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Interesting Interest Questions: Interest Rates for Intra-Family Transactions

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EXECUTIVE SUMMARY[1]

Common sense and a continuing awareness of the rules and opportunities that exist in light of current economic and financial factors enable tax advisors to help clients extend credit and engage in installment sales with family trusts and individuals at the lowest interest rates possible. Doing so requires knowledge of the special income tax and transfer tax rules applicable to installment sales, and may cause the planner to venture into relatively uncharted planning areas, with minimal risk. Income tax aspects of intra-family notes and other types of installment sales will become more important for families who are no longer as concerned about estate tax because of the recently enacted estate tax law.

With the Applicable Federal Rates (the ''AFR'') under §1274(d) at near-historic lows, estate planning practitioners are recommending that clients enter into freeze transactions such as intra-family installment sales to grantor trusts, or engage in the restructuring thereof, in order to maximize the benefits of these unusually low AFRs.[2] When the current month's AFRs are slightly higher than the prior month's AFRs, these same estate planning professionals usually assume that the minimum interest rate [3] can only be the AFR in effect for the month of the installment sale transac-

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[2] Most freeze transactions are premised upon the ability of junior family members, or trusts for junior family members, to borrow at a low rate of interest and invest the borrowed funds at a rate of return greater than the cost of the borrowing. Using financial leverage for wealth shifting from Senior to Junior is especially beneficial because the AFR is a below market interest rate. Since the AFR is based on the prior month's Treasury Bill rates, it will always be less than market rates even in periods of high market rates. See Zeydel, ''Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies,'' 33 *Tax Mgmt. Estates, Gifts & Trusts J.* 223 (2008), which concludes that for many freeze techniques, the interest rate spread is always advantageous even when the AFR is historically high.

[3] The AFR is the minimum rate that can be used without causing the OID rules to treat a portion of the stated principal as disguised interest or a disguised gift. There is no prohibition in the Code or Regulations on using an interest rate higher than the AFR. See §163(i) permitting the use of an interest rate 5.0% higher than the mid-term AFR without having to treat part of the interest as

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tion, or the month that the interest rate for a prior installment sale is reset. Although using the lower of the AFR for the month of the event or the AFR for the two prior months [4] as the minimum interest rate has been mentioned as a possibility for new installment sales to grantor trusts and restructuring prior installment notes,[5] those who have addressed this possibility have said that the AFR for the prior two months cannot be used without citing any authority for their conclusions, or at best say that the answer is not clear. However, the use of lowest AFR for the month in which the event occurs and the two preceding months can be advantageous by allowing the selection of a lower interest rate than the current month's AFR.

> *Example:* Senior lends Junior $1,000,000 during December 2010 at 0.32% interest, payable annually, with all note principal due at the end of three years. Junior purchases a three-year certificate of deposit paying 2.32% annual interest. Each year Junior earns $23,200 on the investment of the loan proceeds and pays $3,200 of interest expense. Thus, Senior is able to shift $20,000 of taxable interest income to Junior without incurring any gift taxes.

Another concern arises where donors who have successfully shifted wealth to family trusts or other family entities for junior family members that are not exposed to the gift or estate taxes now find that they are in a financial position where they need to borrow from these family trusts or other family entities. If loans made by a family trust or other family entity back to the senior family member use rates of interest based upon the AFR, will the use of an interest rate that is lower than market rates [6] create exposure to the inclusion of these trusts or other entities in the senior family member's gross estate under §§2036(a) and 2038?

disguised note principal. And, by analogy, Regs. §1.707-4(a)(3)(ii) provides a safe harbor maximum interest rate of 150% of the long-term AFR then in effect.

[4] *See* §1274(d)(2). GRATs have no such choice as §2702 mandates that the §7520 rate for the month the GRAT is settled must be used.

[5] Section 1274(d)(2) states that ''in the case of any sale or exchange, the Applicable Federal Rate shall be the lowest 3-month rate.'' This means the lowest of the rate in effect for the calendar month of the sale or exchange, or the rates in effect for the prior two calendar months.

[6] As stated above, the AFR is a below market interest rate regardless of whether market rates are high or low.

ANALYSIS

What Is the Minimum Interest Rate That May Be Used?

On the issue of whether the minimum interest rate for the month of a sale or refinancing can be based upon the lower of the Applicable Federal Rate for that month or the Applicable Federal Rate for either of the preceding two months, the Internal Revenue Code provides the answer.

