The Biden 3rd Step –
What To Do With The Promissory Note Owed to the Grantor of an Intentionally Defective Grantor Trust

(PART 1 OF 2)

Forgive or Assign, Keep in Place or Alter the Arrangement

Neither a borrower nor a lender be,
Unless it is a low-interest promissory note owed by a trust formed by thee.

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Special thanks to LISI Business Entities Newsletters: LISI Estate Planning Newsletter #2928 (December 21, 2021) at http://www.leimbergservices.com.

The Biden 2-Step is a nickname used by the authors to describe a traditional installment sale to a defective grantor trust where a taxpayer establishes an irrevocable trust that is disregarded for income tax purposes and will not be subject to federal estate tax on his or her death, makes a seed capital gift to the trust, and sells one or more assets to the trust in exchange for a long-term, low-interest promissory note. The taxpayer can then decide to forgive or make a gift of all or a portion of the note, "undo" the sale by repaying the note, or keep the note in place.

The Biden 2-Step was a good fit for many taxpayers in 2021 who were concerned about the proposed estate tax laws and wanted to reduce their taxable estates before new legislation would pass, and be ready to use their estate tax exemptions by forgiving or gifting a note if and when the exemption would be going down. There are no active present bills in the House or the Senate that would otherwise materially affect the estate and gift tax exemption until its scheduled reduction to one-half of its then-applicable level in 2026, although this could change.

The technique allows for the following:

1. Freezing the value of ownership interests and assets that are expected to grow.

2. Allowing for valuation discounts, such as if the assets are held under an LLC and a non-voting membership interest in the LLC is sold to the trust for the note.

3. Allowing the taxpayer to pay the income tax on income that inures to the benefit of the trust, where the payment of the income tax is not considered a gift for gift tax purposes, thus permitting the trust to grow income tax free and further reducing the taxpayer's estate.

4. Allowing the taxpayer to essentially reverse a significant portion of the transaction if they decide they would like to get most of the assets back by simply repaying the promissory note, or transferring assets back to the taxpayer in full or partial satisfaction of the note.

5. The note may be forgiven or transferred as a gift to make use of some or all of the taxpayer's estate tax exemption amount. Incidental benefits include the fact that a long-term, low-interest promissory note received in exchange for assets is not a gift if the face amount of the note equals the value of the assets sold, and the note pays interest at the applicable federal rate, yet the note is generally worth less than the face amount in both the real world and the estate tax world if it is for a fairly long term, and has recently been set at the now low Applicable Federal Rate. This is due to the fact that a willing buyer would not pay the face amount of the note to a willing seller since the interest rate of the note is less than what such buyer could receive in the market.

6. Place the note into an LLC, into joint names with a spouse, under an incomplete gift domestic or foreign asset protection trust, convert it to a self-canceling installment note or private annuity, or proceed with one of the other strategies discussed in this letter.

On August 2020, in LISI Estate Planning Newsletter #2813 Alan Gassman, Jerry Hesch, and Marty Shenkman discussed how the well-established planning technique conventionally known as the Installment Sale to a Defective Grantor Trust can be combined with forgiveness of the note by gift in order to allow for flexibility, given the uncertainty of whether the estate tax exemption amount would be changed. The authors referred to this technique as the "Biden 2-Step," and encouraged practitioners to consider transferring taxpayers' assets into proper entities to facilitate an installment sale, while also selecting, establishing, and possibly refining, irrevocable trusts, and making seed capital gifts, as appropriate, before selling assets and entity interests to such trusts in exchange for long-term low interest promissory notes.

The Biden 2-Step's basic premise was that many taxpayers could not be sure whether they would need to do estate tax planning, but would be in the best position to do so by first queuing up the arrangement by making a sale in exchange for a note. If done sooner than later, taxpayers would have a better chance of being grandfathered to more favorable estate tax laws allowing for valuation discounts and the use of disregarded trusts for income tax purposes (aka grantor trusts). After implementing the Biden 2-Step, the taxpayer would be able to forgive the promissory note—and use a significant portion of his or her $11,700,000 estate tax exemption—immediately after knowing with reasonable certainty that the exemption was going to be reduced.

