Stitching Shadows in Neverland:

Basis, Disregarded Notes and Grantor Trusts

Presenter

Carl L. King
CULP ELLIOTT & CARPENTER, P.L.L.C.
6801 Morrison Boulevard; Suite 400
Charlotte, North Carolina 28211
clk@ceclaw.com
http://www.ceclaw.com/attorneys/carl-l-king/

Carl L. King

Carl, a partner at his firm, represents individuals, helping them to achieve their family, financial and estate planning goals while minimizing their potential estate, gift and income tax liabilities.

In recent years, Carl's most rewarding professional work has included counseling families (all generations) during the growth of family offices, and providing legal advice with respect to some of the largest charitable gifts in North Carolina's history.

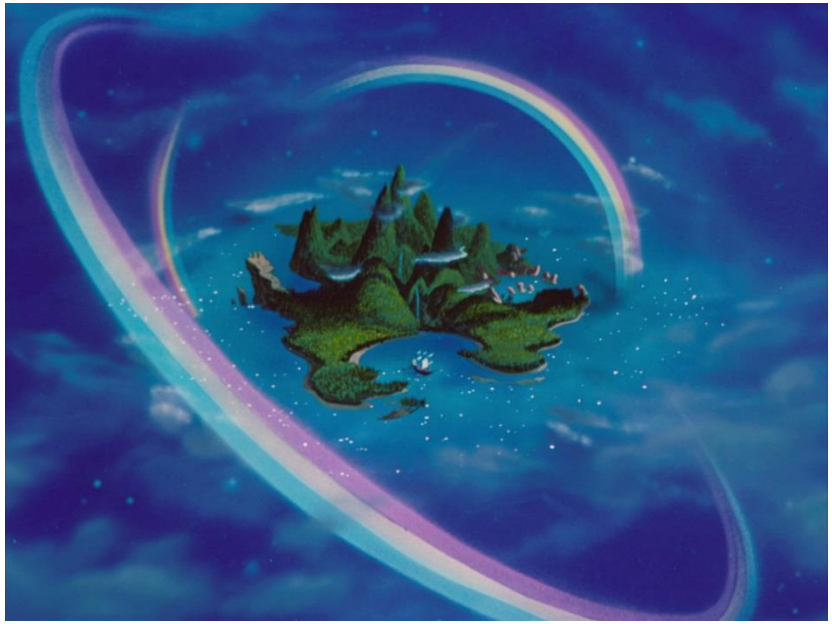
Carl has advised wealthy clients concerning complex gift and estate tax strategies including dynasty trusts, family limited liability companies, installment sales to grantor trusts, grantor retained annuity trusts ("GRATs"), split purchase trusts and the use of a wide variety of charitable entities.

Carl is a Fellow of The American College of Trust and Estate Counsel (ACTEC), a NCBA board-certified specialist in Estate Planning and Probate law, and holds an LL.M. in Estate Planning. Carl's recent speaking engagements have covered the Constitutionality of State Fiduciary Income Tax Statues, Fiduciary Income Tax, Advanced Income Tax Planning for Complex Trusts, and Planning to Protect Fiduciaries.

Previously, Carl clerked both for the U.S. District Court and for the United States Securities and Exchange Commission. In 2008, Carl was selected as the Pro Bono Attorney of the Year by Legal Services of the Southern Piedmont for his work with wills clinics, which continues.

Neverland

“Second to the right, and straight on till morning.”



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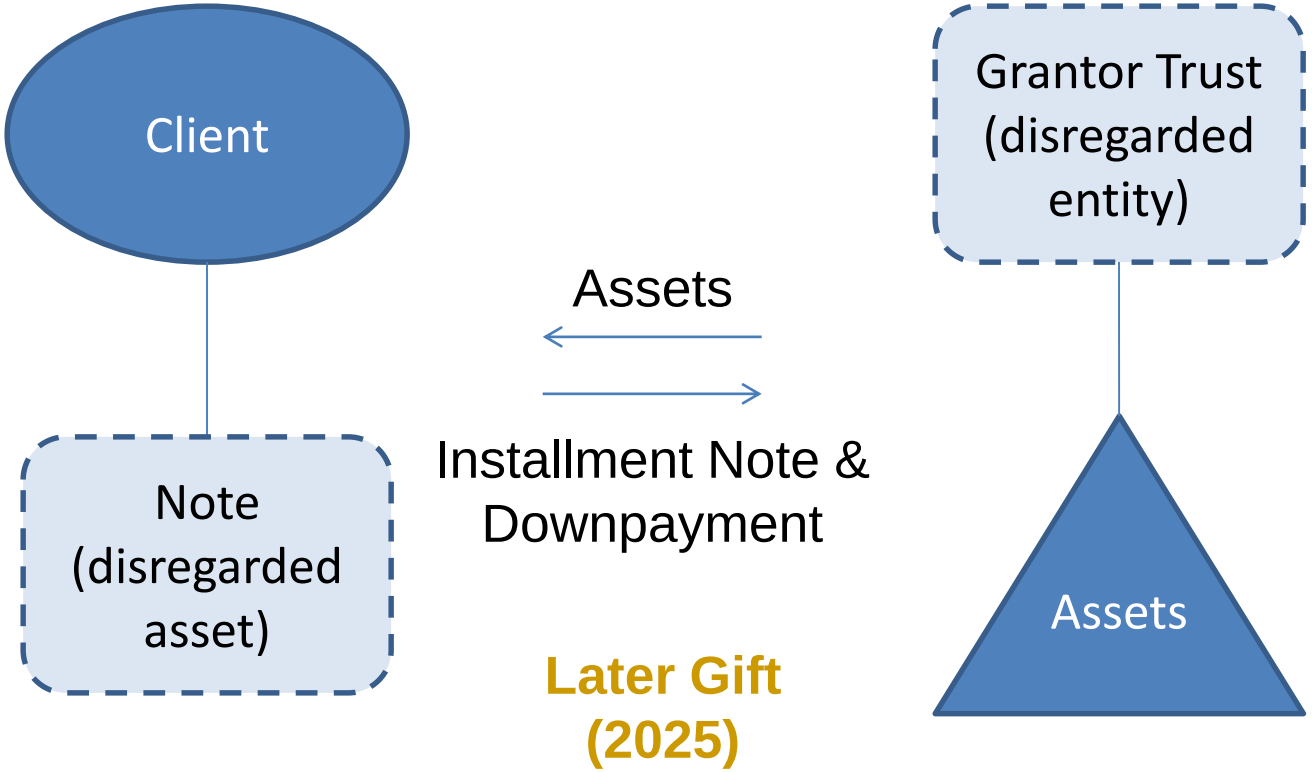
Agenda