Because §1274 is located in that portion of the Internal Revenue Code providing the original issue discount (OID) rules [7] for transactions that are treated as realization events for Federal income tax purposes, several commentators have concluded that §1274 only applies to deferred payment sales that are income tax realization events under §1001(a). These commentators have also concluded that since an installment sale to a grantor trust is disregarded for income tax purposes, there is no ''sale or exchange'' for purposes of §1274.[8] By assuming that §1274(d) only applies to installment sales that are income tax realization events, their conclusion would be that using the lower AFR over a three-month period under §1274(d) is not possible. But then, they conclude that the §1274(d) AFR for the current month would have to apply. A close reading of the Internal Revenue Code shows that for installment sales to grantor trusts the minimum interest rate that must be used is determined under §7872 and not §1274.

Section 7872 is located in Subchapter C of Chapter 80 of the Internal Revenue Code. Given the heading of Subchapter C (*Provisions affecting more than one subtitle*), it is clear that §7872 applies to the gift, estate and income tax subtitles.[9] Moreover, the language in §7872 makes it clear that it affects both the income

[7] The OID rules are designed to determine the amount and the timing of the interest income and interest expense inherent in obligations that are treated as ''debt obligations'' for Federal income tax purposes.

[8] For an analysis of this viewpoint, see Zaritsky, Akers, and O'Grady, ''Useful Uses of Grantor Trusts in Modern Estate Planning: Taking Advantage of a Popular Non-Entity,'' Special Session Materials I-C at pages 73–74, *43rd Univ. of Miami Heckerling Institute on Estate Planning* (2009).

[9] In 1984 Congress enacted §7872, which prescribes the income and gift tax treatment for certain below-market interest rate loans. Deficit Reduction Act of 1984, P.L. 98-369, §172(a), 98 Stat. 494, 699. Under §7872, a below-market loan is characterized as an arm's-length transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all the principal and interest payments due under the loan. Such transfer by the lender to the borrower is deemed a gift. In effect, §7872 requires that all loans among related parties or even unrelated parties bear an interest rate based on the then-current Applicable Federal Rate.

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taxes and the gift taxes. Section 7872(a) states that it applies ''for purposes of this title.'' That title is Title 26 of the United States Code, which is the entire Internal Revenue Code. Now, look carefully at the interest rates that §7872 uses for all purposes. Section 7872(f)(2)(A) incorporates by reference the interest rates in §1274(d). Using this analysis, the minimum interest rates for transactions that are disregarded for income tax purposes (such as a sale to a grantor trust) are still the §1274(d) rates. Thus, one can use the AFR for the current month or either of the AFRs for the prior two months. The estate planning professionals who have questioned whether §1274(d) rates can be used for installment sales to grantor trusts have missed this point.[10]

The language in §7872 makes it clear,[11] at least to the authors, that §1274(d) applies in the context of any ''sale or exchange'' considered to have occurred for income tax, gift tax, or estate tax purposes. Section 7872 must be applied in deciding whether a loan arrangement is considered to be a gift for gift tax purposes.[12] Section 7872(f)(2)(A) specifically states that in the case of a term loan ''the applicable Federal Rate shall be the applicable Federal Rate in effect under §1274(d) 'as of the date on which the loan was made,' compounded semiannually.''

The words ''as of the day on which the loan was made'' refers to the applicable Federal rate determination process under §1274(d), which includes the lowest three-month rate sub-provision referred to under §1274(d)(2). If this were not the case, then the application of §1274(d)(2) would have been explicitly limited to ''income taxable'' sales or exchanges.

This is the position that the IRS took in *Frazee v. Comr.*[13] when it required that the rates prescribed in §1274(d) must be used in determining the value of an installment note for gift tax purposes under §7872. Therefore, *Frazee v. Comr.* is judicial authority for the use of the §1274(d) AFRs in valuing installment notes for the gift tax.

What About When the Interest Rate on an Existing Term Loan Is Reduced?

Obviously, many loans [14] in effect from prior years have interest rates higher than the current level of AFRs. Since the objective is to shift wealth to junior family members, or to trusts for junior family members, one would want these intra-family loans to be at the minimum interest rates that the IRS will accept. The consensus seems to be that if the borrower of the term loan has the ability to prepay principal, it should not be considered a gift if the parties renegotiate to provide that in lieu of being prepaid the payee accepts a reduction of the interest rate to the now lower Applicable Federal Rate.[15] When this situation occurs between borrowers and commercial lenders when interest rates go down, the borrower typically has the liquid funds available to actually prepay the note. If the borrower in an intra-family loan wants to negotiate for a lower interest rate, the borrower should be

[10] Not surprisingly, there are other situations where there has been confusion whether the definitions found in Subchapter C of Chapter 80 are limited to only the income tax. For example, the valuation rules mandated under §7520 apply to the income taxes, the gift taxes and the estate taxes. *See* Regs. §§1.7520, 20.7520 and 25.7520. Another application of the impact of definitions is whether a disregarded entity under the check-the-box regulations is disregarded for the transfer taxes as well as the income taxes. In *Pierre v. Comr.*, 133 T.C. 24 (2009), a divided Tax Court treated a single-member limited liability company as a separate entity for Federal gift tax purposes.