A YouTube video of Alan, Marty and Jerry discussing the Biden Two Step can be viewed at: https://www.youtube.com/watch?v=4e7utgxtn7A.

As the result of the present situation, many individuals and married couples are now owed large low interest promissory notes by trusts that they have established, and the question becomes whether to (a) continue with the note arrangement, (b) forgive, gift, or sell the note, or (c) enter into a Biden 3rd Step alteration of the arrangement, as described herein.

Reasons to Keep the Note in Place

There are a number of reasons to keep a promissory note in place. These should be evaluated based upon the unique circumstances of each taxpayer, and the possible impact that each reason can have on planning.

1. Continued Flexibility. Keeping the note in place permits the taxpayer to take advantage of one or more of the strategies described herein, when the time is right, based upon future circumstances.

2. Keeping the Note in Place Allows the Taxpayer to Reverse the Transaction, at Least to a Great Extent, Based Upon Relative Values at the Time of Reversal. For example, if the assets grow in value after the sale then the appreciation in value will remain under the trust, but asset interests equal in value to the promissory note can be transferred back to the taxpayer in exchange for cancellation of the note.

3. The Payments May be Needed for Living Expenses, to Pay Taxes and for Other Purposes. The taxpayer may be dependent on or may favor receiving annual interest and possibly principal payments on the note to pay for living expenses, taxes imposed on the note holder attributable to trust income, to make $16,000 per year per person annual exclusion gifts, and to give to charity. While the note may be set to pay interest only, if the note holder wants to receive payments of principal to have more in cash flow, this can be arranged if the Trustee of the borrower trust is agreeable to making prepayments.

4. Lender Relationships. Lenders that have approved the arrangement may prefer that it remain in place.

5. To Grandfather Low Rates. Many notes were implemented at very low interest rates to allow growth above the stated rate to remain outside of the taxpayer's estate. This will become more attractive if and when rates go up in value.

6. The Taxpayer Has Had Enough Planning For Now. Many taxpayers feel that they have been through an ordeal, or at least something less than a completely enjoyable experience in tolerating advisor recommendations and the logistics of putting an installment sale into place. Even asking them to make "another change" may be unappealing, despite our using all of our Dale Carnegie skills, grace and even pleading.

Disadvantages of Keeping a Promissory Note in Place

There are likewise a number of reasons to not keep a promissory note in place, and these will vary from taxpayer to taxpayer and situation to situation.

1. More Control and Personal Financial Security for the Note Holder. The taxpayer may want to keep a large net worth and control where a note would pass during his or her lifetime or upon death. It would be wise to carefully consider spending and possible needs before forgiving or giving away a large asset, not to mention psychological issues that can arise if an individual believes that they may run out of assets during their lifetimes.

2. Possible Loss of the Use of the Increased Federal Estate Tax Exemption. If Congress and the President act retroactively to reduce the exemption, then taxpayers risk losing the ability to use the currently high $11,700,000 estate tax exemption.

Though some advisors are concerned that Congress and the President could act during a taxable year to reduce the estate tax exemption, effective January 1 of that year, this type of conduct would more than enrage affluent financial supporters of both political parties. Both the Bernie Sanders Bill and the September 13, 2021 House of Representatives Ways and Means Committee Bill provided that the reduction in the exemption would not occur until January 1, 2022 (the start of the next taxable year).

Even if a law is passed that will only be perspective (applicable in the future) there will inevitably be many families who will not act before the end of the calendar year, for a number of reasons, including not knowing of the issue, not wanting to re-engage with an estate planner, having dementia, or placing higher priority on other things, like going to holiday parties and getting their cars washed.

3. A Note Arrangement May Cause Issues with Lenders. Many taxpayers transfer income-producing property or assets that are leveraged by debt, so lenders will review loan ratios and trust and debt arrangements to determine how those will impact the financing and financing terms.

In the author's experience, lenders typically disregard a promissory note owed by a trust to its Grantor, if both the trust and the Grantor guarantee the indebtedness, but guarantees can cause tax issues, such as if the Grantor of a trust is benefitted by the trust's guarantee.

