Stitching Shadows in Neverland: A Counterpart Basis Analysis Applied to Disregarded Promissory Notes and Assets Owned in Grantor Trusts

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For over 30 years, estate planners have used grantor trusts as an essential component of their clients' planning. Commonly, clients loan funds to grantor trusts, or they finance installment sales of assets to those trusts. Those transactions are disregarded for income tax purposes: the grantor trust is a disregarded *entity*, and the note receivable is a disregarded *asset*.

Although many of the tax compliance issues and tax ramifications of these disregarded transactions are settled, several important questions remain unanswered. Concerning the unanswered questions, important IRS examinations in the past 16 years have explored the applicability of IRC § 2702 to installment sales to grantor trusts, and much has been written and debated about the applicability of the step-up in basis at death rules (IRC § 1014) in such transactions. This article explores a neglected, but increasingly relevant, corner of the analysis for which there are no clear answers: how should we think about the basis of the note receivable held by the grantor and the note's relationship to the assets for which it was exchanged?

Below, the authors will suggest that there is an important opportunity to view the basis of "disregarded" notes receivable held by the grantor as a *counterpart* to the basis of the corresponding transferred assets inside the grantor trust. Rather than viewing the disregarded note as a nullity, we believe that to avoid inequitable results the tax characteristics of a disregarded note should "shadow" the characteristics of the assets for which it was transferred.

Early in the 1911 UK novel *Peter and Wendy* (better known by its preceding theatrical title: *Peter Pan*), Peter and his Shadow become separated from one another. In the novel, Peter Pan reasoned that when he and his Shadow were reunited they "would join like drops of water, and when they did not he was appalled." Wendy came to the aid of Peter (who was then fruitlessly attempting to use a bar of soap as an adhesive) by expertly sewing the Shadow back onto Peter's feet, where it belonged.

Like Wendy, the authors suggest an approach to "disregarded" notes that helps stitch the basis of the note (that is, the shadow) to the full-bodied asset. The disregarded promissory note and the underlying asset held in the trust are much like Peter Pan and his Shadow. They belong attached to one another, linked in changes to their bases much in the same way that Peter and his Shadow are meant to be linked

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in their movement. The most logical approach to avoid the double taxation of assets arising from a grantor trust sale is to treat the promissory note—an asset that is ignored for federal income tax purposes—as a counterpart, or reflection, of the asset transferred to the grantor trust.

Why Basis of Disregarded Notes Is Important—Compliance and Planning

During 2012, the year preceding the passage of the American Taxpayer Relief Act of 2012, 126 Stat. 2313 (enacted on Jan. 1, 2013), many clients made large gifts to exhaust lifetime basic exclusion amounts to mitigate the risk that the then-existing $5.25 million exclusion amount might sunset. As one common approach, many taxpayers with mature estate plans elected to make gifts of a portion of their outstanding notes receivable back to the grantor trusts that originally made the notes. In 2013, gift tax returns were prepared in the aftermath of these gifts. The IRS requires each taxpayer-donor to report the basis of his or her gift on IRS Form 709 (Schedule A, Parts 1, 2, and 3, Column D). In this context, a surprisingly broad range of basis reporting positions were used by tax preparers. The range of actual reporting positions for the basis of the notes suggested for Column D, as experienced by the authors in 2013, included:

- Zero ($0) basis.
- Carryover basis tied to the basis of the sold asset measured as of the date the note first was issued.
- Basis equal to the basis of the assets owned by the grantor trust measured on the date the note was transferred in 2012.
- Basis equal to the fair market value of the note (modestly discounted).
- Basis equal to the face value of the note.
- "Not applicable."
- "Not available."
- "Available upon request."
- Left blank.

This is a surprising range of answers and understandings for such a common planning scenario. When asked to justify their reasoning for reporting positions taken, several tax professionals initially reacted that the answer did not matter. But several circumstances make it particularly relevant:

1. a subsequent taxable or nontaxable disposition (sale or exchange) of the remaining balance of the note;
2. the allocation of basis for any gift tax paid on the transferred note, under IRC § 1015(d);
3. the consequences arising from the termination of grantor trust status during life (or at death, if a step-up in basis might not be available) for any remaining balance of any note; and
4. the contribution of the note to an entity taxed as a partnership (that is, determination of inside and outside basis).