[11] Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

[12] The legislative history of §7872 states that its tests for adequate stated interest and its applications leading to the imputation of interest create interest for income tax purposes and for gift tax purposes. Joint Committee, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 524, 528–529 (Dec. 31, 1984).

[13] 98 T.C. 554 (1992). See also PLRs 9535026 and 9408018 following the Tax Court's analysis in *Frazee*.

[14] The term loan is used in its broadest sense to include any debt obligation, including the promissory note that the grantor takes back as seller-provided financing in an installment sale to a grantor trust.

[15] See Blattmachr and Madden, ''How Low Can You Go?'' 109 *J. of Tax'n* 22 (2008), discussing the tax treatment when this occurs. For a contrary view see Hayes, ''Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners,'' 13 *California Trusts and Estates Quarterly* No. 2, 5 (2007). The complete analysis provided under the article by Philip J. Hayes is as follows:

> One factor indicating that a loan lacks bona fides is the exchange, during periods of falling interest rates, of a note for a new note with the same principal amount but bearing a lower interest rate. Some practitioners are unconcerned with refinancing an intra-family loan to a lower rate if the loan allows prepayment (almost all do, or, if silent, state law permits). More cautious advisors recommend avoiding this practice (see, e.g., Benjamin Feder, The Promissory Note Problem, 142 Trusts and Estates 10 (January 2003)), however, based on the plain economic reality that a true lender would not trade one asset for another less valuable. To avoid the IRS argument that the loan is actually a gift, these advisors recommend renegotiating the terms of the note to compensate the lender for the lower interest rate; perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral. The IRS has provided no direct authority on this issue. The Proposed Regulations include a section entitled ''Treatment of Renegotiations,'' (Prop. Treas. Regs. §1.7872-11(e)) but merely reserves the subject for later guidance, which has not been forthcoming.

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prepared to show that the borrower has the same liquidity.

There has been some confusion in restructuring existing loans and installment notes because the list serve commentary, and the published articles, have not clearly differentiated the discussion between loans made to grantor trusts and loans made to individuals or entities that are treated as separate tax persons for Federal income tax purposes. If the loan is between the grantor and the grantor trust, there is no loan for income tax purposes.[16] Thus, the income tax realization concerns are irrelevant. However, for gift and estate tax purposes, the loan by the grantor to the grantor trust is still treated as a loan. Thus, it is possible that the reduction in the interest rate of a term loan would be considered a gift tax transfer when a term loan interest rate is reduced.

The authors believe that the IRS could take the position that if a ''sale or exchange'' would occur for income tax purposes where the interest rate of a note is reduced, that by analogy the same analysis could be extended to the gift tax. Thus, the IRS could argue that if the modification would create an income tax realization event under Regs. §1.1001-3 (the *Cottage Savings* regulations), by analogy the same modification could create a gift for gift tax purposes, In those Regulations, a reduction in the interest rate of only 0.25% is treated as an income tax realization event.[17] Or the IRS could use new §108(i) by analogy. Section 108(i) is the rule for deferral of income from discharge of indebtedness by an individual in a trade or business which specifically refers to the deferral being applicable where there is an ''exchange of the debt instrument for another debt instrument.'' [18] Section 108(i) further states that an ''exchange of the debt instrument for another debt instrument'' includes an ''exchange'' resulting from the modification of a debt instrument. Under the above rationale, where the interest rate of a note is reduced, the note may be considered as exchanged for another note of different terms, and thus a gift occurs.

What Is the Harm in Reducing the Interest Rate on a Term Rate Loan if This Is Considered a Gift for Gift Tax Purposes?

Suppose that the IRS were somehow able to impose gift treatment on the reduction of the interest rate under a term loan agreement. Would the taxpayer be harmed as a result?

The gift would be measured by the difference between the present value of the term loan before and after reduction. For example, if an interest-only term loan has eight years remaining, and the interest rate is lowered from 5% to the then applicable semiannual AFR rate of 2%, then the gift element would be based upon the difference between the present value of the expected stream of payments, applying a particular discount rate.

On a $1,000,000 loan in the above example, this would be a gift of approximately $201,982, based upon a discount rate of 4%. On the other hand, the lender/parent would receive $30,000 per year less in interest, so over eight years the interest payments back would be reduced by a total of $240,000. Not taking into account the time value of money or anticipated growth in assets, it certainly seems better to make a $201,982 gift by reducing the interest rate, as opposed to increasing the lender/parent's estate by $240,000, which saves $38,018 in payments that would otherwise be made to the lender/parent. Further, if the lender/parent can accomplish this without paying gift tax by simply reducing what remains of the client's $1,000,000 gift tax exclusion, there is no negative impact on the exclusion until the client dies.