Basis of Disregarded Notes in Disregarded Transactions

A. **Where, When and Why** this analytical and reporting issue arises – 2012 (and 2025) – Taxable Gifts; Sales or Exchanges
B. (Limited) **Legal Authority**
C. Suggested **Alternatives** and Options for Determining Basis
D. Why Basis in Notes Matters
    1) **Contributions to Partnerships:**
        1) … to consolidate family investments and reach investment goals
        2) … to mitigate a worrisome tax risk later in life.
    2) Sale to a **Spousal Grantor Trust**
    3) Facilitate Basis-shifting Strategies
E. 'Kernels of Truth,' Items of Practical Value from Conference

Ignored


Client
Grantor Trust (disregarded entity)
Assets
Note (disregarded asset)
Installment Note & Downpayment
Assets
Later Gift (2025)

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Gift Tax Return (e.g., 2012)

Form 709 (Schedule A, Parts 1, 2, and 3, Column D)

Part 3—Indirect Skips. Gifts to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter ½ of column F	H Net transfer (subtract col. G from col. F)
1							
Gifts made by spouse —*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 3. Add amounts from Part 3, column H . . . . . ▶							

(If more space is needed, attach additional statements.) Form **709** (2016)

… an opportunity?

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Basis on Forms 709

Actual Approaches of Professionals in 2012:

1. Zero ($0) basis.
2. Carry over basis tied to the basis of the sold asset, measured as of the date the note first was issued.
3. Basis equal to the basis of the assets owned by the grantor trust, measured on the date the note was transferred in 2012.
4. Basis equal to the fair market value of the note (modestly discounted).
5. Basis equal to the face value of the note.
6. "Not applicable."
7. "Not available."
8. "Available upon request."
9. Left blank.

Peter Pan's Shadow

"Peter and his Shadow become separated from one another."

Counterparts?

Additionally, should there a corresponding adjustment to the basis of the counterpart assets in appropriate circumstances?

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Little Authority

1. Revenue Ruling 85-13 (grantor trust obtains no new basis for assets purchased from grantor)
2. TAM 2008-14-026 (notes with grantor trusts disregarded)
3. Revenue Ruling 77-402 (lifetime termination of grantor trust status treated as transfer of underlying assets to trust)
4. PLR 91-09-027 (granting adjustment under IRC § 1015(d) to grantor trust)
5. Form 709 Instructions ("Show the basis you would use for income tax purposes if the gift were sold or exchanged. Generally, this means cost plus improvements, less applicable depreciation, amortization, and depletion.")
6. House Report 94-1380: "[t]he purpose of the increase in basis for gift taxes paid on the gift is 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***" (emphasis added).

Taxable Gifts

PLR 91-09-027

While expressly concluding that the pair of subject trusts were grantor trusts, the Service while referencing IRC § 1015(d) specifically concluded concerning gifts of stock:

> "the basis of the shares … would be the basis in the hands of the donor increased by an amount which bears the same ratio to the amount of tax so paid as the net appreciation in value of the gift, bears to the amount of the gift."

One can conclude that § 1015, essentially a transfer tax provision (along with § 1014), is not ignored under § 671.

TAM 2008-14-026

Instead of stock, what of a gift of a note?

A taxable gift of a "disregarded" note to a grantor trust also should add basis under § 1015(d) to the underlying counterpart assets of the trust.

Where the Service takes the position that the note does not exist in TAM 2008-14-026, to meet the legislative intent of "*prevent[ing] the imposition of a tax on a tax*" under § 1015(d), the non-disregarded assets seem to be the one (the only?) obvious recipient of the increased basis.