Moreover, some lenders may have issues with debt owed by the trust to the Grantor, and Trust assets or entity interests being pledged as collateral for the indebtedness, and may ask for subordination of the note, or that the debtor use another lender.

4. Risk of Taxable Income on Death With Note Outstanding

Some authors have taken the position that it is possible that there will be recognition of income on the death of a Grantor, as if the Grantor sold the assets held by the disregarded trust to the trust in exchange for the promissory note before death.

The very well written Bloomberg Portfolio on Grantor Trusts by Professor Rob T. Danforth and Howard Zaritsky indicates that "While it is clear that the death of the Grantor terminates having a Defective Grantor Trust considered to be owned by the Grantor for income tax purposes, the IRS's tendency to attempt to cause the death of the Grantor to be a taxable event does not appear to be supported by case law or any clear statutory guidance."

Professor Danforth and Mr. Zaritsky also provide as follows:

There is no case, regulation or ruling that directly addresses the income tax treatment of the termination of a Grantor Trust status at the Grantor's death, but the IRS's own rulings lead to the inescapable conclusion that death of the Grantor should not be a recognition event for income tax purposes, even when the Trust holds encumbered property with a debt in excess of its adjusted basis. Although this conclusion seems escapable, the IRS may assert a different view.

Some advisors tend to be "opinionated" on issues such as these, believing that one position or the other would apply.[1] None of us have a divining rod, nor is it proper to advise taxpayers to "play the audit lottery anyway" if a taxpayer-friendly position can be taken, but we can educate taxpayers as to risks and the likelihood of success and let them make the decisions. Very few large fortunes were made by not taking risks, and the same may apply for keeping a fortune free from taxes that may be avoided.

5. <u>The Taxpayer Might Unwisely Change Their Mind or be Subject to Undue Influence and Dismantle Part of the Estate Plan.</u> A perfectly happy married couple might enter into promissory note arrangements, with the promissory notes being held by the surviving spouse, who loves the note more than the note holder, and might remarry someone, have dementia, or be subject to undue influence.

If the note did not exist, then all assets held by the Trust may be locked in to pass to the descendants of the original married couple. Now, the note may be gifted to the new spouse, although arguably this is based upon what the surviving spouse desires to have happen. Litigation may ensue, which could batter family relationships.

Strategies to preserve the value of the note for the Grantor and intended heirs or other beneficiaries can include the following, which are further discussed below: (1) making the note non-assignable, which may reduce its value for valuation purposes if this is permitted under State law, (2) converting the note to a nontransferable private annuity that vanishes upon the death of the annuitant, or (3) "wrapping the note in an LLC," and giving the controlling interest in the LLC to an entity other than the Grantor that would help to safeguard management and use of the note within the LLC.

Reasons to Forgive or Gift the Note and Use the Taxpayer's Exemption

1. <u>IRS Audit Considerations.</u> If the taxpayer would prefer not to be audited by the Internal Revenue Service, it would likely make sense to use their exclusion in 2021. There is probably a much lower chance that 2021 gift tax returns will be audited than gifts made in 2022 and thereafter. The IRS only has three years to make changes by reason of the audit of a gift tax return that adequately discloses a gift, and will in all probability be short staffed for the next three years, especially given the significant number of gift tax returns that will be filed for 2021. Because the IRS will likely receive funding to increase their staff in the coming years, 2022 gift tax returns will likely have a greater chance of being audited than 2021 returns given IRS budgets and the number of 2021 gift tax returns being filed.

If there will be a taxable estate, then the chances of audit as the result of the note being disclosed someday on a Form 706 – Estate Tax Return should also be considered. Satisfying or repaying the note now causes it not to be an asset disclosed on the estate tax return, which might cause a higher risk of audit or issues upon audit.

2. <u>Yearly Interest From the Note Adds to the Gross Estate.</u> Although the note is bearing interest at a low rate, interest earned is still added to the taxpayer's estate. For example, a $9,000,000 note bearing interest at 1.5% adds $135,000 per year to the taxpayer's estate (plus growth upon the investments made from the payments received).

