	1,669,194	1,437,376
Situation Four—Self-Canceling Installment Note Sale to a Grantor Trust—Senior Survives	1,311,766	622,366
Situation Four—Self-Canceling Installment Note Sale to a Grantor Trust—Senior Does Not Survive	1,940,310	1,619,882
Situation Five—Self-Canceling Installment Note(two lives) Sale to a Grantor Trust—Mrs. Senior Survives, Does Not Collect	2,111,027	1,867,422
Situation Five—Self-Canceling Installment Note(two lives) Sale to a Grantor Trust—Mrs. Senior Survives and Collects	1,589,173	1,025,435
Situation Five—Self-Canceling Installment Note(two lives) Sale to a Grantor Trust—Senior Survives, Does Not Collect	2,111,027	1,867,422
Situation Five—Self-Canceling Installment Note(two lives) Sale to a Grantor Trust—Senior Survives and Collects	1,599,778	1,040,273

	Net to Children	Net to Grandchildren
Situation Six—Private Annuity Sale to a Nongrantor Trust	884,669	257,680
Situation Seven—Private Annuity Sale to a Grantor Trust	1,375,997	623,158

Comparing the sales to the nongrantor and grantor family trusts for each of the types of transactions, fixed payment sales, SCINs and private annuities shows that for each type, the sale to the grantor trust produces superior results. The numerical comparisons, however, do not take into account the differences in basis results. Sales to nongrantor family trusts produce a cost basis for the trust (unless the transferred basis is higher). We believe that the family trust has a cost basis for a fixed payment sale and for a sale for a SCIN for joint lives when Mrs. Senior survives. The advantage is reduced, but not eliminated, for these sales if we are wrong in our analysis of the effect of the grantor's death. Although we believe our conclusions are sound, we cannot guarantee that the IRS will not attack the results and that the courts will not agree. At first blush, the results look too good to be true. On the other hand, the same can be said for the step-up in basis at death in general. As long as that basis step-up is a part of the law, we do not believe that the consequences we urge provide any improper benefit.

As with all examples, the results set forth above should be generalized only after careful analysis. Because our examples of the results of SCINs in which Senior (or Mrs. Senior) does not survive to collect the principal on the SCIN assume death shortly before the payment date, they tend to understate the advantage of death before the end of the actuarial life expectancy. Similarly, because we assume that all post-transaction appreciation is realized annually by the family trust, the disadvantage of not obtaining a step-up in basis at death may be understated.

Nevertheless, we believe the data support the conclusion that an installment sale to a grantor family trust is an estate freeze transaction that deserves careful consideration in appropriate cases. On the other hand, we believe a private annuity sale, even to a grantor trust, is rarely worthwhile. Although a SCIN, particularly a SCIN for joint lives, to a grantor family trust can produce better results than a fixed payment sale, if Senior and Mrs. Senior do not survive to collect the principal, the poor results if they do survive make this a technique to be used only in special circumstances. The increase in risk premium if the maximum term is increased to raise the chance of nonsurvival will probably be a wash.

36TH ANNUAL PHILLIP E. HECKERLING INSTITUTE ON ESTATE PLANNING

CHAPTER 10

Coordinating Income Tax Planning with Estate Planning: Uses of Installment Sales, Private Annuities and Self-Canceling Installment Notes

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CHAPTER **10**

Coordinating Income Tax Planning With Estate Planning: Uses of Installment Sales, Private Annuities and Self-Canceling Installment Notes

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Synopsis

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This paper further expands on two prior articles we published titled "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income Tax and Transfer Tax Elements," 24 Tax Management Estates, Gifts & Trusts Journal 3 (January 1999), and "Beyond the Basic Freeze: Further Uses of Deferred Payment Sales," 34th Annual University of Miami Philip E. Heckerling Institute on Estate Planning, Chapter 16 (2000).

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¶ 1000 Introduction

Today, an almost overwhelming array of estate and income tax planning techniques are available to achieve the goals of reducing the amount subject to the Federal transfer taxes and saving income taxes.[1] The estate tax planning techniques range from the simple, such as outright gifts using the recently increased $11,000 annual exclusion, as announced in Rev. Proc. 2001-59, 2001-52 I.R.B. 623, § 3.19(1), to techniques practitioners view as cutting edge, such as installment sales of discounted limited partnership interests to grantor trusts. The income tax planning techniques have as their primary objective the deferral of income and, potentially, its eventual exclusion. The estate tax planning techniques have two primary objectives: (i) the creation of valuation discounts and (ii) the freezing of that discounted value as the amount exposed to the transfer taxes.

Deferred payment sales of a family business or other financial assets within a family can serve a variety of goals. In many families, there comes a time when it is appropriate to transfer management and control of the family business, other family financial assets, or even nonfinancial property to the next generation. Although this time in the life of Senior may be an appropriate occasion for making major family gifts, frequently, Senior needs to retain some financial stake in the family business or other financial assets to finance retirement after it is time to transfer control. More often than not, there is a general reluctance to pay a gift tax. At the same time, those taking over the family business or other property usually do not have

[1] The Federal transfer taxes include the gift tax, the estate tax and the generation skipping transfer tax. For purposes of this paper, the selling senior family member will be referred to as "Senior" and the purchasing junior family member will be referred to as "Junior."

sufficient financial resources to purchase the assets for cash, and cannot, or are not willing to, obtain the necessary financing from commercial sources.

A seller-financed, deferred payment sale can bridge the gap, using the future cash flows from the newly-acquired assets as the primary source of funds to satisfy the obligation undertaken by Junior as the purchaser. The deferred payment sale can be structured as an installment note, a self-canceling installment note ("SCIN") or a private annuity. An installment note calls for a specified number of fixed payments over a fixed term of years with designated interest. A SCIN is essentially an installment note that also provides that the payments terminate upon the death of the selling senior family member. This termination feature means that the value of a SCIN is less than that of a standard installment note providing for equal fixed payments over the fixed term. Accordingly, to achieve an equivalent initial value, a SCIN must provide greater interim and potential total payments than a standard installment note. A private annuity provides for specified payments over a term of uncertain duration, typically the life of the selling senior family member or the joint lives of the senior family member and spouse. Although a private annuity, like any commercial annuity, involves an implicit interest factor, the interest is not expressly stated.

There are significant differences in the financial terms and economic risks associated with the three types of deferred payment financing identified above. Yet, in the final analysis, all three provide economically equivalent payment arrangements for the assets transferred. Any difference in the risks associated with the different payment terms should be in the amounts provided as deferred payments for the assets or, if it is not, in the portion of the value of the assets transferred that is a gift, compensation, or otherwise. Nevertheless, the differences in the Federal income and transfer tax treatment of the three type of deferred payment arrangements are disproportionate to the financial differences among them.

Under traditional income tax principles, the timing for reporting gain realized by the seller under the annuity rules is significantly different from that under the installment method. There are similar differences in the basis of the property acquired by the buyer. The buyer obligated under a private annuity sale must capitalize the amount treated by the seller as annuity income, but the buyer in an installment sale can deduct as interest expense the amount the seller reports as interest income.

Even greater differences exist in the income taxation of the interest or other time value of money factor inherent in each payment. Although the seller reports interest income in an installment sale and, implicitly, as annuity income in a private annuity sale, the timing of this income is significantly different. Similarly, although the buyer is entitled to an interest expense deduction (subject to the investment interest or other interest limitations) in an installment sale, the buyer is not allowed any deduction for what is the practical equivalent of the interest cost in a private annuity obligation. An anomaly is that an unsecured private annuity obligation is governed by a different set of rules than a secured private annuity obligation on identical terms. Another distorting factor is the use of different interest rate and mortality assumptions for income tax purposes than those used for transfer tax purposes.

The first part of this paper provides an analysis of the income tax and transfer tax treatment of the three financing arrangements (in so far as it is clear) to show how the selling senior family member and younger generation buyer are taxed at the time of the initial sale, the time each payment is made, and the death of the seller while the obligation is outstanding

We address: (i) the principles applicable to fixed deferred payment obligations under the installment method; (ii) traditional private annuity sale principles; (iii) the application of installment sale principles to SCINs, and (iv) the transfer tax treatment applicable to each, including the sometimes surprising differences between similar transactions.

¶ 1001 Deferred Payment Sales: Basic Rules

There are three forms of deferred payment sales, fixed payment installment sales, self-canceling installment note ("SCIN") sales[2] and private annuity sales. Traditionally, the IRS has distinguished between SCINs and private annuities on the basis of the maximum term of the deferred payment obligation—if the maximum term was shorter than the transferor-seller's actuarial life expectancy,[3] a sale was classified as an installment sale under § 453; if longer, it was classified as a private annuity sale governed by § 72.[4] A SCIN for a maximum term exceeding the seller's life expectancy is sometimes referred to as a private annuity for a term of years (a "PATY"), with income tax reporting prescribed by the § 72 annuity rules.

[2] Frequently referred to simply as SCINs although technically a SCIN is a form of promissory note that contains a cancelation feature based on the seller's death.

[3] Using the Reg. § 1.72-9 Table V mortality table. The lives in Table V are based on a 1983 study of individuals who purchased annuities. Annuity purchasers tend to live longer than people of the same age in the general population, presumably because they are self-selected and enjoy better living conditions.

[4] See G.C.M. 39503 (Jun. 28, 1985); see Hesch and Manning, *Family Deferred Payment Sales: Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26th U. Miami Philip E. Heckerling Inst. on Est. Plan. Ch. 3, ¶ 310.3 (1992).

However, a 1998 regulation amendment, intended primarily to prevent noninsurance company financial institutions from offering tax-sheltered investments,[5] may require treating PATYs as installment sales under § 453, in effect, as SCINs, leaving only annuities for life with no term limits or refund features subject to traditional private annuity taxation.

Any of the three deferred payment sale arrangements can be either a sale to a grantor trust, that is not treated as a taxable sale for Federal income tax purposes, or a sale to a non-grantor trust so that is treated as a taxable sale for Federal income tax purposes, even if the sale is to a partnership or S corporation in which the transferor-seller is substantially the sole owner.[6]

¶ 1001.1 Installment Method for Fixed Payment Obligations

The installment method defers payment of the income tax on the gain realized from a sale. It allows a selling senior family member who has realized a gain on the sale of property to postpone reporting any gain from the time of the sale to the receipt of payments of the selling price, regardless of the seller's method of accounting. Specifically, a fraction of each payment, the gross profit ratio (the gross profit divided by the contract price) is included in income.

> **Example 1**: Senior sells family assets worth $1,000 that have a basis of $100, for ten payments of $100 each, plus adequate stated interest. The gain, or gross profit, is $900 ($1,000 − $100). Under the installment method, the gross profit ratio is 90% ($900/$1,000). Thus, 90%, or $90 of each $100 principal payment on the note, is included in income as gain on the sale.

Regardless of the buyer's method of accounting, the obligation to make fixed principal payments is part of the purchaser's basis in the property acquired from the date of sale.

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[5] See the Preambles for the proposed and final regulations. FI-33-94, 1995-1 C.B. 920, 921-22 and T.D 8754, 1998-1 C.B. 146, 146-48.

[6] If Senior's grantor trust is a 100% shareholder in an S corporation, or a 99% limited partner in a partnership, a sale by Senior to his controlled entity is a taxable sale despite the fact that Senior is deemed to be the income tax owner of the purchasing entity under the grantor trust rules. Under Reg. § 1.707-3(a)(3) and (f) Example 1, a transfer may be a sale only in part if the amount paid is less than the fair market value of the property. Under Reg. § 1.707-5(a)(1) and (f) Example 1 a transfer of property subject to a liability is a disguised sale only to the extent that a share of the liability is shifted to other partners. The grantor trust provisions (§§ 671-679) do not apply related party or attribution rules similar to those found in the income tax area, §§ 267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in the gift taxes under § 2701(e)(3). In the absence of specific statutory authority, a sale by a grantor to an entity owned by a grantor trust is not treated as a sale to the grantor trust.

A selling senior family member can elect out of an installment sale,[7] and report the entire gain in the year of sale.[8]

The senior family member can arrange for part or all of the family business interest to be redeemed by the corporation or partnership instead of being purchased by the younger generation family member. A redemption by the family entity has the same economic effect as a sale if the younger generation already owns an interest in the business. A corporate redemption for deferred payments, including one by an S corporation, that qualifies as a sale or exchange under § 302(b) and is not a dividend, is an installment sale.[9] Accordingly, the income tax treatment for the selling senior family member is the same as in a direct sale to the younger family member. Any interest deduction, however, belongs to the corporation (or S corporation shareholders). The corporation does not have any basis in the shares redeemed and the younger family members do not increase the basis of their shares for the amount of the redemption price. The taxation of a deferred payment redemption of a partnership interest is determined under special partnership provisions and not under the installment method.[10]

All initial cash received, and the value of all other assets initially received (other than the buyer's evidences of indebtedness) in a deferred payment sale are treated as payments in the year of sale under the installment method. Demand obligations of the younger generation buyer, or obligations of a corporate issuer regularly traded in an active securities market, do not qualify as the buyer's evidence of indebtedness, so that the deferral under the installment method is not available for these notes.[11]

The buyer's note obligation may be received in an installment sale without immediate gain recognition, regardless of the solvency of the buyer. The installment method is the basic approach to taxing deferred payment sales that qualify; its availability does not depend on the taxpayer's method of accounting or on lack of certainty of payment. All other amounts received in the year of sale, including any third party debt obligations, are payments in the year of sale and result in immediate recognition of gain.[12]

[7] § 453(d); Temp. Reg. § 15A.453-1(d).

[8] Temp. Reg. § 15A.453-1(d)(2).

[9] Prop. Reg. § 1.453-1(f)(4); see *Stiles v. Commissioner*, 69 T.C. 558 (1978), *acq.* 1978-2 C. B. 3. Priv. Ltr. Rul. 90-08-065 (Nov. 29, 1989) (redemption with deferred payments must be reported as installment sale).

[10] See Reg. § 1.736-1(b)(5), (6) and (7).

[11] § 453(f)(4) and (5); Temp. Reg. § 15A.453-1(b)(3)(i) and (e)(1).

[12] § 453(c) and (f)(3); Temp. Reg. § 15A.453-1(b)(3)(i); see *Holmes v. Commissioner*, 55 T.C. 53 (1970) (third party note guaranteed by the buyer constituted a payment).

Gain can be reported under the installment method even when the buyer's obligation is secured.[13] Common forms of security include a mortgage on the property sold, a third-party guarantee or even a standby letter of credit.[14] It is possible to go too far. An obligation secured by an escrow arrangement or by a cash equivalent (e.g. government securities) is treated as a payment in the year of sale.[15]

When liabilities are transferred as part of the sale of the family business or other financial assets, the liabilities are part of the selling price, included in both the seller's amount realized and the buyer's basis.[16] When property is sold subject to liabilities, special rules apply under the installment method. The liabilities are, in effect, applied first against basis instead of simply being considered additional payments. The contract price, instead of the selling price, is used to calculate the gross profit ratio. The contract price is defined as the selling price reduced by liabilities transferred that do not exceed basis.[17]

Example 2: Senior sells property worth $1,000 with a basis of $600, subject to a mortgage of $400, for ten principal payments of $60 each. Although the sales price is $1,000, the contract price is $600 ($1,000 – the $400 mortgage), and the gross profit ratio is 66-2/3% ($400 gross profit/$600 contract price). As each $60 payment is received, only $40 is included in income as gain on the sale.