In 2017, in addition to a trend to engage in further planning with clients' notes receivables, legislative proposals suggest that a framework for considering and reporting note basis is more important than ever before. More specifically, members of the 115th Congress have suggested they may enact a tax regime involving the recognition of capital gains at death to supplement or replace the federal estate tax

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system. During the 2016 Presidential campaign, President (then-candidate) Donald J. Trump suggested that "capital gains held until death will be subject to tax, with the first $10 million tax-free. . . ." Under such a tax regime (in which a step-up in basis under IRC § 1014 would be inapplicable), it will be important to accurately report the basis in notes held by taxpayers at death, so that the taxpayer or her executor can allocate the amount of the $10 million exemption correctly.

The authors suggest that it is important for the tax bar to adopt a deliberative, consistent framework concerning the basis of "disregarded" notes held by grantors. Furthermore, we suggest that a counterpart basis approach that links the bases of promissory notes with the bases of the underlying assets in the grantor trust for which they were exchanged is the framework that is the most equitable and consistent with current law. In addition, with Column D of Parts 1, 2, and 3 of Schedule A of Form 709, the IRS has provided us with an *opportunity* to properly and fairly account for the basis of disregarded notes involved in gift transactions.

Statement of the Law

IRC § 1015(a) generally provides that for gifts occurring after December 31, 1920, the basis of property in the hands of the donee shall be the same as the basis in the hands of the donor, except that if the basis is less than the fair market value of such property, then the basis shall be the fair market value. IRC § 1015(b) provides that the basis of property received by a transfer in trust (other than a transfer by gift, bequest, or devise) will be the same as the basis would be in the hands of the grantor adjusted by the amount of gain or loss recognized by the grantor on such transfer. IRC § 1015(d) modifies that general rule of IRC § 1015(a) by providing that the basis of the property acquired by gift after September 2, 1958, shall be determined under subsection (a) but increased by the amount of taxes paid (but not above the fair market value at the time of the gift). The legislative history of IRC § 1015 explains that the rationale for granting a step-up in basis for gift taxes paid was "to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax."

Rev. Rul. 85-13 is the landmark pronouncement setting forth how the IRS will view trusts that are treated as owned by the grantor under IRC §§ 671–679 for other tax purposes. In that ruling, the IRS determined that any trust that is treated as owned by the grantor would not be viewed as a separate taxpayer for federal income tax purposes. Thus, for federal income tax purposes, a grantor trust is treated as a disregarded entity. TAM 200814026 went on to state that a promissory note of a trust that is held by the grantor is disregarded for federal income tax purposes because a taxpayer cannot be both the obligee and obligor on a debt instrument.

Rev. Rul. 77-402 holds that the termination of grantor trust status by renouncing the grantor's powers results in a deemed transfer of underlying assets from the grantor to the trust. See also Treas. Reg. § 1.1001-2(c), ex. 5. This is somewhat akin to the result under Rev. Rul. 99-5, in which a sole member of an LLC is deemed to transfer a portion of the underlying assets of the LLC to an incoming member at the moment that the sole member's LLC interest will no longer be disregarded for income tax purposes.

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At that time, the original member's outside basis in his LLC interest equals, or reflects, the proportionate basis of the assets he is deemed to contribute. CCA 200923024 states that the conversion of a nongrantor trust to a grantor trust is not a deemed transfer of property from the trust to the grantor.

Sales of Grantor Trust Promissory Notes

Rev. Rul. 85-13 and TAM 200814026 create a peculiar legal conundrum in the case of the promissory note of a trust held by the grantor of that trust. These authorities state that the note is disregarded for federal income tax purposes. Clearly, for state law purposes (and, indeed, for federal transfer tax purposes) a grantor trust's note with the grantor is treated as a separate legal asset and a bona fide debt of the grantor trust. In many cases, this does not present a problem—either the note is repaid before the grantor's death or the basis of the note (whatever it may be) might be stepped up or down to fair market value on the date of the grantor's death under IRC § 1014.

But sometimes the note is disposed of in a different way. The simplest example is when the grantor sells the note to a third party. The third party buys a very real legal asset under state law, but, until the moment of the sale, tax law clearly states that no such asset exists for federal income tax purposes. Does an asset spring into existence for federal income tax purposes at the moment of sale? And if so, what is the basis of this asset? Furthermore, if the sale is taxable, then how does the sale of the disregarded note affect the basis of the assets in the grantor trust?

Several possibilities mentioned in the list of compliance alternatives, above, include: (1) there is a taxable exchange with the buyer in which the basis of the disregarded note is zero ($0) and an amount measured by the taxable gain on the sale is, or isn't, added to the basis of the counterpart assets in the grantor trust; (2) there is a taxable exchange with the buyer and the basis of the note is an exchanged basis, and an amount measured by the taxable gain on the sale is, or isn't, added to the basis of the counterpart assets in the grantor trust; and (3) there is no taxable exchange with the buyer.