Upturned Microscope Cartoon

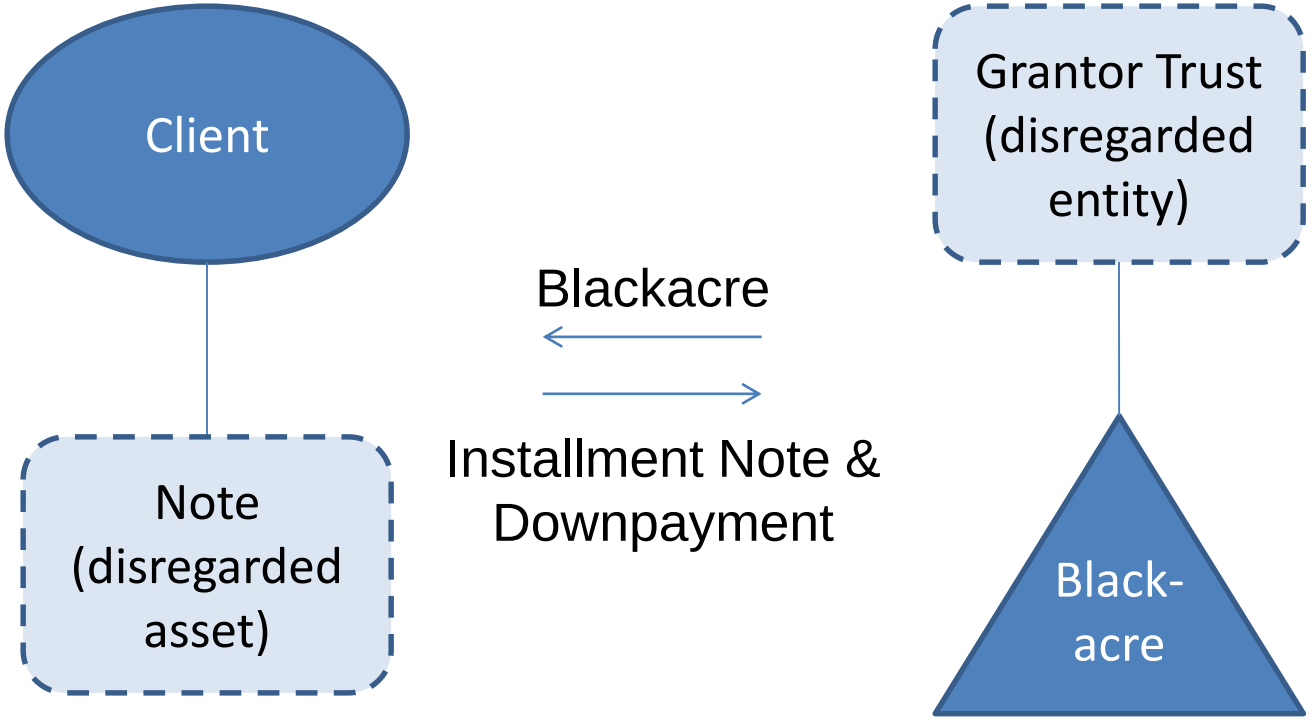
Transfer of Disregarded Note

Interesting Question: What if the "disregarded" note is sold or exchanged, rather than gifted?

Some viable options:

1. Zero basis with gain recognition; upward adjustment in counterpart trust asset; later loss upon sale.
2. No recognition upon sale of note (sale to third party ignored); gain recognized as payments are received, exclusion ratio based on counterpart trust assets.
3. Note is a regarded asset (TAM is wrong) with basis under 453; gain in excess of basis upon sale.

Zero Basis


Client
Note (disregarded asset)
FMV: 100
AB: 0
Gain: 100
Blackacre
Installment Note & Downpayment
Grantor Trust (disregarded entity)
Black-acre
FMV: 100
AB: 60
Gain: 40 or (-60)

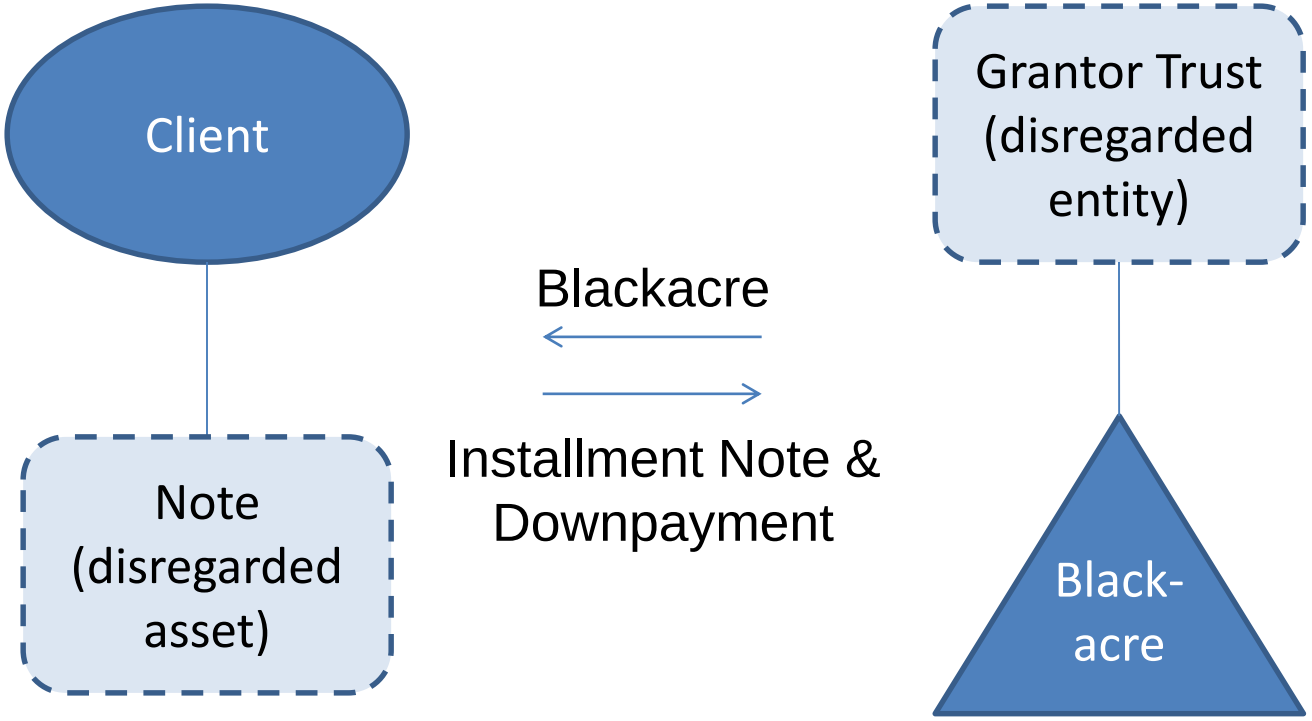
Counterpart Basis

Interesting Question (con'd): What if the "disregarded" note is sold or exchanged, rather than gifted?