3. <u>Notes in Place Still Can Be "Complicated" and Cumbersome.</u> Many taxpayers have a hard time understanding how they can be owed a note that is disregarded for income tax purposes, so they need multiple reminders to make sure that the trustee of the trust makes the note payment to the taxpayer.

Thus, the planner should both (1) remind taxpayers that it is important to follow appropriate formalities and (2) make a spreadsheet and calendar of annual interest payments to remind taxpayers of each payment's due date. Similarly, the taxpayer's certified public accountant and other financial advisors should also be aware of the importance of properly respecting formalities and maintaining financial statement and tax return consistency, which is further complicated by existence of notes.

4. Creditor Claims. Creditors can seize the note, because a note owed to an individual is considered that individual's property. For similar reasons, the note can be taken away by someone asserting undue influence or assigned to a spouse in the event of a divorce.

However, taxpayers should thoroughly consider the implications of such planning. Forgiving or otherwise eliminating the note can be the right move for creditor protection and divorce planning purposes, but not if doing so would be a "fraudulent transfer" for creditor purposes or would invoke the ire of a divorce court judge.

A promissory note owed to a Grantor may be contributed to an "incomplete gift" Asset Protection Trust that will protect the Grantor from creditors, and possibly also from undue influence and the opportunity of the Grantor to change his or her dispositive plans outside of the bounds of conduct that can be permitted under an irrevocable Asset Protection Trust.

Many taxpayers will be well advised to reduce exposure to possible future creditors by placing promissory notes owed to them into limited liability companies that are owned by multiple members, in order to have charging order protection.

Oftentimes, half or more of the voting membership interests of such an LLC will be owned by a separate trust for family members so that a creditor obtaining a judgment against the taxpayer who originally owned the promissory note will not be able to seize the note or take control over payments that are made to the LLC. Such an LLC interest held by the taxpayer may be valued at a significant discount upon death.

While the law of most states provides that a charging order is the sole remedy of a judgment creditor, some states, like Colorado and California, do not.

There is some support for the proposition that the state law where an LLC is formed would be controlling in determining whether a charging order is the sole remedy, but this is far from being firmly established. In 2019, the Iowa Supreme Court found that Iowa law applied to determine whether an LLC ownership interest held by a Florida couple in an Iowa LLC qualified as a tenants by the entireties asset and charging order protection. The Court found that Iowa, and not Florida, law applied.[2]

Also, partial ownership interests in such an LLC can be gifted to irrevocable trusts for children, grandchildren and descendants using the annual exclusion gifts on a discounted basis.

Placing a note under an LLC or family limited partnership with multiple members thus allowing for charging order protection by transferring partial interests for gift tax planning purposes, along with involving family members in management and possibly placing other assets under the same LLC to consolidate holdings can be good business reasons to avoid the application of Internal Revenue Code 2036(a)(2) for estate tax purposes under the bona fide sale exception, and may also facilitate significant discounts, if and when former note holder's interests in the LLC or limited partnership are valued upon death, or transferred or sold during the lifetime of the note holder.

Married couples who live in states that provide creditor protection for tenancy by the entireties assets, which are owed by married spouses, may wish to transfer promissory notes to be held as tenants by the entireties, so that the spouse presently holding a note would not lose the note if there was a creditor action against such spouse.

Where one spouse has made a seed capital gift to an irrevocable trust for the other spouse and/or descendants, and has sold assets that have been subject to valuation discounts in exchange for a note, the transfer of the note into joint names with the spouse who is a beneficiary of the trust might be considered to be evidence to the effect that the gift to the trust that owes the note was actually a transfer by the spouse who receives the note from the original noteholder spouse, or who shares ownership after the original noteholder spouse has placed the note into tenancy by the entireties. There does not appear to be support for the proposition that the transfer of a note after a legitimate installment sale transaction would be evidence to the effect that the recipient or TBE owner spouse has made a transfer to the trust that owes the note, especially if a Wandry assignment, or a King promissory note adjustment clause was used to assure that the value of what was transferred to the trust in exchange for the note was equal in value to the note.