For example, assume a grantor sells Blackacre to his grantor trust ("Trust") in exchange for a disregarded promissory note with a face value of $100. Blackacre had an original basis in the hands of the grantor of $60 and a fair market value of $100 at the time of the sale of Blackacre to the Trust. The grantor then sells his promissory note to a third party for $100. What will be the tax result under the various possibilities?

1. $0 Basis in Disregarded Note

Under possibility one, the sale of the note would be a taxable event. On the sale, the note would spring into existence for federal income tax purposes, and because the basis of the note is zero ($0), the grantor would recognize $100 of taxable gain. Without a counterpart basis adjustment, if the disregarded Trust later sold Blackacre to a third party for $100, then the grantor also would recognize an additional $40 of taxable gain. This result hardly seems equitable. The note was created by the grantor and the Trust based on the value of Blackacre, and yet the note received no basis adjustment for the exchange basis of Blackacre or the cost basis on the sale. This results in double taxation. Under funda-

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mental principles of income tax law—indeed, the reason we measure cost basis in the first place—and following the principles related to the treatment of disregarded grantor trusts, the double taxation of both Blackacre and the note cannot be a lawful or equitable result.

One logical way to avoid this inequity is to attribute the gains from the sale of the disregarded note to the basis of Blackacre—the counterpart asset and the only available asset that is respected for income tax purposes. If we initially assume that the basis in the disregarded note is $0 and the gain on sale of the note is $100, then the basis of Blackacre, the nondisregarded counterpart asset, should be increased by $100, resulting in an adjusted basis of $140 and fair market value of $100. A subsequent sale of Blackacre by the grantor trust would generate $40 of loss to the grantor. In seeking the best framework to analyze these issues, however, the arbitrary creation of loss property seems a curious and unnecessary result. In this case, the taxpayer would be treated fairly, but with unwieldy tax accounting.

2. Exchanged Basis in Disregarded Note

The result is less awkward under possibility two if a counterpart approach to basis is employed comprehensively. In this case, the disregarded note mirrors or shadows the $60 basis in Blackacre and, in effect, enjoys an exchanged basis (akin to its cousin, the note arising from an installment sale between nondisregarded parties). On the sale of the disregarded note, $40 of gain would be recognized by the grantor. If the disregarded Trust subsequently sells Blackacre, absent a counterpart adjustment to basis, then the grantor would recognize an additional $40 of gain. Again, this duplication of gain is not equitable and should not be the correct treatment. *With* a counterpart adjustment to basis, however, Blackacre's basis would be increased by $40 when the disregarded note is sold, and the grantor would have no gain on a subsequent sale of the Blackacre to a third party.

The result under this full counterpart approach might be described by several deemed transactions. Once the sale of the disregarded note to the buyer is under way, the grantor could be deemed to sell the underlying property of the grantor trust to the trust in a *respected* installment sale. This seems to reflect the type of approach the IRS favors in Rev. Rul. 77-402 (trust assumes the debt the grantor is deemed to own once the trust is no longer disregarded) and Rev. Rul. 99-5. Under IRC § 453(c), the grantor would receive an exchanged basis in the note ($60 in our example). The Trust (still taxed to the grantor) would receive a full cost basis ($100) in the assets (Blackacre) the Trust was deemed to acquire. Second, on the disposition of the note by the grantor to the buyer, the grantor would recognize gain ($40) to the extent that the amount realized from the sale ($100) exceeds the exchanged basis in the note ($60) under IRC § 453.

Some challenging questions presented by this approach involving deemed transactions with a disregarded entity include:

- Should the holding period of the underlying assets (Blackacre, for example) be tacked to the disregarded note, so that any gain recognized on the sale of the note, itself, is characterized by the grantor's holding period in the counterpart asset owned by the Trust? (Probably.)

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- Before the sale of the disregarded note, if other assets have been added to the grantor trust because of a gift, the sale and reinvestment of the original asset, or additional installments sales, should the deemed sale by the grantor consist of a proportionate amount of every asset of the trust? (Probably.) Does the answer change if the note is secured by a specific asset of the grantor trust? (Possibly, but perhaps not.)

3. Disregarded Transaction

A third possibility worth mentioning is that the sale of the *disregarded* note to a third party would not be a taxable event. This would further extend the principles of Rev. Rul. 85-13 and TAM 200814026 to third parties. Though not the subject of this article, one possibility is that the disregarded nature of the relationship between the grantor and the Trust will continue even when a third party is introduced. If correct, the most logical treatment would be for the note to be treated as the sale of a note for state law purposes but as a nontaxable loan with offsetting obligation to repay from a federal income tax perspective. Because the grantor and his trust are treated as the same person for federal income tax purposes, the "sale" of the "note" would essentially be the same as if the purchaser had allowed the trust to directly borrow the "sale" proceeds from the purchaser in exchange for the obligation by the trust to repay those funds. See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) (discussing the nontaxable nature of the receipt of loan proceeds because of the offsetting obligation to repay).