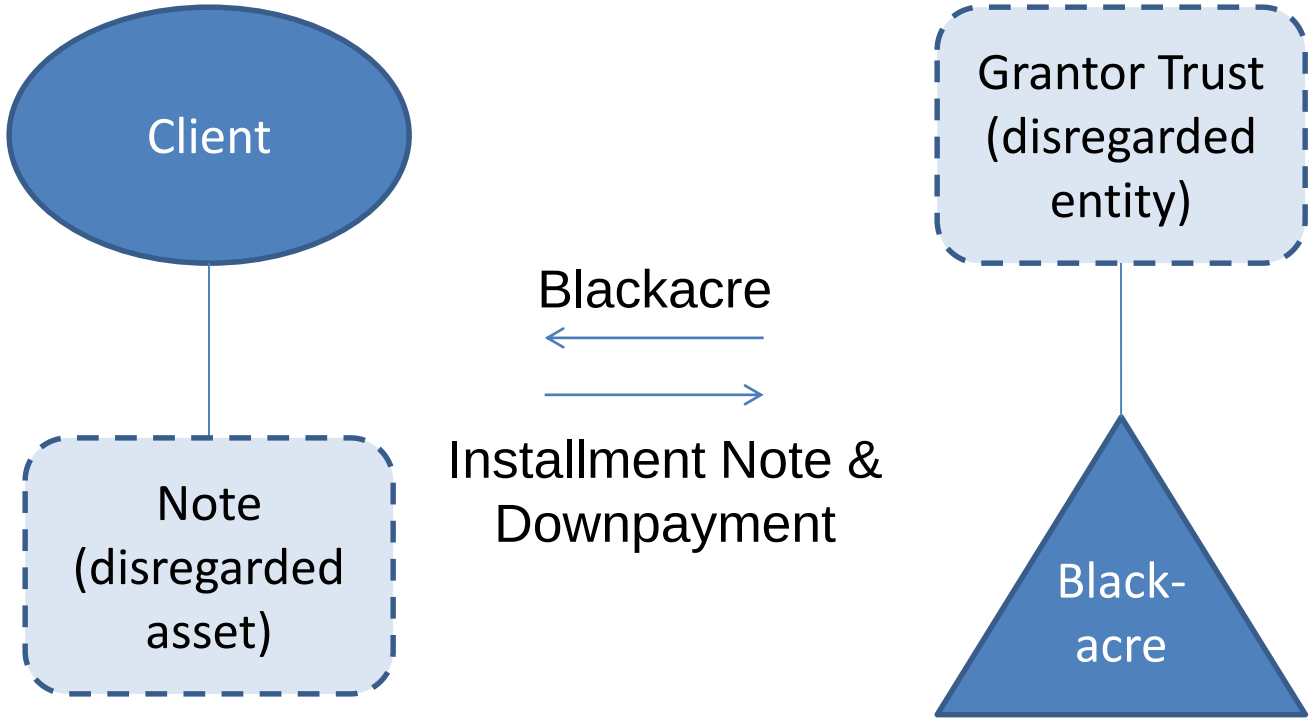
Using IRC § 722 (inside/outside partnership basis) and Rev Rul 99-5 (sale of disregarded LLC interest) to triangulate, another option is for the basis of the "disregarded" note to *reflect* or *shadow* the basis of the counterpart trust assets.

Taxable transactions with notes would increase the basis of the counterpart trust assets, and taxable transactions with underlying trust assets would increase the basis of the note upon sale or exchange.

Shadowed Basis



Sale to 3rd Party Disregarded



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Differing Views

The Answer Matters

- Some planners suggest that clients contribute (or sell) installment notes to "upstream" partnerships prior to the death of the settlor to mitigate the risk of gain at death. Consider basis under IRC § 722.

- Consider a (proposed) income tax at death regime where a +/- $10M "exclusion amount" is allocable to notes. Should you be presently reporting the basis of those notes as $0? In an incomplete manner (i.e., "n/a")?

A Tangential (Popular) Topic

Income Taxation of Installment Sales to Grantor Trusts at Death

Bibliography

Gain at (or after) Death

- Cantrell, Carol, *Gain is Realized at Death*, Trusts & Estates (February 2010), at p. 20 .

- Dunn, Deborah; Handler, David. *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*. 95 J. Tax'n 49 (July 2001).

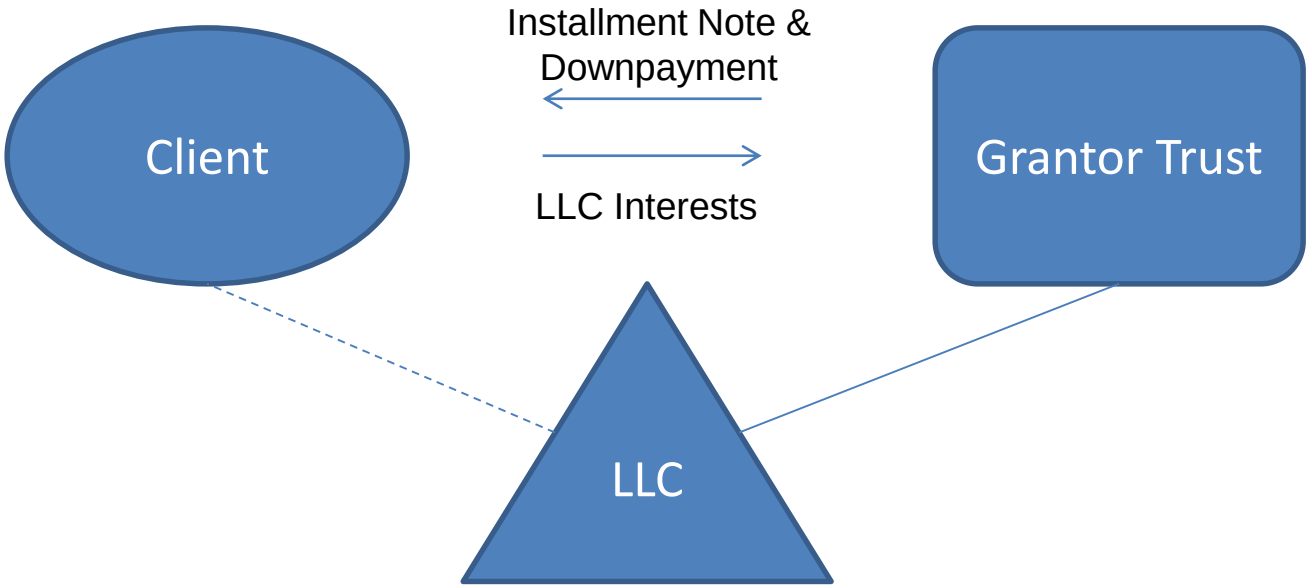
No Gain at Death (or Ever?)