It may nevertheless be a good idea to leave a reasonable amount of time between having the installment sale that resulted in the note existing and having the noteholder transfer it to the other spouse or tenancy by the entireties, and helpful for these steps to not be part of a single integrated plan. Many planners would recommend that separate steps occur in separate taxable years, but this will not be determinative in that the step transaction doctrine has been applied even where several years have transpired between steps that are pulled together into one aggregated transaction. It is helpful not to discuss or even consider a next step when putting the installment sale into place to limit the argument that there was an intent from the beginning to enter into the separate steps.

5. Valuation Discounts. The amount of the gift made upon forgiveness may be significantly less than the face amount owed on the note. Court cases have confirmed that promissory notes bearing interest at less than the normal fair market value rate will be subject to valuation discounts, as will a part ownership of a promissory note.

An excellent article that details the considerations with respect to the valuation of a note can be found in Bloomberg's Tax Management Estates, Gifts, and Trust Journal. [3]

It may be worthwhile to swap an existing long term low interest note for a shorter term higher interest rate note that would have the same value but a lower face amount. At a later time the replacement note could be gifted so that the gift tax return would show a gift equal to the amount owned on the note, as opposed to the discount that was taken into account when the original note was swapped out.

For example, a $10,000,000 20-year note bearing interest at 1.75% may be worth $8,000,000.

The payee of the note and the Trust that is the obligor may agree to swap the note for an $8,000,000 5-year note bearing interest at 6%, based upon the advice of legal counsel and a valuation expert.

The note may thereafter be forgiven or gifted as an $8,000,000 gift.

The exchange of a $10,000,000 1.75% 20-year note for an $8,000,000 6% interest 5-year note could be disclosed on a gift tax return, so that the IRS would have only three years from the date of the return to assert that a gift as occurred.

6. <u>State Tax Considerations.</u> Taxpayers should also consider and plan for the state estate tax consequences of such notes. Oftentimes, notes retained by a Grantor will be considered to be property for purposes of state estate tax calculations.

For example, New York's estate tax exemption is $5,930,000, but New York has no gift tax. As such, a New York resident may have a net worth upon their death under the $11,700,000 federal estate tax exemption (and won't pay federal estate taxes) and still pay estate taxes to the state of New York because the exemption amounts are not tied together. For example, the New York resident may nevertheless owe $399,440 in New York estate taxes if he or she retains the $10 million promissory note and $1 million worth of other assets. Thus, the New York resident must now make two considerations (1) whether to keep the promissory note in place and (2) whether to move to a place without a state estate tax, such as South Florida, which now has a population well exceeding 6 million and has been referred to as the sixth borough of New York City.[4]

Lawyers who represent individuals from high taxation states who still have "summer homes," or living patterns that may expose them to state and city taxes, should be particularly aware of this risk.

7. <u>Finality.</u> Many taxpayers and advisors might agitate over the fact that they simply are not sure what to do with a note. Thus, eliminating the note can provide better simplicity and give taxpayers a sense of finality and closure.

Third Step Strategies

Part II of this article will be issued soon and will discuss the following in more detail, but readers who are interested in something more than simply leaving the note in place, or forgiving or gifting all or a portion of the note may be interested in alternatives (aka the "third step").

Based on the above discussion, planners can make suggestions on how existing promissory notes and private annuity payment arrangements may be changed to best protect grantors and their families from taxation including but not limited to:

1. <u>Abort the Mission and Leave the Dance Floor.</u>
Some taxpayers may elect to step back, meaning that they wish to reverse the process completely, and only entered the dance floor because they feared the exemption would revert to a lower amount, such as $5,000,000. Now that the exemption amount is not expected to be drastically reduced, at least for the next couple of years, that same individual wants a less complicated plan than the Biden 2-step.

2. <u>Transfer the Note to an Asset Protection Trust.</u>
A note could be transferred to an Asset Protection Trust that is considered to be an "incomplete gift" for federal estate and gift tax purposes by reason of the Grantor having the right to consent before any distribution can be made to any person other than the Grantor, and a testamentary Power of Appointment, which may be exercisable solely in favor of descendants of the Grantor, or perhaps up to 25% to future spouses, charities or other individuals or entities, and 75% solely for the descendants of the Grantor.