If the parents have used both of their $1,000,000 gift tax exemptions and are required to pay gift tax upon reduction of interest rate, then because of the tax-exclusive nature of the gift tax, additional savings occur. For example, if the gift tax is based upon 45% of the present value of the reduction, which is $201,982, then a $90,892 tax results (assuming no use of the annual exclusion).

Alternatively, if no reduction in the interest rate is made, and assuming that the $90,892 of gift tax that would have been paid remains in the client's estate, then on death an additional $330,892 is included in the client's estate ($240,000 of additional interest paid to the client because no reduction of the interest rate was made, and $90,892 of gift tax that the client would have paid as a result of the gift which occurred on reduction of the interest rate). If the marginal estate tax is based upon 45% of the $330,892, then $148,901 of estate tax is due (assuming the client has already used his or her entire unified credit).

The result is that a net of $181,991 would pass to the next generation if no reduction of the interest rate was made, while a net of $201,982 would pass to the next generation if a reduction of the interest rate was made and gift tax is paid because of the reduction.

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[16] If there is a reduction in interest rates, there is no need to consider if that modification creates an income tax realization event under Regs. §1.1001-3 (the *Cottage Savings* regulations).

[17] Regs. §1.1001-3(e)(2)(ii).

[18] *See* §108(i)(4). The deferral provisions in §108(i) apply to a ''reacquisition'' of a debt instrument issued by a C Corporation or any other person in connection with a trade or business. The term ''reacquisition'' includes such events as an acquisition of a debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from the modification of a debt instrument), the exchange of a debt instrument for corporate stock or a partnership interest, and the contribution of a debt instrument to capital. A ''reacquisition'' also includes the complete forgiveness of indebtedness by the holder of the debt instrument.

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Disregarding the time value of money, this generates an estate tax savings of $19,991!

One commentator [19] has indicated that a continuing pattern of reducing the interest rate on a term loan might be seen by the IRS as evidence of a side agreement that the term loan was not in reality intended to bear interest at the rate initially set. The IRS will have the burden to show that this was not intended to be a long-term, fixed-rate loan, and the statutes provide no clear path under which to achieve this. Nevertheless, this could result in the IRS imposing a floating interest rate as the interest rate for the loan which, in times of high AFRs, may materially exceed the fixed interest rate stipulated in the loan document. Additionally, if the term of the note is repeatedly extended upon refinancing of a loan the IRS may argue that the loan is not really a term loan, but is instead a demand loan which has an indefinite maturity. The IRS may then argue that the applicable interest rate would be the ''blended annual rate.'' The blended annual rate, which is comprised of one-half of the January short-term AFR for semiannual compounding and one-half of the July short-term AFR for semiannual compounding, may exceed the interest rate stated in the loan document in times of higher interest rates.

Does Annual Interest Mean You Have To Use the Semi-Annual Rate for Annual Interest?

A common misconception among practitioners is that the published rate for ''annual compounding'' should apply when interest is payable annually. Somewhat illogically §7872(f)(2)(A) states that in the case of any term loan the applicable Federal Rate will be the effective rate ''compounded semiannually.'' Further, §7872(f)(2)(B) indicates that the demand loan rate will be the short-term applicable Federal Rate ''compounded semiannually.'' As such, the rate which is ''compounded semiannually'' appears to be universally applicable to loans whose interest rates are determined under §7872. Congress shaped the law in this manner because when §§1274 and 7872 were first enacted in 1984 the statutory mandate was that the AFRs were to adjust semi-annually. The very next year Congress enacted an amendment requiring the AFRs to adjust monthly.[20]

In 1985, the IRS promulgated Prop. Regs. §1.7872-3, which would provide for the annual rate to be used for term loans providing for annual payments. However, this Regulation was never made final. Prop. Regs. §1.7872-3(b)(1) states that ''the applicable Federal rate is an annual stated rate of interest based on semiannual compounding.'' However, the Regulation further states that ''the Commissioner may prescribe equivalent rates based on compounding periods other than semiannual compounding (for example, annual compounding, quarterly compounding, and monthly compounding), to facilitate application of this section to loans other than those involving semiannual payments or compounding.''

This is contradictory to the text of §7872(f)(2)(A), which provides for the use of applicable Federal rates based on semiannual compounding. The authors believe that the ''semiannual rate'' is the appropriate rate to use for a demand loan or a term loan because of the supremacy of the Internal Revenue Code over a Proposed Treasury Regulation.[21] A Proposed Regulation does not have the force and effect of law until it is finalized. Moreover, courts have repeatedly declined to defer to Proposed Regulations.[22] This should be especially true in the situation of a 1985 Proposed Regulation that has not since been finalized.