If the amount of the Senior's transferred liabilities exceeds the basis for the business, the excess is "deemed" to be a payment in the year of sale, because otherwise the gross profit ratio would exceed 100%.[18]

Example 3: Senior sells property worth $1,000 with a basis of $100, subject to mortgage of $400, for ten principal payments of $60. The gross profit is $900 ($1,000 price – $100 basis), and the contract price would be only $600 ($1,000 price – $400 mortgage), resulting in a gross profit ratio of 150%. To prevent this, the mortgage offset in determining the contract price is limited to the $100 basis. Thus, the contract price is also $900, resulting in a gross profit ratio of 100%. The $300 excess is a "deemed" payment in the year of sale. This results in immediate

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13 § 453(f)(3); Temp. Reg. § 15A.453-1(b)(3)(i) and (iii).

14 See Rev. Rul. 82-122, 1982-1 C.B. 80; Rev. Rul. 74-157, 1974-1 C.B. 115; Rev. Rul. 74-557, 1974-2 C.B. 301 (dealing with modifications of terms of installment sales secured by the property sold); Temp. Reg. § 15A.453-1(b)(3)(iii).

15 Temp. Reg. § 15A.453-1(b)(3)(i).

16 Reg. § 1.1001-2(a); *Crane v. Commissioner*, 331 U.S. 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983) (amount realized on transfer of property subject to nonrecourse liability is amount of liability even if value of property is less).

17 Temp. Reg. § 15A.453-1(b)(2(iii).

18 Temp. Reg. § 15A.453-1(b)(2)(iii) and (iv).

recognition of gain in the amount of $300 because the entire basis has been fully offset against the liability.[19]

Taxpayers have succeeded in avoiding immediate gain recognition when liabilities exceed basis by use of a wrap-around note.[20] In a wrap-around note, the selling senior family member does not transfer the liability, but remains primarily liable, agreeing to make payment on the indebtedness as it becomes due.[21] Although the IRS initially resisted this technique,[22] it eventually conceded that it works.[23]

Example 4: The facts are the same as in Example 3. Senior may avoid the gain on the excess of the liability over basis in the year of sale by agreeing to pay off the original borrowing himself. He then receives ten annual principal payments of $100 each and must use part of each payment (or other resources) to make the payments on the original mortgage. He reports $90 of his gain as he collects each principal payment, and he has no deduction or other offset for the mortgage payments.

Because the deferral of tax under the installment method is considered an extraordinary benefit, almost any disposition by a selling senior family member of an installment obligation accelerates the unreported gain realized on the sale of the family business.[24] Even a gift by the selling senior family member is considered an early disposition that accelerates the reporting of gain.[25]

In contrast, a disposition occasioned by the selling senior family member's death does not accelerate the unreported gain. Instead, the deceased selling senior family member's successor-in-interest steps into the decedent's shoes, and, in turn, is subject to the early disposition provisions.[26]

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19 Temp. Reg. § 15A.453-1 (b)(2)(iii) and (iv).

20 See *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987), *acq.* 1988-2 C.B. 1.

21 Wrap-around notes can be for purposes other than avoidance of the payment in year of sale, most commonly to preserve for the selling senior family member the benefit of a low interest rate on the original loan.

22 See Temp. Reg. § 15A.453-1(b)(3)(ii).

23 The IRS acquiesced in *Professional Equities*, *supra* note 20.

24 A transfer of an installment obligation incident to a divorce that meets the requirements for nonrecognition under § 1041 does not result in acceleration of gain, but transfers the unreported gain to the (often unsuspecting) transferee spouse. § 453B(g).

25 Rev. Rul. 67-167, 1967-1 C.B. 107.

26 § 691(a)(2). Since the deferred gain is "income in respect of a decedent" under § 691(a)(4) and Reg. § 1.691(a)-1(b), the successor-in-interest cannot obtain a tax-free step-up in basis for the unreported gain. § 1014(c). Priv. Ltr. Rul. 88-06-048 (Nov. 17, 1987).

Finally, use of the installment note as collateral for a loan is treated the same as an early disposition to the extent of the loan proceeds,[27] with the result that all or a portion of the deferred gain is reported at that time.[28]

Interest paid by individual buyers for shares of a C corporation is investment interest, deductible only within the applicable limits.[29] The character of interest paid by a buyer of an S corporation is determined by an allocation based on the nature of the corporation's underlying assets, that is, business assets, investment assets, etc.[30] When the buyer is a C corporation, the interest should be fully-deductible as business interest.[31]

If Senior dies during the term of the note, the note is included in his gross estate at its fair market value, which is not necessarily the principal amount. Because the gain was realized while Senior was alive, it is income in respect of a decedent ("IRD").[32] Consequently, there will be no tax-free step-up in basis for the note.[33] Under § 691(a)(4), the successor-in-interest will report the capital gain and interest income as payments are received on the installment note, offset by a deduction under § 691(c) for any estate tax attributable to inclusion of the note in Senior's gross estate. The purchaser has a cost basis in the property equal to the principal amount of the note and any additional consideration. That cost basis is not affected by Senior's death, so that any pre-death appreciation that escapes transfer tax is subject to, presumably capital gain, tax to the purchaser. Since the maximum estate tax rate will eventually be 45% and the capital gain tax is 20% and may be further delayed, the tradeoff is usually a good one. If there is a decline in value, the reverse may be true, except to the extent that the value of the promissory note is correspondingly reduced.

Although the installment method is available even when the younger generation buyer's obligations are secured,[34] certain forms of security can convert the buyer's obligation into a current payment. Specifically, security in the form of a cash equivalent, such as a certificate of deposit, triggers gain recognition.[35] The same is true for any form of escrow.[36] Later

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[27] § 453A(d)(1).

[28] § 453A(a)(1) and (b)(1).

[29] § 163(d)(5); Temp. Reg. § 1.163-8T(b)(3).

[30] See Notice 89-35, 1989-1 C.B. 675, 676. In Priv. Ltr. Rul. 91-16-008 (Jan. 10, 1991), the IRS applied this approach to a redemption of S corporation shares, determining the character of the interest by the nature of the corporate assets. Presumably, a similar rule applies to the purchase of a partnership interest.

[31] See § 163(d)(1) and (h) (investment interest and personal interest limits apply only to taxpayers other than C corporations).

[32] § 691(a).

[33] § 1014(c).

[34] § 453(f)(3).

[35] Temp. Reg. § 15A.453-1(b)(3)(i). This regulation effectively overrules *Porterfield v. Com-*

substitution of an escrow or cash equivalent terminates the deferral for a previously qualified installment sale.[37] On the other hand, a standby letter of credit is permissible security.[38] Thus, as a practical matter, when security other than the property sold is needed, a qualifying standby letter of credit should be used.

A selling senior family member may have suspended passive losses, for example, losses from an S corporation owned by a shareholder who does not materially participate or passive losses that were suspended when an activity was contributed in a § 351 transaction. A sale reported under the installment method is not a complete disposition that permits immediate deduction of suspended passive losses.[39] Instead, the suspended passive losses are deducted only as gain is recognized.[40] By parallel reasoning, losses suspended under the at-risk rules[41] should be deductible only as gain is recognized.[42] Losses of a partnership or S corporation that have been suspended because the selling senior family member's basis was not sufficient,[43] do not become deductible at the time of disposition. The sale does not provide the requisite basis. This is not inappropriate, since if deduction of the loss is taken, basis in the shares is reduced,[44] and gain on the sale is equivalently larger.

If the selling senior family member cancels the note by a clause in his will or indirectly effects a cancellation because he bequeaths the note to the obligor, the fair market value of the note is still property included in the selling senior family member's gross estate.[45] The cancellation of a note

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missioner, 73 T.C. 91 (1979) (installment sale qualified even though the buyer's note was secured by escrow when court found escrow was intended as security not source of payment); see also *Sprague v. Commissioner*, 627 F.2d 1044 (10th Cir. 1982) (impractical to evaluate security and whether its quality creates risk).

36 *Oden v. Commissioner*, 56 T.C. 569 (1971) (certificates of deposit placed in escrow); *Pozzi v. Commissioner*, 49 T.C. 119 (1967) (escrow); Rev. Rul. 73-451, 1972-2 C.B. 158 (cash in escrow).

37 Rev. Rul. 77-294, 1977-2 C.B. 173, *revoking* Rev. Rul. 68-246, 1968-1 C.B. 198, *amplified by* Rev. Rul. 79-91, 1979-1 C.B. 179 (installment sale ceased to qualify when escrow substituted for mortgage security).

38 Temp. Reg. § 15A.453-1(b)(3)(iii).

39 § 469(g).

40 Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 226 (1987).

41 § 465.

42 See Prop. Reg. § 1.465-66.

43 §§ 704(d) and 1366(d).

44 § 1367(b)(2)(B).

45 Reg. § 20.2033-1(b) specifically provides that "[n]otes . . . held by the decedent are likewise included [in the decedent's estate] even though they are cancelled by the decedent's will." The rule is different for a SCIN, which expires upon the selling family member's death by its own terms.

on the death of the seller is, however, a disposition that results in the immediate reporting of gain previously deferred under the installment method.[46] Any gain triggered in this manner is reported on the seller's final individual income tax return.

If the obligor under the canceled note is related to the decedent-seller and the value of the note is less than its face amount, then the amount (fair market value) included in the gross estate for Federal estate tax purposes is irrelevant for Federal income tax purposes. Instead, for purposes of determining the gain reported by the estate, the face amount of the note is determinative.[47] Thus, although the theory is different, the amount of gain recognized is the same as for a gift.

Example 5: S dies in 2001 when $300,000 remains unpaid on the note and the gross profit ratio is 100%. S leaves this note as a specific bequest to B, the obligor on the note, who is also his son. At the date of death, the value of the note in S's gross estate is $280,000. S's basis in the note is zero. The Internal Revenue Service takes the position that S's estate is treated as having transferred the note for $300,000 under § 691(a)(2), and that the estate must report the remaining $300,000 of capital gain on its fiduciary income tax return. A better view, supported by the Tax Court's decision in the *Frane* case, is that the gain should be reported on S's final income tax return. B's basis in the land purchased from his father should remain as the same cost basis, on the ground that the termination of the notes is a bequest, even though B pays $300,000 less.

Example 6: The facts are the same except that B, the obligor-buyer is, S's son-in-law. Either S or S's estate must report $280,000 of capital gain upon the cancellation of the note. B's cost basis in the property purchased by issuing his own note is reduced by $20,000 under § 108(e)(5).

When the fair market value of the installment obligation is more than its face amount, the selling senior family member's estate recognizes gain measured by the value of the note.[48] The younger generation buyer should be able to increase his basis in the property purchased by the excess of value over the face amount of the note.[49] If the buyer whose note is canceled by the selling senior family member's will is not a related party within the statutory definition, for example, a son-in-law, the fair market value of the note is used to determine the gain reported by the estate.[50]

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[46] § 691(a)(5)(A)(ii).

[47] § 691(a)(5)(B).

[48] Read § 691(a)(5)(B) carefully.

[49] See Lane and Zaritsky, Federal Income Taxation of Estates and Trusts, 3d Edition ¶ 15.05[5][c][ii] (2001).

[50] § 691(a)(4)(A).

The rule that the value of the note is not less than its face amount applies only when the buyer is related to the selling senior family member.[51] The amount reported as income in respect of a decedent by the successor is the excess of value over the decedent's basis in the note.[52]

¶ 1001.2 Private Annuity Sales

Private annuity sales are arrangements that permit a senior family member to receive a fixed amount periodically for the remainder of the seller's life or the joint lives of the seller and the seller's spouse. The traditional tax treatment of private annuity sales developed in a series of rulings and cases as an application of cash accounting principles in combination with some of the rules that apply primarily to commercial annuities, all without specific statutory authority.

A. Commercial Annuities

Under a commercial annuity arrangement, the insurance company receives one or more premium payments and agrees to make a prescribed series of future payments, usually measured by the annuitant's life, a specified term or some combination. The payments represent not only return of the premium but also an implicit interest element for the annuity term. Under § 72, a portion of each annuity distribution is treated as a tax-free return of the annuitant's initial deposit by use of a mechanism called the "exclusion ratio," and the balance, representing what is essentially interest income, is annuity income.[53] Any distributions representing the annuitant's cost in the annuity contract, referred to as the "investment in the contract,"[54] are a tax-free return of basis.[55] This investment in the contract, the numerator of the exclusion ratio, is the total of premiums the annuitant paid the insurance company. The denominator of the exclusion ratio is the total of all amounts the annuitant expects to receive under the annuity contract (without discounting to present value) determined by actuarial tables,[56] referred to as the "expected return."[57] The exclusion ratio in annuity taxation has a function similar to that of the gross profit ratio in the installment method as the mechanism for defining the recovery of basis. The exclusion ratio determines the amount of each payment that effectively represents interest income. This exclusion ratio

[51] §§ 691(a)(5)(B) and 453B(f)(2).
[52] § 691(a)(4)(B).
[53] § 72(b)(1); Reg. § 1.72-4.
[54] § 72(c)(1); Reg. § 1.72-6.
[55] § 72(b)(1); Reg. § 1.72-3.
[56] See Reg. § 1.72-9.
[57] § 72(c)(3); Reg. § 1.72-5.

differs in that it provides a straight-line allocation of the income on a cash basis rather than the compound-interest accrual approach of the OID interest rules.

When annuity payments are payable for a period measured by a life, the annuitant can die before or after the actuarial period in the mortality table. An annuitant who dies exactly when his actuarial life expectancy ends excludes from income an amount exactly equal to the premiums paid. An annuitant who dies prematurely deducts the unrecovered "investment in the contract" on the final income tax return.[58] An annuitant who survives beyond the table's life expectancy recovers the entire investment in the contract, and can no longer exclude any portion of subsequent annuity payments.[59]

When a senior family member sells the family business or other financial assets to a junior family member on terms that measure the payments by the selling senior family member's (or another person's) life, the transaction is a private annuity sale. Traditional private annuity sale treatment is a special application of cash accounting principles, in which the gain on the sale is allocated over the payment period using the principles of annuity taxation outlined above.[60] A deferred payment redemption by a family corporation can be a private annuity obligation.[61]

During the actuarial life expectancy of the selling senior family member in a private annuity sale, the annuity payments are divided into three parts: (1) a basis recovery element, determined by allocating the basis of the shares over the selling shareholder's life expectancy under the income tax annuity tables; (2) a (capital) gain element, measured by any excess of the value of the annuity under the gift tax actuarial tables over the basis of the shares, which is also allocated over the income tax life expectancy; and (3) an annuity (or interest) income element, measured by the difference

[58] § 72(b)(3)(A); H.R. Rep. No 426, 99th Cong., 1st Sess. 731 (1985); S. Rep. No. 313, 99th Cong. 1st Sess. 607 (1986). No deduction for unrecovered basis is permitted if the annuitant dies before the annuity starting date.

[59] § 72(b)(2). Prior to 1987, the annuitant could exclude a portion of all annuity payments, including the mortality gain payments, and no deduction was permitted for unrecovered basis if there was a mortality loss. There was previously a conflict between Rev. Rul. 69-74, 1969-1 C.B. 43, and Reg. § 1.1011-2(c) Example (8) about what happened if the selling family member lived beyond the actuarial period.

[60] Rev. Rul. 69-74, 1969-1 C.B. 43. The IRS revoked its earlier position in Rev. Rul. 239 where it applied the open transaction approach and allowed all principal payments to be first a recovery of basis. See also Rev. Rul. 55-119, 1955-1 C.B. 352, dealing with the family buyer's basis.

[61] Cf. *Fehrs Finance Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1983), *cert. den.* 416. U.S. 938 (applying § 304 to a redemption through a related corporation with the price paid in the form of a private annuity).

between the amount of the payment and the sum of the first two items, using the lower of the fair market value of the family business or the present value of the annuity to measure the payment.[62] Thus the recovery exclusion in a private annuity sale is divided between the recovery of the selling senior family member's basis in the family assets transferred and any unrealized gain inherent in those assets. Accordingly, private annuity sale treatment parallels the installment method, but with significant differences.[63]

Surprisingly, traditional private annuity sale treatment is not available for secured private annuity sales.[64] Although G.C.M. 39503 seems to assume that being ineligible for private annuity sale treatment means immediate recognition of gain,[65] this is questionable. The cases requiring immediate recognition for secured private annuity sales did so as an application of cash accounting principles and did not discuss installment sales, because, at that time, contingent deferred payment sales were not eligible for installment sale treatment. This is no longer true. Accordingly, the IRS position may create an anomaly in that an unsecured private annuity sale is taxed under annuity principles, while an identical secured one is an installment sale. Despite this possibility, most commentators assume that if a private annuity is secured, immediate gain recognition is required.