- Blattmachr, Jonathan; Gans, Mitchell. *No Gain at Death*, Trusts & Estates (February 2010), p. 34.

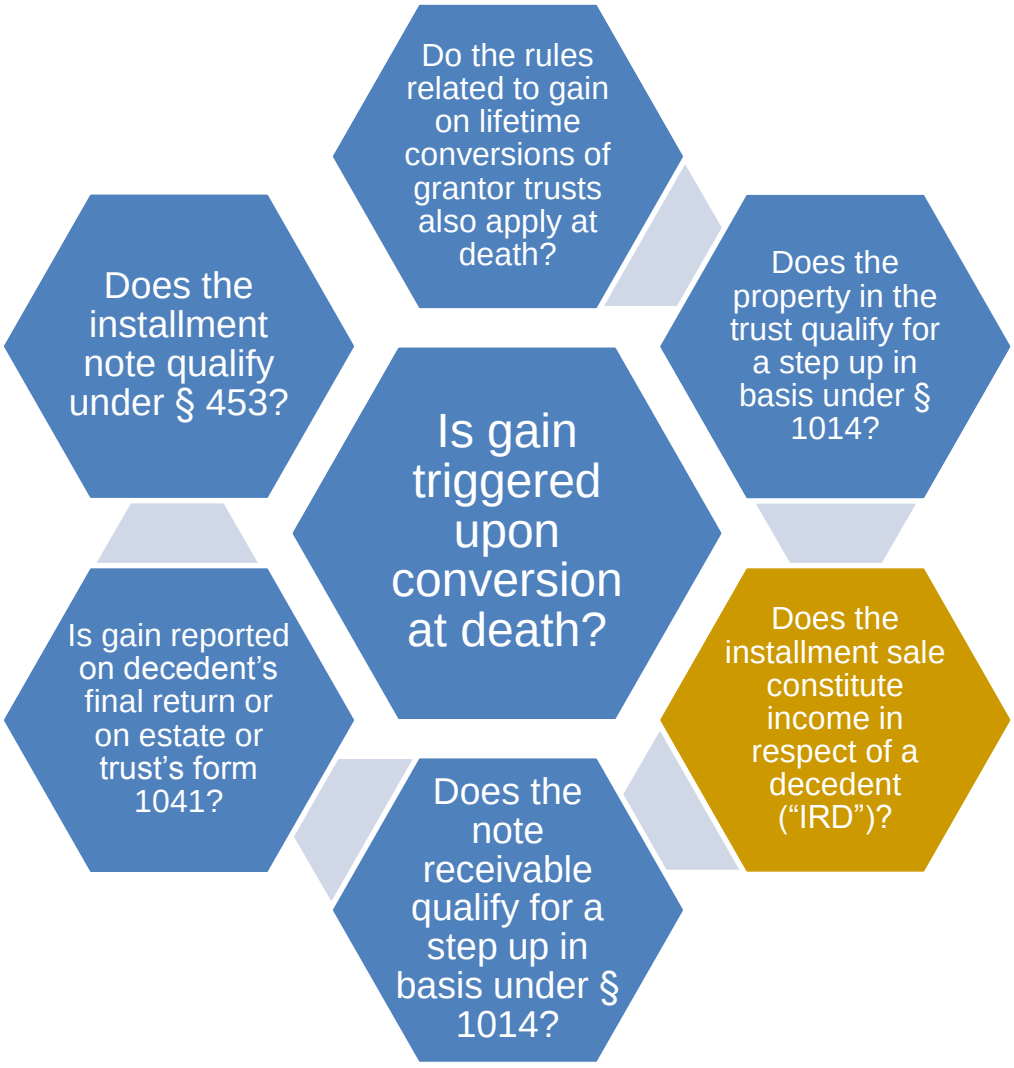
- Blattmachr, Jonathan; Gans, Mitchell; Jacobson, Hugh. *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*," 97 J. Tax'n 149. (Sept. 2002).

Installment Sale to Grantor Trust

- Perhaps the most common and fundamental estate “freeze” technique.
  - Probably even more popular due to increased Basic Exclusion Amount.
  - Can “securitize” a sentimental asset, and transfer between generations.
- Used for shifting appreciation (while retaining income tax liability).
- Sale is “ignored” for income tax purposes under Rev. Rul. 85-13.



Key Tax Issues at Death



Range of Results

No Gain at Death; Step Up in Note; AND Step Up in Trust Assets

No Gain at Death; Step Up in Note to Face

No Gain at Death; Step Up in Note to FMV; Installment Method Reporting

No Gain at Death; No Step Up in Note; Installment Method Reporting

Gain at Death (either to Decedent or Estate)

Do Lifetime Trust Conversion Rules Apply at Death?

Yes

- Argument is that conversion rules apply at death in the same manner they would during life.
- Tax consequences and reporting, therefore, will depend on **timing** of deemed transfer (i.e., before or after death).

No

- Virtually, no provision of the tax code imposes tax upon death as a policy matter.
- "The bill clarifies that **gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property.**" H. Rep't No. 107-84, 107th Cong., 1st Sess. 113 (2001) (concerning now-defunct § 1022).