While Proposed Regulations may be relied upon by taxpayers,[23] at present the applicable Federal rate for semiannual payments is lower than the rate that applies for annual payments, although the difference is almost negligible. For December 2010, the semiannual and annual rates for long-term loans are 3.50% and 3.53%.

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[19] See Hesch and Gassman, LISI *Estate Planning Newsletter* #1447, Technical Editor's Comment by Steve Gorin (4/16/09), at http://www.leimbergservices.com.

[20] Under these revised rules, the AFR will be computed using the same methodology as under present law, except that the rates will be determined on a monthly basis and the rate will reflect the average yields for one-month periods. In addition, the AFR for a particular month may be used as the imputed interest rate for contracts for sales or exchanges entered into in that month and the next two succeeding months. House Conference Report, *Simplification of General Imputed Interest Rules and Lower Discount Rate for Certain Sales*. P.L. 99-121 (10/11/85).

[21] *See* Berg, ''Judicial Deference to Tax Regulations: A Reconsideration in Light of *National Cable*, *Swallows Holding*, and Other Developments'' 61 *The Tax Lawyer* 535 (Winter 2008).

[22] *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007) citing *CFTC v. Schor*, 478 U.S. 833, 845 (1986) (''It goes without saying that a proposed regulation does not represent an agency's considered interpretation of its statute and that an agency is entitled to consider alternative interpretations before settling on the view it considers most sound.''); *but see Boeing Co. v. U.S.*, 537 U.S. 437, 453 n. 13 (''[W]e find these proposed regulations to be of little consequence given that they were nothing more than mere proposals.''); *McNamee v. Dep't of Treasury*, 488 F.3d 100 (2nd Cir. 2007).

[23] Regs. §1.6662-4(d)(3)(iii) (proposed regulations are considered to be ''authority for purposes of determining whether there is substantial authority for the tax treatment of an item'' for purposes of determining whether the accuracy-related penalties under §6662 apply).

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Does Using the AFR Create Inclusion of Previously Transferred Assets in Grantor's Gross Estate?

Although the AFR is a below market interest rate, there is a concern that somehow this exposes the assets in the trust that is the maker of the intra-family loan to inclusion in the lender's gross estate under §2036(a). The authors believe that the same analysis that concludes that the use of the §1274(d) AFR must be used for valuing a term loan under §7872 for gift tax purposes supports the view that the use of the AFR, even if it is a below market interest rate, should not create any powers that would cause inclusion in the lender's gross estate. It is a well-accepted transfer tax principle that, since the gift taxes and the estate taxes are in pari materia, gift tax principles must be used for the estate tax as well.[24] Moreover, using the AFR, even if it is a below market loan, meets the statutory requirement that the loan be a transfer for adequate consideration in money or money's worth. And in the event the IRS is somehow able to convince a court that making a loan at below market rates is a gift, there is no indication that the making of a gift is a retained interest under §2036(a).

The real issue under §2036(a) is whether there was an understanding that the assets in the trust would be accessible to the lender. This is a factual determination, and as long as the parties respect the debtor/creditor relationship, §2036(a) should not be a concern.

What Maximum Interest Rate Can Be Used in a Related-Party Loan?

Assuming that usury laws are complied with, §163(i) provides that a debt instrument with a maturity five years or greater from the date of issue can bear interest, at maximum, at 5% above the mid-term applicable Federal rate. This appears to be a safe harbor for Federal income tax purposes.

Regs. §1.1274-3(b)(3) states that ''interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's-length amount of interest that would have been charged in a cash lending transaction between the same two parties.'' This regulation is far from clear, and uses terms, such as ''clearly excessive'' and ''clearly greater than the arm's-length amount of interest that would have been charged,'' upon which reasonable minds may easily differ. That being said, as a practical rule, it may be preferable to not stray too far from the prevailing market interest rates that are used in similar type transactions when determining the maximum interest rate that can be applied to a transaction.

Additionally, Regs. §1.707-4(a)(3)(ii) can be used by analogy. It provides a safe harbor maximum interest rate of 150% of the long-term AFR then in effect in the context of preferred returns or guaranteed payments made to a partner of a partnership.

What About Self-Cancelling Installment Notes?

If an estate taxable client (i.e., a single client with more than a $5,000,000 estate, or a married couple with more than a $10,000,000 aggregate estate) would like to receive interest payments on an intra-family loan or on an intra-family installment note in excess of the minimally required interest note payment under the applicable federal rates, it makes sense to use a self-canceling installment note (''SCIN''). A SCIN is a promissory note where the remaining debt is cancelled upon the death of the note holder. Because the AFR is a minimum interest rate, the parties are free to use a rate higher than the AFR. And, there are occasions where the note holder would like to receive more than the AFR minimum for personal reasons or financial reasons.