The buying family member is not entitled to any interest deduction even though the portion of the payment representing the time value of money is annuity income for the selling family member.[66] On the other hand, the buyer's initial basis of the family assets transferred is measured by the anticipated payments to the extent of the fair market value of the annuity obligation.[67] Both of these results are inconsistent with those that apply

[62] Rev. Rul. 69-74, 1969-1 C.B. 43; G.C.M. 39503, Issue (2)(C)(1)(a); see Reg. § 1.1011-2(c) Example (8).

[63] See generally, Manning and Hesch, *supra* note 4 at ¶ 302.2.

[64] See *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 788 (1978); but see Priv. Ltr. Rul. 81-02-029 (Oct. 14, 1980) (applying traditional private annuity sale analysis to basis determination in a secured private annuity sale without comment).

[65] G.C.M. 39503, Issue (2)(C)(1)(a), *supra* note 4.

[66] See, e.g., *Dix v. Commissioner*, 392 F.2d 313 (4th Cir. 1968); G.C.M. 39503, Issue (2)(C)(3), *supra* note 4. See, *Rye v. United States*, 92-1 U.S.T.C. ¶ 50,186 (Cl. Ct. 1992), denying an interest deduction even though the seller reported the transaction as an installment sale. The court in *Rye* explicitly stated that there is no need for symmetry between the buyer and the seller.

[67] Rev. Rul. 55-119, 1955-1 C.B. 352; G.C.M. 39503, Issue (2)(C)(2)(a), *supra* note 4. As the buying family member makes further payments, they are added to basis, apparently without regard to fair market value of the property. This converts the excess payment, a substantial part of which represents the time value of money, into a capital loss on disposition of the family business or financial assets by the buyer.

to contingent payment installment sales, but are consistent with the exclusion of annuity transactions from the OID rules.[68] Even with that exclusion, the denial of an interest deduction for the younger generation buyer is questionable.

The younger generation buyer's initial tentative basis for the property is increased when the aggregate of the actual payments exceed the initial tentative basis.[69] Because there is no interest deduction, this occurs well before the end of the selling senior family member's actuarial life expectancy and can lead to a final basis far in excess of value. If the family seller dies before payments equal the tentative basis, the basis is reduced to payments already made.[70] A buyer who disposes of the property during the selling family member's lifetime generally computes gain or loss using the tentative basis at the time of the sale. Subsequent payments are additional losses on sale of the family assets.[71]

When an intended source of payment for the deferred payment obligation to purchase the family business (or other family financial assets) is the income generated by the assets purchased, and the payment is dependent on the selling senior family member's life, there is an appearance of a trust equivalent where there is a retained interest in the property transferred. Nevertheless, the family assets sold should not be included in the gross estate of the selling senior family member as a retained life estate under § 2036(a). Section 2701 applies only to retained equity interests, and, thus, does not apply to debt obligations. Accordingly, a bona fide deferred payment sale should fall outside of § 2701 even when the payment is in the form of a private annuity sale, but not if the payments are dependent on earnings.[72]

An individual who saves by depositing money in a commercial savings account must report the interest earned each year under the doctrine of constructive receipt even if no withdrawals are made. Even an individual who buys a long-term certificate of deposit where early withdrawal incurs a penalty must report interest as earned under the OID rules.[73]

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68 § 1275(a)(1)(B) (debt obligation does not include amounts taxed as annuities). In G.C.M. 39503, *supra* note 4, and Priv. Ltr. Rul. 90-09-064 (Dec. 8, 1989), the IRS indicated that it will continue to apply the § 72 annuity rules instead of the § 453 installment method to private annuity sales. In *Rye v. United States*, *supra* note 66, the court applied the § 72 annuity rules to a private annuity sale.

69 Rev. Rul. 55-119, *supra* note 67; G.C.M. 39503, Issue (2)(C)(2)(a), *supra* note 4.

70 Rev. Rul. 55-119, *supra* note 67.

71 See Rev. Rul. 55-119, *supra* note 67.

72 See Leimberg, Johnson, Doyle and Kurlowicz, *Sections 2701-2704: Good Motives But A Tough Law To Follow*, 16 Tax Management Est. Gifts & Tr. J. 83, 88 (1991).

73 Reg. § 1.1275-1(b).

Example 1: A deposits $2,486.90 in a savings account on January 1, 2000. The bank pays 10.0% annual interest. A intends to withdraw $ 1,000 annually for the next three years beginning on December 31, 2000. The following illustrates the interest income earned each year:

Deposit on January 1, 2000	$2,486.90
Interest at 10.0% for 2000	+ 248.69
Withdrawal on December 31, 2000	- 1,000.00
Balance on January 1, 2001	$1,735.59
Interest at 10.0% for 2001	+ 173.55
Withdrawal on December 31, 2001	- 1,000.00
Balance on January 1, 2002	$ 909.14
Interest at 10.0% for 2002	+ 90.91
Withdrawal on December 31, 2002	- 1,000.00
Balance	-0-

When an individual purchases an annuity, the implicit interest in the internal buildup in the policy is not taxed currently. The doctrine of constructive receipt does not apply because the annuitant does not have a right to withdraw as the interest is earned. Instead, the basic mechanism is to bifurcate each annuity payment between basis recovery and income on a straight line basis by use of the "exclusion ratio,"[74] the fraction determined by dividing the annuitant's "investment in the contract"[75] by the "expected return,"[76] that is, the total of the undiscounted payments to be made. If all payments to be made are not subject to any contingencies, then the guaranteed number of payments is used to determine the expected return.[77] If there is a contingency, such as payments to be made for the rest of the annuitant's life, then the life expectancy of the annuitant at the "annuity starting date" is the multiple used to determine the expected return.[78] The annuity starting date is the date in the future that the annuity payments are to commence.[79] The life expectancy multiples used in determining the expected return are prescribed in the Regulations under § 72.[80]

Example 2: B purchases an annuity on January 1, 2002, for $2,486.90, the present value of $1,000 a year for three years at 10.0%, the § 7520

[74] § 72(b)(1).
[75] § 72(c)(1).
[76] § 72(c)(3).
[77] § 72(c)(3)(B).
[78] Reg. § 1.72-9, Table V.
[79] § 72(c)(4).
[80] Reg. § 1.72-9, Table V.

rate. This annuity contract provides that B will receive $1,000 annually for three years, the first payment to be made on December 31, 2002.

The "investment in the contract" is $2,486.90 (the premium paid). The "expected return" is $3,000. The "exclusion ratio" is 82.89%. Therefore, B must report $171.03 as income every time he receives a $1,000 annuity payment.

The annuity reporting rules do not change the aggregate amount of income reported. But the timing rules for annuities create a deferral advantage.

Table A

Year	*Annuity Income*	*Interest Income*
2000	$171	$249
2001	171	174
2002	171	90
Total	$513	$513

B. Private Annuity Sales

The traditional income tax treatment of private annuity sales developed before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent payment sales,[81] presumably including sales with payments in the form of an annuity.

The following facts will be used to illustrate the tax consequences of the private annuity and SCIN examples below.

Example 3: S is 70 years old. On December 1, 2001, S sells the stock in a family business corporation to B for $ 1,000,000. S's basis for the stock is $200,000 and it is worth $1,000,000.

Under Reg. § 1.72-9, Table V, a 70-year old has a life expectancy of 16.0 years. However, the estate and gift tax valuation tables in Reg. § 20.2031-7(f) which adopt the tables in Book Aleph (the 90CM tables) use 13.9 years as the life expectancy of a 70 year old. As announced in Rev. Rul. 2001-54,[82] the interest rates for December, 2001 are: (i) long-term AFR 5.05% and (ii) § 7520 rate 4.8%.

1. Installment Sale

For comparison purposes, we will first illustrate an installment sale in which the younger generation buyer makes a level annual payment over

[81] See H.R. Rep. No. 1042, 96th Cong., 2d Sess. 10, note 12; S. Rep. No. 1000, 96th Cong., 2d Sess. 12, note 22.

[82] Rev. Rul. 2001-58, 2001-50 I.R.B. 579.

a fixed term. When all payments are fixed, the deferred payment arrangement is an installment sale governed by the installment reporting rules under § 453. The 16-year term for the payments corresponds to the selling senior family member's 16-year life expectancy used in the income tax tables.[83]

Example 4: On December 1, 2001, S sells his family business shares, with a basis of $200,000, to B for $1,000,000. S agrees to finance the entire $1,000,000 purchase price over 16 years. In order to avoid any imputed interest issues, B will pay interest at 5.05%, the long-term AFR for December 2001. A gross profit ratio of 80% is applied to each principal payment to determine the amount of capital gain reported under the installment method.

Using 5.05% interest, the present value of $1.00 annually for 16 years is $10.799304. Therefore, the annual payment is $92,599 ($1,000,000 divided by $10.799304).

For income tax purposes, B's basis is $1,000,000 because § 1274 treats $1,000,000 as both the imputed and the stated principal amount of B's obligation.

The amount, character and timing of S's income upon receipt of each annual payment, using an 80% gross profit ratio for each principal payment, is:

Year	*Payment*	*Basis*	*Capital Gain*	*Interest*
12-1-02	$92,599[84]	$ 8,420	$ 33,679	$ 50,500
12-1-03	92,599	8,845	35,380	48,374
12-1-04	92,599	9,292	37,166	46,141
12-1-05	92,599	9,761	39,043	43,795
12-1-06	92,599	10,254	41,015	41,330
12-1-07	92,599	10,772	43,086	38,741
12-1-08	92,599	11,315	45,262	36,021
12-1-09	92,599	11,887	47,548	33,164
12-1-10	92,599	12,487	49,949	30,162
12-1-11	92,599	13,118	52,471	27,009
12-1-12	92,599	13,780	55,121	23,697
12-1-13	92,599	14,476	57,905	20,218
12-1-14	92,599	15,207	60,829	16,562
12-1-15	92,599	15,975	63,901	12,723
12-1-16	92,599	16,782	67,128	8,689
12-1-17	92,599	17,629	70,518	4,451
	$1,481,577	$200,000	$800,000	$481,577

As the above indicates, the 80% gross profit ratio is applied each year to an increasing principal payment. As the outstanding principal balance

[83] Reg. § 1.72-9, Table V.

[84] Actual payment is $92,598.56.

is reduced each year, the interest portion of each succeeding payment decreases. If any of the seller-provided financing is later canceled, the amount of the cancellation is a purchase price adjustment that reduces the buyer's basis.[85]

2. Traditional Treatment of Unsecured Private Annuities

Because the IRS does not treat a private annuity as a contingent payment installment sale, the IRS requires the reporting of private annuity sales under the annuity rules.[86] Under the annuity rules, the younger generation buyer's basis initially equals the value of the private annuity obligation, but changes depending upon the aggregate amount the buyer pays under the annuity arrangement.[87]

This "tentative basis" is finally determined only after the selling senior family member dies, and all payments are finally fixed. The younger generation buyer's "final" basis is equal to the aggregate of all annuity payments made to the seller.

Once the total of all payments made exceeds the tentative basis amount, each additional payment is added to the buyer's basis. The basis only becomes final when the payments cease. If the selling senior family member dies before the total of the annuity payments made equals the tentative basis amount, then the final basis is an amount equal to the payments actually made. If the younger generation buyer sells the family business or other financial assets before the selling senior family member's death, there is a split basis, with gain determined using the tentative basis, but loss allowed only to the extent the sale price is less than payments made.[88] All subsequent payments are loss, whether gain or loss was realized on the interim sale of the family business or other financial assets.

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[85] § 108(e)(5).

[86] See GCM 39,503 Issue (1) *supra* note 4. Rev. Rul. 55-119, *supra* note 67; Rev. Rul. 69-74, *supra* note 62. At the time Rev. Rul. 69-74 was issued, the annuity rules under § 72 permitted the indefinite use of the exclusion ratio, thereby permitting an annuitant to continue to exclude from taxation a portion of all annuity payments as the investment in the contract even though he had previously recovered his entire investment in the contract. Effective for annuities starting after December 31, 1986, § 72(b)(2) eliminated this so-called mortality gain. The discrepancy between Rev. Rul. 69-74, treating the seller's basis in the property sold as his investment in the contract, and Reg. § 1.1011-1(b) Example (8), treating the value of the property sold as the investment in the contract, no longer has any tax significance because of § 72(b)(2) which precludes the use of the exclusion ratio once the entire basis is recovered.

[87] Rev. Rul. 55-119, *supra* note 67.

[88] *Id.*

No interest is imputed for any annuity payment made by the younger generation buyer.[89] The effect is that the entire amount of each annuity payment made by the buyer is treated as a principal payment. The inability of the buyer to treat any portion of an annuity payment as interest expense requires the buyer to capitalize, as part of his basis, what is realistically an interest expense. Because the younger generation buyer cannot treat any portion of the annuity payment as interest expense, the total of the actual payments will exceed the tentative basis amount well before the selling senior family member reaches his actuarial life expectancy. Therefore, a younger generation buyer using a private annuity sale arrangement can expect to have a basis for an asset far greater than the amount he paid for it (i.e., greater than its value).

Another distortion is caused when the generally higher interest rates (the § 7520 rate is 120% of the mid-term AFR) and shorter mortality assumptions found in the gift tax valuation tables under Reg. § 20.2031-7(f), which adopts Book Aleph, are used to calculate the annuity payments. The amount of each annuity payment will be larger than if the lower income tax interest rate and longer income tax mortality assumptions are used. Since Rev. Rul. 55-119 requires the use of the gift tax valuation tables,[90] the younger generation buyer can end up undertaking an obligation that has a value greater than the value of the property purchased as determined under the OID rules. If the buyer lives to the longer actuarial life expectancy used in Reg. § 1.72-9, Table V, the buyer will end up paying far more for the property than it may be worth, with a resultant basis greater than its value.

Example 5: The facts are the same as in Example 3. B, the buyer, agrees to pay S an annual annuity payment for the rest of the S's life. If the annual annuity payment is computed using the transfer tax tables in the Book Aleph[91] at 4.8%, the § 7520 rate, it is $107,853 ($1,000,000 divided by 9.2719).

The investment in the contract is $200,000. The expected return is $1,725,644 ($107,853 x 16.0 year life expectancy using the income tax annuity tables). Therefore, the exclusion ratio is 11.59%.[92]

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[89] *Dix v. Commissioner, supra* note 66; *Rye v. United States, supra* note 66; *Bell v. Commissioner,* 76 T.C. 232 (1981). Under § 1275(a)(1)(B)(i), the OID and unstated interest rules do not apply. For the seller, the annuity rules under § 72 accomplish the same objective as the imputed interest rules under § 1274. Under § 72, the seller treats a portion of each payment as "annuity income." This is in effect the interest component.

[90] In *Estate of Bell v. Commissioner, supra* note 64, the court sanctioned the use of the estate and gift tax tables in valuing an annuity obligation under Rev. Rul. 55-119 for determining the buyer's tentative basis.

[91] Actuarial Tables Book Aleph, Publication 1457 (July 1999).