When the third-party note purchaser presumably receives basis for her purchase, however, continuing to treat the note as a disregarded asset and disregarding purchase proceeds recognized by the taxpayer altogether similarly seem to create an inequitable result. It also seems that this approach could be subject to significant abuse by taxpayers. For example, rather than a taxpayer selling Green- acre to a buyer outright, the taxpayer first could sell Greenacre to her grantor trust in exchange for a disregarded note with a market interest rate. Second, the taxpayer would sell her "disregarded" note to the buyer for full cash consideration in a disregarded transaction, thereby shifting most of the economic benefits of Greenacre to the buyer. Tax would be recognized by the grantor only when the grantor trust paid off the note to the buyer in-kind with interests in Greenacre.

After examining these three possibilities, the authors' assessment is that the second possibility—the comprehensive counterpart basis approach in which the basis of the disregarded note is understood as tied to the basis of the underlying assets of the grantor trust—is the most reasonable approach. The counterpart basis framework is preferred because the exposure both to whipsaw and to taxpayer abuse is mitigated, the adjustments are less likely to result in assets with false losses, and the approach is more closely akin to the accounting for similar nondisregarded transactions.

Gift of a Grantor Trust Promissory Note

The questions of basis also arise in the context of a *gift* of the promissory note of a trust held by the grantor of that trust. IRC § 1015(a) grants a transferred basis to those acquiring property by gift. IRC § 1015(d) increases the basis of such property by the amount of gift taxes paid on the gift transaction. But what is the result when the gifted property is a note that is disregarded for federal income tax purposes? If a donor makes a gift of the disregarded note, the instructions to IRS Form 709 ask the taxpayer to

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"[s]how the basis you would use for income tax purposes if the gift[ed asset] were sold or exchanged." So, as an initial matter, the conclusion in the preceding section concerning the use of a counterpart basis could apply.

The circumstances in which a *taxable* gift is made—even to a grantor trust—and how the gift tax basis credit should apply under IRC § 1015(d) are particularly interesting. Four possibilities include (1) the credit for gift tax paid is disregarded, perhaps especially if the gift is made to a grantor trust; (2) the gift tax paid on the transfer of the note should increase the basis of the note in the hands of the donee; (3) the gift tax paid on the transfer of the note should increase the basis of the underlying asset in the grantor trust (in our example, Blackacre); or (4) the gift tax paid on the transfer of the note should increase both the bases of the note in the hands of the donee and the underlying asset in the grantor trust under a comprehensive counterpart basis analysis.

As a threshold matter, the authors believe that the IRS, when issuing Rev. Rul. 85-13, did not intend to disregard or ignore the statutes that coordinate the transfer tax system with the income tax system—mainly IRC §§ 1014 and 1015. In particular, the income tax basis adjustment provided in IRC § 1015(d) for gift taxes paid clearly is intended by Congress to avoid a "tax on a tax." Steve R. Akers and Phillip J. Hayes noted in *Estate Planning Issues with Intra-Family Loans and Notes*, Tex. Tax Law., Winter 2013, at 85: "There is no definitive authority as to whether the basis adjustment is authorized, but there would seem to be a good-faith argument that the gift-tax paid basis adjustment should be permitted even though the gift was to a grantor trust." The IRS has taken a similar stance in PLR 9109027 by granting an adjustment under IRC § 1015(d) to a grantor trust. Even though IRC § 1015(d) is an income tax provision, its operation is necessarily predicated on the gift tax regime. Therefore, a transfer that has gift tax significance, even if disregarded for income tax purposes, should result in a basis adjustment under IRC § 1015(d).

Consistent with the approach in this article, the authors believe that Rev. Rul. 85-13 should not be read to render the IRC § 1015(d) adjustment a nullity, resulting in a whipsaw to the taxpayer. Rather, a counterpart basis adjustment is the fair and reasonable result, when the basis of the assets in the grantor trust are adjusted for any gift taxes paid on the gift of a disregarded note and the basis of the disregarded note itself is similarly adjusted.