While the note would still be includable in the Grantor's estate for estate tax purposes, it would be protected from creditors of the Grantor, assuming that the law of the asset protection jurisdiction is controlling, and also from undue influence and "next spouse" claims as well.

The trust could be drafted so that the Grantor could make the trust a "completed gift trust" by just renouncing her right to consent to distributions and her retained power of appointment, and at that time she will be considered to have made a complete gift of the assets under the trust to the Trustee, without further legal work and transfers being needed.

3. Convert the Note Into an Annuity
Noteholders who live in states that provide creditor protection for annuities may wish to convert the note, in whole or in part, to an annuity right.

4. Use a "Zero'd Out CLAT.
Many clients who are owed large promissory notes may not be aware of the ability to transfer a note or other assets to a Charitable Lead Annuity Trust ("CLAT") during life or upon death to qualify for a 100% estate and/or gift tax charitable deduction while expecting half or more of the assets involved to pass to be held for the benefit of family members after a term of years during which payments are made to one or more charities as determined each year by the family.

5. Safely Gifting the Note – Wandry, Petter, Q-TIP, What's Better?
When there has been an installment sale to a Defective Grantor Trust in exchange for non-voting membership or limited partnership interests, the remaining estate tax exemption of the taxpayer may be in doubt.

Should the taxpayer, therefore, wait until after the statute runs in 2025 before making a gift of any portion of the note? Alternatively, can the taxpayer safely use a formula clause transfer, or a lifetime QTIP Trust arrangement to gift as much of the note as possible without triggering gift tax? The answer is "most likely" with a formula transfer note, and "almost definitely" with a lifetime QTIP.

6. Using the Exemption for a QPRT Instead of Note Reduction.
Other alternative uses of the taxpayer's gift tax exemption may be considered. For example, if the taxpayer's homestead is expected to grow in value or to at least retain its value, and the Grantor is expected to live for longer than the period chosen as the retained use interest, then use of part of the taxpayer's gifting allowance for one or more QPRTs that can own all or a part of the taxpayer's primary residence and one other personal residence, can be the most effective use of gift tax exemption.

7. Give the Note Some SCIN.
Another advantage of keeping the note outstanding is the ability to maintain or convert it to a self-canceling installment note, in whole or in part, so that the death of the Grantor or the Grantor's spouse can cause the note not to be included in the Grantor's estate, without having to use the Grantor's estate tax exemption to reduce or eliminate it.

If the Grantor has a health condition or family history that would cause it to be more probable than not that death would occur before the balloon, then this could be a good strategy.

Conclusion

Taxpayers who have taken the first step in selling assets to disregarded trusts in exchange for promissory notes have many opportunities and possibilities to consider in determining whether to terminate or have the note repaid.

For estate tax planning purposes, the best result may be facilitated by forgiving the note, but not always.

Practical concerns such as marital rights, creditor protection, and whether a commitment should be made.

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[1] Ladies and Gentlemen, I have suffered from my music now it is your turn!

All the prophets of doom

Can always find room

In a world full of worry and fear

Tip cigarettes,

And chemistry sets,

And Rudolph, the Red-Nosed Reindeer.

From Monty Python's parody of a Bob Dylan Song. Monty Python Live! At City Center – Track 13 (1976) https://www.youtube.com/watch?v=qfTlGMCeuDE

(Brandon Ketron officially disclaims any participation in the selection or preparation of this footnote)

[2] Wells Fargo Equip. Fin. v. Retterath 2019 WL 1574686.

While some have commented that this decision was "corny" we are not aware of a kernel of contrary authority.

[3]Michael S. Strauss and Jerome M. Hesch, A Noteworthy Dichotomy: Valuation of Intrafamily Notes for Transfer Tax Purposes, 45 Bloomberg Tax Management Estates, Gifts, and Trust Journal 4 (Jan. 2020).

[4] New York City has 5 Boroughs, bring Manhattan, Brooklyn, the Bronx, Queens, and Staten Island. New York's Primary Airports are John F. Kennedy and LaGuardia. Islip (the name has since been changed to Long Island MacArthur Airport) is must less crowded but is a 2 hour cab from Manhattan.

This is Part 1 of this article.

Stay tuned for Part 2 in our next Thursday Report.