[92] By using a 16.0 year life expectancy under § 72, the seller will end up recovering his

Assume that S survives for 19 years and dies on 12-15-20. Under the § 72 annuity rules the amount, character and timing of S's income is as follows:

Date	Payment	Basis	Capital Gains	Annuity Income
12-1-02	$ 107,853[93]	$ 12,500	$ 50,000	$ 45,353
12-1-03	107,853	12,500	50,000	45,353
12-1-04	107,853	12,500	50,000	45,353
12-1-05	107,853	12,500	50,000	45,353
12-1-06	107,853	12,500	50,000	45,353
12-1-07	107,853	12,500	50,000	45,353
12-1-08	107,853	12,500	50,000	45,353
12-1-09	107,853	12,500	50,000	45,353
12-1-10	107,853	12,500	50,000	45,353
12-1-11	107,853	12,500	50,000	45,353
12-1-12	107,853	12,500	50,000	45,353
12-1-13	107,853	12,500	50,000	45,353
12-1-14	107,853	12,500	50,000	45,353
12-1-15	107,853	12,500	50,000	45,353
12-1-16	107,853	12,500	50,000	45,353
12-1-17	107,853	12,500	50,000	45,353
12-1-18	107,853	-0-	-0-	107,853
12-1-19	107,853	-0-	-0-	107,853
12-1-20	107,853	-0-	-0-	107,853
Total	$2,049,202	$200,000	$800,000	$1,049,202

As illustrated below, the younger generation buyer's basis in a private annuity sale reported under the annuity rules exceeds the value of the property purchased far before the selling senior family member reaches the end of his actuarial life expectancy. This is because the buyer cannot deduct any portion of his annuity payments as interest expense, and because the transfer tax tables used in determining the annual annuity payments use shorter life expectancies and higher interest rates, thereby increasing the amount of the annual annuity payment that is required to avoid gift tax.

Example 6: B's tentative basis for the private annuity sale in Example 5 is $1,000,000, the present value of the annuity obligation using the transfer tax tables at 4.8%, the § 7520 rate. As the annuity payments are made, B's tentative and final basis are as follows:

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basis over a longer term than the 13.9 year life expectancy used to compute the amount of the annual annuity payment. In other words, the recovery of basis is over a 16.0 year period instead of over 13.9 years. The 16.0 years is adjusted for the frequency of payment if less often than quarterly. Reg. § 1.72-5(a)(2)(i).

[93] Actual payment is $107,852.75.

Date	Annual Payment	Payments to Date	Tentative Basis[94]
12-1-02	$107,853	$107,853	$1,000,000
12-1-03	107,853	215,706	1,000,000
12-1-04	107,853	323,559	1,000,000
12-1-05	107,853	431,412	1,000,000
12-1-06	107,853	539,265	1,000,000
12-1-07	107,853	647,118	1,000,000
12-1-08	107,853	754,971	1,000,000
12-1-09	107,853	862,824	1,000,000
12-1-10[95]	107,853	970,677	1,000,000
12-1-11	107,853	1,078,530	1,078,530
12-1-12	107,853	1,186,383	1,186,383
12-1-13	107,853	1,294,236	1,294,236
12-1-14	107,853	1,402,089	1,402,089
12-1-15	107,853	1,598,942	1,598,942
12-1-16	107,853	1,617,795	1,617,795
12-1-17	107,853	1,725,648	1,725,648
12-1-18	107,853	1,833,501	1,833,501
12-1-19	107,853	1,941,354	1,941,354
12-1-20	107,853	2,049,207	2,049,207

If the selling senior family member in a private annuity sale reported under the § 72 annuity rules dies before reaching his actuarial life expectancy, there is an unrecovered "investment in the contract." Presumably, the seller may deduct any unrecovered basis on his final income tax return under § 72(b)(3)(A). The character of the loss for unrecovered basis should be determined by reference to the character of the property sold, rather than being viewed as a loss in an independent annuity transaction.[96] Where the asset sold is a capital asset, the loss is a capital loss. Nevertheless, when the buyer in a private annuity sale is related to the seller, the loss provided an annuitant for unrecovered basis on premature death should not be disallowed under the related party rule of § 267(a)(1) because it is not part of the sale, but part of the annuity transaction.[97]

Example 7: If S dies at the end of the year 2010 at age 80, having received only 10 of the expected 16 annual payments, the remaining, unrecovered basis is $75,000. S is permitted to deduct $75,000 on his final income tax return. B's basis is finally determined to be $1,078,528, the aggregate of all payments made for 10 years.

94 Had an interest deduction been allowed equal to the $45,353 annual annuity income the seller reported, so that the tentative basis would not have exceeded $1,000,000 until after 16 years.

95 The buyer's basis in the shares purchase begins to exceed the $1,000,000 value of the shares by the tenth annual payment.

96 See *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

97 § 72(b)(3)(A).

3. Secured Private Annuity

There is some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Reg. § 1.1275-1(j), because there are no provisions that can significantly reduce the probability that the total payments under the contract will increase commensurately with Senior's longevity as there would be for a SCIN (or PATY). On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method.[98] Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of § 453(j)(2) that expressly recognizes contingent payment installment sales.[99] Accordingly, if it is not a private annuity under § 72, a disposition of qualifying property for a secured private annuity based solely on Senior's life should be treated as a contingent payment installment sale. The obligation, however, apparently is not a debt obligation under Reg. § 1.1275-1(j) because security is not one of the factors listed for qualifying for the annuity exclusion. As a contingent payment installment sale, the OID rules would treat a portion of each annuity payment as an interest expense.[100] Since it appears that the IRS will not treat a secured private annuity as an installment sale, the IRS will then require all gain to be recognized at the time of the initial sale. Since we believe that it is unsound to have radically different tax treatment of secured and unsecured private annuities, we favor treating all private annuities as contingent payment installment sales. Since this recommendation has not yet been adopted by any regulations, ruling or other published IRS authority, despite Congressional authority to do so,[101] or by any court decision, traditional private annuity treatment apparently remains available only for unsecured private annuities.

As illustrated above, the capital gain realized on the private annuity sale is reported ratably over the life expectancy of the annuitant, but the life expectancy for this purpose is that in Reg. § 1.72-9 Table V instead of the shorter one in used to determine the annual annuity under Table 90CM. Under Table 90CM an individual age 70 has a life expectancy of 13.9 years. Under the § 72 table, an individual age 70 has a life expectancy of 16.0

[98] *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973); *212 Corp. v. Commissioner*, 70 T.C. 788 (1978); cf. Reg. § 1.83-3(e); G.C.M. 39503 (Issue (2)(c)(1)(a), *supra* note 4.

[99] Sen. Rep. No. 96-1000, 96th Cong. 2d Sess. at 22, 1980-2 C.B. at 496.

[100] Reg. § 1.1275-4(c).

[101] *See* Sen. Rep. No. 96-1000, *supra* note 100, at 23, 1980-2 C.B. at 506.

years.[102] Obviously, the younger the individual, the longer the life expectancy and longer deferral can be achieved. A joint and survivor annuity for the senior family member and that individual's spouse increases the deferral. For example, the joint life expectancy of two individuals, both age 70, is 20.6 years for § 72 purposes, as opposed to the 16.0 years for one individual age 70.

¶ 1001.3 Self-Canceling Installment Note Sales

A senior family member may desire a sale in which the payments are limited to her life expectancy. When the arrangement involves a fixed term with an earlier limit based on life, it is called a self-canceling installment note.

A SCIN is appropriate when the selling family member does not feel the need to receive payments for her entire life. The maximum term places a cap on how much the younger generation buyer pays, but limits the selling senior family member's life-time security. A SCIN is a hybrid, using the installment approach in determining the maximum amount the younger generation buyer will pay, and the private annuity sale approach in the event the selling senior family member dies before the end of the note term. Because the selling senior family member no longer has a right to payment when the note is terminated by its own terms on death, no amount is included in the gross estate.[103]

A major advantage of a private annuity sale to the senior family member seller is that the periodic payments for his life continue to fund his retirement even if he survives beyond the actuarial life expectancy age. The corresponding advantage to the younger generation buyer is that if the selling senior family member dies sooner than actuarially indicated, he may receive a bargain, paying less for the property than it is worth. Because of this risk, private annuity sales and SCINs are generally used only in sales between family members.

The IRS apparently resolves the ambiguity created by the hybrid nature of a SCIN by classifying SCINs as private annuity sales when the maximum fixed period exceeds the selling senior family member's actuarial life expectancy, and as installment sales when it does not.[104]

The IRS position, at least prior to 1999,[105] is that if the selling senior family member's life expectancy, using the mortality assumptions in Reg.

[102] As adjusted in Reg. § 1.72-5 (a)(2)(1) if the payments are less frequent than quarterly.

[103] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result only* 1981-2 C.B. 2; *Cain v. Commissioner*, 37 T.C. 185 (1961), *acq.* 1961-2 C.B. 4.

[104] But, see impact of recent regulation *infra* text at note 135.

[105] G.C.M. 39503, *supra* note 4.

§ 1.72-9, is less than the maximum term of the SCIN, it is taxed as a private annuity sale under § 72, and if the seller's life expectancy is longer than the loan term, it is taxable as an installment sale.[106] In addition to the effects of life expectancy and discount rate differences, there are several crucial income tax differences between these two approaches. The timing of the selling senior family member's gain and ordinary income, the buyer's deductions for the time value of money, the buyer's basis, and the effect of the seller's premature death all differ. There is further confusion because a private annuity sale cannot be secured, but an installment sale can be secured.

A. Under the Annuity Rules

The annuity rules applied to a SCIN are the same as for a straight private annuity sale with only minor modifications to reflect the maximum term.

In calculating the "expected return," the two factor life expectancy multiple under Reg. § 1.72-9, Table VIII, must be used. A SCIN is a "temporary life annuity" because it has a maximum duration. The "exclusion ratio" so determined allocates the same amount of principal and annuity income to each payment.

Even though the income tax consequences are determined using the annuity tables of § 72, the younger generation buyer uses an initial tentative basis equal the present value of the SCIN obligation.[107] As for a standard private annuity sale, the younger generation buyer is not permitted an interest deduction.

When the annuity rules apply, and the SCIN is canceled by the selling senior family member's death before the maximum payment term, the younger generation buyer's final basis under the annuity rules is limited to payments made. Neither the selling senior family member nor the estate reports the remaining gain inherent in the canceled payments because the early disposition rules of § 453B apply only to obligations reported on the installment method. The annuity reporting rules permit the selling senior family member to deduct any remaining basis on his final income tax return.[108]

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[106] G.C.M. 39503, *supra* note 4. In Rev. Rul. 86-72, 1986-1 C.B. 253, the IRS discussed how the installment sale rules under § 453B and § 691(a) applied upon the death of a seller under a SCIN. The maximum term of the obligation in this ruling was 4 years and the seller's life expectancy was 21 years.

[107] It is not clear whether the income tax rate (the AFR) or the § 7520 rate is the proper discount rate to use. See text at note 160 *infra*.

[108] § 72(b)(3)(A). Because practitioners rarely use SCINs characterized as annuities, we omitted examples of § 72 treatment.

B. Under the Installment Method

When a SCIN is treated as an installment sale under the IRS approach, the installment method employs dramatically different rules from those that apply to a SCIN classified as a private annuity sale.

1. Fixed or Contingent Installment Sale?

A SCIN is a contingent payment sale with a stated maximum selling price.[109] The maximum selling price is the "selling price" that is used in the denominator of the "gross profit ratio," and determines the "gross profit" used in the numerator.[110] However, it appears that the IRS treats a SCIN as a fixed payment installment sale.[111]

It is not clear whether the entire premium representing the risk that the selling senior family member will die before the end of the note term must be treated as additional principal, or can be treated as additional interest as long as the interest does not become so high as to be excessive. The IRS has not issued any guidance on this issue.[112]

2. Reporting the Gain in Canceled Principal

If the tax treatment of a SCIN is governed by the installment method, the remaining capital gain is accelerated upon cancellation of the obligation if it is an obligation of a related party.[113]

Although the entire capital gain inherent in the deferred payment obligation is reported even though the obligation is canceled, there may be no symmetrical treatment for the younger generation buyer's basis. Under the contingent payment regulations, the buyer undertaking a contingent payment obligation may obtain basis only for principal payments actually made.[114] We feel that this anomalous result should not apply, and that the younger generation buyer's basis should equal the principal amount of the obligation, even if the note is canceled.

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109 Temp. Reg. § 15A.453-1(c)(1) and (2).

110 Temp. Reg. § 15A.453-1(c)(2)(i)(A), (b)(2)(ii) and (b)(2)(v).

111 See text at note 176 *infra*.

112 There has been a debate on the treatment of this risk premium. Compare Blum, *Self-Cancelling Installment Notes—The New SCIN Game?*, 60 Taxes 183 (1982), with Banoff and Hartz, *It's No Sin to SCIN! A Reply to Professor Blum*, 60 Taxes 187 (1982).

113 Rev. Rul. 86-72, *supra* note 107, and G.C.M. 39503, *supra* note 4; *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992), *rev'd on another issue*, 998 F.2d 567 (8th Cir. 1993).

114 Reg. §§ 1.483-5(b)(3)(iv) and 1.1275-4(c)(4) Example (1)(iii); but see G.C.M. 39503, Issue (2)(C)(2)(b), *supra* note 4 allowing the buyer who purchases for a contingent price to include the maximum principal amount of the obligation in basis. In *Rye v. United States*, *supra* note 66, the court stated that symmetry between the buyer and seller is not required in a private annuity sale.

In Rev. Rul. 86-72,[115] the IRS reached the questionable result that the accelerated gain upon the cancellation of a SCIN is reported by the estate.[116] A better view is that the accelerated gain should be reported on the selling senior family member's final income tax return.[117] Under the IRS view, the "transfer" treated as an early disposition within the context of § 691(a)(2) does not automatically occur at the moment of death. The IRS has ruled that the triggering transfer, and related recognition of gain, does not occur until the earlier of (i) the executor's assent to the distribution of the notes under state law, (ii) the cancellation of the notes by the executor under state law, (iii) the note becoming unenforceable, or (iv) termination of the estate administration for Federal income tax purposes.[118] In other words, state law controls when the obligations are transferred for purposes of determining when the taxable early disposition has occurred.

The SCIN term should not be set to expire too far beyond the grantor's life expectancy because of both practical and reality-of-sale considerations. As a practical matter, the greater the SCIN term, the greater the risk premium and corresponding increase in interim interest payments. Moreover, under reality-of-sale principles, if the principal payment is postponed to a date that makes payment of principal during the grantor's life highly unlikely, the transaction is likely to be recast as a trust substitute under § 2036(a)(1). Possibly because of the practical considerations, there has been little discussion of the maximum SCIN term.[119] One possible analogy is Reg. § 1.1275-1(j)(6)(iii) that treats an annuity with a time limit greater than twice the annuitant's life expectancy as not being subject to a significant limitation, which suggests the contrary—that a SCIN for a term greater than twice the decedent's life will not be treated as a bona fide sale for a stated principal amount. The negative pregnant—that a sale for any shorter period will be treated as bona fide—is sound. Whatever actuarial table is used to measure the decedent's life expectancy already has a built-in assumption that approximately 50% of the class of persons measured—the general population in Table 90CM and annuitants in Reg. § 1.72-9 Table V—will die before the specified term. Accordingly, any term more than a small period beyond that date is subject to substantial risk.

[115] 1986-1 C.B. 253.

[116] § 691(5)(A)(iii).

[117] The Tax Court agreed that the gain should be reported on the seller's final income tax return. *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992), *rev'd* 998 F.2d 567 (8th Cir. 1993). The Eighth Circuit reversed on this issue, requiring the gain to be reported on the estate's first fiduciary income tax return (Form 1041).

[118] Priv. Ltr. Rul. 85-52-007 (Sep. 18, 1985).

[119] See Hartz & Banoff, *Planning Opportunities Available Using a Private Annuity for a Terms of Years*, 65 J. Tax'n 302, 308 (1986).