Rev. Rul. 77-402 (terminating grantor trust status by renouncing the grantor's powers is a deemed transfer of property to the trust.). See also Reg. 1.1001-2(c), Ex. 5.
CCA 2009-23-024 (converting a non-grantor trust to a grantor trust is not a deemed transfer of property from the trust to the grantor).

Focus on Tax Attributes of 3 Items Upon Conversion of Grantor Trust

Grantor is deemed to transfer (sell) **ASSETS** in trust to the new complex trust. Trust should receive basis at fair market value.

New complex trust is deemed to assume the **LIABILITY** of the Grantor, generally resulting in tax to the Grantor. The Trust's assumption of the Grantor's debt is treated as the Trust's payment for the assets.

Grantor retains the **NOTE RECEIVABLE**. Generally, assuming no election out, this may be taxed on the installment method, as principal payments are made.

Does Property *in the Trust* Qualify for a Step up in Basis?

No

- Fundamentally, Trust assets are not assets included in the taxable estate at death.
- To qualify for step-up, property must be "*acquired under the decedent's will or under [intestacy] law[s]" Treas. Reg. 1.1014-2(a)(1).*

Yes

- If assets are deemed to be held by the Grantor at death, and pass to the trust *after* death (i.e., on the day after death under Reg. § 1.451-1), then they should qualify for step up.
- Or, if assets create gain (and are "sold"), then basis should reflect the "sales price."

Acquired as (i) **bequest** (or deemed bequest), (ii) **purchase** (either at outset or deemed), or (iii) **gift** (or part gift)?

Does the Note Receivable Constitute IRD?

Yes

- The note may be among items of gross income which "are not properly includible in respect of the taxable period in which falls the date of his death or a prior period." § 691(a)(1).
- If a conversion occurs immediately before death, then classification as IRD is more likely.

No

- Reg. 1.691(a)-2(b) Ex. 4 (no IRD when a sale is effective only at death).
- IRC § 453(a)(4), requires that the Grantor was reporting gain under the installment method for the note to meet the definition of IRD.

Does the note receivable qualify for a step up in basis?

No

- Practically, the IRS will argue for no step up if (a) there is no gain on the assumption of the trust's debts, and (b) the note *is* IRD.
- IRS seemingly must argue that the deemed transfer occurred immediately prior to death.

Yes

- Generally, a non-IRD asset acquired from a decedent is entitled to a step up in basis in a decedent's estate to the estate tax value of the asset. § 1014.
- Basis might be the face value of the note. IRC § 453B(b).

If Gain, Where is It Reported?

1040

- If the Grantor's deemed assumption of the trust's indebtedness (gain in excess of the basis of trust assets) occurs prior to death.

1041

- With or without a full step-up in basis, gain (if any) would be reported on Form 1041 in most cases, if not IRD.
- Probably on the Trust's 1041, although an argument can be made for the Estate's 1041.

Does the Installment Note Qualify under § 453?

Elect Out

- Estate probably should elect out of installment method if installment note may be passing to a private foundation (self-dealing), or similar.

Yes

- Unless the Estate elects out of the installment method, it seems that the Estate would qualify.
- For balloon notes, practically, installment reporting may defer several issues (i.e., basis in note) for a long time.

Sipress Cartoon

"Don't freak out—it's just a save-the-date."

Plan: Prepayment of Note

Pre-mortem Post-Mortem Planning Requires a **Plan**

A wide variety of actuarial approaches are available to measure reasonable prepayments.

(Unlike Graegin loans) never impose a prepayment penalty on a installment sale to a grantor trust.

TRAP: Do not have trust borrow from third party to pay installment loan. It still may be an assumption of the Grantor's deemed liability.

Table S – Based on Life Table 2000CM @ 10%

Age	Annuity Factor
65	7.4223
66	7.2885
67	7.1483
68	7.0024
69	6.8511
70	6.6946
71	6.5326
72	6.3654
73	6.1937
74	6.0182
75	5.8401
76	5.6597
77	5.4775
78	5.2936
79	5.1085
80	4.9230
81	4.7373
82	4.5520
83	4.3678
84	4.1850