If a SCIN is used, a risk premium must be added as additional consideration. The risk premium can be in the form of additional principal or additional interest. The calculation of the risk premium is based on mortality tables and a discount rate (i.e., an interest rate). However, there is no clear authority as to what interest rate and what mortality table must be used to compute the risk premium for SCINs.[25]

What Discount Rate to Use?

First, it is unclear whether the interest rates applicable to SCINs should be based on the §7520 rate or on the AFR. Based upon the language of §7872, and on the analysis by the Court in *Frazee v. Comr.*,[26] the authors believe that the appropriate interest rate applicable to SCINs taxable as installment sales is the AFR, not the §7520 rate. The §7520 rate is to be used for valuing annuities, term interests, life estate and remainders. Because the SCIN is a ''debt obligation,'' it is unlikely that a SCIN, with an appropriate interest component, would fall into any one of these catego-

[24] *Merrill v. Fahs*, 324 U.S. 308 (1945).

[25] For discussion of this issue, and other issues relating to SCINs, in great detail, please see Hesch and Manning, ''Coordinating Income Tax Planning with Estate Planning: Uses of Installment Sales, Private Annuities and Self-Canceling Installment Notes,'' Chapter 10, *36th Annual University of Miami Philip E. Heckerling Institute on Estate Planning* (2002).

[26] 98 T.C. 554 (1992).

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ries. A SCIN is classified as a debt instrument under Regs. §1.1275-1(j). Moreover, GCM 39503,[27] issued in 1985, provides that a SCIN with a maturity date before the expiration of the holder's life expectancy will be characterized as a debt obligation. The court in *Frazee v. Comr.* reinforces this analysis because it found that the appropriate interest rate for an installment note for gift and income tax purposes is determined under §7872, which uses the AFR under §1274(d). Therefore, the appropriate interest rate for a SCIN (exclusive of the risk premium) should be the AFR in effect on the day that the note was made, which includes the lowest AFR for the current month and the prior two months, as provided under §1274(d)(2).

Choice of Mortality Table?

The question of which mortality table is applicable to determine the appropriate life expectancy of the lender is even less clear. The IRS, in its actuarial tables prescribed in *Actuarial Valuations, Version 3A* (Publication 1457), uses the Mortality Table 2000 CM (derived from the 2000 census) for illustrative purposes to show how to use mortality tables to compute the risk premium on a SCIN. However, other IRS authority, GCM 39503, makes reference to the higher mortality tables under Regs. §1.72-9, Table V, with respect to a SCIN transaction. Because there is no concrete authority for using any particular mortality table, the authors suggest use of the mortality tables under Regs. §1.72-9, which generally provides for longer life expectancies and thus a lower risk premium. For example, under the Mortality Table 2000 CM, the life expectancy of a 70-year-old is 14.27 years, while under Regs. §1.72-9 the life expectancy for a 70-year-old is 16.0 years.

Whenever an installment note utilizes an interest rate greater than the minimum required AFR, planners should always consider adding the SCIN risk component to the note. Even if the client is expected to survive, there is no additional cost to add this component, and it creates a windfall if the client should unexpectedly die.[28]

A taxpayer could use the above-referenced rules as a hedging technique. The taxpayer could sell assets to a grantor trust in exchange for two separate installment notes; one at the AFR and the other with the desired rate of return on the sale. The seller-provided financing can be divided into two components, one component as a SCIN that cancels upon the taxpayer's death, and another as a fixed installment note (i.e., without a self-canceling feature). This strategy can be illustrated by the following example:

> *Example:* A taxpayer, age 70, sells $2,000,000 worth of assets to a grantor trust in January 2011. The long-term AFR for November 2010 is 3.35%. The applicable interest rate (based on the taxpayer's life expectancy) for a SCIN that would pay interest only and would balloon in 16 years would be 8.2970%, based upon the November 2010 rate, which is the lowest of the November 2010, December 2010, and January 2011 rates.
>
> If the client would like to receive 5% annual interest, then the $2,000,000 note could be divided into a $975,000 nine-year note bearing interest at 1.53%, and a $1,025,000 16-year interest-only note at the 8.2970% rate described above. The $1,025,000 note would be a SCIN and would cancel upon the death of the taxpayer.

The above structure could work to potentially reduce the taxpayer's estate tax exposure, while providing the taxpayer with his or her desired annual payments.

What Timing Rules Control Reporting of Interest Income and Deductions?