The Reg. § 1.72-9 Table V more closely reflects the individuals who are likely to engage in the types of transactions considered in this paper. Any period longer than the Reg. § 1.72-9 Table V life is risky, and should be used only for clients who take an aggressive approach to estate planning even recognizing that, because of the risk premium, a SCIN is only a good deal if the grantor-seller dies before payment of the principal on the promissory note

When Senior dies, any unpaid balance on the SCIN is not included in Senior's gross estate because of the self-canceling feature.[120] Nevertheless, the trust has a cost basis in the assets measured by the initial principal amount of the SCIN. This is because notwithstanding the cancellation of the note at death, it is deemed to be satisfied at its principal amount because the obligee is a related party,[121] so that the previously realized but deferred gain is recognized. Although the *Frane* case on appeal held that the gain is reported as IRD on the estate's income tax return, the better view is that the accelerated gain is reported on the decedent's final income tax return.

The difference in payment terms between a SCIN taxed as an installment sale on the one hand, and a SCIN taxed as a private annuity sale on the other is complicated by the different life expectancy and discount rates used for income tax purposes than those used for transfer tax purposes. Using the 90CM tables and the § 7250 rate, the IRS has published a simplified method for determining the relevant divisor to be used in determining the annual payment for a SCIN.[122]

3. Income Tax Characterization of a SCIN

Example 1: Senior, age 70, owns stock in the family business worth $1,000,000, with a basis of $200,000. The long-term AFR for December 2001 is 5.05% annual interest. The § 7520 rate for December 2001 is 4.8%. Under Reg. § 1.72-9, Senior's life expectancy is 16.0 years.[123] Under 90CM Senior's life expectancy is 13.9 years.

Senior agrees to sell his stock to Junior for a 16-year, interest-only installment note, with all principal due at the end of the note term. The

[120] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result only*, 1981-1 C.B. 2; *Cain v. Commissioner*, 37 T.C. 185 (1961), *acq.* 1961-2 C.B. 4.

[121] § 453B(g); see *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992); Rev. Rul. 86-72, 1986-1 C.B. 253.

[122] See Actuarial Values Book Aleph, Publication 1457 (July 1999) at page vi, Example (9), illustrating the determination of factors involving one life and a term of years.

[123] The 12.7 year life expectancy multiple used to determine the expected return is obtained from Reg. § 1.72-9, Table VIII.

note provides that Junior's obligation to pay principal and accrued interest is canceled if Senior dies during the note term.

As discussed above, the income tax treatment of a SCIN depends on whether it is classified as an installment sale or as a private annuity sale. Under G.C.M. 39503, this in turn depends on whether the maximum term exceeds the selling senior family member's life expectancy under the income tax annuity tables of § 72. If it does not, it is an installment sale; but if it does, it is a private annuity sale. Thus, major consequences can depend on relatively minor differences in payment periods.

Example 2: A selling senior family member who is 70 years old has an actuarial life expectancy of 16 years under the § 72 annuity tables. Accordingly, a SCIN that provides a maximum period of 15 years and 11 months is an installment sale, while one that provides a term of 16 years and 1 month is a private annuity sale under the IRS view.

For purposes of the illustrations that follow, we will assume that a 16-year note term for a SCIN is taxable as a fixed payment installment sale.

When a SCIN is taxed under the installment method, the gross profit ratio determines the allocation of each principal payment between return of basis and capital gain.

The following examples illustrate the income tax consequences of a SCIN treated as an installment sale by taking into account:

(i) whether the risk premium is to be treated as additional principal ("SCIN-PRIN") or as additional interest ("SCIN-INT"), and

(ii) the income tax mortality assumptions contained in Reg. § 1.72-9 Table V and the long-term AFR.

If the premium required, because of the risk that the selling senior family member will die before the end of the maximum term of the obligation, is characterized as an additional principal amount, then the maximum sales price of the property is greater than for a fixed payment sale. This may result in additional capital gain and a larger basis for the younger generation buyer. If the risk premium is characterized as a higher interest rate, the principal, gain and basis are the same as for a fixed payment sale, but the interest is significantly more. The discounted value of the series of payments is the same no matter how the payments which are split between principal and interest are characterized, as long as the same discount rate and actuarial assumptions apply.

The Seller

The literature and the computer software on SCINs assume that the gift and estate tax mortality tables and the § 7520 rate are used to determine the risk premium for the SCIN payments. As previously discussed, this assumption is not appropriate in all situations. Therefore, the examples that follow will illustrate the tax treatment for a SCIN using the long-term AFR as the interest rate and the longer life expectancy multiples found in Reg. § 1.72-9, Table V. The following table for a 16-year, interest-only $1,000,000 note illustrates the risk premiums using the 5.05% long-term AFR and Reg. § 1.72-9 Table V:

Life Expectancy

Reg. § 1.72-9 Table V	16.0 years

Risk Premium

Rate Risk Premium	3.60709%
Interest Rate With Premium	8.65709%
Principal Risk Premium	$ 441,528
Principal With Risk Premium	$1,441,528

Example 3 SCIN-PRIN at 5.05%.

Using the long-term AFR of 5.05% and the 12.7-year actuarial period for a temporary life annuity, based on the lesser of 16 years or the life of a 70-year old, found in the income tax annuity tables, the annual interest payment for the purchase of $1,000,000 worth of shares is $72,797 and the principal obligation is $1,441,528.

The $441,528 principal risk premium increases the selling price and the seller's gain by that amount. Thus, the gross profit ratio is now 86.13% instead of the 80% for a fixed payment installment sale. The annual interest payment is greater even though the 5.05% annual interest rate remains the same because of the augmented principal amount.

The amount, character and timing of the income reported by Senior is:

DEBT AMORTIZATION SCHEDULE WITH PRINCIPAL RISK PREMIUM

Pmt No.	Yearly Payment	Interest Portion	Capital Gain Principal	Tax Free Principal	Remaining Principal
1	$ 72,797	$ 72,797	$ 0	$ 0	$1,441,528
2	72,797	72,797	0	0	1,441,528
3	72,797	72,797	0	0	1,441,528
4	72,797	72,797	0	0	1,441,528
5	72,797	72,797	0	0	1,441,528
6	72,797	72,797	0	0	1,441,528
7	72,797	72,797	0	0	1,441,528
8	72,797	72,797	0	0	1,441,528
9	72,797	72,797	0	0	1,441,528
10	72,797	72,797	0	0	1,441,528
11	72,797	72,797	0	0	1,441,528
12	72,797	72,797	0	0	1,441,528
13	72,797	72,797	0	0	1,441,528
14	72,797	72,797	0	0	1,441,528
15	72,797	72,797	0	0	1,441,528
16	1,514,325	72,797	1,241,528	200,000	
Totals	$2,606,282	$1,164,254	$1,241,528	$200,000	

Example 4 SCIN-INT at 5.05%.

Using the long-term AFR of 5.05%, the interest risk premium is 3.60709%. Since the $1,000,000 principal remains the same, the gross profit ratio also remains at 80%. With an 8.65709% annual interest rate, the annual interest payment is now $86,571. The amount, character and timing of the income reported by S is:

DEBT AMORTIZATION SCHEDULE WITH INTEREST RISK PREMIUM

Pmt No.	Yearly Payment	Interest Portion	Capital Gain Principal	Tax Free Principal	Remaining Principal
1	$ 86,571	$ 86,571	$ 0	$ 0	1,000,000
2	86,571	86,571	0	0	1,000,000
3	86,571	86,571	0	0	1,000,000
4	86,571	86,571	0	0	1,000,000
5	86,571	86,571	0	0	1,000,000
6	86,571	86,571	0	0	1,000,000
7	86,571	86,571	0	0	1,000,000
8	86,571	86,571	0	0	1,000,000
9	86,571	86,571	0	0	1,000,000
10	86,571	86,571	0	0	1,000,000
11	86,571	86,571	0	0	1,000,000
12	86,571	86,571	0	0	1,000,000
13	86,571	86,571	0	0	1,000,000
14	86,571	86,571	0	0	1,000,000
15	86,571	86,571	0	0	1,000,000
16	1,086,571	86,571	800,000	200,000	
Totals	$2,385,134	$1,385,134	$800,000	$200,000	

Compared to a SCIN-PRIN, the total payments are $221,148 less for a SCIN-INT, the reason being the larger interest payments received during the 16-year note term reduce some of the required risk premium.

If all payments are made, the total gain is $441,528 less and the total interest is $220,380 more than in Example 3, a difference of $221,148.

The Buyer

As a fixed payment installment sale, the buyer's basis is $1,000,000 for a SCIN-INT and $1,441,528 for a SCIN-PRIN.

C. When the SCIN Is Canceled

Because there is a possibility that none of the note principal payments will be made, under general income tax principles a SCIN is a contingent obligation, and it should be treated as a contingent payment installment sale. As a contingent payment installment sale, the younger generation buyer's basis is limited to payments made. This is an anomalous result when the senior family member seller dies before the end of the maximum SCIN term in a related party sale, in that the younger generation buyer's basis can be less than the aggregate of the capital gain and return of basis reported by the seller or the estate. Whatever the merits of the position of Rev. Rul. 86-72 and G.C.M. 39503 in giving the buyer an initial basis measured by the principal obligation, the logic of requiring the decedent's estate to report the entire inherent gain, supports the view that the cancellation is a bequest to the younger generation buyer that should support a basis at least equal to fair market value at death.[124] A counter argument is that although the gain is reported by the selling senior family member, the value of the remaining payments is not included in the gross estate. Nevertheless, the income tax result should prevail. We believe that a SCIN governed by the installment sale rules should be treated as a fixed payment installment obligation by both the buyer and the seller.

The effect of differences in the amount of principal depending on whether the risk premium is treated as interest or principal carries through to the consequences of termination of the SCIN upon the premature death of the selling senior family member. When the buyer and the seller are related parties, the value of the canceled installment obligation is deemed to be equal to its face amount.[125] Since a SCIN-PRIN treats the risk

[124] See Rev. Rul. 67-96, 1967-1 C.B. 195 (basis of stock acquired through exercise of option provided in will is date of death value plus any consideration paid for option). In *Estate of Frane v. Commissioner, supra* note 117, the facts indicate that the buyer's basis only included the principal payments actually made. Presumably, the buyer should have claimed a basis measured by the contingent payment obligation. The authors feel that the approach taken in G.C.M. 39503, *supra* note 4, giving the buyer an initial basis for the SCIN equal to the note principal is consistent with the required reporting of the remaining gain upon the cancellation of the note.

[125] § 691(a)(2), (a)(4)(B) and (5)(B). § 453B(f).

premium as additional principal, there is more capital gain potential than in a SCIN-INT and a greater basis for the younger generation buyer. Again, when the gain is reported by the senior family member seller's estate, the full basis should be allowed the younger generation buyer.

Example 5: Using the facts in Examples 3 and 4, assume that S dies having received only 10 annual payments. B's obligation to make the remaining six annual payments is canceled. B and S are related parties. Therefore, the value of the canceled payments is treated as equal to its face amount.

(a) SCIN-PRIN. The outstanding principal amount for the remaining payments is $1,441,528, and the unrecovered basis is $200,000. The decedent's final return or the decedent's estate reports $1,241,528 of capital gain upon cancellation of the obligation. B's basis in the shares should remain at $1,441,528 after the obligation is cancelled.

(b) SCIN-INT. The outstanding principal amount is $1,000,000, and the unrecovered basis is $200,000. The decedent's final return or estate reports $800,000 of capital gain. B's basis in the shares should remain at $1,000,000.

All of the capital gain inherent in the annual payments is eventually reported by the seller and the seller's estate. The only difference is that for a SCIN-PRIN there is an additional $441,528 of capital gain. Therefore, an advantage of a SCIN-INT is the potential for less aggregate income being reported in the event of the selling senior family member's premature death.

The irrebutable presumption that the value of the canceled payments equals the principal amount does not apply if the buyer is not a related party, such as a son-in-law. The built-in termination reduces the amount received upon the disposition to zero, permitting the unreported realized gain on a sale to an unrelated party to escape income taxation. The tax savings are further increased because the selling senior family member should receive a deduction for any unrecovered basis.[126] Since an unrelated buyer's initial basis cannot include his initial obligation, the cancellation of the unrelated buyer's remaining obligation has a symmetrical effect with the capital gain reported by the seller.

Example 6: The facts are the same as in Example 5, except that B is S's son-in-law, who is not a related party.

(a) SCIN-PRIN. B's initial basis in the shares is $1,441,528. Upon the death of S, the right to the $1,441,528 of principal payments becomes

[126] Temp. Reg. § 15A.453-1(3)(i) and (4). There is some argument for denying a deduction on the grounds that the loss is not part of a transaction entered into for profit, see Rev. Rul. 72-193, 1972-1 C.B. 58, or that the loss did not occur until death so that it is essentially a reduction in value of the property at death.

worthless. Therefore, none of the remaining capital gain is reported as income. B's basis in the shares should now be reduced to zero because the $1,441,528 of debt cancellation is a reduction in basis under § 108(e)(5).

(b) SCIN-INT. B's initial basis in the shares is $1,000,000. Upon S's death, the remaining $636,641 principal obligation becomes worthless. None of the remaining $1,000,000 capital gain is reported as income. B's basis in the shares is reduced to zero under § 108(e)(5).

D. Impact of Reg. § 1.1275-1(j)

Prior to the effective date of Reg. § 1.1275-1(j),[127] it was generally conceded that a SCIN for a fixed term greater than the seller's life expectancy, as determined by Reg. § 1.72-9, Table V, was characterized as an annuity so that its income tax consequences were determined under the § 72 annuity rules rather than the § 453 installment sale rules.[128] With the issuance of Reg. § 1.1275-1(j), it is likely that few PATYs, even ones with maximum terms significantly greater than the seller's life expectancy, can be "annuities."[129]

The OID rules generally require current accrual of interest on "debt instruments" as defined in § 1275(a)(1) and Reg. § 1.1275-1(d). Annuities are exempted from the application of the OID rules,[130] which has the effect of allowing the "inside buildup" of annuity contracts to escape taxation until amounts are paid out on the annuity. To limit financial arrangements that take advantage of this tax shelter in a manner that the IRS considers improper, Reg. § 1.1275-1(j) limits the annuity exception to contracts containing terms ensuring that the life contingency under the contract is both "real and significant."[131] Reg. § 1.1275-1(j) takes the position that the contract is "real and significant" only if, on the day the contract is purchased, there is a *high* probability that total distributions under the contract will increase commensurately with the longevity of the individual over whose life the distributions are to be made.[132] The regulation

[127] Reg. § 1.1275-1(j)(8)(i) provides an effective date of February 9, 1998.

[128] G.C.M. 39503 (Issue (1)) (Jun. 28, 1985), *supra* note 4.

[129] There appears to be an exception for annuities with a maximum payout period that is more than twice the annuitant's life expectancy, determined, not by Reg. § 1.72-9 Table V, but by the tables prescribed in § 417(e)(3)(A)(ii)(I) relating to determining present value for purposes of restrictions on cash-out of joint and survivor annuities under qualified pension plans.

[130] § 1275(a)(1)(B)(i) exempts an annuity contract to which § 72 applies if the contract depends (in whole or in part) on the life expectancy of 1 or more individuals.

[131] Reg. § 1.1275-1(j)(1).