Use of Upstream LLC to Meet Planning and Investment Goals

Finance Co., LLC

"Upstream" Planning

Older — **Earlier**

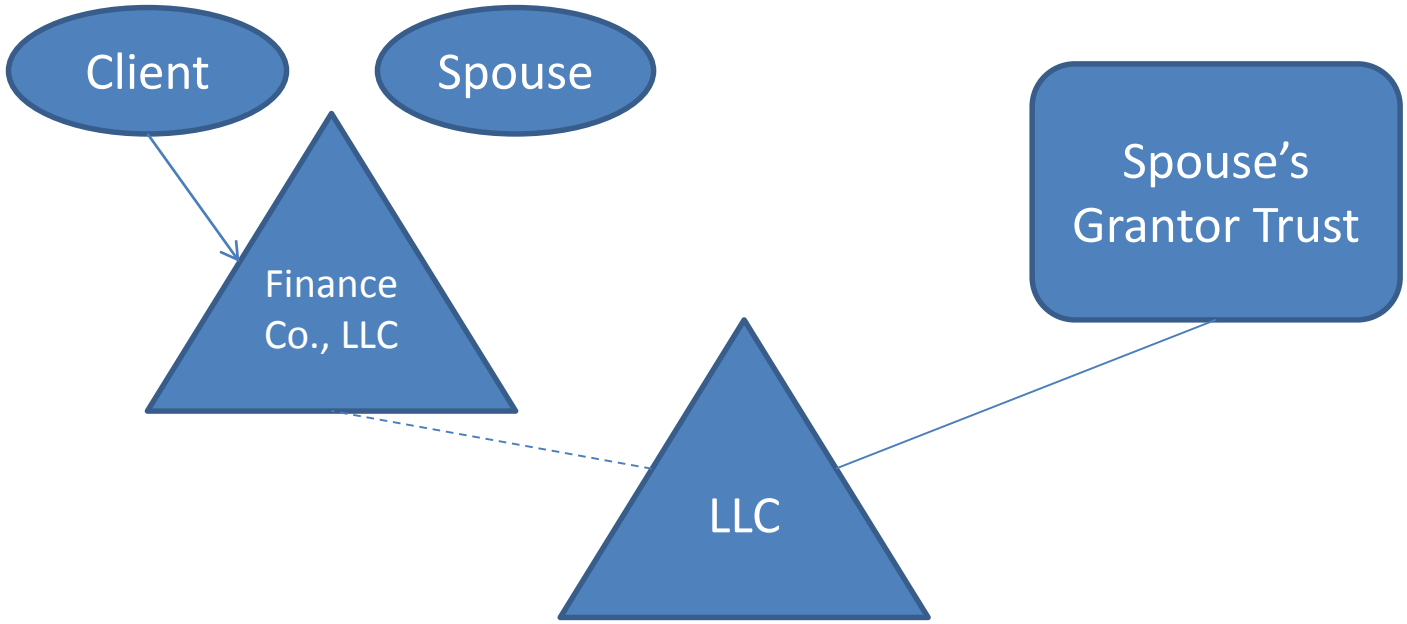
Generation

Pre-mortem Post-mortem Planning

Younger — Later

Client contributes IDGT note to Private Debt LLC

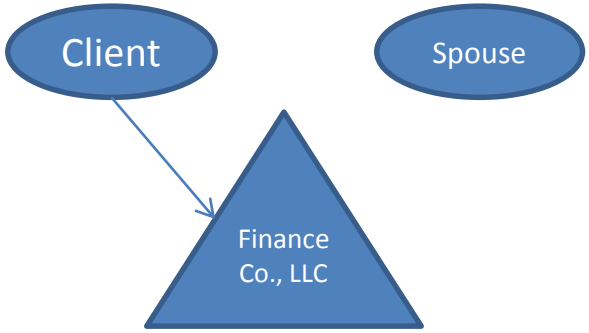
Does the installment sale constitute income in respect of a decedent ("IRD")?



IRD is a Key Issue for Installment Sales at Death

Does the installment sale constitute income in respect of a decedent ("IRD")?

To determine IRD of a partnership, § 691(e) refers to § 753, which in turn provides that "the amount includible in income of a successor in interest of a deceased partner under § 736(a) shall be considered income in respect of a decedent under § 691."

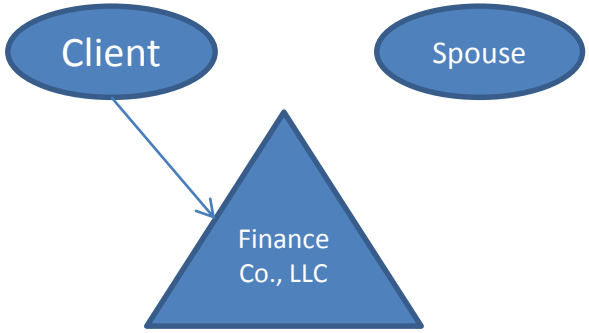


Since § 753 refers exclusively to § 736(a) payments (i.e., payments of income; and payments for unrealized receivables and unstated goodwill made to a general partner of a service partnership), **no other partnership item should make up IRD.**

Further Authority Regarding the IRD of a Partnership

Does the installment sale constitute income in respect of a decedent ("IRD")?

There is no "look through" to assets within the partnership under the statutes. In the *S Corp context*, § 1367(b)(4) provides "section 691 shall be applied with respect to any item of the S Corporation in the same manner as if the decedent had held directly his pro rata share of such item." Congress knew how to apply "look through" provisions, but has elected not to in the partnership context.



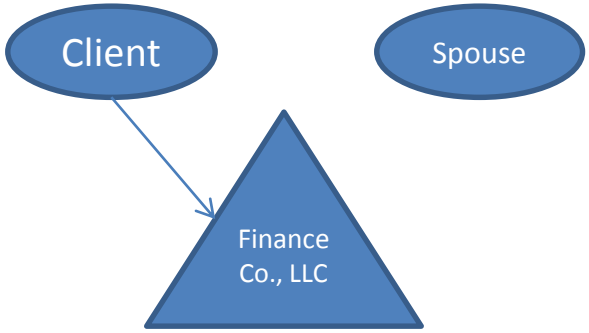
Carefully consider *Quick Trust v. Comm'r*, 54 T.C. 1336, and *Woodhall v. Comm'r*, 28 T.C.M. 1436 (partnership's unrealized accounts receivable treated as IRD), and compare McKee, Nelson & Whitmire ¶ 23.02[2][b].

Thoughts and Conclusions

Does the installment sale constitute income in respect of a decedent ("IRD")?

Contribution by the Grantor of the note receivable to an upstream LLC, absent other facts, should not result in gain recognition upon contribution. Interest may be recognized (and deducted by the trust).

At death, the prior legal arguments indicating that the note receivable is *not* IRD should remain, in addition to the argument that the partnership does not pass through IRD.



A § 754 election paired with a section § 743(b) adjustment should provide a pro rata step up in the basis of the note in the hands of the partnership.