Although the timing rules for the reporting of interest are designed to require that the interest income and interest deduction are reported by both parties to the debt obligation in the same taxable year, it is possible that this timing symmetry is not achieved when the debtor and the creditor use different methods of accounting. When this lack of symmetry may possibly occur, the various related-party rules [29] and the OID rules will frequently apply to override the individual's method of accounting. Therefore, one must determine when the timing of the reporting of interest income and interest deductions can be governed by the debtor's and creditor's individual methods of accounting and when the related-party and OID exceptions apply.

The first set of timing rules provide that ''unstated interest'' must be reported as it accrues financially, unless an exception, such as §1274A(c), applies, in which case the interest is to be reported when it is

[27] GCM 39503 (June 28, 1985).

[28] The authors often create an amendment to a regular installment note to convert the note to a SCIN, but do not have clients sign the amendment unless their health situation changes. If a situation arises and the life expectancy for the client has gone down, the amendment is on hand for execution. It is also important for clients to understand that estate planners need to be notified of any changes in a client's health situation, as they are often overlooked.

[29] *See* §267(a)(2). For employment arrangements requiring reporting symmetry among employers and employees who are not related parties see §404(a)(5). For guaranteed payments in the partnership context, see Regs. §1.707-1(c).

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paid. The timing rules for ''unstated interest'' control regardless of a taxpayer's method of accounting. See §§163(e) and 1272 and Regs. §1.1272-1(a)(1). Nevertheless, an election may be made under §1274A(c), which is permissible for loans to which §1274 applies, of which the stated principal amount does not exceed $2,000,000, and of which the lender does not use the accrual method of accounting and is not a dealer with respect to the property sold or exchanged. Furthermore, the lender and the borrower must jointly make the election with respect to the debt instrument. The result of the §1274A(c) election is that the ''unstated interest'' is reported as it is paid, and not as it accrues.

The second set of timing rules address the reporting of ''stated interest.'' By ''stated interest,'' we are referring to the interest amount provided by the terms contained in the promissory note. The timing of ''stated interest'' is generally determined by the taxpayer's method of accounting and not by the OID rules. Regs. §1.1272-1(a)(1). A debt obligation which provides for the payment of interest does not provide for ''stated interest'' unless it provides that the interest is unconditionally payable at least annually at a single fixed rate. §1273(a)(2), Regs. §1.1273-1(c)(1)(I). In other words, the mere recitation in the note that interest will be paid at a certain percentage rate is not sufficient to qualify as ''stated interest.''

Rev. Rul. 95-70, 1995-2 C.B. 124, discusses the kind of terms needed in a note so that past due interest can be treated as stated interest. Prior to 1996, Regs. §1.1273-1(c)(1)(ii) provided that the interest is unconditionally payable only if late payment or nonpayment is expected to be penalized or reasonable remedies exist to compel payments. The 1996 amendment to Regs. §1.1273-1(c)(1)(ii) now provides that interest is unconditionally payable ''only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment or nonpayment a remote contingency.'' Furthermore, this regulation provides that remedies or terms and conditions are not taken into account if the note holder does not intend to enforce them.

One of the promissory notes discussed in Rev. Rul. 95-70 provided that interest will accrue on the past-due interest and, if there is a failure to pay interest for three years, the creditor can sue the debtor. This note also provided that the debtor cannot pay a dividend to its shareholders while any interest is past-due. The ruling held that the scheduled interest was not unconditionally payable because the dividend restriction does not inure to the benefit of the note holder. The ruling went on to state that a significant increase in the interest rate on the past-due interest may be a sufficient penalty to ensure that the scheduled interest would be paid when due. The Service suggested that an increase of 12 percentage points greater than the stated yield might be sufficient.

In TAM 9538007, the IRS ruled that holders of a debt instrument must continue to accrue the imputed interest in an OID debt instrument even though the issuer's financial condition is such that there is no reasonable expectation that the debt instrument will be redeemed according to its terms. There is no ''doubtful collectibility'' exception from OID accrual. As an alternative, the IRS suggested that due to the speculative nature of the bonds, the bonds could be treated as equity rather than debt.[30]

How Do You Value a Note?

Suppose a sale to a grantor trust occurred in October 2006 for a $5,000,000 promissory note, with interest only payable during the term of the note at an annual rate of 5.29% ($264,500/year) for 20 years with all principal due at the end of 20 years. The long-term AFR for October 2006 was 5.29%. The note can be prepaid at any time. In August 2009 the long-term AFR is 3.84% (the June 2009 long-term AFR is 3.84%, which can be used for transactions occurring in August) and the note has 17 years until maturity.

How is this note valued, in light of the fact that it is paying a rate of return greater than the current AFR?