[132] Reg. § 1.1275-1(j)(2)(i)(B).

identifies terms and provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity, including a maximum payout provision.[133] This applies to most PATYs and SCINs because the Regulation defines a maximum payout provision as a contractual provision that provides that no distributions under the contract may be made after some date even if the terminating death has not occurred.[134] Although the Regulation provides a situation whereby the existence of a maximum payout provision can co-exist with an annuity,[135] it is highly unlikely that a SCIN or PATY would qualify. Although apparently not intended to deal with private annuities, the Regulation eliminating the G.C.M. 39503 distinction based on the relation between the maximum term and the seller-annuitant's life expectancy is sound tax policy. Indeed, although not appropriate for an OID regulation, we believe it would probably be sound policy to treat all private annuities, even those with no maximum term, as contingent payment installment sales subject to the OID rules.[136]

E. Comparison to Using § 7520 Rate and 90CM

For an individual age 70, the 90CM life expectancy is 13.9 years and the Reg. § 1.72-9 Table V life expectancy is 16.0 years. Generally, the § 7520 rate (which is 120% of the mid-term AFR) is higher than the long-term AFR. But, in a low interest rate environment, such as we have at this time, the § 7520 rate happens to be lower than the long-term AFR as the following table illustrates:

Month	§ 7520 rate	Long-term AFR
Jan. 2002	5.4%	5.46%
Dec. 2001	4.8%	5.05%
Nov. 2001	5.0%	5.31%
Oct. 2001	5.6%	5.39%
Sept. 2001	5.8%	5.57%
Aug. 2001	6.0%	5.72%
July 2001	6.2%	5.82%
June 2001	6.0%	5.75%
May 2001	5.8%	5.43%

As the next tables illustrate, for a SCIN, the use of the longer mortality rates under Reg. § 1.72-9 Table V results in lower risk premiums. Assume that Senior is age 70, the asset sold is worth $1,000,000, the note is 16 years, interest-only and the long-term AFR is 5.05% annual interest.

133 Reg. § 1.1275-1(j)(6)(i).

134 Reg. § 1.1275-1(j)(6)(ii).

135 Reg. § 1.1275-1(j)(6)(iii).

136 See Manning and Hesch, *Private Annuities After the Installment Sales Revision Act of 1980*, 6 Rev. Tax'n Indiv. 20, 32 (1982).

Results Using Reg. § 1.72-9 Table V and AFR	Interest Only Note
Interest Rate Risk Premium	3.6071%
Interest Rate With Risk Premium	8.6571%
Principal Risk Premium	$ 441,528
Principal With Risk Premium	$ 1,441,528

Results Using Table 90CM Book Aleph and AFR	Interest Only Note
Interest Rate Risk Premium	5.0104%
Interest Rate With Risk Premium	10.0604%
Principal Risk Premium	$ 640,945
Principal With Risk Premium	$ 1,640,945

Benefit of Using Reg. § 1.72-9 Table V	
Reduction of:	Interest Only Note
Interest Rate Risk Premium	1.4033%
Principal Risk Premium	$ 199,418

¶ 1001.4 Comparison of Installment Method to Annuity Rules

The differences between the income tax treatment of installment sales, SCINs and private annuity sales makes the choice among them ridiculously complex. The following list details the large number of differences that makes this choice a true challenge to the tax professional.

(i) The younger generation buyer's basis is finally determined at the initial time of purchase using the value of the buyer's obligation for a fixed payment installment sale, tentatively determined at the actuarial value of the annuity in a private annuity sale, and may be determined only as payments become fixed for contingent installment sales.[137]

(ii) The younger generation buyer is permitted an interest deduction in fixed or contingent payment installment sales, but not in private annuity sales.

(iii) The selling senior family member reports interest income as it financially accrues, back- or front-loaded for installment sales, but a uniform annual amount for private annuity sales.

137 There may be a purchase price adjustment under § 108(e)(5) if the value of the obligation at death is less than its face amount and the buyer is unrelated to the seller.

(iv) If the younger generation buyer's obligation for a fixed or contingent installment obligation is terminated prior to maturity, the selling senior family member or the estate must report the remaining capital gain, if the buyer and seller are related parties, under the installment method,[138] but not for a private annuity sale. Consequently, the seller does not have unrecovered basis in an installment sale, but may in a private annuity sale.

(v) Depreciation recapture cannot be deferred under the installment method,[139] but there is no similar limitation for private annuity sales.

(vi) The *anti-Rushing* rule of § 453(e) for a subsequent sale by a related purchaser applies to installment sales, but not to private annuity sales.

(vii) The installment method is not available for sales of depreciable property to related parties,[140] but there is no similar limitation for private annuity sales.

(viii) The installment method is not available for dealer or inventory sales, but may be for private annuity.

(ix) The selling senior family member in a large installment sale may be required to pay interest under § 453A on taxes deferred under the installment method, but there is no similar requirement for private annuity sales.[141]

(x) Pledging of an installment obligation as collateral for a loan results in reporting of the gain otherwise deferred,[142] with no similar provision for private annuity sales.

(xi) The installment method is not available if the younger generation buyer's obligation is readily tradable,[143] but such trading may not prevent qualification as a private annuity sale.

(xii) The installment method is available even if the younger generation buyer's obligation is secured, but the private annuity sale approach is not.

(xiii) The installment method is not available for deferred payment sales of publicly-traded securities,[144] but the private annuity sale approach may be.

138 § 691(a)(5)(B).
139 § 453(i).
140 § 453(g).
141 § 453(b)(2) and (1).
142 § 453A(d).
143 § 453(f)(4).
144 § 453(k)(2).

(xiv) The OID and imputed interest rules apparently determine the transfer tax value of obligations taxed under the installment method, but do not apply to private annuity sales,[145] so that the value is determined by discounting under the § 7520 rate.

(xv) The status of a selling senior family member's health and other factors may be considered in an installment sale, but the actuarial tables are more likely to control private annuity sales.

(xvi) Specific rules control when the selling senior family member elects out of the installment method that generally prohibit use of the basis-first method; similar, but different rules avoid basis-first recovery for private annuity sales.

(xvii) The installment method can be used by shareholders for obligations resulting from a corporate sale of property,[146] but there is no similar express provision for private annuity sales.

(xviii) An S corporation can distribute an installment obligation without immediate gain recognition,[147] but there is no similar provision for private annuity sales.

¶ 1002 Unresolved Tax Issues

¶ 1002.1 Valuation Departures From the Actuarial Tables

In Rev. Rul. 77-454[148] the IRS imposed a minimum funding standard on a trust which paid for the asset purchased by issuing its private annuity obligation. The purchasing trust was obligated to only one annuitant. The IRS was concerned about the possibility that the annuitant will live beyond his actuarial life expectancy. Accordingly, the ruling determined how many annual payments could be made by the trust taking into account its initial corpus plus earnings at the assumed interest rate. Using Table S (4.8%) in Book Aleph for an individual age 70, the annuity factor is 9.2720. Therefore, an annuity payable annually, at the § 7520 rate of 4.8% for $1,000,000 is $107,853 ($1,000,000 ÷ 9.2720 = $107,853).[149] A 70-year old individual has a 90CM life expectancy of 13.9 years. If he lives to age 83.9, he will have consumed the entire original corpus plus income at 4.8% by age 83.9. Accordingly, Rev. Rul. 77-454 determines the gift by recasting

145 §§ 483(c)(3) and 1275(a)(1)(B).

146 § 453(h).

147 § 453B(h).

148 1977-2 C.B. 351.

149 If the annuity payments are less frequent that quarterly, an adjustment is required by Reg. § 1.72-5(a)(2)(i). For a 70-year old individual, the adjustment for an annual annuity is -0.5 years. Thus, the 16.0-year life expectancy for a 70-year old is reduced to 15.5 years for determining the "exclusion ratio."

the annuity as one for the lesser of 13.9 years or life, which has a value of $762,446, resulting in a taxable gift of $237,554. In order to have a value of $1,000,000, the initial corpus must be sufficient to fund the annuity to age 110, the maximum age on table 90CM. The amount needed is $1,902,460. Accordingly, to avoid any gift tax, the family trust must have additional funding of $902,460. Presumably, as with family trusts used for installment sales, the additional funding can be provided by arrangements other than current or prior transfers, including guarantees.[150] If the purchaser is an individual, there is no extra funding requirement as it is presumed an individual has the ability to obtain additional funds by his or her ability to earn future income. One way to lower the capital reserves is to use an annuity for joint lives. For example, an annuity for the joint lives of a married couple, both age 70, is $86,151 and the amount of the required capital reserve is $519,672.[151]

If one accepts the IRS's view in Rev. Rul. 77-454 as correct, then this approach should be used in determining the minimum funding of the purchasing trust. There are practitioners who apply the mythical 10% minimum funding standard used for installment sales to grantor trusts for private annuity sales. Obviously, if one wants a minimum funding safe-harbor, the standard promulgated in Rev. Rul. 77-454 is the safer approach.

Since the actuarial value of the $107,853 annual annuity is $1,000,000, the question arises whether the IRS was justified in Rev. Rul. 77-454 in ignoring this objective actuarial standard and using its more pragmatic approach. Interestingly, the Rev. Rul. 77-454 approach was rejected in *Estate of Shapiro v. Commissioner.*[152] The Tax Court refused to allow the IRS to deviate from its own actuarial tables, finding that to do so would contravene the fundamental purposes and functions underlying the actuarial tables. The Tax Court went on to say that one is justified in ignoring the actuarial tables only when their use will violate reason, and that absent an unreasonable result, the actuarial tables must be used.

A Federal district court recently valued a right to an annuity arising from a state lottery,[153] and applied the same standard used in *Estate of Shapiro,* holding that departure from the actuarial tables is justified only where the tables do not produce a value that reasonably approximates fair value. Courts have long recognized that a table-produced valuation is not

[150] See Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts,* 92 J. Tax'n 152 (2000).

[151] The joint life expectancy of two individuals, both age 70, is 18.4 years under Table 90CM and 20.6 years under Reg. § 1.72-9 Table V.

[152] 66 T.C.M. (CCH) 1067 (1993).

[153] *Shackleford v. United States,* 262 F.3d 1028 (9th Cir. 2001).

appropriate only when the result is unrealistic and unreasonable.[154] Surprisingly, the *Shackleford* court found that the state's restrictions on the lottery annuity justified such a deviation. Using the same standard, the Tax Court refused to depart from the actuarial tables in *Estate of Gribauskas v. Commissioner*, 116 T.C. 142 (2001). In *Gribauskas*, the decedent died owning a right to the remaining payments under a lottery he previously won. The estate reported the value of this annuity using general valuation principles for unsecured debt under § 2031. The IRS valued the payments under § 7520 and disregarded the non-assignability factor. The Tax Court disagreed with *Shackleford* and held that the lottery annuity must be valued under § 7520 because they were a series of fixed payments not tied to any specific asset or subject to any market fluctuations. The Tax Court refused to follow the decision in the *Shackleford* case, stating that the district court's analysis in *Shackleford* would undercut the legislative purpose of § 7520 to produce standardized actuarial valuations. The Tax Court went on to state that Reg. § 20.7520-3(b), which provides exceptions to the general application of § 7520, did not apply as there was no substantial risk that the payments would not be made.

In *Estate of Cook v. Commissioner*, 82 T.C.M. (CCH) 154 (2001), the taxpayer owned a winning ticket from her state lottery, entitling her to a fixed amount payable in 20 annual installments. Under Texas law, lottery prizes payable in installments could not be transferred without a court order or converted to a lump sum at any time and there was no market in Texas for lottery prizes payable in installments. The taxpayer contributed her lottery annuity to a limited partnership. In valuing her limited partnership interest on her estate tax return, the Tax Court held that the lottery annuity must be valued under the actuarial tables rather than under general valuation principles, despite the fact that they were held in a limited partnership rather than individually. The Tax Court in *Cook* relied on its previous decision in *Gribauskas* and agreed with the IRS that a lack of a marketability discount was appropriate in valuing the partnership interests but was not grounds for altering the use of the annuity tables to value the underlying annuity owned by the partnership. The Tax Court held that the use of the actuarial tables did not produce a result so unrealistic and unreasonable that the tables were inapplicable.

The crucial issue is whether the valuation principles under the § 7520 Regulations, which were intended to establish a brightline test for the valuation of annuities, should be used where there are significant factors which negate their use. In the *Shackleford* case, the district court noted that

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154 *O'Reilly v. Commissioner*, 973 F.2d 1403, 1407 (8th Cir. 1992) and *Weller v. Commissioner*, 38 T.C. 790, 803 (1962).

there were ten California lottery prize winners who attempted to transfer their awards and the prices at which they were able to sell their awards for were substantially discounted to reflect certain factors. The court in *Shackleford* concluded that the actuarial tables did not reasonably approximate the fair market value of the lottery payments because California's statutory anti-assignment restriction reduced the fair market value.

¶ 1002.2 Income Tax Basis at Death in a Carryover Basis World

If the repeal of the estate tax, scheduled for 2010 is made permanent, new § 1022 will also eliminate the tax-free step-up in basis under § 1014(a) for property passing by bequest or inheritance.[155] New § 1022(a) provides that property acquired from a decedent after 2009 is treated as property acquired by gift. Another new provision, § 2511(c), provides that if an individual makes a gift to a grantor trust after 2009, it will not be treated as a taxable gift. In effect, if there is no assignment of income for income tax purposes, there will be no gift for gift tax purposes.

Even if there is no estate tax, an installment sale to a grantor trust is a viable income tax planning technique if the grantor of the trust dies while the installment note is outstanding. As we pointed out previously, if death occurs while the installment note is outstanding, the trust's income tax status as a grantor trust ceases and the trust comes into existence for income tax purposes as a purchaser. As a result, the trust is treated upon the grantor's death as acquiring the assets previously transferred from the grantor by purchase, the purchase price being the amount of the note outstanding at the time of the grantor's death. In effect, the trust acquired a cost basis in the property under § 1012(a). Since death is not a realization event, none of the built-in gain is realized by the seller or the seller's estate for income tax purposes.

Example 1: Senior age 70 has a life expectancy of 16.0 years. This year Senior sells an appreciated asset worth $1,000,000, with a basis of $200,000, to a grantor trust Senior previously set up for her children. Senior takes back a 20-year interest-only installment note.[156] The repeal of the estate tax is eventually made permanent. Senior dies in 2016 with the $1,000,000 installment note still outstanding. At the time of her death, the asset originally purchased by the trust was worth $1,600,000. At the moment of death, the trust is treated as having purchased the asset for $1,000,000 and takes a $1,000,000 cost basis in the asset. The

[155] However, §§ 1022(b) and 1022(c) will provide a basis equal in value to $1,300,000 and $3,000,000 worth of property. Additionally, a decedent's unused losses can increase basis in certain assets.

[156] Since Senior anticipates being alive in 2010, no valuation discounts were taken on the asset sold.

other $600,000 of value is a gift for income tax purposes and is not income to the trust because of § 102(a). Senior does not realize her $800,000 gain upon her death. Since there was a sale for adequate consideration, there was no gift to a grantor trust. Accordingly, new § 2511(c) cannot apply and remains irrelevant. As we have advocated, none of the appreciation in the value of the asset sold to the grantor trust is realized as a gain for income tax purposes when the grantor dies. The remaining question is the basis that the grantor's estate takes in the installment note given as consideration by the trust when it was a grantor trust. Although not entirely free from doubt, the estate's basis in the note should be the same as the grantor's basis in the note while the grantor was alive. With the repeal of the estate tax, carryover basis applies and the estate is treated for income tax purposes under new § 1022(a) as acquiring the property by gift.

As this analysis illustrates, an installment sale to a grantor trust is a technique designed to shift the built-in gain from the asset sold to the asset (the installment note) which comes into existence for income tax purposes upon the grantor's death. After the grantor's death, the now non-grantor trust can sell the asset it purchased from the grantor without reporting any of the built-in gain existing at the time of the initial sale. Since the built-in gain has shifted to the installment note upon the grantor's death, no gain will be reported on the installment note until principal payments are made. Since there is no longer a concern that a note term greater than the grantor's life expectancy will be treated by the trier-of-fact as a trust substitute under § 2036(a), there is no longer any risk in having a note term longer than the grantor's life expectancy.

Example 2: Upon Senior's death in the above example, the trust now has a $1,000,000 cost basis in an asset worth $1,600,000. If the trust subsequently sells the asset for $1,650,000, its gain will be limited to $650,000. The potential $800,000 gain is now reposed in the $1,000,000 note which has a $200,000 basis for the estate.