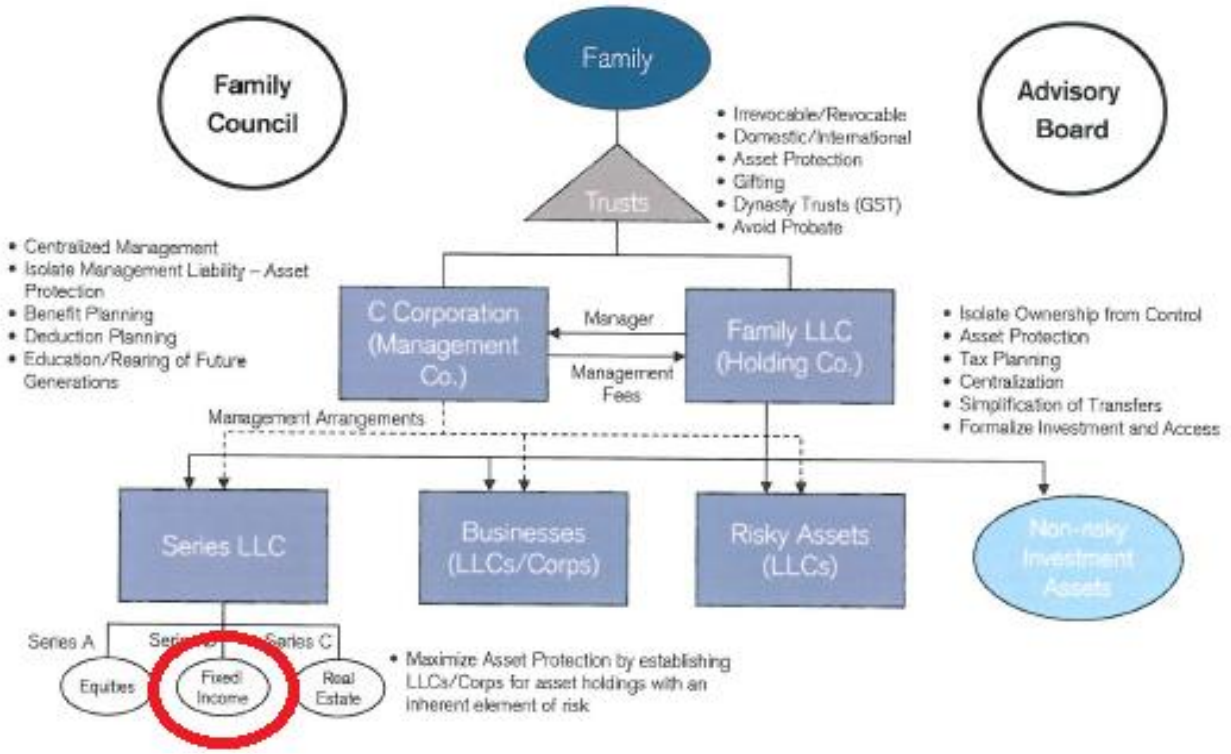
Query whether any valuation discount would apply (wise to apply?) to the client's partnership interest? This is not a valuation "play."

Some Design Observations

- It often is preferable for elderly clients to invest with a heavier weight to fixed income assets (e.g., 30% / 70%).
- Family office clients often hold private and less traditional debt.
- An LLC formed late in life to manage Private Debt and to securitize illiquid assets seems reasonable.
- Such an LLC could hold debt from grantor trusts.
- The LLC might lend assets to family estates after death (*Graegin* loans)
- On the "flip side," such an LLC might be the obligor on uncertain or contingent obligations

Family Office Structure

Best Practice – Organizational Structure



Small Partnership?

Finance Co., LLC

During the Client's lifetime, if only the Client and Spouse—and perhaps a few other U.S. citizen individuals—are members of the LLC, might the "Small Partnership" rules apply? § 6698(a), Rev. Proc. 84-35.

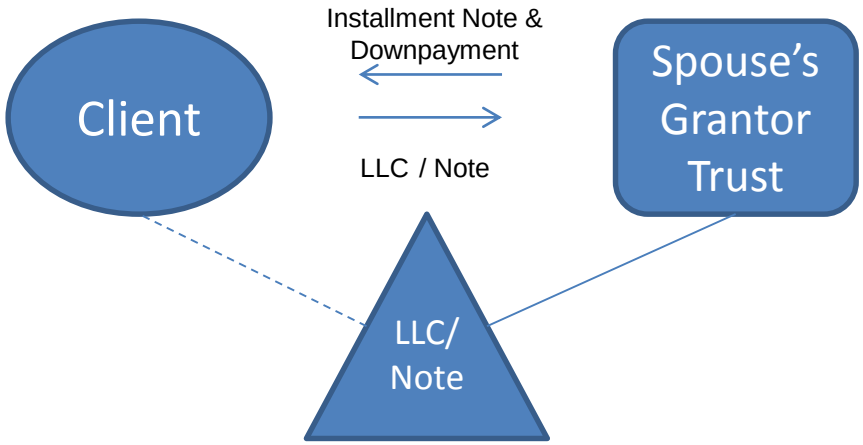
The client and spouse must fully report their share of the partnership income, deductions and credits. *Might* the client (or spouse) be able to ignore interest from an installment sale under Rev. Rul. 85-13 or § 1041?

Would the (small) partnership, effectively, spring into existence at the grantor's death—the moment it is needed?

Strategy: Sale to Spouse's Grantor Trust

- Additional Flexibility: Flexibility to add client as beneficiary of trust; client might hold SPOA; Client might serve as trustee.
- Carefully structuring note as a **nonrecourse loan** avoids recognition of gain at Spouse's death.

See Bennet Mellen, Briani, *The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust.* ACTEC Law Journal, pending (2018); Dana, Andrew, *Till Death Do Us Part: The Riddle of Note Basis in a Sale to a Spouse's Grantor Trust. 114 J. Tax'n 340 (June 2011).*



Other Applications

Also consider other “shadow” assets in addition to notes, for example clients properly might report basis in a Grantor Trust’s remainder interest in a GRAT and in the Grantor’s (transferable?) annuity interest.

Also, consider installment transactions with other disregarded entities: installment sales transactions with single member LLC’s, installment sales with spousal trusts “disregarded” under IRC § 1041.

CE&C
CULP ELLIOTT & CARPENTER, P.L.L.C.
Attorneys at Law

Questions and Answers

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