The calculations are as follows:

Present value of the right to receive $5,000,000 at the end of 17 years, using a 3.84% discount rate		$2,634,938
Present value of the right to receive annual payments of $264,500 for the next 17 years	+	$3,258,118
Value of the note	=	$5,893,056

After three years, the grantor trust has assets valued far in excess of the $5,000,000 it owes on the note. As such, the following considerations should be made:

1. Should the note be prepaid?
2. Should a new note be issued for the same $5,000,000 at the lower AFR of 3.84%?
3. If one of the above questions is answered in the affirmative, how is the $893,056 premium going to treated?

When considering whether to reduce the interest rate on an intra-family loan, the treatment of this premium must be considered.

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[30] For an analysis of whether the doubtful collectability doctrine should be applied, see Pollack, Goldring and Gelbfish, ''Uncollected OID: To Accrue or Not to Accrue,'' 84 *J. of Tax'n* 157 (1996).

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CONCLUSION

By carefully considering the applicable tax laws and current economic and financial environment, planners are able to employ strategies that can be very successful in transferring their clients' wealth to younger generations at a relatively low overall tax cost. Examples of such strategies include structuring installment sales with the lowest applicable federal interest rate from the current month or the prior two months, reducing the interest rate of existing loans, and advising families about having to recognize taxable income and interest expense where required note payments are made or accrued. To effectively implement these strategies, practitioners should be aware of the numerous rules relating to the applicable interest rates that can be used with respect to intra-family transactions.

EXHIBITS

LOWEST OF PRESENT OR LAST TWO MONTHS AFR

SELECTED INTERNAL REVENUE CODE SECTIONS, TREASURY REGULATIONS, AND CASE LAW LANGUAGE

Subtitle F — PROCEDURE AND ADMINISTRATION (Sections 6001 to 7874) / Chapter 80 — General Rules (Sections 7801 to 7874) / Subchapter C — Provisions Affecting More Than One Subtitle (Sections 7871 to 7874)

Sec. 7872. Treatment Of Loans With Below-Market Interest Rates

§7872(a) Treatment Of Gift Loans And Demand Loans

§7872(a)(1) In General

For purposes of this title, in the case of any below-market loan to which this section applies and which is a gift loan or a demand loan, the forgone interest shall be treated as —

§7872(a)(1)(A) transferred from the lender to the borrower, and

§7872(a)(1)(B) retransferred by the borrower to the lender as interest.

*****

§7872(f) Other Definitions And Special Rules: For purposes of this section —

§7872(f)(2) Applicable Federal Rate

§7872(f)(2)(A) Term Loans

In the case of any term loan, the applicable Federal rate shall be the applicable Federal rate in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually.

*****

Subtitle A — INCOME TAXES (Sections 1 to 1564) / Chapter 1 — Normal Taxes and Surtaxes (Sections 1 to 1400U-3) / Subchapter P — Capital Gains and Losses (Sections 1201 to 1298) / Part VI — Special Rules for Bonds and Other Debt Instruments (Sections 1271 to 1288) / Subpart A — Original Issue Discount (Sections 1271 to 1275)

Sec. 1274. Determination of Issue Price In The Case Of Certain Debt Instruments Issued For Property

§1274(d) Determination Of Applicable Federal Rate

For purposes of this section —

§1274(d)(2) Lowest 3-Month Rate Applicable To Any Sale Or Exchange

§1274(d)(2)(A) In General

In the case of any sale or exchange, the applicable Federal rate shall be the lowest 3-month rate.

§1274(d)(2)(B) Lowest 3-Month Rate

For purposes of subparagraph (A), the term lowest 3-month rate means the lowest of the applicable Federal rates in effect for any month in the 3-calendar-month period ending with the 1st calendar month in which there is a binding contract in writing for such sale or exchange.

*****

Selected Language from *Frazee v. Comr.*, 98 T.C. 554 (1992)

Last Sentence of the Opinion:

The value of the promissory note, therefore, must be recomputed using the Federal rate for long-term loans, compounded semiannually, with quarterly payments at the time petitioners conveyed the property to their children. See sec. 7872(f)(2)(A).

Preceding Dicta:

Moreover, there is nothing in the legislative history which indicates that Congress intended any application of section 1274 for gift tax valuation purposes. Rather, in the same year in which section 1274 was enacted, Con-

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gress enacted section 7872 which expressly applies for gift tax purposes. The original issue discount rules of section 1274 and the income and gift tax rules of section 7872 are both tied to the applicable Federal interest rate. It seems implausible that Congress would enact one section which expressly applies to the situation in these cases for valuation purposes, while at the same time enacting another section which it also intended to apply for valuation purposes. The language of the sections as well as the legislative history indicates that section 7872 applies for gift tax valuation purposes, while section 1274 does not. Accordingly, we hold that section 1274 has no relevance for gift tax valuation.

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