If the estate, actually the estate's successor-in-interest, wants to continue the deferral of the $800,000 gain after the note reaches maturity, the note can always be extended. Care must be taken so that the extension of the note is not a taxable realization event under Reg. § 1.1001-3. This may prove to be an obstacle if market interest rates at the time of the note extension are more than 0.25% different from the note's original interest rate.

For those who feel there is no need for installment sales to grantor trusts if the estate tax is repealed, the above-described income tax planning is still something the individual should consider.

¶ 1002.3 SCIN Risk Premiums

A risk premium must be added because of the possibility that the note will never be paid. The premium may be reflected in either a higher interest rate or a greater principal amount, or some combination. Since the process of determining the value of the note is one of discounting, the issues become (i) which of the rates prescribed by the Code for discounting—the AFR prescribed in §§ 1274 and 7872 or the § 7520 rate prescribed for valuing certain term interests—applies and (ii) whether the income tax mortality table prescribed under Reg. § 1.72-9 Table V or the one prescribed in the Book Aleph (90CM) for transfer tax purposes applies. We believe that for a SCIN taxable as an installment sale, it is the AFR, not the § 7520 rate, that applies and that, with somewhat less certainty, the longer lives under Reg. § 72-9 Table V should apply.

A. Discount Rate

Section 7520 prescribes rates (120% of the midterm AFR) to be used for valuing annuities, life estates, remainders and term interests. When a SCIN is not an annuity, the question is whether it is a term interest. The same considerations that lead to the conclusion that an installment note is not a retained life estate also lead to the conclusion that it is not a term interest. This is consistent with (i) the analysis in Reg. § 1.1275-1(j) that a SCIN is treated as a debt obligation subject to the OID rules, including the provisions of § 1274, and (ii) the similar conclusion in G.C.M. 39503 for a SCIN with a maximum term less than the seller's life expectancy is treated under the installment sale rules of § 453.[157] Similarly, according to the Tax Court in *Frazee v. Commissioner,*[158] the interest rate to use in determining the value of the note for both income tax purposes and for gift tax purposes is determined by using § 7872, which uses the AFR. Furthermore, the proposed regulations under § 7872 and related provisions properly recognize that the appropriate-term § 7872 rate controls.[159]

B. Mortality Tables

There is no clear authority whether the life expectancies in Table 90CM[160] or the longer life expectancies in Reg. § 1.72-9 Table V should be used to determine the risk premiums for a SCIN.[161] We believe that

157 Rev. Rul. 86-72, 1986-1 C.B. 253; G.C.M. 39503 (Jun. 28, 1985). *See* Reg. § 1.1275-1(j) for a PATY.

158 98 T.C. 554 (1992).

159 Prop. Reg. §§ 1.7872-1(a), -2(a), 1.1012-2(b) and 25.2512-8.

160 See Reg. § 20.2031-7T(d)(7); Actuarial Tables Book Aleph, Pub. 1457 (July 1999).

161 Under Table 90CM, the life expectancy of a 70-year old is 13.9 years. Under Reg.

the correct approach is to use the income tax annuity tables.[162] In part this conclusion is based on the same reasoning as that supporting the use of the AFR, that a SCIN is not a term interest under § 7520. Although the § 7520 regulations prescribe the use of Table 90CM,[163] there is no corresponding provision in the installment-sale regulations.[164] In a broader sense, however, there is no requirement for any prescribed rate. The underlying assumption for the exclusion of installment sales to family trusts, including SCINs, from giving rise to taxable gifts is that they are bona fide business transactions.[165] Accordingly, the pertinent question is whether an intra-family sale transaction is on arm's length terms. Unrelated parties, of course, are free to use any reasonable basis for actuarial adjustments. Related parties should have the same freedom provided they can show that they have acted within the range of arm's length bargaining.[166] On the other hand, it is doubtful that there are many SCIN transactions entered into by unrelated parties.[167]

However computed, providing for the risk premium by increasing principal rather than interest provides two advantages: the premium is eligible for capital gains rates and may be deferred until payment of principal (or even eliminated if the seller dies before the end of the SCIN term). The deferral and chance of estate elimination can be maximized by providing payment of interest-only during the SCIN term with a balloon payment of principal at the end. The interest will, however, be increased to reflect the increased principal. On the other hand, such a deferral will increase the absolute amount of the principal payment.

C. Disregarding Actuarial Assumptions for a SCIN

Reg. § 20.7520-3(b)(3) provides that the mortality component described under § 7520 may not be used to determine the present value of an

§ 1.72-9 Table V, it is 16.0 years. The reason the annuity tables have longer life expectancies is that they are based on a sample pool of individuals who purchase annuities, which is by self-selection, a healthier group than the general population.

162 See Shore and McClung, *Beyond the Basic Super Freeze—An Update and Additional Planning Opportunities*, 75 Taxes 41, 50 (1997), mentioning that there is no authority requiring uses of the transfer tax tables and suggests use of Reg. § 1.72-9 Table V.

163 Reg. § 25.7520-1T(b)(2).

164 See Reg. § 15A.453-1(c) relating to contingent payment sales. The absence of a regulation may be due to the fact that the installment sale regulations do not even refer to actuarial issues.

165 Reg. § 25.2512-8.

166 *Cf.* § 2703(b); Reg. § 25.2703-1(b)(1) to (4) (excluding buy-sell agreements on terms "comparable to similar arrangement entered into in arms' length transactions").

167 See Strizever, *Self-Cancelling Notes Increase Planning Risks of a Sale Over Private Annuities*, 12 Tax'n for Law. 298 (1984).

annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is "terminally ill" at the time of death. Technically, the position taken in this regulation does not apply to a SCIN because a promissory note is not an annuity or future interest as described in that regulation. However, the better view is that the statement in the regulation is generally illustrative of situations in which the impending death of the individual should be taken into account and that standard actuarial tables do not apply. Indeed, since SCIN transactions of the type being discussed depend for their effectiveness on being treated as bona fide business transactions, applying the actuarial tables for a terminally ill individual would hardly satisfy the standard.

The regulation provides an 18-month safe harbor—if the individual survives more than 18 months, that individual shall be presumed to not have been "terminally ill" unless the contrary is established by clear and convincing evidence. The regulation is an estate tax regulation, which means that the IRS can apply it with the benefit of hindsight. Unfortunately, that type of perfect 20-20 vision is not available when the terms of a SCIN are established. It can only provide limited, after the fact, protection if the grantor-seller survives the 18 months.

D. Application of Estate Freeze Rules to SCINs

Even though it has a contingent payment, a SCIN should not be disregarded in determining whether a SCIN sale to a family trust involves a gift. First, the special valuation rules of § 2701 only apply in determining "the amount of the gift,"[168] and a properly crafted SCIN is a sale for transfer tax purposes not a gift.[169] In addition, since a SCIN is a debt obligation, it cannot be an applicable retained interest subject to the special valuation rules.[170] For similar reasons, it is not a lapsing right subject to § 2704 even though it may terminate on death. Section 2704 applies only to voting rights and limitations on liquidation, neither of which describes a SCIN. Although § 2704(a)(4) gives the Secretary the power to treat "other restrictions" as interests to be disregarded, there are no such regulations. Furthermore,

[168] Reg. § 25.2701-1(b)(1); see Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note; An End Run Around Chapter 14*, 32nd Univ. of Miami Phillip E. Heckerling Institute on Est. Plan. Chapter 15 (1998) at ¶ 1511; Nicholson, *Sale to a Grantor Trust: Better than a GRAT?*, 37 Tax Mgmt. Mem. 99, 100 (1996); Lewis and Laning, *Estate Freezes and Grantor Trust for Business Owners*, 1 Bus. Ent. 10 (1994).

[169] Reg. § 25.2512-8; Prop. Reg. § 25.2512-8 (Mar. 27, 1986).

[170] § 2701(a)(1) applies only to a transfer of an "interest" in a corporation or partnership when there is an applicable retained "interest." Reg. § 25.2701-2(b)(1) defines an applicable retained interest as an "equity" interest in a corporation or partnership. See e.g. Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994) (debt is not an interest subject to § 2701); Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (same).

as the IRS has recognized,[171] § 2702 should not apply because the SCIN event, though subject to contingencies, is a debt obligation of, not a beneficial interest in, the family trust.[172] The note holder's rights are governed by the contract, not the terms of the trust.

E. Inclusion in Gross Income

Despite the breadth of § 61's provision that all benefits received are gross income and must be reported unless an exclusion applies, the cancellation of the SCIN at death should not result in gross income to the family trust. As discussed above, transfer of even property subject to a liability at death does not give rise to gross income for the decedent. Such non-recognition is also recognized by § 102(a), for receipt of property received as a result of death. This is not inappropriate since any unrealized gain is either reported at death under § 453B(f) if the SCIN was still outstanding, or represented by a transferred basis if it was not.

F. Basis to the Purchaser

Under general income tax principles, a contingent liability is not taken into account by the purchaser in determining basis or by the seller in determining amount realized.[173] Without more, a SCIN is a contingent liability because of the possibility it may never have to be paid. When the SCIN sale is to a related party so that under § 453B(f) the termination of the obligation at death is treated as payment at its face amount, a SCIN should not be treated as a contingent liability. Accordingly, the family trust-purchaser should be entitled to include the SCIN principal in basis and the grantor-seller in determining amount realized and the selling price for installment sale purposes.[174]

The 1980 Act added § 453B(f) to overturn the result in *Miller v. Usry*[175] which refused to apply the pre-1980 version of the disposition rule except to actual sales of the note for cash, and to make it clear that a disposition by gift should also be subject to the § 453B(a) disposition rule.[176] The Committee Report makes it clear that in deeming that a payment is received, it also intended that a payment is deemed to be made by stating that:

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[171] See Priv. Ltr. Rul. 94-36-006 (Mar. 14, 1994) (valuation rules of § 2702 do not apply to debt because it is not a term interest); Priv. Ltr. Rul. 95-35-026 (May 31, 1995) (same).

[172] See Mulligan, *supra* note 168, at ¶ 1507.2.

[173] *Albany Car Wheel Company v. Commissioner*, 40 T.C. 831, *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); Reg. §§ 1.338-4T(b)(2)(ii), -4T(d)(2), -5T(b)(2)(ii) and -5T(e)(1).

[174] See G.C.M. 39503 (Issue (2)(C)(2)(b) last sentence) (Jun. 28, 1985).

[175] 160 F. Supp. 368 (W.D. La 1958). S. Rept. No. 96-1000, 96th Cong., 2d Sess. 25 (1980).

[176] A disposition by gift comes within "any other disposition" and is necessary to prevent an assignment of income already realized by the noteholder.

The court [in *Miller v. Usry*] did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale.

Accordingly, the payment that is certain to be either received or deemed received by the seller under a SCIN should also be considered certain to be paid by the purchaser, who should receive an immediate basis in the property purchased with a SCIN. The IRS indicated that it approves of this analysis. "We therefore think it appropriate to allow the buyer-obligor to include the full face value of a note in its basis in the property acquired in the transaction."[177]

The contingent payment OID regulations determine the amount and timing of the interest income to be reported when there is a contingent payment sale.[178] The examples illustrate that the contingent payment OID regulations[179] take the position that a buyer obligated on a contingent payment obligation receives no basis upon incurring the contingent liability and the seller does not initially treat the contingent liability as part of its amount realized. The OID regulations go on to illustrate that the contingent liability gives rise to basis and amount realized only when the obligation becomes fixed or is paid. These regulations do not, however, define the term "contingent payment." The question is whether a SCIN obligation of a related party (as defined for purposes of § 453B(f)) is a contingent payment obligation for purposes of these regulations and, if so, whether they change the result in G.C.M. 39503. We do not believe it should be. Under a SCIN, even one with a balloon payment, interest will be paid on fixed basis until death or another terminating event occurs. As indicated, under a SCIN to a related party of the type we are discussing, the principal will be paid or deemed paid on or before a fixed date. Accordingly, such a SCIN should not be considered a contingent liability and the IRS position in G.C.M. 39503 remains supportable.

The legislative history to the Installment Sales Revision Act of 1980 also provides support for the position that the purchaser can include the principal amount of the SCIN obligation as part of its initial basis in the purchased property. It explicitly states that the deferred gain recognized at such time is the "quid pro quo" for the buyer's cost basis.[180] Accordingly, the IRS would be justified in denying a cost basis for the obligation to the buyer only if it were to concede that gain is not recognized upon the extinguishment of the note. Those commentators who have addressed the issue of the buyer's basis for the SCIN obligation come to the conclusion

177 G.C.M. 39503 (Issue (2)(C)(1)(b) last sentence) (June 28, 1985), *supra* note 4.

178 Reg. § 1.1275-4.

179 Reg. §§ 1.483-5 and 1.1275-4(c).

180 *See* S. Rept. No. 96-1000, 96th Cong., 2d Sess. 25 (1980).

that the face amount of the note, even if the note is self-canceling, should be included in the basis.[181] Furthermore, the Eighth Circuit in *Frane v. Commissioner*[182] mentioned in footnote 5 that it was of the opinion that the buyer is entitled to an initial cost basis for the SCIN obligation. Although this statement was only *dicta* in the *Frane* case, the court in *Frane* went on to conclude that since the G.C.M. 39503 clearly shows that the plain language of § 453B requires that the obligee recognize the gain, it follows that consistent treatment can be afforded to the obligor and no injustice results.

Nor should § 108(e)(5) require an adjustment in the purchaser's basis. Section 108(e)(5) is intended to apply to situations where the noteholder is able to deduct the canceled obligation as a bad debt. Applying this tax symmetry analysis to the SCIN sale illustrates that § 108(e)(5) does not apply. The cancellation of the SCIN is not treated as a cancellation because, as discussed above, § 453B(a), in conjunction with § 453B(f), treats the cancellation as a deemed payment. Applying the tax symmetry principle, the noteholder cannot take a bad debt deduction because § 453B(a) deems that the noteholder received a payment equal to the amount of the liability canceled. Therefore, the fictions created by the § 453B disposition rule remove the cancellation of the liability from the reach of § 108(e)(5).

1. Comparison and Summary

As mentioned previously, the § 7520 rate is generally higher than the long-term AFR. In such a situation, the effect of the combinations of choice of discount rate and actuarial assumptions can be exemplified by the following table based on an interest-only SCIN for $1,000,000 of property sold by Senior, age 70 and all principal payable at the end of 16 years:[183]

For illustrative purposes, we will use the July, 2001 long-term AFR of 5.82% and the July, 2001 § 7520 rate of 6.2%

181 *See Frane v. Commissioner, supra* note 117 at footnote 5 stating that most commentators agree; Massey & Englebrecht, *Self-Cancelling Installment Notes and Private Annuities: An Analysis*, 72 Taxes 27, 28 (1994); Banoff and Hartz, *Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?*, 59 Taxes 499, 506 (1991).

182 998 F.2d 567 (8th Cir. 1993).

183 Although we assume that interest only is payable before the end of the maximum term, there probably should be at least one payment (due in the year after the sale) that is not canceled by death to assure compliance with the definition of an installment sale as one where "at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." § 453(a). A literal reading of this provision could disqualify an interest only SCIN because there may be no payment to be received after the year of disposition if Senior dies in that year.

Mortality and Interest Factors	Interest Rate Increase	Principal Increase
AFR (5.82%) and Reg. § 1.72-9 Table V (16.0 years)	3.56%	$406,212
AFR (5.82%) and Table 90CM (13.9 years)	4.95%	$587,785
§ 7520 rate (6.2%) and Reg. § 1.72-9 Table V (16.0 years)	3.53%	$390,418
§ 7520 rate (6.2%) and Table 90CM (13.9 years)	4.92%	$564,229

As the chart indicates, the choice of actuarial table has a much greater effect on the risk premium than the choice of interest rate. When the premium is assigned to principal, it can increase the purchase price from as little as 39% to as high as 59% on the assumed facts. If Senior lives to collect the principal, this can significantly reduce the benefit of the estate freeze.