Assume the basis of Blackacre is $60 and the "basis" of the disregarded note is also $60. The note is gifted to a third party and results in a gift tax liability of $30. The grantor pays the gift tax. If the note's basis is increased to $90 in the hands of the donee, then a subsequent sale of the note would result in $10 of gain. If there is no parallel basis increase to Blackacre, a sale of Blackacre would result in $40 of gain. Why the $30 difference? The gift of the note triggered a basis increase because of the value being transferred, but if the counterpart asset (Blackacre) to the note does not receive a mirroring basis step-up, then the legislative intent of IRC § 1015(d) appears to have been defeated. The gift tax imposed on the transfer of the note was based on the untaxed appreciation of Blackacre, the underlying asset. If the roles were flipped and only Blackacre's basis were increased, a subsequent sale of the note would likewise trigger additional gain. This would be an equally inequitable result.

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The Solution: A Theory of Counterparts

When a grantor disposes of the previously ignored note in a transaction taxable under either the income or transfer tax regime, the asset held by the grantor trust should receive an adjustment to its basis based on the amount of taxable income realized and recognized or the amount of transfer taxes paid. This result is also consistent with the result found in the application of Rev. Rul. 77-402. Thus, when an asset that exists for state law purposes but not for federal income tax purposes is created from a disregarded transaction involving a nondisregarded asset, the disregarded asset should be treated as having a basis that rises and falls with the basis of the nondisregarded asset until such time as the disregarded asset becomes regarded.

This proposition is consistent with the uniform basis rules applicable to property acquired from a decedent (Treas. Reg. § 1.1014–4(a)), by gift (Treas. Reg. § 1.1015–1(b)), and through a transfer to a trust (Treas. Reg. § 1.1015-2(a)(2)). The uniform basis of such assets will be shared by life tenants and remaindermen and is used to compute depreciation, depletion, and amortization deductions. Applying this approach to the assets involved in grantor trust sales ensures that the grantor will not incur a second tax on the disposition of the asset involved in a grantor trust sale after already paying a tax on the disposition of the previously disregarded promissory note.

Using our examples, we can see how the counterpart bases eliminate income tax disparities. When a promissory note with an exchanged basis of $60 is sold for $100, the grantor recognizes $40 of gain. If a corresponding increase is triggered on Blackacre, its basis will be raised from $60 to $100 and any subsequent sale of Blackacre for $100 will result in no further gain to the grantor. Finally, if the promissory note is gifted to a third party, resulting in gift tax of $30, the basis of the note would increase in the hands of the recipient to $90 while the underlying basis of Blackacre also would increase to $90.

Once the disregarded note is respected for tax purposes, the analysis of the respective bases normalizes because the assets are held by distinct taxpayers, and so any subsequent sales of the note would not trigger further increases or decreases to the basis of Blackacre and vice versa.

Final Comments

Purists, among whom the authors count themselves, rightfully may object to the concept of assigning basis to a disregarded asset. The IRS missed the opportunity to address these basis questions comprehensively in Rev. Rul. 85-13 (that is, the IRS ensured that the IRS would not get whipsawed by providing that assets purchased by a grantor trust do not receive an increased cost basis, but it neglected to equitably address the corollary matter—to ensure that the taxpayer would not be whipsawed in transactions with disregarded notes receivable). We believe that the framework of counterpart bases suggested in this article is a helpful tool for thinking about the basis analysis and making reasoned adjustments to the basis of *respected* tax assets: transferred notes and counterpart assets remaining in grantor trusts. We suggest that the framework can be helpful without resolving the theoretical question of whether a disregarded asset, in fact, can have basis. Furthermore, when the IRS grants us an *opportunity* to report the basis of a challenging asset, we believe that affirmatively reporting a value is a superior approach to "n/a" or leaving Column D blank (arguably, resulting in an incomplete return).

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From a practical standpoint, there is no direct authority for how to assign basis to a disregarded note on transfer or to the counterpart assets. Accordingly, preparers can choose to file Form 8275 with Form 709—or, in the case of an adjustment to basis of a counterpart asset, with the pertinent federal income tax return—including a short description disclosing reasons for the basis adjustment.

Conclusion

As the first principle of tax law, the payment of a tax on a tax is an unconscionable result that must be avoided. The grantor trust rules and derivations therefrom have failed to provide a satisfactory mechanism for avoiding a tax when a grantor engages in transactions with his or her own grantor trust. Rev. Rul. 85-13, although answering the crucial question of a grantor trust's tax basis in assets received in a grantor trust sale, is conspicuously silent on the corollary question of the treatment of a taxpayer's basis in a note received from a grantor trust. The theory of counterpart bases provides a helpful framework for satisfying the requirement of avoiding a tax on a tax by ensuring that an asset with income tax existence is granted the appropriate adjustment for income or gift taxes paid on the disposition of a note arising from a grantor trust sale. n

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