¶ 1002.4 Reality of Sale Revisited

A properly structured installment sale to a grantor trust is shielded from the factual argument that it is a trust substitute under § 2036(a), with resultant inclusion in the grantor's gross estate at death, as long as the reality of the intra-family sale is respected after the sale takes place. Since the senior family member is asking the IRS to respect the intra-family sale as if it were a sale to a third-party, the family should do the same.

Some tax planners suggest that if the death of the grantor is expected before the end of the note term, that the grantor trust should prepay the note while the grantor is alive with some of the appreciated assets originally sold to the grantor trust. Thus, the note's existence is eliminated and the grantor now owns an appreciated asset eligible for a tax-free step-up in basis at death.

Example: Senior sells an asset worth $1,000,000 with a $200,000 basis to a grantor trust for an interest-only installment note. Several years later, when the property sold to the grantor trust had appreciated in value to $2,000,000, Senior became ill and was not expected to survive. The trust uses $1,000,000 of assets with a basis of $100,000 to prepay the note while Senior is still alive.

If this course of action is followed, the soon-to-be decedent has given the IRS and the Tax Court as the trier-of-fact a factor that can be used to disregard the reality of the sale and treat the note as a § 2036(a) trust substitute. The reason is apparent when viewed in the context of real world, seller-financed sales. Sellers do not typically take back the asset sold in satisfaction of the note principal unless there is a foreclosure or the purchaser is in financial distress and unable to meet its obligations on the note as they become due. Therefore, this course of action is not recommended. And, since we believe that the trust takes a cost basis by purchase if the grantor dies while the note is outstanding, there is no need to take this risk by prepaying the note.

¶ 1002.5 Conversion of Trust's Income Tax Status

A. Termination During Grantor's Life

If Senior relinquishes the power(s) that intentionally made the family trust a grantor trust during his life, a realization event has occurred for income tax purposes.[184] The issue of the family trust's basis for the property is whether it should be a basis determined under the part sale, part gift provisions of § 1015,[185] or should be a cost basis. We believe the considerations discussed there apply equally to transfers during the grantor's life. On the other hand, since the transfer is during life, Senior now realizes gain on the installment sale. Because the sale for income tax purposes occurs only upon termination of grantor trust status, it does not relate back to the time when the original sale was made for transfer tax purposes. The gain is measured using the then tax amount of the balance of the installment note, not the original sale price, and the then basis of the property. The tax balance of the note is, in turn, determined using the AFR at that time. The then basis of the property is determined with appropriate adjustment for any depreciation since the transfer, any capital expenditures made by the trust and any other appropriate items.

The conclusion that termination during life is a realization event is not inconsistent with the judgment that the automatic termination of grantor-trust status at death is not a realization event. Transmission of property at death is, as far as we know, the only disposition that is not a realization event and that generally eliminates unrealized gain or loss because of the basis adjustment under § 1014(a). Most so-called nonrecognition transactions involve both basis carryover and recognition to the extent of boot. Donative family transactions involve recognition if consideration is received, including consideration in the form of a liability transfer.[186] Even

184 Rev. Rul. 85-13; Reg. § 1.1001-2(c) Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; G.C.M. 37228 (Aug. 23, 1977).

185 See Reg. § 1.1015-4.

186 See *Estate of Levine v. Commissioner*, 634 F.2d 12 (2nd Cir. 1980); *Ebban v. Commissioner*, 783 F.2d 906 (8th Cir. 1986); *Diedrich v. Commissioner*, 457 U.S. 191 (1982); Rev. Rul. 81-163, 1981-1 C.B. 433.

transfers in connection with a divorce under § 1041 can involve recognition under assignment of income principles.[187] At most, transmission at death can result in a transfer, not a realization, of IRD.[188]

B. Conversion of Non-Grantor Trust to Grantor Trust

Although not a termination of grantor trust status, similar issues arise when a non-grantor trust is converted into a grantor trust, either intentionally or by mistake. Under principles analogous to those of Rev. Rul. 85-13,[189] a taxable event has occurred; the transfer of the assets from the trust to the grantor.[190] The family trust should recognize gain, but only for any difference between amount of the liability on the promissory note at that time and its cost basis in the property.

What is clear is that the liability no longer exists for income tax purposes because of the merger of the obligor and the obligee by application of the grantor trust rules. The seller, now treated as the grantor of the purchasing trust, should realize gain on the deemed receipt of the family trust property in satisfaction of the installment obligation, because the conversion means that the grantor is now the owner of the family trust's property for income tax purposes and the family trust's note has been satisfied by his "receipt" of the property in settlement of the note.[191] Any future conversion of the grantor trust back to nongrantor trust status has the consequences discussed above, although with lesser consequences because the grantor-seller has now realized the gain and has a purchase price basis in the property.

Example Senior owned stock in the family S corporation worth $1,000,000 with a basis of $200,000. In 1999, Senior sold her stock to a family trust, which was an eligible S corporation shareholder because it was a QSST. Senior took back an interest-only installment note, 20-year

[187] Temp. Reg. § 1.1041-1T(a) Q&A–4; *Kochansky v. Commissioner*, 92 F.3d 957 (9th Cir. 1996); *Yonadi v. Commissioner*, 21 F.3d 1292 (3rd Cir. 1994); *Balding v. Commissioner*, 98 T.C. 368 (1992); *Gibbs v. Commissioner*, 73 T.C.M. (CCH) 2669 (1997).

[188] § 1014(c); but cf. Rev. Rul. 87-112, 1987-2 C.B. 207 (accrued interest on Series E bond recognized by donor on transfer to ex-spouse in connection with divorce).

[189] See also Reg. § 1.1001-2(c) Example 5.

[190] *Cf.* Rev. Rul. 99-5, 1991-1 C.B. 134 (dealing with converting an LLC taxed as a partnership into a single member LLC that is a disregarded entity); Reg. § 1.1361-4(a)(1)(i) and (ii) and (a)(4) (dealing with the effect of an election to treat a qualified subchapter S subsidiary as, in effect, a division).

[191] See Rev. Rul. 73-423, 1973-2 C.B. 161 (transfer of installment obligation by seller to debtor in § 351 transaction treated as taxable settlement by seller); *Jack Ammann Photogrammetric Engineers, Inc. v. Commissioner*, 341 F.2d 466 (5th Cir. 1965) (corporate-purchaser transferee does not realize gain because it issued its stock under § 1032 to settle obligation); Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984).

term, for the entire purchase price. The family trust was not a grantor trust at the time of the sale. In 2002, the family trust became a grantor trust for Federal income tax purposes. For 2002, Senior must report the $800,000 capital gain, and the trust's basis in the stock is now $1,000,000. All subsequent principal payments on the note are a return of basis.

Gain recognition upon the conversion to a grantor trust should occur even though it is possible that the trust may again become a non-grantor trust in the future.

¶ 1002.6 Disposition of Note or Purchased Asset

A. Grantor Trust Disposes of Purchased Asset Subject to the Promissory Note

Even though it does not involve a termination of grantor trust status, the family trust's disposition, while it is a grantor trust, of the purchased asset subject to the obligation on the promissory note, must result in a similar taxable event for income tax purposes. The grantor now has a third-party obligor and is no longer taxable on the income from the purchased property transferred to the obligor. Under the principles of Rev. Rul. 85-13, the grantor has made a taxable sale of the property for income tax purposes at that time. The taxable gain should be measured by the tax amount of the promissory note, determined under the OID rules based on the AFR at that time, plus any additional consideration received by the family trust.[192]

B. Grantor's Disposition of the Family Grantor Trust's Note

Even though it does not involve a termination of grantor trust status, the grantor's disposition of the promissory note issued by the family trust while it is a grantor trust, must result in a similar taxable event for income tax purposes. The note that was disregarded for income tax purposes as an obligation owed by the grantor to himself, when owed to a third party, can no longer be disregarded.[193] In the first instance, the grantor's transfer of the note should have the same consequences as would apply if the grantor issued the note to the transferee. If the note is given to a charity, it represents a charitable contribution, albeit one that probably cannot be

[192] See Tech. Adv. Mem. 2000-11-005, Nov. 23, 1999 (gain realized by grantor on termination of grantor trust when corpus of GRAT transferred to remainder trust subject to loan incurred to pay GRAT); Tech. Adv. Mems. 2000-10-010 and 2000-10-011, Nov. 23, 1999 (apparently identical rulings).

[193] *Cf. U.S. v. Wham Construction Corp.*, 600 F.2d 1052 (4th Cir. 1979) (liability owed by one corporate division to another is not treated as a liability assumed by the transferee when the division is incorporated, but is treated as boot paid).

deducted until paid.[194] The fact that the legal obligor on the note is the family trust probably does not change the general rules on payment since, under Rev. Rul. 85-13,[195] the grantor is not merely taxed on the income of the trust, but owns the trust.[196] Similarly, if the family trust's note is transferred to a family member without consideration, it is a gift.[197] If the note is transferred in consideration of goods or services, it amounts to payment for those goods or services and has the appropriate tax character under general income tax principles as deductible, capitalizable or neither, when appropriate under the taxpayer's method of accounting.

For income tax purposes, the more difficult question is whether the transfer should also be treated as a taxable sale of the property previously transferred to the family trust. Although the matter can hardly be considered free from doubt, a substantial argument can be made that since the grantor still owns the family trust corpus for income tax purposes and will still be taxed on the family trust's income used to pay the note, the note does not represent consideration for the property.[198] Under this view, the family trust would not be entitled to a cost basis or even a part sale, part gift basis in the property. On the other hand, the initial transaction was an installment sale, disregarded it is true for income tax purposes, that has become a transaction recognized for tax purposes simultaneously with the transfer of the note. The note is an obligation of the family trust as a matter of state property law, whatever the grantor trust rules may provide as a matter of tax law. Accordingly, it appears more appropriate to view the transaction as involving a transfer of the property to the trust at that time for the note followed immediately by Senior's *transfer* of the note. Under this approach, Senior's transfer of the family trust's note is a taxable installment sale, so that the disposition rules under § 453B would then

[194] See, e.g., *Don E. Williams Co. v. Commissioner*, 429 U.S. 569 (1977) (corporation's note not deductible contribution to a qualified pension plan because not cash); Rev. Rul. 68-174, 1968-1 C.B. 81 (taxpayer's note not deductible charitable contribution); Rev. Rul. 82-197, 1982-2 C.B. 22 (written option on corporation's stock granted to charity not deductible until exercised, no payment).

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

[196] But see *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984). In that case, the court determined that the grantor trust rules do not actually treat the grantor and the trust as one, but merely require that the grantor report all of the trust's items as his own and recognized a sale by the trust to the grantor as allowing the grantor-purchaser to use the purchase price as the basis of the assets. A taxpayer who initially treated the transaction under Rev. Rul. 85-13 would almost certainly be bound by a duty of consistency in treating the transfer of the note.

[197] Rev. Rul. 67-396, 1969-2 C.B. 351 (gift of donor's note, assumed to be unenforceable under state law, is not gift until paid or transferred for value); Rev. Rul. 84-25, 1984-1 C.B. 191 (gift of enforceable note is gift when delivered).

[198] *Cf. U.S. v. Wham Construction Corp.*, *supra* note 193.

apply to require the grantor to recognize the inherent gain in the property and, incidentally to provide the family trust with a cost basis. The tax fiction of Rev. Rul. 85-13 should not be carried to the point of completely disregarding a transaction that has effect under both local law and the transfer tax. Disregarding the transaction for income tax purposes under the grantor trust rules does not change its nature as an installment sale that should be so characterized for income tax purposes when it is no longer disregarded.

¶ 1002.7 Use of a SCIN for Sale to a Grantor Trust

Most individuals anticipate a slow but steady appreciation in the value of their assets. The use of an installment sale to a grantor trust as an estate freeze shifts future appreciation to the estate-tax exempt trust because the AFR is always lower than comparable market rates. For example, the Dec. 2001 long-term rate is 5.05% annual interest. And, if one uses a note where the interest rate adjusts annually, the short-term AFR can be used (2.48% annual interest for Dec. 2001). If the grantor trust invested in assets that produced a combined annual rate of return of 7.5%, there would be a slow but steady tax-free built-up in the grantor trust.

For this type of situation to be successful, the estate planning freeze depends upon a build-up over several years and the compounding effect which increases over time. Because there is always a possibility the grantor will die sooner, the fixed payment installment sale to a grantor trust may not shift much wealth if early death occurs. For Senior age 70, the probability of Senior dying during the next 10 years is 34.0%. And, the probability of Senior dying before reaching his life expectancy age of 86 is 59.8%. Surviving ten years is significant if there will be no estate tax after 2010.

The use of a SCIN for a healthy senior family member should be considered in this type of situation. Assume that the seller-provided financing that Senior provides is an interest-only 10-year deferred payment sale to a grantor trust and the long-term AFR is 5.05%. If Senior uses a 10-year SCIN and the risk premium is additional interest, the annual interest rate on the note would increase to 7.68%, an increase of only 2.63%. Alternatively, if the risk premium is additional principal for the sale of a $1,000,000 asset, the risk premium would increase the note principal to $1,217,777. Using the 5.05% long-term AFR as the base, the annual interest payment would be $61,498, an effective interest rate of 6.15%.

If a SCIN is used instead of a fixed payment installment note, the financial leverage of the freeze is reduced somewhat. If Senior survives the 10-year term of the note, the freeze is successful, although at a slightly lower amount. If Senior dies during that 10-year period, the SCIN is estate freeze insurance because the note is not in his gross estate and the grantor trust receives the tax-free wealth shifting windfall of the note cancellation.

¶ 1002.8 Does a Demand Note Eliminate the Risk Premium for a SCIN?

It has been suggested that if a SCIN is payable upon demand, there is no need for a risk premium because the selling senior family member has the ability to obtain the entire principal amount at any time. Although far from clear, it is possible that a demand SCIN without a risk premium is subject to the interest free loan rules under § 7872. In effect, an interest risk premium should be imputed as a gift under § 7872 at year-end for each taxable year the SCIN remains outstanding, probably using the interest rates in effect at the end of each year.

Example: Senior sells an asset worth $1,000,000 for a SCIN on January 1, 2001, using the long-term AFR in effect in January. The SCIN is a demand note; the principal is $1,000,000 and the fixed annual interest is the long-term AFR for January, 2001. Using the December, 2001 long-term AFR of 5.05%, the interest risk premium is 2.3%. Each year-end § 7872 applies, and a gift of $23,000 will be imputed (2.3% × $1,000,000).

¶ 1003 Income Tax Planning With Stock Options

The character of the income reported by an employee upon the exercise of a non-qualified stock option ("NQSO") is compensation income. First, it is reported as ordinary income, not a capital gain. Second, as compensation income, it is exposed to the Medicare portion of the employment taxes. Third, as compensation income it is subject to withholding even though there is no cash received. Thus, the amounts withheld must come out of other income the employee receives.

Example: Senior, the founder of a publicly-traded corporation, was granted non-qualified stock options to purchase 10,000 shares of stock for $12 a share. At the time of the grant, the market price of the stock was $12 a share. In December, 2001, shortly before the options were to expire, Senior exercised her options by paying $120,000 for the 10,000 shares she acquired. At the moment of exercise, the stock was trading at $38 a share. For 2001 Senior must report $260,000 of compensation income (ordinary income) and the corporation deducts $260,000 in 2001. Later, Senior sold all 10,000 shares in August, 2002 for $40 a share, a total of $400,000, realizing and recognizing a short-term capital gain of $20,000 for 2002. Senior's basis in the stock sold was $380,000. The